Denver Law Review

Volume 72
Issue 3 *Tenth Circuit Surveys*

Article 9

January 1995

Contracts Survey

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Contracts Survey

CONTRACTS SURVEY

INTRODUCTION

During the 1994 survey period, the Tenth Circuit decided two notable contract cases regarding the extent of governmental liability. In *United World Trade, Inc. v. Mangyshlakneft Oil Production Ass'n*,[1] the Tenth Circuit permitted a foreign state to evade liability for its nonperformance of contractual obligations by invoking foreign sovereign immunity. On the domestic front, however, the Tenth Circuit required U.S. government agencies to honor their contractual obligations owed to private investors in *RTC v. FSLIC*,[2] despite the agencies' attempt to invoke the sovereign acts doctrine.

Part I examines the Tenth Circuit's application of foreign sovereign immunity to a contract dispute between a Denver corporation and the Republic of Kazakhstan. Part II explains the events occurring in the United States' thrift industry during the past decade which led to litigation against the Federal Savings & Loan Insurance Corporation (FSLIC) and related agencies. The Survey concludes by reviewing how the Tenth Circuit was able to hold those federal agencies liable for their breach of contract.

I. INTERNATIONAL CONTRACTS AND FOREIGN SOVEREIGN IMMUNITY

A. *The Development of Foreign Sovereign Immunity in the United States*

Foreign sovereign immunity is an international law doctrine whereby domestic courts relinquish their jurisdiction over a foreign state.[3] Thus, granting immunity to foreign states is not constitutionally mandated; rather, it is a "matter of grace and comity" exercised by the United States.[4]

In the early nineteenth century, in *The Schooner Exchange v. McFaddon*,[5] Chief Justice Marshall laid the foundation for the absolute theory of foreign sovereign immunity, which lower courts generally followed until 1952.[6] At that time, the U.S. State Department announced its adoption of the restrictive theory of foreign sovereign immunity in the "Tate Letter".[7] This theory re-

1. 33 F.3d 1232 (10th Cir. 1994), *cert. denied*, 115 S. Ct. 904 (1995).
2. 25 F.3d 1493 (10th Cir. 1994).
3. H.R. REP. NO. 1487, 94th Cong., 2d Sess. 8 (1976), *reprinted in* 1976 U.S.C.C.A.N. 6604, 6606.
4. Verlinden B.V. v. Central Bank of Nigeria, 461 U.S. 480, 486 (1983).
5. 11 U.S. 116 (1812).
6. *Verlinden*, 461 U.S. at 486. The absolute theory grants a state complete immunity from the adjudicatory jurisdiction of foreign states. *See* Joan E. Donoghue, *Taking the "Sovereign" Out of the Foreign Sovereign Immunities Act: A Functional Approach to the Commercial Activity Exception*, 17 YALE J. INT'L L. 489, 497 (1992).
7. Donoghue, *supra* note 6, at 497. Jack B. Tate, the Acting Legal Advisor to the Department of State, wrote a letter to the Attorney General on May 19, 1952 explaining why the

stricted immunity to cases involving the public acts of foreign governments and denied it for suits stemming from the commercial acts of foreign governments.[8]

In 1976, Congress codified the American version of the restrictive theory in the Foreign Sovereign Immunities Act (the Act).[9] The stated purpose for such action was "to provide when and how parties can maintain a lawsuit against a foreign state . . . in the courts of the United States."[10] The Act provides the only basis for obtaining jurisdiction over a foreign government in American courts,[11] and must be applied in every action against a foreign sovereign.[12]

A foreign state is presumed immune from the jurisdiction of American courts unless the case falls under one of the exceptions provided for by the Act.[13] The most significant of these is the commercial exception found at § 1605(a)(2).[14] Under § 1605(a)(2), courts will exercise jurisdiction if the suit is based upon: (1) an act committed outside of U.S. territory; (2) which is connected to a foreign state's commercial activity elsewhere; and (3) causes a direct effect within the United States.[15] In such cases, the critical determination is whether the activity constitutes commercial activity causing direct effects within the United States.

The Act defines "commercial activity" as "either a regular course of commercial conduct or a particular commercial transaction or act. The commercial character of an activity shall be determined by reference to the *nature* of the course of conduct or particular transaction or act, rather than by reference to

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State Department would no longer grant foreign governments immunity in certain types of cases. 26 DEP'T ST. BULL. 984 (1952). The change in policy was necessitated in part by the increasing amount of commercial activity governments were conducting. The change was also necessary because the restrictive theory, under which "the immunity of the sovereign is recognized with regard to sovereign or public acts (jure imperii) of a state, but not with respect to private acts (jure gestionis)," was gaining widespread acceptance outside of the Soviet bloc. *Id.* at 984-85.

