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Possible reform of investor-State dispute settlement (ISDS)

Shareholder claims and reflective loss

Note by the Secretariat

Contents

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I. Introduction

1. At its thirty-fourth to thirty-seventh sessions, the Working Group undertook work on the possible reform of investor-State dispute settlement (ISDS), based on the mandate given to it by the Commission at its fiftieth session, in 2017.[1] The deliberations and decisions of the Working Group at the thirty-fourth to thirty-seventh sessions are set out in documents A/CN.9/930/Rev.1 and its Addendum, A/CN.9/935, A/CN.9/964, and A/CN.9/970, respectively. At those sessions, the Working Group identified and discussed concerns regarding ISDS and considered that reform was desirable in light of the identified concerns.

2. At its thirty-seventh session, the Working Group agreed that it would discuss, elaborate and develop multiple potential reform solutions simultaneously (A/CN.9/970, para. 81). In that light, the Secretariat was requested to undertake preparatory work on a number of topics, including indirect claims, claims by shareholders and reflective loss. It was said that this could take into consideration the work carried out by the Organization for Economic Cooperation and Development (OECD) and complement the work already undertaken on the topic of multiple proceedings (A/CN.9/970, para. 84).

3. Accordingly, this Note aims at providing information to assist the Working Group with respect to the question of shareholder claims and reflective loss. As is the case for other documents provided to the Working Group, this Note was prepared with reference to a range of published information on the topic, including the working papers by OECD.[2] It does not seek to express a view on the possible reform options, which is a matter for the Working Group to consider.

II. Shareholder claims and reflective loss

A. Approaches to shareholder claims and reflective loss

4. Shareholders of companies can be harmed in broadly two different ways. First, they can suffer "direct" injury to their rights as a shareholder (for example, seizure of shares or interference with declared dividends), which may lead them to raise direct claims. The second type is "indirect" injury – the so-called "reflective loss", through an injury to "their" company. A government measure that injures a company may affect its overall value, which could, for example, lead to a loss in the value of the shares.

5. Domestic courts in States with advanced national corporate law systems generally reject shareholder claims for reflective loss – largely for policy reasons relating to consistency, predictability, avoidance of double recovery and judicial economy. Shareholders are permitted to bring cases for direct injury but not for reflective loss they suffer. Only the directly-injured company can bring a claim. A single company claim and recovery of any damages is viewed as both more efficient and fairer to defendants and corporate stakeholders, including creditors and shareholders. There are few shareholder claims against governments for reflective

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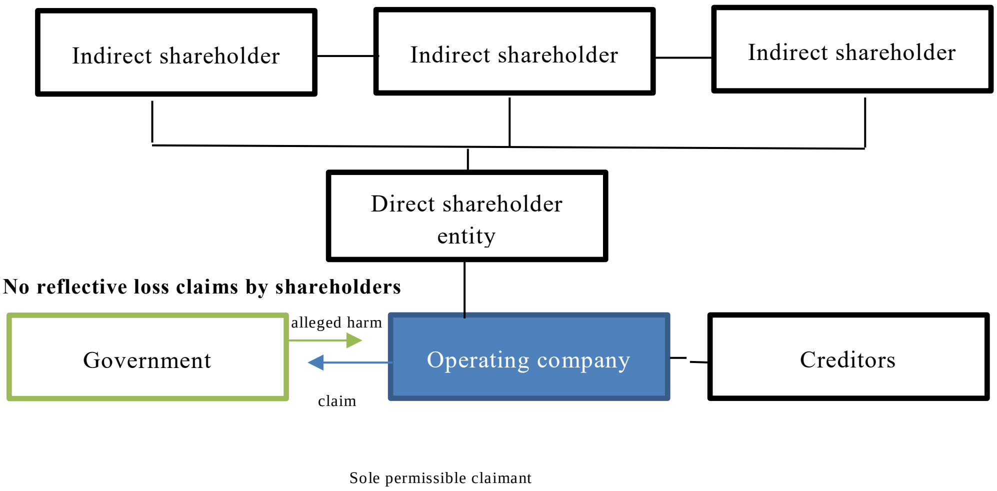
[1] *Official Records of the General Assembly, Seventy-second Session, Supplement No. 17* (A/72/17), paras. 263 and 264.

