Piercing Corporate Veil May Invite Close Scrutiny of Corporate Family Tree

Kluwer Arbitration Blog

January 30, 2009

Luke Eric Peterson (Investment Arbitration Reporter)

Please refer to this post as: Luke Eric Peterson, 'Piercing Corporate Veil May Invite Close Scrutiny of Corporate Family Tree', Kluwer Arbitration Blog, January 30 2009, http://arbitrationblog.kluwerarbitration.com/2009/01/30/piercing-the-corporate-veil-may-invite-close-scrutiny-of-your-corporate-family-tree/

What exactly is a foreign investor?

To the layperson, it may seem self-evident: a national of one country who invests in another country.

But in an era when foreign investors often enjoy much more favourable legal and financial benefits than their domestic counterparts, it seems that everyone is scrambling to be classified as a foreigner these days.

One particular catalyst for this trend has been the proliferation of investment protection treaties which are designed to protect foreign investors from expropriation or other forms of mistreatment at the hands of their host state.

Because many of these treaties are drafted loosely, they often protect businesses which incorporate off-shore and reinvest in their own country. This form of round-tripping has grown by leaps and bounds as law firms encourage businesses operating within their own borders to dress themselves up as foreigners by incorporating an off-shore ownership structure.

Lately, this practice has been given a stamp of approval by arbitration tribunals convened to resolve disputes between governments and "foreign" investors.

In one recent case, Romanian business interests were able to use a Dutch holding company, The Rompetrol Group N.V., in order to sue Romania under the Netherlands-Romania bilateral investment treaty.

Similarly, in another prominent case, a majority of a World Bank arbitration tribunal upheld jurisdiction over a dispute between a Lithuanian company and the Republic of Ukraine. Although one arbitrator objected to the case on the grounds that Ukrainian investors lay behind the Lithuanian company, Tokios Tokeles, the majority ruled that it would not pierce the veil of the Lithuanian company in order to inquire into its ultimate ownership.

Given the ease with which businesses can dress themselves up as "foreigners" it remains to be seen whether governments will try to rein in this practice – by drafting less generous investment protection treaties, for starters.

In the mean time, arbitrators are signaling that there are at least some types of corporate shell games

which may be anathema.

In a recent case at the World Bank's International Centre for Settlement of Investment Disputes (ICSID), an Argentine company, TSA Spectrum de Argentina S.A., was denied the opportunity to sue its own government over a contested radio broadcasting concession.

In contrast to the cases mentioned earlier in this post, the arbitration claim was not filed by a foreign entity. Rather, the Argentine company urged the presiding arbitrators to pierce its corporate veil, so as to confirm that a Dutch owner lurked further up the ownership chain. The claimant hoped that this would be enough to deem them "foreign controlled" for purposes of the ICSID Convention.

Unfortunately, for the claimant, once the arbitrators began to examine its family tree, they were not satisfied to identify the parents. While acknowledging that a "foreign controlled" Argentine company could sue the Argentine government under the Netherlands-Argentina investment protection treaty, a majority of the arbitrators said that the inquiry into corporate ownership should be an all or nothing exercise.

To this end, they traced the ownership structure all the way to its roots and found an Argentine citizen sitting at the very top of the chain. According to the majority, there was no "foreign control" and hence no jurisdiction to hear the arbitration suit. (The minority opinion of the third arbitrator is available here).

One lesson seems clear enough: where local companies are owned by off-shore interests, the off-shore interests have had better luck initiating any arbitration suits – rather than letting the local company try to bring the claim.

Where a local company files arbitration papers – at least in ICSID proceedings – and invites arbitrators to scrutinize its corporate family tree, they should be on notice that they could come in for a thorough background check.