State Responsibility for Regulatory Measures Under International Law: Recent NAFTA Arbitration Cases

Publication
January 24, 2003


The NAFTA investment provisions embodied in Chapter Eleven brought to fruition decades of diplomacy in which the United States encouraged governments in the Western Hemisphere and elsewhere to assure foreign investments minimum standards of international law and just compensation for expropriated property. Chapter Eleven also implements long-standing U.S. policy supporting amicable resolution of investment disputes between host governments and foreign investors by impartial, third-party arbitration.

NAFTA entered into force on January 1, 1994. About twenty arbitration cases have been filed under Chapter Eleven to date. A number of the early cases involved environmental regulations imposed by state, local or federal authorities in all three NAFTA countries. Specifically, Canadian and American authorities were accused of manipulating environmental rules to protect domestic interests from foreign competition, and Mexican authorities were accused of repudiating investment-backed promises made to foreign investors in response to local concerns over environmental impacts.

There was a strong political response to these claims in all three countries with some critics arguing that Chapter Eleven was never intended to permit international review of regulatory measures and that NAFTA undermines national sovereignty. In the United States, negative reactions to proceedings challenging state and judicial actions culminated in the Trade Act of 2002[1], which assumes that U.S. law meets minimum international standards and instructs U.S. trade negotiators to ensure that foreign investors in the United States are not accorded greater substantive rights with respect to investment protections than U.S. investors in the United States.[2]

But it is not clear that Congress's assumption is correct. U.S. Fifth Amendment cases focus mainly on real property, and international law on this subject has been developed more by the State Department than by the Supreme Court. There is a real question, now that the United States has become a defendant in international arbitration, whether we remain committed to minimum standards of international law.
All too often the debate over Chapter Eleven has proceeded without regard to the specific allegations made by claimants or to the rulings made by NAFTA tribunals. Questions have been raised whether the cases brought under Chapter Eleven strike a proper balance between a state’s right to regulate business activity within its territory and the state’s obligations to foreign investors under international law. To my mind, the correct question is whether the decisions of NAFTA tribunals under Chapter Eleven reflect the Agreement made by the NAFTA parties. Some people may not have noticed, but the United States, as a party to the ICSID Convention and to dozens of FCN treaties and bilateral investment agreements, has long agreed to impartial, third-party review of investor complaints against U.S. government action.

My purpose this afternoon is to examine the NAFTA cases dealing with regulatory measures, to define some of the major questions arising under international law, and to review the answers provided so far by NAFTA tribunals. As we know, Chapter Eleven establishes an integrated regime for the protection of investment under international law, including four complementary elements:

Article 1102 – “treatment no less favorable than that [a Party] accords, in like circumstances, to its own investors”; Article 1103 – most-favored nation treatment; Article 1105(1) – treatment in accordance with international law, including "fair and equitable treatment"; and Article 1110(1) – compensation for expropriation including measures "tantamount to nationalization or expropriation."

This afternoon, I will focus my remarks primarily on Article 1110. More generally, though, it should be noted that NAFTA tribunals have been conservative in addressing jurisdictional issues and, in most cases, have been deferential to the state’s right to regulate business activity in its territory.

In Methanex,[3] for instance, the tribunal set a high bar for jurisdiction requiring claimant to submit at the jurisdictional stage credible evidence of California’s alleged intent to discriminate against Canadian products. In Waste Management,[4] the case was dismissed on jurisdictional grounds and has been resubmitted. In UPS,[5] the tribunal held that Chapter Eleven does not permit claims of anti-competitive behavior to be based on Chapter Fifteen alone or on Article 1105. In Azinian[6] and Mondev[7] all claims were denied on the merits.

To date, damage awards have been made in four Chapter Eleven cases:

Two against Canada, for breaches of Article 1102 in Myers[8] and Article 1105 in Pope & Talbot;[9] and
Two against Mexico, for breaches of Articles 1105 and 1110 in Metalclad[10] and 1102 in Feldman.[11]
Article 1110(1)

Only one NAFTA tribunal has sustained an expropriation claim under Article 1110, however – in Metalclad.[12] Expropriation claims were asserted but rejected in several cases, including three cases where claims based on Articles 1102 or 1105 were recognized as meritorious. This appears to be a trend.

