

4-1-2001

Who Then Should Judge? Developing the International Rule of Law under NAFTA Chapter 11

Charles N. Brower

Lee A. Steven

Follow this and additional works at: <https://chicagounbound.uchicago.edu/cjil>



Part of the [Law Commons](#)

Recommended Citation

Brower, Charles N. and Steven, Lee A. (2001) "Who Then Should Judge? Developing the International Rule of Law under NAFTA Chapter 11," *Chicago Journal of International Law*. Vol. 2: No. 1, Article 12.

Available at: <https://chicagounbound.uchicago.edu/cjil/vol2/iss1/12>

This Article is brought to you for free and open access by Chicago Unbound. It has been accepted for inclusion in Chicago Journal of International Law by an authorized editor of Chicago Unbound. For more information, please contact unbound@law.uchicago.edu.

Who Then Should Judge?: Developing the International Rule of Law under NAFTA Chapter 11

Charles N. Brower* and Lee A. Steven**

I. INTRODUCTION

One wonders what all the furor is about.

For all the calumny heaped upon Chapter 11 of the North American Free Trade Agreement (“NAFTA”) by opponents of globalization, as well as more measured responses by think tanks, academics, and the NAFTA Parties themselves, NAFTA’s investment protection and promotion regime is but another example of an evolving consensus regarding international investment regulation. The theme of this evolution over the past several decades has been internationalization and privatization, as evidenced by the now ubiquitous Bilateral Investment Treaty (“BIT”) and the increasing use of investor-State arbitration of investment disputes. In the last decade the BIT has become the predominant method by which States regulate investment on the international plane¹ and it should come as no surprise that NAFTA’s investment protection scheme, including provision for the arbitration of investor-State disputes,

* Special Counsel, White & Case LLP, Washington, DC; Judge, Iran-United States Claims Tribunal; Judge ad hoc, Inter-American Court of Human Rights; Member, Panels of Arbitrators and Conciliators of the International Centre for Settlement of Investment Disputes. Formerly, Acting Legal Adviser, United States Department of State; Deputy Special Counsellor to the President of the United States; President, American Society of International Law. Judge Brower has served as arbitrator in the NAFTA Chapter 11 arbitration *Ethyl Corp v Government of Canada* and as counsel for the investor in the pending NAFTA Chapter 11 arbitration *Mendev v International Ltd v United States of America*.

** Associate, White & Case LLP, Washington DC. Mr. Steven is currently serving as counsel for the investor in the pending NAFTA Chapter 11 arbitration *Mondev International Ltd v United States of America*.

1. By one count, of the 1162 BITs worldwide signed as of Sept 22, 1997, 829 had been signed since 1990. *Status of Investment Treaties*, 36 ILM 1404, 1404 (1997). A more recent count estimates that the number of signed BITs now stands at about 1800. Antonio R. Parra, *Applicable Substantive Law in ICSID Arbitrations Initiated under Investment Treaties*, Address Before the Seventeenth ICC Court/AAA/ICSID Colloquium on International Arbitration (Nov 10, 2000). (On file with the Chicago Journal of International Law)

is essentially identical to that of the vast majority of BITs concluded since 1990. The NAFTA Parties themselves have negotiated no less than eighty-six BITs with other States² and Chapter 11 closely follows the US Model BIT.

Criticism of Chapter 11, which has emanated almost exclusively from Canada and the United States, is all the more ironic because its inclusion in NAFTA was accomplished despite initial resistance by Mexico. Consistent with its BIT policy towards other developing countries, the United States lobbied hard to include Chapter 11's investment protections precisely because it wanted "to liberalize Mexican restrictions on investment and to lock in legal protections for [US] investors."³ US wariness of Mexico's investment climate was not without precedent. Experience with the Mexican expropriations of foreign-owned agrarian and oil concerns in the early part of the twentieth century had prompted US Secretary of State Cordell Hull, in a now famous exchange of notes with the Mexican Minister of Foreign Affairs, to formulate the position that "no government is entitled to expropriate private property, for whatever purpose, without provision for prompt, adequate, and effective payment therefor."⁴ Prior to NAFTA, Mexico had long held (consistent with the practice of Latin American countries in general) that foreign investors did not enjoy investment protection beyond that afforded to its own nationals under domestic law.⁵ That Mexico was willing to accept substantive investment protections and investor-State arbitration of investment disputes under an international treaty was a major vindication of an important, long-standing US policy.

