

Reforming Shareholder Claims in ISDS

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Julian Arato, Kathleen Claussen, Jaemin Lee & Giovanni Zarra

INTRODUCTION

1. Arbitral tribunals have generally interpreted investment treaties as granting shareholders wide access to investor-state dispute settlement (*ISDS*). By covering shareholders in a local company as “investors,” most investment treaties afford them an international private right of action to sue host States for treaty breach. However, few treaties specify what kinds of claims shareholders can bring, and under what circumstances.¹ Though controversial, ISDS decisions have for the most part found that a shareholder’s right of action includes not only *direct* claims (e.g., for seizure of shares, interference with dividends, or total expropriation of the firm), but also claims for *shareholder reflective loss* (*SRL*): claims over injuries to the company which consequently diminish share value.²
2. ISDS stands alone in empowering shareholders to bring claims for reflective loss. National systems of corporate law generally bar reflective loss claims for strong policy reasons bearing on the efficiency and fairness of the corporate form.³ Similarly, international jurisdictions mostly refuse to entertain SRL claims.⁴ Only ISDS tribunals allow

¹ Julian Arato, *The Private Law Critique of International Investment Law*, 113 AM. J. INT’L L. 1, 4, 32–34 (2019).

² See David Gaukrodger, “Investment Treaties and Shareholder Claims for Reflective Loss: Insights from Advanced Systems of Corporate Law” 15 (OECD Working Papers on International Investment, 2014/02); Vera Korzun, *How International Investment Law Changes Corporate Law and Governance*, 40 U. PA. J. INT’L L. 189 (2018).

³ English Law has prohibited reflective loss claims since *Foss v. Harbottle*, (1843) 67 ER 189. In the leading case of *Johnson v. Gore Wood Co.*, Lord Millet explained the unambiguous policy behind the principle:

If a shareholder is allowed to recover in respect of [reflective] loss, then either there will be double recovery at the expense of the defendant or the shareholder will recover at the expense of the company and its creditors and other shareholders. Neither course can be permitted. ... Justice to the defendant requires the exclusion of one claim or another; protection of the interests of the company’s creditors requires that it is the company which is allowed to recover at the exclusion of the shareholder.

[2000] UKHL 65; [2002] 2 A.C. 1, 62 (Lord Millet). Courts apply similar restrictions for similar reasons across common law jurisdictions. See, e.g. *Gaubert v. United States*, 855 F.2d 1284 (5 Cir. 1989) (United States); *Hercules Management Ltd. v. Ernst & Young*, [1997] 2 S.C.R. 165 (Canada); *Gould v. Vaggelas*, [1984] H.C.A. 68 (Australia); *Waddington Ltd. v. Chan Chun Hoo* [2009] 4 HKC 381 § 49 (Hong Kong). In civil law countries, SRL is similarly prohibited by statute or case law. See, e.g., Italian Civil Code, art. 2395 (Italy); Company Law, arts. 847, 423 (Japan); the *Girmes* case, BGH 20.03.1995, BGHZ 129, 136, 166 (Germany); Cour de cassation, chambre commerciale, No. 97-10886 (15 January 2002) (France); *Poot v. ABP*, Hoge Raad, 2 December 1994, NJ 1995, 288 (Netherlands) (with narrow exceptions where the wrongdoer and shareholder are in privity). See further Gaukrodger, *supra* note 2; Bas de Jong, *Shareholders’ Claims for Reflective Loss: A Comparative Analysis*, 14 EUR. BUS. ORG. L. REV. 97 (2013); Korzun, *supra* note 2. However, in most of these jurisdictions, shareholders do have limited rights to bring derivative claims—*on behalf of the company* and *with recovery due to the company*—where, for example, directors or management have a conflict of interest in the dispute. See Gaukrodger, *supra* note 2, at 19.

⁴ The International Court of Justice (*ICJ*) has held that customary international law prohibits diplomatic protection for SRL claims, and that a shareholder’s national State can invoke diplomatic protection only if the shareholder suffered a direct injury. See *Barcelona Traction, Light and Power Company, Limited (Belgium v. Spain)*, Judgment, paras. 46 & 47 (1970); and *Ahmadou Sadio Diallo (Republic of Guinea v. Democratic Republic of the Congo)*, Judgment, para. 87 (2007) (denying diplomatic protection for SRL even where the shareholder is sole owner). The ICJ has acknowledged, however, that States can opt out of the customary no-SRL rule. See, e.g. *Case*

shareholders broad and regular access to seek relief for reflective loss. Moreover, their openness to SRL is neither necessitated by treaty text, nor, on balance, beneficial in policy terms. The availability of SRL claims in ISDS ultimately harms States and investors alike. In the short term, it imposes surprise *ex post* costs on States and various corporate stakeholders (particularly creditors).⁵ In the long run, it creates perverse incentives likely to raise the cost of doing business *ex ante*.⁶

3. At its 37th session, UNCITRAL Working Group III (*WGIII*) indicated that it would continue to study shareholder claims as a possible subject of reform. The problems posed by SRL relate strongly to numerous concerns expressed by States, and already on *WGIII*'s agenda, including inconsistency, multiple proceedings, finality, duration and costs. This paper aims to support *WGIII* and the UNCITRAL Secretariat in rethinking reflective loss. It *first* explains ISDS tribunals' permissive approach to SRL. *Second*, it sets out the harms caused by allowing ISDS claims for reflective loss. *Third*, it explores possible justifications for allowing SRL claims in this context. We suggest, however, that potential benefits of SRL can be realized through less invasive means. *Fourth*, this paper explores how States and tribunals have sought to mitigate problems associated with SRL. While important, these solutions have mostly proven irregular, inconsistent, and incomplete. *Fifth*, this paper concludes by setting targets for reforming shareholder claims in a balanced manner, taking into account the diversity of interests at stake.
4. A follow-up report will present *WGIII* with a series of options for reforming the structure of shareholder claims in ISDS. Even at this stage, it bears emphasizing that no option will be a perfect fix. Potential solutions here should be understood as imperfect alternatives, each with its own tradeoffs.⁷ Without advocating for any particular reform, these papers seek to help ground the reform process by clarifying the objectives, and comparing concrete alternatives.

