

## OTHER INTERNATIONAL DEVELOPMENTS

## NAFTA

## Chapter 11 and the Environment

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## I. Introduction

Drafted in 1992 by Canada, Mexico, and the United States, NAFTA was meant to promote free trade among the negotiating countries by ensuring fair competition and by increasing cross-border investment activities. One of the key components of the world economy is foreign direct investment (FDI) – investment by private sector companies into foreign countries. From 1988 to 1997, flows of FDI from OECD<sup>1</sup> to non-OECD countries grew by a factor of five.<sup>2</sup> Clearly, FDI was, and still is, an important source of capital in developing nations. However, corporations have been wary of investing in foreign countries because they have feared expropriation by national governments.

Chapter 11 of NAFTA was written to avoid incidents such as the one in 1938 when the Mexican government nationalized the oil industry and some US companies lost their entire investment.<sup>3</sup> Chapter 11 allows private firms to bring suits against foreign countries for unjustly expropriating their investments. However, instead of using these provisions as protection against expropriation, an increasing number of companies have begun using Chapter 11 to recoup losses resulting from environmental regulations.

This article, will summarize the contents of Chapter 11, outline two cases brought under Chapter 11 in recent years, namely *Metalclad v. Mexico* and *Methanex v. US*, analyse the problems of Chapter 11, and present a few solutions.

## II. Structure and Objectives of Chapter 11

As noted, though originally intended to protect FDI from nationalization, Chapter 11 has been increasingly used to recover a decline in profits due to environmental regulations. In recent cases, foreign companies have claimed that expropriation happens when investments are greatly diminished in value by environmental protection policies that were promulgated after the original investment was made.<sup>4</sup>

## TERMS

The varying interpretations of Chapter 11 stem from its broad and imprecise wording. Under Chapter 11, an “investment” is not restricted to direct speculation in a venture, but also includes “real estate or other property, tangible and intangible” and enterprises where profit de-

pends upon future production.<sup>5</sup> Similarly, a “measure” taken by a government against an investor includes all national laws, regulations that apply to these laws, local laws, and policies that affect relations between governments and businesses.<sup>6</sup> Finally, Article 1110 of Chapter 11 states, “[N]o party may ... take a measure tantamount to nationalization or expropriation.”<sup>7</sup> The inclusion of the term “tantamount” makes it easy to label a variety of actions as expropriation even if they do not clearly fall under this category. These wide-ranging definitions of Chapter 11 terms make it much easier for companies to claim that they should be compensated because government “measures” have infringed upon their “investments” in a way that is “tantamount to expropriation”.

## BASIC RIGHTS

The basic rights guaranteed to nations under Chapter 11 are national treatment, performance requirements, minimum standard of treatment and freedom from expropriation without compensation.<sup>8</sup> Article 1102 (national treatment) requires that member parties treat foreign investors in the same way that they would domestic companies. Article 1106 (performance requirements) prohibits countries from imposing conditions on FDI such as that a certain percentage of the product must be exported or that the company must assist the host country with technology transfer. Article 1105 (minimum standard of treatment) provides that all investors must receive a minimum standard of fair and equitable treatment in accordance with international law.<sup>9</sup> Essentially, these three articles mandate that countries cannot discriminate against investors based on their nationality but must treat foreign companies no less favourably than domestic companies.

Finally, Article 1110 deals with expropriation of foreign investments and specifies that expropriations are allowable only (1) for a public purpose, (2) when non-discriminatory, (3) in accordance with due process of law, and (4) when compensated by the expropriating government.<sup>10</sup> If the arbitration panel rules that a government has unfairly expropriated the investment of a foreign corporation, it must pay compensation to the amount of the market value of the investment at that time.<sup>11</sup>

## ARBITRATION

Arbitration of Chapter 11 cases is administered by an international tribunal composed of one member chosen by each party and a third agreed upon by both parties.

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Judgments are binding and there is no appeals process. All court documents and proceedings are kept private, in accordance with the view that this information would compromise the confidentiality of business workings.