The only potentially unique aspect of NAFTA Chapter 11 is that the governments of two nations with developed economies agreed to enter into an investment protection treaty between themselves. The overwhelming majority of

-
2. As of November 1, 2000, the United States has signed forty-six BITs, thirty-one of which have entered into force and fifteen of which are awaiting ratification. US Department of State, Bureau of Economic and Business Affairs, *List of US Bilateral Investment Treaties* (Nov 1, 2000), available online at <http://www.state.gov/www/issues/economic/bit_treaty.html> (visited Mar 25, 2001). Canadian BITs, known as foreign investment protection and promotion treaties, number twenty-four (twenty in force and four signed but not yet in force). Department of Foreign Affairs and International Trade, *Listing of Canada's Foreign Investment Protection and Promotion Agreements (FIPAs)* (Oct 26, 2000), available online at <<http://www.dfait-maeci.gc.ca/tna-nac/fipa-e.asp>> (visited Mar 25, 2001). Mexico has negotiated sixteen BITs (seven of which are in force) and is actively engaged in the negotiation of several more. SECOFI, *Instrumentos de Promoción*, available online at <http://www.secofi-snci.gob.mx/Inversi_n/Inst_de_promoci_n/inst_de_promoci_n.htm> (visited Mar 25, 2001).
 3. United States General Accounting Office, *North American Free Trade Agreement: Assessment of Major Issues: Report to Congress*, GAO/GGD-93-137B at 19 (Sept 1993).
 4. Green H. Hackworth, 3 *Digest of International Law* § 288 at 658-59 (GPO 1942).
 5. Like other Latin American countries, Mexico incorporated the Calvo Doctrine in its constitution. This doctrine, named after the Argentine statesman who first propounded it, holds that an alien must rely on the law and procedure of the local jurisdiction for the resolution of disputes arising from commercial activities in the local jurisdiction and may not petition its own government to espouse its claim in an international forum.

BITs to date have been North to South, between capital-exporting countries and capital-importing countries, and the private investors who actually have benefited from such treaties have been those from the North. Practically speaking, countries such as Canada and the United States simply have not had to worry that they would ever have to defend a claim in arbitration under a BIT. The cross-border investment flows between Canada and the United States, however, are astronomically higher than, for example, those between Cameroon and the United States, and it was inevitable, once NAFTA's investment protection regime became operative, that Canada and the United States would be defending themselves before an international tribunal. Indeed, it is no coincidence that all of the Chapter 11 cases thus far commenced against the United States have been brought by Canadian nationals and all but one of the cases against Canada have been brought by US nationals. One may surmise that at least some of the distress felt by Canada and the United States over NAFTA Chapter 11 has been caused by the novel and disconcerting fact of having to live up to the same substantive and procedural guarantees that they have required of their BIT partners.

Of course the fact that the NAFTA Parties are getting precisely what they bargained for does not necessarily answer the specific criticisms being leveled against Chapter 11. In analyzing the substance of this criticism, however, one should not lose sight of the reasons why the NAFTA Parties negotiated Chapter 11 in the first place. NAFTA Chapter 11 creates substantive investment protections that are enforceable in arbitration by the individuals directly impacted by any breach of such protections. In establishing this investment regime, the NAFTA Parties wanted to achieve three main objectives: (1) to tear down existing foreign investment barriers by eliminating arbitrary and discriminatory restrictions; (2) to build investor confidence throughout the region through the elaboration and enforcement of clear and fair rules; and (3) to "depoliticize"⁶ the resolution of investment disputes by eliminating the need for State-to-State adjudication. Any criticism of the Chapter 11 regime that fails to take account of these three factors is, literally, beside the point.

