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LEGAL ASPECTS OF DIPLOMATIC PROTECTION OF FOREIGN INVESTMENT

Introduction

Entry of foreign investment to any State (host State) creates complex legal problems linked not only with specific economic environment existing in a particular country but also with socio-economic, legal and other factors operating in the international community. The contemporary legal doctrine has developed various approaches to examine these problems, among which the following three-tier analysis[1] of the concurrent problems has achieved wide recognition:

a. problems concerning entry of foreign investment to a host State;

b. problems linked with functioning of foreign investment;

c. problems relating to resolution of disputes between a host State and the foreign investor.

Quite naturally, this three-tier analysis can not sufficiently define and explain all the numerous problems concerning functioning of foreign investment. Nevertheless, by differentiating different stages of foreign investment presence (stage of entry, stage of operation, and stage of dispute dissolution), this approach simplifies to a great extent study of main problems.

1. For a vivid analysis of this approach, see, F. P. Feliciano "Legal Problems of Private International Business Enterprise", *Recueil des Cours*, The Hague 1966, II, vol. 118, p. 214.

A very general analysis of the problems concerning foreign investment exhibits that quite often a host country conflict vis-a-vis foreign investor transforms into a host country conflict vis-a-vis country of origin of the investment, i.e the home country. This is possible due to the fact that under specific conditions of regulation of foreign investment by the host State, the home State for protection of its interests, either on request from the investor or on its own initiative, may try offer its national diplomatic protection. This raises questions not only regarding the legal foundation of diplomatic protection of foreign investment by the home country, but also regarding the applicablity of host country jurisdiction to foreign investment.

Movement of capital, controlled or unrestricted, within the territory of a host State may thus lead to cases of diplomatic protection of investment by the home country. This is a problem of international relations, and consequently of international law. In this paper an attempt is made to examine in brief, the legal aspects of diplomatic protection of foreign investment, taking into special consideration interests and views of the developing countries.

Theory of Diplomatic Protection : Genesis and After

Historically, the problem of diplomatic protection emerged as a direct result of the sharp political conflict between the USA and the Latin American States. Independent economic policy pursued by these States included nationalization of private property belonging to the US Government interfered to protect the interests of its nationals considering nationalization and other similar measures as violation of the norms of general (customary) international law.[2]

Primarily, the institution of diplomatic protection was considered by western lawyers as a tort liability case.[3] Later on it started to

2. B.O. Brookens, "Diplomatic Protection of Foreign Economic Interests", *Journal of International Studies and World Affairs*, Vol. 20, No. 1, London, 1978, p. 38.
3. C. Borchard, *Diplomatic Protection of Citizens Abroad and the Law of International Claims*, New York, 1927, pp. 836-838.

be treated as a case of contract liability i.e. liability due to violation of contractual obligation in relation to a particular State. This latter view that, "injury to a foreign national actually means injury to the property of a foreign state-ergo the state itself".[4] This contractual theory of the institution of diplomatic protection in its turn, got strength from some traditional legal theories, significant among which are the theory of "International Minimum Standard" and the theory of "Acquired Rights".

According to the first theory, it was believed that the legal status of foreign nationals must not be below a definite minimum standard of civilization. If the status, nevertheless, degenerates below that "minimum", the state enforcing that status can not insist upon legality of its actions (i.e conformity of its actions with its national law) in case of foreign intervention.

Western legal doctrine is characterised by a more or less general acceptance of this theory notwithstanding the fact that actual content of the aforementioned "standard" has never been clearly defined, either by law or by the court. Even back in 1926, it was indicated in the *Neer Case* that no intelligent and unbiased person can question the "inadequacy" of this theory.[5] Some western lawyers have gone so far as to refer to the inconsistency of theory. Thus in 1928, Eagleton wrote: "vagueness of the 'standard' actually affects adversely the interests of the weaker party".[6]

As a legal foundation of diplomatic protection, western lawyers also refer to another theory—Theory of Acquird Rights. Traditionally this was supposed to mean recognition of legality and immunity of

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4. B.O. Brookens, *op. cit.*, p. 42.

5. "Opinions of the Commission"; *General Claims Commission, United States-Mexico*, Washington, p. 71.

