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Research on shareholders' exercise of indirect loss claim in international investment arbitration

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Abstract: *The shareholder's right to claim for indirect losses refers to the shareholder's filing of arbitration in its own name to the international arbitration tribunal on the basis of the investment agreement signed by the investor's home country and the host country. The arbitration tribunal determines whether the shareholder is a qualified investor under the investment agreement by interpreting the meaning of "investment" in the investment treaty. But at the same time, there are some problems arising from shareholders' indirect loss claim. Therefore, how to deal with the problems arising from shareholders' indirect loss claim is of great significance.*

Keywords: *Shareholder's right to claim indirect losses, International investment arbitration, Investment agreement*

1. Introduction

In the field of international investment arbitration, the loss of the shareholder's equity in the shares held by the foreign shareholder after the company has suffered damage is called consequential damage. Indirect losses of shareholders are also called reflective losses of shareholders. The exercise of the shareholder's right to claim for indirect loss means that the shareholder submits the investment arbitration to the host country on the grounds of the indirect loss suffered by the shareholder. With the development of the world economy and the increase of transnational investment, China has transformed into a two-way investment country and has a dual investment status. By analyzing the provisions on "investment" in Article 25 of ICSID Convention and the recognition of shares in international investment agreements, this paper provides some references for China to deal with the problems that shareholders' indirect loss claims may face.

2. The basis for shareholders to exercise the right to claim indirect losses

2.1. The designation of "investment" in the ICSID Convention

Article 25 of the Convention on the Settlement of Private Investment Disputes between States and Other States (ICSID Convention) stipulates that investors are eligible to initiate arbitration as long as they enjoy the investment, but the specific provisions and scope of "investment" are not clearly defined in the ICSID Convention. Therefore, when there is a dispute over "investment" in a case, it is necessary for the arbitral tribunal to make an award according to the specific circumstances of the case. As to whether an "investment" meets the criteria of the ICSID Convention, the arbitral tribunal has a variety of interpretation methods in practice, but the most widely accepted is the "Saarini standard". According to the "Saarini criterion", investment should include: contribution as input, a certain period of time for the performance of the contract, the risk of participating in the transaction, and the contribution of the investment to the development of the host country[1]. Under normal circumstances, the value of the equity held by shareholders is related to the status of the company, which means that the equity held by shareholders may fluctuate with the changes of the company's operating conditions. At the same time, shareholder ownership is usually an ongoing process, so according to the "Saarini criteria", "equity" generally meets the definition of "investment" in the ICSID Convention [2].

2.2. Recognition of shares in international investment agreements

In international investment agreements, investment is often defined as a series of assets, and the scope of investment varies in the context of different treaties[3]. Countries will adopt a relatively broad

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definition of investment when signing investment treaties, shares, stocks, etc., will be included in the scope of eligible investment, and "equity" will often be included in it. Therefore, as long as the "equity" is included in the international investment agreement and is included in the scope of protection of the international investment Agreement, the shareholder has the right to claim compensation for the indirect losses it has suffered through the investment agreement. The investment of equity is naturally found by the arbitral tribunal to be within the broad scope of investment, so the applicant, as a shareholder, is entitled to apply for indirect loss claims. In practice, the arbitral tribunal usually does not construal the investment agreement between the two parties. In addition, when defining the concept of "investment" in bilateral investment treaties, it is generally required that such "investment" must have a territorial connection with the host country. In practice, the International Investment Tribunal does not require that the "investment" must have a physical territorial connection with the host country. It is concerned whether the funds of the "investment" ultimately flow to or for the host country, and if the funds ultimately flow to or for the host country, then the "investment" has territorial connectivity with the host country[4].

3. Classification of shareholders in international investment arbitration

3.1. The connotation of indirect loss of shareholders

In international investment arbitration, the indirect loss of shareholders means that the shareholders' rights and interests are also indirectly damaged after the company holding the shares is damaged. Compared with the direct loss suffered by shareholders, the indirect loss of shareholders is related to the damage suffered by the company. When the company in which shareholders hold shares suffers damage and its own value is reduced or reduced, which will affect the shares of shareholders, this situation belongs to the indirect loss of shareholders.The shareholders' right to consequential damages, on the other hand, refers to the right of shareholders to arbitrate their consequential damages before an international arbitral tribunal on the basis of a bilateral investment treaty between the investor's home country and the host country, in the event that the shareholders suffer consequential damages as a result of losses incurred by the company.

