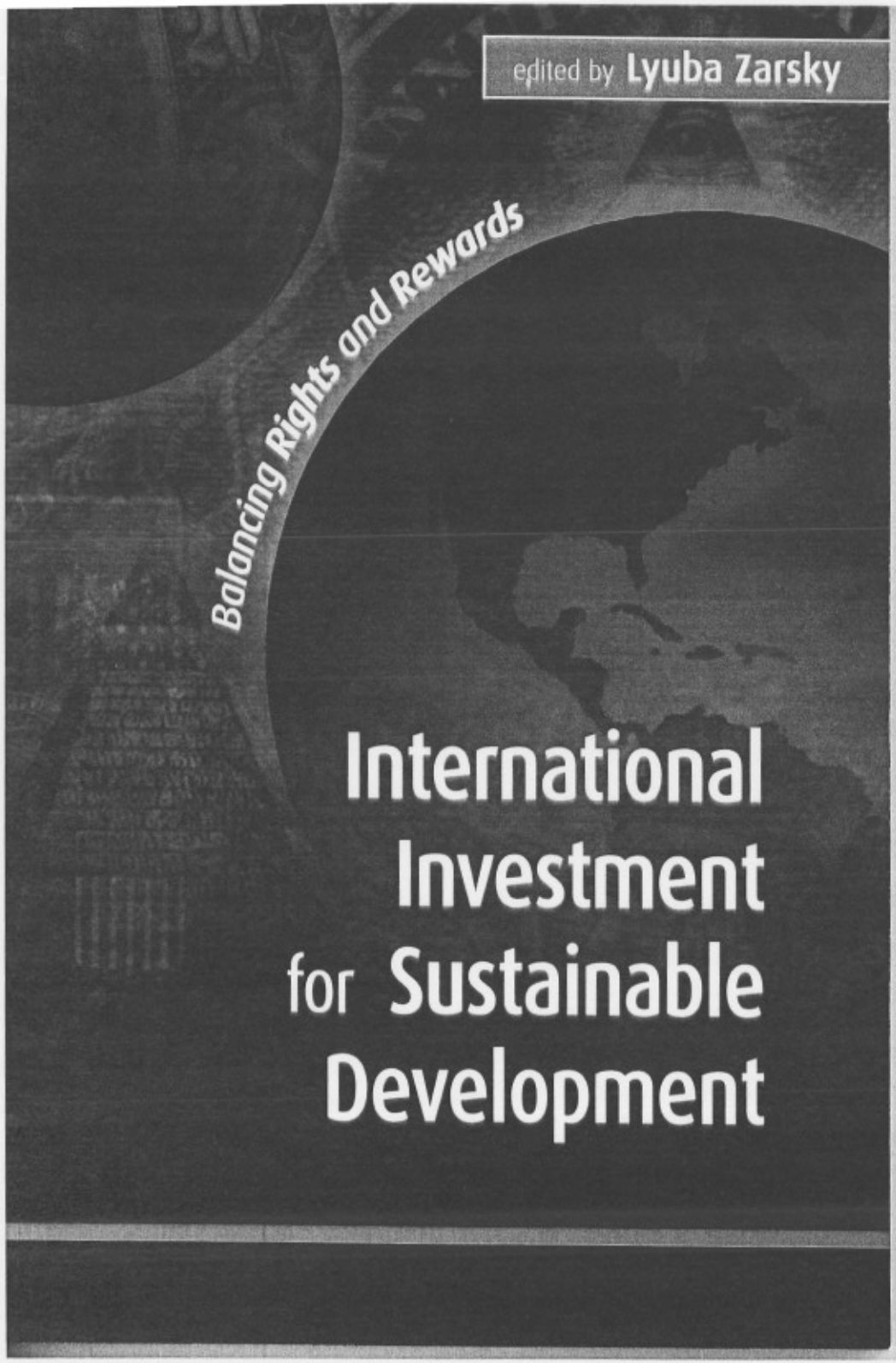
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Chapter 6

The Road to Hell? Investor Protections in NAFTA's Chapter 11

Aaron Cosbey

Abstract

NAFTA's (North American Free Trade Agreement) Chapter 11 was designed to protect North American investors from mistreatment at the hands of governments and thus to accelerate intra-regional investment. But it has proven more problematic than anyone imagined, triggering high-profile challenges by corporations against domestic environmental, health and safety measures. The challenges, in turn, have generated a storm of criticism by environmental and other public interest groups.

This chapter describes and analyses problems with the procedural and substantive provisions in Chapter 11 for the protection of foreign investors. These problems include the lack of transparency, accountability, and legitimacy in the investor–state dispute settlement process; the broad definition of 'investors'; and the overly broad interpretations of host state obligations in areas such as expropriation, non-discrimination, and minimum standards of treatment.

As a package, the Chapter 11 measures constitute a powerful mechanism to protect foreign investors. However, these tools have too often been used – in ways unintended by the drafters of the agreement – to attack or threaten public policy regulations that might incidentally harm investors' economic interests.

The chapter concludes by examining four potential solutions to these problems, each of which has its own shortcomings: 1) interpretive statements; 2) exceptions to the Chapter 11 obligations; 3) amendments to clarify the substantive provisions; and 4) reform of the arbitral institutions, UNCITRAL and ICSID.

Introduction

NAFTA's Chapter 11 was forged in the fires of good intention, designed to protect investors of the three NAFTA countries from mistreatment at the hands of governments and thus to accelerate investment among them, presumably for the benefit of all. But like the proverbial 'road to hell paved with good intentions', it has proven to be more problematic than anyone imagined during the pre–1995 negotiations. Chapter 11 has given rise to a number of high-profile challenges brought by corporations against environmental, health and safety measures taken by the three governments, providing fuel for the anger of myriad civil society organizations opposed to trade and investment liberalization.

This chapter examines the protection of investors of NAFTA parties investing in other NAFTA parties. NAFTA's Chapter 11 provisions on investor protection have a rich parentage in the many pre–1994 bilateral investment treaties (BITs), and before them in the early Commerce, Friendship and Navigation Treaties of the 19th century.

