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An Overview of the NAFTA Investment Chapter: Substantive Rules and Investor-State Dispute Settlement

Trade and investment flows are interdependent. To achieve the benefits of economic liberalization, investment barriers must be addressed as comprehensively as trade barriers. Hence, a chapter on investment was an essential element of an agreement that was to provide the basis for hemispheric free trade.

Chapter 11 of the North American Free Trade Agreement (NAFTA), the investment chapter, has three objectives: establish a secure investment environment through the elaboration of clear rules of fair treatment of foreign investment and investors; remove barriers to investment by eliminating or liberalizing existing restrictions; and provide an effective means for the resolution of disputes between an investor and the host government.

These three objectives are reflected in the structure of the chapter. Section A of the chapter sets forth the principal substantive obligations of the parties on matters concerning the treatment of investment. Section A and annexes I–IV contain exceptions to those obligations as well as commitments for liberalization of existing restrictions. Section B establishes a dispute settlement mechanism for resolving claims by an investor that the host government has breached its obligations under the chapter. This article provides a brief overview of these three parts of the investment chapter.

I. Section A: Substantive Rules and Principles

A. Scope

The scope of the chapter is very broad. It affords protection to existing as well as future investments in one NAFTA Party owned or controlled, directly or

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indirectly, by investors of another NAFTA Party. Two key defined terms are essential to understanding the scope and operation of the chapter: "investor" and "investment."

An investor of a Party is defined to include a "national or enterprise of a Party, that seeks to make, is making or has made an investment."[1] An enterprise of a Party includes all forms of business entities (for example, corporations, partnerships, trusts) "constituted or organized" under the laws of that Party.[2]

Investment is defined very broadly in article 1139 to include ownership and other interests in an enterprise, such as equity or debt securities of an enterprise as well as certain loans to an enterprise. Investment covers interests that entitle an owner to share in the income or profits of an enterprise; real estate; and all forms of tangible and intangible property, including intellectual property. The definition of investment also extends to interests arising from the commitment of capital or other resources such as under concession agreements; turnkey or construction contracts; or contracts where the remuneration depends on the production, revenues, or profits of an enterprise such as may occur under license or franchise agreements.

Putting these two key terms together, the chapter applies in general to how a Party must treat investors of another Party and their investments in its territory.

B. Treatment Principles

Section A is built around four principles: (1) national treatment and most-favored-nation (MFN) treatment; (2) prohibition of performance requirements; (3) free transfers of profits and other international payments associated with the investment; and (4) international law standards on expropriation and compensation.

1. *National and MFN Treatment*

This is the fundamental obligation of the chapter. Simply put, each Party must treat other NAFTA investors and their investments no less favorably than it treats its own investors and their investments (national treatment[3]) or investors and investments of third parties (MFN treatment[4]). A Party is obliged to accord the better of national or MFN treatment.[5]

These treatment obligations apply to all measures relating to the "establishmen acquisition, expansion, management, conduct, operation, and sale or other disposition of investments."[6] These basic obligations ensure that, subject to agreed

1. North American Free Trade Agreement [hereinafter NAFTA] art. 1139. All references to the NAFTA are to the October 7, 1992, draft.
2. *Id.* art. 201(1).
3. *Id.* art. 1102.
4. *Id.* art. 1103.
5. *Id.* art. 1104.
6. *Id.* arts. 1102, 1103.

exceptions in the annexes, a Party may not subject enterprises to different or more onerous operating conditions simply by virtue of foreign ownership. In addition to these general provisions, the chapter expressly prohibits certain commonly encountered forms of discrimination such as requirements that a minimum level of equity be held by local nationals,[7] or that certain senior management positions be reserved to local nationals.[8] Finally, the foregoing comparative standards and explicit prohibitions are supplemented by the incorporation of customary international law principles obligating the host government to accord "fair and equitable treatment" and "full protection and security" to investments in its territory.[9]

2. *Prohibition on Performance Requirements*

The second main principle is the prohibition on performance requirements. Article 1106 makes clear that no NAFTA country can impose requirements on investors that they export a certain percentage of output; give preferences for domestic sourcing; achieve a certain level of domestic content; transfer technology; or achieve a certain trade balance by restricting domestic sales to some proportion of exports or foreign exchange earnings.

The prohibition on performance requirements serves two goals. First, it eliminates trade distortions that arise from the imposition of performance requirements. Hence a Party is prohibited from imposing such requirement even on its own investors. Second, it ensures a degree of entrepreneurial autonomy: sourcing and sales decisions are based on the investor's judgment, not by the dictates of the host government. Finally, with respect to performance requirements, there is a prohibition on certain requirements linked to incentives.[10] The essence of this provision is that certain performance requirements are so unacceptably trade-distorting or intrusive that host governments should not be able to induce an investor to accept them by conditioning the receipt of any advantage on their fulfillment by the investor.