II. REALIZING THE AIM AND PURPOSE OF NAFTA CHAPTER 11

Section A of Chapter 11 establishes the substantive investment protections that each NAFTA Party is required to honor, including the better of national treatment or most favored nation treatment, the minimum international standard of treatment, elimination of performance requirements, free transfer of funds, and expropriation protection. The point of these protections is to establish a rule-based investment regime in which foreign direct investment can thrive. Specific barriers to and

6. See Ibrahim F.I. Shihata, *Towards a Greater Depoliticization of Investment Disputes: The Role of ICSID and MIGA*, 1 ICSID Rev-Foreign Inv LJ 1, 4-5 (1986).

restrictions on investment are eliminated and positive guarantees are extended. Moreover, all of this is done at the international level so as to place all three NAFTA countries and their investors, so far as possible, on an equal footing.

Section B of Chapter 11 is intended to reinforce that regime and make it work by giving foreign investors standing to bring claims in arbitration against the NAFTA Parties for breach of the substantive investment protections found in Section A. A rule-based system must have an enforcement mechanism if its substantive rules are to have any meaning over the long term. Just as important, however, is the form which that enforcement mechanism takes. After all, giving private individuals standing to sue a State before an international tribunal was not the only means of enforcement open to the NAFTA Parties. Consistent with existing international practice, the Parties could have relied on diplomatic protection, requiring the government of each NAFTA country to espouse the claims of its nationals. Alternatively, the Parties could have required that Chapter 11 claims be litigated in the domestic courts of the three NAFTA countries.⁷

Neither of these alternative options, however, would serve the aims of Chapter 11 as well as does investor-State arbitration. Investor confidence, for example, is not furthered by requiring domestic litigation. Indeed, the fundamental reason that the great majority of modern investment protection treaties have opted for international adjudication is that domestic courts are often in fact, and, just as important, usually are perceived to be, biased against alien investors, especially when those courts must evaluate and pronounce upon acts of their own governments. Further, domestic courts often do not have the legal expertise and experience to free themselves from the confines of their own domestic regimes so as to give proper attention and respect to international law (which, along with NAFTA itself, expressly governs Chapter 11 disputes⁸). Another factor is that the interests of alien investors are more vulnerable than those of local investors because, as aliens, they are cut off from any direct participation in the host State's political process and are therefore in greater need of protection at the international level. An international dispute resolution mechanism best serves Chapter 11 precisely because the NAFTA Parties are trying to build an international investment protection and promotion regime, a rule-based system that will be elaborated and enforced uniformly and consistently in each of the three NAFTA countries.

Equally important was the choice of investor-State dispute resolution over State-to-State adjudication. A system that originates in diplomatic protection—a product

7. Yet another alternative would have been to create a standing NAFTA Tribunal to resolve investment disputes. The great advantage of this kind of system is the ability to generate a uniform body of substantive and procedural law, creating greater consistency over time, but the significant cost to the NAFTA Parties of maintaining such a body makes its realization improbable.

8. See North American Free Trade Agreement, Art 1131(1), 32 ILM 605, 645 (1993).

of expediency, it may be noted, from a time when the international legal order did not recognize the individual as able to invoke international law—places the burden and expense of prosecuting an investment dispute on the investor's government, a process that can be highly inefficient, arbitrary, and politically explosive: inefficient because governments are pressured to prosecute, or at least investigate, a great number of frivolous claims that would not otherwise be pressed if the responsibility and cost of prosecution remained with the individual investor; arbitrary because the exigencies of time, money, political priorities, and the whims of individual bureaucrats may cause a government to downgrade, or even ignore, meritorious claims; and politically explosive because diplomatic protection has the distinct disadvantage of pitting two States against one another in an inherently confrontational setting where, once a case is commenced, government officials cannot be seen as acting indifferently to the interests of their nationals. International "incidents," and the longstanding resentment and ill will between nations they generate, simply are not as likely to occur when the private investor itself has the right and the responsibility to prosecute its own claim and hence only one government is actively involved in the litigation.

III. NAFTA'S EXPROPRIATION PROTECTION

In light of the above discussion, what is one to make of the outpouring of critical comment concerning Article 1110, NAFTA's expropriation provision? On its face, Article 1110 appears uncontroversial (at least to an international lawyer). The provision prohibits expropriation without the requisite compensation, a standard rule of international law (with recognized exceptions such as confiscation as a criminal penalty or as a defense measure in time of war) that also has been incorporated in most BITs worldwide. Further, Article 1110 requires expropriations to be for a public purpose, non-discriminatory, and in accordance with due process of law and the international minimum standard of treatment. All of this is standard fare.

