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Commentary

NAFTA's Indirect Expropriation Protections:

Will Compensation Be Required When Ecological Protections Are Applied?

(An Analysis Of Metalclad Corporation's Claims Against Mexico)

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The proponents of the North American Free Trade Agreement ("NAFTA"),[1] which was completed in 1992 and has been effective since 1994, hailed it for the anticipated gains in economic efficiency that would result from eliminating trade barriers between the economies of Mexico, Canada and the United States. At the same time, environmentalists and labor activists worried that the treaty, by according novel protections to foreign investors' rights, would potentially undermine domestic legislation that protects vital public interests, especially in Mexico and Canada. As arbitrators are more frequently called upon to resolve claims arising from NAFTA and other trade agreements, an awareness of the negotiator's original intent and the potential repercussions of arbitral decisions beyond the parties to the dispute are increasingly important.

This paper analyzes the still pending case of Metalclad Corporation v. Mexico.[2] The case is the first of four attempts by private companies to secure monetary compensation from the signatory governments for alleged violations of novel, NAFTA-created rights through NAFTA-mandated arbitration procedures. The other three cases are: DESONA v. Mexico (a pending case involving an alleged breach of contract by a Mexican municipality), Ethyl Corporation v. Canada (a case settled in 1998 involving a ban on the import and interprovincial trade of MMT, a gasoline additive produced by Ethyl), and S.D. Myers Inc. v. Canada (a pending case involving a ban on PCB waste exports that Myers processed). Because Metalclad may represent the first occasion where an arbitration panel fully adjudicates the issues presented, it may have a great impact on how NAFTA treaty rights of private investors are balanced against other values and interests in the future.

Metalclad's Toxic Waste Treatment Facility In San Luis Potosi

In 1994, California-based Metalclad received authorization to enter into a joint venture with Quimica Omega de Mexico to build the country's third toxic waste disposal facility

in the state of San Luis Potosi.[3] More precisely, Metalclad took over an existing waste landfill site that had a history of contaminating local groundwater with the obligation to make improvements and clean up existing pollutants.[4] Metalclad reportedly spent US$22 million in preparing the San Luis Potosi site.[5]

The motivations for the following governmental actions are hotly contested. However, the following facts are not disputed.

The State of San Luis Potosi sent state troopers to block Metalclad's attempt to reopen the landfill in 1995.[6] In late 1996, the Governor of San Luis Potosi, Horacio Sanchez Unzueta, ordered the Metalclad hazardous waste facility closed down, declaring the site to be an environmental hazard to surrounding communities.[7] This decision was supported by the findings of a geological audit performed by environmental impact analysts at the University of San Luis Potosi that conflicted with previous studies undertaken by the Mexican federal government and Metalclad.[8] The study concluded that the facility is located on a sensitive alluvial stream and therefore could contaminate local water supplies.[9] Governor Unzueta subsequently declared the site part of a 600,000 acre ecological zone.[10]

Procedural History Of Metalclad's Suit Against Mexico

On October 2, 1996, having completed extensive negotiations with the Mexican federal government on the opening of the San Luis Potosi facility, the company filed a Notice of Claim under the International Convention on the Settlement of Investment Disputes between States and Nationals of other States (ICSID) in Washington, D.C. pursuant to NAFTA.[11]

On January 2, 1997, Metalclad Corporation filed its actual grievance with ICSID, alleging that San Luis Potosi violated several provisions of NAFTA when it prevented the company from opening its waste disposal plant.[12] This claim was the first of its kind to be brought under NAFTA.[13] Metalclad sought US$90 million in compensation from Mexico.[14]

On October 13, 1997, Metalclad filed a memorial that included the claim and all the evidence supporting the claim, including expert witness studies.[15] The document was 1200 pages long.[16] Mexico filed its response to the company's claims on February 17, 1998.[17] A final decision in the matter was expected during calendar year 1998.[18] As of September 30, 1998, Metalclad announced that it had suspended further work on its three regional waste treatment and landfill facilities (CIMARI's) in Mexico until the resolution of its NAFTA claim.[19]