SHAREHOLDER CLAIMS IN ISDS

5. The vast majority of investment treaties define their ambits broadly. They typically incorporate broad definitions of "investment," capacious enough to include both

concerning Elettronica Sicula S.p.a. (United States of America v. Italy), Judgment, 1989, paras. 106, 132–33 (accepting in principle that treaties can authorize diplomatic protection for SRL as *lex specialis*, without deciding whether the bilateral treaty in question actually did so); *see also Barcelona Traction*, para. 90; *Diallo*, para. 87. The European Court of Human Rights (*ECtHR*) takes a softer approach. In general, it also denies shareholder standing to claim for SRL under the right to property, at Article 1 of Protocol 1 of the European Convention on Human Rights (*ECHR*). However, the *ECtHR* allows several exceptions. *See e.g., Agrotexim and others v. Greece* (1995) Series A no. 330, para. 66 (permitting "piercing of the 'corporate veil'... where it is impossible for the company [itself] to apply to the Convention institutions"); *GJ v. Luxemburg* App no. 21156/93, para. 24 (*ECtHR* 26 October 2000) (allowing an SRL claim by a 90% shareholder where the company was in liquidation and the claim involved the actions of the liquidators); and *Ankarcrona v. Sweden* (2000) *ECHR* 2000-VI (allowing a sole owner to bring an SRL claim, reasoning that there would not be competing interests within the company). *See further* De Jong, *supra* note 3, 104.

⁵ David Gaukrodger, "Investment Treaties as Corporate Law: Shareholder Claims and Issues of Consistency," 34–47 (OECD Working Papers on International Investment, 2013/03); Arato, *supra* note 1, at 37, 39; Korzun, *supra* note 2.

⁶ *See* Arato, *supra* note 1, at 38–39; Gaukrodger, *supra* note 2, at 29.

⁷ *See* Sergio Puig & Gregory Shaffer, *Imperfect Alternatives: Institutional Choice and the Reform of Investment Law*, 112 AM. J. INT'L L. 361 (2018).

enterprises, and stocks or shares in an enterprise.⁸ They generally define “investors” as natural or legal persons with the nationality of one party and with an investment in the other. And they entitle covered investors to invoke ISDS to enforce the host State’s treaty obligations—to claim redress for treaty breaches that affect the value of their investment. However, they usually do not specifically authorize shareholder-investors to claim relief for reflective loss.

6. ISDS tribunals tend to accept that, taken together, these provisions empower shareholders-qua-investors to bring ISDS claims against host States for any treaty breach that harms them—whether directly (e.g., seizure of shares or total expropriation) or indirectly (SRL). Still, it is not clear that investment treaties are best interpreted as departing from the near-universal “no-SRL” rule in domestic corporate law and customary international law.⁹ While investment treaties clearly ascribe to shareholder-investors *some* right to invoke ISDS, they usually say nothing about *what kind of access* shareholders should have. This ambiguity can be interpreted narrowly to allow only shareholder claims for direct loss.¹⁰ Yet ISDS tribunals frequently adopt a permissive approach—accepting that the typical investment treaty authorizes SRL on its face by simply including stocks and shares in the definition of investment.¹¹
7. As a consequence of ISDS tribunals’ permissive approach to SRL (the “pro-SRL interpretation”), investment treaties expose the States parties to multiple (potentially limitless) claims in relation to a single dispute. The firm and its individual shareholders may all bring suit over the same alleged treaty breach. And most treaties require neither that such claims be joined nor that they be brought simultaneously.¹²

⁸ See, e.g., Germany—Russia BIT, Art. 1(a) (“The term ‘investment’ shall apply to all types of assets ... in particular ... shares and other forms of participation in commercial enterprises”); Canada—Peru BIT, Art. 1 (“investment means: (I) an enterprise; (II) an equity security of an enterprise ...”).

⁹ Some observers have questioned whether these broad provisions, on their own, necessarily imply that SRL claims should be allowed in ISDS. See Arato, *supra* note 1, 35 and fns. 182 & 183 (“even as a matter of formal treaty interpretation, it is not clear why tribunals have given such short shrift to the position in general international law, or the uniformity across domestic jurisdictions” which arguably reflects a general principle). Under normal rules of treaty interpretation, an interpreter should take into account customary international law and general principles—and all the more so when treaty text is silent or unclear. Vienna Convention on the Law of Treaties, Art. 31(3)(c), May 23, 1969, 1155 UNTS 331 (1969) (“There shall be taken into account, together with context ... any relevant rules of international law applicable in the relations between the parties.”). See also Gaukrodger, *supra* note 5, at 25.

¹⁰ See Arato, *supra* note 1, at 35; Gaukrodger, *supra* note 5, at 30.