### III. Metalclad v. Mexico

In September 1993, Metalclad, a US corporation, acquired a Mexican hazardous waste company, believing that it had a permit issued by the Mexican federal government to construct a landfill at the La Pedrera site in the city of Guadalcazar in the state of San Luis Potosi. Local residents, government officials and non-governmental organizations (NGOs) opposed the landfill, claiming that the site was geologically unsuitable and that the landfill that had previously operated in the same area was responsible for health problems among the local population. Heeding the complaints, the city of Guadalcazar shut down the project after five months of construction on the grounds that although Metalclad had a federal permit, they had not obtained a municipal permit.<sup>12</sup> Ultimately, the Guadalcazar city council denied Metalclad the permit and the Governor of San Luis Potosi declared the property a new ecological preserve where industrial activity was prohibited.<sup>13</sup> In response, Metalclad filed a Chapter 11 suit, demanding compensation for violations of the articles mandating non-discrimination against foreign investors and prohibiting expropriation of investments without compensation. In August 2000, the international tribunal found in favour of Metalclad and required Mexico to pay damages of \$16.7 million.<sup>14</sup>

The tribunal ruled that because Metalclad was operating under the assumption that it had authorization from the Mexican federal government to build the landfill, the eventual denial of a municipal construction permit by the Guadalcazar city council was tantamount to expropriation of Metalclad's investment in the area.<sup>15</sup> The tribunal also stated that, in reality, Guadalcazar did not have the jurisdiction under Mexican law to deny Metalclad a construction permit on the basis of environmental hazards. The tribunal found that Mexico did not adhere to Chapter 11's requirement of fair and equitable treatment because it did not "ensure a transparent and predictable framework for Metalclad's business planning and investment."<sup>16</sup> In addition, the tribunal decided that both the actions of Guadalcazar to prevent the

operation of the landfill and the governor's declaration of the site as an ecological preserve constituted expropriation.

### IV. Methanex v. United States

The chemical MTBE was originally added to gasoline to reduce harmful emissions, but started showing up in California drinking water in 1995. Studies by both the University of California at Davis and independent researchers linked MTBE to cancer<sup>17</sup> and the US Environmental Protection Agency (EPA) classified it as a possible cancer-causing agent.<sup>18</sup> In March 1999, Governor Gray Davis of California issued an executive order requiring that MTBE be phased out of all gasoline by December 2002.<sup>19</sup> However, in 2002, he delayed the ban until January 2004 to prevent a sudden increase in gas prices due to insufficient supplies of ethanol, an MTBE substitute.<sup>20</sup>

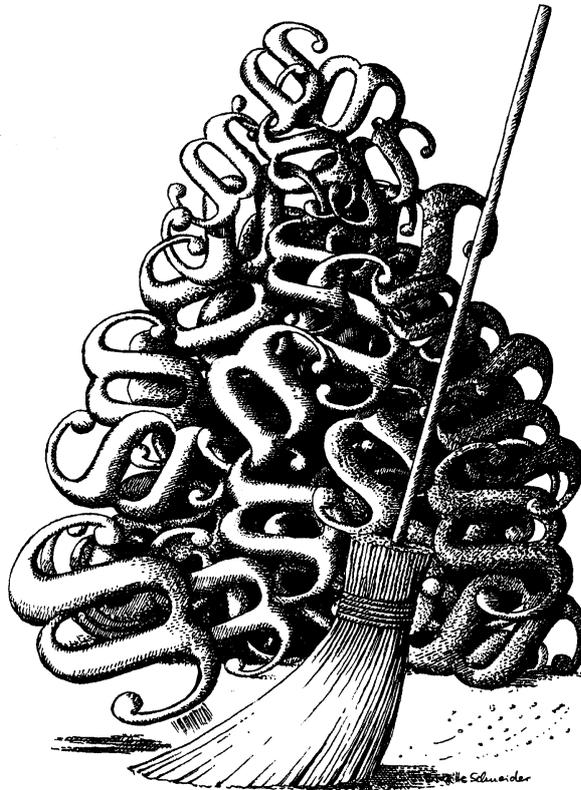
In March 2001, Methanex, a Canadian manufacturer of methanol, a major component of MTBE, brought a Chapter 11 case against the USA, citing violations of national treatment, minimum standards and expropriation without compensation. Methanex is seeking damages in the region of \$970 million.<sup>21</sup> In August 2002, the NAFTA tribunal trying the case said that it needed more evidence from Methanex to support its claim that California's ban on MTBE was an intentional discrimination against foreign investors by driving the gasoline additive market away from methanol and towards the US ethanol industry.<sup>22</sup> In November 2002, Methanex re-filed its complaint and is currently waiting for the trial to proceed.<sup>23</sup> In January 2003, several American environmental NGOs sought permission to

present an *amicus curiae* brief and urged the tribunal to open hearings to the public.<sup>24</sup>

