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The Paradoxical Relationship between "Foreign Direct Investment Screening" and International Investment Law: What Role for Investor-State Arbitration?

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On March 25, the European Commission issued a set of guidelines addressed to Member States, concerning foreign direct investment (FDI) from third countries and the protection of European critical assets. In face of the current crisis caused by the outbreak of Covid-19, the European Commission calls upon Member States to make full use of their existing FDI screening mechanisms, or in the alternative to set up full-fledged screening mechanisms to cope with the increased potential risk to EU strategic industries.

The communication of the European Commission follows the increasing trend to adopt national laws aimed at screening FDI potentially impinging on national security or strategic interests. This trend has grown out of concerns related to the foreign investments of sovereign wealth funds and state-owned enterprises, in particular that these subjects may be driven by geo-political rather than financial interests. However, the question arises as to the relationship between FDI screening measures and international investment law, in particular whether foreign investors enjoy any protection under international investment agreements (IIAs) in case of exclusion due to discriminatory or abusive use of the screening powers granted to host states.

This question becomes central when one considers the opposite trends followed in this regard by domestic and international law. On the one hand, states have been reinstating their right to subject the admission and pre-establishment phase of foreign investments solely to domestic law. On the other the conundrum of bilateral and multilateral IIAs has brought the post-establishment phase of foreign investments to a supranational level, thus not only ruling out the jurisdiction of state courts, but also providing for the application of public international law, in addition to the host state's domestic law.

The question tackled in this post is whether the pre-establishment phase of foreign investments is *tout court* left out of the scope of international investment law (and, consequently, of the jurisdiction of the arbitral tribunal that would accordingly have jurisdiction over any dispute arising between the foreign investor and the host state) or, instead, whether the scope of application of the latter extends to the pre-establishment phase of the investment, so as to generate a potential conflict with national screening mechanisms.

In other words, the question is whether the temporal dimension of the investment determines a fork in the road between two opposite directions followed by, respectively, the law governing the treatment of foreign investment after its establishment in the host state and that governing the foreign investment prior to it.[1)]

In order to assess the applicability of international investment law to – and the subsequent jurisdiction of investment treaty arbitral tribunals over – the admission and pre-establishment phase of a foreign investment, a distinction has been drawn between three different approaches to this point that can be identified among IIAs drafted over the decades.

The First Model: IIAs Silent on the Pre-Establishment Phase

The first model, mostly adopted by early IIAs, is not to regulate the pre-establishment phase of investments at all. These treaties do not encompass a right of establishment in the host state, but rather merely require the latter to abide by the investment protection standards and guarantees in relation to those foreign investments that it has unilaterally decided to admit (*see*, e.g., the 1972 Democratic Republic of Congo – France BIT).

Under this model, domestic regulations screening the entry of FDI would not be prohibited nor limited by the host state's treaty obligations, and the host state would hold discretion to decide which foreign investments to admit.[2)]

As a consequence, under such a treaty, where a host state adopts discriminatory or abusive measures in the pre-establishment phase, the foreign investor will not be entitled to trigger the investment treaty arbitration clause in respect of such measures. It will instead only have access to the domestic remedies made available by the host state.

The Second Model: "Best Effort" Clauses

The second approach is the one adopted by most European Union member states. IIAs following this model generally include clauses requiring States Parties, on the one hand, to reciprocally promote investments from the other State Party, and on the other, providing that such investments' admission be regulated by domestic law (*see*, e.g., Article 2.1 of the 2008 German Model BIT).

These provisions do not impose any treaty obligation as to the admission of the investment, but rather qualify as "best effort" commitments undertaken by host states to promote foreign investment from the other State Party.

As a consequence, following this model, any protectionist measure adopted by host states pursuant to their domestic regulations prior to the establishment of an investment will not amount to a violation of the IIA. This, more importantly, rules out the possibility for the investor to resort to investment treaty arbitration.

The Third Approach: International Investment Law's Expansion to the Pre-Establishment Phase

As opposed to the European Union member states, the United States, Canada and Japan have promoted yet another model, explicitly bestowing upon foreign investors the right to have their investment admitted into the host state.

Such right of establishment is usually provided under the "National Treatment" standard of protection, by which the host state agrees to accord to the foreign investor, under equal circumstances, a treatment not less favorable than that it accords to domestic investors (*see*, e.g., Article 3.1 of the 2012 U.S. Model BIT).

In addition, these treaties frequently place the admission of investments under the "Most-Favored Nation Treatment" standard. Thereby, States Parties to the treaty agree to grant investors from the other State Party a treatment not less favorable than that they accord to third states' investors pursuant to other IIAs (*see*, e.g., Article 4.1 of the 2012 U.S. Model BIT).