The Azinian and Metalclad cases present the question of state responsibility for repudiation of an investment agreement. In Azinian, claims under Articles 1105 and 1110 were dismissed. The tribunal recognized that repudiation of an investment agreement might constitute expropriation under extraordinary circumstances, but said that breach of contract was not in itself sufficient. The real point of that case, however, is that the Mexican courts were correct in upholding termination of the concession because claimants entered into the contract on false pretenses and were incapable of performing it.[13]

Metalclad went the other way. The tribunal sustained claims for breach of Articles 1105 and 1110 when local and state authorities barred implementation of a concession agreement that had been approved by federal authorities. Significant investments had been made in the project, and the tribunal concluded that the investors were entitled to rely on federal approval coupled with federal assurances that local approval was not required and would be forthcoming. The opinion emphasized the NAFTA Parties’ duty to maintain a transparent investment regime.

Mexico filed a motion to set aside the award in British Columbia, and the court set aside part of the interest award on the grounds that the tribunal exceeded its competence by basing its decision on the transparency provisions of the NAFTA Preamble that do not appear in Chapter 11 and are, therefore, not subject to arbitration. The court affirmed the award in part because the tribunal also based its Article 1110 holding on a decree by state authorities. The parties settled the case following a second order by the court remanding the matter to the tribunal for determination whether there was a basis other than lack of transparency for a breach of Articles 1105 and 1110 prior to the state’s decree.

The Metalclad tribunal took a broad view of Article 1110, noting that expropriation under NAFTA includes not only open, deliberate and acknowledged takings of property, such as outright seizure or formal or obligatory transfer of title in favour of the host State, but also covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or significant part, of the use or reasonably-to-be-expected economic benefit of property even if not necessarily to the obvious benefit of the host state.[14]

The reviewing court expressed concern about the scope of this holding but, noting the limited scope of judicial review, declined to disturb the arbitrators’ conclusion of law.
The Mondev tribunal also addressed the place of contract rights in Article 1110, holding that intangible property including contract rights are protected under both Articles 1110 and 1105.[15] That does not mean that every breach of contract is an expropriation, but the arbitrary or discriminatory repudiation of an investment agreement would be an expropriation under Article 1110.

In the case of regulations not involving contract repudiation, both normative considerations and economic impact are relevant. The tribunal in Myers held that a Canadian rule which discriminated against American waste processors was not expropriatory, because the rule was temporary and merely delayed access to the Canadian market. Similarly, in Pope & Talbot, the tribunal recognized that a complex Canadian regime implementing the Softwood Lumber Agreement with the United States disadvantaged certain American-owned exporters, but it concluded that Canada had made reasonable regulatory choices, and that the interference with claimant’s investment in Canada was not substantial enough to be characterized as an expropriation under international law.[16] Profits were diminished but substantial exports and profits remained. Thus, there was no “substantial deprivation” as required by international law.

The most recent decision was issued on December 16, 2002, in Feldman v. Mexico.[17] I represented claimant, a U.S. citizen, in that case. He is no relation.

In Feldman, claimant alleged that Mexico shut down cigarette exports by his Mexican trading company, CEMSA, in violation of Articles 1102 and 1110, by refusing rebates of cigarette taxes that Mexico granted on exports by Mexican cigarette producers and by other resellers owned by Mexican nationals. The 1110 claim relied on Mexican court decisions that claimant believes preclude tax discrimination in favor of producers and on an agreement with senior Mexican officials that was implemented by Mexico for sixteen months before the government abruptly terminated rebates to CEMSA in October 1997. The tribunal accepted an 1102 claim because Mexico granted tax rebates to cigarette resellers owned by Mexicans, and it awarded claimant damages of about $1.7 million including pre-award interest. But the tribunal rejected the expropriation claim brought under Article 1110.

