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The Madrid Court of Arbitration (MCA) and
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Annex to Programme with Background Information for Panel II.B (Multiple Proceedings in Investment Arbitration: Causes, Consequences and Remedies; Monday 19 Nov. 11:45 – 13:00)

Reflective Loss Claims in Investment Arbitration as a Source of Multiple Proceedings

This annex to the programme for the fifth annual Euro-Med Conference provides background information for the panel on multiple proceedings.[1] Investor-state dispute settlement (ISDS) is unique among dispute settlement systems in broadly allowing claims for reflective loss, in particular by shareholders. (Shareholders' reflective loss is incurred as a result of injury to "their" company, typically a loss in share value.) Claims for reflective loss in ISDS constitute a substantial number of claims and multiple claims arising from the same dispute; they also constitute a much greater number of potential multiple claims.

Reflective loss in ISDS has been analysed and discussed by governments and stakeholders at the OECD in recent years. Pointing to this work, several governments and observers identified reflective loss as an issue in ISDS in the recent UNCITRAL Working Group III discussions on multiple claims; the Working Group decided that the development of reforms by UNCITRAL is desirable to address concerns related to the lack of a framework for multiple proceedings.

This annex provides background information for consideration and discussion of ISDS approaches to reflective loss as a source of multiple claims, their consequences and possible remedies.

Summary Overview of Reflective Loss Claims in ISDS as a Source of Multiple Claims

Recent OECD analysis has identified a unique combination of interpretations generally applied by ISDS arbitral tribunals under many investment treaties that create broad scope for multiple claims.[2] First, ISDS arbitral tribunals have found that treaty-covered shareholders are entitled to recover for reflective loss under many first-generation investment treaties. In contrast, courts in advanced systems of national corporate law generally reject shareholder claims for reflective loss – largely for explicit policy reasons (including the avoidance of multiple claims). Shareholders are permitted to bring cases for direct injury – for example to

1 This annex has been prepared by the OECD Secretariat. It does not necessarily reflect the views of the OECD or of the governments that participate in work on investment at the OECD, and it should not be construed as prejudging ongoing or future negotiations or disputes pertaining to investment treaties.

2 Further analysis of reflective loss and ISDS is included in a series of OECD Secretariat working papers on international investment (nos. 2013/03, 2014/02, 2014/03) and summaries of inter-governmental discussions at the OECD (summaries of Roundtables 18 and 19) available on the OECD website. See also chapter 8 of the 2016 OECD Business and Finance Outlook.

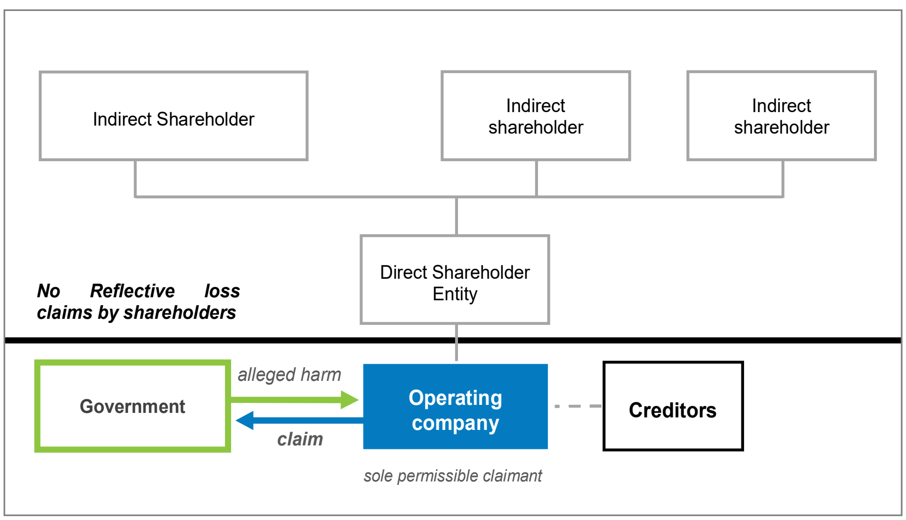
their voting rights as shareholders – but not where they suffer reflective loss due to an injury to the company. Only the directly-injured company can bring the claim.

