“SHAREHOLDER CLAIMS BY SUBSTITUTION FOR COMPANIES” — THE SCOPE AND STATUS IN INTERNATIONAL LAW POST DIALLO

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With a focus on cases involving diplomatic protection, the note argues that there exists a rule in international law whereby the home state of the shareholders could bring a claim against the host state in case of an injury to the corporation. Such a rule finds its legal basis in the principle of equity which has been recognized as a general principle under art. 38(1)(c) of the ICJ Statute. The note also attempts to formulate the specifics of such a rule as it exists in international law today.

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I. INTRODUCTION

The *casus classicus* addressing claims of shareholders under customary international law is the decision of the International Court of Justice (ICJ) in the *Case concerning Barcelona Traction, Light and Power Co.* In this decision, the ICJ laid down the general rule that the home state of the shareholders of a company does not have standing to present a claim on behalf of the company for the injuries suffered by the company at the hands of the host state. Though the ICJ accepted that the Belgian shareholders had suffered losses due to the bankruptcy of Barcelona Traction, it refused to accept the *jus standi* of Belgium as the alleged conduct by Spain did not interfere with the legal rights but mere “economic interests” of the shareholders. However the Court recognised, on grounds of equity, an exception to the aforementioned rule. As per the exception, when the affected company was unable to take up a claim to protect itself, the state of nationality of the shareholders could bring a claim in certain situations. One such situation arises when the state of incorporation is itself responsible for inflicting injury on the company and the foreign shareholders’ sole means of protection at the international level is through their state(s) of nationality. However, the Court noted that this principle was not applicable to *Barcelona Traction*, since Spain was not the national state of the company injured. The ICJ noted that,

> [T] is quite true that it has been maintained that, for reasons of equity, a State should be able, in certain cases, to take up the protection of its nationals, shareholders in a company which has been the victim of a violation of international law. Thus a theory has been developed to the effect that the State of the shareholders has a right of diplomatic protection when the State whose responsibility is invoked is the national State of the company.

This exception laid down in *Barcelona Traction* was later incorporated with some modifications as Article 11(b) to the Draft Articles on Diplomatic Protection (DADP) for the purpose of progressive development of customary international law. It added the condition that the corporation injured must be shown to have been incorporated in the host state as a precondition for business there. The provision reads thus,

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1 *Case Concerning Barcelona Traction, Light & Power Co., Ltd. (Second Phase) (Belg. v. Spain)*, 1970 I.C.J. 3 (Feb. 5) [hereinafter *Barcelona Traction*].
2 *Id.* at ¶¶41, 42.
3 *Id.* at ¶46.
4 *Id.* at ¶92.
5 *Id.*
6 *Id.*
The State of nationality of shareholders in a corporation shall not be entitled to exercise diplomatic protection in respect of such shareholders in the case of an injury to the corporation unless:

(b) The corporation had, at the date of injury, the nationality of the State alleged to be responsible for causing the injury, and incorporation in that State was required by it as a precondition for doing business there. 

This exception laid down in Barcelona Traction and Article 11(b) was again brought into contention in the Case Concerning Ahmadou Sadio Diallo (Diallo). The ICJ discussed the scope and the status of this claim by “substitution” (as the ICJ coined it) whereby the state of nationality of the shareholders could bring a claim against the host state even in the case of an injury to the corporation.

This note proposes to discuss the status and the scope of this rule as it stands post the Diallo decision with respect to the one exception discussed above. The note is divided into 5 parts. Part II of the note analyses Article 11(b) of the DADP. Part III discusses the decision of the ICJ in Diallo in respect of the “rule of substitution.” Part IV evaluates the scope and the status of this rule in international law, followed by Part V that concludes the note.