8. *Verlinden*, 461 U.S. at 487.

9. H.R. REP. NO. 1487, *supra* note 3, at 7, *reprinted in* 1976 U.S.C.C.A.N. at 6605. For a more detailed discussion of the reasons for codification, see *id.* at 6606-08; *Verlinden*, 461 U.S. at 487-88. The Foreign Sovereign Immunities Act is codified at 28 U.S.C. §§ 1602-1611 (1988 & Supp. V 1993).

10. H.R. REP. NO. 1487, *supra* note 3, at 6, *reprinted in* 1976 U.S.C.C.A.N. at 6604.

11. Argentine Republic v. Amerada Hess Shipping Corp., 488 U.S. 428, 443 (1989).

12. *Verlinden*, 461 U.S. at 493.

13. Saudi Arabia v. Nelson, 113 S. Ct. 1471, 1476 (1993). The exceptions are found at 28 U.S.C. §§ 1605, 1607 (1988 & Supp. V 1993).

14. Republic of Argentina v. Weltover, Inc., 112 S. Ct. 2160, 2164 (1992). The Act states in relevant part:

> (a) A foreign state shall not be immune from the jurisdiction of courts of the United States or of the States in any case—
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> . . .
>
> (2) in which the action is based upon a commercial activity carried on in the United States by the foreign state; or upon an act performed in the United States in connection with a commercial activity of the foreign state elsewhere; or upon an act outside the territory of the United States in connection with a commercial activity of the foreign state elsewhere and that act causes a direct effect in the United States.

28 U.S.C. § 1605(a)(2) (1988 & Supp. V 1993).

15. 28 U.S.C. § 1605(a)(2).

its *purpose*."[16] In *Republic of Argentina v. Weltover, Inc.*,[17] the Supreme Court recognized the vagueness of this definition and attempted to clarify it. The Court concluded that when a foreign state acts as a private player rather than as a market regulator, its actions are commercial for purposes of the Act.[18] The central issue in *Weltover* focused on whether the foreign state's actions were of the type a private party would perform while conducting trade or commerce, and did not focus on the reasons behind such action.[19] The Court also rejected the interpretation of "direct effect," followed by some circuits, which required the effect to be both substantial and foreseeable.[20] Instead, the Court defined a direct effect under the Act as one which follows as an "immediate consequence" of the foreign state's activity.[21]

Although the Supreme Court has attempted to provide guidelines for interpreting the commercial exception, the critical terms involved still remain ill-defined. The effect is that a plaintiff attempting to file suit against a foreign state is forced to accept the commercial label placed on the foreign state's activity by a district court. A court's characterization of the foreign state's act, therefore, determines whether the suit is barred by immunity. *United World Trade v. Mangyshlakneft Oil Production Ass'n*[22] provides an example as to how costly sovereign immunity can be for companies contracting with foreign states.

B. *Tenth Circuit Decision:*
United World Trade, Inc. v. Mangyshlakneft Oil Production Ass'n[23]

The plaintiff, United World Trade, Inc. (UWT), was a Colorado corporation operating out of Denver, Colorado.[24] One defendant, Mangyshlakneft Oil Production Ass'n (MOP), was authorized to conduct oil production and exportation on behalf of the Republic of Kazakhstan,[25] and another defendant, Kazakhstan Commerce Foreign Economic Association (Kazcom), served as MOP's agent for its transactions with UWT.[26]

In December of 1991, representatives from UWT, MOP and Kazcom entered into a preliminary agreement in Moscow. Under the terms of the agreement, UWT was required to locate potential oil buyers for the first quarter of 1992. MOP agreed to negotiate with UWT for prospective buyers, supply 200,000 metric tons of oil during the first quarter if a qualified buyer was found by UWT, and provide 800,000 metric tons of oil during the rest of

16. 28 U.S.C. § 1603(d) (1988) (emphasis added).
17. 112 S. Ct. at 2165-66.
18. *Id.* at 2166.
19. *Id.*
20. *Id.* at 2168.
21. *Id.* (quoting Weltover, Inc. v. Republic of Argentina, 941 F.2d 145, 152 (2d Cir. 1991), *aff'd*, 112 S. Ct. 2160 (1992)).
22. 33 F.3d 1232 (10th Cir. 1994), *cert. denied*, 115 S. Ct. 904 (1995).
23. 33 F.3d 1232 (10th Cir. 1994), *cert. denied*, 115 S. Ct. 904 (1995).
24. *Id.* at 1234.
25. *Id.*
26. *Id.* at 1234-35.