Metalclad's Claims

While ICSID arbitration rules require that the complaints and deliberations of the tribunal remain confidential for the duration of the dispute, several things are known about the contents of the memorial filed with ICSID on October 13, 1997.[20]

The primary theory for recovery articulated in the complaint is that the state's closure of the waste dump and the zoning of the area as an ecological zone constitutes an indirect expropriation — an effective seizure of the company's property that requires compensation.[21] This expropriation claim, if based on a regulatory taking, would probably be

viable in a U.S. court in the wake of Lucas v. South Carolina Coastal Council.[22] The expropriation claim may be even more likely to succeed in the case of Metalclad because, as described in the next section, the text of the NAFTA expropriation provision uses broad language to describe the protections that investors are entitled to.[23] Since Metalclad's main theory for recovery is one of expropriation, the remainder of this paper will focus upon evaluating this claim.[24]

Analysis Of The Potential Claims Of Metalclad: Does Metalclad Present A Valid Claim Of Expropriation?

Since definitive sources and customs of international law require that the text of a treaty be respected as binding authority during disputes, it is appropriate to begin an analysis of Metalclad's claims be consulting NAFTA's text.

Chapter 11: The Basis Of Compensable Claims In NAFTA

Chapter 11 of NAFTA describes the standards of nondiscriminatory treatment that signatory countries have agreed to extend to one another's investors and their investments. Section A of Chapter 11 outlines four basic protections each NAFTA state must offer investors from the other signatory states — these protections effectively create enforceable rights for investors. Section B outlines the procedures through which investors can secure monetary compensation if these rights are interfered with.[25] The pertinent part of Chapter 11 is Section A, Article 1110, which allows expropriation in accordance with international law.

Chapter 11, Article 1110: Expropriation

Besides addressing conventional, overt physical seizure of private property by a government, NAFTA's text states that an "indirect" expropriation is a valid basis for recovery.[26] The relevant text of Chapter 11, Article 1110 reads as follows:

> No Party may directly or indirectly nationalize or expropriate an investment of an investor of another Party in its territory or take a measure tantamount to nationalization or expropriation of such an investment ("expropriation"), except:
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> (a) for a public purpose;
>
> (b) on a non-discriminatory basis;
>
> (c) in accordance with the due process of law and Article 1105(1); and
>
> (d) on payment of compensation in accordance with paragraphs 2 through 6.[27]

In analyzing this language, several commentators have pointed out the ambiguity of this provision.[28] For example, the treaty does not define what "measures" or government motivations satisfy the criterion of serving a "public purpose."[29] In the context of the Metalclad arbitration, both the nature of the government action and the nature of the interest seized will have to be examined to determine whether a compensable expropriation occurred.

Articles 1131 and 1132 of Chapter 11 explain what substantive law is to be applied in arbitration when such ambiguities arise. These articles state that tribunals are to decide issues in accordance with NAFTA and applicable international law.[30] This means that NAFTA was intended to be codification of existing law.[31] In practice, it means that Metalclad's expropriation claims should be read against the background of customary international law.[32]

Interpreting The Ambiguities Of The Treaty Language

The Vienna Convention on the Law of Treaties, Section 3, Article 31 provides the general standard for the interpretation and application of treaties.[33] First and foremost, the convention requires that the treaty terms be interpreted in good faith in accordance with the context, object, and purpose of the treaty.[34] As a secondary consideration (after the text, preambles, annexes, and instruments related to the treaty are considered) the subsequent practices in the treaty's application may be taken into account.[35] Judicial and arbitral decisions are intended to serve only as evidence of established, customary state practice. NAFTA incorporated this customary principle by stating that any arbitration decisions should be arrived at in accordance with established doctrines of international law.[36]

Article 38(l) of the Statute of the International Court of Justice sets out a similar authoritative standard on the appropriate sources of international law.[37] Likewise, it requires that state practice, in the form of treaties, conventions, and customs, should be given primary consideration.[38] Judicial decisions are described as a "subsidiary means for the determination of rules of law.[39]

