

Introduction to Foreign Direct Investment: History, Trends and Rationales

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1.1 International Investment Law

International investment law is best described as a field of public international law which deals with the laws governing the commercial activities of multinational enterprises that are undertaken in foreign states. This occurs when a business or firm decides to open a branch of operations overseas, such as a factory or a mine, and in so doing it may come into conflict with that host state's laws. These may control the nature or extent of the economic activities the firm is allowed to pursue, such as licensing requirements, labour or environmental standards. While this situation may appear to be a matter for resolution by application of domestic laws of the host state through its courts, increasingly recourse is given to international law and international tribunals for answers. International investment law is a species of public international law in the sense that it comprises legal commitments made by sovereign states at the international level as captured by the international investment agreements. While often overlooked, it also has private law elements because the rights (and to a lesser extent obligations) of firms are in some cases formulated by investment contracts between firms and the states in which they operate. In this latter sense, international investment law can be viewed as a field of transnational contract law, governed both by domestic legal systems and the rules of international law.

The law of foreign investment is one of the oldest branches of international law. But it remained relatively undeveloped until the latter part of the twentieth century, growing in-step with globalization, meaning the intense interrelation of markets as well as the mobility of people and capital around the world. Prior to the 1990s there were few treaties governing international investment and the resolution of disputes between investors and host states was mostly informal, consisting for the most part of diplomatic pressure, often backed up by the threat of force. Yet within a relatively short period of time this area of law witnessed a phenomenal

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growth to become one of the most dynamic and intensively studied spheres of international law. It now comprises many thousands of treaties and highly formalized dispute settlement procedures which have resulted in hundreds of cases brought by expert practitioners and a growing body of specialized jurisprudence. Investor–state arbitration itself has acquired a new status in international law – it has transformed from its origins as a rather obscure, private dispute settlement mechanism to a high-profile forum for the resolution of complex claims. It often has a significant public dimension because of the legal consequences of regulations pursued in the interest of society at large. International investment law has far-reaching implications with respect to both international commerce as well as fundamental issues of sovereignty and by extension the constitutional role of states – essentially the way in which a country governs itself.

The remarkable growth of international investment law as a semi-autonomous discipline within international law is largely the consequence of foreign investment's importance both to the highly mobile firms which engage in it and the growth-focused states which seek to attract it. Just as many companies rely on an international presence in order to sustain and enlarge profits, so many countries depend on foreign capital in order to develop and achieve economic prosperity. Yet there is now widespread concern that the rapid pace of change in the global economy, including the fervid ascendance of the emerging markets, the role of State-Owned Enterprises (SOEs) pursuing non-traditional strategies, highly interconnected financial markets and the dominance of supply chain manufacturing has transformed the way governments interact with foreign investors. There is justifiable concern that the encroachment of states on the commercial activities of multinational enterprises has not been properly managed, in that it is at times excessive and undisciplined while at other times it is merely the manifestation of government's right to regulate its own economic affairs. Likewise, it is often suggested that many of the decisions of international tribunals have gone too far in interpreting the protective provisions of treaties in favour of investors, undermining the legitimate sovereign rights of host states, for example by construing environmental regulations as a form of expropriation, effectively taking private property that does not belong to it.¹ On the other hand, some feel that strong

¹ See e.g. D. Schneiderman, *Constitutionalizing Economic Globalization* (Cambridge University Press, 2008).

protection for the foreign firms which have risked exposing their assets to the whims of unstable governments is essential to stimulate the flow of badly needed capital to poorer nations. These issues will be explored in greater detail throughout this book.

1.2 Foreign Direct Investment

International investment law primarily covers the international laws which control Foreign Direct Investment (FDI). The phrase ‘direct’ investment is important because this is meant to exclude investment activities for which the extra-territorial component of the enterprise is too small for it to genuinely be considered foreign, although such forms of investment may also be contemplated by some treaties in this field. Put another way, direct investment means that the foreign firm has a sufficient stake in the firm that it exercises meaningful management or control. This is normally thought to be at least 10 per cent of the voting shares in the firm.² Below 10 per cent ownership would normally qualify the investment as ‘portfolio investment’. Portfolio investment refers to investments that lack direct personal management, such as when ordinary people purchase stocks and shares in large public corporations. The inclusion of portfolio investment into the understanding of ‘investment’ for the purposes of international investment law has the potential to bring various entities within the ambit of protection available under an investment treaty that may not necessarily deserve special protection under international law, because such individuals are not exposed to the same level of risk as genuine managers of foreign firms. Moreover, such entities do not provide the same advantages of foreign capital to host states that are associated with the truly multinational firm. Still, as will be explained in Chapter 3, a number of investment treaties have extended their coverage to indirect forms of investment.

