"PIERCING THE CORPORATE VEIL" IS RELATIVE

By Leonid Shmatenko

A. Introduction

Every legal term has a specific meaning. In order to determine the meaning of a given legal term, regard has to be made, *inter alia*, to the context in which it is used (systematic interpre-tation). A given legal term may thus have different implications, depending on the context (specifically: the legal "framework") in which it is used. Correspondingly, the meaning of the legal term "piercing the corporate veil", which is the core aspect of this essay, is also relative. This essay seeks to name certain areas of the law in which the term is used and to highlight and describe its context-specific meaning and to show its evolution in investment arbitration deriving from a mainly common approach with commercial arbitration.

Arbitration is the most commonly used method to settle international investment disputes, international and national commercial disputes. Even though the term "Piercing the Corporate Veil" may at first glimpse primarily bring certain corporate law – and thus also commercial arbitration – issues to mind, it also plays a role in foreign investment arbitration. Gien, however, that the relevant legal frameworks in question are different so is the meaningng of the term. While in investment arbitrations the term is applied in connection with a shareholder's standing to sue for loss suffered as a consequence of direct expropriation of a host-state company[1], in international commercial arbitration the term – or rather the concept behind it - is applied to bind a non-signatory to the arbitration agreement. In regard to the latter, international legal scholars as well as courts and arbitral tribunals have developed different approaches to bind nonsignatory parties to arbitral contracts. These approaches to bind third parties include: the principles of Agency[2], the principles of Estoppel[3], the "Group of Companies" Doctrine , the above mentioned "Doctrine[4] of Piercing the Corporate Veil" also referred to as "Alter Ego" Doctrine[5] and others[6].

This article seeks to shed light on the different contextspecific meanings of "Piercing the Corporate Veil", and to describe the theoretical background of the concepts of "Piercing the Corporate Veil" in international commercial arbitration and its application by the courts and arbitral tribunals on the one hand (**B.**), and in investment arbitration and its application by ICSID on the other (**C.**). Finally, this paper will provide a summary of the analysis and an outlook on how the concept of piercing the corporate veil is likely to be used in future (**D.**).

B. The Doctrine of "Piercing the Corporate Veil" in International Commercial Arbitration

Piercing the Corporate Veil is one of the most difficult approaches to bind a third party to an arbitration agreement. While signatories of the contract are bound by the contract itself, a nonsignatory may be bound to an arbitration agreement using the principles of contract law[7], despite the rules of limited liability[8]. The concept of piercing the corporate veil "is based upon the principle of good faith and the concept of an abuse of rights, i.e., the inadmissible abuse of the separation of legal entities"[9] . It is recognized by arbitral tribunals that the corporate veil can be pierced if the third party is closely related to the party of the arbitration agreement.[10]

The requirements to include third parties were developed by courts and have to be fulfilled cumulatively. The requirements, which are going to be discussed further, are:

- A close relationship between both corporations (**I.**)
- Control of one corporation over the other (**II.**) and
- A recognition of both companies as separate entities would lead to fraudulent or inequitable results (**III.**). [11]

It is remarkable that the so-called "Piercing the Corporate Veil" or "*Alter Ego*" Doctrine has major similarities to the "Group of Companies Doctrine" established in the case *Dow Chemical v. Isover Saint Gobain*[12]. This results from an inconsistency in the usage of the different theories by the U.S. Courts in regard to the "Group of Companies Doctrine". However the doctrine of piercing the corporate veil is still used whenever a corporation is used as a shield to avoid liability and is under the influence of a natural or legal person.[12]

I. Close relationship between both corporations

The first requirement to pierce the corporate veil that needs to be fulfilled is a close relationship between both corporations.[14] UK and US courts have developed different approaches to determine when this requirement is given, i.e. whether the subsidiary has a close relationship to its parent. While the UK courts held that the companies have a close connection if the company is established for fraudulent purposes or in the case when it wants to circumvent obligations[15], US courts developed a "laundry list"[16] with factors, which are indicative of a close relationship.[17] However such factors are not conclusive, as arbitral tribunals also use different approaches like the "administrative and financial control over [a parents] subsidiar[y]".[18]

II. Control of one corporation over the other

As a second requirement, which is needed to pierce the corporate veil and to hold the parent liable, the parent has to exercise full control over the corporation.[19] One may argue that 100 or close to 100 percent of shares are needed to have control over the corporation. One could consider that the fulfilment of the subsidiary's obligations or the majority in the governing board may be sufficient to fulfil this requirement. Nevertheless, a 100 percent of shares certainly would be recognized as control.