Chapter 11, however, singles itself out as an interesting case study for several reasons. It is the most open of any of the existing models (although critics argue forcefully that it still has far to go), meaning the various legal rulings are available for public scrutiny and analysis. Since the myriad other bodies of investment law do not, as a rule, release such documents, analysing the growing body of Chapter 11 case law is one of the only ways to gain insight into the implications of these other agreements.

Moreover, NAFTA is one of the 'modern' investment agreements, offering a greater degree of investor protection than afforded by the previous generation of agreements. As such, it is a good laboratory in which to examine the pros and cons of the standard elements of the modern BITs and regional investment agreements – elements which are likely to be the starting point of future investment agreements both bilaterally and in regional agreements such as the Free Trade Area of the Americas.

This chapter analyses Chapter 11 through the lens of its impacts on the environment, especially on regulatory capacity for environmental management. NAFTA's investor protection regime has, in recent years, weathered a great deal of criticism from the environmental and social justice communities (Mann, 2001; Tollefson, 2002; Greider, 2001). The central argument is that the regime has gone from being a protective shield for defending corporations against unfair treatment, to a sword used by those corporations to attack legitimate government regulation in the public interest, notably in areas such as public health and the environment. The process by which claims are lodged and pursued has also been widely criticized as being closed to public scrutiny, although this situation is now changing.

Section 2 outlines concerns with respect to the Chapter 11 process of dispute resolution, focusing on deficits of legitimacy, accountability and transparency. Section 3 turns to the five key substantive provisions of Chapter 11 – obligations that host countries have accepted in their treatment of investors from the other NAFTA parties. In each case it discusses the concerns voiced

with respect to the environmental impact the provisions might entail, the discussion being informed by the cases to date.

In light of the preceding analysis, the final section of the chapter explores four options that have been proposed to address Chapter 11's shortcomings: an exception for environment, health and safety; interpretive statements; amendment of the NAFTA; and reform of the arbitral institutions UNCITRAL (United Nations Commission for International Trade Law) and ICSID (International Center for the Settlement of Investment Disputes).

Chapter 11's Dispute Settlement Process

In what is known as an investor–state dispute mechanism, NAFTA Chapter 11's dispute settlement process allows private parties (investors) to directly initiate arbitration with host states. This procedure contrasts with the process of trade law disputes, for example in the WTO, which are strictly state-to-state.

Chapter 11 allows parties to arbitrate cases under any of three pre-existing arbitration mechanisms: ICSID, the ICSID Additional Facility, and UNCITRAL (see Chapter 5). An investor initiates a case by submitting to the government involved a notice of intent to submit a claim to arbitration – a document that lays out the grounds for its case. Thereafter, the investor may submit its claim to any of the above venues, provided that the state involved is a signatory and that at least six months have passed since the events giving rise to the claim.

Until recently, investment arbitration was considered to be a private commercial matter between two disputants. Present institutions are still geared towards this concept. However, the majority of the Chapter 11 cases to date have had implications that go far beyond commercial impacts to such public policy objectives as the protection of the environment and public health and safety, in which more than the two disputants will share a legitimate interest (Mann and von Moltke, 2002). Two tribunals to date have been petitioned to grant friends of the court status to non-disputing, non-parties and both have agreed that the disputes go beyond purely commercial spats, one stating that 'there is an undoubtedly public interest in this arbitration' (Methanex Corp *v* the United States of America, 2001).

Rulings in such cases amount to a determination of the balance between competing public policy objectives, with final results that impact on the public welfare. In one pending case, for example, the right of the investor to import its product must be balanced against the right of the public to limit its exposure to suspected carcinogens (Crompton Corp *v* Canada, 2001). This type of balancing is done on a regular basis by a number of domestic institutions in all three NAFTA parties, including the judiciary and various governmental bodies. There is, however, a striking contrast in the attributes of these well-developed institutions and the commercial-model arbitration conducted under Chapter 11. The former are carefully constructed so as to operate with legitimacy, accountability and transparency, qualities that are – except for some transparency provisions in the case of ICSID – utterly lacking in the latter.

As to legitimacy, the Chapter 11 dispute process is lacking in several respects. First, each litigant is able to choose one of the three arbitrators and potentially to collaborate on the choice of the third – a situation that invites biased choice. Second, and in a directly related vein, the arbitrators themselves are not generally drawn from a permanent roster of arbitrators but from the international commercial arbitration bar. This is particularly the case for the third arbitrator selected as president of the panel. As a result, arbitrators can be deciding cases on one file while arbitrating on behalf of clients in other files facing similar legal issues. Decisions they make as arbitrators may impact the positions of their own clients, or of colleagues in their firms or through other contacts. The point here is not that the arbitrators lack personal integrity but rather that the system for selecting arbitrators is inherently flawed when issues of public and private rights are involved. The old maxim that justice must be blind is clearly not at play here.

As regards accountability, the investor–state dispute process allows only a very limited form of review, and the standard for review in such cases is much higher than that set for domestic appeals. In the end it is not an appeal process; the review cannot rule on simple errors of fact or law, or substitute a decision for the one made by the tribunal. The widely acknowledged value of the World Trade Organization's (WTO's) permanent appellate body in giving consistency and predictability to the process should be seen as instructive.

Moreover, both legitimacy and accountability are impossible where there is no transparency. On this score, even Chapter 11's strongest supporters agree that change would be beneficial. As befits a purely commercial dispute mechanism, there is no provision for mandatory public access to the litigation documents. ICSID cases must at least be notified in a public registry available on the ICSID website (ICSID), but UNCITRAL lacks even this basic requirement. There is an obligation on the NAFTA secretariat to keep a public register of notices of intent to arbitrate, but compliance with this obligation has been patchy at best. However, there is no requirement to inform the public when an investor signals its intention to arbitrate a case.

There have been promising signs of change on this score. Most prominent was the set of statements emerging from the October 7, 2003, meeting of the NAFTA trade ministers – the Free Trade Commission (Mann, 2003). These included a joint statement of suggested guidelines for considering petitions for *amicus curiae*, or friend of the court, status. A non-party might seek such status in order to intervene in the proceedings of a particular case. The statement outlines the FTC's recommendations for how a tribunal might decide whether to accept or reject such petitions, which have, in the past, been controversial. However, while the FTC has the power to issue binding interpretations of Chapter 11's substantive provisions, its power over the tribunals' proceedings is limited; its guidance on this matter is not legally binding, but does carry some weight.

