Reforming Shareholder Claims in ISDS

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Outline

(A) Harms of shareholder claims for reflective loss (SRL) in ISDS

(B) Particular situational benefits of SRL in ISDS

(C) Reforming shareholder claims in ISDS

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(A) The Harm in SRL

Allowing SRL claims in ISDS is harmful as a matter of both corporate law and investment treaty law

Corporate Law Perspective:
- ISDS is out of step with corporate law everywhere
- Allowing SRL distorts the corporate form
- Inefficient and unfair for all corporate stakeholders (costly for both States and investors)

Investment Law Perspective:
- SRL undercuts the object and purpose of investment treaties
- SRL drives many of the concerns identified by WGIII

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SRL From a Corporate Law Perspective

Permitting SRL claims undercuts core functions of the corporate form:

- Separate Legal Personality
  - Company owns property in its own name
  - Company contracts in its own name
  - Company vindicates its own rights / makes litigation decisions on its own behalf

- Delegated Management
  - Company decisions are made by centralized management, not individual shareholders.
  - Promotes efficient firm-level decision making
  - Protects third-parties (outsiders know that management speaks for the firm)

Direct Claims vs. Claims for Reflective Loss

To preserve separate legal personality and centralized management, corporate law everywhere restricts when shareholders can sue third-parties

- Shareholders *may* sue third parties for **direct harm** to their rights (e.g. voting rights, right to dividend)
- Shareholders *may not* sue for **reflective loss** (loss in share value due to third-party harm to the firm)
- Shareholder **derivative suits** provide a limited alternative remedy, where shareholders can step into the shoes of the firm if management is compromised

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SRL in ISDS Distorts the Corporate Form

Permitting SRL claims lets a **claiming shareholder** circumvent basic expectations of other stakeholders

- Allows recovery ahead of **creditors** (who expect priority on firm assets)
- Allows recovery ahead of **other shareholders** (who expect parity)
- Allows second-guessing **managerial** decisions to litigate / settle
- Leads to unfair surprises for **States** – in negotiations with management, and as defendants

All this raises the costs of doing business for *both* States and investors *ex ante*

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Harms of SRL In Relation to WGIII Concerns

SRL is a key driver of many of the concerns identified for reform by WGIII:

- *Multiple Claims*
- *Double Recovery*
- *Dispute Prevention*
- *Duration & Cost*
- *Unjustifiable Inconsistency*

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Harms of SRL In Relation to WGIII Concerns

SRL expands the set of actors who can invoke ISDS for the same contested state measure

- Allows proliferation of claims: by the company, discrete shareholders, and “indirect” owners

SRL also enables sophisticated businesses to game the system through creative structuring

- Treaty shopping
- Multiple bites at the apple

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(B) Particular Benefits of SRL in ISDS

Allowing SRL in ISDS provides some possible benefits specific to the investment context, where foreign owners are often expected to invest through a locally incorporated firm

- Provides an avenue for relief where the local entity lacks access to ISDS under treaty nationality rules
- Protects foreign owners where the local company cannot vindicate its own rights (e.g. total expropriation) or where management is otherwise compromised by state action

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(C) Reforming Shareholder Claims in ISDS

Allowing SRL claims in ISDS creates ample harms, but also produces limited situational benefits

The starting point for reform should be expressly prohibiting SRL claims in general

Shareholders can be afforded less restrictive alternative avenues for recourse where needed

Three alternative models:

i. “Derivative action” regimes – e.g. NAFTA Arts. 1116 & 1117
ii. “Deemed foreign” regimes – e.g. ICSID Convention Art. 25(2)(b)
iii. Clarifying / expanding scope of permissible shareholder “direct” claims

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(i) Derivative Action Model

NAFTA Art. 1116: Claim by an Investor of a Party on Its Own Behalf

1. An investor of a Party may submit to arbitration under this Section a claim that another Party has breached an obligation under [this Chapter] … and that the investor has incurred loss or damage by reason of, or arising out of, that breach.

NAFTA Art. 1117: Claim by an Investor of a Party on Behalf of an Enterprise

1. An investor of a Party, on behalf of an enterprise of another Party that is a juridical person that the investor owns or controls directly or indirectly, may submit to arbitration under this Section a claim that the other Party has breached an obligation under [this Chapter] … and that the enterprise has incurred loss or damage by reason of, or arising out of, that breach. …

3. Where an investor makes a claim under this Article and the investor or a non-controlling investor in the enterprise makes a claim under Article 1116 arising out of the same events that gave rise to the claim under this Article … the claims should be heard together … unless the Tribunal finds that the interests of a disputing party would be prejudiced thereby.

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(i) Derivative Action Model

NOTE: NAFTA and its progeny typically stop short of expressly foreclosing SRL claims, and several tribunals have interpreted Art. 1116 to allow both shareholder direct claims and SRL claims

To be effective, reform options on the "derivative action" model should expressly prohibit shareholder claims for reflective loss

(ii) "Deemed Foreign" Model

ICSID Convention, Art. 25(2)(b): "'National of another Contracting State' means: … (b) … any juridical person which had the nationality of the Contracting State party to the dispute on that date and which, because of foreign control, the parties have agreed should be treated as a national of another Contracting State for the purposes of this Convention."

Energy Charter Treaty, Art. 26(7): "An Investor other than a natural person which has the nationality of a Contracting Party party to the dispute on the date of the consent in writing referred to in paragraph (4) and which, before a dispute between it and that Contracting Party arises, is controlled by Investors of another Contracting Party, shall for the purpose of article 25(2)(b) of the ICSID Convention be treated as a 'national of another Contracting State' …"

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(ii) “Deemed Foreign” Model

NOTE: as with the derivative action model, treaties with “deemed foreign” clauses typically do not bar SRL claims, and tribunals have interpreted them to allow claims for both direct harm and SRL

To be effective, reform options on the “deemed foreign” model should expressly prohibit shareholder claims for reflective loss

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(iii) Calibrating Direct Claims

Scoping and definitional provisions can be used to calibrate shareholder claims, by:

- expressly distinguishing between direct shareholder claims and SRL
- explicitly barring SRL claims
- permitting direct claims, and calibrating their scope
  - E.g. defining a total direct or indirect expropriation as actionable direct loss (rather than reflective loss)

This calibration strategy can be combined with either the derivative action or deemed foreign models to ensure the availability of both company claims, and (limited) residual shareholder claims

Concept Paper

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