Indirect Investments Through Chain Of Intermediary Companies: A Philosopher’s Stone Or Not Any More?

Kluwer Arbitration Blog
July 3, 2013

Inna Uchkunova (International Moot Court Competition Association (IMCCA))

Please refer to this post as: Inna Uchkunova, ‘Indirect Investments Through Chain Of Intermediary Companies: A Philosopher’s Stone Or Not Any More?’, Kluwer Arbitration Blog, July 3 2013, http://arbitrationblog.kluwerarbitration.com/2013/07/03/indirect-investments-through-chain-of-intermediary-companies-a-philosophers-stone-or-not-any-more/

Foreword

For centuries people have searched for the formula which may give them more gold. It may turn out that some investors have found it. As it will be explained, indirect investments through a chain of intermediary companies hides the risk of multiplication of claims and double recovery. But not according to the tribunal in *Standard Chartered Bank v. United Republic of Tanzania* (ICSID Case No. ARB/10/12, Award, 2 November 2012).

I. Standard Chartered Bank v. United Republic of Tanzania

This tribunal recently denied standing to an indirect investor by finding that:

> *“[P]rotection of the UK-Tanzania BIT requires an investment made by, not simply held by, an investor… (para. 257)*
> *[I]t would be unreasonable to read the BIT to permit a UK national with subsidiaries all around the world to claim entitlement to the UK-Tanzania BIT protection for each and every one of the investments around the world held by*

> *these daughter or granddaughter entities." (para. 270)*

The case concerns Standard Chartered Bank, a UK company ("SCB UK"), which holds 100% of SC Sherwood, a Hong Kong company, which – for its part – has majority share of SCB Hong Kong ("SCB HK").

Fig. 1.

The latter company, SCB HK, purchased in 2005 the debt owed under a loan agreement by Independent Power Tanzania Limited ("IPTL"), thus becoming the sole lender of the alleged sum of US$ 118,609,392.31. This money, IPTL needed for the construction of an electricity-generating facility located in Tegeta, Tanzania. IPTL had concluded a power purchase agreement with the Tanzanian Electric Supply Company ("TANESCO") according to which TANESCO was obliged to pay capacity payments to IPTL. As a result of a controversy on calculation of invoices, TANESCO stopped paying. Thereafter, SCB UK presented a claim based on the UK-Tanzania BIT asserting that its investment – the loan acquired by the Claimant's subsidiary – was effectively expropriated.

The dispute settlement clause contained in Article 8(1) of the BIT reads as follows:

> *"Each Contracting Party hereby consents to submit to the [ICSID] any legal dispute arising between that Contracting Party and a national or company of the other Contracting Party concerning an investment of the latter in the territory of the former."*

A. Investment implies action, not mere passive ownership

The tribunal had to interpret Article 8(1) in order to see whether the loan held by the subsidiary may be considered an "*investment of*" the Claimant. Taken in context, the tribunal looked at Article 1(a) of the BIT which refers to the "territory of the Contracting State in which the investment is *made*", and concluded that:

> *"To benefit from Article 8(1) […] a claimant must demonstrate that the investment was made at the claimant's direction, that the claimant funded the investment or that the claimant controlled the investment in an active and direct*

> *manner. Passive ownership of shares in a company not controlled by the claimant where that company in turn owns the investment is not sufficient." (para. 230)*

B. Other cases distinguished

The tribunal next discussed a number of cases on which the Claimant relied. However, these cases were based, *inter alia*, on the fact that the relevant BIT contained a broader definition of investment covering assets *owned or controlled, directly or indirectly*. (para. 255)

One case of particular interest was *Cemex v. Venezuela* where the tribunal held that:

> *"[W]hen the BIT mentions investments 'of' nationals of the other Contracting Party… this does not imply that they must be 'directly' owned by those nationals." (Cemex Caracas Investments B.V. and Cemex Caracas II Investments B.V. v. Venezuela (ARB/08/15), Decision on jurisdiction, 30 December 2010, para. 157.)*

The *Standard Chartered Bank* tribunal distinguished the decision in *Cemex* reasoning that:

> *"[T]he Dutch claimants in Cemex had 100% ownership in a Cayman Island subsidiary and intermediary which in turn held a majority stake in the allegedly dispossessed investment in Venezuela…*
> *Admittedly, no bright line exists to determine how remote or near a corporate relationship should be in order to be considered relevant. The Tribunal attempts no such line-drawing, but… the type of indirect investment in Cemex [is not] present in the instant case with respect to SC Sherwood. Even applying the Cemex standard, Claimant would fail to demonstrate its control over the relevant subsidiary." (paras. 251-253)*

Accordingly, the tribunal dismissed SCB UK's claims.

While the reasoning of any arbitral award is necessarily limited to the underlying facts and terms of the BIT, the reasoning of the present award sends a powerful

message to the arbitration community regarding the problem of indirect investments carried out through layers of intermediary companies.