Second, investment treaties make money damages generally available as redress against government breaches of investment treaties. Subject to appropriate proof, treaty claimants can generally recover past and future lost profits as well as interest. In contrast, only non-monetary remedies (such as annulment of improper government action) are generally available for investors against governments under domestic law in advanced economies, except for expropriation or contract claims. Unlike non-pecuniary relief, damages are divisible.

These principles change how claims are brought following an injury to a company. If an operating company suffers an injury, for example due to a breach of contract or regulatory action, it suffers a direct loss. Stakeholders in the company (its shareholders and creditors) will suffer reflective loss. The value of shares in the company will generally fall. The company's debt will become more risky because the company has fewer assets as a result of the injury. The distribution of these reflective losses between various shareholders and various creditors (bondholders, banks, trade creditors, employees, etc.) can be very difficult to determine – it depends notably on the financial condition of the company. Creditors generally suffer relatively more reflective loss as the company approaches insolvency; in contrast, if the company is financially strong even after the injury, shareholders generally suffer most of the reflective loss.

Under normal corporate law principles, the injured operating company owns the claim for recovery of its direct loss. As the owner of the claim, it is generally the only entity that can bring it. Reflective loss claims are generally barred. (Figure 1) If the company recovers its loss, the recovered assets restore the company's value and eliminates the reflective loss suffered by the company's stakeholders. The company's recovery of its loss makes its stakeholders whole without the need to try to evaluate the precise reflective loss suffered by each stakeholder. Reflective loss claims are barred in part to give primacy to the company claim.

Figure 1: Domestic Law: Only One Claimant
"No Reflective Loss" principle bars shareholder claims



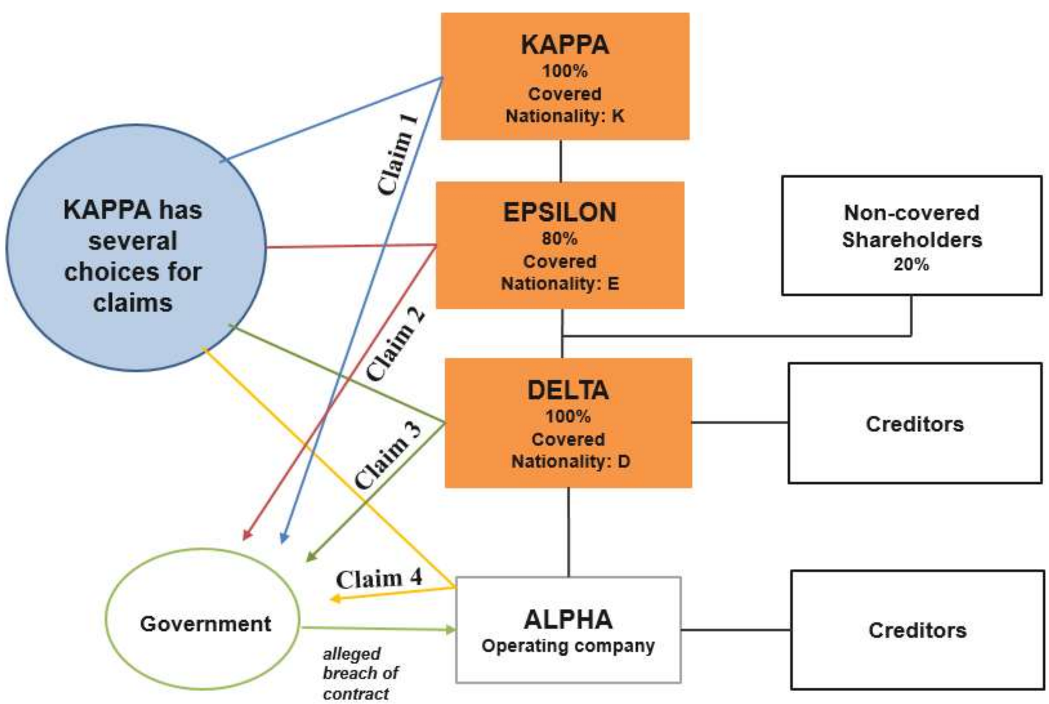
The result is that as a general matter, nothing that happens to the shareholder structure of a company – above the bold horizontal line in figure 1 – affects the company claim. Multiplying the number of shareholders or creating them in particular jurisdictions has no impact. This disconnect between shareholder structure and the company claim is of fundamental importance to a range of issues, including the protection of company creditors, the free transferability of shares, and ensuring the effective control of the litigation by the board of directors of the directly-injured company. It also limits the scope for multiple claims when the company suffers an injury.

