The International Investor's Guide to Retaining a Successful NAFTA Chapter 11 Award on Appeal

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INCE 1994, NAFTA has dramatically changed how investors pursue international business in Canada, Mexico, and the United States. Because NAFTA was created with the purpose of substantially increasing investment opportunities in the free trade area, it was imperative that NAFTA implement regulations to protect these investors from discrimination by the government of the state in which the investor was investing. Chapter 11, the Investment Chapter, is deemed to be that protection for investors. By examining the Investment Chapter, the three successful Chapter 11 claims by foreign investors, and the impact of this jurisprudence, foreign investors can effectively and successfully respond to appellate procedures under the NAFTA dispute resolution process.

I. THE INVESTMENT CHAPTER

A. Disputed Provisions

NAFTA’s eleventh chapter specifies the relational conduct between the investor from one NAFTA state (foreign investor) and the NAFTA state in which investor is investing (host state). Often noted for its linguistic ambiguity, the Investment Chapter is a source of significant international trade dispute. The following three provisions are the most debated between foreign investors and host states.

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2. Id. at art. 1101.
1. National Treatment

One controversial Chapter 11 provision, article 1102, describes the type of treatment between host states and their foreign investors. This provision states that foreign investors from other NAFTA states should be treated in the same manner by the host state as the domestic investors from that host state. For example, if a Canadian company has an office in Mexico, the Mexican government should treat the Canadian company like it would treat a Mexican company performing the same services.

Article 1102 is designed to prevent domestic governments from requiring foreign investors to confer benefits to the domestic economy beyond those extended in the ordinary course of their business, from imposing more burdens on foreign economic interests than on domestic concerns, and from excluding foreigners from certain sectors of the domestic economy.

Specifically, this type of treatment means "treatment no less favorable than the most favorable treatment accorded" by that governmental entity.

2. International Law and Interpretive Note

The second controversial Chapter 11 provision is article 1105, and it specifies the standard of international treatment afforded to foreign investors. The provision states that each host state shall treat foreign investors "in accordance with international law, including fair and equitable treatment and full protection and security." Violations not only include outright discriminatory laws and regulations, but also discriminatory application and administration of non-discriminatory laws or regulations. As this article provides the minimum standard of treatment between these parties, the standard is treated as a condition precedent to investment in a host state. Because no NAFTA provisions acutely define "fair and equitable treatment," there is fear that inconsistent tribunal decisions will lead to unequal application of the phrase in both domestic courts and international arbitrations.

In 2001, NAFTA's Free Trade Commission, which is composed of representatives from all three NAFTA states, issued the Interpretive Note to clarify application of NAFTA article 1105. The Interpretive Note speci-
fied the following:

1. Article 1105(1) prescribes the customary international law minimum standard of treatment of aliens as the minimum standard of treatment to be afforded to investments of investors of another Party.

2. The concepts of "fair and equitable treatment" and "full protection and security" do not require treatment in addition to or beyond that which is required by the customary international law minimum standard of treatment of aliens.\(^\text{15}\)

Initially, arbitrators and scholars questioned the legitimacy of the Interpretive Note.\(^\text{16}\) Since that time, tribunals have affirmed that the Interpretive Note demonstrates international custom, but no tribunal has accorded it complete legitimacy as law.\(^\text{17}\)

3. *Expropriation*

Article 1110, the third controversial provision, stipulates a no-expropriation policy, whereby a host state cannot expropriate the investment of the foreign investor in its territory.\(^\text{18}\) The only exception to this provision is if the host state expropriates the investment for a public purpose.\(^\text{19}\) But even this exception is qualified in that the expropriation has to be non-discriminatory and compliant with article 1105, and the foreign investor has to be accurately compensated by the host state.\(^\text{20}\) A prominent view of article 1110 is that it essentially embodies the U.S. common law of eminent domain.\(^\text{21}\) But some would argue that this is an extreme position that has not been adopted by a significant number of tribunals; therefore, the expropriation provision is not equivalent to regulatory takings.\(^\text{22}\) As a result of the ambiguity of article 1110, what actually constitutes an expropriation is also the basis of many disputes.