3.2. Direct shareholder

Direct shareholders are foreign investors who directly own shares of local companies in the host country. First, if the foreign investor holds more than 50% of the total share capital, it is a controlling shareholder. As for the controlling shareholder, the controlling shareholder generally refers to the shareholder holding more than 50% of the total share capital in the relevant provisions of the domestic company law of some important countries in the world. In this regard.The International investment Tribunal usually recognizes the arbitration of indirect loss claims by the controlling shareholder.That is the shareholder who has control over the company. For example, in the case of Gas Nature SGS.A. V. Argentina[5],the Spanish gas company held 70% of the shares of a local company in Argentina, but after that due to various decrees and measures adopted by Argentina. A large number of investment disputes were arbitrated against Argentina, including the natural company. The gas company's applicant argued that the measures taken by Argentina had harmed its investment and filed a request for arbitration with the ICSID. The Argentine government argues that because the applicant is not a qualified investor as a shareholder, the shareholder is generally not eligible to file a claim on behalf of the company. The ICSID held that although the specific provisions and scope of "investment" were not clearly defined in the ICSID Convention, after an analysis of the bilateral investment treaty signed between Spain and Argentina, the Tribunal found that the applicant's shares in the company owned by Argentina met the definition of investment in the bilateral Investment Agreement. Accordingly, it is confirmed that the applicant is qualified to initiate arbitration. In accordance with the ICSID Convention and the BIT, the Tribunal upheld the claimant's claim for arbitration by finding that the claimant was entitled to bring a claim against the respondent. In addition, direct shareholders also include the form of minority shareholders, under a specific investment agreement, the international investment tribunal will also recognize the minority shareholders for indirect losses claim rights. Minority shareholders are described in relation to controlling shareholders and usually mean that the foreign investor holds less than 50 per cent of the total share capital.

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3.3. Indirect shareholder

In the field of international investment arbitration, indirect shareholders do not directly own shares of the company as direct shareholders do. However, the ownership and control of the company are to be achieved through indirect methods. The most typical is indirect shareholders. Indirect shareholders refer to investors who hold the shares of the target company indirectly, but do not directly hold the shares of the target company. The arbitral tribunal will usually recognise an indirect loss claim when the investor, by way of being the ultimate shareholder, asserts an indirect loss claim when it suffers an indirect loss through the establishment of a new company in the host State and effectively controls the new company. In the field of international investment arbitration, the exercise of indirect loss claims by indirect shareholders is usually recognized by the arbitral tribunal.

In addition to indirect shareholders intermediate shareholders also belong to this classification. As they invest in a target company through one or more intermediate companies. When the intermediate company attempts to seek compensation for indirect losses. It often encounters obstacles as the respondent frequently rejects the claim on the grounds that the intermediate company lacks the status of a qualified investor. The fundamental reason behind this rejection is that from the legal perspective of the intermediate company itself. It cannot be classified as either a direct shareholder or an indirect shareholder of the target company. This situation presents challenges in clearly defining the rights and responsibilities of the intermediate company in relation to the target company and potentially leading to disputes and legal complexities. For example, in other cases the respondent contends that the claimant is merely a shell company established for the convenience of investment arbitration and was not a qualified investor. The arbitral tribunal had no jurisdiction. However, the arbitral Tribunal held that the bilateral investment treaty in question did not explicitly define investors. So it had no right to arbitrarily limit the scope of eligible investors.