6. C. Eagleton, *Responsibility of States in International Law*. N. Y, 1928, p. 86.

rights acquired during earlier lawful regimes.[7] Two completely different conclusions were drawn from this theory. According to the first conclusion, recognition of acquired rights *per se* signifies prohibition of expropriation of foreign property acquired through lawful means.

The second conclusion drawn from the same theory is of a more contemporary nature. Proponents of this view submit that acquired rights do not signify absolute, unlimited or unqualified respect of foreign property, but in all cases foreign property is protected from "full and exclusive" expropriation by the host State, and in case of "unlawful" expropriation, the home country can (has the right to) offer diplomatic protection.

In the changed scenario of international relations, such traditional concepts naturally could not satisfy the interests of developing countries. These "young states realized that international law had, so far been, law of the West only."[8] So, beginning from the 1960s, the developing counties started pressing for "New International Law, oriented towards the Third World countries."[9] In such an atmosphere fierce theoretical conflict round the question of diplomatic protection ensued between the developing countries and the Western States, who (latter group of countries) declared that "defence of the principle of diplomatic protection is the obligation of all international jurists".[10]

7. See, Kaeckenbuck. "The Protection of Vested Rights in International Law", *British Yearbook of International Law*, Vol. 17, London, 1936, pp. 2-4.
8. O.E. Bring, "The Impact of Developing States on International Customary Law Concerning Protection of Foreign Property" *Scandinavian Studies in Law*, vol. 24, Stockholm, 1980, p. 99.
9. J. Castaneda, "The Underdeveloped Nations and the Development of International Law," *International Organization*, Vol. 15, Boston, 1961.
10. Main postulates of this western approach can be found in R. B. Lillich "The Diplomatic Protection of Nationals Abroad : An Elementary Principle of International Law under Attack", *The American Journal of International Law*. Vol. 69, No. 2, 1975, Washington, pp. 359-365.

Lawyers from the developing countries, on the other hand, insist that international law must take into account interests of the whole international community and include as integral part of the law some elements of the legal systems and culture of the Third World countries.[11] This attitude was also manifested in various decisions of the International Court of Justice (ICJ). For example, in the *North Sea Continental Shelf Case*, the Court held : "in accordance with customary international law, the process of creation of norms of international law, primarily includes the practice of those states whose interests are specifically linked with the issue in question".[12] On this basis the developing countries formulated their arguments in favour of changing the existing law. This was to a great extent materialized in various resolutions of the UN General Assembly. Already from the beginning of 1970 demands of the developing countries are reflected on the existing law which has been justifiably described as the "Non-Occidental Trend" in international law in the sense that non-western states are struggling for a legal order not based on traditional western concepts but on principles which take into full account interests of the "Have-not" States.[13]

The foregoing analysis should be taken into account while interpreting the position of developing countries regarding diplomatic protection of foreign investment. Policy of developing countries to this effect has been to a great extent predetermined by the practice of Latin American States. It has already been mentioned that home States formulated the institution of diplomatic protection with the motive of protection of interests of its nationals from effects of independent economic policy of the Latin American countries.

Diplomatic protection assumes the character of negotiations, economic and political pressure, or even the form of military intervention. Such protection, according to the opinion of Latin American

11. R.P. Anand, *New States and International Law*. New Delhi, 1972.
12. *ICJ Reports*, 1969, pp. 43-44 176, 227-230.
13. O.E. Bring, *op. cit.* p. 101.

lawyers, is based more on political motives than on questions of legal rights. This compelled the Latin American states to take refuge of the now famous Calvo Doctrine for safeguarding their economic and political sovereignty.

Diplomatic Protection and the Calvo Doctrine

The doctrine has been named after the famous Argentinian lawyer and diplomat C. Calvo. Calvo elaborated his thoughts on the question of diplomatic protection in his book entitled *El Derecho Internacional Teoretico y Practico de Europa y America,* published in 1868. His doctrine is based on two basic principles : firstly, non-interference in the matters of another State and secondly, equality of status according to which no State is obliged to grant foreigners a status more favourable than that which is granted to its own nationals, and consequently, foreign nationals can defend their rights only according to, and with the help of, local means.

