

ISSUE PROFILE

INTERNATIONAL PANEL RULES INVESTOR CAN OBTAIN DAMAGES FROM NAFTA GOVERNMENT

On August 25, 2000, an international tribunal convened under NAFTA ordered the Mexican government to pay US\$16.7 million in damages for breaching its obligations toward a foreign investor (U.S.-based Metalclad Corporation) under NAFTA's investment rules. This case marks the third substantive ruling under NAFTA's investor-state dispute settlement provisions and provides a preliminary indication of the way in which future decisions may evolve.

The NAFTA investment rules provide a comprehensive set of minimum standards that each of the NAFTA Parties must adhere to in their treatment of investors from other NAFTA countries ("Investors"). The rules allow an individual citizen or firm to *directly* challenge *any* measure of a NAFTA government - Canada, the United States and Mexico - and obtain an award of damages if the Investor can establish before an impartial panel of arbitrators that its investment rights under NAFTA have been breached and the Investor has suffered losses as a result of that breach. The members of the arbitral tribunal are appointed jointly by the Investor and the NAFTA government being sued. The tribunal must decide a dispute in accordance with the provisions of Chapter 11 of NAFTA and any applicable rules of international law. In the event that an Investor's claim is successful, the government found to have contravened its NAFTA obligations may be ordered to pay monetary damages plus interest.

Of 13 claims filed since the inception of NAFTA in 1994, there have been three substantive decisions to date: one was decided in favour of the Investor, and two were decided in favour of the NAFTA government. One case against Canada was settled in favour of the Investor and a further case was dismissed for lack of jurisdiction. Eight cases are currently pending.

The Metalclad Decision

The most recent case involved a successful claim against the Mexican government by Metalclad Corporation ("Metalclad"), a hazardous waste treatment and disposal company. The tribunal found that the Mexican government's treatment of Metalclad's investment in Mexico violated its obligations under NAFTA because it prevented the opening and full utilization of a multimillion dollar hazardous waste treatment and disposal site. Metalclad had invested approximately US\$25 million to build the site in the Mexican province of San Luis Potosi. After obtaining the approval and endorsement of the investment by the Mexican federal government, Metalclad's investment was blocked by the local governor, who prevented the plant from opening because of a number of environmental concerns which were later determined to be unfounded. The project was also prevented from proceeding due to the refusal of the local authorities to issue a construction permit for reasons unrelated to construction concerns.

The tribunal affirmed that the Mexican federal government was responsible for ensuring that the obligations of NAFTA were enforced at all levels of government, even local government. It ruled that Mexico violated the obligation to treat Investors "in accordance with international law, including fair and equitable treatment and full protection and security". More significantly, the tribunal ruled that the Mexican government had deprived the owner of its reasonably expected economic benefit of the property by permitting the local governor to deny Metalclad the right to operate the landfill notwithstanding its prior approval. Thus Mexico had "taken a measure tantamount to expropriation" without providing compensation equivalent to fair market value as required by the standards of international law. Normally, the fair market value of a business which has a history of profitable operation may be based on an estimate of future profits subject to a discounted cash flow analysis. However, the Tribunal's award compensated Metalclad for only part of its investment in Mexico, and denied its claim for lost future profits, stating that "the landfill was never operative and any award based on future profits would be wholly speculative".

The Record to Date

The first case against the Canadian government was settled before the tribunal process was complete. In 1996, U.S.-based Ethyl Corporation ("Ethyl") made a NAFTA claim against the Canadian government for US\$251 million in damages flowing from a Canadian ban of international and interprovincial trade in the fuel additive MMT. In July 1998, the Canadian government decided to compensate Ethyl in the amount of C\$19.3

million and to lift the trade ban on MMT. The settlement occurred shortly after a decision was made by a panel established under the *Agreement on Internal Trade* (AIT), a Canadian agreement which prohibits interprovincial restrictions in trade unless there is a sound public policy basis to override such a restriction. The panel had found that the ban was an unjustifiable restriction on trade because there was insufficient environmental data to support the ban. Although the Government of Canada argued that its decision to settle the NAFTA claim was motivated by the AIT decision, that panel had no jurisdiction to make an award of damages.