¹¹ See, e.g., *Impregilo v. Argentina*, ICSID Case No. ARB/07/17, Award, para. 138 (June 21, 2011); CAMPBELL MCLACHLAN, LAURENCE SHORE & MATTHEW WEINIGER, INTERNATIONAL INVESTMENT ARBITRATION: SUBSTANTIVE PRINCIPLES, §§ 6.77, 6.79 (1st ed. 2007) (“Given the wide definition of investment ... there is no conceptual reason to prevent an investor recovering for damage caused to those shares which has resulted in a diminution in their value”). However, the link between a broad definition of investment and a permissive approach to SRL is more tenuous than advertised. There are strong interpretive reasons to doubt that the pro-SRL interpretation follows logically from a wide definition of investment (*supra*, fn. 9), and strong policy reasons to prefer a no-SRL interpretation (*infra*, para. 9 *et seq.*). As Gaukrodger notes, ISDS tribunals “have apparently considered it unnecessary to consider policy consequences in any detail because they consider that the issue is resolved by the inclusion of shares in the investment definition ... [and by force of] arbitral precedent”—although the precedents themselves “rarely if ever addressed the policy issues or consequences.” Gaukrodger, *supra* note 5, at 30.

¹² A few treaties do incorporate sophisticated consolidation (or joinder) regimes. See, e.g., EU—Canada Comprehensive and Economic Trade Agreement, Art. 8.43 (CETA) available at <http://ec.europa.eu/trade/policy/in-focus/ceta/ceta-chapter-by-chapter>; and North American Free Trade

8. The situation is compounded where investment treaties cover “indirect equity,” which expands the universe of potential claimants.¹³ Indirect equity refers to an ownership stake in a firm that is held through a (potentially limitless) chain of companies. The “indirect” owner itself holds no formal shares in the local corporation actually engaged in the investment. It has an indirect stake, through ownership of shares in an intermediary entity that itself holds shares in the local company. Including indirect equity within the definition of investment exponentially expands the possibility of shareholder claims in ISDS. Most tribunals read such provisions to allow any entity in the chain to bring claims against the host State as indirect shareholders alongside any claims by immediate shareholders and/or the local firm itself.

THE HARMS IN UNREGULATED SHAREHOLDER CLAIMS

9. Allowing SRL claims in ISDS creates numerous risks and perverse incentives. Most glaringly, the possibility of multiple claims exposes the State to a risk that it will have to defend itself repeatedly with respect to essentially the same claim, even if it wins (*multiple bites at the apple*); and that it might be forced to pay overlapping damages claims where it loses successively (*double recovery*). At the same time, the pro-SRL interpretation harms foreign investors and States alike by distorting the corporate form, inefficiently undermining national corporate governance law, and creating significant conflicts of interest between various corporate stakeholders. All this can inflate the costs of doing business for all parties *ex ante*.
10. *Multiple bites at the apple*. SRL claims derive from an original harm caused by a State’s measure to a single economic entity (the primary entity). Losses associated with that harm can be “reflected” in diminution of share value, causing secondary harm to the primary entity’s owners—the shareholders. Such diminution in value may be further reflected in tertiary losses for the shareholders’ shareholders (“indirect owners”), and so on *ad infinitum*. Tribunals tend to recognize claims by the entity, its shareholders, and indirect owners as independent. And investment treaties rarely provide for mandatory joinder of claims.¹⁴ Moreover, tribunals tend to allow investor-shareholders to plead for compensation not only for demonstrable diminution in share value, but for the value of the harm inflicted on the company in proportion to their shareholding—a potentially significantly higher figure. As a result, the most glaring consequence of the pro-SRL interpretation is that it subjects States to concurrent and successive claims by all of these entities, for recompense for the same alleged injury to the same primary entity. Even if a

Agreement, Art. 1117(3) entered into force Jan. 1, 1994, Pub. L. No. 103-182, 107 Stat. 2057, Art. 1117(3) (1993) (*NAFTA*), discussed further below.

¹³ See, e.g., Japan—Israel BIT, Art. 1(a) (“the term ‘investment’ means every kind of asset . . . owned or controlled, directly or indirectly, by an investor”); US—Turkey BIT, Art. 1(c) (“‘investment’ means every kind of investment owned or controlled directly or indirectly”) (emphasis added). Tribunals tend to read “indirect” equity broadly. See, e.g., *Ampal-American Israel Corp. v. Egypt*, ICSID Case No. ARB/12/11, Decision on Jurisdiction, para. 343 (Feb. 1, 2016) (refusing to “read into the Treaty restrictions . . . [on] ‘passive, indirect and very small’ holdings”).

¹⁴ Even where keenly aware of the consequences of multiple SRL claims, tribunals have proven hesitant to require joinder without clear treaty-based authorization to do so. See, e.g., *Eskosol v. Italy*, para. 170 (“Obviously there are both efficiency and fairness reasons to prefer that all shareholders of an entity affected by a challenged State measure [and the entity itself] could be heard in a single forum at a single time . . . But the fact remains that neither the ICSID system, as presently constituted, nor the ECT itself, incorporate clear avenues (much less a requirement) for joinder.”).

State defeats the entity claim, it may face additional reflective claims by other stakeholders.¹⁵ In a world of SRL, a defensive victory may not be final.¹⁶

11. This situation creates numerous perverse incentives for sophisticated investors. By investing through a chain of treaty-covered subsidiaries, an ultimate owner can ensure that, should a dispute arise, it will have the opportunity (or opportunities) to relitigate.¹⁷ This possibility of endless claims also endows well-structured investors with extraordinary leverage in pressing for settlement.¹⁸ To some extent, this situation can be mitigated by tribunals through careful application of equitable doctrines like *res judicata*,¹⁹ collateral estoppel/issue preclusion,²⁰ and abuse of right²¹—but given the *ad hoc* structure of ISDS such solutions are at best irregular, inconsistent, and incomplete.²²
12. *Double recovery*. A related concern about SRL is that multiple overlapping claims can allow shareholder-investors to secure double (or more) recovery, either at the expense of the State or at the expense of other corporate constituencies.²³ This would occur, for example, if one tribunal awarded recovery to the primary entity while another awarded recovery to a shareholder. This problem has not tended to materialize in practice—in part for the contingent reason that, where shareholder and company have brought separate claims, they have mostly not resulted in separate successful awards. Tribunals are also often attentive to this issue, and several have taken proactive steps to avoid it, such as by considering related pending and prior claims and pro-rating recovery.²⁴ However, these are not perfect fixes. Double recovery remains a distinct possibility when both shareholder and company claims succeed, because the shareholder cannot be blocked from participating

