Maastricht University

Managing the Risk of Self-Judging Security Exceptions Through Insurance: How Recent Mergers and Acquisitions Practice Copes with Investment Screening

Citation for published version (APA):

Hagemeyer, T. M., & Pohl, J. H. (2021). Managing the Risk of Self-Judging Security Exceptions Through Insurance: How Recent Mergers and Acquisitions Practice Copes with Investment Screening. *Journal of World Investment & Trade*, *22*(4), 596-625. https://doi.org/10.1163/22119000-12340219

Document status and date:
Published: 16/08/2021

DOI:
10.1163/22119000-12340219

Document Version:
Publisher's PDF, also known as Version of record

Document license:
Taverne

Please check the document version of this publication:

• A submitted manuscript is the version of the article upon submission and before peer-review. There can be important differences between the submitted version and the official published version of record. People interested in the research are advised to contact the author for the final version of the publication, or visit the DOI to the publisher's website.
• The final author version and the galley proof are versions of the publication after peer review.
• The final published version features the final layout of the paper including the volume, issue and page numbers.

Link to publication

General rights
Copyright and moral rights for the publications made accessible in the public portal are retained by the authors and/or other copyright owners and it is a condition of accessing publications that users recognise and abide by the legal requirements associated with these rights.

• Users may download and print one copy of any publication from the public portal for the purpose of private study or research.
• You may not further distribute the material or use it for any profit-making activity or commercial gain
• You may freely distribute the URL identifying the publication in the public portal.

If the publication is distributed under the terms of Article 25fa of the Dutch Copyright Act, indicated by the "Taverne" license above, please follow below link for the End User Agreement:

www.umlib.nl/taverne-license

Take down policy
If you believe that this document breaches copyright please contact us at:

repository@maastrichtuniversity.nl

providing details and we will investigate your claim.

Download date: 05 Jan. 2023

BRILL NIJHOFF

JOURNAL OF WORLD INVESTMENT & TRADE 22 (2021) 596–625

The Journal of World Investment & Trade
Law * Economics * Politics
brill.com/jwit

Managing the Risk of Self-Judging Security Exceptions Through Insurance: How Recent Mergers and Acquisitions Practice Copes with Investment Screening

Teoman M. Hagemeyer | ORCID: 0000-0002-2709-4364
Berlin Adminstrative Court, Berlin, Germany
thagemeyer@zedat.fu-berlin.de

Jens Hillebrand Pohl | ORCID: 0000-0001-7634-4799
Institute of Globalization and International Regulation, Maastricht University, Maastricht, Netherlands
jens.pohl@maastrichtuniversity.nl

Abstract

In light of the limited possibility to seek legal recourse against screening of foreign investments on grounds of national security, can insurance provide an alternative avenue to compensate affected investors? The answer is: Yes, but with caveats. For investors, even if insurance does not provide an equivalent to full reparation, it can serve as a useful mitigant of the risk that contemplated investment transactions cannot be consummated as anticipated due to screening measures. For host States, insurance provides a useful mechanism by which they can facilitate compensation of investors without having to disclose information contrary to their essential security interests and thus a means by which host States can remain attractive to foreign direct investment in spite of investment screening.

Keywords

diplomatic protection – essential security interests – foreign direct investment – geoeconomics – investment screening – screening risk insurance – screening risk

© KONINKLIJKE BRILL NV, LEIDEN, 2021 | DOI:10.1163/22119000-12340219
Downloaded from Brill.com01/03/2023 01:18:51PM
via free access

1 Introduction

National security has entered the centre stage of cross-border corporate mergers and acquisitions (M&A) as host States increasingly intervene to 'screen' foreign direct investment (FDI) involving critical technologies and infrastructure. Investment screening is an administrative procedure, formal to a varying degree, by which a national authority of a host State (screening authority) may, on a case-by-case basis, assess, investigate, authorise, condition, prohibit, or unwind individual FDI transactions on grounds of national security or public order.

Investment screening regimes differ in design, but typically provide for an obligation of investors to notify the competent national screening authority of impending or concluded investments above a certain threshold and in certain sectors of the economy.[1] The screening authority may then decide to open an investigation to assess the effect of the investment on the host State's security interests.[2] At the end of the screening process, the screening authority may decide to authorise the transaction, with or without conditions, to prohibit it, or, in case it has already been consummated, to order its unwinding.[3]

Investment screening in its current form has existed for decades,[4] but so far it could have been regarded as a limited exception to a long-standing trend

1 Some investment screening regulations provide for prior review as a precondition to consummation, while others allow for screening to take place within a period after an investment has been made (cf Gisela Grieger, 'Foreign Direct Investment Screening: A Debate in Light of China EU FDI Flows' (2017) 6 <www.europarl.europa.eu/RegData/etudes/BRIE/2017/603941/EPRS_BRI(2017)603941_EN.pdf> and 'EU Framework for FDI Screening: Briefing of the European Parliamentary Research Service' (2018) 3 <www.europarl.europa.eu/RegData/etudes/BRIE/2018/614667/EPRS_BRI(2018)614667_EN.pdf> both accessed 25 June 2021). Note that the Committee on Foreign Investment in the United States (CFIUS) allows for indefinite review (Gaurav Sud, 'From Fretting Takeovers to Vetting CFIUS: Finding a Balance in US Policy Regarding Foreign Acquisitions of Domestic Assets' (2006) 39 Vand J Transnatl L 1303, 1316; Frederick P Waite and M Roy Goldberg, 'National Security Review of Foreign Investment in the United States: An Update on Exon-Florio and the Final Regulations Which Implement It' (1991) 6(2) Fla J Intl L, 191, 196).

2 Investment review in accordance with a broader set of economic, social, or other policies has become increasingly uncommon. For example, New Zealand employs an 'economic benefit' test (see Overseas Investment Act (2005) s 16(1)(e)(ii) juncto s 17(2)).

3 See eg 50 US Code § 4565 (d)(4) and Daniel Metzger, *Staatliche Kontrolle ausländischer Investitionen in Deutschland, Frankreich, Grossbritannien und den USA* (Lit 2015) 300–01.

4 See Peter Muchlinski, *Multinational Enterprises and the Law* (OUP 2007) 206 ff; OECD, 'Acquisition- and Ownership-Related Policies to Safeguard Essential Security Interests: Current and Emerging Trends, Observed Designs, and Policy Practice in 62 Economies' (OECD 2020) para 23.

Downloaded from Brill.com01/03/2023 01:18:51PM
via free access

towards liberalisation of capital flows.[5] Recent legal developments, however, point towards an expanded use of investment screening and may even indicate a shift away from the 'full liberalisation' trend towards greater national control over FDI. Notably, 2018 saw a significantly enhanced national security review in the United States by virtue of the Foreign Investment Risk Review Modernization Act (FIRRMA).[6] Meanwhile, Regulation (EU) 2019/452 of the European Parliament and of the Council of 19 March 2019 establishing a framework for the screening of foreign direct investments into the Union (EU Screening Regulation)[7] marks the beginning of a common approach to investment screening within the European Union. These developments follow years of steadily increased use of investment screening, including some highly publicised cases, such as the (envisaged) acquisitions of Aixtron SE, Lattice Semiconductor, Qualcomm and Grindr.[8]

Invariably, investment screening involves delicate assessments by host State governments of the nature of their national security interests to which courts and (international) tribunals are not unlikely to pay deference.[9] At the

5 For an overview see, for instance, Maurice Obstfeld and Alan M Taylor, 'Globalization and Capital Markets' in Michael D Bordo and others (eds), *Globalization in Historical Perspective* (University of Chicago Press 2003) 121, 127; Steffen Hindelang, *The Free Movement of Capital and Foreign Direct Investment* (OUP 2009) 31–41; Chester Brown, 'The Evolution of the Regime of International Investment Agreements: History, Economics and Politics' in Marc Bungenberg and others (eds), *International Investment Law* (Beck, Hart and Nomos 2015) 202–34; Kenneth J Vandevelde, 'A Brief History of International Investment Agreements' in Karl P Sauvant and Lisa E Sachs (eds), *The Effect of Treaties on Foreign Direct Investment* (OUP 2009) 3–35.

6 Public Law No 115–232. The law amends the 1950 Defense Production Act, especially s 721 thereof. For a general discussion, see Patrick Griffin, 'CFIUS in the Age of Chinese Investment Notes' (2017) 85(4) Fordham L Rev 1757, 1784–92.

7 Regulation (EU) 2019/452 of the European Parliament and of the Council of 19 March 2019 Establishing a Framework for the Screening of Foreign Direct Investments into the Union (21 March 2019) (EU Screening Regulation) OJ L 79 I/1.

8 See James K Jackson, 'The Committee on Foreign Investment in the United States (CFIUS)', Congressional Research Service (2019) 4, 12–13, 21 <https://crsreports.congress.gov/product/pdf/RL/RL33388/83>; US Department of the Treasury, 'Letter Regarding CFIUS Case 18-036' (2018) <www.sec.gov/Archives/edgar/data/804328/000110465918015036/a18-7296_7ex99d1.htm> both accessed 25 June 2021; Georg Fahrion and Shi Ming, 'Der Staatsstreich' (September 2016) Capital 58–63.

9 The degree of deference varies, as do the techniques employed to effectuate it. In some jurisdictions, deference is achieved by denial of remedy. For example, US courts have no jurisdiction to review the screening measure itself on the merits, see 50 US Code § 4565 (e)(1) (however, section (2) of this provision allows civil actions challenging an action or finding). For the situation in the European Union, see Teoman M Hagemeyer, 'Access to Legal Redress in an EU Investment Screening Mechanism' in Steffen Hindelang and Andreas Moberg (eds), *YSEC Yearbook of Socio-Economic Constitutions: A Common European Law on Investment Screening* (Springer 2020) 795. With respect to investor-State arbitration, see

Downloaded from Brill.com01/03/2023 01:18:51PM
via free access

domestic level, this executive discretion is often safeguarded in host State legislation. At the international level, relevant standards of investor protection in investment treaties are often subject to (sometimes extensive) security exceptions, essential parts of which are (allegedly) of a self-judging nature.[10] Nevertheless, the exact degree of deference that courts and tribunals in a particular case may give to executive determinations is very difficult to predict, leaving a residue of legal uncertainty both for parties to M&A transactions and host States. It is clear, however, that the stakes are high. This is true for investors and target companies certainly, but also for host States, who cannot exclude, e.g., the possibility that an international tribunal requires some degree of transparency on the host State's national-security analysis[11] and that the host State's reputation as an investment destination is tarnished in the process.