II. ARTICLE 11(B) OF THE DADP

As discussed earlier, the International Law Commission (ILC) Draft Articles recognizes certain exceptions to the rule laid down in Barcelona Traction. Article 11(b) identifies one such situation. It states the twin requirements for the application of the exception: First, that the company must have the nationality of the state alleged to have caused the injury and second, that the incorporation of the injured company in that state must be required as a precondition for doing business there. This is clearly a narrower right than the one recognised by the majority opinion in Barcelona Traction — it requires those wanting to rely on the exception, an additional condition to establish that incorporation in the host state was mandatory.

The ILC, in its Commentary to the DADP accepts that art. 11(b) has not attained the status of customary international law. However, there is a support for such an exception, gaining recognition through awards by arbitral tribunals.

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7 Draft Articles on Diplomatic Protection with Commentaries, U.N. Doc A/61/10 (2006), art. 11(b) [hereinafter DADP].
9 Id. at ¶76-95.
10 DADP, supra note 7, art. 11, ¶12.
This, as per the ILC, indicates that the limited exception is gaining legal force on the basis of judicial opinion. Even the separate opinions of both, Judge Fitzmaurice and Judge Jessup in *Barcelona Traction* expressed full support of an equity based exception where the nationality of the shareholders can exercise diplomatic protection when the company was injured by the state of incorporation. Their opinions highlight that the rule was “particularly required” when incorporation was a precondition for doing business in the host state.

Judge Fitzmaurice noted that,

> [N]otwithstanding these cogent considerations of principle, the validity of this exception to or limitation on the rule of non-intervention by the government of the shareholders in respect of wrongs done to the company, is contested on a variety of grounds. It is said for instance that this type of intervention on behalf of foreign shareholders ought only to be permissible where the company itself is also essentially foreign as to its management and control, and the nature of the interests it covers, and where its local nationality did not result from voluntary incorporation locally, but was imposed on it by the government of the country or by a provision of its local law as a condition of operating there, or of receiving a concession…

> [I]t is doubtless true that it is in the case of such ‘enforced’ local nationality that situations leading to foreign shareholders in the company invoking the intervention of their government are most liable to arise.

As per the DADP, even post *Barcelona Traction*, such an exception was brought before the ICJ in the *Case Concerning Elettronica Sicula S.p.A. (ELSI)*. Though the Court was silent on the aspect, John Dugard believes that this silence can also be seen as a support for the exception in favour of the right of the state of shareholders in a corporation to intervene against the state of incorporation when it is responsible for causing injury to the corporation.

The ICJ again came up with this issue in the 2010 decision on preliminary objections in the case of *Diallo*. The next Part discusses the same.

### III. DIALLO AND ARTICLE 11(B) OF THE DADP

*Diallo* involved claims presented by Guinea on behalf of its national, Ahmadou Sadio Diallo. Mr. Diallo was the manager and sole shareholder of two

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13 *Barcelona Traction*, supra note 1 (separate opinions Fitzmaurice and Jessup).
14 *Id.*, (separate opinions Fitzmaurice) at ¶15, 16.
15 *Case Concerning Elettronica Sicula S.p.A. (ELSI) (United States of America v. Italy)* 1989 I.C.J. 87-88 (July 20). This is clear from an exchange of opinions between Judges Oda, *id.* at 87-88 and Schwebel, *id.* at 94 on the subject.
16 DADP, supra note 7, art.11, ¶11.
companies, both incorporated in the Democratic Republic of Congo (DRC) - Africom-Zaire and Africontainers-Zaire. Guinea claimed that the DRC, formerly Zaire, took actions that harmed the companies as well as Mr. Diallo, individually and, as a shareholder of the companies. Guinea also claimed to exercise diplomatic protection to espouse the claim Mr. Diallo made against the injury to Africom-Zaire and Africontainers-Zaire by substitution. In other words, the ICJ had to find out if such a substitution was permissible in international law.\textsuperscript{17} This Part proposes to analyse the Court’s response to this claim.