¹⁵ This risk has materialized in numerous high profile cases. See, e.g., *CME v. Czech Republic*, UNCITRAL, Final Award, para. 436 (Mar. 14, 2003), and *Ronald Lauder v. Czech Republic*, UNCITRAL, Final Award, para. 172 (Sept. 3, 2001) (in which separate suits by the company (CME) and the controlling shareholder (Lauder) both proceeded to the merits, resulting in inconsistent awards on liability—Lauder lost on the merits while CME recovered over \$270 million). For a more recent example, see the successive claims against Italy in *Blusun* (corporate claim) and *Eskosol* (SRL). *Eskosol v. Italy*, para. 166 (“The ECT authorizes a variety of entities to proceed as qualified ‘investor[s]’ under its terms. This includes *foreign* [shareholder] investors like Blusun. ... But it also includes *local companies* like Eskosol ... A shareholder’s claim for its reflective loss through an entity in which it holds shares cannot be equated automatically to that entity’s claim for its direct losses.”). See also *Union Fenosa Gas, S.A. v. Arab Republic of Egypt*, ICSID Case No. ARB/14/4, Award of 31 August 2018, para. 6.81; ZACHARY DOUGLAS, *THE INTERNATIONAL LAW OF INVESTMENT CLAIMS*, 455 (2009); GIOVANNI ZARRA, *PARALLEL PROCEEDINGS IN INVESTMENT ARBITRATION* 40 (2016) (“when giving their consent to investment arbitration, the normal expectation of the parties—and in particular States (and the national public opinion)—is, *inter alia*, that an issue will be tried only once”).

¹⁶ Emmanuel Gaillard, *Abuse of Process in International Arbitration*, 32 ICSID Rev—FILJ 1, 9 (2017) (“To prevail in the overall dispute, the host State must win each of the arbitrations brought against it, while the investor need only succeed before any one of the tribunals”); ZARRA, *supra* note 15 (emphasizing finality and judicial economy).

¹⁷ Gaukrodger, *supra* note 5, at 37; ZARRA, *supra* note 15, at 41.

¹⁸ Arato, *supra* note 1.

¹⁹ See, e.g., *Apotex Holdings Inc. & Apotex Inc. v. United States*, ICSID Case No. ARB(AF)/12/1, Award, paras. 7.30–7.35–7.39, 7.57, 7.58 (Aug. 25, 2014).

²⁰ See, e.g., *Grynberg et al. v. Grenada*, ICSID Case No. ARB/05/14, Award, para. 7.1.6–7 (Mar. 13, 2009).

²¹ See, e.g., *Orascom TMT Investments v. Algeria*, ICSID Case No. ARB/12/35, Award, para. 542 (May 31, 2017).

²² Arato, *supra* note 1.

²³ This reflects Lord Millet’s concern in *Johnson v. Gore Wood Co.*, [2000] UKHL 65; [2002] 2 A.C. 1, 62 (“If a shareholder is allowed to recover in respect of [SRL], then either there will be double recovery at the expense of the defendant or the shareholder will recover at the expense of the company and its creditors and other shareholders.”).

²⁴ ZARRA, *supra* note 15, at 39 (2016).

proportionately in any company recovery.²⁵ Further, even seemingly effective tribunal-imposed limitations on double recovery can be difficult to manage at the enforcement stage, where enforcing courts may not be well positioned to appreciate the interaction between multiple compensation awards.

13. *Corporate governance distortions.* The availability of SRL in ISDS has the further effect of distorting the corporate form itself—inefficiently undercutting basic principles of corporate governance and generating significant conflicts of interests among all corporate stakeholders, including insiders (shareholders and management), and outside constituencies (creditors, governments, and publics). The corporate form is a uniquely efficient vehicle for mobilizing capital at scale.²⁶ The prime function of corporate law is to *empower* private parties to make use of this legal vehicle for doing business.²⁷ Yet, despite its advantages, the corporate form gives rise to conflicts of interests among its stakeholders.²⁸ As a legal entity, a corporation can only act through agents, and this fact creates numerous significant “agency problems,” or misaligned interests between those who invest in a corporation, those who manage it, and those who engage with it. As a result, the second function of corporate law is *regulatory*.²⁹ In most domestic systems, much of corporate law is directed at mitigating three kinds of conflicts of interests: between shareholders and management; between controlling and minority shareholders; and between shareholders and outside constituencies (especially creditors).³⁰
14. Permitting SRL claims in ISDS seriously undermines both of the main functions of corporate law. The pro-SRL interpretation inefficiently distorts the very features of the corporate form that make corporations appealing investment vehicles. In particular, it undermines the firm’s *separate legal personality* by enabling treaty-covered shareholders to gain access to funds rightly belonging to the firm. By suing the host State directly, a shareholder can recover on corporate monies that would normally be shielded from liquidation by shareholders, on which various creditors may have priority, and on which other shareholders expect parity.³¹ This rule also undermines *centralized management* by giving treaty-covered shareholders the ability to second-guess management on questions

²⁵ Timing is crucial here. If the company wins full recovery first, then the tribunal hearing the later shareholder claim could award the shareholder zero damages, confident that the claimant had already recovered through its stake in the firm. The problem is more acute when the shareholder wins its SRL claim first, because this makes a shareholder windfall unavoidable. If, thereafter, the tribunal hearing the later company claim awards full compensation to the firm, the shareholder would share in that award in proportion to its shares, and thus recover double (at the expense of the State). But even if the latter tribunal pro-rates recovery in inverse proportion to the prior award, the shareholder would still recover an overlapping share of the now-reduced company claim (at the expense of other corporate stakeholders).