3. *Transfers Relating to Investments*

Transfers are the lifeblood of an investment. Article 1109 guarantees that investors can obtain foreign currency at a market rate of exchange for the purpose of making payments associated with their investments. This includes transfers to the investor such as the remittance of profits and dividends, the payment of interest and principal under a loan agreement, royalty payments, management fees, and proceeds from sale or liquidation of an investment. The transfers article also applies to payments or transfers by an investment, such as a subsidiary, to a third party such as payments under a contract for goods or services.

7. *Id.* art. 1102(4).
8. *Id.* art. 1107(1).
9. *Id.* art 1105(1).
10. *Id.* art. 1106(3).

4. *International Law Standards on Expropriation and Compensation*

Article 1110 addresses nationalization and expropriation of investments. It covers direct, indirect, and so-called "creeping" expropriation. It provides that investments may not be expropriated except for a public purpose, on a nondiscriminatory basis, in accordance with due process of law, and upon payment of compensation as specified in the article. Compensation must be paid without delay, be equal to the fair market value of the investment, include interest from the date of expropriation, and be fully realizable and freely transferable as provided in the transfers article.

Usefully, article 1110(2) specifies that valuation criteria should be used that are appropriate to determine fair market value. For example, one of the criteria listed, "going concern value," would be appropriate to determine fair market value in the case of an expropriation of a business or other ongoing enterprise. Other criteria listed may be appropriate if a single piece of tangible property or some other discrete asset—as distinct from assets used as part of an ongoing business—has been expropriated.

The article does not attempt to articulate the line between a legitimate regulation and a compensable taking. However, because loans are included within the definition of investment, the Parties did offer one clarification. Article 1110(8) provides that a nondiscriminatory measure of general application would not be considered a "measure tantamount to an expropriation" of a loan or debt security solely on the ground that it increases the debtor's general costs of doing business, thus causing it to default on the debt.

Agreement between Mexico and the United States on the expropriation article effectively ends a difference that has persisted for decades on what compensation is due in the event of an expropriation.

5. *Environmental Provisions*

Article 1114 sets forth two provisions highlighting the importance of environmental protection. Paragraph 1 notes that the chapter should not be construed to prevent a Party from adopting measures to ensure that investments are undertaken in an environmentally sensitive manner, provided that those measures are otherwise consistent with the chapter. In paragraph 2 the Parties record their shared conviction that investment should not be encouraged by relaxing health, safety, or environmental measures.

II. Exceptions to the Rules and Liberalization Commitments

Exceptions to rules set forth in section A and certain liberalization commitments are found in the annexes to the investment chapter. These are briefly reviewed.

Annex I lists existing measures of a Party that derogate from the national treatment, MFN, or performance requirement obligations. Measures listed in this annex are subject to the so-called "ratchet" rule: a measure may not be made more restrictive and, if liberalized, may not later be made more restrictive.

Annex II lists sectors such as maritime and basic telecommunications that are not subject to the ratchet rule.

Annex III lists Mexico's constitutionally based exceptions. These exceptions are subject to the ratchet rule. In addition, any foreign investment (as defined in the chapter) that is or may be permitted in a constitutionally reserved sector will receive the benefits of the chapter.[11]

Annex IV lists sectors and certain agreements that are excluded from the scope of the MFN obligation. For example, all three Parties have excepted past investment agreements and future agreements in certain sectors such as fishing and aviation.

Commitments to phase out measures inconsistent with the chapter are also found in the annexes. For example, in annex I Canada and Mexico commit to alter their investment screening laws, but nonetheless retain a right to review certain foreign takeovers. Canada will still review acquisitions in excess of Can$150 million (adjusted annually for GNP growth and inflation). Mexico reserves the right to review transactions where a foreign investor acquires more than 49 percent of the equity of Mexican enterprises. The threshold for such review is acquisitions of enterprises with assets greater than $25 million in the first year increasing to $150 million in the tenth year (also adjusted for GNP growth and inflation). Canada and Mexico reserve the right to review greenfield investment only in specified sectors.

In addition to exceptions in the annexes, chapter 21 of the NAFTA contains certain generally applicable exceptions to NAFTA rules such as exceptions relating to national security and balance of payments measures.

III. Settlement of Investment Disputes

Section B of chapter 11 establishes a mechanism for the settlement of investment disputes between a NAFTA country and an investor of another NAFTA country through international arbitration. It is one of the key achievements of the investment chapter. It represents the first time Mexico has entered into an international agreement providing for investor-state arbitration. It is as well the first time two OECD countries have included such provisions in agreements between themselves.