Jens Hillebrand Pohl, 'Impact of Investment Treaty Commitments on the Design and Operation of EU Investment Screening Mechanisms' in ibid 725. For a comprehensive review of other devices to achieve deference, ie at the application and post-application stages, see Jorge E Viñuales, 'Seven Ways of Escaping a Rule: Of Exceptions and Their Avatars in International Law' in Lorand Bartels and Federica Paddeu (eds), *Exceptions and Defences in International Law* (OUP 2020) 65–87, ranging from rules on burden of proof, choice of applicable law, exhaustion of domestic remedies, exclusions, and exceptions proper, to excuses or preclusions of responsibility and circumstances precluding wrongfulness.

10 Some investment treaties exclude disputes relating to investment screening from investment arbitration (see eg art 8.45 and Annex 8-C of the Comprehensive Economic and Trade Agreement Between Canada, of the One Part, and the European Union and its Member States, of the Other Part (signed 30 October 2016, provisionally entered into force 21 September 2017) (CETA) OJ L 11/23). However, most treaties rely, if at all, on standard security exceptions, often closely modelled on art XXI(b) General Agreement on Tariffs and Trade (15 April 1994) 33 ILM 1153 or art XIVbis(1)(b) General Agreement on Trade in Services (15 April 1994) 33 ILM 1167. Such standard exceptions have in arbitral case law been analysed as exclusions, ie operating to prevent the application of the substance of the treaty, insofar as the security exception is not self-judging, ie not subject to a subjective necessity requirement (see eg *CMS Gas Transmission Company v Argentine Republic*, ICSID Case No ARB/01/8, Decision on the Application for Annulment (25 September 2007); *LG&E Energy Corporation v Argentine Republic*, ICSID Case No ARB/02/1, Decision on Liability (3 October 2006); *Sempra Energy International v Argentine Republic*, ICSID Case No ARB/02/16, Award (28 September 2007); and *Enron v Argentine Republic*, ICSID Case No ARB/01/3, Award (22 May 2007)). By contrast, self-judging security exceptions are subject to the host State's 'consideration' that an excepted action is necessary to protect its security interests and are therefore not self-executing, see further Pohl (n 9) and generally Stephan W Schill and Robyn Briese, '"If the State Considers": Self-Judging Clauses in International Dispute Settlement' (2009) 13 Max Planck Yearbook of United Nations Law 61.

11 Only recently the WTO Dispute Settlement Body adopted a panel report holding that the obligation to act in good faith under customary international law requires WTO Members not to invoke the security exception as a means of circumventing their GATT obligations and, as a consequence, requires them (a) to act transparently by articulating

Downloaded from Brill.com01/03/2023 01:18:51PM
via free access

From the perspective of parties to M&A transactions specifically, investment screening involves the uncertain prospect of undesirable outcomes, such as prohibition, divestment, conditions, and delays; for them, it is thus a risk. Investment screening can significantly restrict parties' freedom to engage in economic activities, interfere with their rights, and severely change the anticipated economics of a transaction. Specifically, investment screening carries the risk that contemplated transactions cannot be consummated as anticipated (screening risk). The costs associated with screening risk cannot be recovered from the immediate causer of that risk because investors have but limited possibility to seek legal recourse against screening measures. Hence, these costs are allocated between investor (buyer) and divestor (seller).

Out of the current intensification of challenges for investors, a trend in recent cross-border M&A practice has been born: Investors have begun assuming the screening risk from divestors and transferring it to third-party risk carriers by means of insurance.[12]

This article investigates whether such screening risk insurance (SRI) can provide an alternative avenue to compensate affected investors and, if so, how. It finds SRI to be an alternative of sorts, but by no means a substitute for legal redress, because it does not provide an equivalent to full reparation for investors. Nonetheless, this article argues that SRI can serve as a useful mitigant

---

the essential security interests at stake 'sufficiently enough to demonstrate their veracity' and (b) to rely upon the exception only with respect to actions that are 'not implausible as measures protective of these interests' (cf WTO, *Russia – Measures Concerning Traffic in Transit*, Report of the Panel (26 April 2019) WT/DS512, paras 7.134 and 7.135). Although art XXI(b)(iii) GATT was not considered self-judging in its entirety, the expression 'which it considers' was held to allow a WTO Member State 'to determine the "necessity" of the measures for the protection of its essential security interests' under the abovementioned conditions (ibid para 7.146). Instructively Geraldo Vidigal, 'WTO Adjudication and the Security Exception: Something Old, Something New, Something Borrowed – Something Blue?' 46(3) LIEI 203.

12 For instance, Aon plc, which also brokers M&A risk insurance, litigation and contingent liability insurance, offers insurance against (CFIUS) review issues (Aon plc, 'Risk in Review 2019' (2019) 3 <www.aon.com/m-and-a-riskinreview/index.jsp#myModal5>); Reuters also reported that Jardine Lloyd Thompson Group plc has begun brokering such 'CFIUS-risk insurance' covering reverse break-up fees incurred in consequence of blocked or delayed transactions (Olivia Oran, 'Chinese Buyers Seek Insurance to Protect Against Failed US Deals' (*Reuters*, 11 November 2016)); Zurich Insurance Group Ltd includes the risk from CFIUS scrutiny in its risk analysis and recommends 'political risk insurance' (Zurich and EY, 'Borders vs Barriers, Navigating Uncertainty in the US Business Environment' (2018) 2, 17–18, 21 <www.zurich.com/-/media/project/zurich/dotcom/industry-knowledge/geopolitical-risks/docs/borders-vs-barriers-navigating-uncertainty-in-the-us-business-environment.pdf?la=de-de> all accessed 25 June 2021); whether a specific insurance product is available, is not clear.

Downloaded from Brill.com01/03/2023 01:18:51PM
via free access

of screening risk, which makes it an alternative in the sense that it provides at least some compensation. The article goes on to explore the reasons why investors may opt for SRI as a way to manage screening risk instead of, or as a complement to, reliance on legal redress, such as investment arbitration. In conclusion, we find that SRI provides both an alternative non-adjudicative compensation scheme for investors, which relies on the subrogation of claims to third parties (notably political-risk re-insurers and home States) with superior negotiation power, as well as a useful mechanism for host States aiming to remain attractive to FDI flows in spite of heightened investment screening with limited legal scrutiny of their security interests. In that respect, the development could fall into line with nascent trends towards de-judicialisation and home States' aim to regain control as 'masters' of investment treaties in order to minimize risks of liability and exposure to investor-State dispute settlement.[13]

To develop these arguments, Section 2 of this article puts screening risk into the context of M&A practice and explains how that risk is allocated and transferred. Section 3 addresses the usefulness of SRI as a risk mitigant from both an economic and non-economic perspective by comparing it to traditional M&A insurance and political risk insurance. It examines whether SRI is capable of satisfying the theoretical criteria for insurability and thus whether it could be considered true insurance, rather than a paid-up loss fund by another name. In light of these findings, Section 4 analyses the rationale for the actual and potential use of SRI as a risk mitigant. The insurance compensation of SRI is compared to damages as remedies in investment arbitration. It is argued that even if investors were paying into 'false insurance', they may nevertheless gain access to insurers' enhanced bargaining power. Turning to the perspective of host States, we submit that it is in their interest to support SRI as a means of countering possible chilling effects[14] of investment screening on inward FDI flows without compromising their national security interests. Conclusions are drawn in Section 5.

2 Screening Risk

In preparation of a review of exactly what risks parties to M&A transactions allocate (Section 2.1), the following introduces the concept of screening risk employed in this article (Section 2.2).

13 See Rodrigo Polanco, *The Return of the Home State to Investor-State Disputes: Bringing Back Diplomatic Protection?* (CUP 2019) 6, 10, 308.

14 OECD (n 4) paras 345 f ('anecdotal evidence').

Downloaded from Brill.com01/03/2023 01:18:51PM
via free access

2.1 *Conceptualising Screening Risk*

Screening risk describes the uncertain prospect of losses suffered (screening losses)[15] when a contemplated transaction cannot be consummated as anticipated due to a measure adopted by a host State screening authority in application of its investment screening regulations (screening measure).[16]

More generally, the concept of screening risk captures a number of potential unwelcome consequences of investment screening for investor, divestor, and target enterprise. These consequences result not only from the exercise of legal powers by the screening authority, which in many jurisdictions include: suspension of a transaction during the screening process, thus causing delay; placing conditions upon the transaction, thus altering the terms anticipated by the parties; and even blocking a transaction altogether or ordering its unwinding. Of even greater practical importance are the factual powers of the screening authority: Public knowledge of pending or ongoing review of a transaction can lead to investors' withdrawal from a transaction altogether, while the target company may face significant loss of market value as a consequence of such review or denied screening approval.[17]

15 Economically, screening losses normally include direct costs incurred in consequence of the failing or delay of the contemplated transaction (such as contractual penalties or legal fees), but could also include indirect costs (such as lost profits) and loss of opportunity, depending on the nature of the screening measure.

16 This could be expressed as the product of the probability of the risk event occurring (the adverse screening measure) and the expected magnitude of losses in the event that it does (expected loss given the risk event). In theory, '[r]isk is a condition in which there is a possibility of an adverse deviation from a desired outcome that is expected or hoped for.' Emmett J Vaughan, *Fundamentals of Risk and Insurance* (Wiley 1996) 5, for alternative definitions 13–17. Conceptually, risk is commonly understood as 'modellable' uncertainty about a future outcome, as distinguished from uncertainty proper, which is not capable of being the object of a conceptual model (Frank H Knight, *Risk, Uncertainty and Profit* (Hart 1921) 19).