[2] See OECD, "The impact of investment treaties on companies, shareholders and creditors" in *OECD Business and Finance Outlook 2016* and OECD Working Papers on International Investment by David Gaukrodger (*Investment Treaties as Corporate Law: Shareholder Claims and Issues of Consistency* (2013/03), *Investment Treaties and Shareholder Claims for Reflective Loss: Insights from Advanced Systems of Corporate Law* (2014/02) and *Investment Treaties and Shareholder Claims: Analysis of Treaty Practice* (2014/03)); See also the publication by the Academic Forum, Julian Arato, Kathleen Claussen, Jaemin Lee, and Giovanni Zarra, "Reforming Shareholder Claims in ISDS," *Academic Forum on ISDS Working Paper* 2019/9, available at http://bit.ly/ISDS_AF_SRL_2019 (referred to as the "Academic Paper").

loss in domestic courts; those few cases are generally dismissed on the grounds that only the company can submit a claim (see figure 1).[3]

Figure 1
Domestic Law – "No Reflective Loss" principle bars shareholder claims (based on OECD)[4]



6. The distinction between shareholders' direct injuries and reflective loss, and the general bar on claims based on reflective loss, is also recognized in general international law and has been reaffirmed by the International Court of Justice (ICJ) in a number of instances.[5]

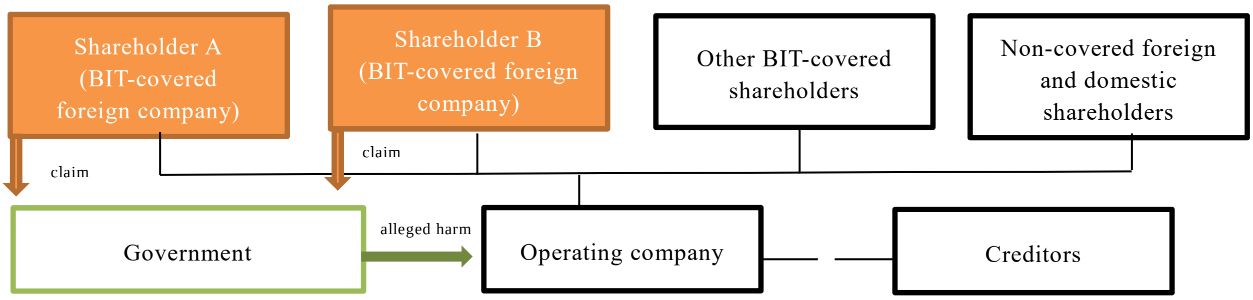
7. In contrast, many existing investment treaties have been interpreted to allow claims by covered shareholders for losses incurred by companies in which they own shares.

8. Foreign investments are often structured through companies incorporated in the host State; more generally, foreign shareholdings in listed companies have greatly increased in recent years in many jurisdictions. The availability of reflective loss generates multiple claims where a shareholder brings a reflective loss claim and the injured company also claims in a different forum. Multiple claims can arise from claims by unrelated shareholders of the same injured company (see figure 2). These situations contrast with the single company claim under normal corporate law principles. Reflective loss claims allow investment-treaty-covered shareholders of domestic companies to directly access ISDS and to recover damages directly. It increases protection for covered shareholders, but creates new risks for the injured company, other investors in the company, and for governments. It substantially increases the potential number of ISDS claims.