While the direct component of FDI is reasonably straightforward, the definition of ‘investment’ itself remains controversial. It is undefined in some treaties, or expressed in a purposefully open manner, leaving arbitration tribunals the task of interpreting the concept on a case-by-case

² *IMF Glossary of Selected Financial Terms and Definitions*, 31 Oct 2006, www.imf.org/external/np/exr/glossary/showTerm.asp#117.

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basis. Perhaps more controversially, this affords tribunals the latitude to consider various commercial ventures as deserving of protection where this is arguably unjustified for the reasons noted above. Establishing a definition for ‘investment’ and ‘investor’ will be explored more fully in Chapter 3, but for now it is useful to observe that most investment treaties define the term ‘investor’ to include all sorts of commercial entities including SOEs, foreign nationals or a private enterprise of a foreign state that has engaged in commercial activity in the territory of another state.

For now it should be noted that the trend in modern investment treaties is to define the terms ‘investor’ and ‘investment’ broadly, with indicative rather than definitive lists of investors and investment. In order to encompass as many forms of commercial activity as possible, many treaties provide that the term ‘investment’ includes ‘every kind of asset’ and supply a non-exhaustive list of specific forms of investment, such as the equally expansive ‘property, rights and interests of every nature’. For example, the US Model Investment Treaty of 2012 states that investment means: ‘every asset that has the characteristic of an investment, including such characteristics as the commitment of capital or other resources, the expectation of gain or profit, or the assumption of risk’, followed by a non-exhaustive enumerated list of various types of investment.³ This is obviously very wide, covering effectively all varieties of commercial activity by foreigners in host states. Clearly this wide definition is of value to a capital-exporting state such as the USA because it protects as many varieties of businesses as possible.

Still, not every kind of commercial venture will amount to an investment and therefore attract the protections of international investment law, including most importantly, the protections enshrined in treaties. One of the ways in which ‘investment’ has been established by arbitration tribunals, at least for the purposes of establishing jurisdiction under the International Centre for the Settlement of Investment Disputes (ICSID) Convention, is known as the *Salini Test*, taken from the *Salini v. Morocco*⁴ dispute. There remains a lively debate as to whether the *Salini Test* should be followed even in the context of ICSID disputes because it is seen by some to expand ICSID’s jurisdiction beyond what is granted in that organization’s founding documents, and in so doing introduces

³ Art 1. ⁴ Decision on Jurisdiction, ICSID Case No. ARB/00/4 (23 July 2001).

a significant degree of uncertainty into international investment.⁵ Some of these issues will be explored later in Chapter 3. For the time being it is important to mention that the *Salini* Test states that to be an investment, the activity in question must: (1) involve the transfer of funds or the contribution of money or assets; (2) be of a certain duration; (3) have the participation of the individual transferring the funds in the management and risks associated with the project; and finally (4) bring economic contribution to the host state. Of these, the requirement of certain duration is perhaps the hardest criterion to satisfy. To be an investor, one must have a lasting relationship with the host state, although whether that means a few months or a few years is unclear. More certainly this means that a single transaction, such as a one-off contract, does not count.⁶ The final component of the test, the obligation to contribute to the host state's development, has been rejected by some tribunals in part because it is simply too ambiguous to constitute an enforceable legal obligation.⁷ The lack of this final component is problematic however, given the obligations of investment treaties are placed uniformly on host states rather than investors who enjoy all of the benefits.

While it has less legal relevance, economists often split FDI into two additional categories that help clarify the nature of foreign firms' involvement in the domestic economies of other states: mergers and acquisitions (meaning a foreign company purchasing all or a portion of an existing local company) and greenfield. Greenfield investment means creating an entirely new project or company from nothing – such as an oil field, a mine or a new factory. Host states often have a preference for the second category because it represents an entirely new source of capital, rather than the reorganization of an existing one. Mergers and acquisitions are often associated with the loss of employment as old companies are restructured by foreign managers to become more competitive, sometimes referred to euphemistically as 'synergies' in management speak. The concept of 'investment' will be revisited again throughout this book. The precise definition is often challenged in the context of establishing jurisdiction for the purposes of arbitration.

⁵ See e.g. A. Grabowski, 'The Definition of Investment Under the ICSID Convention: A Defense of *Salini*' 15:1 *Chicago Journal of International Law* 287 (2014).

⁶ E.g. *Burimi SRL and Eagle Games SH.A v. Republic of Albania*, ICSID Case No. ARB/11/18, Decision on Jurisdiction (29 May 2013).

⁷ E.g. *Quiborax v. Bolivia*, ICSID Case No. ARB/06/2, Decision on Jurisdiction (27 Sept 2012).