The two unique ISDS interpretations profoundly change this scenario. They fragment the claim that is normally held only by the injured company. As noted, in ISDS, shareholders have been permitted to claim for their reflective loss arising out of the injury to "their" company. Companies may have many direct shareholders. Under ISDS interpretations, each treaty-covered direct shareholder can bring a claim for its reflective loss. This fragmentation of recovery of the loss generates many more potential ISDS claims including overlapping claims for the same damages.

Furthermore, ISDS cases have allowed indirect as well as direct shareholders to recover reflective loss. The extension of recovery of reflective loss to indirect shareholders amplifies the fragmentation of recovery of corporate loss. Together with the acceptance of reflective loss and damages remedy, it creates broad potential for treaty shopping as illustrated in figure 2.

A controlling indirect shareholder (beneficial owner) of an allegedly-injured operating company can bring multiple claims by attributing reflective loss claim(s) to one (or more) entities in the chain of ownership between the beneficial owner and the operating company. In figure 2, Kappa is an indirect 80% shareholder of Alpha, an operating company. (Kappa owns 80% of Alpha through its 100% ownership of Epsilon, Epsilon's 80% share of Delta and Delta's 100% share of Alpha.) Alpha is an operating company with a contract with the government which has allegedly been breached.

Figure 2. Multiple Potential Claims Using Reflective Loss Claim(s) in ISDS



Kappa can cause the directly-injured company, Alpha, to bring a claim for its alleged loss under the contract. This claim is generally brought in domestic courts or commercial arbitration. Kappa can also attribute a reflective loss claim in ISDS to itself or one or more of its controlled shareholder entities (Epsilon or Delta) for reflective loss arising out of the same basic injury to the operating company.

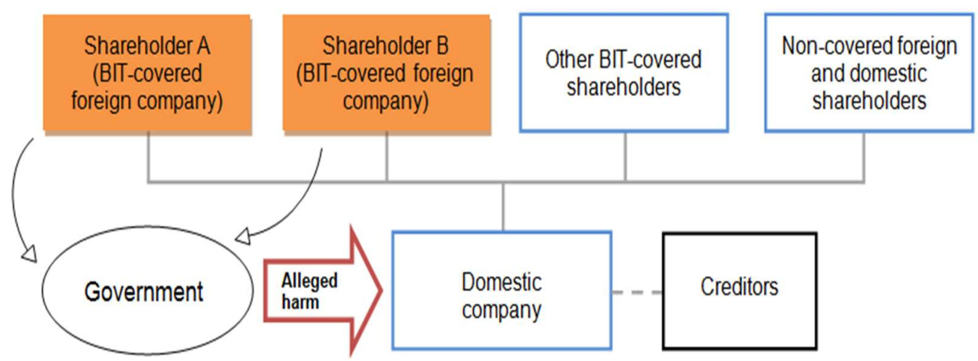
The power to attribute reflective loss claims thus gives rise to many potential multiple claims. For example, one Kappa-controlled entity can bring a reflective-loss based treaty claim while the Kappa-controlled operating company brings a contract claim. Kappa can also cause more than one controlled treaty-covered entity to bring ISDS claims. Kappa can also create new entities with desirable nationalities – this lengthens the chain of ownership and creates new potential claimants.