### V. Critiques of Chapter 11

#### CHAPTER 11 OVERSTEPS THE DOMESTIC LAWS OF ITS MEMBER PARTIES

Under Mexican law, the government is free to restrict the use of property owned by either Mexican citizens or foreign investors as long as the property is not directly expropriated. In Canada, the government can pass regulations that result in the total loss of an investment; compensation is not required unless the regulation directly



Courtesy: SZ

transfers a benefit from the property owner to the government. While US courts seek to evaluate regulatory takings by balancing the benefits to the public against the economic losses suffered by the property owner, in reality, US courts rarely provide compensation even when the damages are large.<sup>25</sup>

Although the objective of Chapter 11 is to ensure that countries do not favour domestic investors over foreign investors, essentially it ends up having just the opposite effect. Except in rare instances, none of the party nations provides compensation to domestic companies that incur losses as a result of government regulations. However, as the *Metalclad v. Mexico* ruling illustrates, under Chapter 11, foreign investors can sue and win against a host nation for any present and future damages from new environmental policies. In the end, Chapter 11 provides more protection for foreign firms than is available to domestic firms under any of the member countries' laws or practice.

#### CHAPTER 11 PUTS INVESTMENT OVER ENVIRONMENT

As foreign investors are currently using it, Chapter 11 presents a challenge to national sovereignty because States are less likely to pass public health measures while under the threat of being perceived as anti-investment or of being sued for large sums of money.<sup>26</sup> If the USA is required to compensate Methanex for its losses from the California MTBE ban, it is far less likely that other States will ban MTBE, for fear of suffering the same penalty. Since NAFTA entered into force in 1994, the Canadian legislature has only considered two new environmental regulations, both of which were challenged under Chapter 11 and both of which were eventually rejected by the Canadian government.<sup>27</sup> This illustrates the pre-emptive nature of Chapter 11: countries think twice about passing or even seriously contemplating new environmental policies when they anticipate opposition from foreign investors.

#### CHAPTER 11'S LACK OF TRANSPARENCY ENDANGERS DEMOCRACY

Under Chapter 11, investors bypass domestic law and bring cases to closed international tribunals whose rulings are binding and not subject to appeal. Without public accountability, it is far more likely that arbitration panels will rule against the public interest and against the host country, again decreasing the likelihood of the success of new environmental regulations. In addition, since a new tribunal is selected for each case, it can be quite difficult to find expert and unbiased panelists. For example, in *Methanex v. US*, it is highly desirable for the tribunal members to have knowledge of the nature of MTBE, environmental management, and the economics of environmental regulation in California.<sup>28</sup> The relatively impromptu make-up of the panel, the inability to appeal rulings, and the lack of binding precedent, result in an unpredictable and inconsistent arbitration process for each new case brought under Chapter 11. Because there is little sense of constancy from trial to trial, it can even be argued that Chapter 11 violates the democratic right to a fair trial.<sup>29</sup>

#### CHAPTER 11 IGNORES THE INTERESTS OF THE AFFECTED COMMUNITY

NAFTA's preamble includes a commitment to using foreign investment to create employment opportunities and to improve the working and living standards in the territories of the member parties.<sup>30</sup> However, instead of listening to the concerns of local communities and taking them into account when making a decision in a case, Chapter 11 tribunals have done almost the opposite. In *Metalclad v. US*, the tribunal did not consider the motivations behind the actions of the Guadalucazar city council and the Governor of San Luis Potosi, but only looked at the resulting damages incurred by Metalclad. Even though the community would have received large economic benefits from the operation of the landfill, hundreds of local people showed up to protest at its inaugural ceremonies.<sup>31</sup> Though the local Mexican government officials were acting in the clear interests of their constituents, the tribunal only took the end result of their actions into account and made Mexico compensate Metalclad for its losses.