Reading the opinion, you may get the impression that claimant argued that international law requires similar treatment for cigarette producers and resellers. That is not the case.[18] Rather, we argued that this form of tax discrimination is prohibited by the Mexican Constitution as expounded by the Mexican courts, including two decisions by the Mexican Supreme Court. Further, we argued that the Mexican government’s failure to apply a Supreme Court decision in a case brought by CEMSA and its failure to live up to its agreement with claimant constituted a denial of justice under paragraph(c) of Article 1110. While NAFTA Article 1105 does not apply to tax cases as such, in expropriation cases, Article 1110 (c) requires fair and equitable treatment as stipulated in Article 1105(1).
The tribunal recognized that Mexican officials "followed an inconsistent and non-transparent course of action" over a period of years, 19] and treated claimant "in a less than reasonable manner."[20] The tribunal also understood that the denial of tax rebates to CEMSA shut down its cigarette export business and deprived claimant "completely and permanently" of any economic benefit from that activity.[21] The tribunal doubted claimant’s damages, however, and concluded on the facts that no expropriation took place in this case. The factors cited by the tribunal include its narrow reading of the Mexican Supreme Court decisions; claimant’s alleged failure to obtain formal clarification of his rights during the period that Mexico was making rebates to CEMSA;[22] and the fact that Mexico did not take control of CEMSA from claimant.[23]

Of more general interest are the tribunal’s comments on how Article 1110 applies to "indirect" takings due to regulatory measures not involving nationalization as such. According to the tribunal,

the essential determination is whether the actions of the Mexican government constitute an expropriation or nationalization, or are valid governmental activity.[24]

It frames the issue by noting, first, that "[n]o one can seriously question that in some circumstances government regulatory action can be a violation of Article 1110."[25] In the past, "confiscatory taxation, denial of access to infrastructure or necessary raw materials, imposition of unreasonable regulatory regimes, among others, have been considered to be expropriatory actions."[26] And, following Pope & Talbot, the tribunal concludes that there can be expropriation without deprivation of ownership rights.[27] On the other hand, the tribunal affirms that
governments must be free to act in the broader public interest through protection of the environment . . . and the like. Reasonable government regulation of this type cannot be achieved if any business that is adversely affected may seek compensation, and it is safe to say that customary international law recognizes this.[28]

As the tribunal notes, the same broad distinction is made in the Restatement (Third) of the Foreign Relations Law of the United States, section 712 (Restatement (Third)). Taxation can be expropriation and a state is responsible for unreasonable interference with an alien's property. But there is no liability for non-discriminatory, bona fide general taxation.

To support its conclusion that expropriation did not take place in this case, the tribunal relies heavily on the opinion in Azinian,[29] where the tribunal emphasized that not every business problem experienced by a foreign investor is an expropriation.[30] In my view, this truism adds nothing to the legal analysis, but shows the tribunal’s reluctance, a reluctance shared by other NAFTA tribunals, to find expropriation even in cases where violations of 1102 and 1105 are established. One reason for this reluctance may be, as the tribunal states, that no one has
developed a convincing rationale for distinguishing expropriation from legitimate economic regulation. In my view, however, the Feldman tribunal failed to give proper weight to the provisions of Article 1110 relating to discriminatory treatment, due process, and fair and equitable treatment in accordance with minimum standards of international law.

As I see it, article 1110 presents two basic questions:

To what extent does Article 1110 recognize a state’s right under international law to exercise so-called "police powers" without incurring any liability for injury to the rights of aliens?
What showing must a claimant make to establish the right to compensation for a so-called regulatory taking?

**Police Powers**

There is some authority in international law for the proposition that a state does not incur liability for regulatory actions, such as the collection of taxes, that are said to involve the police power.[31] But I am not aware of a case of discriminatory, arbitrary, or confiscatory regulation that has been justified on that ground. Moreover, international law is evolving. The bitter international debate over expropriation law has been largely resolved in favor of state responsibility. The Restatement (Third) and the Iran Claims Tribunal cases indicate that compensation is required when a state "subjects alien property to taxation, regulation, or other action that is confiscatory, or that prevents, unreasonably interferes with, or unduly delays effective enjoyment of an alien's property or its removal from the state’s territory."[32]

Article 1110 tracks Restatement (Third) in structure and substance requiring compensation at fair market value for every expropriation, including indirect or constructive expropriations. Thus, it is not clear that the "police powers" doctrine persists under NAFTA or, more generally, under contemporary international law. Conceivably, the NAFTA Parties may take a different view, but I would say that, absent extreme emergency involving national security or public safety, compensation should be required for every expropriation. That leaves the critical question of what constitutes an expropriation requiring compensation in the context of social, economic or environmental regulation.