III. Recognition of separate entities would lead to fraudulent or inequitable results

The third requirement, whether fraudulent conduct by the parent is needed or not, is highly disputed within jurisprudence. In Gregorio v. IntransCorp., a Canadian case[20] and in Bridas S.A.P.I.C v. Government of Turkmenistan[21] the courts affirmed that fraud is one of the requirements to pierce the corporate veil. However some American cases reject the requirement of a fraudulent behaviour.[22] Such a rejection of the requirement seems inappropriate, as it would result in the possibility to pierce the corporate veil wherever a corporation has a subsidiary. Furthermore it would lead to legal uncertainty and could result in the anxiety of corporations to establish subsidiaries with their own limited liability, as it would have no legal significance since the corporate veil could be pierced at any time.

IV. Conclusion

When applying the Doctrine of Piercing the Corporate Veil in International Commercial Arbitration, most courts and arbitral tribunals prefer to determine the control of a subsidiary by its economic reality and do not follow strict legal rules.[23] However, they still use "transnational norms, gleaned from published decisions in significant cases"[24]. Hence, it is important that in its application tribunals examine the liaisons between the corporations and the level of the exercised control of one company over another. In conclusion, the application of the doctrine has to be adamant and coherent in order to guarantee a legal certainty. Simultaneously one should bear in mind that such a restrictive approach might result in ineffectiveness of arbitral proceedings.[25]

C. The Doctrine of "Piercing the Corporate Veil" in Investment Arbitration and its use by ICSID

It is acknowledged that private parties have the power to submit claims against sovereign states.[26] According to Art. 25 (2) (b) Clause 1 ICSID-Convention the jurisdiction of ICSID extends to disputes between a Contracting State and a "national of another Contracting State". The requirement of a "national of another Contracting State" means that a legal entity incorporated in the host state must have the nationality of a Contracting State other than the host state.

In spite of this, exceptional cases may also fall within the jurisdiction of ICSID, according to an exception included in Art. 25 (2) (b)

Clause 2 ICSID-Convention. Following the wording of the latter an agreement of foreign control between a Contracting State and legal entities with the nationality of that same Contracting State needs to be given, i.e. to treat the legal entity of the host State as a national of another Contracting State.

The first ruling on the Doctrine of Piercing the Corporate Veil in investment arbitration was the *Barcelona Traction Light and Power Company, Limited*[27] case (hereinafter: Barcelona Traction) of the ICJ. Barcelona Traction was a company that controlled light and power utili-ties in Spain and was incorporated in Canada. After starting bankruptcy proceedings in Spain, it supposedly suffered damages. Although the company was incorporated in Canada and per-formed in Spain, Belgian nationals owned 89.3 percent of the shares of *Barcelona Traction*. Those shareholders claimed that their rights were violated by the Spanish acts. As a result the ICJ denied its jurisdiction and ruled that the Belgian shareholders were not entitled to protection.

Belgium applied twice for the institution of proceedings at the ICJ. While in the first application, Belgium tried to claim on behalf of *Barcelona* Traction itself[28], in its second application[29] it tried to protect the rights of the Belgian shareholders.

However, Barcelona Traction was incorporated in Canada. It had not only its seat in Canada, but also accounts and share registers. It held its board meetings in Canada and was listed in the records of the Canadian tax authorities.[30] Thus, even Belgium and Spain acknowledged the Canadian nationality of *Barcelona Traction*.[31] Consequently in its decision the ICJ ruled that "a close and permanent connection has been established" and that "Barcelona Traction's links with Canada are thus manifold"[32]. However, the Court also stated that there was "no absolute test of a genuine connection"[33] and thereby reduced the effect of the previous statement. This is however coherent, as the Court emphasised the distinction between the corporation and shareholders, which were "separated […] by numerous barriers" including the "separation of property rights"[34]. In contrast the Court also stated that situations where the national State acted on behalf of the corporation, it was insufficient to equate shareholders' rights to the company.[35] The Court ruled that the state could exercise shareholders' rights only in exceptional situations.[36] Nevertheless, it is remarkable that Canada did not act on behalf of *Barcelona Traction* for 18 years.[37] Moreover, the Court omitted to state whether Spain had violated direct rights of the shareholders or not.[38]

However, one can deduce from the decision of the ICJ that the doctrine[39] is applied in cases such as:

- Fraud or malfeasance
- The protection of third persons such as a creditors or purchasers
- Prevention of the evasion of legal requirements or of obligations.