#### VI. How can Chapter 11 be Improved?

Despite the fact that foreign investors use it as protection against environmental regulations, Chapter 11 is a good idea and should not be completely done away with, or even significantly revised. Instead, member parties should seek to amend Chapter 11 so that it achieves a greater balance between the power of States to pass public health regulations and the fair treatment of foreign investors.

#### MORE SPECIFIC DEFINITIONS OF TERMS

The sweeping definitions of some of the terms in Chapter 11 make it applicable to many situations, including those to which it was not necessarily meant to apply. To restrict Chapter 11 to protection of FDI, terms such as "expropriation" and "fair and equitable treatment" must be more specifically defined.<sup>32</sup> In addition, an explicit protocol for determining whether an environmental action is discriminatory should be established so that the process of deciding Chapter 11 cases is less arbitrary and less dependent on the character of the particular tribunal selected. For example, a provision could be added to Chapter 11 requiring the arbitration panel to look at the nature of the investment, the impact of the environmental regulation, the prospective changes over time and the urgency of the environmental issue.<sup>33</sup> By looking at all these factors as a whole rather than by only considering the impact of the regulation, as in *Metalclad v. Mexico*, the panel would have a more complete picture to help it determine whether or not a policy is discriminatory in nature.

#### INTERPRETIVE STATEMENT

Along the same lines, one of the most constructive actions that could be taken to improve the application of Chapter 11 is the drafting of an additional interpretive statement to reinforce its intended objectives. Only if all three NAFTA parties formally agree can a legally binding interpretation of any of the provisions be established. In July 2001, the NAFTA trade commission issued a joint inter-

pretive statement that encourages increasing transparency in Chapter 11 arbitration and precludes corporations from claiming that a breach of another NAFTA provision constitutes a violation of minimum standards of treatment.<sup>34</sup> Despite these improvements in clarifying the objectives of Chapter 11, other points could be more clearly defined through another joint interpretation. In fact, in October, 2002, the Canadian government called for another joint interpretive statement clarifying the definition of the term "tantamount to expropriation".<sup>35</sup> The main goals of the next Chapter 11 interpretive statement should not only be to (1) refine the definition of an expropriation to specifically exclude non-discriminatory environmental regulations, but also (2) clarify the meaning of "national treatment" and the extent to which foreign investors should be treated like domestic investors, and (3) reassess how strict the prohibition on performance requirements should be.<sup>36</sup>

#### TRANSPARENCY

Finally, Chapter 11 proceedings should be made open and unrestricted so that both foreign investors and national governments are made accountable to the public. The current lack of transparency in Chapter 11 arbitration makes it easier for the panel to pass judgments that ignore the public interest. Although the member parties have pledged to make documents in Chapter 11 cases open to the public, there is still a provision in the joint interpretation that allows each tribunal to decide the level of transparency it will permit.<sup>37</sup> To restrict the potential of foreign companies to pre-empt national environmental legislation, the parties should ensure full public access to documents and information. Public scrutiny operates as a check on a Chapter 11 tribunal's abuse of discretion, and seems essential to ensure democratic processes in such bodies.

#### VII. Conclusion

Although it was originally intended as a defence against discrimination by host countries, Chapter 11 has been used by foreign investors as an offensive strategy, allowing them to escape the normal risks of the market by demanding compensation for losses caused by national environmental policy. The balance between environmental protection and investment protection is not obvious. In *Metalclad v. Mexico*, both sides of the dispute seem justified in their actions. The local residents of San Luis Potosi should have been able to defend their health and environment, but not at the expense of Metalclad, which seems to have invested in the site under the mistaken assumption that it had the necessary permits to begin construction. In cases like this one, where neither party seems to be in the wrong, it is hard to decide who should bear the resulting economic or environmental burden. The best that NAFTA can do to resolve such dilemmas is to clarify Chapter 11 through more specific definitions of terms, to increase transparency in arbitration, and to issue a formal joint interpretation. This process should result in an understanding of Chapter 11 that more clearly separates justified environmental regulations from genuine cases of discrimination against foreign investors.