A. Standing and Jurisdiction

As part of its NAFTA obligations, each NAFTA country has consented to the submission of a claim to arbitration in accordance with NAFTA procedures.[12]

11. *Id.* art. 1101(2); annex III(B), (C); note 39.
12. *Id.* art. 1122.

Under the investor-state arbitration mechanism an investor of a NAFTA country, on its own behalf,[13] or on behalf of an enterprise that the investor owns or controls directly or indirectly,[14] may assert a claim that the investor or the enterprise has incurred loss or damage as a result of a breach by the host country of a provision of the NAFTA. Article 1117 is intended to resolve the *Barcelona Traction*[15] problem by permitting the investor to assert a claim for injury to its investment even where the investor itself does not suffer loss or damage independent from that of the injury to its investment.

The investor-state arbitration provisions extend, subject to explicit reservations set out in the NAFTA, to (1) actions taken by federal, state, and provincial governments; (2) certain actions taken by state enterprises; and (3) actions taken by certain state-chartered monopolies when the actions are inconsistent with the NAFTA.

Claims must be brought within three years of when the investor (or enterprise) first acquired, or should have acquired, knowledge of the breach and knowledge of loss or damage. At least ninety days before submitting a claim to arbitration, an investor must so notify the host country.[16]

B. Applicable Rules[17]

With certain exceptions and when six months have elapsed since the events giving rise to a claim, an investor may submit a claim to arbitration under:

(1) the Convention on the Settlement of Investment Disputes between States and Nationals of other States (ICSID Convention),[18] provided that both the host country and the investor's home country are parties to the Convention;

(2) the Additional Facility Rules of the ICSID Convention, provided that either the host country or the investor's country is a party to the Convention; or

(3) the UNCITRAL Arbitration Rules.

The applicable arbitration rules govern the arbitration except as modified by NAFTA rules.

At present, only the United States is party to the ICSID Convention. Hence, only U.S. investors, or claims against the United States, may be heard under the Additional Facility Rules.

C. Conditions Precedent[19]

An investor may submit a claim for arbitration under the investment chapter only if the investor (and enterprise, where the claim is submitted on its behalf)

13. *Id.* art. 1116.
14. *Id.* art. 1117.
15. Barcelona Traction Case (Belgium v. Spain), [1970] I.C.J. Rep. 3 (Preliminary Objections).
16. NAFTA art. 1119.
17. *Id.* art. 1120.
18. [1966] 17 U.S.T. 1270, T.I.A.S. No. 6090.
19. NAFTA art. 1121.

satisfies certain conditions. It must consent to arbitration in accordance with the procedures set out in the NAFTA. It must also waive the right to initiate or continue before any administrative tribunal or court under the law of any NAFTA partner, or other dispute settlement procedures, any proceedings with respect to the measure that is alleged to be a breach of the NAFTA, except for proceedings for injunctive, declaratory, or other extraordinary relief not involving the payment of damages. The consent and waiver must be delivered to the host country in writing. Because a tribunal is empowered to award only monetary damages,[20] investors are not required to waive their right to seek other relief in domestic courts.

D. Composition of Tribunal

As a general rule, an arbitration tribunal will comprise three arbitrators, one appointed by each disputing party and the third (the presiding arbitrator) appointed by agreement of the disputing parties.[21] When a tribunal has not been constituted within ninety days from the date the claim is submitted to arbitration, the secretary-general of the ICSID, on the request of either party, will appoint the arbitrator or arbitrators not yet appointed.[22] When the disputing parties are unable to agree on a presiding arbitrator, the secretary-general of the ICSID, on the request of either party, will appoint such arbitrator (who is not a national of either disputing party) from a roster of forty-five persons appointed by consensus by the NAFTA Parties,[23] or if no one on the roster is available, from the ICSID panel of arbitrators.

E. Consolidation of Claims[24]

One of the novel features of the dispute settlement mechanism is provision for the consolidation of claims. Thus, where two or more claims submitted to arbitration have a question of law or fact in common, the claims may "in the interests of fair and efficient resolution of the claims" be consolidated and heard by a tribunal established under the UNCITRAL Arbitration Rules, except as modified by the NAFTA.[25] The decision to consolidate can be made only after hearing the disputing parties on the question of whether consolidation in a particular dispute meets the criteria of the article.

The question of consolidation is heard by a tribunal comprising three arbitrators each appointed by the secretary-general of ICSID from the agreed roster.[26] The

20. *Id.* art. 1135.
21. *Id.* art. 1123.
22. *Id.* art. 1124.
23. *Id.* art. 1124(4).
24. *Id.* art. 1126.
25. *Id.* art. 1126(2).
26. *Id.* art. 1126(5).

presiding arbitrator cannot be a national of either the disputing investors or a disputing Party. If the tribunal believes that consolidation is appropriate, it may assume jurisdiction over and decide (1) all or part of the claims, or (2) one or more claims that it believes would assist in the resolution of the others.

