PART THREE

PUBLIC POLICY ISSUES

The increasing globalization of transnational corporations (TNCs) and their foreign affiliates[1] has implications for public policy. In particular, the emergence of an integrated international production system is beginning to strain traditional concepts and approaches.

The classical notion of the corporation, initially developed in a different environment but creatively transformed so as to adapt to, and at the same time significantly influence, changing economic and legal conditions, is at the centre of the current *problematique.* As economic boundaries begin to disappear in terms of corporate strategies and TNCs develop complex inter-firm linkages, three interconnected issues, all directly related to the legal effects of the fundamental notions of the legal personality of the corporation, on the one hand, and the functional unity of the enterprise, on the other, appear to need close consideration. They are the subject of the three first chapters of Part Three: corporate nationality, parent-affiliate relations and responsibilities, and the international allocation of taxes on TNCs.

From a legal and public policy perspective, some characteristics of integrated international production are particularly relevant:

- The division of labour between foreign affiliates and their parent firms and among foreign affiliates located in a number of countries, so that specific tasks are the responsibility of particular units of the TNC system.
- The decline of the economic autonomy of each constituent part.
- The increasing difficulty of distinguishing between "parent firms" and "affiliates".

In the light of those changes, it is appropriate to re-examine the concept of the corporate nationality of TNCs since identifying the national origin and attachment of corporations in such a context has become not only more difficult but also less obviously significant. Chapter VIII deals with this subject.

Chapter IX looks at the legal relationship between parent firms and their foreign affiliates, which is becoming increasingly complex as those affiliates lose some of their operational autonomy. In strict legal terms, they remain independent units with limited liability for the results of a production process of which they are an integral part. How far is this still appropriate and realistic?

Nowhere are the consequences of this relationship more clearly felt than in the area of taxation, the subject of chapter X. With business becoming more global, and with more value-adding activities being undertaken by different foreign affiliates spread over many countries, it is increasingly difficult to determine where profits are being earned and what income individual Governments can tax. Moreover, with the integration of value-adding activities among affiliates, the application of methods for the allocation of the business income of TNCs based on arm's-length prices raises complex questions.

Chapter XI discusses, at the level of countries, some of the policy implications of the convergence of foreign-direct-investment policies and the emergence of integrated international production.

Notes

1 As elsewhere in this volume, the term "foreign affiliates" is meant to include subsidiaries (more than 50 per cent equity is controlled by the parent firm) and associates (10 to 50 per cent controlled by the parent firm), which are typically incorporated in their host country as separate legal entities, as well as foreign branches, which are treated in law as integral parts of the parent corporation. In the context of chapters VIII-X, "foreign affiliate" refers only to subsidiaries and associates.

CHAPTER VIII

CORPORATE NATIONALITY

The growth of foreign direct investment (FDI) and the expansion of transnational corporations (TNCs) have been possible partly because of the lowering of national barriers to the movement of goods and services and to the location of factories and offices. More recently, bilateral and multilateral agreements have increasingly held national treatment as the proper standard for foreign affiliates. If this were to become the norm, it would ease the problems associated with the notion of corporate nationality, although the need to determine a firm's nationality would not disappear.

A. The grounds of corporate nationality

In law, it is sometimes necessary to establish a company's national identity in order to determine its legal capabilities, rights and duties. A distinction between domestic and foreign enterprises is also needed where national legislation favours domestic firms or where international law and practice accord a distinctive status to foreign enterprises.

National security considerations are at the root of much of the discrimination against TNCs, such as the closing of certain economic sectors to foreign firms or the privileged treatment of domestic firms for public procurement or subsidies. As long as the international order is based on the existence of sovereign and equal nation states, concern for national security is bound to be at the centre of governmental policies. However, legitimate considerations of national security are sometimes twisted and abused. National security is not a synonym for the national interest; yet it is sometimes construed so broadly as to include most national economic interests. National security is also used as a pretext to justify measures that are, in fact, intended to protect special interests unrelated to security. Beyond these abuses, even a country's genuine national security interests may sometimes conflict with the orderly functioning of the world economy. For example, efforts to expand a home State's jurisdictional grasp to include the foreign affiliates of its corporations may serve legitimate national interests, including national security, but their effects may conflict with the laws and policies of host States. This question of "extra-territoriality" has caused much uncertainty and controversy over the years.