17 For example, when a Chinese investor attempted to acquire almost 20% of the shares in publicly traded US financial services firm Cowen Inc in March 2017, 'delays and uncertainty in securing approval from CFIUS' (Cowen Inc, 'Cowen and CEFC China Announce Mutual Agreement to Withdrawal from Filing with the CFIUS' (2017) <https://investor.cowen.com/news-releases/news-release-details/cowen-and-cefc-china-announce-mutual-agreement-withdraw-filing>) moved the parties to renounce the transaction in November 2017 (The Trade Practitioner, 'CFIUS Filing Withdrawn: China Energy Company Limited and Cowen Inc' (2017) <www.tradepractitioner.com/2017/11/upcomingnew-cfius-filing-china-energy-company-limited-and-cowen-group-inc/>). During a takeover attempt by a Chinese investor, public announcement of the German authorities to re-open the review of the transaction of Germany-based Aixtron SE sealed the deal's fate (Stefan Flaßhoff and Stefan Glasmacher, 'Wankende Verwaltungsakte im Außenwirtschaftsrecht bei Unternehmenskäufen' (2017) 20(3) Neue Zeitschrift für

Downloaded from Brill.com01/03/2023 01:18:51PM
via free access

2.2 *Allocation of Screening Risk*

The necessity of allocating screening risk among parties to M&A transactions arises from the fact that host States assume no portion of that risk. While host States create screening risk, they also shield themselves from potential liability related thereto. Legal remedies against screening measures are (sometimes severely) limited or (in extreme cases) even completely barred, both before State courts and arbitral institutions. While the reasons for, and the extent of the techniques to achieve, this incontestability are beyond the scope of the present article, it should be noted that the material criteria which screening measures are based on, *viz* national security and public order, are for legal and practical reasons either non-reviewable by adjudicators or reviewable only in (at least partial) deference to State choices.[18] In a nutshell, investors faced with adverse screening decisions cannot expect full judicial review of the decision and in any case face some degree of legal uncertainty.[19]

The absence of other voluntary or involuntary risk bearers leaves the risk with the parties to M&A transactions. Every individual allocation of screening risk among them is the result of a negotiation (whose outcome has to observe the boundaries, if any, set by the applicable contract law). In fact, M&A agreements owe their existence, to a considerable degree, to their risk-allocating function.[20] Profit-maximizing investors and divestors will bargain and strive to reflect their respective interests to the highest degree in the M&A agreement.

Gesellschaftsrecht 489; Christoph H Seibt and Sabrina Kulenkamp, 'CFIUS-Verfahren und Folgen für M&A-Transaktionen mit Beteiligung deutscher Unternehmen – und als Modell für die Weiterentwicklung des deutschen Außenwirtschaftsrechts?' (2017) 38(29) Zeitschrift für Wirtschaftsrecht 1345, 1347). Another example is Voltabox AG, which stepped back from acquiring US competitor Navitas Systems after delayed CFIUS approval (Voltabox AG, 'Jahresabschluss 2018' (2018) <www.wiso-net.de/document/JABU__190414048549> all accessed 25 June 2021). See also Helmut Lecheler and Claas F Germelmann, *Zugangsbeschränkungen für Investitionen aus Drittstaaten im deutschen und europäischen Energierecht* (Mohr Siebeck 2010) 171 ff; Richard M Steuer and others, 'Competition Law in Merger Transactions: Managing and Allocating Risk in the New Normal' (2013) 9(1) Competition L Intl 31, 33.

18 Supra nn 9–10. Typically, screening measures involve a self-judging element regarding its substantive legal criteria: Hagemeyer (n 9), cf Pohl (n 9).

19 See supra n 9 and similarly Foreign Investment Law of the People's Republic of China (promulgated on 15 March 2019, effective on 1 January 2020) art 35; for Canada see Muchlinski (n 4) 212, for Australia see Vivienne Bath, 'Foreign Investment, the National Interest and National Security – Foreign Direct Investment in Australia and China' (2012) 34(1) Sydney L Rev 5, 13–14.

20 John C Coates, 'M&A Contracts: Purposes, Types, Regulation, and Patterns of Practice' in Claire A Hill and Steven Davidoff Solomon, *Research Handbook on Mergers and Acquisitions* (Elgar 2016) 29, 30.

Downloaded from Brill.com01/03/2023 01:18:51PM
via free access

Taking on that risk imposes costs on the person bearing it and – assuming risk-aversion – divestors and investors will try to push as much risk as possible to the other party.[21] A glimpse at the default allocation of screening risk (Subsection 2.2.1) serves as the departure point for the ensuing examination of how that risk is typically risk transferred in M&A practice (Subsection 2.2.2).

2.2.1 Default Allocation of Screening Risk

The default allocation of screening risk largely depends on the laws governing the M&A agreement. This article will assume that the divestor is generally under the primary obligation to deliver its ownership rights to (and, if necessary, possession of) the investment to the investor.[22] Upon delivery, the risk passes to the investor. Further, it will be assumed that – prior to the passing of risk – failure to deliver subjects the divestor to some form of remedy toward the investor, such as damages and rescission of the contract.[23]

In this setting, the delay or even prohibition of a transaction due to investment screening amounts to a breach of contract by the divestor, who is unable meet its obligation to deliver. Screening laws have different ways of ensuring compliance of the parties, for instance by nullifying the M&A agreement (e.g. German Foreign Trade and Payments Act 2013 s 15(2)) or by giving the screening authority the power to order divestment (e.g. 50 US Code § 4565(d)(3)). Under said assumptions, the screening risk is by default burdened upon the divestor.[24]

Obviously, this default risk allocation might seem paradoxical. While the material grounds for delay or prohibition primarily lie with the investor, who is vetted according to the applicable screening law (e.g. EU Screening Regulation art 4 (2); 50 US Code § 4565(f)(3), (4), (8), (9)), it is the divestor

21 Joseph V Moreno and others, 'CFIUS Unbound: Foreign Investor Deals Continue to Draw Intense National Security Scrutiny' (1 August 2019) X(306) National L Rev <www.natlawreview.com/article/cfius-unbound-foreign-investor-deals-continue-to-draw-intense-national-security> accessed 25 June 2021.

22 Such obligation seems to be common to many major jurisdictions. See, for instance, Annex I Proposal for a Regulation of the European Parliament and of the Council on a Common European Sales Law (11 October 2011) COM/2011/0635 Final – 2011/0284 (COD) s 91; Uniform Commercial Code (United States) § 2–031; French Civil Code art 1582; German Civil Code Section § 433(1); Japanese Civil Code art 555.

23 Some jurisdictions might free the divestor from its delivery obligation (and the investor of its corresponding payment obligation) if delivery is (legally) impossible due to the screening measure. Yet, even in this setting, the divestor might at least face fault-based damages claims.

24 In jurisdictions where the investor bears the risk as soon as the contract is concluded, the logic applies vice versa.

Downloaded from Brill.com01/03/2023 01:18:51PM
via free access

whose performance is hindered by the screening process or measures based on these very grounds. To be sure, reasons for screening are not exclusively connected to the investor, but can also relate to the target and its significance for national security or State interests, recently also reaching into the political and economic spectrum (see, for instance, 50 US Code § 4565(f)(5): 'international technological leadership'). But, as of now, the practically meaningful grounds for prohibition are predicated upon the foreign investor, whose investment is treated with greater suspicion as compared to domestic investment, which would not be subjected to foreign investment screening.

2.2.2 Contractual Risk Shifting

In view of the above, parties to M&A transactions strive to alter the default risk allocation contractually to their benefit. M&A transactions are primarily governed by the provisions of the M&A agreement in question. The applicable contract law only fills the voids of the agreement (if any). Apart from defining the primary obligations of the parties, typical M&A agreements also include provisions on representations and warranties (R&W), covenants, closing conditions, and termination rights.[25] These provisions are among the most important to allocate risk.[26]

One reaction of M&A practice to the paradoxical default allocation of risk described previously come in the guise of provisions triggering so-called reverse break-up fees. By design, regular break-up fees have to be paid by the divestor to a (prospective) investor if the divestor is unable or unwilling to fulfil an M&A agreement, for instance by accepting a higher bid by another investor.[27] By requiring the investor to pay a reverse breakup fee in case of non-consummation of an M&A transaction due to (contractually specified) reasons tied to the review process, divestors shift the screening risk to the investor. Reverse break-up fees are not uncommon tools of M&A practitioners to alleviate the divestor of certain risks; they are especially used to allocate

25 Florian Kästle and Dirk Oberbracht, *Unternehmenskauf – Share Purchase Agreement* (Beck 2018) 112 ff; Reid Feldman, 'Recent Trends in European SPAs and Comparisons with US Practice' (2016) 17(3) J Intl Business & L 217.

26 For allocation of antitrust risk, see Steuer and others (n 17) 35 ff.

27 Cf Judd F Sneirson, 'Merger Agreements, Termination Fees, and The Contract-Corporate Tension' (2002) Columbia Bus L Rev 573, 575; John C Coates and Guhan Subramanian, 'A Buy-Side Model of M&A Lockups: Theory and Evidence' (2000) 53(2) Stan L Rev 307, 331. Generally, reverse break-up fees have to be paid by the investor for reasons specified in the M&A agreement, for instance due to lack of willingness or ability to complete the transaction, see Afra Afsharipour, 'Transforming the Allocation of Deal Risk through Reverse Termination Fees' (2010) 63(5) Vanderbilt L Rev 1161, 1164.