[3] OECD, supra note 2, Working Paper 2013/03, p. 11.
[4] OECD, supra note 2, Business and Finance Outlook 2016, p. 232 (figure 8.2).
[5] For example, *Case Concerning Ahmadou Sadio Diallo (Republic of Guinea v. Democratic Republic of the Congo)*, Judgment on Preliminary Objections (2007), § 67 (distinguishing between admissible claims based on direct rights as shareholder and inadmissible claims based on reflective loss); *Barcelona Traction, Light and Power Company, Limited (Belgium v. Spain)*, Second Phase, Judgment (1970), § 47 ("a distinction must be drawn between a direct infringement of the shareholder's rights, and difficulties or financial losses to which he may be exposed as the result of the situation of the company"). The Principles of Corporate Governance of the American Law Institute (ALI) sets forth: "a wrongful act that depletes corporate assets and thereby injures shareholders only indirectly, by reason of the prior injury to the corporation, should be seen as derivative in character; conversely, a wrongful act that is separate and distinct from any corporate injury, such as one that denies or interferes with the rightful incidents of share ownership, gives rise to a direct action". See American Law Institute, Principles of Corporate Governance, § 7.01 (1994 and 2012 Supp.).

Figure 2

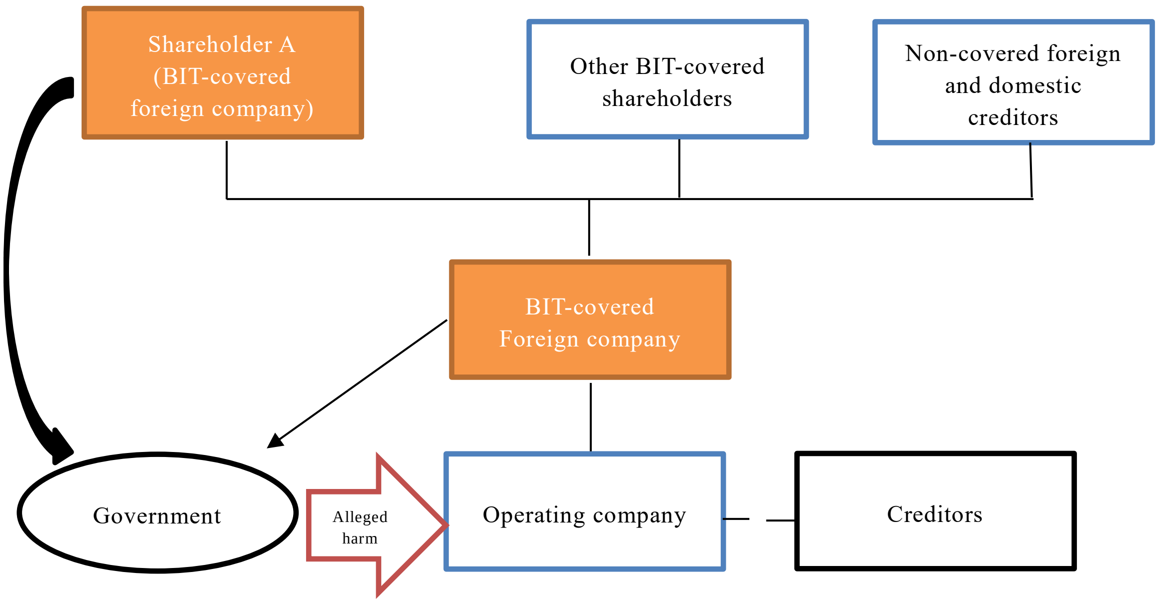
Multiple claims for reflective loss by unrelated shareholders (based on OECD)[6]



9. Multiple claims can also arise where related shareholders of the same company (such as a parent company and its subsidiary, both shareholders of the injured company) separately bring claims under different investment treaties (see figure 3 below). A single beneficial owner can have multiple chances to raise claims using different controlled entities. It only needs to prevail in one of them, whereas the respondent State needs to successfully defend all such claims.

Figure 3

Multiple claims by related entities Two different tier foreign shareholders both with access to ISDS (based on OECD)[7]



10. Given that claims for reflective loss are generally barred under national corporate law and other systems of law, the general acceptance of shareholder claims for reflective loss and the permissive approach of ISDS tribunals can be deemed to be unique in nature. This unique approach may have the effect of fragmenting recovery of corporate loss. And this effect is amplified because, frequently, indirect shareholders higher up in the corporate ownership chain have also been permitted to recover reflective loss.

[6] OECD, supra note 2, Business and Finance Outlook 2016, p. 234 (figure 8.3).

[7] Ibid., p. 235 (figure 8.4).