²⁶ JOHN ARMOUR, ET AL., *THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH* 1, 1–2 (3d ed. 2017). Across all legal systems, the corporate (or company) form exhibits the same core characteristics: (1) separate legal personality (2) limited shareholder liability; (3) transferable shares; (4) centralized management; and (5) shared investor ownership. These features act together to allow the firm to operate as a nimble, independent, and potentially immortal market actor, while protecting owners from the debts of the firm (limited liability) and protecting the firm from the debts of its owners (entity shielding). *See also* KATHARINA PISTOR, *THE CODE OF CAPITAL* (2019). As a result, the business corporation is the most common vehicle for the large scale investment projects at issue in ISDS. Gaukrodger, *supra* note 2, at 8. For clarity, the analysis here is limited to formal corporations—but analogous problems arise for other organizational forms (such as LLCs and partnerships). Arato, *supra* note 1, at n. 148.

²⁷ Arato, *supra* note 1, at 30.

²⁸ ARMOUR, ET AL., *supra* note 26, at 2.

²⁹ Arato, *supra* note 1, at 30.

³⁰ ARMOUR, ET AL., *supra* note 26, at 2.

³¹ Gaukrodger, *supra* note 2, at 20; Arato, *supra* note 1, at 39; Korzun, *supra* note 2; Douglas, *supra* 15, at 455.

of when to litigate, when to settle, and how much to settle for.³² From the State's perspective, this makes it difficult to know who speaks for the firm in settlement negotiations, and difficult to rely on settlement more generally. All this may afford *ex post* advantages to particular covered shareholders, to be sure, but it diminishes the broader *ex ante* business advantages of the corporate form—by calling into question the firm's independence from its owners, undermining its credibility as a separate owner of firm assets, and by weakening management's hand at critical moments.

15. At the same time, the possibility of SRL claims gives rise to significant conflicts of interests when a potential investor-state dispute arises, which can lead to unfair practices *ex post*, and raise the costs of doing business *ex ante*. Most importantly, SRL claims create conflicts between shareholders and creditors by upending typical creditor-priority rules. This creates significant risks for creditors which, if adequately understood and accounted for, would tend to drive up the costs of credit. SRL also creates conflicts among shareholders: including conflicts between treaty-covered shareholders and uncovered shareholders who may be left out of any eventual recovery; as well as first-mover conflicts among treaty-covered shareholders.³³ And, as noted above, it creates conflicts between shareholders and management with respect to litigation decisions, including about whether to litigate at all. All of these potential conflicts create perverse incentives *ex post*, once an ISDS dispute arises (or seems likely to arise). And these become especially distortive where the firm is involved in bankruptcy proceedings—or where for other reasons there may not be sufficient assets to make all corporate stakeholders whole even after recovery.³⁴ Moreover, as awareness of these problems grows, they are likely to have significant *ex ante* costs: by raising transaction costs for investing through the corporate form, inflating the costs of credit, and raising the costs of doing business for all concerned.³⁵

PARTICULAR BENEFITS OF SRL IN THE CONTEXT OF ISDS

16. A case can be made that SRL has particular benefits in the context of ISDS that might not arise in other international or domestic law settings. The functional case for making SRL available in ISDS turns on the fact that foreign investments are frequently structured through companies incorporated in the host State—often at the latter's behest. SRL thus arguably helps avoid formal and material impediments to investor access to ISDS that might dilute its utility. However, these potential benefits can also be realized through other, less restrictive means.
17. *First*, opening ISDS to SRL claims avoids an unfortunate consequence of most treaties' formal nationality rules, which cover only *foreign* investors hailing from a treaty party other than the host State. If an investor in State A makes an investment in State B through a locally incorporated entity, that entity would not normally have a right to invoke ISDS against the host State (being its formal state of nationality). Without some fix, this lacuna would leave the investor from State A without a path for relief under ISDS—even if the State had required the investor to operate through a local entity. Allowing SRL claims

³² Gaukrodger, *supra* note 2, at 25; Arato, *supra* note 1, at 39; Korzun, *supra* note 2, at 196.

³³ Arato, *supra* note 1, at 39.

³⁴ Korzun, *supra* note 2, at 192.

³⁵ Gaukrodger, *supra* note 2, at 20; Arato, *supra* note 1, at 51.

clears this hurdle by enabling the foreign shareholder to claim for losses associated with injuries to the local firm.