1992.[27] On January 23, 1992, UWT, MOP and Kazcom signed a contract for the sale of crude oil in Moscow. The contract required MOP to supply 200,000 metric tons of oil to an Italian customer (ISAB), and required UWT to pay MOP 97% of the price paid by ISAB.[28] The contract terms specified the method of payment: in U.S. dollars via irrevocable credit opened by a "first class European/USA bank."[29]

The oil was to be transported to ISAB in four tanker shipments. UWT selected the London branch of the San Paolo Bank to issue a credit letter covering payment to MOP and to send Kazakhstan notice of the letter prior to each delivery. Once notified, MOP was to ship the oil to ISAB and, upon delivery, send the shipping documents to the bank in London. The London bank would then send payment to MOP's account with the Credit Commercial de France bank in Paris.[30]

The dispute between the parties arose when the bill of lading for the third oil shipment was allegedly stolen from a Kazcom representative.[31] This event led to UWT's six-year indemnification of ISAB in order to secure its payment from ISAB. UWT then claimed that the defendants refused to supply it with more oil and instead sold directly to ISAB. As a result, UWT filed suit for breach of the preliminary agreement.[32] MOP and Kazcom claimed foreign sovereign immunity and UWT countered that the defendants were subject to the jurisdiction of American courts under the commercial exception to the Act.[33] The resultant issue therefore, was whether the defendants' actions qualified as a direct effect under the Act.[34]

The district court declined to interpret *Republic of Argentina v. Weltover, Inc.*[35] as requiring only a slight effect in the United States.[36] Rather, the court held that an effect qualifies as direct only if it flows as an immediate consequence of the foreign state's activity.[37] Moreover, the court concluded that a financial loss alone incurred by a plaintiff in the United States is insufficient to satisfy the direct effect requirement.[38] After finding that both the

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27. *Id.* at 1235.
28. *Id.*
29. *Id.*
30. *Id.*
31. United World Trade, Inc. v. Mangyshlakneft Oil Prod. Ass'n, 821 F. Supp. 1405, 1407 (D. Colo. 1993), *aff'd*, 33 F.3d 1232 (10th Cir. 1994), *cert. denied*, 115 S. Ct. 904 (1995).
32. *Id.*
33. *Id.* at 1408.
34. For a discussion of previous judicial interpretations of the meaning of "direct effect," see *supra* notes 20-21 and accompanying text.
35. 112 S. Ct. 2160 (1992).
36. *United World Trade*, 821 F. Supp. at 1408. Note that in doing so, the district court refused to follow the rationale of Ampac Group Inc. v. Republic of Honduras, 797 F. Supp. 973 (S.D. Fla. 1992), *aff'd*, 40 F.3d 389 (11th Cir. 1994). *Ampac* involved a breach of contract claim by a Florida corporation against the government of Honduras for a dispute arising from the sale of a cement business as part of the government's privatization plan. *Id.* at 975-76. In holding that the nature of the transaction qualified for the commercial exception, the court stated, "*Weltover* therefore teaches that the effect in the United States need only be slight." *Id.* at 977.
37. *United World Trade*, 821 F. Supp. at 1408.
38. *Id.* at 1409 (citing Gregorian v. Izvestia, 871 F.2d 1515, 1527 (9th Cir.), *cert. denied*, 493 U.S. 891 (1989)).

preliminary agreement and the sales contract had virtually no connection with the United States, the court held that the losses suffered by UWT were not legally significant[39] and did not constitute a direct effect in the United States.[40] It consequently granted the defendants' motion to dismiss.[41]

The Tenth Circuit affirmed the grant of immunity.[42] The court itself recognized the direct effect clause as "hopelessly ambiguous when applied to any particular transaction."[43] In reaching its decision, therefore, the court attempted to apply the *Weltover* guidelines to the particularities of the specific case before it.[44] It noted that UWT's case differed significantly from the situation in *Weltover* because no part of MOP's performance occurred in the United States: the oil was transferred from Kazakhstan to Italy. While performing their contractual obligations, the defendants had absolutely no connection with the United States.[45] UWT's place of performance for its contract obligation was specified as Paris.[46] The court, therefore, concluded that converting funds into American dollars was not a direct effect following as an immediate consequence from the defendants' acts.[47]

Likewise, the court found that Kazcom's failure to provide a bill of lading for the third shipment did not have a direct effect within the United States.[48] UWT's loss caused by indemnifying ISAB stemmed from its contractual obligations with ISAB and not from those it had with MOP and Kazcom. Thus, the contract with ISAB functioned as an intervening factor which prevented the indemnification from being an immediate consequence of the defendants' acts.[49]

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39. *Id.* at 1408 (citing Zedan v. Kingdom of Saudi Arabia, 849 F.2d 1511, 1515 (D.C. Cir. 1988)). The "legally significant" standard seems to require that the losses arise from acts that created legal obligations or invoked the sanction of the law. The *Zedan* court listed a bank's refusal to pay on a letter of credit, a transfer of money, and incurring a debt, as legally significant events. *Zedan*, 849 F.2d at 1515. *But see* Antares Aircraft, Ltd. Partnership v. Federal Republic of Nigeria, 999 F.2d 33, 36 (2d Cir. 1993) (finding that drawing a check on an American bank was not a legally significant act), *cert. denied*, 114 S. Ct. 878 (1994).