One might think that the controversy surrounding Article 1110 would center on the detailed elaboration of how compensation is to be determined and paid, which adopts the investor-friendly position long advocated by capital-exporting countries such as the United States at the expense of the sovereign-friendly rules proposed and vigorously advocated by developing countries in decades past.⁹ Such is not the case, however. Controversy exists primarily because Article 1110 applies not only to direct seizures of property, but also to any State "measure tantamount to nationalization or expropriation," and to a variety of property rights, both tangible and intangible (including contract rights). Article 1110, together with the arbitral mechanism

9. On the latter see United Nations, Charter of Economic Rights and Duties of States, GA Res 3281, UN Doc A/9631 (Dec 1974), reprinted in 14 ILM 251 (1975); Resolution on Permanent Sovereignty over Natural Resources, GA Res 3171, UN Doc A/9030 (Dec 1973), reprinted in 13 ILM 238 (1974).

established in Section B of Chapter 11, thus makes it possible for investors to recover in arbitration for so-called indirect expropriations,¹⁰ including wealth deprivation caused by legislation, regulation, and other government actions that fall short of outright seizure and control of property.

For critics of NAFTA, including in particular environmentalists, Article 1110 goes too far by making it possible for private corporate interests to “undermine” legitimate governmental regulations in a “supranational” forum insulated from the usual domestic political and legal processes.¹¹ Moreover, at least one of the NAFTA Parties (Canada) formally has called for a clarifying interpretative statement regarding Article 1110 because the “NAFTA Parties never intended the expropriation and compensation provisions of NAFTA Chapter Eleven to limit the legitimate rights of governments to regulate.”¹² Canada argues that Chapter 11 should not give investors the right to seek compensation for wealth deprivation caused by “acts or measures [that] are non-discriminatory and within the normal exercise of a State’s regulatory prerogative.”¹³ This statement begs the question, however, because, depending upon how it is interpreted, it (1) simply restates an existing rule of international law that would be applied by any international tribunal hearing an expropriation claim under NAFTA Chapter 11, or (2) unjustifiably seeks to modify the existing rule of international law relating to indirect expropriation in a manner not supported by the language of Article 1110.

The mere fact that NAFTA recognizes the possibility that governments may be responsible for regulatory actions that destroy or severely damage the value of a property right should be uncontroversial. State responsibility for indirect expropriation is a recognized principal of customary international law¹⁴ and not an innovation of NAFTA. At the same time, however, international law also recognizes that, in general, “[a] state is not responsible for loss of property or for other economic

-
10. For a general discussion of issues related to indirect expropriations under international law, see Rudolf Dolzer, *Indirect Expropriation of Alien Property*, 1 ICSID Rev-Foreign Inv L J 41 (1986); Burns H. Weston, “Constructive Takings” under International Law: A Modest Foray into the Problem of “Creeping Expropriation”, 16 Va J Intl L 103 (1975).
 11. Consider Howard Mann and Konrad von Moltke, *NAFTA’s Chapter 11 and the Environment: Addressing the Impacts of the Investor-State Process on the Environment*, International Institute for Sustainable Development Working Paper (1999), available online at <<http://iisd1.iisd.ca/pdf/nafta.pdf>> (visited Mar 25, 2001).
 12. Nihal Sherif, *Canadian Memo Identifies Options for Changing NAFTA Investment Rules*, Inside US Trade 1, 20 (Feb 12, 1999) (reprinting and commenting upon a Chapter 11 operational review memo authored by John Gero of the Canadian Department of Foreign Affairs and International Trade).
 13. *Id.* at 21. Canada has pressed this argument as a defense on the merits in a least one Chapter 11 arbitration. See *Pope & Talbot Inc v Government of Canada*, Award (June 26, 2000) at para 90, available online at <<http://www.appletonlaw.com/4b3P&T.htm>> (visited on Mar 25, 2001).
 14. Consider Dolzer, 1 ICSID Rev-Foreign Inv L J 41 (cited in note 10); and Weston, 16 Va J Intl L 103 (cited in note 10).