Downloaded from Brill.com01/03/2023 01:18:51PM
via free access

the risk of failing to obtain antitrust clearance (antitrust risk).[28] Thus, it seems natural that the M&A market reacted to enhanced investment screening activity by applying the tried and tested reverse break-up fee clauses to screening risk. In the context of investment screening, reverse break-up fees are contingent upon the clearance of the transaction by the screening authority, failure of obtainment of which, within a specified timeframe, voids the agreement and triggers a payment obligation of the investor.[29] The few reported fees indicate that (in the United States) the fee level is similar to the market standard for antitrust reverse break-up fees.[30]

A second path to relieve the divestor of risk (without necessarily placing it on the investor) conditions the divestor's obligation to deliver on the clearance of the transaction by the screening authority.[31] Thereby, the divestor is not in breach of contract if such clearance cannot be obtained. Hence, at least if the investor is only obligated to pay the purchase price upon delivery, the clause stalemates the transaction and the parties at least legally share the screening risk.[32]

28 'Antitrust-Related Reverse Break-Up Fees in 2018' (*Thomson Reuters Practical Law*, 2018) <https://content.next.westlaw.com/Document/I1f1da84d6139711e9a5b3e3d9e23d7429/View/FullText.html?contextData=(sc.Default)&transitionType=Default&firstPage=true&bhcp=1Thomson>; John C Coates and others, Reverse Termination Fees in M&A (2018) 6–7 <http://dx.doi.org/10.2139/ssrn.3016785>; Wolfgang Meyer-Sparenberg and Christoph Jäckle, *Beck'sches M&A-Handbuch* (Beck 2017) ch 7, § 30, para 21; Ethan A Klingsberg and others, 'An Updated Look at How M&A Agreements Handle the Risks and Challenges of PRC Acquirors' (2017) <www.clearymawatch.com/2017/08/updated-look-ma-agreements-handle-risks-challenges-prc-acquirors/> all accessed 25 June 2021.

29 Tatyana Shumsky and Nina Trentmann, 'China-Backed Firm Escapes Breakup Fee in Lattice Deal' (*The Wall Street Journal*, 21 August 2017); Klingsberg and others (n 28); Francesca MS Guerrero, 'CFIUS: Deal Considerations Beyond Security' (*Corporate Counsel*, 2018) <www.winston.com/images/content/1/3/v2/136970/Winston-CFIUS-Deal-Considerations-Beyond-Security-Francesca.pdf> all accessed 25 June 2021.

30 See *Thomson Reuters Practical Law* (n 28); for the figures in antitrust context see also Steuer and others (n 17) 35. M&A practice under CFIUS' jurisdiction has seen these types of clauses backed by a requirement to deposit the fee in an escrow account, see Adam O Emmerich and Robin Panovka, 'Cross-Border M&A – 2019 Checklist for Successful Acquisitions in the United States' (2019) <https://corpgov.law.harvard.edu/2019/01/30/cross-border-ma-2019-checklist-for-successful-acquisitions-in-the-united-states/>; Guerrero (n 29); Moreno and others (n 21); John Lash, 'Navigating National Security M&A Deal Risk in US FDI – CFIUS Considerations' (Intralinks, 2019) <www.intralinks.com/blog/2019/06/navigating-national-security-ma-deal-risk-us-fdi-cfius-considerations> both accessed 25 June 2021.

31 Kästle and Oberbracht (n 25) 113–14, 134.

32 This is also the case for clauses that condition the validity of the contract on the approval (for antitrust law, see Daniela Seeliger and Dorothee de Crozals, 'Kartellrecht im M&A

Downloaded from Brill.com01/03/2023 01:18:51PM
via free access

Other tools to shift risk to the investor are conceivable.[33] However, for present purposes, the quoted practice suffices to show that screening risk can be – and is increasingly being – burdened upon investors.

3 Insurance as a Mitigant of Screening Risk

Insurance against screening risk appears to have emerged as an adaptation of existing insurance coverage for R&W breaches in M&A transactions.[34] This development, as well as the differences between SRI and traditional M&A insurance, are addressed first in order to understand the role of SRI as a risk mitigant (Section 3.1). Thereafter, it is established that SRI is a type of insurance against political risk by arguing that the screening risk covered by it is similar to antitrust risk, which is not covered by traditional M&A insurance (Section 3.2). If SRI is a form of political risk insurance, it could be argued that screening risk is, like all political risk, uninsurable. In order to determine SRI's suitability for risk mitigation, it is therefore examined if SRI could be considered true insurance or rather a financial arrangement similar to a paid-up loss fund (Section 3.3). In the latter case, such 'false insurance' is not a risk mitigant in a strictly economic or actuarial sense. Instead, it is argued that by paying into such an insurance scheme, investors gain access to the enhanced bargaining power of the insurers (Section 4).

3.1 *Screening Risk Insurance and Traditional M&A Insurance*

Investors, in the face of a screening risk allocation to their detriment, seek to mitigate the consequences of the contractually agreed risk allocation. While traditional tools of M&A practice offer no solution, SRI seems to be a promising

Prozess' in Christoph Schalast and Lutz Raettig (eds), *Grundlagen des M&A Geschäfts* (Springer 2019) 431, 460–61).

33 For example, clauses defining the standard of effort that investors have to meet vis-à-vis the screening authority in the screening process, see Kästle and Oberbracht (n 25) 137 ff. This avenue of risk moderation involves a stipulation as to which of the parties is to initiate and oversee the investment screening process. However, such clauses alone do not distribute screening risk since they say nothing about which party is liable in case of a negative or delayed screening measure. Thus, such clauses have to be combined with some sort of sanction (eg indemnity provisions) in order to create palpable incentives and effectively allocate the screening risk to the party in charge of overseeing the investment screening process. Another avenue is to stipulate 'ticking fees', ie requiring the investor to pay interest after lapse of a specified date (see Steuer and others (n 17) 37).

34 Also referred to as M&A insurance, representations and warranties (R&W) insurance or warranties and indemnities (W&I) insurance.

Downloaded from Brill.com01/03/2023 01:18:51PM
via free access

alternative. However, a closer look at SRI coverage shows that it differs from traditional M&A insurance in key aspects. These differences qualify SRI as a type of political risk insurance, thereby calling into question its capacity to mitigate risk in economic terms.

The necessity of traditional M&A insurance products arises from the customary use of representations and warranties (R&Ws). Usually in departure from the applicable domestic law, M&A agreements contain R&Ws by virtue of which the divestor, under strict liability, guarantees certain legal, commercial, or factual features of the investment (R&Ws by the investor are also possible).[35] Uncertainty regarding liability from R&W (merger risk) represents a significant risk for the parties.[36] The risk-bearing party has the option of reducing or eliminating the risk by insuring it.[37] Whether the party does so, depends on its risk preferences, a valuation of the risk in face of the probability of the undesirable event, and the potential loss caused by it (and, indeed, the availability and terms of insurance). Given the risk-allocating function of M&A agreements, the popularity of insurance products covering merger risks is no surprise.[38] Insurance products known as 'Warranty and indemnity (W&I) insurance', 'R&W insurance' or – more broadly – 'transactional insurance products (TIPs)' (which are collectively referred to here as 'traditional M&A insurance') cover some of the merger risk burdened upon the investor by alleviating the latter from potential financial liability arising from the M&A agreement.[39] Insurers

35 Feldman (n 25) 222; Mario Schmidt, 'Unternehmenskaufvertrag' in Schalast and Raettig (n 32) 383, 411.

36 Theodore A Boundras and Teri Lee Ferro, 'Representations and Warranties Insurance and Other Insurance Products Designed to Facilitate Corporate Transactions' in Christopher L Culp (ed), *Structured Finance and Insurance: The ART of Managing Capital and Risk* (2006) 764, 765.

37 Culp (n 36) 31–32; Vaughan (n 16) 12, 19 ff.

38 Boundras and Ferro (n 36) 764–76; for a review of the German M&A market, see Dennis Froneberg and Frank Kafka, 'AIG Schadensstudie 2018: Warranty & Indemnity Versicherungen etablieren sich am Markt – Erste Erkenntnisse zu branchenspezifischen Garantieverletzungen' (2018) 29(6) M&A Rev 234; for Asia cf Lizzie Meager, 'M&A Insurance Comes of Age in Asia' (2019) <https://link.gale.com/apps/doc/A583122586/ITOF?u=fub&sid=ITOF&xid=95f22837>; Sean J Griffith, 'Deal Insurance: Representation & Warranty Insurance in Mergers and Acquisitions' (2020) 104(4) Minnesota L Rev 1839; Dean Carrigan, 'W&I Insurance: Current Trends and Its Utility' (2016) Governance Directions 105; a report by Allen & Overy finds that W&I insurance was used on some 70% of private equity exits the firm advised on globally in 2018 (Allen & Overy, 'M&A Insights' (2019) <www.allenovery.com/MAInsights/>). The picture is different with regard to non-private equity exits (see Paragon, '2018 Mergers and Acquisitions (M&A) & Tax Insurance Global Review' (2018) <www.paragonmanda.com/reports/pdfs/Paragon-M&A-2018-Global-Review.pdf> all accessed 25 June 2021).