A distinction between domestic and foreign firms is based on several widespread assumptions:

- National borders are deemed of primary importance because they correspond to economic as well as political dividing lines; they separate not only discrete political units, but also discrete national economies. However, this notion is being undermined by the growth of an integrated international production system.
- The economic circumstances of countries (and groups of countries) vary enormously, and these differences should help determine the standards of TNC treatment to which they are held. For developing countries, in particular, the fact that a corporation comes from a developed country may be more significant than its precise national origin. On that basis they may adopt measures to distinguish between domestic and foreign enterprises. However, this conventional wisdom is increasingly being doubted, with many developing countries deciding that equal treatment for all enterprises ("national treatment") is an effective way to attract FDI on appropriate terms.

Whatever the validity of their approach, the fact remains that States still regard nationality as significant, for individuals and for corporations. This fact is so central that it cannot be ignored in a discussion of the topic.

B. Corporate nationality: where and how it matters

In an international order based on the coexistence and cooperation of nation-states, nationality, the legal relationship linking individuals to a particular State plays a pivotal role in law as well as in politics. A person's national identity is an important part of his or her personality. An individual's nationality, the legal manifestation of his or her national identity, is a central part of personal legal status. In international law, nationality (along with territory) constitutes a principal base for the exercise of jurisdiction by States. The general rule, with limited exceptions, is that a State has full jurisdiction over people, goods and activities within its territory—and it also has jurisdiction over people who are its nationals, whether or not they are within its territory.

Since the legal condition of corporations is generally modelled on that of individuals, it is easy to assume that nationality plays a correspondingly large role in their case as well. In fact, corporate nationality raises different legal issues (box VIII.1) and is a significantly different legal notion from nationality. And it is worth noting that, in current policy debate, the term "corporate nationality" is often used to refer to broader notions than the strictly legal one (Reich, 1991; Hu, 1992).

The attribution of nationality to corporations takes place in a variety of policy contexts that reflect the pertinent concerns of States.

Box VIII.1. Legal tests of corporate nationality

No single test of corporate nationality is universally applied today in national and international law. Indeed, in national law there is sometimes no reference to the term or notion of corporate nationality as such, yet the State claims jurisdiction over corporations on the basis of considerations that lead to the same result as nationality. In international law, the issue of corporate nationality arises in relatively few contexts. The criteria most commonly used, separately or in combination, to determine a company's nationality are: the place of incorporation; the location of the "seat" of the corporation; and the nationality of the shareholders who "control" the corporation.

In the *national* legal systems derived from Anglo-American common law, the State of incorporation is the main test of nationality. In most civil law systems of continental Europe and those influenced by them, the test is that of the company's "seat", i.e., the place where the direction and central administration are located. The two tests lead to similar results in the many cases where the seat formally provided for in the corporation's statutes is the place of incorporation. Where the statutory seat does not coincide with the place from which direction is actually exercised, the latter (the "real seat" as distinguished from the statutory one) prevails in many continental legal systems.

The legitimacy of the third test, of "control", is controversial. This test is political in origin, since in many countries it was first used in wartime to deal with locally incorporated companies whose shareholders were enemy aliens. It is still true that the more politically charged an issue, the more likely it is that the test of control will be used. However, the test is used in a variety of regulatory contexts to distinguish between domestic and foreign corporations, in order to restrict the access of foreign companies to particular industries (e.g., air transport, coastal shipping) or to provide privileged treatment (e.g., government subsidies) to local firms. It is also sometimes used by home countries to establish jurisdiction over aspects of the activities of foreign affiliates of corporations owned by their nationals.