4. Problems existing in shareholders' exercise of indirect loss claim

4.1. Damage the independent legal personality of the company

Since the indirect losses of shareholders are related to the damage of the company, when the company suffers direct losses, the value of the shareholders will also be affected because of the shares they hold. Under the principle of the independence of legal personality, shareholders bear limited liability for the debts of the company according to the amount of capital contribution, so the shareholders can not claim for personal losses caused by the losses caused by the third party. The company may claim rights and assume obligations in the name of its endowed independent legal personality, and has the right to file claims in the status of independent legal personality. It is very important for a company to have independent legal personality which is the key for a company to conclude contracts and undertake obligations[6].Therefore the exercise of indirect loss claim by shareholders may infringe the independent legal personality status enjoyed by the company as an independent legal person. When the rights and interests of a company are infringed upon. The company has the flexibility to choose various procedures or pathways to safeguard its interests. Tepending on its specific situation and needs. However, if shareholders were to have the unchecked ability to arbitrarily initiate international arbitration proceedings for indirect losses they have suffered. This could pose a significant threat to the corporate legal system constructed by company law. Such actions could potentially disrupt the well-established framework of corporate governance, undermining its stability and effectiveness and leading to unforeseen legal complexities and disputes. At the same time, the exercise of indirect loss claims by shareholders can also have ramifications on related issues. Such as equity transfers. As domestic shareholders and overseas investors are different. Domestic shareholders can neither be recognised as overseas investors by an investment agreement nor are they foreign shareholders. Consequently domestic shareholders are not able to bring an indirect loss claim in the same way as overseas investors. Domestic shareholders have no additional protection in the event that they receive consequential damages. Therefore when the shares are transferred, they will be in a lower and more backward position compared to the former.

4.2. Initiate parallel arbitration

Allowing shareholders to initiate arbitration for consequential losses suffered by them may lead to the problem of parallel arbitration. Parallel arbitration may arise when a shareholder claims compensation for indirect losses suffered by the applicant by investing in and holding shares in a

number of intermediary companies in the host country on the basis of the shares held in those intermediary companies. If there is no restriction on the shareholder's right to claim indirect losses, then in theory any subsidiary shareholder located in the host country can apply for arbitration, and the bilateral investment treaty is concluded to better protect the investment, which can lead to parallel arbitration if the investment treaty does not explicitly bind the shareholder's right to claim indirect losses[7]. It not only increases the burden of the respondent. But also increases its pressure to respond to the lawsuit. In practical scenarios. Controlling shareholders and minority shareholders and indirect shareholders even intermediate companies may all potentially file arbitration requests. This can give rise to complex situations of parallel arbitration when these diverse groups of shareholders simultaneously initiate international investment arbitration proceedings or opt to file arbitration cases with different arbitration institutions. Such parallel arbitration scenarios can lead to overlapping proceedings and increased legal costs. And potential conflicts in rulings.

4.3. Causing double claims

Since both direct shareholders and indirect shareholders have the potential to file indirect loss claims. It is conceivable that multiple shareholders may file such claims in a single case. This situation can complicate and prolong the arbitration process significantly as it leads to an increase in the number of cases based on the same factual scenario. Consequently, the respondent is compelled to respond multiple times. Facing the peril of double or even multiple claims. This not only exacerbates the respondent's burden but also prolongs the dispute resolution process adding unnecessary complexity to the legal proceedings. In addition, after the shareholder claims indirect losses and gets compensation. The compensation that should be obtained by the company will flow directly to the shareholder. So the interests of the company's creditors will be infringed indirectly[8].Creditors have priority over shareholders in the order of compensation for corporate assets, but in a situation where compensation that should have gone to the company flows directly to the shareholders, the fact that corporate creditors, in order to protect their rights, turn to arbitration in international investment arbitration tribunals as well will further increase the pressure on the host State to respond to the claims, leading to an increase in the number of arbitration cases.

5. The path to dealing with shareholders' claims for Indirect Losses

5.1. Set a minimum shareholding ratio

In terms of restricting shareholders' right to claim indirect losses. Some countries restrict minority shareholders' right to claim indirect losses by setting and modifying the definition of "investment" when they sign investment agreements. In the bilateral investment agreement signed by the contracting parties. A minimum shareholding ratio for "investment" is stipulated. This regulation restricts shareholders with insufficient shareholding ratios from exercising indirect loss claims. By doing so. It helps to prevent a situation where shareholders excessively litigate their indirect loss claims. Thereby maintaining a balanced and orderly dispute resolution process. Therefore when China signs investment agreements with other countries. It can restrict the minority shareholders to exercise the right to claim indirect losses by setting the minimum shareholding ratio. So as to avoid the arbitration that causes the shareholders to claim indirect losses at will.