**Expropriation**

The jurisprudence under Chapter Eleven should be reassuring. It seems clear that the phrase "tantamount to expropriation" is not additive but refers to indirect and constructive takings, including "creeping expropriation", recognized in customary international law.[33] Further, the cases put to rest the concern that compensation may be required simply because a regulation diminishes profits. In *Pope & Talbot*, where the investor’s asset base in Canada was largely dependent on exports of lumber to the United States, the tribunal concluded that Article 1110 was broad enough to apply to export regulation that might be said to fall within a state’s so-
called police powers. Profits had been reduced but substantial profits remained. The tribunal concluded, therefore, that the regulations at issue were not sufficiently restrictive "to support a conclusion that the property has been 'taken' from the owner."[34]

The Myers tribunal, noting that "expropriations tend to involve the deprivation of ownership rights; regulations a lesser interference," went on to comment that this distinction reduces the risk that governments will be subject to claims as they go about their business of managing public affairs. The focus in these cases on the extent of interference and the level of economic impact seem to me appropriate. I am confident that an international tribunal would follow the United States Supreme Court in holding that a regulation destroying all economic value constitutes a compensable taking.[35] Moreover, under the Restatement (Third), a showing of significant interference or substantial deprivation would suffice to support a claim of state responsibility.

There may be another obstacle to claims under Chapter Eleven, however. Article 1110(1) states that Chapter Eleven applies to measures "relating to" an investment. In Methanex, the tribunal held that a claimant challenging California's environmental rule must show that the measure bears a legally significant relationship to the investment.[36] However, the tribunal did not clarify what it meant by such a relationship other than to note that the United States did not contend that the measure must be primarily directed at the investment.[37]

The Feldman decision on Article 1110 is worrisome to the extent it implies that even arbitrary regulatory actions having a significant economic impact may not rise to the level of expropriation. A narrower reading of the opinion, however, may be that a stronger showing of abuse or economic harm could have tipped the balance towards a finding of expropriation.

The opinion appears conflicted about the relevance of subparagraphs (a)-(d) of Article 1110 (1). Yet, the history of those provisions is well known. They are based on the Restatement (Third) and the traditional United States position articulated most famously by Secretary of State Hull in his note to Mexican Foreign Minister Hay.[38] The United States has long recognized that a state has the right under international law to expropriate alien property, provided that the taking is for a public purpose, is non-discriminatory, and is accompanied by payment of prompt, adequate and effective compensation. If a state does not comply with those conditions, the taking is deemed illegal.

Many governments disputed the compensation standard asserted by the United States. Some rejected any international accountability. Some authorities claimed that prompt, adequate and effective compensation was only required in the case of illegal takings. And some international decisions held that a claimant was entitled to "restitution" damages in the case of an illegal taking.[39]
Article 1110 (1), like the Restatement (Third) and numerous bilateral investment treaties ("BITs") that preceded it, resolves these issues. It clearly states that takings that do not conform with subparagraphs (a)-(d) are prohibited:

No Party may directly or indirectly nationalize or expropriate an investment . . . or take a measure tantamount to nationalization or expropriation . . . except

(a) for a public purpose;

(b) on a non-discriminatory basis;

(c) in accordance with due process of law and Article 1105(1); and

(d) on payment of compensation [as prescribed].

NAFTA, like the Restatement (Third) and the BITs, spells out what compensation is required for lawful expropriation – fair market value, including going concern value where it applies.