A second important outcome of the October 2003 meeting is a pair of statements from Canada and the US indicating that they will push for public hearings in all Chapter 11 cases – a commitment that Mexico apparently was

not ready to countenance (*US Trade Representative*, 2003). Again, this is not a legally binding decision. Indeed, previous tribunals have ruled that proceedings may not be opened to the public without the consent of both arbitrating parties (that is, the investor must also agree). But it does mean that in every case against them the two governments are now committed to push for such openness.

It should be emphasized that the shortcomings surveyed above are not criticisms of the right to an investor–state process per se. The history of investment protection shows that it is probably best not left up to governments, who may respond only to bigger players, and whose decisions whether to proceed with any given claim will always be tied up in the politics of the moment (Vandevelde, 1992). But taken together they are an indictment of an inadequate process for the balancing of private rights and public goods in the investment context.

The Substantive Provisions

NAFTA's Chapter 11 contains a number of provisions that oblige the host country to accord certain types of treatment for investments from its NAFTA partners. These provisions include the following:

- Protection from direct or indirect expropriation (Article 1110).
- National treatment obligations (Article 1102).
- Most-favoured nation obligations (Article 1103).
- Prohibition of performance requirements (Article 1106).
- Obligations for minimum international standards of treatment (Article 1105).

Together, these provisions and others in the chapter constitute an accord among the NAFTA governments on what constitutes fair treatment of investors from the other NAFTA countries. The specifics of each of these provisions are examined in more detail below, but as background it is worth first elaborating on the *scope and coverage* of the obligations. That is, these provisions restrict the types of measures that can be imposed on investments. To fully understand the impacts of the provisions, we must first understand how NAFTA defines both 'measures' and 'investments'.

The definitions are unusually broad. The measures covered by Chapter 11 include 'any law, regulation, procedure, requirement or practice'. This covers most conceivable acts of government (at all levels from federal to municipal), from lawmaking to zoning codes, and even extending to cover the actions of the courts.

Investment is also broadly defined, encompassing not only direct investment by an enterprise, but also such things as a debt security or loan to an enterprise, or equity securities in an enterprise. A holder of a bond from a multinational enterprise is thus an investor, conferred with the extensive legal rights discussed below.

This broad definition has been extended by several rulings that have held that a company's *market share* is an investment asset that can be protected. When the US market share of Pope & Talbot – a US-owned forest products company operating in Canada – decreased as a result of Canadian government policy, the tribunal agreed that this market share itself was an 'investment' protected by the provisions of Chapter 11[1]. In effect, this approach has the potential to bring the full gamut of *trade* measures, such as bans and restrictions, under the purview of NAFTA's *investment* law, as most trade measures will affect market share. This would greatly extend the reach of the provisions, and would grant more access to the direct investor–state process (discussed below) than was arguably ever intended.

Expropriation

Article 1110 stipulates that any expropriation must fulfill four conditions. It must be:

- for a public purpose;
- non-discriminatory (that is, not targeted at a specific company or nationality);
- in accordance with the due process of law; and
- compensated by the expropriating government.

It also notes that its strictures cover both direct and indirect expropriation but, importantly, fails to define these terms. This is not so problematic with the former; direct expropriation – the physical taking or nationalization of an enterprise – is easy to identify, and there is a significant body of international law to guide arbitrators in addressing it.

But indirect expropriation is much more difficult. Indirect expropriation has three separate forms. One is commonly referred to as 'creeping expropriation'. This implies a series of measures that collectively have the effect of depriving an owner of their property, even where one individual measure would not do so. A firm, for example, might be subject to increasingly onerous reporting requirements, increased tax burden, mandated replacement of its foreign managers with locals, a permit system for importing key inputs, etc. By themselves none of these types of measures would constitute an expropriation, but combined they may be sufficient to drive a company out of business. Note that it is not necessary for a business to be 'taken' by the government in order for indirect expropriation to occur – depriving the owner of its investment, even if the investment does not then go to the state, is sufficient.

The second form is disguised expropriation, whereby a measure is really intended to deprive a person of their property or of all ability to use it, but does so through essentially indirect or disguised means. Rather than nationalizing an investment outright, for example, a country might levy an impossibly high tax on the firm involved, with the intent of putting it out of business. These

two forms of indirect expropriation achieve more or less the same final effect as direct expropriation[2].

The third and most controversial concept of indirect expropriation falls under the notion of regulatory taking, a US concept that was, until NAFTA, largely foreign to international law. This doctrine holds that a regulation amounts to a form of indirect expropriation by virtue of having a significant negative impact on the economic value of an investment. For example, a government might enact land use regulations that preclude the kind of activity in which a firm is engaged. With the advent of NAFTA's Chapter 11, this expanded concept of expropriation moved to centre stage in the arbitrations initiated by foreign investors under its provisions. The comments that follow are focused on this third form of indirect expropriation – regulatory takings.

The key question in the NAFTA context is this: If a NAFTA government measure is undertaken for a clear public welfare purpose (such as health and safety, environment, public morals or order, etc.) and is non-discriminatory, but has the effect of harming a NAFTA foreign investor, are there any circumstances under which that measure can be held to be an indirect expropriation for which the government must pay compensation? If so, what are those circumstances?

The concern is obvious: most people would agree that taxpayers should not be paying investors to alter behaviour that is contrary to the public interest. A secondary concern is that regulators who are held liable for their impacts on investors will not regulate to the extent that they should (the *regulatory chill* argument).

What might allay these concerns? Most obvious would be a clear statement that regulations that apply to all firms (that is, non-discriminatory regulations of general application) cannot be held to constitute expropriation. However, such an approach would leave a very wide scope for governments to cloak expropriation in the guise of regulation. Even critics of Chapter 11 concede that such a broad statement is not workable (Mann and Soloway, 2002).

Failing that, we might look for some delineation that would exempt *bona fide* public welfare regulations from being considered expropriation. That is, non-discriminatory regulations that are obviously intended to serve the public good, such as environmental protection and human health and safety measures, while they might impact on the profitability of some companies, could not be held to be expropriation. This would necessarily involve defining the 'untouchable' regulations, or at least giving guidance as to their characteristics.