Beneficial owners like Kappa can attribute ISDS reflective loss claims to different entities for additional purposes beyond bringing multiple claims. The reflective loss interpretation also creates risks of opportunistic behaviour by the beneficial owner vis a vis other investors. If a subsidiary has debt obligations (like Alpha or Delta), Kappa can attribute the claim to an entity above the debt in the corporate chain (eg. claim 2 by Epsilon or claim 1 by Kappa). Similarly, an entity with other shareholders (such as Delta) can be circumvented by a higher tier claim (1 or 2). The non-covered shareholders of Delta only benefit if the recovery is by Alpha or Delta. Thus, while the power to attribute the claim benefits beneficial owners and claimants, it raises risks for other investors and stakeholders.[3] If ex ante investor attention to investment treaties is assumed, these risks to other investors can be expected to raise the cost of their capital.

Treaty shopping and the power to bring multiple claims are thus only some of many advantages for claimants of the reflective loss interpretation.[4] This and other claimant advantages to reflective loss attribution can make it difficult to determine the scope of the attribution of reflective loss claims in ISDS for various purposes.

In addition to possible multiple claims arising from vertical corporate chains of control between related entities exemplified by the Kappa – Epsilon – Delta – Alpha chain in figure 2, many other scenarios can give rise to potential multiple claims using the attribution of reflective loss claims. Multiple unrelated entities can also bring reflective loss claims arising out of an alleged injury to a single operating company, as illustrated in figure 3.

Figure 3. Multiple Potential Claims in ISDS by Unrelated Shareholders (domestic law claims omitted)



The scenarios and figures 2 and 3 can be combined, generating additional potential claims from the same alleged injury to the operating company. Higher tier shareholders (beneficial owners) of for example Shareholder A and Shareholder B in Figure 3 are not shown, but could be added above those entities. Those upper tier shareholders of the direct shareholders could attribute claims within their controlled chain of shareholders to any covered controlled shareholders. This further increases the number of potential claims.

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3 In theory, arbitral tribunals could identify the exact losses of each sufferer of reflective loss, and discount the claimant's damages accordingly. In practice, this is extremely difficult even if arbitral tribunals had bankruptcy court powers to evaluate claims on the company and jurisdiction over all relevant entities. See, e.g., *Mid-State Fertilizer Co. v. Exchange National Bank of Chicago*, 877 F.2d 1333, 1335-36 (7th Cir. 1989) ("Divvying up the recovery [between sufferers of reflective loss] would be a nightmare .... Why undertake such a heroic task when recovery by the [company] handles everything automatically? – for investors, workers, lessors, and others share any recovery according to the same rules that govern all receipts"). The additional fees and costs in ISDS legal, expert and arbitral time to seriously attempt such analysis are difficult to estimate, but would be very substantial.