39 Boundras and Ferro (n 36) 768.

Downloaded from Brill.com01/03/2023 01:18:51PM
via free access

usually charge a premium of 2–3% of the coverage and cap policy coverage at 10–20% of the transaction value.[40]

However, SRI covers a risk that differs fundamentally from the risks that are covered by traditional M&A insurance:

Firstly, screening risk involves a measure of a third person – the screening authority – whereas traditional M&A insurance usually covers risks associated with one of the parties to the transaction. It could be argued, however, that management of such 'external' risks is not entirely new to M&A practice. For instance, the operation of certain businesses requires licences or operating permits, which can be denied or withdrawn by the authorities competent to grant them.[41] Likewise, parties to M&A transactions can anticipate a certain tax treatment of their transaction or tax exemptions for the target, which may not materialise. M&A practice manages some of these risks, especially those concerning tax contingencies, through TIPs.[42]

With a view to these forms of traditional M&A insurance, the recent extension of insurance to screening risk should be expected, and SRI could be argued to be another form of traditional M&A insurance. Having an information advantage with respect to their own situation, which may be relevant to the screening process (e.g. with respect to ownership structure), investors are better placed than divestors to negotiate insurance terms and provide disclosures required by prospective insurers. In exchange for the premium and under the terms of the insurance policy, the insurer alleviates the risk-burdened investor of its potential indemnity vis-à-vis the divestor in case the clearance by the screening authority cannot be obtained (timely and unconditionally). Indeed, potential liability for reverse break-up fees arising from US investment screening can reportedly be insured at premiums between 10–15 % of the fee.[43]

However, secondly, screening risk is different from merger risk in general, in that it involves the risk of non-consummation of the transaction rather than

40 David E Barrett and Scarlet McNellie, 'Representations and Warranties Insurance' (Norton Rose Fulbright, 23 October 2018) <www.projectfinance.law/publications/representations-and-warranties-insurance>; Richard Harroch and others, 'A Guide to M&A Representations and Warranties Insurance in Mergers and Acquisitions' (*Forbes*, 2019) <www.forbes.com/sites/allbusiness/2019/01/23/guide-mergers-acquisitions-representations-warranties-insurance/#135b216267f3> both accessed 25 June 2021.

41 Famous is the case of *Metalclad Corp v United Mexican States*, ICSID Case No ARB(AF)/97/1, Award (30 August 2000) paras 30–36.

42 Boundras and Ferro (n 26) 764 ff.

43 Moreno and others (n 21); Emmerich and Panovka (n 30); Lash (n 30); Olly Jackson, 'Merger Reverse Break Fees Are Here to Stay' (2018) Intl Financial L Rev <www.iflr.com/Article/3800339/Merger-reverse-break-fees-are-here-to-stay.html?ArticleId=3800339> accessed 25 June 2021.

Downloaded from Brill.com01/03/2023 01:18:51PM
via free access

mere post-closing liability. This makes screening risk similar to antitrust risk.[44] Merger control under antitrust law can require parties to obtain approval of the transaction by antitrust authorities (e.g. Merger Regulation[45] arts 4 and 6(1)) It is also not uncommon that antitrust authorities subject merger clearance to conditions (e.g. Merger Regulation arts 6(2) and 8(2)).[46] Moreover, antitrust authorities can veto transactions and even dissolve them after implementation (e.g. Merger Regulation art 8(3)–(4)). In addition, antitrust law provides for enforcement mechanisms at least as effective as those of investment screening.[47]

If parties decide to share antitrust risk,[48] the distribution of risk is subject to provisions in the M&A agreement. In practice, M&A agreements contain risk-handling provisions that crucially inspired those discussed in Section 2.2.2.[49] These provisions usually navigate between the extremes of a so-called 'hell or high water' clauses (requiring the investor to accept any conditions or even divestments imposed by the antitrust authorities) and full-risk bearing by the divestor.[50] Despite the hefty break-up fees for materialised antitrust risk,[51] no insurance is available for antitrust risk to the best of the authors' knowledge,[52]

44 Cf Meyer-Sparenberg and Jäckle (n 28) ch 7, § 32, paras 1–6.

45 Council Regulation (EC) No 139/2004 of 20 January 2004 on the Control of Concentrations Between Undertakings (29 January 2004) (Merger Regulation) OJ L 24/1.

46 Meyer-Sparenberg and Jäckle (n 28) ch 7, § 30, para 20.

47 Closing a transaction prior to regulatory approval – in antitrust parlance: 'gun jumping' – in many jurisdictions entails the danger of being fined significantly (cf Merger Regulation (n 45) art 7 (1), 14 (2)). See eg Autorité de la concurrence, 'Gun Jumping/Acquisition of SFR and Virgin Mobile by Numericable' (2016) <www.autoritedelaconcurrence.fr/user/standard.php?id_rub=629&id_article=2895&lang=fr> or US Department of Justice, 'Justice Department Reaches Settlement with Duke Energy Corporation for Violating Premerger Notification and Waiting Period Requirements' (18 January 2017) <www.justice.gov/opa/pr/justice-department-reaches-settlement-duke-energy-corporation-violating-premerger> both accessed 25 June 2021.

48 Other than that, parties can agree that either is entitled to rescind the contract (without or with monetary consequences) in case merger approval has not been acquired by a specified (drop dead) date. See Kästle and Oberbracht (n 25) 260.

49 Steuer and others (n 17) 35–44.

50 Kästle and Oberbracht (n 25) 259–60. For use of 'hell or high water' clauses in screening context, see Guerrero (n 29).

51 Cecilia Kang, 'AT&T Drops Bid for T-Mobile, Takes $4B Penalty' (*The Washington Post*, 19 December 2011).

52 Directors and officers (D&O) liability insurance covering 'antitrust risk' is available (cf Sarah Downey, Amanda Wait and Lorelie Masters, 'Optimizing Antitrust Coverage in Private Company D&O Policies' (*Lexology*, 2019) <www.lexology.com/r.ashx?l=8UTTAC2> accessed 2 November 2020), but this is no TIP and it is not clear whether such insurance

Downloaded from Brill.com01/03/2023 01:18:51PM
via free access

which – given the availability of SRI – places screening risk in yet a separate risk category.

Unlike antitrust clearance, screening measures are subject to less rigorous and less transparent material criteria, limited procedural rights, limited access to adjudicatory remedies, and a higher degree of deference of adjudicators to host State policy choices (including by declining jurisdiction altogether), translating into less robust safeguards against arbitrary decision making. This uniquely distinguishes screening from antitrust risk, where the application of pertinent laws can draw on a rich casuistry and is fully reviewable by courts. In addition, antitrust risk is – at least nominally[53] – apolitical.[54] To the extent of these differences, and insofar as screening measures constitute political rather than legal measures, SRI constitutes a form of political risk insurance.

3.2 *Screening Risk Insurance and Insurance Against Political Risk*

Qualifying SRI as a form of political risk insurance makes it necessary to delineate what is meant by the term (Subsection 3.2.1). Also, it is important to note the limited coverage offered by SRI as compared to political risk insurance, as this is another important factor for evaluating the suitability of SRI as a risk mitigant (Subsection 3.2.2).

3.2.1 Insurance Against Political Risk

There have been many efforts to define political risk.[55] For the practical purpose of delimiting the coverage of investment insurance, it can be thought of as

---

covers only antitrust risk arising from anticompetitive behaviour (such as abuse of market power) or also merger risk arising from merger review under antitrust law.

53 Cf Muthucumaraswamy Sornarajah, *The International Law on Foreign Investment* (CUP 2017) 110 ff; Thomas W Wälde, 'Investment Arbitration Under the Energy Charter Treaty – From Dispute Settlement to Treaty Implementation' (1996) 12(4) Arb Intl 429, 454; in China, national security concerns form part of the antitrust review, see Andreas Heinemann, 'Government Control of Cross-Border M&A: Legitimate Regulation or Protectionism?' (2012) 15(3) JIEL 843, 849–50.

54 Heinemann (n 53) 859–60; Merger Regulation (n 45) art 21(4). See generally Herbert Hovenkamp, 'Antitrust Policy After Chicago' (1985) 84(2) Michigan L Rev 213; Robert H Bork, 'Legislative Intent and the Policy of the Sherman Act' (1966) 9 The J of L & Economics 7; Richard A Posner, *Antitrust Law: An Economic Perspective* (University of Chicago Press 1976) 211 ff.

55 See eg Panayotis M Protopsaltis, 'Investment Guarantees and Political Risk Insurance' in Markus Krajewski and Rhea Tamara Hoffmann (eds), *Research Handbook on Foreign Direct Investment* (Elgar 2019) 299; Kaj Hobér and Joshua Fellenbaum, 'Political Risk Insurance and Investment Treaty Protection' in Bungenberg (n 5) 1517, 1519; Jason Webb Yackee, 'Political Risk and International Investment Law' (2014) 24(3) Duke J Comp & Intl L 477, 479.

Downloaded from Brill.com01/03/2023 01:18:51PM
via free access

comprising (i) the risk of nationalization, expropriation and confiscation of property, (ii) the risk of host State exchange restrictions, (iii) the risk of political violence, and (iv) the risk of sovereign breach of contract.[56] Yet, it is widely acknowledged that political risk is often used as an omnibus term for a more fundamental and far-reaching concept, which covers the uncertain possibility of losses attributable to any political event, including, but not limited to, instances where State powers are exercised.[57]

Indeed, the exercise of State power is inherently a result of political judgement and political choices, to which the administrative and judicial organs of the State concerned, and even other States, are prone to give varying degrees of deference when interpreting and applying the law.[58] As noted above, screening measures are subject to law, but also to limited contestability. Even where such measures are subject to adjudication, they normally involve host State assessments in matters of public policy, notably national security and public order, to which adjudicators are likely to defer to a high degree. To the extent of such deference, screening measures are political events and the risk attributable to such measures are a kind of political risk.

Investors manage political risk through a variety of partly overlapping techniques. These include (i) self-insurance strategies (e.g. risk assessment, monitoring and diversification as well as capital budgeting), (ii) risk sharing through business operating strategies (e.g. local joint ventures and financing as well as partnering with major foreign banks), (iii) reliance on unilateral host State assurances (e.g. investment charters and domestic investment protection laws), (iv) obtaining mutual assurances from the host State (e.g. by entering into an investor-State contract), (v) reliance on host State international commitments (e.g. international investment agreements), and (vi) risk sharing with third party risk carriers (e.g. guarantees, derivatives, and insurance).[59]

Insurance against political risk, comprising investment insurance, sovereign non-payment insurance, and other cross-border insurance, accounts for a

56 Protopsaltis (n 55); cf Hobér and Fellenbaum (n 55).

57 See Raoul Ascari, 'Political Risk Insurance: An Industry in Search of a Business?' (March 2010) SACE Working Paper No 10, 3 <www.sace.it/docs/default-source/documenti-importati-(pubblicazioni)/wp12_political_risk_xcx-pdf.pdf?Status=Master&sfvrsn=0> accessed 25 June 2021.