But drawing that bright line in the sand has proven too difficult a task for the NAFTA parties, despite years of debate and discussions. In the words of one of the tribunals, it is difficult to say 'when governmental action that interferes with broadly-defined property rights . . . crosses the line from valid regulation to a compensable taking, and it is fair to say that no one has come up with a fully satisfactory means of drawing this line' (Marvin Feldman *v* Mexico, 2002, para 100).

Finally, failing guidance from the lawmakers, we might hope to see some signs that the tribunals were at least considering the purpose of regulations,

as opposed to simply looking at the extent to which they affected investors. Such a consideration would, in the end, come close to being a case-by-case determination of what regulations should be exempt, presumably on the basis of their *bona fides* and their public welfare objectives.

In one of the first cases to consider the expropriation argument, the Metalclad tribunal considered the case of a US hazardous waste company (Metalclad Corp.) that was eventually denied the ability to establish a hazardous waste processing facility in Mexico, first by bureaucratic means and finally by the decree that the land on which the plant was located would henceforth be a nature reserve for the preservation of rare cactus species. The tribunal in this case ruled that 'the tribunal need not decide or consider the motivation or intent of the adoption of the Ecological Decree' (Metalclad, 2002, para 111). The fact that there was substantial interference was enough to establish expropriation, and it was unnecessary to ask *why* that interference had occurred.

The tribunal in Pope & Talbot (2000), which considered whether that company's Canadian forest products export business had been expropriated by Canadian forest management regulations, took a similar tack: the test of whether there has been an expropriation has nothing to do with the measure's objectives but is judged only by the degree of interference (Pope and Talbot *v* Canada, 2000, para 102). If followed, this reasoning threatens to seriously erode the ability of governments to regulate in the public interest. Or, more precisely, it would have governments pay each time such regulations sufficiently impacted the private sector, even if the regulations were non-discriminatory and were legitimately designed to serve the public good.

Subsequent rulings have taken a different approach, holding that while a regulation can clearly constitute an expropriation, this will only rarely be the case. But there is still no guidance on how to distinguish between those that do and do not cross the line based on their purpose.

One positive development is a test introduced by the tribunal in the S.D. Meyers case, where a US-based processor of PCBs complained that its investment in Canada had been expropriated by a Canadian export ban on PCBs. While the tribunal still did not go to the purpose of the measure in denying a finding of expropriation, it did rule that 'expropriations tend to involve the deprivation of ownership rights; regulations a lesser interference' (S. D. Meyers Inc. *v* Canada, 2000, para 282). Specifically, the tribunal noted that an expropriation usually amounts to 'a lasting removal of the ability of an owner to make use of its economic rights'.

This same standard was followed in the subsequent Feldman case, where the Mexican tax authorities in effect shut down a 'grey market' cigarette exporting business through regulations that the business could not possibly meet (Marvin Feldman *v* Mexico, 2002, paras 152–153). This is a higher standard than one that simply looks at the degree of interference, and one that if followed would save most regulatory measures from being found to be expropriation.

Also hopeful in the Feldman ruling is the fact that the tribunal was guided in its considerations by the American Law Institute's 'Restatement of the Law Third, the Foreign Relations of the US', which says on the subject of regulatory expropriation:

> *A state is not responsible for loss of property or for other economic disadvantage resulting from* bona fide *general taxation, regulation, forfeiture for crime, or other action of the kind that is commonly accepted as within the police power of states, if it is not discriminatory. . . .*
>
> (American Law Institute, 1987)

In other words, if the measure in question is propounded in good faith and is non-discriminatory, then it cannot constitute an expropriation no matter what the extent of the damage. The Feldman tribunal did not go so far as to use this reasoning in its findings and did not actually consider whether the measure met these criteria. But the fact that it referenced this passage and used it as guidance shows at least that there is a viable alternative to the approach used in Metalclad and Pope & Talbot.

National treatment

Article 1102 obliges parties to 'accord to investments of investors of another party treatment that is no less favourable than that it accords, in like circumstances, to those of its own investors'. The main cause for concern here is the difficulty in determining whether circumstances are 'like'. Clearly the text does not mean 'identical', but neither does it give any guidance on how to determine whether circumstances are sufficiently similar as to trigger this obligation.

For example, if several existing firms are already polluting to the maximum allowed in a certain ecosystem, would a refusal to permit a foreign investor to open another plant at the same site amount to a breach of national treatment? Certainly the foreign investor is not being treated as well as the existing domestic firms. If there is existing legislation that applies to all firms this may not be an issue – any reasonable panel would give deference to regulatory authority in such a case. But if there is no existing legislation covering the situation, and the new entrant faces a licensing process that turns it down, or faces new legislation designed to deal with the new problem of potentially excess pollution at the site, then the jury is out as to how a panel would interpret such a situation.

The rulings to date have been mixed, and have left us not much closer to an agreed understanding of how to determine like circumstances. In a particularly convoluted piece of reasoning, the S. D. Meyers panel ruled that a Canadian processor of hazardous waste was in 'like circumstances' with a Canadian office established by the US investor for the purpose of brokering the export of hazardous waste. That being established, it was a simple matter to show that an export ban on hazardous waste accorded very different treatment to the two, although both were equally bound by it.

The ruling in the ADF case also gives pause for thought. ADF was a contractor bidding to supply structural steel components in a Virginia highway construction project, but as its offices are located in Canada it ran afoul of the Federal 'Buy USA' regulations that cover any project with Federal support. The tribunal ruled that both ADF and the US competitors were in like circumstances – both had to comply with the same local content regulations. But it also seemed to suggest that if ADF had more strongly made a case for economic damage as a result of the regulation, it would have successfully demonstrated a breach of the national treatment obligations (ADF *v* United States of America, 2003, para 157)[3].

The tribunal in Pope & Talbot (2000), on the other hand, used reasoning that gives more hope for the rational application of national treatment obligations. Pope & Talbot, a US-owned forest products company operating in the Canadian province of British Columbia, had argued that it was in like circumstances with producers in those provinces that were not restricted by the quotas of the Canada–US softwood lumber agreement. The tribunal rejected these arguments, noting that the differential treatment bore a 'reasonable relationship to rational policies not motivated by preference of domestic over foreign owned investments'. This is a welcome sign of deference to governmental authority in balancing the many competing priorities of public policy.