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."¹⁵ Moreover, NAFTA Chapter 11 itself provides that "[n]othing in this Chapter shall be construed to prevent a Party from adopting, maintaining or enforcing any measure otherwise consistent with this Chapter that it considers appropriate to ensure that investment activity in its territory is undertaken in a manner sensitive to environmental concerns."¹⁶

Whether *all* nondiscriminatory regulations that fall within the normal exercise of a State's police power are, or should be, categorically exempt from compensation is another matter. Just as the Supreme Court of the United States has held that the government's police power under US law does not extend so far,¹⁷ so it is understood that a State may be responsible under international law for "taxation, regulation, or other action that is confiscatory, or that prevents, unreasonably interferes with, or unduly delays, effective enjoyment of an alien's property."¹⁸ There is nothing in NAFTA generally or in Article 1110 in particular that suggests that the NAFTA Parties collectively intended to modify this rule of international law so as to immunize governments categorically from culpability with respect to indirect expropriations.¹⁹

Of course it cannot be gainsaid that it is often an extremely difficult, politically sensitive task to distinguish between a compensable taking and a non-compensable regulation in a specific case. Indeed, this appears to be Canada's real concern:

[C]ustomary law and the writings of leading commentators have yet to articulate clear rules to distinguish between a compensable taking and non-compensable regulation.

In this light, how can an interpretation confirm that the regulatory actions of government are not covered to the extent that such actions or measures are reasonable on their face? Could we confirm that it would be up to the challenger of an act or measure to demonstrate an absence of bona fides, or an abuse of governmental powers or that the effect of the government actions or measures is truly expropriative?

15. 2 *Restatement (Third) of the Foreign Relations Law of the United States* § 712, comment g (ALI 1937).

16. NAFTA, Art 1114(1), 32 ILM at 642 (cited in note 8).

17. See, for example, *Pennsylvania Coal Co v Mahon*, 260 US 393, 415 (1922) ("[W]hile property may be regulated to a certain extent, if regulation goes too far, it will be recognized as a taking."). See also *Lucas v South Carolina Coastal Council*, 505 US 1003, 1015 (1992) (compensation is required when regulation works a physical invasion of property or denies all economically beneficial or productive use of property).

18. *Restatement* at § 712, comment g (cited in note 15).

19. Accordingly, the *Pope & Talbot* tribunal has held that "the scope of [Article 1110] *does* cover nondiscriminatory regulation that might be said to fall within an exercise of a state's so-called police powers" but that Article 1110 does not "broaden [] the ordinary concept of expropriation under international law to require compensation for measures affecting property interests without regard to the magnitude or severity of that effect." *Pope & Talbot v Canada*, at para 96 (emphasis added) (cited in note 13) Applying this standard, the tribunal rejected the investor's expropriation claim.

Is it feasible to define a list of government activities as illustrations of legitimate government activities not requiring compensation?²⁰

These comments demonstrate that Canada's real source of unease is not with the substantive rule articulated in Article 1110, but with how the system itself operates. Stated plainly, Canada is apprehensive that the arbitral tribunals constituted pursuant to Chapter 11 may not make the right decisions.

Someone must decide, however. Granted, it is a difficult task to draw the line between a taking and a regulation, and international law has not fully articulated all the relevant criteria. This is equally true under domestic law (US federal and state law not excepted) and will remain so for as long as government regulation, business enterprise, and technological innovation entwine in ever increasing complexity.²¹ In light of the aims and objectives of NAFTA Chapter 11, then, who should judge? Although not stated in so many words, the implication of Canada's call for an interpretive statement is for the NAFTA Parties to take the power of decision away from the international tribunals constituted under Chapter 11, leaving it to municipal law, it may be supposed, to provide any redress. Canada effectively has agreed with those public interest groups that interpret investor claims under Article 1110 as a cynical and illegitimate attempt to bypass the domestic political process and undermine environmental and other public interest laws, regulations, and procedures.