11. While most ISDS tribunals have proceeded on the basis that reflective loss claims are permissible under investment treaties without regard to the consequences, a few have recognized some potential problems.[8]

12. Intergovernmental discussions at OECD have preliminarily concluded that while reflective loss claims raise significant policy issues, there appears to be lack of an identifiable policy rationale for the general acceptance of reflective loss claims under investment treaties.[9] Governments have challenged reflective loss claims in a number of ISDS cases. However, tribunals have generally found that shareholders are entitled to recover for reflective loss.[10]

B. Correlation with concerns identified by the Working Group

13. The issues that arise from reflective loss claims and response thereto cannot be considered independently. Rather, they are closely linked with concerns that have been identified by the Working Group as deserving reforms. The following illustrates some possible correlations.

Increased number of cases and multiple proceedings

14. The Working Group may wish to consider whether the availability of reflective loss claims could increase the overall number of cases that could arise from the same injury. When the Working Group identified the lack of a framework to address multiple proceedings as one of the concerns regarding ISDS during its thirty-sixth session, it was mentioned that the acceptance by arbitral tribunals of reflective loss claims was one of the instances leading to multiple claims in ISDS (A/CN.9/964, para. 43). Indeed, permitting reflective loss claims makes multiple claims (both in ISDS and other fora) possible in many cases because in addition to possible claims by the injured company, each covered shareholder can potentially bring a claim.

15. In this regard, the Working Group may wish to note that a single economic entity would have multiple chances to raise claims (including through its shareholders), only needing to prevail in one of them, whereas the respondent State would need to defend all such claims. This scenario exposes a State to the risk that makes it necessary to defend itself multiple times against essentially the same alleged injury to the same economic entity, even if it had prevailed in one of them.

[8] *Eskosol S.p.A. in Liquidazione v. Italian Republic*, ICSID Case No. ARB/15/50, Decision on Respondent's Application Under Rule 41(5) (20 March 2017), para. 170, where the tribunal stated: "Obviously, there could be both efficiency and fairness reasons to prefer that all shareholders of an entity affected by a challenged State measure could be heard in a single forum at a single time, together with the entity that they collectively own. The Tribunal is not unsympathetic to Italy's circumstances, having to face claims now that are closely related to those it already successfully vanquished in a prior proceeding. But the fact remains that neither the ICSID system as presently designed, nor the ECT itself, incorporate clear avenues (much less a requirement) for joinder in a single proceeding of all stakeholders potentially affected by the outcome. Absent such a system – which States have the power to create if they so wish – it would not be appropriate for tribunals to preclude arbitration by qualified investors, …". In a footnote, the tribunal further stated: "Had Italy instead not prevailed in the prior proceeding but been ordered to pay compensation to the *Blusun* claimants, the Tribunal of course would have to be vigilant to prevent double recovery from Italy for the same loss. Because of the outcome of the *Blusun* case, however, that situation does not arise here."

[9] OECD Roundtable on Freedom of Investment 19 (15–16 October 2013) – Summary of the Roundtable discussions by the OECD Secretariat, p. 18 available at https://www.oecd.org/daf/inv/investment-policy/19thFOIroundtableSummary.pdf. See also summary of the OECD Roundtable on Freedom of Investment 18 (20 March 2013) available at https://www.oecd.org/daf/inv/investment-policy/18thFOIroundtableSummary.pdf.

[10] In contrast, see *Bilcon of Delware et al v. Government of Canada, PCA Case No. 2009-04*, Award on Damages (10 January 2019), para. 389. The tribunal stated: "(…) Articles 1116 and 1117 (of NAFTA) are to be interpreted to prevent claims for reflective loss from being brought under Article 1116. (...) Moreover, the Tribunal takes account of the common positions of the NAFTA Parties in their submission to Chapter Eleven tribunals."

16. While the use of consolidation, joinder and coordination mechanisms could limit multiple proceedings resulting from reflective loss claims, not all treaties or arbitration rules have relevant provisions. Moreover, existing rules have not been designed to address reflective loss claims specifically.