1.3 Historical Context – Beginnings of Foreign Direct Investment (FDI)

In order to appreciate the content of international investment law as a living discipline and an area of legal practice, it is useful to have an understanding of the origins of foreign investment itself. While FDI levels have reached unprecedented levels in recent years, the presence of commercial entities from one state in the territory of another is not a phenomenon exclusive to the twenty-first or even twentieth century. Foreign investment has occurred throughout history and across the world for many hundreds of years. Indeed, the establishment of foreign investment was one of the chief motivations behind the expansion of the European empires to the four corners of the world in the early pre-modern period. Conscious of a certain historic irony, the forays of modern multinational enterprises into developing states is depicted by some critics as a kind of neo-colonialism, reasserting the historic power imbalances between capital-importing and capital-exporting countries.

One of the earliest known examples of foreign investment in its purest form is that of the Phoenicians, a civilization that flourished from 1500 BC in what is now Israel and Palestine. The Phoenicians traded by ship with the Greeks and established outposts around the Eastern Mediterranean from which they could sell goods from their homeland, such as wood and textiles. It is important to recognize that this type of activity was not simply international trade (an item from one place being sold somewhere else) – the Phoenician outposts are correctly described as a lasting commercial presence in a foreign state. Interestingly, the act of establishing commercial settlements in foreign states on the shores of the Mediterranean Sea also led to the diffusion of the Phoenician alphabet, which is the ancestor of all modern Western alphabets. While this may not have been an intended benefit at the time, this eventuality helps fulfil the requirement of contribution to the economic development of the host state. As will be shown later, the transfer of knowledge is often seen as one of the ‘spillover’ advantages of FDI.

A few centuries after the Phoenicians, the Silk Road land-based trading routes were established between Europe (then controlled by the Roman Empire), the Middle East and the Pacific Ocean, extending over 6000 km through the deserts, plains and mountains of Asia. This early conduit allowed for the exchange of goods such as fabrics, spices and jewels.

Importantly, these commercial relationships also involved the transfer of language and culture, primarily through trading agents who often established themselves in foreign states for extended periods of time. These were the settlements which became some of the early cities of regions like the Persian Empire such as Samarkand. Recall that a key feature of investment as distinct from trade or other forms of commercial activity is the creation of a long-term relationship – the commitment of resources to an enterprise for the pursuit of profit over a period of time, rather than linked to one particular transaction. Help in the creation of lasting outposts may further be seen as key contributions to the development of foreign lands.

The Silk Road remained a key link between Europe and Asia until the Middle Ages when sea travel came to dominate international investment, as well as international trade. Beginning in the fifteenth century there was extensive trans-oceanic commerce between Europe and China, as well as India, involving exotic commodities like spices and tea. Port cities became the major focus of commercial activity and money was increasingly channelled into the building and maintenance of the ships themselves. The operation of commercial shipping can be viewed as an early form of foreign investment – the sailing vessels were constructed and operated at great expense, and successful missions abroad were fraught with risk both for the crew as well as the owners. The rise of commercial shipping during this period was in tandem with the expansion of ports in the destination countries. As then, the creation of infrastructure in host states remains one of the chief benefits associated with FDI.

1.4 The Colonial Period

During the early modern period (the fifteenth century and onwards) Western European states began to establish permanent colonies in the locations where they had previously visited on trade missions, building ports such as Hong Kong and New Amsterdam (later New York). The Dutch East India Company was formed in 1602 in order to carry out commercial activities in Indonesia, particularly in relation to the transportation of spices like pepper. It is quite rightly described as the world's first multinational corporation. Likewise, the Portuguese began establishing colonies in India and Africa, as did the British and French. The latter two states

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also set up colonies in North America where fur trapping was a lucrative enterprise. Spain and Portugal had also begun settling South and Central America by the mid-seventeenth century, driven in part by the pursuit of gold.

The practice of colonialism as employed by the European powers of the time was rooted in the economic objective of exploiting the abundant resources and in some cases cheap labour available in lesser developed countries through a military and administrative presence. Wealth generated from foreign investment, and trading activities overseas was itself tied to the political goal of land acquisition and expansion of territorial sovereignty of the major European powers as wealth from the colonies, especially gold and silver, enriched the home country which in turn funded greater armies and navies. Much like a good portion of modern FDI is predicated on the application of technology and infrastructure from the industrial world to resource-rich developing states, colonialism was made possible by an imbalance in technology. The European states had expertise in tools like cartography, shipbuilding, navigation and weaponry which translated into extractive capabilities that native peoples in Africa and the Americas did not possess. This paradigm is worth keeping in mind when considering the relationship between signatory parties and modern international investment treaties.