A second feature of NAFTA's national treatment provisions is that they are part of the rights of investors both before and after they have made an investment. In other words, foreign investors are due national treatment not only 'post-establishment' but also 'pre-establishment'. While NAFTA permitted exceptions to be made, and each party availed itself of this opportunity, the general principle of the right of foreign NAFTA investors to make investments into the territory of another party is established here[4]. While it appears in a limited number of pre-NAFTA investment treaties, the concept of a foreign investor's 'right to invest' reached a new breadth in the NAFTA context. This approach to pre-establishment rights is intimately linked with the ability of governments to establish and implement domestic development strategies.

Most-favoured nation treatment

Article 1103 states that parties shall accord to investors and investments of other parties: 'treatment no less favourable than it accords, in like circumstances, to investors of any other Party or of a non-Party . . .' In other words, all NAFTA parties shall be 'most-favoured'.

There is, of course, the same problem here as in the national treatment provisions: what constitutes like circumstances? But another concern haunts the most-favoured nation (MFN) obligations.

The MFN obligations may provide a way to import into NAFTA the most favourable treatment found in any of the bilateral treaties signed by the defendant in a dispute. That is, if a party is obliged under NAFTA to provide a certain standard of protection, but a higher standard exists in a treaty signed by that party with a non-NAFTA country, does the most-favoured nation

obligation mean that the higher standard prevails? An example illustrates the power of this possibility. The US and Zaire have a bilateral investment treaty that sets a very low threshold for finding regulatory expropriation, protecting against any measures that cause, 'the impairment of [the investment's] management, control or economic value'. Such a standard would arguably be unacceptable to the NAFTA parties, and was arguably not part of the accord they thought they were signing[5].

Should this US–Zaire standard be accorded to Mexican and Canadian investors in the US by means of Chapter 11 MFN obligations? This possibility is more than speculative. At least one bilateral investment treaty dispute (Maffezini *v* the Kingdom of Spain) found in favour of such a use of the treaty's MFN provisions[6]. Closer to home, several Chapter 11 claimants have argued that the NAFTA Free Trade Commission's 2001 interpretive statement (discussed below) – on minimum international standard of treatment – is worthless, since a stronger standard of treatment exists in various BITs, and since Article 1103 obliges the parties to accord the higher standard. This argument was favourably considered in Pope & Talbot (2000), although the tribunal did not find it necessary to rule on it: 'The tribunal's view is well known – the Commission's interpretation would, because of Article 1103 . . . produce the absurd result of relief denied under 1105 but restored under 1103.'[7] The tribunal is arguing, in other words, that it is absurd that the MFN provisions in BITs can 'restore' the protections the FTC's interpretation has allegedly removed.

The ADF tribunal considered this argument as well, but did not have to rule on its validity since it held that the obligations the claimant was trying to import (from US BITs with Albania and Estonia) were equivalent to those in Chapter 11 (ADF *v* United States of America, 2003, paras 194–195).

The above description points to the need to carefully consider the relationship between different treaties when they are drafted. If the inclusion of an MFN provision along the lines used in NAFTA results in the risk of a reading in of investor rights and remedies negotiated in another context, and the potential expansion of any rights, obligations and remedies negotiated in the WTO context, this would raise very significant concerns from both a legal and policy perspective. Note, however, that even in the Maffezini context the tribunal was careful to stress that MFN could not, in their view, reach across different issues (e.g. import a transparency standard into a minimum international standards obligation that does not already deal with transparency), or act so as to thwart the clear wishes of the parties.

Performance requirements

Article 1106 of NAFTA prohibits host countries from imposing certain types of requirements on investors as a condition of entry and establishment. Among the requirements proscribed are demands to export a certain percentage of sales, demands to purchase locally for certain inputs and demands to transfer certain technologies to the host country.

The concerns that arise from this type of prohibition are twofold. First, many developing countries have expressed the view that this approach prohibits them from adopting the very types of tools that developed countries have used to promote their own development. Thus, a direct relationship with setting and implementing domestic development goals and strategies is implicated by performance requirement prohibitions. This is not an environmental problem per se, but falls clearly within the wider remit of sustainable development.

Second, there is a connection to certain types of regulatory measures. It has been argued in several cases now (although no ruling has yet been issued) that an import ban constitutes a performance requirement by forcing an investor to use only domestically sourced materials in its production processes or services. This was part of the claim in the Ethyl case[8]. Canada had banned the import of a gasoline additive – MMT, a suspected neurotoxin – and Ethyl argued that this meant its Canadian subsidiary would have to substitute local alternatives for imports from its US parent plant. Because the case was settled out of court, there was no ruling on this argument.

The same argument is now part of the claim against Canada in the Crompton case, where Canada banned the import of lindane-based seed treatments for canola on environment and health grounds. Crompton US, the manufacturer, plans to argue that the ban forces its Canadian subsidiary to buy local substitutes, and thus is in effect a local purchasing requirement (Crompton Corp *v* Government of Canada, 2001).

It is clear that the obligations on performance requirements were not intended to provide a remedy for measures that limit imports or exports for the sake of public protection from environmental and health hazards. However, this issue continues to arise in various cases. It is equally clear that prohibitions on performance requirements are intended to curtail the same types of development policies used by western countries over the entire 20th century. Thus, both the environmental and developmental pillars of sustainable development face challenges from this type of article.

Minimum standard of treatment

Article 1105 requires that investors shall receive treatment 'in accordance with international law, including fair and equitable treatment . . .'. The text leaves this requirement undefined, and before it was specifically ruled out by a Free Trade Commission (FTC) interpretive note dated July 2001, several cases interpreted it to mean that investors were due treatment spelled out in *any* international law, including the WTO, and even non-Chapter 11 parts of NAFTA[9]. The interpretive statement narrows the scope considerably, asserting that the parties meant to commit to treatment in accordance with customary international law.

Still, this does not leave matters completely resolved, as there is no clear-cut consensus on what constitutes customary international law in this area. But it has at least narrowed the scope for bringing into Chapter 11 a wide variety of law that is not specified anywhere in its text.