The ICJ, while deciding the same, acknowledged that the ILC Draft Articles on Diplomatic Protection contemplated an exception to the general rule that would permit the home state of the shareholders of a company to present a claim on behalf of the company itself. This situation would arise when the company was required to be incorporated in the state whose conduct is alleged to have caused injury.\textsuperscript{18}

The Court in \textit{Diallo} clearly rejected the broad exception of “substitution” (similar to the one expressed in the majority opinion in Barcelona Traction)\textsuperscript{19} relied on by Guinea saying that it has not attained the status of customary law.\textsuperscript{20} However the court refused to answer the status of a limited exception given under art. 11(b) of the DADP,\textsuperscript{21} It said,

\begin{quote}
[It is a separate question whether customary international law contains a more limited rule of protection by substitution, such as that set out by the ILC in its draft Articles on Diplomatic Protection, which would apply only where a company’s incorporation in the State having committed the alleged violation of international law “was required by it as a precondition for doing business there” (Article 11, paragraph (b)).\textsuperscript{22}
\end{quote}

Nonetheless, the court went into an investigation of the facts which clearly pointed out that the companies, Africom-Zaire and Africontainers-Zaire, were not required to be incorporated in DRC. Hence, it was noted that they would not fall within the scope of protection by substitution in the sense of Article 11, paragraph (b), of the DADP.\textsuperscript{23} This, however, was solely done to avoid the question of whether or not paragraph (b) of Article 11 reflects customary international law.\textsuperscript{24} The next Part analyses if there was any other way to deal with the question the Court faced

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\textsuperscript{17} Diallo, \textit{supra} note 8, at ¶¶76-95.
\textsuperscript{18} Id. at ¶91.
\textsuperscript{19} Id. at ¶83, for the contention by Guinea.
\textsuperscript{20} Id. at ¶89.
\textsuperscript{21} Id. at ¶91.
\textsuperscript{22} Id.
\textsuperscript{23} Id. at ¶92.
\textsuperscript{24} Id. at ¶93.
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IV. SCOPE AND STATUS OF “RULE OF SUBSTITUTION” IN INTERNATIONAL LAW

As discussed earlier, the Court in Diallo declared that the wider rule of substitution has no status in customary international law and refused to apply the same. Even the limited exception proposed under Art. 11(b) has not attained the status of customary international law as suggested by the ILC. The decision in Diallo was not helpful in clarifying the scope and the status of substitution since it remains silent in relation to these questions. The question thus arises, if the approach the ICJ adopted in Diallo i.e. to look at customary law status alone, was correct. The doubt arises since the majority decision of Barcelona Traction, along with the separate opinion of Judge Fitzmaurice and Judge Jessup, pointed out that the rule of substitution is based on equity. It could be argued that the rule of substitution can derive itself from equity under art. 38(1)(c) of the ICJ Statute and that the dismissal of the legal validity of substitution, without finding its roots in equity under art. 38(1)(c), is questionable (However it should be kept in mind that this could also be because a contention to that effect was not raised by Guinea). This Part seeks to deliberate on the same. It will first discuss equity and its use under art. 38(1)(c) of the Statute of the ICJ and will then elaborate on the status and the scope of the rule of substitution under international law.

A. EQUITY PRAETER LEGEM UNDER ART. 38(1)(c) OF THE ICJ STATUTE

The positions in law that the ICJ has the freedom to apply equity within article 38(1)(c) of the ICJ Statute and that such power is not restricted by the special power to decide cases ex aequo et bono under art. 38(2) are not much in contention today. The doubt arises in the way equity could be applied i.e. should its application be restricted as an interpretative tool within the confines of law (infra legem) or should it also be used to fill gaps in law or individualize justice by tempering the rigours of strict law (praeter legem) The latter has found considerable support in the practice of the ICJ.

