Effects of Settlements in Investor-State arbitration

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What are the effects of a settlement agreement between the locally incorporated company and the host state on the foreign shareholder's pending BIT claim? Two views have emerged under investment treaty arbitration case law. The first view, adopted in *Sempra v. Argentina* (ICSID Case No. ARB/02/16) and *Hochtief v. Argentina* (ICSID Case No. ARB/07/31) decisions, holds that a settlement agreement does not prevent the shareholder from pursuing international proceedings against the State. The second view, sustained in *SAUR v.* Argentina (ICSID Case No. ARB/04/4), contends that the effects of a settlement agreement preclude the investor from proceeding with an international action against the State. The first approach seems correct, it acknowledges the different legal personalities of a shareholder and the locally incorporated company and differentiates between the rights of investors under BITs and the rights of a local company under local municipal law.

Investment arbitration case law shows a trend in international law to recognize the independence that shareholders have from the corporation that they own shares in. Both entities are not only independent legal persons but also because they hold different rights of action against a State for any harmful measures: a shareholder has "a separate cause of action under the Treaty in connection with the protected investment, […] which can be asserted independently from the rights of [the company]". *See*, CMS v. Argentina, ICSID Case No. ARB/01/8, ¶ 68.

In practice, shareholders will sue a host State under the BIT provisions for reflective loss when, for example, the local company's assets have been expropriated. For breaches of other standards such as fair and equitable treatment, full protection or security, national treatment or most-favored-nation treatment; the damage to the shareholders can take the form of a diminution in the value of his shares. The shareholder therefore has a right to pursue a claim against the host State because his interests have been prejudiced. Also, a shareholder can suffer a direct loss upon an injury to the company if he has entered into loan agreements to fund the activities of the local company.

On one side of the debate, the tribunal in Sempra recognized the 'procedural independence' that exists between an investor and the local company. A shareholder filed a suit before ICSID for regulations that affected natural gas distribution licensees' tariffs during the Argentine crisis. After negotiations with the government, the local company settled the dispute with the Argentine state. However, the shareholder did not sign or agree to the settlement agreement between the company and the Government. The tribunal held that the investor could not be bound by an agreement he was not a party of and, therefore, his interests were still covered by the BIT. *See,* ¶ 227.

In the same way, the tribunal in Hochtief had to address a very similar issue when the majority of members in a consortium settled a claim with the government and the claimant did not. The tribunal recognized two independent causes of action, one under municipal law and another one under treaty law. Then, the tribunal concluded that the "question must be addressed within the particular context of the BIT, and not by proceeding from principles of municipal company law." ¶ 157. The decision reasoned that since there was no evidence that the claimant's rights under the BIT were transferred to the local company to take action in his own name, the claimant retained his standing to bring claims with respect to the treatment of his shareholding under the BIT. *See,* ¶ 168.

Contrary to the prior decisions, the decision in the SAUR case gives full power to the release agreement signed between the local company and the Argentine government. The decision dismisses the shareholder's expropriation claims – which were settled – on admissibility grounds. The tribunal begins its reasoning by accepting that a release agreement, as any other contract, has binding effects for the parties to that agreement. The award agrees on that the only parties to the release agreement were OSM (the national company) and the Argentine government. However, it then concludes that such agreement has binding effects for the investor and that his claims (based on expropriation measures that were settled by the company) are precluded from being adjudicated by the arbitrators.

The approach in SAUR disregards a potential conflict of interest that may arise between the shareholders of a company and the company itself (*i.e.* on a real case, the board of directors of El Triunfo Company in El Salvador fraudulently ratified a petition for bankruptcy before the local courts so that the company could enter into winding up proceedings to intentionally dismantle the investment of its shareholders). S*ee*, Douglas, Zachary. *The International Law of Investment Claims*. Cambridge: Cambridge University Press, 2009, p. 425. For instance, where the managerial body of the local company decides to settle a dispute with the governmental authorities notwithstanding the opposition of the minority shareholders or, when a company decides to settle a claim with the host State for undervalue. Shareholders' rights under the treaty would remain available because those shareholders have not withdrawn or gave express power to the company to settle their BIT claims in their behalf. A decision like the one in SAUR leaves the interests of minority shareholders defenseless. According to its reasoning, a settlement agreement between a company and the host State implies an immediate withdraw of the opposing minority shareholder's rights under the treaty regime.

Furthermore, the decision in SAUR is problematic under a strict legal-technical approach. The decision in SAUR is justified under the provisions of the Argentinian civil code and the principles of civil law that apply to a settlement agreement as a contract. The tribunal considers the application of *res judicata* principle, but disregards the application of another essential principle in contract law: *res inter alios acta*, also known as privity of contract. The parties to a contract are those subjects upon whom the legal effect of the contract bears. By legal effects, we refer to the rights and obligations that each party undertakes as a result of the agreement. The main obligation that arises under a settlement agreement is a negative one: abstention to sue the other party. That obligation can only be enforced against the party who agreed on that obligation; in these three cases, is the local company, not the shareholder. Under basic principles of contract law, a bilateral contract such as the settlement agreement can never bind third parties – minority shareholders – without their express consent.

Also, *res judicata* can be successfully raised as a defense to a claim when a party files the exact same claim for a second occasion. To proof that both claims are the same, they must share the same object, parties and cause of action. In agreements like those explored above, the claim settled with the local company has for object (i) compensating the local companies' rights under local municipal law and (ii) preventing any future lawsuits against the State; the parties to the agreement are the local company and the State; and the cause of action is any that national law recognizes for expropriation without compensation. On the other hand, under an investor-state arbitration, the

object of the claim is the compensation of the investor for State violations to BIT protections standards; the parties to the arbitration are the investor (shareholder under our proposition) and the host State; the cause of action is solely based on rights conferred upon a foreign investor under the treaty. From a simple review, none of the three elements to admit *res judicata* defense are present in the suit between the local company and the State. Hence, the tribunal in SAUR omitted the three-part test for admission of *res judicata* defense by the host State.

Therefore, it might be worth considering that the decision in SAUR is not well motivated under civil law principles. Also, it doesn't consider the procedural rights of investors under BITs nor the economic realities of a business where there can be a conflict of interest between majority shareholders and the managerial bodies of the company on one side, and the minority shareholders' interests, on the other.

In sum, it is undisputed in international treaty arbitration that shareholding in a company can be a form of investment that enjoys the full protection that BITs offer to foreign investors. In investor-state arbitrations, shareholders are not exercising the contractual rights of the local company but rather their own rights under the Treaty. Thus, under the proposed set of facts, a settlement agreement will have no preclusive effects on an ongoing arbitration if the suing-investor has not agreed on the settlement or given sufficient authority to the company to represent his rights under the BIT and settle them directly with the host State.

* *It is important to bear in mind that this post does not address the double compensation issue that will be discussed in a subsequent one.*