40. *United World Trade, Inc.*, 821 F. Supp. at 1409.

41. *Id.* at 1410.

42. United World Trade, Inc. v. Mangyshlakneft Oil Prod. Ass'n, 33 F.3d 1232, 1234 (10th Cir. 1994), *cert. denied*, 115 S. Ct. 904 (1995).

43. *Id.* at 1237.

44. *Id.*

45. *Id.*

46. *Id.*

47. *Id.* at 1238. "The requirement that an effect be 'direct' indicates that Congress did not intend to provide jurisdiction whenever the ripples caused by an overseas transaction manage eventually to reach the shores of the United States. Such is the case here." *Id.* House Report No. 1487 explains the meaning of "commercial activity":

> This definition includes cases based on commercial transactions performed in whole or in part in the United States, import-export transactions involving sales to, or purchases from, concerns in the United States, business torts occurring in the United States . . . and an indebtedness incurred by a foreign state which negotiates or executes a public lending institution located in the United States. . . . It will be for the courts to determine whether a particular commercial activity has been performed in whole or in part in the United States. *This definition, however, is intended to reflect a degree of contact beyond that occasioned simply by U.S. citizenship or U.S. residence of the plaintiff.*

H.R. REP. NO. 1487, *supra* note 3, at 17-18, *reprinted in* 1976 U.S.C.C.A.N. at 6615-16.

48. *United World Trade*, 33 F.3d at 1238.

49. *Id.*

The Tenth Circuit concluded its opinion by holding that UWT's claim of lost profits was not covered by the commercial exception because such losses did not occur in the United States.[50] The acts giving rise to the suit occurred entirely in Europe: the contract was signed in Moscow, the oil was shipped from Kazakhstan to Italy, UWT was paid in London, and MOP received its payment in Paris. After examining the particularities of the situation, the court held that the defendants' acts, as well as the resultant direct effects, occurred in Europe rather than the United States.[51] The effect of UWT transferring its proceeds from London to the United States was insufficient for invoking the commercial exception. To rule otherwise would be to interpret the commercial exception in such a way as to grant district courts jurisdiction over any suit arising out of an overseas transaction in which an American claims losses that resulted from the acts of foreign states.[52]

C. *Analysis*

In *United World Trade*, the Tenth Circuit sought to impose parameters on foreign governments' amenability to suit in American courts. In upholding the defendants' claim of sovereign immunity, the Tenth Circuit followed other circuits' interpretation of the scope of the commercial exception.[53] American companies should take notice. A corporation cannot satisfy the direct effects requirement for jurisdiction against a foreign state simply by showing it is incorporated under U.S. law and has its principal place of business within the United States. Furthermore, those companies functioning as middlemen for international transactions with no contractual performance obligations in the U.S. should be particularly cautious. Under *United World Trade*, requiring payment in American dollars and transferring those funds to the U.S. after their initial deposit in a foreign bank will not allow a plaintiff to defeat the presumption of immunity granted to foreign states. Such acts simply do not rise to the level of direct effects.

This is a fair and reasonable decision. If a sophisticated business chooses to deal outside of the United States in search of new business opportunities, it should be prepared to bear the risks of operating within different legal regimes. United World Trade went to Kazakhstan searching for new opportunities. Such opportunities do not come without risks. United World Trade could

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50. *Id.* at 1238-39.

51. *Id.* at 1239.