Perhaps more than any other power, the British Empire exemplified the colonialism that contained the seeds of modern international investment. It reached its peak in the nineteenth century and was the largest empire in the history of the world, covering a quarter of the land area of the planet. Multinational enterprises, often enjoying government-granted monopolies, played a significant role in its expansion and dominance, including the British East India Tea Company and Hudson's Bay Company. These organizations were focused on exploiting particular resources in the then-developing world by building and enlarging permanent outposts and infrastructure such as housing, roads and ports. These commercial activities were closely tied to the home state's drive for territorial and geopolitical dominion, and while the legacy of these ventures and their effects on indigenous peoples remains highly dubious, the role that the early multinationals played in the spread of European civilization cannot be denied.

In the very early days of international travel for the purposes of business when Europeans began to go to Asia, Africa and the Americas to

set up trading posts with local communities, it was understood that local law, such as it was, could not be applied to these people because they were already subject to the law of their more powerful and more civilized (as they saw it) home country. Viewed by many as the first international jurist, the Dutchman Hugo Grotius supported this position in his seminal writings on international law in the seventeenth century.⁸ This concept went on to be enshrined in treaties concluded between the many European states and their colonies, collectively known as Friendship Commerce and Navigation treaties. These early treaties, extensively used by the USA in particular, addressed a wide range of issues including not just investment and trade, but also immigration, taxation and issues which today we now understand as human rights.⁹ The idea that early investors carried their own law with them wherever they went normally meant that the foreigner was entitled to better treatment by the local community than a native person would be, where punishments for petty crimes could end in execution, a reflection of the need to maintain order in an environment lacking a permanent military presence. Over time this superior treatment came to be defined by reference to an international minimum standard of protection with which all aliens should be treated, which survives today as a principle of customary international law as a check on the arbitrariness of a state's exercise of its power over individuals. This baseline of legal entitlement grew largely out of the nineteenth-century US experience in Latin America where there had initially been much resistance to the notion that the rights of individuals could come from anywhere other than domestic law.¹⁰ Clearly the presumption behind the international minimum standard of treatment was the often inaccurate view that some countries' legal systems were simply inadequate, at least from the standpoint of the European power.

Since, as suggested above, much early foreign investment was done in the context of colonial expansion by the European powers, these forms of investment did not need protection from interference by troublesome locals through a specialized regime for foreigners because the colonial

⁸ E.g. H. Grotius, *The Freedom of the Seas* (1608), Carnegie Endowment For International Peace, J. B. Scott (ed.) (Oxford University Press, 1916).

⁹ J. F. Coyle, 'The Treaty of Friendship, Commerce and Navigation in the Modern Era' 51 *Columbia Journal of Transnational Law* 302 (2013).

¹⁰ E. Borchard, 'Minimum Standard of Treatment of Aliens' 38:4 *Michigan Law Review* 445 (1940).

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systems were well integrated within the imperial system. In this sense the colonies were effectively within the jurisdiction of the home state. This gave sufficient protection for the investment against the risk of seizure of the investor's assets by the colonial authorities, or at least the risk was no greater than that which would be faced by domestic investors who had stayed at home.

1.5 Post-colonialism and Gunboat Diplomacy

Often by force but in many instances through peaceful settlement, colonialism began to unravel in the late nineteenth century. The Spanish Empire was among the first to dissolve, followed by the German, Ottoman and Russian Empires after World War I, then those of the other European powers like the British and French after World War II. When colonies gained independence they began to challenge the concept that foreigners who continued to reside and do business in those countries were not governed by the laws enacted by the local population. The international minimum standard of protection of aliens did not sit well with these new nation states eager to assert their own autonomy. Indeed, the ability of the newly independent states to impose their own laws on residents, including aliens, was a key aspect of nascent sovereignty. Uncertain as to the nature of their rights, this unsurprisingly left foreign investors apprehensive about the security of their commercial endeavours abroad. During this time a mixture of diplomacy and force (so-called 'gunboat diplomacy') was used by the former imperial powers to ensure that those new states did not encroach on foreign investors' use of their property adversely, for example by seizing it outright or applying onerous taxes or other fees. If this type of interference did happen, then instead of relying on international or domestic law, capital-exporting states would retaliate by sending a fleet of warships to moor off the coast of the host state until it relented, reminding the former colonies of the might of their former masters even if there was notional autonomy. In one example of this practice, in 1850 the British navy blockaded the Greek port of Piraeus as retaliation for the harming of a British subject without compensation. Half a century later Great Britain and Italy sent ships to the Venezuelan coast to demand reparation for Venezuela defaulting on its sovereign debt. The implication was clear: just as former colonies were expected to safeguard the