B. *Dispute Resolution*

1. *Arbitration Procedure*

NAFTA Chapter 11 creates a broad jurisdictional scope, because the treaty's definitions of investor and investment are very broad and inclusive.\(^\text{23}\) The Investment Chapter provides that pertinent disputes by foreign investors be resolved through a tribunal arbitration process.\(^\text{24}\)

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\(^\text{15}\) *Id.* § B.


\(^\text{17}\) *Id.* at 1429-30.

\(^\text{18}\) NAFTA, *supra* note 1, at art. 1110.

\(^\text{19}\) *Id.*

\(^\text{20}\) *Id.*

\(^\text{21}\) Afilalo, *supra* note 7, at 289.

\(^\text{22}\) Hufbauer & Schott, *supra* note 4, at 206-07.

\(^\text{23}\) Afilalo, *supra* note 7, at 290; see NAFTA, *supra* note 1, at art. 1138.

\(^\text{24}\) NAFTA, *supra* note 1, at art. 1115.
NAFTA parties first utilized this dispute resolution process in September of 1996, and all three NAFTA states have increasingly continued to utilize the process in order to resolve disputes between the foreign investors and the host states in which they invest. The typical Chapter 11 arbitration tribunal includes three arbitrators— one arbitrator appointed by each of the two opposing parties and one presiding arbitrator agreed upon by both of the opposing parties. The tribunal usually determines the place of arbitration. NAFTA article 1120 provides a choice of rules for the arbitrations: either the International Center for Settlement of Investment Disputes (ICSID) Additional Faculty Rules or the United Nations Commission on International Trade Law (UNCITRAL) Rules. NAFTA article 1136 provides three guidelines for applying tribunal awards:

First, awards "have no binding force except between the disputing parties and in respect of the particular case." . . . Second, . . . losing parties [have] an opportunity to seek revision or annulment of Chapter 11 awards by municipal courts at the seat of arbitration. . . . Third, investors may . . . seek enforcement of [the] awards.

2. Appellate Procedure

The three tribunal awards that have been appealed by host states had their original seat of arbitration in different provinces of Canada. Once the appeal is claimed, the appellate court must decide under which domestic law to review the award. Canadian courts can review the tribunal award under either the International Commercial Arbitration Act (ICAA) or the Commercial Arbitration Act (CAA), which gives the force of law to the Commercial Arbitration Code (CAC). The ICAA applies only to international commercial arbitrations, while the CAA applies to the rest of the arbitrations within the Canadian provinces. In Metalclad v. Mexico, the host state argued for the application of the CAA review, because the CAA "allow[ed] courts to set aside awards on broad grounds including errors of law." The foreign investor, however, successfully argued for the application of the ICAA review, which is noted to be narrower in its review process. Therefore, deciding which domestic law is applicable is very important to the parties' appellate strategies.

27. Id. at 1389.
28. Id.
29. HAUFBAUER & SCHOTT, supra note 4, at 204.
32. Id.; see infra note 59, ¶ 21.
33. Id. at 199.
34. Id.
35. Id.
II. PERTINENT CASES

Only three cases have ever been appealed beyond the tribunal level: Metalclad, S.D. Myers, and Feldman. In each of these cases the foreign investor-complainant received a successful judgment against the host state in which the foreign investor was investing. The host state then appealed the tribunal’s judgment, and the judgment was reviewed by a national court of a NAFTA state agreed upon by the parties to the dispute. The proffered court opinions in these cases are essential to understanding the evolving Chapter 11 jurisprudence, both at the tribunal and appellate levels.

A. Metalclad v. Mexico

1. Facts

The Metalclad Corporation (Metalclad) was a U.S. waste disposal company seeking a municipal license in Mexico that would have granted Metalclad the ability to operate its hazardous waste treatment facility and landfill site. After Metalclad had significantly invested in the project through construction, the Mexican government declared that the facility and landfill site were an ecological zone.