The main context in which corporate nationality is relevant in *international* law has traditionally been that of diplomatic protection. The most recent authority, the 1970 decision of the International Court of Justice in the *Barcelona Traction Case* established a rather restrictive test, according to which only "the State under the laws of which [the corporation] is incorporated and in whose territory it has its registered office" has the ability to exercise diplomatic protection (ICJ, 1970). In some of the judges' opinions in this case, and in the extensive analysis of it, other criteria were proposed and discussed (Cafisch, 1971; Ohly, 1983), but they do not seem to have seriously affected established views on customary law. Later decisions, especially the 1989 *Elsi Case*, may have relaxed the standard a little, but the current state of customary law seems to be fairly restrictive (Sacerdoti, 1989; Stern, 1990; Staker, 1991).

The traditional tests have retained their place in the bilateral treaties of some countries and in arrangements for the establishment of TNCs. On the other hand, recent treaty practice in "lump-sum compensation" agreements for nationalized property and in the bilateral investment protection agreements of some large countries has advanced variants of the control test ("substantial interests"), whether independently of the traditional criteria or in combination with them.[a] Outside the strictly legal arena, moreover, classical nationality tests do not count for much. In international relations, where each State seeks to influence the other in order to advance the economic interests of its nationals, the actual control of firms is what counts.

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a For earlier treaty practice of a major country, see Walker (1956); for recent bilateral investment treaties, see Laviec (1985); for "lump-sum" agreements, see Lillich and Weston (1975).

- *Determining the law to be applied.* Host countries attribute a specific corporate nationality to TNCs in order to deal with some common legal problems: whether the corporations have been formed in conformity with applicable legal rules; whether they thereby possess the capacity to contract and to sue and be sued; and what legal rules govern their internal structure and the functions and capacities of their organs. These are all concerns that are strongly influenced by private law, and are often subsumed under the rubric of "lawyer's law". In many cases, they involve routine matters of no great overall significance. But they may affect some important public policy issues, especially where there are significant differences between the company laws of home and host countries.

  Laws on the structure and functioning of corporations seek to regulate what firms do, to protect minority shareholders, to determine the rights of creditors and to clarify the status of all those who come into contact with the corporation. Where there are differences in the approach of home and host countries, the hosts may require additional measures to replace the missing company-law regulations or to ensure legal uniformity. For example, a host State may require all banks and insurance companies operating in its territory to be incorporated therein, i.e., that they operate through subsidiaries rather than through branches. This is intended to ensure that they conform to all local requirements on minimum amounts of capital, protection of creditors and clients, etc. The free establishment of foreign affiliates may be allowed where the national laws of the countries concerned are similar enough to permit mutual reliance. In the context of schemes for economic integration, such as the European Community, mutual acceptance and recognition of the effects of company laws are based on the premise of deliberate harmonization of the relevant basic regulations. In other cases, attitudes may be influenced by the type of home regulation that is applied. For example, branches of banks from States with effective supervision may enjoy a competitive advantage in their foreign operations if they are considered safer by prospective customers. On the other hand, if effective regulation imposes additional costs on enterprises or limits their ability to act in a particular way, corporations from home countries with weak supervision may possess, at least temporarily, a competitive advantage of sorts.

- *Restrictions on TNCs.* Corporate nationality may also matter when a State allows only "domestic" firms to operate in certain industries (e.g., civil aviation, coastal shipping, mining) on national security grounds or in order to ensure national control of economic resources. A State may also reserve various kinds of special treatment (e.g., Government subsidies, public procurement) for domestic firms alone. In such cases, Governments may insist not just on local incorporation, but also on full or substantial control by their nationals.