Possible Solutions

It has been argued above that the provisions of Chapter 11 are being interpreted, or risk being interpreted, in ways that are overly broad. This problem, of course, is compounded by the expansive definitions of investments and measures, giving a wide scope to extremely effective investor protections.

It needs to be asked: What is wrong with giving broad, effective protection to investors? Investment, after all, can be an engine of sustainable development. And the growth it brings can, if managed appropriately, bring real welfare benefits (although note the critical caveats offered in Chapter 1).

Whether the NAFTA parties are currently equipped to manage growth appropriately is beyond the scope of this chapter. The issue of more direct relevance to the present enquiry is one of balance. Expanding the rights of private investors typically comes at the expense of the rights of the public at large. This is perhaps most clearly demonstrated in the granting of patents, which allow a limited monopoly (monopolies always being against the public interest, other things being equal) as a reward to investment and innovation. To use an example from the context of investment law, Metalclad Corp.'s right to run a hazardous waste processing facility outside San Luis Potosi, Mexico, must be balanced against the public's right to an ecological preserve on that same land. Neither right is absolute, and it is normally the task of governments to find the appropriate balance.

The concern expressed by many with NAFTA's Chapter 11 is that there seems to be real potential to shift the balance unduly in favour of investor protection and away from the public good. It is not at all clear that the parties anticipated the broad readings of Chapter 11's provisions now being accepted or contemplated. Or, if they did, it is not at all clear that the balance they strike, or threaten to strike, would be acceptable to the public at large.

The issues discussed above have at their core a concern that NAFTA's Chapter 11 may restrict the parties' ability to exercise their legitimate authority to regulate in the public interest. That is, in seeking to protect investors from egregious government behaviour, Chapter 11 may tip the balance too far in their favour, to the detriment of non-commercial, public policy objectives such as environmental integrity and public health and safety.

Given those concerns, and the public policy implications of many of the cases to date, there is also concern at the closed nature of the dispute resolution proceedings, although there are welcome signs that this situation is changing. Still unaddressed is the problem that experts in international law are being asked to preside over proceedings that must balance between the private rights of investors and the public good – a position for which they are arguably not qualified.

There have therefore been a number of calls for reform both of the substance of NAFTA's Chapter 11 provisions and the process of dispute resolution. In examining them, it is useful to keep in mind that the two types of reform are very different propositions. As discussed below, some of the proposed solutions work better for one type than for the other. The proposals fall into three main categories, the pros and cons of which are discussed below:

- Interpretive statements issued by the FTC.
- Exceptions in Chapter 11 for environment, health and safety.
- Amendment of the Chapter 11 text to narrow its scope, add precision to provisions, and to improve the dispute resolution process.

Interpretive statements

NAFTA states: 'An interpretation by the [Free Trade] Commission of a provision of this Agreement shall be binding on a tribunal established under this Section' (NAFTA, Article 1131 (2)). In other words the FTC – the three NAFTA ministers of trade – may issue binding interpretations of the Chapter 11 provisions, presumably in circumstances of uncertainty. Given the concerns that have been voiced about the overly-broad interpretation of Chapter 11's provisions, an obvious solution would seem to be interpretive statements issued by the FTC clarifying exactly what the drafters meant by, for example, indirect expropriation.

In fact the FTC did issue such a statement (hereafter, the FTC statement) in July 2001 (NAFTA Free Trade Commission, 2001). It had two parts: first, an interpretation of Article 1105 (minimum international standards of treatment); and second, a clarification and commitment on the issue of transparency. (A more recent statement, discussed above, dealt only with process issues.) An analysis of this statement illustrates the limited function such a mechanism can play in reforming some of the problems identified in this chapter (Cosbey, 2001).

The FTC statement had asserted that NAFTA's drafters, when promising treatment in accordance with international law, in fact meant *customary* international law – a much weaker standard of protection. The FTC interpretation of the obligations on minimum standards of treatment has been criticized on two grounds. First, it has been argued that Chapter 11's MFN provisions can end-run any attempts to limit the scope of those obligations by reference to bilateral investment agreements where the parties have already committed to a stronger standard of protection. This is arguably not much of a stumbling block, since the FTC could simply issue a subsequent interpretation limiting this sort of reading of the MFN provisions.

Another fault is that in several cases the investor has argued that the 'interpretation' was in fact an amendment, since it actually changed the meaning intended by the drafters. While the FTC has authority to render binding interpretations, actual amendment is a much more difficult process, and is outside the FTC's jurisdiction. The Pope & Talbot tribunal was inclined to agree with this argument, but did not in the end rule on it. Several panels since then have ruled against this argument and the growing consensus is that the FTC interpretation will not be successfully challenged as an amendment (Mondev, 2002; ADF *v* United States of America, 2003).

This brings us back to the proposition that the interpretive statement is a solution to the problems identified in this chapter. While the early attacks on the FTC's first interpretive statement as an 'amendment' dimmed hopes that this mechanism would be useful, the recent cases have given more cause for

optimism. Probably any interpretation worth its salt will repeatedly be the target of the same type of legal attack, but at this point such attacks look likely to fail. This leaves the interpretive statement as a good potential tool for reinterpreting the troubling provisions surveyed above.

However, the potential is much lower that interpretive statements can address Chapter 11's problems with the process of dispute resolution[10]. The discussion above of the October 2003 FTC statements indicated that this route might be problematic. Using the 2001 statement is also instructive. The statement commits the parties to 'make available to the public in a timely manner all documents submitted to, or issued by, a Chapter 11 tribunal'. This pledge is subject to three possible exceptions, one of which is vitally important: except for 'information which the party must withhold pursuant to the relevant arbitral rules, as applied'.

Early Chapter 11 tribunals established high levels of secrecy which would have been fundamentally altered by the parties' commitments, were they fulfilled[11]. But then again, in none of these cases *could* they have been fulfilled, since the information in question was being withheld pursuant to the relevant arbitral rules. The problem here is one of jurisdiction. By ICSID and UNCITRAL rules, each tribunal at the outset agrees with the parties on rules of procedure, including confidentiality orders. While the parties may have authority to issue interpretations of the NAFTA provisions, they have no authority to interpret or change the procedural rules of ICSID or UNCITRAL. The only way this agreement will have any impact is as a morally binding commitment on the part of the governments to promote more transparent proceedings when such issues arise for decision-making by a tribunal (Cosbey, 2001). This may assist in setting a better direction.