Unlike the first and the second approaches analyzed above, this model raises problems concerning the relationship between the international protection of investments at the pre-establishment phase, on one side, and national FDI screening procedures adopted by host states, on the other.

National Security as a Potential Defense by the Host State

In case the applicable IIA expressly provides for a right of establishment (e.g., through its inclusion under the "National Treatment" standard), any foreign investor being denied admission of its investment pursuant to domestic FDI screening regulations may trigger the treaty arbitration clause. Under such a treaty, the investor may start an arbitration against the host state claiming the latter's violation of its international obligations under the IIA.

In this case, however, the host state might raise a defense based either on possible IIA clauses leaving specific economic sectors out of the treaty's scope or, more in general, on the national security exception. An analysis of the latter ultimately allows to shed some light on the relationship between the host state's international obligations and domestic FDI screening regulations.

In particular, the host state may invoke national security as enshrined in "Non-Precluded Measures" (NPM) provisions contained by many IIAs, limiting the applicability of treaty investment protections in case of measures, though detrimental to the foreign investor, justified by "essential national security interests" (*see*, e.g., Article XI of the 1991 U.S.-Argentina BIT).[3)]

The Role of Investment Treaty Arbitral Tribunals before National Security Exceptions

When confronted with such a defense, the arbitral tribunal will first be called upon to assess whether the relevant clause is "self-judging". A "self-judging" clause gives the host state power to unilaterally decide whether a national security interest exists. Such assessment should be carried out based on the wording of the treaty. "Self-judging" clauses typically read "*it considers necessary*", while "non-self-judging" clauses will merely indicate that measures must be "*necessary*".

In the *Nicaragua* case the International Court of Justice used this reasoning to affirm the "non-self-judging-nature" of the NPM clause included in the 1956 Treaty of Friendship, Commerce and Navigation between the U.S. and Nicaragua. The Court stressed that such clause spoke "*simply of "necessary" measures, not of those considered by a party to be such*". Though with reference to an alleged violation of the host state's post-establishment obligations in the context of severe economic crisis, the same stance was taken by the ICSID tribunals in the Argentine cases. Among others, the Tribunal in *CMS v Argentina* inferred the "non-self-judging" nature of the NPM clause in the 1991 U.S.-Argentina BIT through a comparison with differently worded provisions such as GATT Article XXI(b).

The latter ICSID tribunals also gave a good explanation of the extension of the arbitral tribunal's jurisdiction where the national security exception is grounded on a "non-self-judging" clause. In these cases, "*the judicial control must be a substantive one*" as to whether the conditions to invoke such exception have been met (*see*, e.g., *Enron v Argentina*). In other words, the arbitral tribunal may evaluate the factual circumstances on which the measure has been grounded, in order to assess whether it is justified by national security interests.

On the other hand, a "self-judging" clause prevents or limits the arbitral tribunal's review of the implemented measure. Though in the context of trade, the WTO Panel approach in the *Russia – Traffic in Transit* Report was to find an external limit to state discretion in the principle of good faith. It then found to have jurisdiction as to whether the state invoking the exception had sufficiently articulated its national security interests, and the measures at issues were plausibly protective of such interests. Similarly, the Statement of Administrative Action to the 1993 U.S. NAFTA Implementation Act interpreted the NPM clause of the NAFTA (i.e., Article 2102) to be "*self-judging in nature, although each government would expect the provisions to be applied by the other in good faith*".

To sum up, potential contrasts between, on one side, international treaty protection to the pre-establishment phase of foreign investments and, on the other side, FDI screening regulations adopted at the domestic level only emerges in limited situations. This problem arises where the applicable IIA grants foreign investors a right of establishment and refuses to accord to the host state full discretion (though with the good faith limit) to invoke the national security exception. Only in this case will foreign investors be able to resort to international investment arbitration against any abusive or discriminatory use of the host state's screening powers. In all other cases, host states retain full discretion in unilaterally denying admission to foreign direct investments pursuant to their domestic law, or in assessing whether an investment constitutes a threat to their national security.

References

?1 *See* M. Burgstaller, *Sovereign Wealth Funds and International Investment Law*, in C. Brown, K. Miles (eds.), *Evolution in Investment Treaty Law and Arbitration*, Cambridge, 2011, at pp. 179-180.

?2 *See* P. Blyschak, *State-Owned Enterprises and International Investment Treaties. When Are State-Owned Entities and Their Investments Protected?*, in *Journal of International Law and International Relations*, 2011, 6, p. 17.

?3 *See* W. Burke-White, A. von Staden, *Investment Protection in Extraordinary Times: The Interpretation and Application of Non-Precluded Measures Provisions in Bilateral Investment Treaties*, in *Virginia Journal of International Law*, 2008, *passim*.

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