The Calvo doctrine, quite naturally, was recognized neither in the USA nor in other western States. Irrespective of this, the Latin American States widely applied this doctrine as much in municipal law (for example Article 27 of the Constitution of Mexico) as in concessions and other investment agreements with foreign element. This doctrine is also consolidated in Articles 50 and 51 of the Andean Code on foreign investment.[14]

This short examination of the Calvo doctrine exhibits that it does not operate from the concept of "Minimum International Standard" and rather establishes, so to say, the "Maximum Standard" upon which the foreign investor can count. All the more, any attempt to render diplomatic protection is considered as violation of sovereignty of the host State. This is one of the reasons, why many western lawyers resist application of this doctrine characterising it to be based on the so called out-dated concept of State sovereignty.[15]

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14. *International Legal Materials,* Vol. II, 1972, p. 126.
15. R.B. Lillich, *op. cit.* p. 362.

It has earlier been pointed out that the position of developing countries to this effect has been reflected in a number of UN General Assembly Resolutions and in the decisions of other International Organisations. It seems that the most important Resolution to this effect is Resolution No. 3281 (XXIX) of 12 December, 1974. Article 2 of this Resolution carries direct imprortance, because it establishes national regime for foreign investment in host countries and deny all possibilities of diplomatic protection by the home State. Article 2(c) further says : Every State has the right to "regulate and control foreign investment within its national jurisdiction ... No State should be forced to grant preferential regime to foreign investors."[16] In our opinion, such resolutions express the *opinio juris* of the absolute majority of the international community, and in that context also represent the *opinio necesatis*, which must have its reflection in contemporary international low. And this deserves special mentioning that although the UNGA resolutions do not have mandatory character, they establish that "International standard" which should be strictly followed in inter-State relations".[17]

Transational Corporations (TNCs) and Diplomatic Protection

Foreign investments by the so-called Transnational Corporations (TNCs) demand special attention, because they account for nearly 90% of all foreign direct investments.[18] So, any question of foreign investment is necessarily also a question of TNCs.

Operations of TNGs in developing countries give birth to very peculiar problems which to a greater extent entangle the question of

16. UN General Assembly, XXIX Session. Official Reports. Suppl. No. 31 (A/9631), N.Y. 1975, p. 66.
17. About this role of UN GA Resolutions see, P. Jessup, "Non-universal International Law", *Columbia Journal of Transanational Law*, Vol. 12, No. 3, N.Y. 1973, pp. 424-425.
18. M. Rahman "Legal Regulation of Transnational Corporations in Sweden", *Nordic Journal of International law*, Vol. 55, Fasc. 4, Copenhagen, 1986, p. 356.

diplomatic protection. In accordance with the spirit of New International Law "application of law in relation to TNCs" is the "exclusive prerogative of the host country."[19] But western States refuse to accept this thesis and propogate the concept of "definite liability of the host State under international law" *vis-a-vis* TNCs. As the basis of this concept lawyers advocate traditional theories formulated during the colonial epoch—theory of "rights of aliens", "respect of acquired rights", "state liability", "diplomatic protection of nationals abroad" etc. etc.[20]

In the opinion of western lawyers any violation of the aformentioned "international standard" tantamounts to "denial of justice" and consequently violation of another principle of international law, namely the principle of "fair and adequate justice"[21] This author maintains that such position of the western lawyers is rather unjustified, because content and principles of international law are in a continual process of change, and in that flow old principles should be replaced by new and modern principles depicting the reality of international relations.

Entry of TNCs to a host State *per se* signifies, that firstly, the TNCs have the right to participate in the economic life of the host State, albeit within permissible limits, and secondly, TNCs fall under the jurisdiction of the host State and are liable to the latter for any deviation from its statutory functions. Contemporary practice of international law recognizes full and exclusive right of the host States to regulate foreign investments including that by the TNCs. The

19. UN General Assembly Resolution No. 3281 (XXIX).
20. See. G. Amador, "International Responsibility, Fourth Report." *Yearbook of International Law Commission*, Vol. 2, N.Y. 1958, p. 1. See also : H.G. Angelo, "Multinational Corporate Groups," *Recuiel des Cours*, 1968, Vol. 125, part III, Leyden, 1970, p. 511.
21. This formulation was first used by the US Supreme Court in the International Shoe Co. vs. Washington case. See 326, *US Supreme Court*, 1945, p. 144.