58 See generally Viñuales (n 9).

59 For a comprehensive review of political risk mitigation techniques, see Guy Leopold Kamga Wafo, 'Political Risk and Foreign Direct Investment' (Lizenziatenarbeit, University of Konstanz 1998); Ilan Alon and others, 'Managing Micro-Political Risk: A Cross Sectional Study' (2006) 48(5) Thunderbird Intl Bus Rev 623 ff.

Downloaded from Brill.com01/03/2023 01:18:51PM
via free access

small part of the universe of political-risk mitigation techniques.[60] Investment insurance includes investment guarantees issued by public guarantors and political risk insurance underwritten by private political risk insurers,[61] covering political violence, expropriation, contract frustration, wrongful calling of bonds, business interruption, and currency inconvertibility.[62] Sovereign non-payment (non-honouring) insurance covers both the inability and unwillingness of sovereign debtors to honour their obligations, thus both credit and political risk.[63] Political risk is also covered under medium or long-term insurance for credit on private debtors in cross-border trade transactions.[64]

3.2.2 Level of Compensation

An important difference between SRI and conventional investment insurance against political risk concerns the level of compensation. While the former is meant to compensate for costs incurred as a direct result of the failure to consummate an agreed investment transaction, compensation under the latter is based on the standard of damages applicable to delinquencies under international law, which amounts to full reparation in the case of unlawful takings.[65]

However, such comparison is inapposite. A screening measure is not *per se* unlawful under international law. First, unless the M&A transaction is an expansion of an existing investment, the investor may not yet have derived

60 Political risk insurance statistics are published by the Berne Union. Kathryn Gordon, 'Investment Guarantees and Political Risk Insurance: Institutions, Incentives and Development' (2008) OECD Investment Policy Perspectives 91 uses reported new insurance cover between 2003 and 2005 from the Berne Union 2007 Annual Report to calculate the percentage of FDI flows covered by political insurance (with total FDI figures from the 2006 UNCTAD World Investment Report). She finds that the value of investment insurance averaged about 3% of total FDI flows. Replicating her analysis using figures for 2014–2018 from the Berne Union and the 2019 UNCTAD World Investment Report, the authors of this article find that the value of investment insurance averaged about 3.8% and all categories of insurance against political risk about 6.7%. These numbers should be treated with caution given the difficulty in assessing the comparative importance of all risk mitigation techniques, which are not mutually exclusive but are often relied upon in combination.

61 For the distinction between these types of insurance against political risk, see Protopsaltis (n 55) 303.

62 Berne Union, *Berne Union Yearbook* (Berne Union 2018) 31–35.

63 ibid.

64 ibid.

65 This comparison is complicated by the fact that political risk insurance is normally subject to important limitations, including ceilings, risk-sharing provisions, valuation rules, limits, exclusions, covenants and conditions, which result in significant deviations from the level of damages to be expected under international law. See Mark Kantor, 'Comparing Political Risk Insurance and Investment Treaty Arbitration' (2015) 12(6) TDM 455, 456 ff.

Downloaded from Brill.com01/03/2023 01:18:51PM
via free access

rights to protection under an investment treaty by the time the screening measure is made.[66] Second, even if such rights have already vested, investment treaties often contain security exceptions that could be invoked to preclude liability for screening measures.[67] Third, the legal and factual consequences of screening measures can take many forms besides outright prohibition of a contemplated investment, including investigative measures or the imposition of conditions. This brings screening measures as a category further away from regulatory takings. For example, if a screening measure leads to a delay beyond the closing date of an agreed M&A transaction, it does not follow that the investor would have a (viable) claim under international law.

While internationally unlawful screening measures are conceivable in spite of the large leeway that host States enjoy in matters concerning their national security, a right to compensation for future profits as a result of investment screening in violation of international law must nevertheless be considered exceptional. Consequently, screening risk is normally limited to the loss that can be expected from internationally lawful screening measures.

To the extent a screening measure is internationally lawful,[68] investors' compensable loss could not go beyond the *damnum emergens* – the cost of restoring the position of the investor to what it would have been if the investment transaction had not been agreed in the first place.[69] Only where screening violates international law could an investor expect to be placed in the position it would have occupied had the investment transaction been consummated as agreed. In other words, SRI normally compensates investors for the loss of attempting to invest, not for the loss of the investment had the attempt succeeded.

Moreover, compensation as a remedy in investment arbitration differs from the insurance compensation available under political risk insurance and particularly SRI with respect to the level of certainty of compensated amounts. While the standard of compensation in investment arbitration is more

66 Pohl (n 9).

67 ibid. See also supra nn 10–11 above.

68 For example, if an EU Member State's screening authority (nb Canadian investment screening is excluded from the scope of the protections, cf art 8.45 CETA) screens an (already established) investment that is expanded beyond the screening threshold and a fundamental breach of due process, such as a fundamental breach of transparency, occurs in the screening proceedings (cf art 8.10(2)(b) CETA), this might be successfully argued to constitute a breach of the fair and equitable treatment standard.

69 Cf Irmgard Marboe, 'Valuation in Cases of Breach of Contract' in Bungenberg (n 5) 1103 ff. This is the 'full reparations' principle expressed in the *Chorzów* formula, according to which reparation must 're-establish the situation which would, in all probability, have existed if [the act giving rise to the claim] had not been committed', *Case Concerning the Factory at Chorzów* (*Germany v Poland*) (Merits) PCIJ Rep Series A No 17, 47.

Downloaded from Brill.com01/03/2023 01:18:51PM
via free access

generous, not only, as just discussed, are the grounds for compensation narrower (i.e. internationally unlawful acts) and the outcome of an arbitration case always inherently uncertain, but also is there a significant variation in how the standard is interpreted and the amounts awarded.[70] For these reasons, both political risk insurance and SRI offer greater certainty in terms of amounts to be expected in case of compensation and the likelihood of being compensated, which, even though the level of compensation is lower, nevertheless may assist businesses in anticipating transactional risks.

Even if SRI provides adequate compensation for the kind of screening losses that are covered, to assess whether it is an efficient risk mitigant, it remains to be examined if SRI is an economically useful way to manage risk or if it would be equally efficient for investors to self-insure, i.e. set aside own funds, by making provisions on their balance sheets for expected screening losses on foreign investments.[71] This question – i.e. if SRI is true insurance in an actuarial sense – has been raised with respect to political risk insurance and its answer depends on whether screening risk is theoretically insurable.[72]

3.3 *Insurability of Screening Risk*

The extent to which a risk may be insured and the conditions which determine its insurability have been extensively researched.[73] Ultimately, a risk is insurable to the extent that an insurer actually assumes the risk from an insured. To that extent, insurability is a subjective, and thus inherently dynamic, concept.[74] A risk can be considered objectively insurable if it is (subjectively) deemed insurable by all insurers, and objectively uninsurable if (subjectively) deemed uninsurable by all insurers.[75] As an objective concept, the degree of insurability thus describes the extent to which insurers, as a matter of general practice, are willing to assume a particular risk.

70 See Marboe (n 69) 1109–14.
71 See generally Griffith (n 38) 1887 ff.
72 See eg Alberto Tita, 'Investment Insurance in International Law: A Restatement on the Regime of Foreign Investment' (2010) 11 JWT 651, 652, 656; Ascari (n 57) 6 ff; Gordon (n 60) 93.
73 See eg Baruch Berliner, 'Large Risks and Limits of Insurability' (1985) 10 Geneva Papers on Risk and Insurance 313; Alsem and others, 'Insurability of Export Credit Risks' (2003) University of Groningen SOM Research Report 03F07 <http://hdl.handle.net/11370/e84d7ec0-8637-4f45-8dc6-ca63e54bc9b2> accessed 25 June 2021; Christian Gollier, 'Insurability' in Jozef L Teugels and Bjørn Sundt (eds), *Encyclopedia of Actuarial Science* (Wiley 2006) 899–903.
74 Berliner (n 73) 322 ff.
75 ibid.

Downloaded from Brill.com01/03/2023 01:18:51PM
via free access

Theoretical criteria have been devised in an attempt to crystallise the concept of objective insurability, which will be examined in this Section.

It is unsurprising therefore that, not infrequently, theoretically insurable risks may not be insurable in practice.[76] Less intuitive is the fact that insurers also seem to insure theoretically uninsurable risks – i.e. such risks which do not satisfy theoretical criteria of insurability and which would thus be expected to be objectively uninsurable.[77] This is arguably the case with respect to insurance against political risk, which some authors have deemed technically uninsurable as a result of difficulties in defining political risk events in a way that can be expressed in terms of probability of loss or by applying actuarial methods.[78]

The following will examine whether screening risk is theoretically insurable on the basis of the technical criteria of insurability developed in economic and actuarial literature (Subsection 3.3.1), economically insurable (Subsection 3.3.2) and legally insurable (Subsection 3.3.3).

3.3.1 Technical Insurability

Although no universally accepted definition of technical insurability exists, a number of conditions are consistently applied in practice in the insurance industry in order to consider a risk to be technically insurable.[79] Such risk needs to be: (i) assessable, (ii) random and (iii) capable of being mutualised.

First, a risk is assessable if it is possible to quantify, with sufficient accuracy and robustness, the probability of the risk event occurring and the severity of losses given the occurrence of a risk event.[80] This requires that the risk event is precisely defined so that its occurrence can be readily confirmed. It also requires a sufficient body of reliable data on the frequency of risk events and on losses incurred as a result of occurrence of such risk events.

Turning to screening risk, the definition and determination of occurrence of an adverse screening measure should in principle not cause great difficulty. It is possible to stipulate in an M&A agreement a strict time limit within which

76 See OECD, 'Check-List of Criteria to Define Terrorism for the Purpose of Compensation: Recommendation of the Council' (2004) Annex I, Appendix, fn (c) <www.oecdchina.org/OECDpdf/34065606.pdf> accessed 25 June 2021.