Article 1110 does not specify, and may or may not imply, a higher measure of damages for an illegal expropriation, but the NAFTA Parties clearly intended that a state’s failure to comply with subparagraphs (a)-(d) would weigh in the determination of state responsibility for expropriation under Article 1110(1). In the case of regulatory takings, I would submit that compensation is required under Article 1110 whenever there is both (1) a significant interference with the use or enjoyment of an investment, and (2) discrimination, lack of due process, or denial of fair and equitable treatment required by customary international law. Compensation may also be required in other cases where economic value is totally or substantially destroyed, but that high standard should not be imposed where a violation of international norms is established.

**Article 1105**

That brings us to Article 1105. Much of the debate concerning Article 1105 arose out of the dictum in *Pope & Talbot* that the guarantee of "fair and equitable" treatment was additive to customary international law. The three NAFTA Parties rejected that position in a decision of the Free Trade Commission (FTC) issued on July 31, 2001.[40] I will leave the merits of that issue and the controversy over the FTC intervention to other panel members who were directly involved. More important, to my mind, is the NAFTA case law holding that the customary international law standard applicable under Article 1105 is an evolving one, that customary international law reflects the large body of state practice embodied in more than two thousand bilateral investment agreements, and that "fair and equitable" treatment embodies a higher standard than "outrageous conduct."
The most detailed discussion is in Mondev where claimants alleged denial of justice by the Massachusetts courts in connection with a real estate development contract in Boston. NAFTA had not entered into force at the time of the alleged misconduct by the City of Boston and the Boston Redevelopment Authority. Thus, the only arbitrable claims related to the decision of the Supreme Court of Massachusetts reversing a jury verdict for claimant.

A distinguished panel, including Sir Ninian Stephen, Professor James Crawford, and Judge Stephen Schwebel, dismissed the claims, holding that there was no denial of justice by the Massachusetts courts. The opinion provides important guidance, however, for future tribunals deciding issues of fair and equitable treatment or of denial of justice. Having confirmed that Article 1105(1) incorporates customary international law as decided by the NAFTA Parties in the FTC interpretation, the tribunal concluded that customary law evolves and that NAFTA reflects such development, at least to January 1, 1994, when NAFTA entered into force.[41]

According to the tribunal, the standard for breach of Article 1105 is higher than "outrageous" or "egregious" conduct where the state itself, as opposed to private persons, acts against the investment: "[t]o the modern eye, what is unfair or inequitable need not equate with the outrageous or the egregious. In particular, a State may treat foreign investment unfairly and inequitably without necessarily acting in bad faith."[42]

Contrary to Azinian and Feldman, Mondev appears to recognize that denial of justice may occur in cases involving executive or legislative action. Where judicial action alone is at issue, however, the tribunal agrees with Azinian that claimant must show "clear and malicious misapplication of the law" or "pretence of form."[43]

In the end the question is whether, at an international level and having regard to generally accepted standards of the administration of justice, a tribunal can conclude in the light of all available facts that the impugned decision was clearly improper and discreditable, with the result that the investment has been subjected to unfair and inequitable treatment.[44]

In my view, the FTC interpretations and the Mondev opinion together provide the proper framework for future tribunals to address claims of denial of fair and equitable treatment under Article 1105(1). States are free to regulate business activities within their territory according to policies of their own choosing. In so doing, however, states must conform with international norms relating to non-discrimination, due process and fair and equitable treatment.


According to the facts set forth in the Metalclad award, supra note 10, claimant invested in a hazardous waste landfill project approved by federal and state authorities and ratified by Convenio between the Mexican enterprise, COTERIN, and a federal agency. Relying on federal assurances that municipal approval was not required and would be forthcoming, the enterprise applied for a permit. Municipal authorities denied the permit and, months later, state authorities issued an ecological decree blocking the landfill.

Claimant alleged breach of NAFTA Articles 1105 and 1110. The tribunal sustained both claims holding, inter alia, that:

1) The municipality acted beyond its authority under Mexican law. Metalclad, supra note 10 ¶ 86. Exclusive authority for siting and permitting a hazardous waste landfill resides with the Mexican federal government. Id. ¶ 105.

2) Metalclad relied on federal assurances. Id. ¶¶ 87, 89.
(3) Mexico was required to make its investment laws transparent by virtue of the NAFTA Preamble. Id. ¶ 88.