II. Investment through layers of intermediary companies

Almost any BIT includes shares into the definition of investment, thus giving shareholders standing to present their claims before ICSID tribunals. For example, in *CMS v. Argentina*, CMS successfully presented a (direct) claim for violations of the US-Argentina BIT as a shareholder in an Argentine incorporated company. (*CMS Gas Transmission Company v. Argentina* (ARB/01/8), Decision on jurisdiction, 17 July 2003)

In comparison, an indirect investment, as exemplified by *Standard Chartered Bank* case, is one in which the investment is channeled through one or more levels of subsidiaries. This form of investment involves a number of problems to be discussed in the next section.

A. Risk of double recovery

Given that a company and its shareholders are separate legal entities, when the company suffers an injury this does not automatically result in a direct injury to the shareholders. This has led scholars to emphasize the risk of *overcompensation* since, in principle, a shareholder is not entitled to receive compensation for the loss suffered by the company. Rather a shareholder is entitled to compensation for the diminution of the value of the shares (indirect damage). As some authors noted, "[i]n such situations arbitrators may need to determine how the damage caused by the host State to the company flows to the claimant-shareholder (flow-through of damage)." (S. Ripinsky & K. Williams, *Damages in International Investment Law* (2008) 148, 148-161)

Next to this, investment through layers of intermediary companies hides a risk of *multiplication of claims and double recovery*. This is so since "[t]he extension of treaty protection to indirect shareholders creates an option for a group of companies to bring multiple claims through different companies in the group regarding the same investment and against the same measures of the host State." (K. Yanacca-Small, "P*arallel Proceedings*" in Muchlinski et al. (eds.), *The Oxford Handbook of International Investment Law* (2008), 1010-1011)

Thus, in the case of *Standard Chartered Bank v. United Republic of Tanzania*, the

Hong Kong companies may, in theory, also institute separate proceedings against Tanzania, should there be an applicable BIT. (See Fig. 1.)

B. Possible solutions

The risk of double recovery in chain-structured investments has not been properly addressed in the arbitral practice and, therefore, guidance as to how this problem may be solved is required.

If two companies in the group present claims, the principle of *res judicata* will not apply since the parties are, formally, not the same. In their Legal Opinion in the *CME v. Czech Republic*, Professors Schreuer and Reinisch tried to overcome this difficulty by proposing that intermediary companies be treated as a *single economic entity* in order to prevent re-litigation. (C. Schreuer & A. Reinisch, Legal Opinion (2002), available here, para. 28) This approach was, however, not accepted by the *CME v. Czech Republic* tribunal. (*CME Czech Republic B.V. v. Czech Republic*, UNCITRAL, Final Award, 14 March 2003, para. 436)

On the other hand, the *Enron* tribunal has usefully noted:

> *"[T]here is a need to establish a cut-off point beyond which claims would not be permissible as they would have only a remote connection to the affected company." (Enron Corporation and Ponderosa Assets, L.P. v. Argentina (ARB/01/3), Decision on jurisdiction, 14 January 2004, para. 52)*

This "*cut-off point*", however, has not been identified and this question needs clarification in the future. It is in this regard that some BITs include a "*denial of benefits*" clause which allows "a party to a BIT to deny the benefits of the treaty protection to an investor when its investment is ultimately owned or controlled by a national of a non-party…" (M. Valasek & P. Dumberry, *Developments in the Legal Standing of Shareholders and Holding Corporations in Investor-State Disputes*, 26:1 ICSID Rev. 34 (2011), pp. 40-41, p. 74)

Another possible solution is *piercing the corporate veil*. For example, in *Saluka v. Czech Republic*, the Respondent State argued that Saluka was a mere shell company, while Nomura was the real beneficiary, therefore the tribunal shall refuse to exercise jurisdiction. In this regard, the tribunal held that:

> *"[Piercing the corporate veil is] an equitable remedy where corporate structures*

had been utilised to perpetrate fraud or other malfeasance, but, in the present case, the Tribunal finds that the alleged fraud and malfeasance have been insufficiently made out to justify recourse to a remedy which, being equitable, is discretionary." (Saluka Investments BV (The Netherlands) v. Czech Republic, UNCITRAL, Partial Award, 17 March 2006, para. 230)

This approach might not be very helpful, although some tribunals have lifted the corporate veil. See for example, *TSA Spectrum de Argentina S.A. v. Argentina* (ARB/05/5), Award, 19 December 2008, para. 147.

The most burning issue is, therefore, how to account for the *flow-through of damage* among the companies included in the group so as to prevent double recovery. For example, if claims are presented by two shareholders from the same level of ownership, the tribunal will have regard to their respective capital share when evaluating damages. (*Enron*, Award, 22 May 2007, para. 401) Thus, simplistically stated, if the first claimant owns 30% in a local subsidiary, he will be entitled to receive 30% of the compensation due, the other 70% being reserved for the other shareholder. However, in the case of a chain-structured investment, when claims are presented by shareholders from different levels of ownership, there is no guidance in the arbitral practice as to how a tribunal should take into consideration the flow-through of damage between layers of intermediary companies. The cut-off point has to be finally identified.

Conclusion

By and large, the matter remains unsettled and needs further clarification. The *Standard Chartered Bank v. United Republic of Tanzania* has brought a new insight into the problem of investment channeled through layers of intermediaries.