On other process issues, such as changing the selection process for arbitrators, and opening up the process to public input and observation, the FTC has even less sway, although the 2003 FTC statements contained commitments by the US and Canada to consent to, and ask for, Chapter 11 hearings that are open to the public. These are not part of the rules of procedure on which parties agree in each case, and are either the prerogative of the tribunal, or are laid down in the rules of ICSID and UNCITRAL.

Thus, while in some cases interpretive statements may help curtail some expansive readings of the provisions, they may be subject to attack as *de facto* amendments. And because the process of arbitration is governed outside the NAFTA's legal framework, there is only so much that FTC statements can do to address Chapter 11's process faults.

An environment, health and safety exception in Chapter 11

An exception would be an addition to the text of NAFTA that exempted parties from their Chapter 11 obligations when applying specified types of measures. The most commonly called for types are those aimed at protection of human health and safety, and protection of the environment, but it is not difficult to think of other important public policy goals that might also merit inclusion on the list.

The proposal for such a mechanism derives in large part from the existence of similar exceptions in trade law. Perhaps the best known example is Article XX of the General Agreement on Tariffs and Trade (GATT): General Exceptions. This article lists ten types of measures that can be exempted from GATT law, including measures:

- necessary to protect public morals;
- necessary to protect human, animal or plant life or health;
- relating to the products of prison labour;
- imposed for the protection of national treasures of artistic, historic or archaeological value;
- relating to the conservation of exhaustible natural resources;
- essential to the acquisition or distribution of products in general or local short supply.

Before a measure can be considered as benefiting from these exceptions, it must qualify as per the opening paragraph to Article XX (the *chapeau*), which demands that the measures in question not be 'applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade'. In other words, GATT will allow exceptions, but the drafters wanted to make sure that the exceptions were not abused to protect domestic producers under the guise of loftier principles.

Three considerations make this option questionable. First, to request an exception for a given behaviour is to concede that such behaviour is not normal and acceptable in the first place. Some argue that in the investment arena there should be a presumption of the right to regulate in the public interest, especially given the life span and potentially broad societal impacts of a productive investment (Mann, 2002). This right may be circumscribed by international agreement, but to *start* by assuming that regulating in the public interest is illegal (save for certain exceptions) seems a weak position. It has been suggested throughout the above analysis that some of the expanded interpretations have gone beyond what was intended by the drafters of NAFTA – an argument that would be severely compromised by seeking exceptions to cover the newly prohibited behaviour.

But if the effect is the same, should we care how the objective is achieved? The second cause for worry is that the effect is not the same. The experience of the GATT shows that the Article XX exceptions are an extremely tough hurdle to clear. Any wording intended to prevent protectionism will undoubtedly cause a great deal of error on the side of caution. For example, the term 'necessary' in the environmental exception above has been read by the panels to mean 'least trade-restrictive' – a characteristic possessed by relatively few measures.

A third cause for concern is that an EH&S exception would not by itself address the process problems identified above. This is not a serious fault, since addressing those problems and creating exceptions are not mutually exclusive endeavours. Since the NAFTA would have to be amended to accomplish the former, the latter could be revised at the same time.

A final cause for concern is precisely that adding exceptions would involve amending the NAFTA. This would be an extremely difficult proposition. The problem is that most trade agreements (or, more accurately, trade, investment and other related policy agreements) are something like an over-packed storage trunk that one has had to greatly compress to finally get it closed and locked. They are usually nailed down at the last minute, under great pressure, by way of compromises that none of the parties is particularly happy with, but with which they all can live. It will not be a simple matter to go into the storage trunk to retrieve just one pair of socks – once it is sprung open all manner of things are coming out again. As of this writing, for example, the Mexican government is under extreme pressure to reopen NAFTA's Chapter 7 to obtain more protection for its agricultural sector. Further, Mexico is being pressured by partners in other trade agreements to re-open those agreements in *their* favour, and the precedent set by renegotiating NAFTA would be impossible to downplay. It is no wonder the trade ministries are loathe to bring the trunk out of the closet.

Given the first two weaknesses cited above, if we are to embark on amendment, it would seem wiser to undertake a comprehensive repacking while we have the trunk open. The next section considers such a course of action.

Amending Chapter 11

The previous section made it clear that there is little political appetite for re-opening the NAFTA to fix Chapter 11. The paradox is that amendment would be the most direct route for implementing the types of fixes discussed above. In terms of substantive concerns, it would be theoretically simple to open the NAFTA to insert language specifying in greater detail the intent of the original drafting on provisions such as expropriation and minimum standards of treatment. Such an approach would not suffer the fate of interpretive statements that have been challenged as amendments in disguise.

The difficulty, particularly with respect to expropriation, would be in finding language that gave appropriate space to legitimate government regulations, exempting them from being found compensable expropriations, without creating a gaping loophole for government misbehaviour. As noted above, the challenge of how to draw this fine line was deemed too tough by the original negotiators, and has been a stumbling block for the FTC in saying anything on the subject by way of interpretation.

In terms of changes to the process of dispute resolution, the amendment route would be more effective than either an interpretive statement (which has only persuasive force) or an exception (which has no force). It could not involve the FTC dictating changes to the rules of UNCITRAL or ICSID, the

frameworks in which the arbitrations actually take place; these are multilaterally agreed conventions. But within those frameworks it could do either of two things.

It could commit the parties to certain types of transparency that depend on the will of the parties under the current rules. For example, it could commit the parties to agreeing to release case documents (as do the FTC statements of October 2003, discussed above), but could also make such agreement on the part of the investor a prerequisite to launching a case.

It could set up a dispute settlement system that was entirely ad hoc and separate from either the UNCITRAL or ICSID rules. Of course any such system would be modelled in large part on such rules, but as an ad hoc system could, for example, specify the procedures to be followed in accepting *amicus* briefs, an area under which the FTC has no legal jurisdiction within the UNCITRAL and ICSID frameworks.