It is remarkable that these requirements defined in the case of Barcelona Traction reflect exactly the same requirements as in the "Group of Companies Doctrine" discussed above in commercial arbitration. Whereas it might be regarded as an exceptional application of the doctrine referring to the fraudulent behaviour of a major shareholder in a corporation, being a case of the "real Doctrine of Piercing the Corporate Veil", it explains simultaneously why the term is used for both doctrines, in commercial and investment arbitration.

Admittedly, in the field of investment arbitration the doctrine of piercing the corporate veil has evolved in a different way since the decision by the ICJ in 1970. As a result of this evolution, nowadays the Barcelona Traction decision "no longer [reflects] current standards of international law"[40] , which is made particularly evident by the background of the Tokios Tokeles v. Ukraine (hereinafter: Tokios Tokeles) decision.[41] The latter "rests on the assumption that the origin of the capital is not relevant and even less decisive"[42]. Therefore the Barcelona *Traction* decision is not the standard to determine the nationality of the investor anymore.

In that regard the Tokios Tokeles plays an instructive role as to how to pierce the corporate veil in investment arbitration proceedings and to show the requirements that are needed. Under the premise of the Barcelona Traction decision of the ICJ, ICSID stated that the „Piercing the Corporate Veil Doctrine" is not only applicable to national disputes, but also applies to international disputes.[43]

In *Tokios Tokeles* the arbitral tribunal held "that none of the Claimant's conduct with respect to its status as an entity of Lithuania constitutes an abuse of legal personality".[44] Hence, the tribunal did not apply the doctrine, which was established in *Barcelona Traction*. [45]

In that regard the tribunal evaluated the *Award of Loewen v. United States of America*[46] (hereinafter: *Loewen*) and demonstrated that although the tribunal denied the use of the doctrine of piercing the corporate veil[47], the tribunal did exactly that".[48] In *Loewen* the Canadian Claimant declared bankruptcy after the arbitral tribunal ruled on its jurisdiction. Before the opening of the insolvency proceedings the Claimant transferred its claim to a newly established company, which only purpose was to continue pursuing the claim.[49] In contrast to the tribunal's view, scholars tried to support the *Loewen's* tribunal view that the doctrine was not applied.[50] However, the tribunal did not specify further details and ruled that all benefits of the judgment would pass to the other US owned corporation.[51]

Several other arbitral tribunals followed the decision of *Tokios Tokeles*.[52] Hence, the doctrine is only applied if an abuse of legal personality can be proven. The latter can be deduced from a fraudulent behaviour, where the corporation purports to fulfil all requirements provided in an International Investment Agreement (hereinafter: IIA).

In conclusion, Art. 25 ICSID-Convention distinguishes two requirements for the valid existence of foreign control:

- The objective presence of foreign control (**I.**) and
- The host State's approval of that presence in the form of an agreement (**II.**).

I. The objective presence of foreign control

The first objective requirement is the existence of foreign control.[53] The parties cannot waive the jurisdiction of the ICSID by an agreement. Arbitral tribunals determined the requirement of the existence of foreign control in many different ways.

The first and the most common way to determine the existence of foreign control is the determination, whether a locally incorporated entity is fully controlled by ways of share ownership. Such approaches have been applied in different judgments. [54]

On the one hand, foreign control should not be identified by exclusive control only. Whereas 100 percent ownership definitely leads to foreign control, absolutely no ownership means that there regularly is no foreign control, although this point might be argued and the foreign control could be established by other means.

On the other hand one may establish foreign control "through the control of a corporation of convenience".[55] This means that whenever an investor controls a locally incorporated corporation, it leads to the conclusion that nationals of other States control the corporation.