In spite of these formal doctrines, practitioners, arbiters, and scholars of the international legal system seem to accord previous arbitrations and judicial decisions a significant amount of respect.[40] In the words of Patrick M. Norton, "Virtually all of the recent opinions instead placed their principal reliance on judicial and arbitral precedents — 'subsidiary means' under the approved doctrine. . . . [T]his practice is as common among civil law arbitrators as among the Americans and English."[41]

The following analysis will begin by following the formal dictates of the Vienna Convention and the Statute of the International Court of Justice, examining how NAFTA investor protections were intended to be applied given the context of the treaty and its underlying motivations. However, the analysis will also include an examination of the reasoning of previous arbitrations, acknowledging the reality that they may influence the conclusions of the tribunal in the Metalclad case.

Chapter 11 Ambiguities Interpreted In The Context Of The Treaty

The Negotiators' Intent

The expropriation provisions were originally intended to guard against governmental seizures of U.S. and Canadian businesses, a risk historically associated with investing in the Latin American region, including Mexico.[42] Historical events such as Mexico's nationalization of the oil industry in 1938 reportedly motivated the call for investor protection mechanisms in NAFTA.[43]

Specifically, the investor protections were included to obviate the Calvo Clause of the Mexican Constitution.[44] The Calvo Clause banned foreign investors from seeking the assistance of their own governments in investment disputes.[45] This effectively left foreign investors at the mercy of local Mexican courts, creating a significant risk of having to forfeit investments. NAFTA Chapter 11 was intended to mitigate this risk.[46]

The private investor protection provisions of NAFTA were probably not intended to protect investors from "regulatory" takings such as those alleged by Metalclad.[47] In the opinion of Lawrence Herman:

> [T]he main reason I thought a trade case [for Ethyl] would be problematic in 1995 was because the investor-state arbitration provisions of NAFTA seemed confined to cases where governments took assets away by direct action and refused to compensate the investor. Having closely watched the evolution of these provisions in the trade agreement negotiations, and having been involved as a government lawyer in settling several international expropriation claims, I thought there had to be this essential element of a[n] [overt] "taking."[48]

Metalclad's Claims: Congruous With These Intentions?

Metalclad's claims are not congruous with the contemplated objectives and motivations behind the expropriation provisions. The intent of the negotiators (the closest equivalent to the legislative intent behind a domestic law) was to prevent the nationalization of assets, not eviscerate the presumptively valid, customary police powers of sovereign governments.[49]

In other words, to present a compensable claim, NAFTA negotiators probably would have required that Mexico (or one of its states) physically seize the property and assets of an investor. Metalclad's facility was not physically seized and the operations were not nationalized in the conventional, anticipated sense.

The repercussions of creating a compensable protection from indirect or "creeping" expropriations quickly become apparent in a case such as Metalclad. It would shift the burden of non-market-related risks that is inherent to all investments onto the host government.[50] Since a host government could be made to shoulder the costs of any closure of ecologically unsound operations, investors would not have an incentive to perform diligent ecological studies before investing.[51] Finally, it would have a chilling effect on regulatory activity at every level of government.

Chapter 11 Ambiguities Interpreted In The Context Of Previous Expropriation Arbitrations

The Reasoning Of Previous Arbitrators

As mentioned above, previous arbitrations are not formally binding, nor are they supposed to be primarily referenced as sources of international law. However, in practice, they tend to influence the reasoning of subsequent decision makers. Therefore, it is appropriate to take these previous arbitrations into account.

The leading international expropriation cases (including those decided under ICSID and the Iran-U.S. Claims Tribunal) almost exclusively address situations involving government concession contracts.[52] This fact may suggest that the essential circumstances of an expropriation claim should involve a contractual arrangement with a state.