5.2. Restrictive clauses in international investment treaties

In the international investment agreement, in order to prevent investors from abusing the right of action, the contracting parties usually set up some restrictive clauses. If a merger clause is set up in an investment agreement, the merger procedure refers to the consolidation of two or more independent but related arbitration procedures in the field of international investment arbitration for unified trial[9]. In essence, the consolidation process does not restrict the exercise of indirect loss claims by shareholders, but combines multiple arbitration proceedings for hearing, so as to save the cost of responding to the lawsuit of the host country and investors.

The refusal of benefit clause means that a contracting party reserves the right to deny part or all of the benefits to the investor of another Contracting party under the investment agreement[10]. With the development of the international investment field, the refusal of interest clause has been applied to the investment agreement. In the field of international investment arbitration, sometimes there are inappropriate investors who want to claim through international arbitration, and the denial of interest

clause can prevent this situation, so countries usually agree on the denial of interest clause in the international investment agreement.

For example, when an investment dispute occurs, the investor can choose one of the two ways to submit arbitration to an international arbitration institution or to Sue in a domestic court. Once the investor has made a choice between the two, he can not seek another form of relief, that is, he loses the possibility of another form of relief. This approach is known as a fork in the road clause, and the inclusion of a fork in the road clause in an investment treaty can reduce the risk of a shareholder filing a claim for indirect losses. However, the fork in the road clause requires shareholders to choose only one way of relief, so investors have little choice in the way of relief. Therefore, whether to establish a fork in the road clause in the investment agreement should be decided in the context of the corresponding investment[11].

The waiver clause is also one of the ways to deal with the shareholders' indirect loss claim in the investment treaty. Since the effect of the fork clause on the shareholders' indirect loss right is weak, the waiver clause can be included in the investment treaty to make up for the deficiency of the fork clause. The waiver clause means that when an investment dispute occurs, the investor decides to settle the investment dispute by submitting arbitration to the International investment Tribunal in accordance with the international investment agreement, that is, to give up other remedies. For example, Article 1121 of the North American Free Trade Agreement provides for the corresponding provisions.

5.3. Strengthen voluntary autonomy between companies and shareholders

Strengthening the autonomy of will between shareholders and the company can make the company and shareholders more flexible in applying the rules. For example, when shareholders suffer indirect losses in respect of the company shares held by them, the company and the shareholders can deal with the situation such as the claims and settlement terms of the shareholders for the indirect losses according to the law or the company's articles of association through negotiation and other ways to avoid lengthy arbitration.[12]

6. Conclusion

In order to increase the attractiveness of foreign capital and create a more favourable investment climate. Many countries have adopted a broad and inclusive definition of the term ‘investment’ as well as other relevant provisions within the framework of investment treaties. In this way, clearer protection is provided to foreign investors. Meanwhile, this approach can attract more foreign investment and promote economic growth to enhance its global competitiveness and can better provide stronger protection for overseas investors. On the other hand, this approach entails potential negative consequences due to the adoption of expansive and inclusive definitions of the term "investment" and other related provisions within the framework of investment treaties. It may inadvertently create opportunities for shareholders to abuse their litigation rights. This has led to a proliferation of litigation disputes. Which may lead to excessive submission of arbitration claims by investors. This leads to an increase in the number of cases in arbitral tribunals and reduces the efficiency of the legal system. There may also be a corresponding negative impact on the investment climate.

Meanwhile, in the field of international investment arbitration that the abuse of litigation rights by shareholders has led to an increase in arbitration disputes, resulting in numerous problems. One is a case of double claiming. The filing of identical or duplicated arbitration claims by investors in multiple arbitral institutions leads to inefficiency in arbitration and waste of judicial resources. Secondly, in the case of parallel arbitration. Parallel arbitration can complicate matters, as well as increase the burden of being claimed and the stress of responding to claims. Thirdly, where the separate legal personality of the company has been compromised. Addressing these issues is essential to guarantee fairness, efficiency and predictability in international investment arbitration. The most direct and effective way of dealing with shareholders' claims for consequential damages is to limit them by appropriate provisions in international investment agreements. It also takes into account the need to protect investors to attract foreign investment. Therefore, effectively resolving issues in shareholder indirect loss claims is critical to fully safeguard the rights of Chinese overseas investors and drive sustainable economic development.

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