Understandable as it may be, this concern is short-sighted and misplaced. What the NAFTA Parties set out to accomplish—the protection and promotion of investment through the uniform application of rules and guarantees in all three NAFTA countries—can best be sustained through the enforcement of Chapter 11 by independent and impartial international tribunals. Justice and fairness demand that Canada and the United States live up to the same substantive rules and procedural mechanisms as have been accepted by Mexico, and they need not worry about doing so. The international adjudication of investor-State disputes has a long history and, as the increasing caseloads of such disputes at arbitral institutions such as the International Centre for Settlement of Investment Disputes demonstrate, has become commonplace. The arbitrators participating in these cases are highly competent members of academia and the international bar, with experience and expertise in the relevant areas of law exceeding that of the vast majority of the domestic judiciary in each of the three NAFTA countries. The quality of decisions being rendered in these

20. Sheriff, *Inside US Trade* at 21 (cited in note 12).

21. As long ago as 1959 it was recognized that "the distinction between a State's acts of expropriation founded on the right of 'eminent domain' and those which fall within the exercise of its police power—a distinction which originally stems from differences in grounds and purposes and also has a bearing on the question of compensation—is daily becoming more difficult to make, because of the evolution which the conception of the State's social functions has undergone in both those areas." F.V. García Amador, *Fourth Report on International Responsibility*, 2 YB Intl L Commission 1, 12 UN Doc A/CN.4/Ser.A/1959/Add.1 (1960).

cases is high and there is every indication that the tribunals are properly balancing the legitimate interests of both investors and the NAFTA Parties.²²

Perhaps just as important, however, is the impact that Chapter 11 cases—and the NAFTA Parties themselves—will have on the further development of international law. Canada may be wary of having to defend indirect expropriation claims because of the lack of clear rules in this area of the law, but the very indefiniteness of the law represents an opportunity. With each new case commenced, the NAFTA countries will be arguing their interpretations of international law and urging their views of the proper application of each provision of Chapter 11. Not only will the NAFTA Parties gain expertise through their regular participation in such proceedings; their persistent involvement in Chapter 11 cases cannot help but influence and shape the direction of international investment law in ways that will best serve their nationals' interests. Moreover, as more and more cases are decided, the content of NAFTA's substantive rules will be expounded, the Parties' treaty obligations clarified, and important principles of international law refined, thus helping to sustain and develop the rule-based investment regime that the NAFTA Parties are in the process of creating.

There is in the end, therefore, little substance to the argument that NAFTA empowers corporate interests at the expense of legitimate regulation. Let the NAFTA countries legislate in a truly non-discriminatory manner; let them extend the same opportunities to alien investors as their own nationals; let them in accordance with international law compensate for measures that substantially destroy the value of alien investments; let them, in short, live up to their substantive obligations under NAFTA Chapter 11, and they will be vindicated in any arbitration brought against them. Even when arbitral decisions go against a NAFTA Party, however, participation in the

22. Indeed, of the three final awards that have been rendered in Chapter 11 cases thus far, two have been rendered in the State Respondent's favor. See *Azinian v United Mexican States*, Award (Nov 1, 1999) 39 ILM 537 (2000) (finding in Mexico's favor) also available online at <<http://www.naftaclaims.com>> (visited April 3, 2001); *Waste Management, Inc v United Mexican States*, ICSID Case No ARB(AF)/98/2, Award (June 2, 2000) (finding in Mexico's favor) also available online at <<http://www.naftaclaims.com>> (visited April 3, 2001); *Metalclad Corp v United Mexican States*, ICSID Case No. ARB(AF)/97/1, Award (Aug 30, 2000) (finding in favor of the investor) also available online at <<http://www.naftaclaims.com>> (visited April 3, 2001). In a fourth case, as part of a bifurcation of the merits in that proceeding, the tribunal issued an Interim Award in favor of the State Respondent on two of the four claims, including the expropriation claim under Article 1110. See *Pope & Talbot v Canada*. Finally, in a Partial Award rendered in *SD Myers v Canada*, the tribunal found in favor of the investor on two of four claims, but did so by finding that the government measure in question was discriminatory; it rejected the investor's expropriation claim under Article 1110. *SD Myers, Inc v Government of Canada*, Partial Award (Nov 13, 2000) available online at <<http://www.appletonlaw.com/cases/Myers - Final Merits Award.pdf>> (visited Mar 25, 2001).

process will have its benefits. In either case, the rule of law will be realized, and thus strengthened for the future.