17. Even when consolidation is provided for in a treaty or procedural rule, it can be circumvented as different reflective loss claimants from a single injured company can bring claims based on different investment treaties and in different arbitration institutions. This would generate multiple arbitral tribunals that are unconnected and can even be perceived to compete (see also paras. 32–33 below).

18. More generally, even though multiple claims may not actually be raised, the possibility of such claims could make it more difficult for the disputing parties to reach an amicable settlement due to the existence of potentially multiple as well as unknown claimants in any given case.[11]

Impact on the cost and duration of ISDS proceedings

19. The interest in reducing litigation costs, often referred to as judicial economy, is a core reason quoted for domestic courts generally prohibiting reflective loss claims. Multiple claims arising out of the same injury can generate additional costs and take longer to resolve.

20. In considering this matter, the Working Group may wish to note that reflective loss claims usually require an assessment of how much of the company loss flows through to or impacts the shareholders as well as other relevant parties (for example, creditors who might not be claimants). Such an assessment could also have an impact on the cost and duration of the proceedings.

Lack of consistent outcomes and interpretations

21. The Working Group may wish to consider the impact of allowing reflective loss claims on both the dispute itself as well as the overall ISDS system.[12] For example, inconsistencies in outcomes with the same facts and issues as well as diverging legal interpretations of the same treaty provision may pose challenges to the system as a whole.

Double recovery, possibly leading to excessive damages

22. The Working Group may wish to consider whether allowing reflective loss claims increases the risk of double (or even more) recovery. In other words, a State might be required to pay overlapping damages, where it loses in more than one case. Attempts to address this could be at the expense of the State or at the other company (and thus at the expense of other corporate constituencies). The Working Group may, however, wish to note that some ISDS tribunals have been attentive to this issue and have taken proactive steps to avoid it, such as by considering related pending and prior claims and prorating recovery.[13] The Working Group may also wish to consider that the sequencing of the claims and of resulting awards is another element to be considered in addressing concerns arising from double recovery.

Distortion of the corporate law and finance

23. The Working Group may wish to consider whether the availability of reflective loss claims undermines the company's separate legal personality by enabling shareholders to gain access to funds belonging to the company. By raising claims, a shareholder can recover damages that would normally be shielded from liquidation

[11] The Academic Paper, in paragraph 14, notes: "the availability of reflective loss claims also makes it difficult for States to have confidence in any settlement with management, or individual shareholders, as other shareholders may still be able to bring independent reflective loss claims for the same alleged injury."
[12] OECD, supra note 2, Working Paper 2013/03.
[13] Giovanni Zarra, *Parallel Proceedings in Investment Arbitration* (2016), p. 39.

by shareholders, on which various creditors may have priority, and on which other shareholders expect parity.[14]

Summary

24. Taken together, the above-mentioned elements relating to shareholder claims for reflective loss could contribute to undermine the predictability and legal certainty for States, investors and shareholders alike, potentially leading to increases in cost of ISDS. It may in particular have a negative impact on the predictability of the ISDS system from the respondent State's perspective, as it is difficult to assess whether there would be any additional claims and who the claimants might be.

C. Investment treaty provisions and reflective loss claims by shareholders

25. Few if any investment treaties expressly address reflective loss claims. Governments have successfully argued that certain investment treaties exclude such claims. In addition, some have included provisions to prevent the occurrence of multiple proceedings (which may result from reflective loss claims) or to limit their impact.

Definition of "investors" and "investment"

26. The definition of the terms "investor" and "investment" in investment treaties determine which investors are protected and are able to bring claims against host States. Interpretations by ISDS tribunals have extended broad protection to shareholders.

27. Treaty provisions have been drafted to prevent certain claims by certain investors.[15] For example, some investment treaties contain provisions that set out the level of direct ownership (or a significant degree of influence in the management) that is required for a shareholder to acquire standing under the investment treaty.[16] In some recent model treaties, States have adopted an "enterprise approach" in defining covered investments, which excludes short-term portfolio investments.