- *Jurisdiction over companies abroad.* Where the unit involved is a branch of a domestic firm, the claim of jurisdiction will normally be based on its "nationality", according to all traditional tests. Where an affiliate incorporated abroad is concerned, the home State may apply the control test, arguing in effect that foreign affiliates have the nationality of the parent corporation. Such claims of jurisdiction, however, are rarely based on a formal claim about a company's nationality. They tend to be simply asserted with the unspoken assumption that the enterprise is a unity. According to that view, the separate legal personality of a foreign affiliate may, for some purposes, be disregarded: its "corporate veil" may be lifted (see also chapter IX). The approach is reversible for sometimes the host State may also want to lift the corporate veil in order to claim jurisdiction over the parent company. However, the nationality approach cannot be used in that way; it cannot be claimed that the parent company has the nationality of the foreign affiliate because it owns its capital. In another variant of the "enterprise-unity" approach, the home State may formally impose its requirements not on the foreign affiliate itself, but on the parent company, expressly expecting it to discipline its foreign affiliates in any manner it chooses, as long as a the desired results are achieved. Whichever approach is followed, however, it often leads to disagreement between home and host Governments.

- *The international law context.* Corporate nationality is important when a State seeks formally to exercise diplomatic protection over a company or invokes relevant provisions of international treaties (box VIII.1). However, the broadening of the ambit of protection, especially in bilateral investment treaties, through often overlapping provisions on independent grounds (covering, for instance, the rights of shareholders and broad categories of assets) may ultimately decrease the importance of the notion of corporate nationality in investment protection.

C. Integrated international production and corporate nationality

The discussion so far has dealt with corporations operating internationally, under any conditions, even if only a single parent company with a single affiliate in another State is involved. However, modern TNCs typically consist of many legal persons, usually incorporated and operating in different countries. The picture becomes even more complicated by present trends towards integrated international production, because current relations between TNC units no longer necessarily reflect the patterns of hierarchy and subordination that may have applied in the past.

To begin with, the TNC as a whole does not possess a legal personality of its own. It does not therefore possess formal nationality. Only in political terms is it associated with a particular country—its home country or, more accurately, the country of nationality of its parent company or of the company that constitutes its decision-making centre. How far it is possible in law to deal with the TNC as a single entity is still very much an open question. The usual legal approaches limit themselves to establishing links between parents and affiliates, even where successive parent-affiliate pairs are involved.

The component parts of a TNC may be subsidiaries, associates or branches. Branches seldom possess any significant autonomy; they are treated in law as parts of the company to which they belong. Subsidiaries and associates do have some autonomy and are typically incorporated in their host countries (or in a third country) as separate legal entities. For some purposes, therefore, each subsidiary has the nationality of the country where it is incorporated and where it has its seat. For other purposes, however, the fact of control by a foreign company means the subsidiary has a "foreign" character. Thus, each subsidiary may, for some purposes, be treated as possessing two (and conceivably more) nationalities.

When the control test is applied, things may be relatively simple where a 100 per cent subsidiary of a foreign corporation is involved. In some complicated cases, difficult problems arise. For instance, it is not clear how far back in the chain of "parent" companies it is appropriate to reach in order to determine a subsidiary's nationality. Nor is it clear whether it is legitimate to apply more than one test to determine the nationality of each unit in that chain of corporations.

Most legal discussions on TNCs (and, in most cases, national law as well) continue to rely on the initial paradigm of a parent company that owns several subsidiaries. Increasingly, however, TNCs develop into networks in which responsibilities for specific tasks are distributed among various units, and the interdependence brought about by a more sophisticated intra-firm division of labour reduces the autonomy of all participating entities. With management and decisions spread among several parts of a TNC, it becomes increasingly difficult to speak of a "parent firm", although it is clear to which corporate system each unit belongs. When the units are incorporated and administered in different countries, and even more when they are owned by shareholders of different nationalities or are linked to one another by contractual arrangements, it may become factually difficult to attribute nationality to a particular subsidiary; perhaps more important, the attribution may have only a distant connection with reality.