18. *Second*, even where formal nationality rules are not a hurdle, local companies are still beholden to the State in myriad ways. This can give rise to “hold-up” problems, which reflective loss claims can help mitigate. For example, if all claims must be routed through the local company, a government could potentially interfere with that entity to disrupt an investor’s access to ISDS (without fully expropriating it). Similarly, if all recovery is due to the local company, a government could interfere with its ability to transfer post-award recovery back to creditors and owners. Permitting SRL claims avoids these hold-up problems by shifting the right of action to shareholders, who are comparatively less likely to be beholden to the State.
19. However, permitting SRL claims is not necessary to achieve these objectives. They can be met through less restrictive means. Indeed, some investment treaties already incorporate other mechanisms that ensure local company access to ISDS, by providing for: (1) *constructive foreign nationality* for local companies owned or controlled by treaty-covered shareholders; or (2) *shareholder derivative suits*. The first allows a local company to itself invoke ISDS if it is owned (completely or partially) by investors from the other treaty party.³⁶ The second allows foreign shareholders to bring suit in the company’s name and on its behalf.³⁷ These options differ from SRL in limiting the universe of possible claims and claimants, and by directing any recovery to the company itself. Absent access to SRL, these “company recovery regimes” would present a genuine alternative for preserving investor access to ISDS.³⁸ As typically drafted, they perfectly respond to the formal nationality concerns noted above. And they could be supplemented with relative ease to mitigate the risk of hold-ups. Moreover, under either approach, shareholders would still have residual access to ISDS for claims of *direct* loss.³⁹

CURRENT LIMITS ON SHAREHOLDER CLAIMS IN ISDS

20. A few treaties have sought to introduce limits on SRL claims, and a few tribunals have likewise imposed partial limitations. Some of these approaches are promising. But the problems with SRL are difficult to solve through either tribunal action or one-off bilateral treaty reform.
21. The greatest hurdles to meaningful reform are uncertainty and arbitrage. The fragmented nature of ISDS means that even tribunal decisions that challenge the conventional pro-SRL

³⁶ See, e.g., US—Argentina BIT, Art. VII(8); US—Turkey BIT, Art. VI(6); Energy Charter Treaty, Art. 26(7).

³⁷ See, e.g., NAFTA Art. 1117.

³⁸ See David Gaukrodger, “Investment Treaties and Shareholder Claims: Analysis of Treaty Practice,” (OECD Working Papers on International Investment, 2014/03), available at <http://www.oecd.org/daf/inv/investment-policy/WP-2014-3.pdf>. Though many treaties provide for company recovery regimes, they are often interpreted as *also* providing for SRL. See, e.g., *Eskosol S.p.A. in Liquidazione v. Italian Republic*, ICSID Case No. ARB/15/50, Decision on Respondent’s Application Under Rule 41(5), para. 166 (Mar. 20, 2017). As a result, at the time of a dispute, a shareholding investor has little incentive to opt for the former over the latter. SRL action both affords better control over the litigation, and allows the shareholder to recover directly. To provide an effective alternative, company recovery mechanisms must affirmatively *exclude* access to SRL. Gaukrodger, above; Arato, *supra* note 1, at 36.

³⁹ These alternatives have their own difficulties and tradeoffs, which will be assessed in a follow-up paper. At present, suffice it to note that SRL claims are not *necessary* for investor relief via ISDS.

approach cannot be relied upon for future planning. To be reliable, meaningful reform must be accomplished through treaty-drafting. However, the fragmented nature of the investment treaty regime allows sophisticated firms to structure investments through the most favorable treaties they can find (“treaty shopping”). Further, some tribunals have interpreted broadly drafted Most-Favored-Nation (“MFN”) clauses to allow investors to invoke more favorable dispute resolution provisions from the host State’s treaties with third States—albeit inconsistently and controversially.⁴⁰ As a result, meaningful reform requires systematic efforts, whether through comprehensive treaty-by-treaty reform or multilateral treaty-making.⁴¹

22. Nevertheless, much can be learned from existing treaty- and tribunal-based responses in relation to any future systematic reform—about what works, and what does not. The below canvasses some of the main approaches as potential models for future systematic treaty reform.

Treaty-based responses

23. Some States have attempted to scale back the scope of SRL claims, or to mitigate their harmful side-effects, in their treaties. Most of these set only marginal restrictions, and only a few attempt to limit SRL claims comprehensively. A handful of approaches stand out.
24. *Exclusive shareholder derivative suit regimes.* Very few treaties address SRL head on, openly and explicitly. However, some treaties appear to mirror the classical domestic law distinction: permitting only direct shareholder claims and shareholder derivative suits, and implicitly excluding SRL claims. The North American Free Trade Agreement (*NAFTA*) models this approach. The *NAFTA* permits a shareholder to bring a claim “on its own behalf” (Article 1116) as well as a claim “on behalf of an enterprise” that it owns or controls (Article 1117).⁴² All three *NAFTA* parties have argued that this division excludes SRL claims. According to Canada, Mexico, and the United States, the *NAFTA* only enables a shareholder-investor to bring a claim for direct loss under Article 1116, or a derivative claim for injury to the company under Article 1117, but not its own claim for mere reflective loss.⁴³ Early *NAFTA* tribunals split on how to interpret these provisions: some accepted that they implicitly bar SRL,⁴⁴ but others found that Article 1116 is itself broad enough to allow shareholders to bring claims for both direct and reflective loss.⁴⁵ Yet the

⁴⁰ See, e.g. *Maffezini v. Spain*, ICSID Case No. 97/7, Decision on Jurisdiction (January 25, 2000) (allowing importation of more favorable procedural mechanisms); see contra *Plama Consortium Ltd v. Bulgaria*, ICSID Case No. ARB/03/24, Decision on Jurisdiction (February 8, 2005) (barring importation of procedural terms).

⁴¹ One possible model would be that of the Mauritius Convention on Transparency. United Nations Convention on Transparency in Treaty-Based Investor-State Arbitration, adopted 10 Dec., 2014, entered into force 18 Oct. 2017, available at http://www.uncitral.org/uncitral/uncitral_texts/arbitration/2014Transparency_Convention.html.

⁴² See *NAFTA*, Arts. 1116 & 1117.