TNCs for their part, can of course, count on "fair and just treatment" by the host State.

Host State relation *vis-a-vis* TNCs is established upon consideration of specific interests of the host State which in the first place include the creation of a favourable investment climate in the country. The host State, to say the least, is never interested in the withdrawal of investment by the TNCs. Consequently, it would be quite logical to presume, that treatment of the TNCs by the host State can not be anything short of "fair and just" treatment. But the western doctrine testifies to a completely opposite position regarding the issue in question. They maintain, that in cases of "unjust and unfair" treatment of the TNCs by the host State, the home country of the TNCs has the right to diplomatic protection of the corporation. In this regard, the TNC is defined either as "a group of companies or as formation of a foreign law". The point is that, when a TNC is formed as a local company application of local law of the host State to that company is always lawful and unquestionable. But when a TNC is defined as a "formation of foreign law", the definition follows an ulterior motive, namely that of excluding the TNC from the domain of national jurisdiction of the host State. But one can hardly deny that consent on the part of a TNC to invest in any country *per se* signifies its consent to be regulated by the law of that country.[22]

It is well known that functioning of a TNC in a host country is always influenced by the aim of the latter to contend the negative aspects of TNC operations. In the process of regulation of TNC activities, the host country collides with the home country in case of latter's attempt to "protect" TNC interests. It would be logical to ask here which particular State should be considered as the home State? Answar to this question is of utmost importance, because

22. See. C.H. Peterson, "The Law Applicable to the Multinational Corporations from the Perspectives of the United States". *Law in the USA in Social and Technological Revolution*, Bruxelles, 1974, p. 177.

of the fact that the international practice recognizes the "exclusive right of the home country to protect the interests of its corporations". It deserves special mentioning, that the western doctrine has failed to formulate any uniform yardstick to determine the home country.

According to the common western approach the home State is not only that country according to whose law a particular TNC is formed, but also that State whose nationals constitute absolute majority of shareholders of the TNC.[23] This policy is directed towards unilateral protection of TNC interests and that of its patrons and does not take into account those changes which took place in the sphere of determination of nationality of TNCs. This author has shown elsewhere

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The content and principles of International law are in a continual process of change, and should be replaced continually by new ones reflecting the reality of changing international relations.

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that the home State is that "with which the TNC maintains genuine link."[24] But in whichever way the home State is identified, it can never be the State of incorporation of the TNC and State of the majority shareholders simultaneously, rest it is one and the same country. Even as earlier as at the outset of this century, international legal practice recognized the right to protect its corporations abroad only for those States according to whose law the corporation was incorporated.[25] In a more recent case—*Barcelona Traction, Light and Power Co. Ltd.*[26] the ICJ made it clear that nationality of a legal person should not be confused with the nationality of physical persons

23. This approach is followed by F.P. Feliciano, *op. cit.* p. 284.
24. M. Rahman, Problemi Pravovovo Regulirovanie THK vo Razvivauohıkhsa Stranakh. (Problems of legal Regulation of TNCs in Developing Countries) Unpublished Ph. D Thesis, Moscow, 1984. p. 70.
25. Moore, *Digest of International law,* 1906. p. 641-642.
26. *ICJ Reports,* 1970.

appertaining thereto, and interest of the legal person is also distinct from that of the physical persons connected with it. So, the mere fact of belonging of phyiscal persons to a particular State does not confer upon this State the right to grant diplomatic protection to physical person from damages caused to the legal person with which these physical persons possess legal link.[27]

Attitude of the developing countries to the principle of diplomatic protection can be characterized in a word as negative. These states do not want to see their conflict *vis-a-vis* TNCs turn into a conflict *vis-a-vis* home States of the TNCs. With this end in view, many developing countries insert into their investment agreements with a foreign investor the so called Calvo clause[28], which prohibits the TNC to ask its home country for diplomatic protection of its interests. Countering this stand the US, for example, maintains, that although the inclusion of Calvo clause in the agreement might prohibit the TNC, it has no connection whatsoever with the home country which on its own initiative can offer its national diplomatic protection.[29] Moreover, such an initiative is described as corresponding to, and emanating from international law.