The chapter does not resolve all the questions that may occur during consolidation. Many issues will need to be worked out by the tribunal in consultation with the disputing parties.

F. Place of Arbitration and Governing Law

Unless the disputing parties agree otherwise, an arbitration tribunal will hold the arbitration in the territory of a NAFTA country that is a party to the New York Convention,[27] to ensure enforceability under that Convention.[28] An arbitration tribunal must decide the issues in dispute in accordance with the NAFTA and applicable rules of international law.

G. Role of the Parties

Section B contains a number of provisions affording a role to the NAFTA Parties in the interpretation of the chapter. First, a defending state party must provide notice of a claim to the other Parties and provide copies of the pleadings filed in the arbitration.[29] Second, a Party not involved in the dispute may make submissions on a question of NAFTA interpretation.[30] Finally, the NAFTA Party against which an arbitration claim is filed may request the NAFTA Commission (i.e., the three state Parties) to issue a binding interpretation on whether the measure alleged to be a breach is within the scope of a reservation or exception set out in annexes I–IV.[31] If the Commission fails to submit an interpretation within sixty days of the request, the tribunal shall decide the issue itself.

H. Interim Measures of Protection and Final Award

An arbitration tribunal may order an interim measure of protection to preserve the rights of a disputing party, or to ensure that the tribunal's jurisdiction is effective, including an order to preserve evidence in the possession or control of a disputing party or to protect the tribunal's jurisdiction.[32]

An arbitration tribunal may award, separately or in combination, only monetary damages and applicable interest. Or it may order restitution of property, in which

27. Convention on the Recognition and Enforcement of Foreign Arbitral Awards (1958), 21 U.S.T. 2517, 330 U.N.T.S. 3, T.I.A.S. No. 6997.
28. NAFTA art. 1130.
29. *Id.* art. 1127.
30. *Id.* art 1128.
31. *Id.* art. 1132.
32. *Id.* art. 1134.

case the award must provide that the disputing country may pay monetary damages and applicable interest in lieu of restitution. An arbitration tribunal may also award costs in accordance with the applicable arbitration rules.[33]

I. Finality and Enforcement of an Award[34]

Section B is drafted so as to permit investors to avail themselves of the enforcement mechanisms provided in the ICSID Convention, the New York Convention, and the Inter-American Convention on International Commercial Arbitration.[35] Article 1122 states that the consent of the state Party recited in that article together with the submission of a claim by an investor satisfies the jurisdictional requirements of the three conventions. At the same time, this section permits enforcement action to be initiated by the state Party whose investor has received an award.

Each NAFTA country is obligated to abide by and comply with a final award and to provide for the enforcement of an award in its territory. An investor may seek enforcement of the award after 120 days in the case of an ICSID award, or ninety days in the case of an UNCITRAL award. If the NAFTA host country fails to abide by or comply with a final award, the NAFTA Commission, on the request of the home country of the investor, must establish an arbitral panel under chapter 20 of the NAFTA. In such proceedings, the requesting country may seek a determination that the failure to abide by or comply with the final award is inconsistent with NAFTA obligations and a recommendation that the NAFTA country abide by or comply with the final award. Failure to comply with the final award triggers the right of the state party under chapter 20 to suspend NAFTA benefits.

The section provides that an award by a tribunal will have no binding force except between the disputing parties and in the particular case.[36] In practice, however, tribunals are likely to take into account decisions of other tribunals.

J. Exclusions

The investor-state dispute settlement provisions exclude certain matters. If a NAFTA country blocks an investment on national security grounds, it may refuse to participate in investor-state dispute settlement, and its decision may not be challenged in an arbitral proceeding before the NAFTA Commission. Likewise, a refusal by Canada or Mexico to permit an acquisition under its investment screening law is not subject to investor-state or chapter 20 proceedings.

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33. *Id.* art. 1135.
34. *Id.* art. 1136.
35. [1990] Kavass 2215.
36. NAFTA art. 1136.

IV. Conclusion

Chapter 11 is the most comprehensive investment accord to date. The breadth of coverage and the strength of the disciplines exceed those found in any bilateral or multilateral instrument to which the United States is a party. The chapter unites two countries—Mexico and the United States—that have for decades sat on opposite sides of an ideological divide on such fundamental issues as expropriation, dispute settlement, and government control over foreign investment. Just as importantly, the chapter represents the first occasion when two developed OECD countries have made the same commitments to each other that they have demanded of developing countries. The chapter ought to set a standard for further multilateral and bilateral investment accords in the hemisphere.