The potential for confusion resulting from such complications is great. In the customary international law of diplomatic protection, for instance, the combination of strictly formal criteria and complex business realities brought, for a time, application of the law to a virtual standstill (Fatouros, 1983). Overall, however, the impact in practice has been rather limited. International legal practice has circumvented round many difficulties by means of the skilful structuring of relevant international instruments and transactions. The developments described, moreover, affect today a relatively small number of TNCs, albeit large and important ones, and their impact is not uniform for all countries and regions.

D. Towards more order and clarity

The issue of corporate nationality raises difficult problems, not just for the law, but also for national and international public policy. One way of easing those problems would be to bring the various national laws closer together. That could happen at two interrelated but still distinct levels: public policy and legislation; and the harmonizing of legal methods and techniques of private law approaches by the courts.

Efforts on the first level could be tied to an important current development, the gradually emerging international legal framework for FDI. Recent developments (see chapter I) generally deal with only one aspect of this framework, the liberalization of access and increased legal protection for FDI. Another major dimension, that of developing standards for the activities of TNCs, has had much attention in the past, but is now somewhat neglected. Yet the combination of both approaches might make the emerging legal framework particularly relevant. Liberalization measures tend, by definition, to reduce or eliminate discrimination against TNCs and treat them on a par with domestic companies. And substantial agreement on international standards for TNCs could serve much the same purposes that national regulation of foreign affiliates seeks to achieve. Those aspects of an international legal framework for FDI might be strengthened by adopting a scheme for international incorporation or registration of TNCs (box VIII.2). Even then, however, it would be wrong to suppose that all the issues of corporate nationality would be resolved.

The second approach for dealing with the issue of corporate nationality is harmonization. Two international conventions, the Hague Convention of 1 June 1956 on Recognition of the Legal Personality of Foreign Companies,[1] and the Brussels Convention of 29 February 1968 on the Mutual Recognition of Companies and Legal Persons,[2] have already considered the topic. However, they both avoid using the notion of corporate nationality, they are both narrowly legal in their focus, and neither of them is in force, because they have not been ratified by enough countries.

In the light of those difficulties, other approaches need to be explored. One approach might be developed along the lines of the efforts of OECD in dealing with the problem of "conflicting requirements" imposed on TNCs. Initially, OECD began by considering the possibility of an overall agreement on matters of conflict of jurisdiction between States, but found that this was not feasible. It therefore adopted a set of "general considerations and practical approaches", that is to say, a body of relevant policy principles, intended to guide the practice of Governments, and a series of procedural suggestions for consultations and other arrangements (OECD, 1992c, pp. 57-71, 119-120).

Box VIII.2. Is international incorporation an answer?

The idea of an international company law for the incorporation of TNCs—which would accord to them a truly international status—has been about for several decades (Ball, 1970). However, with the exception of the discussion in the *Institut de Droit International* in 1977, there has been no thorough study of the topic (Goldman, 1977). The lack of interest comes from a general perception that the idea is impractical: it would be too hard to draft such a statute, presumably in the form of an international convention; it would be unlikely that all major home and host States would agree to be bound by it; and TNCs themselves have consistently opposed it. The chief advantage of such a scheme would be that it would deal with the TNC as a whole, filling the gap of legal regulation at the international level. National laws can be fully effective only within the limits of national jurisdiction. They cannot handle all the truly transnational aspects of TNC activities, and run the risk of jurisdictional conflicts, due to differences in policies or legal approaches. An international incorporation arrangement would presumably establish international public policy, and it would simplify the legal treatment of particular issues.

Those advantages, however, presuppose agreement on the policies to be served by the incorporation mechanism as a whole and the particular legal provisions on company law. It is not obvious that such agreement would by feasible, partly because there has been little preparation for it. Even if the technical difficulties are ignored, national company laws reflect significant policy differences that may be difficult to bridge. To take one example, the efforts to create a *societas europea* in the European Community began in the late 1960s, but have been fruitless so far, because of policy disagreements between the member countries (Stein, 1971; Buxbaum and Hopt, 1988). At the same time, the lack of a federal incorporation statute in some federal countries does not appear to have led to serious practical problems (Rubin, 1973; Buxbaum and Hopt 1988).