One of the first few cases to apply equity praeter legem are the North Sea Continental Shelf Cases. It must be noted that though the authority for the use of equity was not derived from art. 38(1)(c) of the ICJ Statute, the equitable principles that the ICJ identified for delimitation of continental shelf were “general

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25 Id. at ¶89; See also Alberto Alvarez-Jimenez, Foreign Investors, Diplomatic Protection and the International Court of Justice’s Decision on Preliminary Objections in the Diallo Case, 33 N.C.J. INT’L. L. & COM. REG. 437 (2008), on the point that the court ignored the grounds of equity laid in Barcelona Traction.
26 DADP, supra note 7, art.11, ¶12.
27 See Diallo, supra note 8, at ¶¶91 -93.
28 See Barcelona Traction, supra note 1, at ¶92; supra note 13.
principles.” We could identify the Court’s decision in terms of a renvoi to equity as a source of principles that are recognised by nations. 30 This view has been supported in the writing of scholars like M. W. Janis and C. W. Jenks. 31 This approach was followed in number of delimitation cases by the ICJ to prevent an unjust result. 32 For instance, the ICJ, in the Case concerning the Continental Shelf (Tunisia/Libyan Arab Jamahiriya) says,

“[Equity] was often contrasted with the rigid rules of positive law, the severity of which had to be mitigated in order to do justice. In general, this contrast has no parallel in the development of international law; the legal concept of equity is a general principle directly applicable as law.” 33

This view has, however, been criticised as the principles could be subjective, unstructured and could permit the international judge to exercise unfettered judicial discretion. 34 However, there are benefits of such application too. Besides the prevention of unjust application of rules, the use of equity praeter legem prevents the creation of non-liquet as well. Hence, this rule will suffer less criticisms if the “equitable principles” could be predictable in certain concrete circumstances. 35

With this background in mind, the note now proposes to explore if there is a basis to sustain the rule of substitution under art. 38(1)(c) of the ICJ Statute and also see if we could define concrete circumstances where this rule could apply.

B. STATUS OF THE RULE IN INTERNATIONAL LAW

It is accepted that the rule of substitution, both in its traditional version and in the modified version (as adopted by the ILC) lacks customary status. 36 However, the rule cannot be denied a normative status on grounds of equity under art. 38(1)(c) of the Statute of the ICJ. The ICJ’s approach in Barcelona Traction itself supports this claim. In this case, the ICJ did not rule out the possibility of recourse

30 Id. at ¶85.
32 Case concerning the Continental Shelf (Tunisia/Libyan Arab Jamahiriya) 1982 I.C.J. 18 (Feb. 24) [hereinafter Continental Shelf - Tunisia/Libyan Arab Jamahiriya]; Case concerning Delimitation of the Maritime Boundary in the Gulf of Maine Area (Canada/United States of America) 1984 I.C.J. 246 (Oct. 12) [hereinafter Gulf of Maine].
33 Continental Shelf - Tunisia/Libyan Arab Jamahiriya, supra note 32, at ¶71.
34 Dissenting Opinion of Judge Gros, Continental Shelf - Tunisia/Libyan Arab Jamahiriya, supra note 31, at ¶18-19 (highlights the problem of subjectivity); Dissenting opinion of Judge Gros, Gulf of Maine, supra note 31, at ¶41-44 (highlights the problem that it will become a government of judges); Advisory Committee of Jurists, PROCEDES-VERBAUX OF THE PROCEEDINGS OF THE COMMITTEE, 1920 296-333 (highlighting the issue of “unfettered judicial discretion”).
36 See supra notes 25-27.
to equity as an alternative to law. However, it did not apply equity since Spain was not the national state of Barcelona Traction – a situation which the ICJ felt did not demand a departure from the general rule. Substitution, under equity, has also found express support in the Iran-US Claims Tribunal that allowed shareholders to take claims on behalf of the corporation subject to the defences and counterclaims that could have been raised against the corporation in Harza et al v The Islamic Republic of Iran. This shows that a rule of substitution can, subject to the scope, derive its source from article 38(1)(c) of the ICJ Statute.