We have already seen that international law does not contain such norms. One can talk only of doctrine and not of law. This however, does not imply any oversimplification of the role of international legal doctrine as a source of international law. However, the home State always looks for "legal excuses" for diplomatic protection and in doing so, the principal stress is put upon nationality of property (capital) of the TNC. This technique is applied not only when the

27. Western lawyers show a very sceptical attitude towards such conclusion. See, W. Friedmann et al. *Cases and Materials on International Law*, N.Y, 1969, p. 748.

28. More on this see, I. Delupis, *International Law and the Independent State*, N.Y. 1974, pp. 127-128.

29. R.B. Mehren et al. "Multinational Corporations : Conflicts and Controls", *Standford Journal of International Studies*, 1976, vol. 11, p. 9.

mother company (legal person of the home State) possesses controlling packet of shares of daughter companies (legal persons of host States), but also in cases where it participates as a "junior partner." In the first case it is argued that nationality of the majority or controlling packet of TNC shares defines legality of diplomatic protection of TNC by the national State i. e. the home State. In the second case, it is held that diplomatic protection is accorded not to all the "foreign companies", but only to that of its part which belongs to the mother company—subject of its (foreign company's) rights.[30]

Nationality of private investments abroad by itself does not empower the State of nationality to accord diplomatic protection. Moreover, right to diplomatic protection does not exist if the host State makes available to the TNC all local means for protection of its interests. Quite aptly the ICJ noted that "when a State admits to its territory foreign investment or foreign nationals, she ... is obliged to cover them with the protection of law. Yet, in doing so she does not become a guarantor of that investment, any investment of this type is connected with definite risk. The fundamental question is whether any right is infringed..."[31] The expression "any right" in our opinion indicates the right of the TNC to resort to all local means (offered by the municipal law of the host country) for protection of its interests.

It has been repeatedly pointed out that there exists no international legal norm permitting diplomatic protection of TNC by the home State. Individual cases of existence of contractual norms or arbitral practice when diplomatic protection is permitted should be explained as *lex specialis* and can not be generalised. Sometimes, such protection is admitted in accordance with a special clause inserted into the agreement— the so called "compromis"— which

30. G. Abi-Saab "The International Law of Multinational Corporations, A Critique of American Legal Doctrines", *Annals of International Studies*, Vol. 2, 1971, p. 119.

31. *ICJ Reports*, 1970. p. 46.

empowers the parties to protect respective shareholders.[32] Even in these rare cases, interests of the shareholders have to be differentiated from that of the TNCs[33], since shareholders can be protected only when their individual rights distinct from TNC interests are violated.

Contemporary western legal doctrine on TNCs is characterized by two conflicting tendencies: on the one hand, western lawyers mention "international" character of TNCs and on that ground proclaim international legal subjectivity of TNCs, while on the other, for diplomatic protection of TNCs the same lawyers indicate "national" character of these corporations. Pertinence of a TNC to a particular "national law" (of the home country) is provided as the legal foundation of the theory of diplomatic protection. Western lawyers themselves have emphasized the unscientific nature and vagueness of such interpretation. Abi-Saab deduces that "development of international law certainly cannot be founded on such conflicting and narrow concepts however well-founded and well argumented they might appear to be."[34]

Conclusion

This brief study of diplomatic protection of foreign investment enables us to conclude that this institution in its very core is founded on unequal relations among great western powers and weaker developing states.[35] The traditional international law, in this aspect, deals with questions of protection of foreigners and their investment

32. Abi-Saab, *op. cit.* p. 119.

33. Some western lawyers identify interests of the shareholders with interests of the company itself, which contravenes national law of the majority of States. See A. Bagge, "Intervention on the Ground of Damage Caused to Nationals", *British Yearbook of International Law*, Vol. 34, London, 1958, p. 175.

34. Abi-Saab, *op. cit.* p. 121.

35. P. Nervo, in *Yearbook of the International Law Commission*, Vol. 1, 1957, p. 155.

only.[36] But the "Non-Occidental trend" in contemporay international law manifesting interests of the overwhelming majority of states of the interational community rejects this institution. This, however, does not mean that foreign investors can not expect "fair and just" treatment by the host developing States. On the contrary, for any violation of the alien's rights the foreign investor is free to resort to any pressure permissible under municipal law of the host State or by the agreement for mitigating its losses.

36. O.E. Bring, *op. cit.* p. 102.