52. *Id.*

53. *See, e.g.*, Goodman Holdings v. Rafidain Bank, 26 F.3d 1143, 1146-47 (D.C. Cir. 1994) (upholding sovereign immunity because of the absence of direct effects in the United States), *cert. denied*, 115 S. Ct. 728 (1995); Antares Aircraft, Ltd. v. Federal Republic of Nigeria, 999 F.2d 33, 36 (2d. Cir. 1993) (finding no direct effects when there is "no connection with the United States other than the citizenship or place of incorporation of the plaintiff"), *cert. denied*, 114 S. Ct. 878 (1994); Gregorian v. Izvestia, 871 F.2d 1515, 1527 (9th Cir. 1989) (finding that "mere financial loss suffered by a plaintiff in the United States as a result of the action abroad of a foreign state" is an insufficient basis by itself for subject matter jurisdiction against a foreign state), *cert. denied*, 493 U.S. 891 (1989); Zedan v. Kingdom of Saudi Arabia, 849 F.2d 1511, 1514 (D.C. Cir. 1988) (finding no direct effects in the United States from financial hardships incidental to a contract formed in Saudi Arabia).

not expect the benefits of recourse in United States courts after it chose to do business elsewhere. To hold otherwise would allow corporations the benefits of overseas ventures, while insulating them from the consequences of such ventures. American courts are not a residual insurance policy for American corporations seeking overseas opportunities. Such corporations should not look to American courts to minimize their risks when they have made deliberate choices to do business elsewhere.[54]

United World Trade exemplifies a situation in which a plaintiff may not sue a foreign sovereign under the commercial exception. What *United World Trade* does not demonstrate, however, is what type of contract with a foreign state would satisfy the minimum threshold required to meet the direct effect clause. Apparently, without some product or service crossing a U.S. border, or at least one party utilizing a U.S. bank, there is no direct effect within the United States for purposes of the Foreign Sovereign Immunities Act. The peculiar irony is that *foreign* parties with sufficient savvy to contract with foreign states for payment or partial performance within U.S. territory will likely obtain recourse from U.S. courts in cases of breach. On the other hand, American companies that contract with foreign states outside of U.S. territory and transfer the proceeds home, will have no recourse from the U.S. judicial system.[55]

II. THE FSLIC, FIRREA & THE DENIAL OF THE SOVEREIGN ACTS DEFENSE

A. *Brief History of the Modern Thrift Industry*

With its 1,700 failed thrift organizations, the Great Depression prompted the congressional reform that provided the structure of the nation's savings and loan industry for roughly fifty years.[56] To regulate the thrift industry and provide a deposit insurance fund, Congress created the Federal Home Loan Bank Board ("Bank Board") and the Federal Savings and Loan Insurance Corporation (FSLIC).[57] These agencies were responsible for promulgating regulations governing all federal savings and loan associations, including those setting minimum capital requirements.[58]

The 1980s, however, proved to be a devastating decade for the nation's savings and loan industry. High interest rates and deregulation were a fatal

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54. *See* Tubular Inspectors, Inc. v. Petroleos Mexicanos, 977 F.2d 180, 186 (5th Cir. 1992) (granting sovereign immunity and noting that doing so prevents a company from "jurisdictionally having its cake and eating it").

55. Compare the result in Republic of Argentina v. Weltover, Inc., 112 S. Ct. 2160 (1992) (denying immunity to Argentine government when sued by two Panamanian corporations and a Swiss bank in U.S. federal court) with that in United World Trade, Inc. v. Mangyshlakneft Oil Prod. Ass'n, 33 F.2d 1232 (1994) (granting immunity to Kazakhstan government when sued by an American corporation in U.S. federal court), *cert. denied*, 115 S. Ct. 904 (1995).

56. H.R. REP. NO. 54(I), 101st Cong., 1st Sess. 292 (1989), *reprinted in* 1989 U.S.C.C.A.N. 86, 88.

57. Winstar Corp. v. United States, 994 F.2d 797, 800 (D.C. Cir.), *vacated and withdrawn*, (August 18, 1993); *see also* Federal Home Loan Bank Act, Pub. L. No. 72-304, 47 Stat. 725 (1932); Home Owners' Loan Act of 1933, Pub. L. No. 73-43, 48 Stat. 128 (1933); National Housing Act, tit. IV, Pub. L. No. 73-479, 48 Stat. 1246 (1934).

58. *Winstar*, 994 F.2d at 800-01.

combination for many thrifts.[59] As an incentive to induce profitable financial institutions to acquire the failing thrifts, the Bank Board and FSLIC allowed them to deviate from generally accepted accounting principles (GAAP) in order to satisfy capital requirements.[60] The Bank Board thereby encouraged acquisitions that would have otherwise failed due to regulatory capital requirements. The Bank Board's purpose was to prevent the closure of all the insolvent thrifts that the FSLIC's resources could not cover.[61] The use of supervisory goodwill and regulatory accounting practice (RAP) goodwill comprised two of the major deviations from GAAP.[62]