77 Tita (n 72) 656 f.

78 See supra n 72.

79 Baruch Berliner, *Limits of Insurability of Risks* (Prentice-Hall 1982); Michael G Faure, 'The Limits to Insurability from a Law and Economics Perspective' (1995) 20 Geneva Papers on Risk and Insurance 454 ff; Göran Skogh, 'Development Risks, Strict Liability and the Insurability of Industrial Hazards' (1998) 23 Geneva Papers on Risk and Insurance 247 ff.

80 OECD (n 76) Annex II, s 3.1.1.

Downloaded from Brill.com01/03/2023 01:18:51PM
via free access

the M&A transaction must have received screening clearance, either as a condition precedent to the closing or condition subsequent following the closing. The non-fulfilment of such conditions, formulated to the liking of an insurer, could constitute a precisely defined risk event.[81]

The task of collecting data on the frequency of such risk events and the severity of losses incurred given the occurrence of such risk events does not differ materially from the task of collecting similar data on other breaches of R&W currently covered under traditional M&A insurance.[82] The frequency of occurrence of different types of screening measures can be quantified on the basis of historical data. Likewise, historical data on reverse break-up fee magnitude in M&A transactions in general could be used to estimate the losses expected in case of a risk event because the expected losses of a failure to consummate an M&A transaction would equal the agreed reverse break-up fee.

Second, with respect to randomness, the occurrence of a risk event must be uncertain, and it must not be possible for the insured to control the occurrence of a risk event.[83] This criterion is also readily satisfiable since the occurrence of a screening measure of a particular material content cannot be controlled at will by the investor, whose main influence on the screening process is its compliance with the screening authority's requests. As long as such compliance is a condition for coverage, the occurrence of the risk event is beyond the control of the insured. To the extent that the criteria for screening are known in detail, such as concerning the ownership structure of the investor, the insurer is in a position to request relevant information from its client and to conduct its own due diligence review as a precondition for extending coverage.

Third, with respect to mutuality, investors exposed to the risk of screening losses must have a mutual incentive to join together to form a risk community within which screening risk can be shared and diversified.[84] Unlike macro-political risks such as currency inconvertibility, political violence and sovereign

81 Cf Frederick E Jenney, 'A Sword in a Stone: Problems (and a Few Solutions) Regarding Political Risk Insurance Coverage of Regulatory Takings' in Theodore H Moran and others (eds), *International Political Risk Management – Needs for the Present, Challenges for the Future* (World Bank 2005) 171, 181 ff. Note however that the existence of an international wrong may determine the compensable loss, but it is not a criterion for technical insurability.

82 Of course, the occurrence of screening measures itself is also empirically measurable, see Theodore H Moran, *Three Threats: An Analytical Framework for the CFIUS Process* (Peterson Institute for International Economics 2009) 7 ff, 41 ff; Paul Connell and Tiang Huang, 'An Empirical Analysis of CFIUS: Examining Foreign Investment Regulation in the United States' (2014) 39 Yale J Intl L 131, 134.

83 OECD (n 76) Annex II, s 3.1.1.

84 ibid.

Downloaded from Brill.com01/03/2023 01:18:51PM
via free access

non-honouring of obligations, screening measures are specific to an investor or an investment. Screening measures are thus idiosyncratic events, similar to antitrust clearance in merger control, the frequency of occurrence and material content of which are mutually independent across a sample of investors and investments. Nothing about screening risk thus appears to prevent investors from forming such a risk community, provided that the risk is economically insurable and thus can be fairly priced.

3.3.2 Economic Insurability

Technically insurable risks may yet not be economically insurable. Whether a risk is economically insurable depends on: (i) the magnitude of maximum potential losses, (ii) the nature of potential losses that are covered, and (iii) the ability to determine an actuarially fair insurance premium.[85]

First, the loss absorption capacity of insurers constitutes a limit to insurability.[86] Being akin to traditional M&A insurance, SRI could be expected to cover losses to the same extent. The maximum potential losses covered under a SRI policy would thus be no different from those under a traditional M&A insurance policy, being limited to an agreed (part of) reverse break-up fee in connection with an M&A transaction. In this respect, SRI differs starkly from natural hazard insurance and some types of political risk insurance, which may involve much greater maximum losses.

Second, to be insurable, potential losses must comply with insurers' qualitative segmentation of risks, or, in other words, the terms and conditions for insurance coverage, including the adopted definitions of trigger events (such as, what is a covered investment, a cover investor, an adverse screening measure, an intolerable delay, etc.) and the extent of coverage.[87] Given that SRI covers reverse break-up fees just like traditional M&A insurance, it is submitted that the nature of the potentially insurable screening losses is comparable to the nature of potentially insurable losses attributable to breach of R&W in M&A transactions generally and that both these types of losses could be covered to the same extent.

Third, for a risk to be insurable, it must be possible for the insurer to gather certain technical characteristics of the risk to be able to calculate

---

85 ibid.

86 René Doff, *Risk Management for Insurance Firms: A Framework for Fair Value and Economic Capital* (Dissertation, University of Twente, 2006) 28–32. In a nutshell, insurers must maintain a minimum level of capital calculated to cover both normal and improbable losses. If maximum potential losses are too high for premiums to cover expected claims, the risk can be said to be economically uninsurable.

87 OECD (n 76) Annex II, s 3.3.

Downloaded from Brill.com01/03/2023 01:18:51PM
via free access

an economically adequate and actuarially fair insurance premium that is both economically justifiable *vis-à-vis* potential insureds and profitable for the insurer.[88] This is not only a problem of appropriately balancing (expected and acceptable unexpected) potential losses to the insurer and the cost of maintaining an adequate level of loss absorbing capital on the insurer's balance sheet and of ensuring adequate profitability after covering the operating costs associated with the insurance product.[89] It is also a matter of ensuring that the resulting premium is fair and adequate from the perspective of the insured. If the premium is too high, lower demand will diminish the pool of insureds and thus the prospects of risk diversification.

In addition, risk mispricing is associated with adverse selection problems.[90] By being more informed of their own risk types, potential insureds are likely to succeed in buying insurance at a premium that is too low given their risk type.[91] Raising premia does not solve the problem since only bad risk bearers would be willing to pay such premia, leading to increased risk for the insurer and thus even higher premia; rather, the solution to this problem is to apply differentiated pricing which in turn requires extensive fact finding about potential insurance buyers.[92]

However, the problems of actuarially fair pricing, taking into account adverse selection, are not unique to screening risk, but also apply to traditional M&A insurance.[93] No obvious reasons exist why adequate and actuarially fair premia could not be set that could be considered as economically justifiable by potentially insured foreign investors. Indeed, the existing examples of SRI allow for the conclusion that buyers and sellers of insurance have been able to find mutually acceptable insurance premia.

3.3.3 Legal Insurability of Screening Risk

Whether a risk is insurable also depends on the applicable insurance law and the decisions of insurance regulators.[94] Certain risks that are technically or

88 See supra n 83.
89 ibid.
90 OECD, *Policy Issues in Insurance: Terrorism Risk Insurance in OECD Countries* (OECD 2005) 116 ff.
91 ibid.
92 ibid.
93 Griffith (n 38) 1911 ff.
94 Christian Biener and Martin Eling, 'Insurability in Microinsurance Markets: An Analysis of Problems and Potential Solutions' (2012) 37 Geneva Papers on Risk and Insurance 77, 91; Jan H Holsboer, 'Insurability and Uninsurability: An Introduction' (1995) 20 Geneva Papers on Risk and Insurance 407, 408; Arend J Vermaat, 'Uninsurability: A Growing Problem' (1995) 20 Geneva Papers on Risk and Insurance 446, 447 ff.

Downloaded from Brill.com01/03/2023 01:18:51PM
via free access

economically insurable may be the subject of mandatory insurance.[95] Insurance premia may be regulated.[96] Moreover, certain risks that are technically and economically insurable may be uninsurable because of laws or regulations restricting the underwriting of such risks.[97] With respect to the novelty of SRI, it is not surprising that laws addressing such insurance do not exist. Nor do insurance regulators appear to have issued any rules or guidelines with respect to such insurance.

4 Solving the Insurability Conundrum: Insurance as Political Leverage?

From the analysis so far it is clear that, although plausible arguments can be devised in support of the proposition that screening risk is capable of being regarded as technically, economically, and legally insurable, its degree of insurability can be questioned. In other words, insurability is not, conceptually speaking, the 'yardstick' to compare SRI with legal remedies as means of managing the risk of investment screening. While one could expect some insurers to regard SRI as 'true insurance' built on actuarial principles, one could also expect others taking the opposite view. Therefore, if SRI is not true insurance, then what is it? And is it useful for risk mitigation after all or, if not, why else could investors be expected to obtain SRI?

One way of conceptualising insurance against uninsurable risks is that it is not true insurance, but a paid-up loss fund (risk pool).[98] However, setting aside funds for future loss coverage in a pool together with other investors without risk sharing in an actuarial sense could simply be replicated by self-insurance.[99] It can therefore not be argued that such 'false insurance' is an efficient mitigant of risk in a strictly economic or actuarial sense. Why pay into an external loss fund instead of simply provisioning internally? Why would it be cheaper to draw funding from such a loss fund in case of a risk event, rather than drawing on an ordinary line of credit? The indicated explanation is that the rationale for false insurance must be primarily of non-economic nature.

95 Christian Biener and others, 'Insurability of Cyber Risk: An Empirical Analysis' (2015) 40 Geneva Papers on Risk and Insurance 131, 146; Vermaat (n 94) 449.
96 Ray Rees and others, 'Regulation of Insurance Markets' (1999) 24 Geneva Papers on Risk and Insurance 24, 55, 56; Vermaat (n 94) 450.
97 Biener and Eling (n 94) 91; Vermaat (n 94).
98 Tita (n 72) 657.
99 See supra n 71.