In November 1999, a NAFTA tribunal issued its decision in a case involving a U.S.-based waste disposal company's claim against the Mexican government for over US\$14 million. Desechos Solidos de Naucalpan S.A. de C.V. ("DESONA") had argued that the City of Naucalpan had violated the terms of a concession contract for waste collection and that "a long series of unfair and conflicting decisions and actions by local authorities had resulted in losses and the forcible removal of its managers from the site of the business". The tribunal ruled against DESONA, finding that it had failed to make its case that Mexican court decisions which had previously ruled against it constituted a fundamental departure from established principles of Mexican law and thus was a violation of NAFTA. The tribunal wrote that "[i]t is a fact of life everywhere that individuals may be disappointed in their dealings with public authorities, and disappointed yet again when national courts reject their complaints, [however] NAFTA was not intended to provide foreign investors with blanket protection from this kind of disappointment". The tribunal further stated that the investor's credibility was weak throughout the proceedings.

In an interim decision issued on June 26, 2000, a NAFTA tribunal dismissed a part of the claim made by U.S.-owned Pope and Talbot, Inc. ("Pope") against the Canadian government over Canada's implementation of the quota system under the 1996 Canada/U.S. *Softwood Lumber Agreement* which restricts the export of softwood lumber from Canada to the United States. Pope manufactures softwood lumber in Canada and exports the majority of its production to the United States. The interim decision of the tribunal denied Pope's claims that the terms of the *Softwood Lumber Agreement* imposed performance requirements that were prohibited under NAFTA, and that the interference with its business of exporting amounted to an expropriation by the Canadian government. While dismissing these claims, the tribunal nevertheless acknowledged that Pope's access to the U.S. market is a property interest subject to protection under the expropriation provisions of NAFTA. Pope's remaining claims with respect to alleged violations of national

treatment and minimum standards of treatment applicable to foreign investors are still pending before the tribunal and are expected to be decided in the near future.

Currently in progress is a claim against the Canadian government initiated by S.D. Myers Inc., an Ohio-based hazardous waste disposal company. S.D. Myers is claiming US\$20 million in compensation, alleging that the Canadian government's 15-month ban (in 1995) on the export of PCBs was tantamount to an expropriation of its business, imposed illegal performance requirements, and violated the minimum standard of treatment provisions of NAFTA. Prior to the Canadian ban on exports, the U.S. government had maintained a closed border to imports of PCB waste. When the U.S. government lifted this restriction, the Canadian government immediately imposed the ban, thereby foreclosing competition in the Canadian hazardous waste disposal market with U.S. firms. Some industry participants have suggested that the Canadian government was motivated more by protecting Canada's hazardous waste disposal industry than any environmentally-related concerns.

Another ongoing case against Canada was initiated by United Parcel Service of America, Inc. ("UPS"). UPS is arguing that the Canadian government has violated NAFTA through the activities of a Crown corporation, Canada Post, and is seeking C\$230 million in damages. UPS has alleged that Canada Post's competitive courier businesses derive a discriminatory advantage because Canada Post cross-subsidizes and leverages its non-monopoly courier and parcel services by using its letter mail monopoly infrastructure to reduce the costs of its non-monopoly courier and parcel services. UPS has argued that this violates NAFTA provisions that prohibit discrimination against foreign investors, as well as rules that prohibit state monopolies from acting in a manner inconsistent with NAFTA.

Two other ongoing NAFTA claims have been brought by Canadian investors against the Government of the United States. The first claim is by Loewen Corporation ("Loewen") for US\$725 million in connection with alleged violations of the NAFTA investment rules arising in the course of a US\$500 million award of damages against Loewen by a Mississippi jury in 1995. The second claim has been brought by Methanex Corporation which is seeking US\$970 million in damages as a result of a California ban on the use of MTBE as a gasoline additive.

Implications for Canadian Business

The Metalclad case suggests that NAFTA's investment rules can be an effective tool to seek relief against certain types of government action that detrimentally affect an investment in a NAFTA country. Moreover, the interim ruling in Pope indicates that NAFTA tribunals are likely to adopt an expansive definition of the kinds of interests which qualify for protection under Chapter 11 of NAFTA. Although the full extent of the rights conferred by the NAFTA investment rules is yet to be determined, early results suggest that Canadian investors in the U.S. or Mexico, and U.S. and Mexican investors in Canada, should carefully consider the potential application of NAFTA when confronted with government actions that significantly diminish the value of an investment.

The foregoing is a summary of some of the more important elements of the NAFTA investor-state dispute settlement process. If you have any questions or would like additional information about the investment rules and remedies under NAFTA, please contact Milos Barutciski (416-367-6906), Julie Soloway (416-863-5522), Dany Assaf (416-863-5567) or any other member of the International Trade and Business Regulation Practice Group at Davies, Ward & Beck at 416-863-0900.

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