In view of those difficulties, less intrusive variations of an international scheme have been suggested. The Goldman report at the *Institut de Droit International* explored the possibility of a registration scheme, which might provide some of the advantages of international incorporation, but on a voluntary basis. For such a scheme to work, both States and TNCs would have to be convinced that they could derive advantages from it, while being protected from any untoward consequences.

Such a scheme might also be linked to the emerging international framework for FDI, in terms of both its chief dimensions, i.e., liberalization and protection of investments and the establishment of standards for TNC activities. The interweaving of standards and procedures concerning national and international policies on FDI and TNCs may render more effective any attempt at ordering the issues discussed herein.

To tackle the question of corporate nationality, it may thus be useful to combine prescriptions with procedures. The prescriptions would not be formally binding; rather, they would be suggestions or recommendations, addressed mainly to national decision makers—lawyers, judges and administrators, as well as legislators and policy makers. They would thus be in the broad area of "soft law", although the machinery and procedures supplementing them might be in somewhat "harder" form. Some prescriptions would have to be reasonably specific and, on occasion, deal with common cases that arise in real life.

A set of drafts could thus be prepared in the framework of the appropriate international agencies. They would cover principles and rules of thumb for the attribution of corporate nationality and its effects, as well as for the exercise of jurisdiction. It might be possible to develop some functional criteria to replace or supplement the traditional legal ones, geared to the novel circumstances arising from the globalization of TNC activities. It might also be possible to indicate cases where the use of particular criteria is more appropriate and those where it would be less (or not) appropriate. The drafts could consider the special situation of developing countries and see how far the various prescriptions are appropriate for them. It might even be possible to formulate principles for limiting the incidence of conflicts of jurisdiction.

These standards and prescriptions would have to be supplemented by provisions for procedures of consultation and even for the settlement of disputes. These procedures, too, would have to be flexible and avoid the appearance of a rigid, quasi-judicial approach.

E. Looking ahead

There is today a widening gap between the increasing globalization of TNCs and the notion of corporate nationality. The control and direction of TNCs is now spreading horizontally, and clear hierarchical links are becoming less common or less functionally important. As a result, the fundamental assumption in law of a relationship of subordination between units of a TNC is less and less consistent with reality. Yet, while the law acknowledges, in specific contexts, the impact of the presence of the TNC on the units that constitute it, it has not yet found a way to deal with the TNC as a single unified whole. Absent "legal personality", the TNC has no formal existence in law, and therefore no identity and no nationality.

Thus far, no acute problems appear to have arisen from this changing pattern. The ingenuity of lawyers has helped to invent ways in which established concepts and rules can be applied to new situations. However, this process requires increasingly complicated planning. After a certain point, it becomes confusing and costly—in a word, counter-productive. Use of the notion of corporate nationality to protect or to regulate enterprises begins to cost too much.

In a world of nation-states, even one with globalized TNCs and an integrated economy, the notion of nationality, for individuals and companies, will not readily disappear. But its consequences will become less important: apart from its formal role of identifying the legal rules applicable to a corporation's formation and personality, corporate nationality as a ground for distinguishing between companies will be used less and less frequently. National treatment will become more common, with whatever variations the differing situations of countries may make necessary. This is the way that States seem to be moving, through their national legislation as well as through bilateral and multilateral instruments. But it will take many years for the change to be completed.

Notes

1 For the text of the Convention, see "Treaty Regarding the Jurisdictional Existence of Corporations, Societies, Associations and Foundations", *Journal of Treaties of the Netherlands*, vol. 131 (1956), The Hague: The Government of the Netherlands Publisher, pp. 1-5.

2 Text in *European Communities Bulletin*, Supplement 13/73 (Brussels, Commission of the European Communities, 1973).