2. Tribunal Award

Metalclad filed a claim against Mexico under NAFTA Chapter 11, asserting that Mexico had breached the provisions under NAFTA articles 1105 and 1110 by the government’s refusal to grant the license and subsequent declaration of an ecological zone. In 2000, the tribunal made history by being the first tribunal to award a foreign investor a judgment under NAFTA Chapter 11 against a host state. Specifically, the tribunal held “that Metalclad was not treated fairly or equitably under NAFTA and succeeds on its claim under Article 1105.” Also, the tribunal held that Mexico’s tolerance of the municipality’s inequitable conduct towards Metalclad was “a measure tantamount to expropriation in violation of NAFTA Article 1110(1).” Because Mexico did not compensate Metalclad for the indirect expropriation, Mexico violated article 1110. The

37. Id. ¶¶ 9, 11, 17.
38. Wiltse, supra note 3, at 1163.
41. Id. ¶ 104.
42. Id. ¶ 112.
tribunal decision was controversial in two respects: (1) the tribunal interpreted article 1105 as requiring complete transparency of host states;\(^{43}\) and (2) the tribunal defined expropriation under article 1110 broadly, perhaps more broadly than international custom permitted.\(^{44}\)

3. Judicial Review

According to the ICSID Additional Faculty procedures, Mexico appealed the tribunal’s decision to the Supreme Court of British Columbia, because Vancouver, British Columbia, was the original seat of arbitration. In its appeal to the Supreme Court of British Columbia, Mexico argued that the court should set aside the tribunal award “on the grounds that it exceeded its jurisdiction and that enforcing the award would violate public policy.”\(^{45}\) This case again made history by setting aside a tribunal award, even if only in part.

Regarding article 1105, Justice Tysoe found that the provision merely sets the minimum standard for fair and equitable treatment, and this standard does not include the transparency imposed on Mexico by the tribunal.\(^{46}\) In Tysoe’s opinion, Mexico had been held liable based on the inference formed by lack of transparency.\(^{47}\) Because the requirement of transparency was beyond the scope of arbitration, Mexico won this point under article 1105 on appeal.\(^{48}\) Justice Tysoe found that part of the decision must also be set aside due to article 1110. Regarding Metalclad’s claim concerning the events before the ecological decree,

the Tribunal’s reliance on a concept that was beyond the scope of the submission to arbitrate—transparency—to ground a conclusion that there had been an “expropriation” contrary to Article 1110 meant that this latter finding must also be set aside on the ground that it was beyond the scope of the submission to arbitrate.\(^{49}\)

The only part of the tribunal’s award that was not set aside was the tribunal’s findings concerning article 1110 and the situation after the ecological decree.\(^{50}\) Tysoe did not find the tribunal’s definition of expropriation patently unreasonable, and he did not have jurisdiction to set aside the tribunal’s decision that the ecological decree constituted an expropri-

\(^{43}\) Specifically, the tribunal defines transparency as includ[ing] the idea that all relevant legal requirements for the purpose of initiating, completing and successfully operating investments made, or intended to be made, under the Agreement should be capable of being readily known to all affected investors of another Party. There should be no room for doubt or uncertainty on such matters.  
\(\text{Id.} \gg 76.\)

\(^{44}\) Tollefson, supra note 31, at 185.


\(^{46}\) Tollefson, supra note 31, at 209.

\(^{47}\) Id. at 212.

\(^{48}\) Id.

\(^{49}\) Id. at 218.

\(^{50}\) Metalclad Corp., 89 B.C.L.R.3d ¶ 81.
ation under article 1110. As the only opinion that has set aside a tribunal award, even though only in part, the Metalclad decision is one that will likely remain very influential as an indication for Vancouver arbitration awards and as an example of how to nullify Chapter 11 awards.