⁴³ See, e.g., *Bilcon v. Canada*, PCA Case No. 2009-04, Canadian Counter-Memorial on Damages, para. 26 (June 9, 2017) (allowing shareholder reflective loss “undermines one of the most fundamental rules of corporate law in all three *NAFTA* Parties. . . . [This] will weaken the corporation’s separate legal personality, create unpredictability for investors, creditors, banks, and others who participate in the foreign direct investment market, create unfair conditions of competition among these different sorts of investors, and hence, inevitably decrease the opportunities for investment in the *NAFTA* Parties.”); see also *GAMI v. Mexico*, Submission of the United States, para. 17 (June 20, 2003); *GAMI v. Mexico*, Escrito de Contestación of Mexico, para. 167 (Nov. 24, 2003).

⁴⁴ See, e.g., *Mondev Int’l v. United States*, ICSID Case No. ARB(AF)/99/2, Award, paras. 84–86 (Oct. 11, 2002).

⁴⁵ See, e.g., *GAMI v. Mexico*, Award, paras. 120–21 (Nov. 15, 2004) (acknowledging the policy tradeoffs); *Pope & Talbot v. Canada*, Award in Respect of Damages, paras. 75–76 (May 31, 2002).

NAFTA parties have continuously affirmed that the division between Articles 1116 and 1117 was designed to exclude SRL claims, and recent tribunals have concluded from the parties' consistent interpretive statements that the treaty bars SRL claims.⁴⁶ A good case can be made that ISDS provisions in other treaties that follow the NAFTA model should be read similarly to exclude SRL—such as the Central American Free Trade Agreement (*CAFTA*),⁴⁷ the Comprehensive and Progressive Trans-Pacific Partnership (*CPTPP*)⁴⁸ and the Korea—United States FTA (*KORUS*).⁴⁹ Nevertheless, going forward, it would appear that this sort of implicit limit on SRL remains risky and unpredictable—given the varied interpretations of the NAFTA, and the fragmented institutional structure of ISDS.

25. *Minimum equity requirements.* A handful of treaties limit SRL claims by small shareholdings by imposing minimum equity requirements on access to ISDS.⁵⁰ Such provisions may limit the universe of potential claimants at the margins. But they do little to limit multiple claims by parent-subsidiary chains, or to mitigate the corporate governance problems described above.
26. *Consolidation and sequencing regimes.* Several treaties envision joinder of overlapping claims. They do so by empowering parties to an ISDS dispute to request consolidation, and/or by empowering tribunals to order consolidation under certain circumstances.⁵¹ However, they rarely mandate joinder—nor could they do so comprehensively under current institutional arrangements, as overlapping claims may arise under separate treaties. Some treaties supplement claims consolidation rules by empowering tribunals to issue a stay pending resolution of overlapping or related ISDS claims.⁵² But, here too, most treaties stop short of requiring such sequencing. Consolidation and sequencing provisions can strongly limit the universe of possible claims. They do not, however, limit SRL claims directly, and thus neither close off the possibility of overlapping claims and double recovery, nor resolve the basic corporate governance problems that SRL claims engender.

Tribunal-based responses

27. Most ISDS tribunals simply assume that investment treaties authorize SRL claims. Some have recognized potential problems with SRL—in relation to double recovery and multiple claims, and, occasionally, corporate governance. Lacking guidance in the underlying

⁴⁶ See *Bilcon v. Canada*, Award on Damages, paras. 379 & 389.

⁴⁷ See Dominican Republic—Central America Free Trade Agreement, Art. 10.16(1) (*DR-CAFTA*), available at https://ustr.gov/sites/default/files/uploads/agreements/cafta/asset_upload_file328_4718.pdf.

⁴⁸ Comprehensive and Progressive Agreement for Trans-Pacific Partnership, Art. 9.19(1) (*CPTPP*), available at <https://dfat.gov.au/trade/agreements/in-force/cptpp/official-documents/Pages/official-documents.aspx>.

⁴⁹ Korea—United States Free Trade Agreement, Art. 11.16(1) (amended in 2018) (*KORUS 2.0*), available at https://ustr.gov/sites/default/files/uploads/agreements/fta/korus/Chapter_Eleven_Investment.pdf.

Article 11.18(4) further bars an investor from pursuing a KORUS claim while its parent or subsidiary (owned or controlled, directly or indirectly) is litigating a separate claim over the same measure and “arising from the same events or circumstances.”

⁵⁰ See, e.g., Turkey—Azerbaijan BIT, Art. 1 (2011) (excluding access to ISDS for shareholdings under 10%). The Southern African Development Community (*SADC*) Model BIT similarly excludes portfolio investments, defined as shareholdings under 10%. See SADC 2012 Model BIT Template with Commentary, 9-11 (2012), available at <https://www.iisd.org/itn/wp-content/uploads/2012/10/SADC-Model-BIT-Template-Final.pdf>.

⁵¹ See, e.g. NAFTA Art. 1117(3) (mandating joinder of shareholder and company claims concerning the same facts, unless this would prejudice the interests of a party); and CETA, Art. 8.43 (providing for more comprehensive joinder rules within the structure of the standing CETA Tribunal).

⁵² See, e.g. NAFTA Art. 1120(9); CETA Art. 8.24.

treaties, some tribunals have considered these concerns regrettable but unresolvable.⁵³ Yet a few have sought to craft techniques to minimize these problems *ex post*—essentially engaging in equitable balancing on a case-by-case basis. A few approaches can be distilled from the cases.