Downloaded from Brill.com01/03/2023 01:18:51PM
via free access

Following such line of reasoning, it is not difficult to envisage that investors' purchase of SRI may not just be motivated by an interest in arranging for potential future compensation in case of losses stemming from investment screening. Another explanation is that they obtain SRI as a means to obtain a negotiation advantage, both with respect to the divestor and target company and with respect to the host State. SRI relieves the divestor and target of the transactional risk, as discussed above.[100] At the same time, however, SRI is also a means of obtaining support for the transaction from a reputable and powerful third-party guarantor. Indeed, it has been argued that political risk insurance is really a modern form of diplomatic protection or a means to obtain political leverage by transferring a (future) claim against a host State to a powerful insurance company, which (by means of subrogation clauses in investment treaties) may pursue insurance reimbursement claims against host States.[101] The same logic may apply to SRI. Investors would turn to SRI as a means of enhancing their bargaining power *vis-à-vis* host States.

From the perspective of the home State, the availability of SRI offers an alternative tool to promote outbound foreign investment while at the same time asserting its own regulatory autonomy. This is because home States are often political risk re-insurers of last resort and may thus indirectly support SRI in respect of the screening risks to which its outbound investors are exposed overseas, just like home State re-insurance of investment insurance, sovereign non-payment insurance, and other kinds of insurance against political risk.[102] Thus, by supporting SRI, the home State is in a position to effectively (albeit not *de jure*) offer 'conditional' diplomatic protection to its nationals investing overseas, to control the screening risk taken by them, and generally provide regulatory incentives for outbound FDI flows.[103]

Viewed from this perspective, SRI is part of an alignment with a recent trend of home and host States to joining efforts to regain control over investment treaties in order to safeguard their regulatory space and curtail their exposure

100 See supra Section 3.2.2.
101 Tita (n 72) 653 ff.
102 Protopsaltis (n 55) 313 ff.
103 The role of insurance is here as a 'surrogate regulation' mechanism, where the insurer attempts to control the risk allocation by means of shaping the insureds' incentives for prevention and precaution, which in turn is achieved through the insurer's methodology for risk assessment, its ongoing inspections, and its risk management assistance to the insured. As such, political risk insurance can be regarded as a means of a (transnational) private legal ordering of rights and obligations. See Omri Ben-Shahar and Kyle D Logue, 'Outsourcing Regulation: How Insurance Reduces Moral Hazard' (2012) 111 Michigan L Rev 197, 200 ff; Kenneth S Abraham, *Distributing Risk: Insurance, Legal Theory, and Public Policy* (Yale UP 1986) 57–63.

Downloaded from Brill.com01/03/2023 01:18:51PM
via free access

to investment arbitration.[104] In this context, SRI could be understood as a geo-economical policy tool. Specifically, insurance provides a range of regulatory techniques that allow insurers to control the behaviour of the insured, from differentiated premiums, variable insurance terms (such as ceilings and dedictibles), imposing behavioural codes, to techniques influencing government regulation.[105]

This is not to suggest that home States today actually view political risk insurance or SRI, as a 'surrogate' regulatory mechanism or geoeconomic tool, but only that it could be utilised in such way. Indeed, investment insurance generally has been a neglected lesser alternative to investment treaties and arbitration as means to regulate foreign investment. Nevertheless, the possibility of deploying investment insurance, including SRI, in this manner cannot be ignored. As Polanco has persuasively argued, home States have been reasserting their control over foreign investment in the recent past. If this trend is to endure, investment insurance may yet have a second lease of life, particularly in light of the fact that investment insurance is an essentially unilateralist alternative to investment treaties in times of challenges to multilateral consensus. At the same time, the home State remains nominally out of the picture, since, unlike investment treaty protections, SRI is a private contract between an investor and an insurer.

To assess whether investors currently look to SRI as a means of contracting a conditional access to home State-backed superior bargaining power, it remains to reconcile this hypothesis with the expectation that the existence of subrogation clauses in investment treaties between the insured's host States and the home State is a *sine qua non* underwriting criterion for political risk insurance (and SRI). Empirical studies have shown that the existence or content of investment treaties do not play a crucial role in the underwriting process and that it is exceptionally rare that such treaties have a decisive impact on political risk coverage or pricing.[106] This may indicate a contradiction yet to be investigated, or merely the possibility that the regulatory role of political risk insurance is independent of, and co-existant with, the investment treaty regime.

Taken together, it seems that the question whether, or to what extent, screening risk is insurable could be settled by empirical evidence of the relative

104 See Polanco (n 13) 308 ff.

105 See generally Ben-Shahar and Logue (n 103).

106 Lauge N Skovgaard Poulsen, 'The Importance of BITs for Foreign Direct Investment and Political Risk Insurance: Revisiting the Evidence' in Karl Sauvant (ed), *Yearbook on International Investment Law and Policy* 2009–2010 (OUP 2010) 539.

Downloaded from Brill.com01/03/2023 01:18:51PM
via free access

importance of investment treaty protections and subrogation rights for the SRI underwriting process. While political risk appears theoretically insurable, and thus capable of being subjectively insurable – with the consequence that political risk insurance is capable of being designed as true insurance –, the alternative explanation of SRI enhancing bargaining power could be relevant, nevertheless. In either case, SRI may be a means to mitigate screening risk, either economically or politically.

This leaves the question of the role of SRI from the perspective of the host State. The fact that an investor is protected by SRI, or political risk insurance generally, does not exclude the exposure of the host State to the risk of investment arbitration. Nevertheless, the advantages of SRI for the investor compared to investment arbitration – speed, greater certainty of outcome, lower but more certain payout – probably reduce the incentive of the investor of pursuing claims via arbitration, e.g. in the event that the relevant investment treaty does not provide for subrogation. In the event of subrogation, the risk of arbitration probably remains. Given, as has just been discussed, that home States usually provide re-insurance of political risk insurance, we are indeed faced with something that looks very much like a return of diplomatic protection, but with insurance companies as go-betweens and investment arbitration instead of interstate arbitration as adjudicatory remedy.

This is problematic from a host State perspective because, despite the deference that an investment tribunal may (often) be inclined to accord to executive determinations of the host State on matters of national security, the host State is still exposed to the risk of being drawn into arbitration proceedings. This involves above all litigation costs, but also negative publicity, including potential damage to the host State's reputation as an investment destination. Moreover, arbitration exposes the host State to the risk of being compelled to articulate (or even disclose) its national security concerns or of refraining from relying on facts, arguments, or evidence that would reveal sensitive information, and thus being unable to defend itself effectively.[107]

5 Concluding Remarks

This article argues that SRI is a hybrid insurance product, borrowing features from both traditional M&A insurance and political risk insurance. For investors, even if SRI does not provide an equivalent to full reparation, it can serve as a useful mitigant of screening risk either economically, offering a

107 See supra n 11.

Downloaded from Brill.com01/03/2023 01:18:51PM
via free access

certain but lower payout, or politically, as a means of obtaining enhanced bargaining power.

Parties to an M&A transaction have to consider the possibility of investment screening and factor potential outcomes into their decisions, which, from an economic perspective, adds to transaction costs.[108] Thus, all things being equal, host States employing investment screening raise the cost of foreign capital for the economic sectors concerned.[109] From the perspective of investors, investment screening raises the price of target enterprises in the screening host State. Allocation of screening risks and costs associated therewith is managed on a case-by-case basis in the process of negotiation between the parties to the investment transaction, the outcome of which is dependent on countless factors.[110] Thus, there is no generally applicable optimal risk allocation and no *passe-partout* advice for parties.

However, from the insight alone that screening risk is isolable, transferable and insurable, host States providing only limited legal remedy against screening measures could support the use of SRI in analogy to trade-related assistance designed to reduce export-related risk, such as political developments or exchange rate movements.[111]An optimal sharing of screening risk through insurance may minimise the negative impact of screening on corporate values and thus the economic cost to the host State of maintaining an investment screening regime.

In this respect it is noteworthy that recovery of damages from the host State is not an essential feature of SRI, the first of which was underwritten in the United States, where no effective domestic judicial recourse exists against decisions by CFIUS.[112] Moreover, the existence of arbitral recourse under investment treaties is irrelevant to political risk insurance underwriting. While antitrust risk remains uninsurable, it is certainly not because of lack of judicial

108 Fundamentally, Ronald H Coase, 'The Nature of the Firm' (1937) 4(16) Economica 386, 392; cf also Jonathan Law, *A Dictionary of Finance and Banking* (OUP 2018) 'transaction costs'; Arnold Picot, 'Transaktionskosten' (1985) 45(2) Die Betriebswirtschaft 224.

109 Cf Eric A Posner and Alan O Sykes, *Economic Foundations of International Law* (Harvard UP 2013) 288–89.

110 See Stefano Caselli and Giulia Negri, *Private Equity and Venture Capital in Europe* (Academic Press 2018) 188.

111 See Egon Tuchtfeldt, 'Exportförderung in der Marktwirtschaft' (1984) 35(2/3) Jahrbuch für Sozialwissenschaft 198, 206–08; Hans Janus, 'Exportkreditgarantien des Bundes: Exportförderung mit Hermesdeckungen auch in Zeiten der globalen Wirtschaftskrise' (2010) Zeitschrift für die gesamte Versicherungswissenschaft 335, 336–39.

112 *Ralls Corporation v Committee on Foreign Investment in the United States*, DC Cir (United States) 758 F.3d 296, Opinion (15 July 2014) 14–18 found that only procedural matters are justiciable, not presidential decisions (see supra n 9).

Downloaded from Brill.com01/03/2023 01:18:51PM
via free access

remedies. For these reasons, host States may promote SRI on inbound investments without the necessary implication of having to subject themselves to the risk of adjudicatory proceedings that may compromise their national security. In this context, SRI fits into the recent efforts of not only home States but also host States to reassert their control over foreign investment.

Acknowledgments

The authors wish to thank Alberto Tita and Joachim Pohl for constructive comments on an earlier draft of this article which was presented at the 'International Economic Law and Security Interests' (IELSI) Conference, Amsterdam, in November 2019. Any remaining errors are solely attributable to the authors.

Downloaded from Brill.com01/03/2023 01:18:51PM
via free access