B. S.D. Myers v. Canada

1. Facts

The U.S. company S.D. Myers, Inc. (S.D. Myers), operated a Canadian subsidiary for the purpose of exporting polychlorinated biphenyls (PCBs) to the United States for disposal. Even though the United States had given permission to S.D. Myers to import the PCBs, Canada passed a "facially neutral" regulation that banned PCB exportation. Some Canadian government officials even stated that the "handling of PCBs should be done in Canada by Canadians."

2. Tribunal Award

S.D. Myers brought a NAFTA Chapter 11 claim against Canada, under articles 1102, 1105, and 1110. The tribunal upheld the foreign investor's claims under articles 1102 and 1105, but dismissed the claim under 1110. With respect to article 1102, the tribunal found that S.D. Myers was "in like circumstances" with Canadian domestic investors, and therefore should have been treated no less favorably than these domestic investors. Because Canada banned PCB exportation after lobbying by Canadian PCB disposers, the tribunal determined that Canada violated NAFTA article 1102. Regarding article 1105, "the tribunal concluded that the phrase 'fair and equitable' could not be read in isolation but, rather, must be read in conjunction with the introductory phrase 'treatment in accordance with international law.'" Because Canada blatantly preferred domestic investors over foreign investors, the tribunal found Canada to be in violation of NAFTA article 1105. The tribunal denied the 1110 claim because the PCB exportation ban was temporary and there was no property conveyance to the government or any other party.

51. Id. ¶¶ 99, 100, 105.
52. Coe, supra note 16, at 1411-12.
53. Wiltse, supra note 3, at 1166; see infra note 59, ¶ 4.
54. Id.
56. Id. at 1576-77 (quoting S.D. Myers, Inc. v. Canada, UNCITRAL (2000)).
57. Wiltse, supra note 3, at 1166.
58. Id.
60. Id.
61. Franck, supra note 55, at 1577.
62. Id.
63. Wiltse, supra note 3, at 1167.
3. Judicial Review

In accordance with the UNCITRAL rules, Canada appealed the tribunal award to the Federal Court in Canada, because Toronto, Ontario, was the original seat of arbitration.64 In applying the domestic statute CAC article 34, the Federal Court dismissed Canada's appeal from the tribunal's verdict for lack of jurisdiction.65 Because Canada appealed from the judgments under NAFTA articles 1102 and 1105, and articles 1102 and 1105 were within the scope of the original arbitration, the Federal Court found that it did not have jurisdiction to review the tribunal's decision.66 Moreover, even if the Federal Court did have jurisdiction to review, it stated that article 1102 gave the tribunal a "flexible benchmark" by which to gauge "like circumstances."67 The Federal Court gave no opinion on Canada's actions under article 1105.68

C. Feldman v. Mexico

1. Facts

The Corporación de Exportaciones Mexicanas S.A. de C.V. (CEMSA) was a cigarette exporting company solely owned by U.S. investor Marvin Feldman.69 During the years from 1990 to 1997, CEMSA operated through a series of legislation permitting and then disallowing certain tax rebates resulting from cigarette exportation.70 The Impuesto Especial Sobre Producción y Servicios (Special Tax) was the Mexican regulation governing cigarette taxation.71 If a company exported cigarettes, the company was eligible for a tax rebate.72 But in order to receive the tax rebate, the company would have to specify how much of the Special Tax was actually paid on the invoice.73 Because CEMSA exported the cigarettes to mass wholesale organizations, the invoices did not have the Special Tax specifically enumerated separately from the other taxes.74 Mexico subsequently denied CEMSA the tax rebates as well as refused CEMSA authorization as a cigarette exporter.75

2. Tribunal Award

Feldman brought a claim against Mexico for breaching its duties under NAFTA articles 1102, 1105, and 1110. Feldman argued that Mexico's re-