(4) Mexico violated article 1110 by permitting municipal conduct and the state ecological decree which denied Metalclad the right to operate the landfill. Id. ¶ 104.


[16] Pope & Talbot, supra note 9 ¶ 96.


[18] The opinion acknowledges this fact at ¶ 118.

[19] Id. ¶ 109.

[20] Id. ¶ 113.

[21] Id. ¶ 109.

[22] Id. ¶ 114.

[23] Id. ¶ 111.

[24] Id. ¶ 98.

[25] Id. ¶ 110.

[26] Id. ¶ 103.

[27] Id. ¶ 110.

[28] Id. ¶ 103.

[29] Azinian, supra note 6. In the facts of Azinian, Mexican federal and state authorities approved a concession agreement for solid waste disposal between DESONA, a Mexican company owned by claimants, and the City of Naucalpan de Juarez. Shortly after signature, local officials challenged the agreement. When DESONA sought relief in the Mexican courts, the City nullified the agreement on various grounds, including misrepresentation and lack of capacity to perform. Nullification was approved by Mexican administrative courts and sustained on appeal. Claimants sought arbitration under NAFTA.
The Tribunal dismissed claims that nullification violated NAFTA Articles 1105 and 1110, noting that the "authorities . . . entrusted a public service to foreign individuals whom they were falsely led to believe were part of an experienced concern possessed of financial and technological resources adequate for the job." *Id.* ¶ 31. "The evidence compels the conclusion that the Claimants entered into the Concession Contract on false pretenses, and lacked the capacity to perform it." *Id.* ¶ 33.

The Tribunal stated that a breach of contract was not enough in itself to establish a violation of NAFTA Article 1110. *Id.* ¶¶ 83-84, 87. While leaving open the possibility that repudiation of an agreement may, in some extraordinary circumstances, constitute a taking, the tribunal observed:

How can it be said that Mexico breached NAFTA when the [authorities] . . . purported to declare the invalidity of a Concession Contract which was by its terms subject to Mexican law, and to the jurisdiction of the Mexican courts, and the courts of Mexico then agreed with the [authorities'] determination?

*Id.* ¶ 96. There being no contention that Mexican legal standards concerning validity or annulment of the agreement violated NAFTA Article 1110, claimants were required to show that the courts breached Mexico's obligations. Judicial actions are subject to review, but it is not enough to establish an error of law. Claimants must show either denial of justice or "a pretence of form to achieve an internationally unlawful end." *Id.* ¶ 99. Claimants must show that evidence for court's finding "was so insubstantial, or so bereft of a basis in law, that the judgments were in effect arbitrary or malicious." *Id.* ¶ 105.

[30] *Id.* ¶ 112.


[32] *Restatement (Third), § 712, cmt. g.* See also *Starrett Housing Corp. v. Iran*, 16 Iran-U.S. Cl. Trib. Rep. 112 (1987).

[33] See, e.g., *Meyers*, supra note 8 ¶ 287; *Feldman*, supra note 11 ¶ 100.

[34] *Pope & Talbot*, supra note 9 ¶ 102.

[36] Methanex, supra note 3 ¶¶ 139, 147.

[37] Id. ¶ 142.

[38] See Letter from U.S. Secretary of State Hull to the Mexican Ambassador in Washington, D.C. (Apr. 3, 1940), excerpted at M. Whiteman, 8 Digest of International Law 1020 (1967) (noting that "the right to expropriate property is coupled with and conditioned on the obligation to make adequate, effective, and prompt compensation").


[40] Free Trade Commission Clarifications Related to NAFTA Chapter 11, § B.2. (July 31, 2001)

[41] Mondev states that the FTC interpretations incorporate current international law "whose content is shaped by the conclusion of more than two thousand bilateral investment treaties," supra note 7 at ¶ 125, but the UPS tribunal doubts that the BIT provisions are accepted as opinio juris.

[42] Id. ¶ 116.

[43] Id. ¶ 126 (quoting Azinian ¶ 103).

[44] Id. ¶ 127.