28. *Identity of parties limitations.* A few tribunals have resisted entertaining multiple claims by an entity and its 100-percent owner(s), and instead looked through the corporate form.⁵⁴ In *Grynberg v. Grenada*, for example, three shareholders claimed reflective loss arising out of an injury to their wholly-owned firm (RSM), after Grenada successfully fended off an earlier arbitration against the company itself. Highlighting the total identity of interest between these Claimants and RSM, the tribunal was comfortable invoking collateral estoppel to block the successive claims.⁵⁵ As an equitable *ex post* control, estoppel-style remedies are by nature indeterminate and likely to be inconsistently applied in practice. It is particularly difficult to draw bright lines for identifying a firm with its shareholders. Equitable limits based on identity-of-parties thus do little to remove the cloud of SRL claims *ex ante*, with its attendant negative effects for corporate governance, pricing credit, and host states' internal risk assessments.
29. *Identity of shares limitations.* A similar equitable approach bars multiple SRL claims over the same tranche of shares. According to the tribunal in *Ampal v. Egypt*, this occurs where direct and indirect shareholders sue separately for reflective loss arising out of “the same tranche of interest in the same investment.”⁵⁶ Such would be “tantamount to double pursuit of the same claim,” and would amount to an “abuse of process” irrespective of the claimant’s good or bad faith.⁵⁷ Although this approach may do more to limit multiple claims than the identity-of-parties test, it is similarly only a partial solution, unlikely to alleviate SRL’s *ex ante* impact.
30. *First shot rules.* Another recent approach focuses on limiting a controlling investor’s ability to exploit parent-subsidiary chains to secure multiple bites at the apple. In *Orascom v. Algeria*, the ultimate owner both brought its own SRL claim against the State, and caused several subsidiary entities to bring separate claims under discrete treaties (including the local entity, the direct shareholder, and several intermediaries). In the tribunal’s view “an investor who controls several entities in a vertical chain of companies may commit an abuse [of rights] if it seeks to impugn the same host state measures and claims for the same harm at various levels of the chain.”⁵⁸ On this theory, such an investor can choose which entity brings the claim, but the first claim “crystallizes” the dispute and bars further shots.⁵⁹ This approach focuses on policing coordinated abusive practices within parent-subsidiary chains. It does not limit claims by non-controlling shareholders, and it is unclear if it would limit good faith *uncoordinated* action by discrete entities in the chain.⁶⁰ This *ex post*

⁵³ *Eskosol v. Italy*, para. 170; *GAMI v. Mexico*, paras. 120–121; DOUGLAS, *supra* note 15, at 455.

⁵⁴ See, e.g., *Eskosol v. Italy*, para. 167.

⁵⁵ *Grynberg et al. v. Grenada*, ICSID Case No. ARB/05/14, Award, para. 7.1.6–7 (Mar. 13, 2009) (the “Claimants collectively own 100% of RSM’s stock and therefore entirely control the corporation. In these circumstances ... there is nothing unfair in holding them to the results of RSM’s Prior Arbitration.” In claiming “standing on the basis of their indirect interest in corporate assets, they must be subject to defences that would be available against the corporation.”).

⁵⁶ *Ampal-American v. Egypt*, para. 331

⁵⁷ *Id.*

⁵⁸ *Orascom TMT Investments v. Algeria*, ICSID Case No. ARB/12/35, Award, para. 542 (May 31, 2017).

⁵⁹ *Id.*, paras. 496, 523–524, 543.

⁶⁰ *Id.*, para. 543, n. 835 (viewing minority shareholder claims as essentially independent).

approach can somewhat reduce well-structured investors' leverage, and can partially limit the State's exposure to multiple claims. But it too is ultimately unpredictable and does little to resolve the *ex ante* problems that SRL creates. It may also amplify inefficient first mover incentives within the corporate chain.

31. A review of the relevant decisions suggests that case-by-case equitable balancing is an insufficient solution. Most of these approaches address only the problems of double recovery and multiple bites at the apple, and these only partially and indeterminately—although the *Orascom* abuse of rights standard goes furthest, and represents an ambitious and interesting development. Moreover, the fragmented nature of the system makes tribunal-driven reform unreliable in practice. To have full effect, any reform on this model would need to be codified.

REFORMING SHAREHOLDER CLAIMS

32. The availability of SRL claims in the context of ISDS causes significant harm—by exposing States to multiple overlapping claims, and by distorting basic principles of corporate governance on which all stakeholders rely. While allowing SRL claims in this context can have benefits, these are strongly outweighed by the harms. The benefits can also be realized through other, less restrictive means. On balance, the availability of SRL claims in ISDS is unfair, inefficient, and likely to drive up the costs of doing business for all concerned in the long term.
33. States and tribunals have sought to grapple with these problems to only a limited extent. While some existing treaty- and tribunal-based solutions are promising, these efforts remain irregular, inconsistent, and incomplete. Comprehensive, treaty-based reform is sorely needed in this area.
34. Any project for reforming shareholder claims in ISDS should take into account the varied interests at stake, including those of host States (as potential defendants) as well as corporate investors—with a special focus on the varied interests of key corporate constituencies (controlling and minority shareholders, management, and creditors). These interests should not be thought of in zero-sum terms. However, they can be in tension. It may not be possible to perfectly balance all relevant interests, and any plausible reform options will likely be in the nature of imperfect alternatives. Still, it is certainly possible to improve upon the *status quo ante* for all concerned. A follow-up report will explore and compare concrete options.
35. In relation to the specific reform proposals already on WGIII's agenda, shareholder claims is a cross-cutting issue. To the extent that the Working Group wishes to address SRL claims, this need not turn on broader questions of whether to focus on developing discrete reforms to particular aspects of investor-state arbitration or more transformative structural reforms (*e.g.*, a multilateral investment court or appellate mechanism). Concerns about SRL would have to be addressed directly either way. Reforming shareholder claims in ISDS might thus be best conceived as a building block that could fit a wide range of approaches to reform.