This practice continued until Congress enacted the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).[63] The "precarious financial condition" of the thrift industry, the "waning" consumer confidence in it, and the "bankruptcy of FSLIC" necessitated the legislation.[64] FIRREA abolished both the FSLIC and the Bank Board.[65] The FSLIC's insurance function was assigned to the Federal Deposit Insurance Corporation (FDIC), and the Bank Board's regulatory function was transferred to the newly created Office of Thrift Supervision (OTS).[66] Additionally, the previous accounting standards allowed by the Bank Board were denounced as "regulatory and statutory accounting gimmicks."[67]

FIRREA phased out the use of supervisory goodwill and stiffened capital requirements. It required OTS to implement "uniformly applicable capital standards for savings associations," including a leverage limit that maintained core capital at not less than three percent of the savings association's total assets, a tangible capital requirement of not less than 1.5 percent of total assets, and a risk-based capital requirement.[68]

Consequently, FIRREA's stricter capital requirements thrust some of the thrifts acquired by private investors prior to its enactment into noncompliance with the new federal regulations. Litigation arose across the country as the OTS informed reorganized thrifts and their investors that they were now insolvent. Security Federal Savings and Loan Association of Albuquerque was one such thrift caught in FIRREA's web after signing a deal with the FSLIC.[69]

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59. H.R. REP. NO. 54(I), *supra* note 56, at 294, *reprinted in* 1989 U.S.C.C.A.N. at 90.

60. *Winstar*, 994 F.2d at 801-02.

61. *Id.* at 801.

62. *Id.* at 801-802. Supervisory goodwill allows any excess in an acquisition's cost beyond the fair market value of the acquired assets to be separately recorded as goodwill: capital deficits are thus treated as an asset. RAP goodwill resulted when the FSLIC provided cash aid to the acquiror. Rather than treating the cash amount as an asset which would have increased net worth and decreased the amount of goodwill, the cash assistance was recorded as a credit to the net worth without reducing the goodwill. Hence, the monetary contribution was counted twice: once as tangible capital and once as RAP goodwill capital. *Id.* at 802.

63. Financial Institution Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 (1989) [hereinafter FIRREA].

64. H.R. REP. NO. 54(I), *supra* note 56, at 302, *reprinted in* 1989 U.S.C.C.A.N. at 98. As of December 31, 1988, the FSLIC was $56 billion in the red, $37 billion of which stemmed from 1988 alone. *Id.* at 100.

65. *See* FIRREA, *supra* note 63.

66. *Winstar*, 994 F.2d at 804.

67. H.R. REP. NO. 54(I), *supra* note 56, at 298, *reprinted in* 1989 U.S.C.C.A.N. at 94.

68. 12 U.S.C. § 1464(t)(1)(A), (t)(2)(A)-(B) (Supp. V 1993).

69. Security Fed. Sav. & Loan Ass'n v. FSLIC, 796 F. Supp. 1435, 1437 (D.N.M. 1991),

B. *Tenth Circuit Decision:* RTC v. FSLIC[70]

After the failing Security Federal Savings and Loan Association of Albuquerque (Old Security) fell under federal regulatory control, FSLIC determined that it would be more cost-effective to solicit new capital sources rather than to liquidate Old Security.[71] Plaintiffs, First Southwest Financial Services, Clarence Ashcraft, and Allen White (the Investors), invested in and formed Security Federal Savings and Loan Association of Albuquerque (New Security) in 1985 by merging with Old Security. Although the Investors contributed $6 million in cash to New Security, the amount was insufficient to bring the merged institutions into solvency. As part of an Assistance Agreement with the Investors, FSLIC agreed to include a $7 million debenture as regulatory capital and $12 million as supervisory goodwill to be amortized over a period of thirty-five years.[72] New Security then proceeded to operate profitably under the terms of the Assistance Agreement.

After the passage of FIRREA, however, OTS notified Security Federal of its tangible insolvency and imposed lending restrictions on it. The Investors tendered ownership of Security Federal via letter back to the OTS and requested restitution which OTS refused.[73] Plaintiffs then filed suit claiming, among other things, breach of contract and frustration of purpose.[74] OTS placed Security Federal into receivership with the Resolution Trust Corporation (RTC) shortly thereafter.[75]

The district court held that there were no genuine issues of material fact regarding the documents and events of the case.[76] Within the three documents forming the contract[77] between the Investors and the defendants, the court found that "treatment of goodwill as regulatory capital [was] an express term of the overall contractual agreement."[78] It held that the defendants had also explicitly waived the application of contrary regulation disallowing the use of goodwill as regulatory capital by not expressly or implicitly reserving any statutory rights to do so.[79] The court noted that the treatment of goodwill was fundamental to the contract, since "the merger would have made no sense without this special treatment of goodwill, as the new institution would have been insolvent at its inception and no rational investor would have participated under those conditions."[80]

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aff'd sub nom. RTC v. FSLIC, 25 F.3d 1493 (10th Cir. 1994).