65. Id. ¶ 1. 76.
66. Id. ¶ 76(10).
67. Id. ¶ 76(11).
68. Id.
70. Id.
72. Id.
73. Id.
74. Sharma & Goodman, supra note 69.
75. Karpa, 74 O.R.3d ¶¶ 7, 8.
fusal to pay the tax rebates specifically constituted (1) a breach of 1102, under which Mexico promised to treat foreign investors in a manner no less favorable than Mexico treats its own domestic investors; (2) “a denial of natural justice” under 1105; and (3) an expropriation under 1110. The tribunal found that Mexico had violated article 1102. The majority did not rule on Mexico’s actions under 1105 or 1110, although the opinion indicated that Mexico’s actions did not amount to expropriation under 1110. The tribunal awarded judgment to Feldman based on the conclusion that CEMSA was denied tax rebates in accordance with tax regulations that were waived for Mexican domestic companies. Thus, the tribunal determined that Mexico, as the host state, had violated NAFTA article 1102 by not treating the foreign investor in the same or better manner than Mexico treated domestic investors.

3. Judicial Review

Pursuant to the ICSID Additional Faculty rules, Mexico appealed the tribunal decision to the Ontario Superior Court, because Ottawa, Ontario, was the original seat of arbitration for this dispute. Mexico argued that the tribunal adopted “impermissible inferences from the evidence” and awarded a judgment in conflict with public policy. The Superior Court note the tribunal’s award deserved a high degree of deference upon review. On those grounds, the Superior Court noted that the tribunal had found, not on inferences, but “on Mexico’s own evidence,” that Mexico had granted the same tax rebates to domestic investors that had been denied to CEMSA. Additionally, the Superior Court found that the tribunal’s monetary award did not violate public policy. Therefore, the tribunal’s original award for the foreign investor and against the host state was upheld by the Ontario Superior Court on appeal.

III. IMPACT OF CHAPTER 11 JURISPRUDENCE

A. Precedential Value

The Metalclad case created the possibility that Chapter 11 tribunal judgments could be set aside by an appellate procedure. Both the S.D. Myers and Feldman complainants have sought to emulate the set-aside response by Judge Tysoe in Metalclad, although their efforts have proven futile with the claim dismissals. But Metalclad “has been studied by Chapter 11 tribunals, both for interpretive guidance and presumably in

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76. Id. ¶ 11.
77. Id. ¶ 12.
78. Id. ¶ 21.
79. Id.
80. Id. ¶¶ 1, 31.
81. Id. ¶ 25.
82. Id. ¶ 42.
83. Id. ¶ 60.
84. Id. ¶ 68.
seeking to immunize their awards from a similar fate." Therefore, it is a possibility that these judgment immunization efforts by tribunals will produce a somewhat cohesive evaluation of future awards.

The controversial NAFTA articles of 1102, 1105, and 1110 will likely remain the source of foreign investor claims in the future. According to the appellate decision in *S.D. Myers*, article 1102 has a "flexible benchmark" by which to measure "like circumstances." Foreign investors can use this benchmark to their advantage when arguing that a similar domestic investor is receiving preferential treatment by the host state over the foreign investor. Host states will likely seek to define the benchmark as narrowly as possible, with the consideration that like circumstances be proved in order to compare treatment. But foreign investors can rely on the outcome in *Feldman* in arguing the benchmark is flexible enough to infer from the host state's own evidence that the host state is in violation of article 1102.

Regarding NAFTA article 1105, *Metalclad* and the Free Trade Commission's Interpretive Note have set a stronger standard of interpretation of fair and equitable treatment. This provision merely sets the minimal standard of treatment according to customary international law. Foreign investor claimants probably will have to define their injuries under 1105 more narrowly. Moreover, a foreign investor cannot claim a violation of fair and equitable treatment when that violation is predicated on complete transparency by the host state. Therefore, the foreign investor most likely will have to narrowly tailor the 1105 claim to specific instances of mistreatment by the host state that do not have to be proved by evidence from the host state.