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#### Notes

<sup>1</sup> OECD is the Organization for Economic Cooperation and Development and is generally understood as an abbreviation for the most industrialized nations, or first world, developed countries.

<sup>2</sup> Mann, Howard and Konrad von Moltke. *NAFTA's Chapter 11 and the Environment*. International Institute for Sustainable Development: Winnipeg, Canada, 1999, p. 1.

<sup>3</sup> Harbine, Jenny. "NAFTA Chapter 11 arbitration: deciding the price of free trade." *Ecology Law Quarterly*, Vol. 29, No. 2 (August 2002).

<sup>4</sup> Soloway, Julie A. "The North American Free Trade Agreement: Alternative Models of Managing Trade and the Environment." *The Greening of Trade Law*, 2002.

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<sup>6</sup> Mann, Howard. "Private Rights, Public Problems: A Guide to NAFTA's Controversial Chapter on Investor Rights." 2001.

<sup>7</sup> Louthan, *supra* n. 5.

<sup>8</sup> Cosbey, Aaron. "NAFTA's Chapter 11 and the Environment." A Briefing Paper for the CEC's Joint Public Advisory Committee: Ottawa, June 2002.

<sup>9</sup> *Id.* Information on Articles 1102, 1106, and 1105 from this source.

<sup>10</sup> Mann, *supra* n. 2 at page 38.

<sup>11</sup> Louthan, *supra* n. 5.

<sup>12</sup> Harbine, *supra* n. 3.

<sup>13</sup> Dubal, Veena, Jung Lah, Ian Monroe and Martha Roberts. "Why Are Some Trade Agreements 'Greener' Than Others?" *Earth Island Journal*, Vol. 16, No. 4 (Winter 2001–2002).

<sup>14</sup> Harbine, *supra* n. 3.

<sup>15</sup> Starner, Gregory M. "Taking a constitutional look: NAFTA chapter 11 as an extension of member states' constitutional protection of property." *Law and Policy in International Business*, Vol. 33, No. 2 (Winter 2002).

<sup>16</sup> Dubal, *supra* n. 13.

<sup>17</sup> *Bill Moyers Reports: Trading Democracy*. Produced by Public Affairs Television, Inc. Aired 2/5/02 on PBS.

<sup>18</sup> Hunter, David, James Salzman, and Durwood Zaelke. *International Environmental Law and Policy*, 2002, p. 1219.

<sup>19</sup> Starner, *supra* n. 15.

<sup>20</sup> Platts' Global Energy. "History of move to ban MTBE in the U.S." [www.platts.com/features/mtbe/history.shtml](http://www.platts.com/features/mtbe/history.shtml).

<sup>21</sup> Hunter, *supra* n. 18.

<sup>22</sup> Seskus, Tony. "Methanex loses NAFTA complaint: More evidence needed." *National Post*: 8 August 2002.

<sup>23</sup> "Methanex re-files NAFTA complaint against California over MTBE." *Oxy-Fuel News*: 11 November 2002.

<sup>24</sup> International Institute for Sustainable Development and Communities for a Better Environment, Bluewater Network, and Center for International Environmental Law. "Joint Motion to the Tribunal regarding the Petitions for Amicus Curae Status." 29 January 2003.

<sup>25</sup> Harbine, *supra* n. 3.

<sup>26</sup> Starner, *supra* n. 15.

<sup>27</sup> *Bill Moyers*, *supra* n. 17.

<sup>28</sup> Cosbey, *supra* n. 8 at p. 8.

<sup>29</sup> *Ibid.*

<sup>30</sup> North American Free Trade Agreement Preamble.

<sup>31</sup> Harbine, *supra* n. 3.

<sup>32</sup> *Ibid.*

<sup>33</sup> Cosbey, *supra* n. 8 at p. 31.

<sup>34</sup> International Institute for Sustainable Development. "A note on the NAFTA Commission's initiative to clarify Chapter 11 provisions." 2001.

<sup>35</sup> Jack, Ian. "Canada seeks narrowing of NAFTA lawsuit terms." *Financial Post*: Canada. 22 October 2002.

<sup>36</sup> *Ibid* at p. 49.

<sup>37</sup> International Institute for Sustainable Development, *supra* n. 34.