70. 25 F.3d 1493 (10th Cir. 1994).

71. *Security Federal*, 796 F. Supp. at 1437.

72. *Id.*

73. *Id.* at 1438.

74. *Id.*

75. *Id.* at 1438. FIRREA established Resolution Trust Corporation as the successor to FSLIC as conservator or receiver to manage and resolve cases involving thrifts insured by FSLIC prior to enactment of FIRREA. FIRREA, *supra* note 64, at 369-70.

76. *Security Federal*, 796 F. Supp. at 1442.

77. Three writings, the Assistance Agreement, the Resolution, and the Letter, formed the contract between the Investors and the defendants. *See id.* at 1443-44.

78. *Id.* at 1444.

79. *Id.*

80. *Id.* at 1445.

As a last resort, the defendants attempted to bar any liability by invoking the sovereign acts doctrine. The district court found that the doctrine's purpose was to ensure that the government, when acting as a contractor, was treated as any private contractor would be regarding contractual liability. Indeed, its goal was not simply to immunize the government whenever it legislates for the general welfare.[81] The court held that the sovereign acts doctrine did not bar the Investors' breach of contract claim, because the FSLIC specifically promised the Investors the use of goodwill as regulatory capital for a 35-year period, and, thereby, waived the application of contrary regulations.[82] The district court found the defendants in breach of the contract and held them liable just as it would any private contractor.[83] The Investors were therefore awarded rescission and restitution on their motion for summary judgment.[84]

The Tenth Circuit affirmed the lower court's decision on appeal.[85] The court recognized that supervisory and regulatory goodwill played "crucial" roles in the acquisition of Old Security, and that without them, New Security's capitalization would have been $6.5 million short of the regulatory compliance amount.[86] The defendants asserted that the Assistance Agreement, exclusive of the Resolution and the Letter, formed the contract and did not concern supervisory goodwill.[87] The court disagreed with the defendants' interpretation of the contract. It found that the Assistance Agreement relied upon both the Resolution and the Letter due to the three writings' contemporaneous issuance for the purpose of acquisition and the explicit cross-references to the other writings contained within each of them.[88] Furthermore, the contractual language clearly stated that the supervisory goodwill was to apply to continuing regulations and not just the acquisition.[89] The Tenth Circuit held that the language of the contract was completely unambiguous: the government could have easily restricted the supervisory goodwill to the transaction had it so desired.[90]

The defendants also asserted that OTS's enforcement of FIRREA's capital regulations could not constitute breach of contract due to the sovereign acts doctrine.[91] The court explained the doctrine as follows:

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81. *Id.* at 1446. For further explanation regarding the doctrine's origins, evolution, and application, see Ronald G. Morgan, *Identifying Protected Government Acts Under the Sovereign Acts Doctrine: A Question of Acts and Actors*, 22 PUB. CONT. L.J. 223 (1993).

82. *Security Federal*, 796 F. Supp. at 1447.

83. *Id.*

84. *Id.*

85. *RTC v. FSLIC*, 25 F.3d 1493, 1497 (10th Cir. 1994).

86. *Id.*

87. *Id.* at 1499.

88. *Id.*

89. *Id.* at 1500. The Resolution stated, "for purposes of reporting to the Bank Board or the FSLIC, the value of any intangible assets on the books of New Security resulting from accounting for the Merger in accordance with the purchase method may be amortized by New Security over a period not to exceed 35 years. . . . " *Id.* The Letter also stated that "for purposes of reporting the value of any intangible assets resulting from accounting for the acquisition in accordance with the purchase method, may be amortized by Security of Albuquerque over a period not to exceed 35 years. . . . " *Id.*

90. *Id.*

91. *Id.* at 1501.

> The sovereign acts doctrine operates to insulate the government from liability for certain inabilities to perform contractual obligations. More specifically, when the government enacts legislation of general applicability for the benefit of the general welfare and such legislation inadvertently affects the government's performance of a contract to which it is a party, the government cannot be held liable for damages resulting from its failure to perform any more than it would if it were an individual private party.
>
> . . . .
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> The bounds of the immunity afforded the government by the sovereign acts doctrine, however, are not limitless. The limits of this immunity are defined by the extent to which the government's failure to perform is the result of legislation targeting a class of contracts to which it is a party. *If Congress enacts legislation targeted to abrogate preexisting contract obligations the government owes to private citizens, the government may be properly sued for breach.*[92]