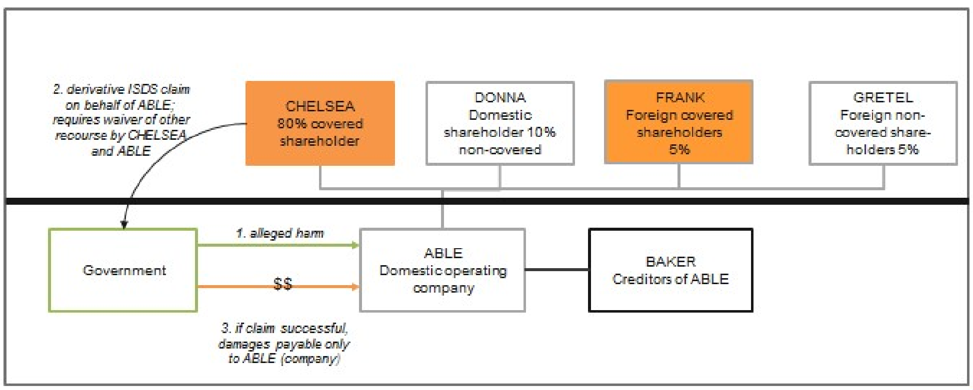
4 In addition to the examples above, Kappa can also attribute the reflective loss claim to an entity in the most tax-favourable jurisdiction. It can attribute the claim to an offshore "shell" special purpose vehicle with few assets other than the claim, which may make the claimant "judgment-proof" in the event of an award of legal and arbitral costs to the government.

There is recent government action of interest with regard to reflective loss. For example, Canada recently argued, in a brief that became public earlier this year, that allowing individual shareholders to claim for reflective loss under NAFTA would cause decreased investment.[5] The government further underlined that "the risks of double recovery and inconsistent decisions arise, and concerns for judicial economy grow, as the number of cases brought to address the same harm increases." Id. para. 23. It argued that it would be "inappropriate for a shareholder to take advantage of the separate legal status of a corporation to shield itself from potential liability, but then disregard that legal status for the purpose of making claims for reflective loss". Id. para. 25 (footnotes omitted).

The United States submitted a non-disputing party brief in *Bilcon*, also rejecting the availability of individual shareholder claims for reflective loss under NAFTA.[6] Both Canada and the United States noted that Mexico has taken the same position on the issue.[7] Other governments have also opposed reflective loss claims in recent ISDS cases under other investment treaties, but the government submissions are not publicly available.

NAFTA is unlike the typical older investment treaties addressed above.[8] Alongside the art. 1116 claim by the investor, it provides for a form of derivative action in art. 1117. The derivative action provides the controlling foreign covered shareholder with the power to bring a claim on behalf of the company for the injury to the company. Recovery for the company protects the corporate entity and thus corporate creditors and other shareholders. See Figure 4.

Figure 4 – NAFTA-style Derivative-type action



In this derivative action, the *power to decide* on the claim moves to the controlling covered shareholder (Chelsea), above the solid horizontal black line (separating the company from its shareholders – see figure 1 above). But the *flow of money* stays below the line. Only the company (Able) recovers from the government. Able's creditors (Baker) are protected. Able's recovery also makes all of its shareholders (including Chelsea, Donna, Frank and Gretel) whole. In contrast, in figure 2 above, claims 1 and 2 make Kappa whole if they succeed but leave Delta's other shareholders with the loss.

The additional derivative action provides protection for foreign direct investment where normal corporate rules apply to bar individual shareholder claims for reflective loss including in ISDS. It restores recovery to the company and only the company, reducing the scope and incentive for multiple claims. The additional derivative action does not change the effects of individual reflective loss claims if they are permitted.

5 *Bilcon of Delaware Inc. v. Canada*, Canada Counter-Memorial on Damages (9 June 2017), para. 26.

6 *Bilcon of Delaware Inc. v. Canada*, Submission of the United States of America (29 Dec. 2017), paras. 2-22.

7 Id. para. 5; Canada Counter-Memorial para. 28 & n.50.

8 Derivative-type actions generally similar to the NAFTA model are included in a number of major treaties, such as the CPTPP, CETA or Protocol to the Pacific Alliance.

Under treaties with derivative action mechanisms, the multiple claim risk is also addressed in part through waiver provisions. As noted in Figure 4, Chelsea can only bring a derivative claim if both Chelsea and its controlled company (Able) waive other recourse. The multiple claim risk is reduced if individual shareholder claims for reflective loss are barred. The multiple claim risk would appear to remain essentially unchanged if individual reflective loss claims are permitted.

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