When evaluating NAFTA article 1110, a question remains as to the definition of expropriation. In *Metalclad*, the appellate court refused to find that the tribunal's construction of the term expropriation was patently unreasonable. Instead, the court recognized the tribunal's jurisdiction to interpret the bounds of the meaning of expropriation. Neither *S.D. Myers* nor *Feldman* gave an exact definition of the term, but the tribunal in *S.D. Myers* indicated that an action by the host state may be an expropriation if the action is permanent and conveys property to the government or another party. Therefore, even though the parameters of expropriation are far from defined by Chapter 11 jurisprudence, the previous cases indicate that a successful foreign investor claimant should prove the permanency of an actual property transfer based on the host state's actions.

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85. Coe, supra note 16, at 1411.
88. Id. ¶ 99.
89. See Wiltse, supra note 3, at 1167.
B. Impact on States

The Investment Chapter impacts the three NAFTA states in more respects than international relations. Chapter 11 also impacts how these state governments regulate and oversee their own domestic affairs. The arbitration process effectively holds states accountable not only to foreign investors, but also to their own citizens affected by the tribunal judgments. "Citizens of the three states have a stake... in the way in which [their governments] mediate the sometimes competing goals of promoting trade, protecting local enterprise, and regulating on the public’s behalf." Therefore, even though NAFTA provides a forum for international arbitration, tribunal judgments pierce the core of domestic relations as well. Domestic law regarding appellate procedure of NAFTA tribunal awards can significantly affect the strategy of the foreign investor complainants.

1. Canada

Currently, only Canada’s federal level of review of Chapter 11 awards is somewhat predictable because the ICAA expressly handles international commercial arbitrations. The evaluation by the provincial courts is less predictable, because the individual provinces have not specified how they are going to apply the ICAA. This ambiguity results in a possibility that host state appellants may be able to convince the appellate court to apply the CAA rules, which arguably provide a broader scope of review for setting aside judgments.

2. Mexico

Mexico has adopted a statute similar to Canada’s ICAA, which is specifically focused on international commercial arbitrations. But like the Canadian provinces, Mexico has yet to identify how this statute applies to Chapter 11 claims. This situation gives rise to the same opportunity that host state appellants may be able to convince the appellate court to apply the more broadly sweeping rules.

3. United States

The United States has not adopted a statute equivalent to Canada’s ICAA. Rather, appellate procedures of NAFTA tribunal awards conducted in the United States are governed by the Federal Arbitration Act...
The FAA rules may give more discretion to appellate courts to set aside judgments than Canada’s ICAA rules. Therefore, based on the applicable domestic law for appellate procedures regarding Chapter 11 claims, the foreign investor claimant would have the most predictable, and probably most favorable, outcome in the Canadian federal courts. These courts apply the ICAA rules that set out limited rationales for setting aside a tribunal award.

C. Impact on Investors

In addition to defining foreign investor claims more clearly, *Metalclad*, *S.D. Myers*, and *Feldman* also demonstrate how a successful NAFTA claim does not mean the complaining party will receive the total amount of damages pleaded. The award in *Metalclad*, although a significant $17 million, “constituted less than 20 percent of what the claimant sought.”101 S.D. Myers received only $6 million, after claiming $20 million in damages.102 And Feldman originally claimed $50 million, but only received $1.6 million.103 Even though the Chapter 11 jurisprudence has started to solidify principles set forth in the controversial articles of 1102, 1105, and 1110, foreign investors are still not receiving damages that are even close to what they originally claimed. Thus, on one hand, foreign investors can be more confident when claiming injuries under NAFTA Chapter 11, because tribunals are indicating principles of interpreting these provisions. On the other hand, foreign investors might be discouraged from submitting Chapter 11 claims if they are not likely to receive an amount in damages comparable to what they plead or deserve. By evaluating the impact of prior Chapter 11 jurisprudence and weighing the possible outcomes demonstrated therein, foreign investors can develop effective strategies in navigating the NAFTA tribunal and appellate proceedings.

99. Id.
100. Id. at 201-02.
102. Id. at 1438, 1459 n.277.
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