In the case of congressional legislation involving agencies, discretion becomes the crucial element. If Congress provides an agency with discretion in the enforcement of a mandate because it is aware that an abrupt change in law would abrogate prior agreements, the agency may be held in breach of any agreement that the agency could have honored by exercising such discretion.[93] The court found that FIRREA's structure reflected Congress's awareness of, and desire to mitigate, the paralyzing effects that the heightened capital requirements would have on mergers.[94] FIRREA provided OTS with the ability to allow for both the limited use of supervisory goodwill and the exemption of thrifts from the revised capital standards.[95] Because the Director of the OTS had the discretion to allow for continued use of regulatory accounting measures but opted instead to ignore the contract's goodwill terms, the court found OTS to be in breach of contract.[96]

Furthermore, because no rational investor would have entered into the contract without the special accounting arrangements, the court agreed that they constituted material terms of the contract.[97] "[W]ithout supervisory and regulatory goodwill, New Security would have debuted as an insolvent institution."[98] The court held, therefore, that OTS's actions constituted breach of a material term of the contract and discharged the plaintiffs from further performance.[99] In addition to the breach of contract, the Tenth Circuit also found frustration of purpose. It held that the application of FIRREA's capital requirements made it impossible for the Investors to fulfill their contractual obligation

92. *Id.* (citations omitted) (emphasis added).
93. *Id.*
94. *Id.* at 1502.
95. *Id.*
96. *Id.*
97. *Id.*
98. *Id.*
99. *Id.* at 1503.

to operate the thrift in compliance with regulations.[100] This completely frustrated the investors' purpose and warranted discharge of their agreement to acquire the thrift.[101]

Finally, the Tenth Circuit upheld the district court's ruling granting the Investors $6 million and postjudgment interest as restitution.[102] The purpose of rescission and restitution is to restore the plaintiff to the position he or she enjoyed before entering into the contract by requiring the defendant to return the value of plaintiff's consideration.[103] The measure of restitution falls within the discretion of the trial court and depends on the circumstances of the case.[104] Because the court found no abuse of discretion by the trial court, the amount of the award was upheld.[105]

C. *Analysis*

The court's opinion is a refreshing dose of common sense. OTS must wish that it would have exhibited just that when it considered how to handle the application of FIRREA to Security Federal. Congress passed FIRREA in an effort to lead the way out of the thrift industry fiasco of the last decade. Its intent was to restructure the system in order to remedy the volatile situation and limit losses. If anything, OTS's actions in *RTC v. FSLIC* would have exacerbated the situation. The FSLIC elected to find capital investors for a failing thrift because it was a cheaper solution than liquidation. After passage of FIRREA, OTS attempted to renege on its end of the deal by denying the special accounting promised to the investors. This would have returned New Security to the insolvent state it was in 1985 and bilked the Investors of their $6 million.

What Congress surely did *not* intend by enacting FIRREA was to abandon any and all contracts that the FSLIC entered into with investors and declare profitable, restructured thrifts insolvent. The Tenth Circuit recognized the folly in this. To rule otherwise would establish a dangerous precedent of allowing the government to breach its express obligations every time it changed its mind. Because the Tenth Circuit wanted to send such a broad message, it ruled that the government's breach was grounds for awarding rescission and restitution. The court could have avoided the issue of breach, sidestepped the government's sovereign acts defense, and still awarded the restitution sought by the investors by rescinding the agreement on the grounds of frustration of purpose. Instead, it chose to meet the government's sovereign acts defense head-on, and effectively sent a broader message to federal agencies generally to keep their promises whenever they have the discretion to do so. Perhaps in the future OTS will pay more attention to the discretion granted to it and heed the old adage: "if it ain't broke, don't fix it".

100. *Id.*
101. *Id.*
102. *Id.* at 1504-1507.
103. *Id.* at 1504 (citing RESTATEMENT (SECOND) OF CONTRACTS § 370 (1981)).
104. *Id.* at 1505 (citing RESTATEMENT (SECOND) OF CONTRACTS § 371 & cmt. a (1981)).
105. *Id.*

CONCLUSION

The 1994 survey period presented two unusual contract cases that required the Tenth Circuit to apply federal law rather than state law via the Erie doctrine. Both of the scenarios presented by these cases are ripe for repeat occurrence in the future. International commerce will only expand as more players opt to enter the global market, and thrift investors will continue to fight the application of FIRREA's capital requirements. In *United World Trade*, the Tenth Circuit realized the limits to its own power. The foreign state's connections to the U.S. were insufficient for asserting jurisdiction under the Foreign Sovereign Immunities Act. In *RTC v. FSLIC*, however, the Tenth Circuit realized the limits of the OTS's power and accordingly forced it to act as a private player would under the law.

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106. The author would like to thank Jon-Mark C. Patterson for his invaluable assistance.