28. Further, a commonly mentioned approach is the one adopted in the North American Free Trade Agreement (NAFTA) which establishes an explicit regime for covered shareholder claims. In addition to claims by covered shareholders on their own behalf (Article 1116), NAFTA permits shareholder derivative suits, in other words, claims by a controlling shareholder on behalf of the company with recovery that accrues to the company (Article 1117). NAFTA-party governments have stated that covered shareholders cannot bring reflective loss claims on their own behalf. Tribunal decisions have reached varying results, with more recent tribunals concluding in favour of the NAFTA parties' consistent interpretative statement that NAFTA prohibits reflective loss claims.[17] Other recently concluded treaties have adopted similar approaches.[18]

29. In addition to the above-mentioned approaches, the Working Group may wish to consider others means to limit reflective loss claims, such as: (i) prohibiting claims

[14] OECD, supra note 2, Working Paper 2014/02, p.20.

[15] UNCTAD World Investment Report (2015), Chapter IV, available at https://unctad.org/en/PublicationsLibrary/wir2015_en.pdf.

[16] For example, Turkey-Azerbaijan BIT, Art. 1 (2011) (excluding access to ISDS for shareholdings under 10 per cent). The Southern African Development Community (SADC) Model BIT similarly excludes portfolio investments, defined as shareholdings under 10 per cent. 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.

[17] Supra note 10.

[18] See, for instance, the Central American Free Trade Agreement (DR-CAFTA), the EU-Canada Comprehensive Economic and Trade Agreement (CETA), the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP) and the Korea-United States FTA (KORUS).

by investors where the company itself is pursuing a remedy in a different forum; (ii) permitting submission of a claim by an investor only if the investor and the local company withdraw any pending claim and waive their rights to seek remedy before other forums; and (iii) limiting forum selection options to claims that have not yet been asserted elsewhere.

Preventing abuse of process

30. Treaty provisions to prohibit abuse of process could provide the necessary mechanisms to allow arbitral tribunals to dismiss certain reflective loss claims and further encourage investors to agree on a single forum for the resolution of their claims. Clear criteria on which reflective loss claim will be regarded as abusive could be considered, which could enable disputing parties to have a clear understanding of those situations and possibly limit the claims raised.

31. For example, in a case, the ISDS tribunal concluded that the prior award regarding a company had a binding effect on its shareholders invoking the doctrine of collateral estoppel. The three shareholders had claimed reflective loss arising out of an injury to their wholly-owned company, against which Grenada had defended.[19] In another case, the ISDS tribunal held that a claim by a shareholder in the proceeding and a claim by a 100 per cent subsidiary of that shareholder in a parallel arbitration was "tantamount to double pursuit of the same claim in respect of the same interest." The tribunal further observed that since jurisdiction of both proceedings were confirmed, it would crystallize in an "abuse of process" because, in substance, the same claim was to be pursued on the merits before two tribunals.[20] In yet another case, the ISDS tribunal observed that an investor who controls several entities in a vertical chain of companies may commit an "abuse" if it seeks to impugn the same host State measures and claims for the same harm at various levels of the chain in reliance on several investment treaties concluded by the host State.[21]

[19] *Grynberg et al. v. Grenada*, ICSID Case No. ARB/05/14, Award, para. 7.1.5–7 (13 March 2009). The tribunal stated: "Of course, RSM is a juridical entity with a legal personality separate from its three shareholders. But this does not alter the analysis. First, the Claimant shareholders' only investment is a contract to which RSM is a party and the shareholders are not: the shareholders seek compensation for damage they allege they have suffered indirectly, 'through RSM,' for violations of RSM's legal rights. Second, the three individual 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. It is true that shareholders, under many systems of law, may undertake litigation to pursue or defend rights belonging to the corporation. However, shareholders cannot use such opportunities as both sword and shield. If they wish to claim standing on the basis of their indirect interest in corporate assets, they must be subject to defences that would be available against the corporation – including collateral estoppel."

[20] *Ampal-American Israel Corp. v. Egypt*, ICSID Case No. ARB/12/11, Decision on Jurisdiction, paras. 330–333 (1 February 2016) The tribunal further noted: "It follows from this therefore that there is no risk of a denial of justice occasioned by the absence of a tribunal competent to determine the MAGL portion of the claim. Both Tribunals are seized of the merits and neither Tribunal has yet reached a decision on the merits."