Even though it is acknowledged that an indirect control might establish foreign control, tribunals decided differently in regard of Art. 25 (2) (b) ICSID-Convention.[56]

Regarding the period in which foreign control must exist, it is suitable to refer to the conclusion of the agreement to treat the locally incorporated entity as a national of another Contracting State. Nevertheless, there is a possibility that the distribution of shares and thus control can change over time and not correspond to the contractual agreement of foreign control. Regardless of these changes the tribunals ruled that since the foreign control according to Art. 25 (2) (b) ICSID-Convention must exist at the time of the conclusion of the contract, the parties' status regarding the latter does not change over time.[57]

II. Agreement on foreign control

The second objective requirement of Art. 25 (2) (b) ICSID-Convention is that there should be an agreement on the issue of foreign control. Whenever such an agreement is missing, tribunals tend to determine the nationality by *siége social*.[58]

However, the ICSID-Convention neither contains a form requirement for the agreement, nor states whether an agreement must be concluded explicitly, thereby excluding the possibility of an implied agreement.

Although the ICSID-Convention does not require an explicit agreement, some tribunals stated that an agreement of foreign control should be explicit. Whenever assuming that the parties have concluded the agreement implicitly, certain additional circumstances, such as the explicit intention of the parties have to be proven.[59]

However, there is no consistency in the decisions of the tribunals. In a different case a tribunal decided that the mere existence of an ICSID arbitration clause in the agreement between the investor and the state was sufficient for the existence of the agreement of foreign control.[60]

III. Conclusion

In conclusion, the last two of the mentioned aspects are particularly problematic, but nevertheless have to be resolved by the competent tribunals.

Concededly, it is intricate for the tribunals to determine how foreign control might be exer-cised. It might easily happen that the tribunals end up in an infinite loop when trying to de-termine the real and right controlling national. In such cases the jurisdiction of the tribunal should be determined according to the ICSID-Convention. Additionally the tribunals should consider the wording of the IIA's, which might give clues or a strictly defined provision on how to determine the nationality.

In conclusion, the tribunals do not establish stiff and precise requirements to determine whether a locally incorporated entity is under foreign control according to Art. 25 (2) (b) ICSID-Convention or not. Given that the aforementioned rules have a very broad scope of application and are, on top of that and as has been shown, applied very generously, legal uncertainty is the inevitable consequence.

D. Final Conclusion

As previously shown, both doctrines share the same name and certain requirements need to be fulfilled in both cases. However, they must be not confused. Indeed some tribunals used similar requirements "to pierce the corporate veil" such as the share amount of a parent corporation, or to determine whether there was a foreign control in international investment and in international commercial arbitration proceedings. The tribunals even used approaches, which just determined whether there was control at all. In that regard, the Barcelona Traction tribunal used also the requirement of fraudulent behaviour, which is regularly a requirement to pierce the corporate veil in international commercial arbitration. Hence, it shows that the "Doctrine of Piercing the Corporate Veil" in commercial and investment arbitration derived from the very same approach, but evolved in two different ways, especially in investment arbitration. In this regard, one should not forget that both doctrines have different purposes. Whereas international commercial arbitrators seek to bind a nonsignatory (parent corporation) to an arbitration agreement, the international investment arbitrators try to find the "foreign state"investor in the legal entity to fulfil the requirements of Art. 25 (2) (b) ICSID-Convention and to thereby establish jurisdiction. Hence, Tokios Tokeles[61] makes a coherent evolution from *Barcelona Traction*[62] and specifies that the origin of the capital is less decisive, emphasising the requirement of fraud or malfeasance of an investor's abuse of legal personality and the factual control of a corporation.[63]

Despite everything, both doctrines represent adequate expressions of the approach to pierce the corporate veil in their respective area of law. As one may say, having the same ovum, they are dizygotic twins. As a consequence, two different names should thus be used. On the one hand international commercial arbitration should stick to the traditional hypernym of "Piercing the Corporate Veil" containing all "subdoctrines", and on the other, international investment arbitration and the establishment of jurisdiction of the ICSID according to Art. 25 (2) (b) ICSID-Convention should use another *mot juste*. Hence, since the tribunal seeks to determine the nationality of an investor of another Contracting State, the doctrine should be so-called *quaesitio auctoris hospiti* - the "Doctrine of the Foreign Ancestor".

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