The difficulty of amending the NAFTA boils down to the fact that if it is opened for one purpose (such as amending Chapter 11), it is effectively open for all purposes – a prospect that would put the political leaders of the time under intense pressure to renegotiate key areas, and which might doom the talks to years of difficult wrangling. It might be possible for the parties to draft an agreement in advance of re-opening the agreement, specifying exactly which elements were touchable. The key question is whether such an agreement would be respected once the negotiations were underway.

In concluding, it is worth noting that the NAFTA itself was actually completed in 1992, although it entered into force in 1994. Thus, the text is already over 11 years old. In the lifespan of any major trade treaty, it is inevitable that after a decade or so the parties seek to expand, alter and fine tune an agreement. In the case of NAFTA, there is a risk that amendments might be made through additions, without revisiting some of the more controversial elements such as Chapter 11. This potential should be carefully monitored.

Amending ICSID and UNCITRAL

If amending NAFTA is the most direct route to giving greater clarity to its substantive provisions, amending the ICSID and UNCITRAL rules is similarly the most direct route to fixing NAFTA's problems of process. But just as opening the NAFTA to agreement among three parties would be extremely difficult, opening the ICSID Convention and negotiating changes to the UNCITRAL rules (both would need to be altered) would be a Herculean task.

The ICSID Convention has some 140 parties, and UNCITRAL rules would have to be changed from within the UN system by consensus. The types of change proposed here (transparency of proceedings, openness to *amicus* briefs, a roster of arbitrators) are certain to be a hard sell to some governments, particularly those with a tradition of closed dealings with their citizens, and those worried about the embarrassment of having their possible misbehaviour aired in full public view.

This option should not be ignored, as it represents a powerful way to change the way disputes are handled not only in the NAFTA, but in the myriad of bilateral investment treaties and investment contracts that resort to ICSID and UNCITRAL as frameworks of arbitration. The challenges involved, however, are daunting.

Conclusions

NAFTA's Chapter 11 aims to protect investors from unfair treatment at the hands of host governments, with the desired result of greater investment flows. Whether, and in what circumstances, such investment is beneficial to the host country, has been studied elsewhere (see Chapter 1 and Chapter 2). This chapter has focused on the unintended effects of the rules themselves.

The substantive provisions of Chapter 11 are being tested in the early years of the agreement by imaginative claimants who seek to stretch its intended interpretations to afford ever greater protections for investors[12]. Those protections may come at the expense of other public policy objectives; as this chapter has shown, there are a number of troubling ways in which the provisions might be interpreted that would restrict the parties' ability to regulate in the public interest. Moreover, as such claims notch up victories, the mere *threat* of a Chapter 11 suit may constitute an attractive weapon in the arsenal of firms looking to forestall or weaken regulations that affect them.

These problems are compounded by the procedural weaknesses of Chapter 11's dispute settlement system. While it looks as though the issues of public access and transparency are being addressed, if slowly, there remain a number of worrying institutional problems, such as the lack of an effective appeal mechanism, and the questionable selection process for arbitrators.

Further, it is inappropriate that the balancing of public policy priorities such as health and safety, the environment and economic growth be conducted outside of government and with few of the procedural safeguards that help ensure legitimacy, transparency and accountability.

Interpretive statements seem to be the repair tool of choice for the NAFTA trade ministers, and there is some reason to hope that these will have a positive influence, at least in terms of interpreting the obligations. As to reforming dispute settlement, that particular tool is not well suited since the process relies on rules over which the parties have little control – ICSID and UNCITRAL. Reforming those rules, or opening up the NAFTA to reform the process by amendment, present seemingly intractable difficulties.

It is, however, important to get it right in the NAFTA context, if only because the NAFTA parties and others are busy drafting investment rules in other contexts including the Free Trade Area of the Americas, various bilateral agreements and possibly the World Trade Organization. Just as NAFTA has served as an instructive laboratory for the weaknesses of the typical investment agreement, it should strive to serve as an example of how the shortcomings of such agreements can be addressed, such that investment agreements actually help to achieve sustainable development.

When it is expressed in those terms, such an objective seems eminently reasonable, even uncontroversial. And so it should be. It is a pity that the propriety of the objective is not matched by the simplicity of the solutions.

Endnotes

1 The tribunal in the end ruled, however, that this 'investment' had not suffered enough of an impact that the measure in question could be held to be expropriation. See Pope & Talbot paras 97–98.

2 Article 1110 also refers to measures 'tantamount to' expropriation. The consensus to date is that this is equivalent to indirect expropriation.

3 Note that this breach itself would have been saved by the fact that the tribunal found the Virginia contract to be 'government procurement' as defined in the NAFTA, and therefore not subject to Chapter 11's non-discrimination obligations (as per Article 1108(7)).

4 See Annex I of NAFTA for these exceptions.

5 This assertion is based on the language of the recent US Trade Promotion Authority Act, which mandates that in future trade and investment agreements 'foreign investors in the United States are not accorded greater rights than United States investors in the United States' – a condition that would be violated if foreign investors were accorded the US–Zaire-level of protection. And it is based on the public comments by Canada's Minister of Trade questioning the value of a broad interpretation of Article 1110. The author has no evidence of a Mexican position on expropriation but strongly suspects that the US–Zaire language would be unacceptable. Also see Been and Beauvais (2003).

6 ICSID Case No. ARB/97/7, 25 January, 2000; 40 ILM 1129 (2001).

7 Letter to the investor and defendant from The Hon. Lord Dervaird, Chair, Pope & Talbot tribunal, dated September 17 2001.

8 The case of Ethyl Corp *v* Government of Canada never proceeded to final ruling, but rather was settled in 1998 by the Government of Canada, which, among other things, paid Ethyl CAD$13 million. For details, see www.dfait-maeci.gc.ca/tna-nac/ethyl-en.asp

9 See www.dfait-maeci.gc.ca/tna-nac/NAFTA-Interpr-en.asp

10 In fact such statements are not 'interpretive' in the sense of clarifying the intent of NAFTA's drafters – rather, they seek to give FTC guidance to the conduct of the panels.

11 More recent tribunals have been less secretive; to date, two have opened their proceedings to the public, and most case documents are now available on government websites.

12 While the NAFTA itself is now ten years old, the cases actually settled under Chapter 11 arbitration number less than a dozen.

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