[21] *Orascom TMT Investments v. Algeria*, ICSID Case No. ARB/12/35, Award, paras. 542–543. The tribunal further stated that "It goes without saying that structuring an investment through several layers of corporate entities in different states is not illegitimate. Indeed, the structure may well pursue legitimate corporate, tax, or pre-dispute BIT nationality planning purposes. In the field of investment treaties, the existence of a vertical corporate chain and of treaty protection covering 'indirect' investments implies that several entities in the chain may claim treaty protection, especially where a host state has entered into several investment treaties. In other words, several corporate entities in the chain may be in a position to bring an arbitration against the host state in relation to the same investment. This possibility, however, does not mean that the host state has accepted to be sued multiple times by various entities under the same control that are part of the vertical chain in relation to the same investment, the same measures and the same harm." The tribunal further justified its conclusion stating that "If the protection provided under an investment treaty is sought at one level of the vertical chain, and in particular at the first level of foreign shareholding, that purpose is fulfilled and that the purpose is not served by allowing other entities in the vertical chain controlled by the same shareholder to seek protection for the same harm

Consolidation and joinder

32. Provisions on consolidation and joinder are increasingly found in investment treaties. Such procedural measures could possibly address multiple proceeding that arise from shareholder claims.[22]

33. While consolidation may also be carried out under applicable institutional arbitration rules, it is usually not possible to consolidate proceedings which have started under different arbitration rules and/or administered by different arbitration institutions.[23] Consolidating claims based on different underlying treaties can prove difficult because they may contain differing substantive obligations, as well as diverging time limits, procedural obligations and dispute settlement forums. The Working Group may also wish to consider the fact that disputing parties are often reluctant to consolidate and how this could be overcome in addressing reflective loss claims.

Other considerations

34. In addressing issues that arise from reflective loss claims by shareholders, the Working Group may wish to also take into account the following additional elements:

- Degree of protection of foreign shareholders under investment treaties
- Potential impact that treatment of shareholder claims could have on the rights of creditors and other non-claimant shareholders as well as the corporate/investment structure
- Potential risk of continued treaty shopping by shareholders
- Allocation of costs for shareholder claims as well as security for costs, noting the greater risk of non-payment of costs awards by reflective loss claimants and
- Third-party funding for reflective loss claims

D. Concluding remarks

35. Considering that a number of issues covered in this Note have yet to be discussed by the Working Group and as those issues are closely linked with other identified concerns and reform options, the Working Group may wish to consider whether the topic should be explored further by the Secretariat in cooperation with the OECD Secretariat and other relevant and interested international organizations, for example through a conference or an inter-sessional expert group meeting. Such a meeting could possibly take place at the OECD premises in Paris in the spring of 2020 with the objectives of (i) examining further the issues outlined in this Note and (ii) compiling the views of States on possible options for reform in relation to shareholder claims and reflective loss. The results of that meeting could be summarized by the Secretariat and reported back to the Working Group at a future session.

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inflicted on the investment. … such additional protection would give rise to a risk of multiple recoveries and conflicting decisions, not to speak of the waste of resources that multiple proceedings involve. The occurrence of such risks would conflict with the promotion of economic development in circumstances where the protection of the investment is already triggered. Thus, where multiple treaties offer entities in a vertical chain similar procedural rights of access to an arbitral forum and comparable substantive guarantees, the initiation of multiple proceedings to recover for essentially the same economic harm would entail the exercise of rights for purposes that are alien to those for which these rights were established."

[22] For example, NAFTA Article 1117(3) mandates joinder of shareholder and company claims concerning the same facts, unless this would prejudice the interests of a party. CETA Article 8.43 provides for more comprehensive joinder rules within the structure of the standing CETA Tribunal. NAFTA Article 1126(9) and CETA Article 8.24 empower tribunals to issue a stay pending resolution of overlapping or related ISDS claims.

[23] The Working Group may wish to note that a recent treaty allows for consolidation across dispute settlement mechanisms (see article 9.29 of the EU-Singapore Free Trade Agreement).