C. Scope of the Rule in International Law

It is difficult to contain the content of equity to one specific rule guiding all situations. This “subjectivity” has often been criticised. However, in the context of substitution, Barcelona Traction identifies a specific circumstance (i.e. when the state of incorporation is itself responsible for inflicting injury on the company and the foreign shareholders’ sole means of protection at the international level is through their state(s) of nationality) that triggers the application of equity to protect the shareholders against a situation without a remedy. A similar situation logically demands an assessment to see if a remedy could be provided in equity. The same should have been done in Diallo.

However, it could be argued that the narrower rule identified by the DADP (as discussed above, the principle codified is also a principle of equity even though it does not have a status in customary international law) is correct and it goes a step further in identifying a more concrete circumstance in which the rule must apply. However, it is questionable to restrict a rule based in equity to this degree to avoid subjectivity. Even Judge Fitzmaurice in Barcelona Traction did not suggest that it is in cases of forced incorporation that the intervention is mandatorily needed, (He said that it is “most” needed in such situations). Kunzli believes that this narrower right under DADP is correct since Diallo acknowledged the merits of the exceptions provided in this article. This viewpoint has been criticized by various scholars like Knight and O’Brien who believe that this rule in equity has been unnecessarily stunted to reduce the number of claims. The requirement to show that incorporation is a pre-condition is stringent and arbitrarily excludes cases where business prudence demands the

37 Barcelona Traction, supra note 1, at ¶92-102.
39 Barcelona Traction, supra note 1, at ¶92.
40 DADP, supra note 7, art.11, ¶9; supra note 14.
setting up of business. It could render many claims without remedy. Knight and O’Brien suggest,

[C]onsistent with past authority, both the Court and the ILC treated the requirement to incorporate in a state in order to do business there as potentially giving rise to different legal rights. Logically, it is difficult to see why this would be so. In both cases, the investor has made a choice to conduct business in the state and has thereby assumed the risk that it will be subject to regulatory or other intervention. When both investors freely choose to conduct business in a foreign state, thereby assuming risk of regulation, why should one investor be denied diplomatic protection simply because they incorporated in the wrongdoing state? If ‘considerations of equity’ necessitate a substitution rule, there appears to be no good reason why the rule should benefit only those legally required to incorporate in a state as a prerequisite to doing business there. A cynical view might be that the distinction has arisen because it will reduce the number of diplomatic protection claims brought. Perhaps this is not surprising when the very existence of the doctrine is premised on ‘considerations of equity’ rather than any logical consistency with the principles of diplomatic protection. [Emphasis added]  

It must be pointed out that the note does not attack ILC’s approach towards the progressive development of customary law. ILC is not incorrect to work towards a narrower right of substitution to which many states may consent (However, this effort may be not be required in light of the existence of a broader rule in equity). In fact, the rule under art. 11(b) of the DADP is also for progressive development and has been accepted by many states. However, as far as equity goes, it will be wrong to limit it to the narrow exception the ILC proposes in art. 11(b) of the DADP.

V. CONCLUSION

The rule of substitution was first introduced in the Barcelona Traction as a relief under equity and could be continued to be defended as a manifestation of equity, i.e. a general principle under art. 38(1)(c) of the ICJ Statute. However, subsequently in Diallo, the ICJ ignored the equity ground and restricted itself to finding if the traditional notion of substitution has reached the status of customary

international law. Post Diallo, mostly, the scholars have focused merely on Art. 11 of the DADP to define the content of the rule; or have focused solely on determining the status of such a rule in customary international law. This is clearly not the best route to take. With already established reasons in equity, the development of the rule under art. 38(1)(c) of the ICJ Statute is desirable. It, in fact, makes the application easier – as one will not have to take an elaborate assessment of its customary status (or even work towards progressive development). Further, it also avoids the unnecessary exclusion of shareholders who cannot establish that incorporation of the company was a precondition of doing business in the host state from any possible remedy. It is perhaps the ILC’s efforts in the progressive development of the customary status of art.11 (b) that has been the reason for the ICJ and scholars to not explore alternative sources to back the rule of substitution. A serious re-consideration of the rule’s status is thus welcome.