Inasmuch as the reasoning of previous expropriation decisions is applicable to the Metalclad case (where the permit obligations were the only pseudo-contractual obligations to the host governments), the following observations are relevant. Scholars analyzing the pattern of expropriation decisions observe that:

> [E]xpropriation has been thought of as a state's unanticipated and arbitrary deprivation of rights unaccompanied by any invocation of legal rules. . . . The investors must show that the government's action was discriminatory in nature . . . or the government failed to provide an adequate forum to determine the claim for repudiation . . .
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> . . . arbitration tribunals look to circumstantial evidence in determining whether the government's cancellation was politically, and therefore likely discriminatorily, motivated [as opposed to being motivated by faulty performance on the part of a business].[53]

The circumstantial evidence sufficient for a finding of a compensable, discriminatory expropriation in previous cases has included (1) a governmental cessation of an investor's activities before judgments could be made about the investor's performance, or (2) governmental harassment of an investor, such as blocking access to the investor's property.[54] Regardless of the governmental action, the denial of a forum in which the investor could contest the government's action is a third way that the investor can demonstrate an arbitrary deprivation of rights.[55]

Precedent Arbitral Standards Applied To The Facts Of The Metalclad Case

The circumstantial evidence in the Metalclad case may be sufficient to support a conclusion that, in the context of precedent arbitral standards, the relevant governmental action was political, discriminatory, and not motivated by inadequate performance of Metalclad's legal obligations.

First, Metalclad's facility was shut down preemptively. The Metalclad disposal site, in its renovated state, was not even allowed to begin operations. Therefore, it may be difficult for the government of San Luis Potosi or the government of Mexico to show that the terms of Metalclad's permits were violated. As stated above, if the governmental action preceded any breach of legal obligations, the action may be deemed to be an expropriation with a discriminatory intent, and therefore compensable.

Second, the government of San Luis Potosi used state police to block Metalclad employees' access to Metalclad's site during the renovation and preparation of the site. In precedent cases such as Fearn International, Inc. v. Somalia of 1973, using police to block access to a legally approved plant site has supported a finding of a compensable, discriminatory expropriation.

Third, Metalclad may argue that it was denied an opportunity to contest the shutting down of its facility. The arbitrators of previous cases and Section 712 of the 3d Restatement of the Foreign Relations Law of the U.S. (1986) have stated that a government which closes an operation without providing an adequate forum for disputes with the investor has unlawfully expropriated.

What The Case Of Ethyl Corporation v. Canada Indicates

In the case of Ethyl Corporation v. Canada, the Canadian government banned the importation and interprovincial trade of a gasoline additive (MMT) while internal production and use of the product was allowed.[56] Because the only producer of the additive was American, this encouraged speculation that the regulation was protectionist and discriminatory.

Ethyl's case never reached final arbitration. ICSID rules state that, even if there was a final arbitration, the rulings of tribunals are not binding from one case to another. Despite theses facts, the settlement of Ethyl's dispute with the Canadian government does suggest that NAFTA Chapter 11 claims are at least viable. Ethyl Corporation v. Canada demonstrated that even when there is no real property affected and no seizure of title, a viable claim for recovery exists. Ethyl's case also demonstrated that these claims for damages may present enough of a threat that governments will prefer settlement to full arbitration.

Perhaps the most important legacy of the Ethyl settlement, in the opinion of some experts, was the demonstration that an investor could utilize Chapter 11, Article 1110 as the basis of a viable claim for an indirect expropriation that involved no conventional seizure of title to property. Again, to borrow Lawrence Herman's words:

> The intelligent and astute counsel to Ethyl Corp. has proved, however, the legal concept of expropriation and the protection afforded under NAFTA provisions go beyond these traditional legal concepts [of physical seizure and nationalization of property]. The MMT case has thus emerged as one of the most important in the annals of Canadian trade law. Even though it was settled out of court, it has established a far-reaching precedent.
>
> It [the Ethyl settlement] illustrates governments are at peril if they adopt measures having the "effect" of expropriating foreign-owned assets, directly or indirectly.[57]

Therefore, while certainly not dispositive, the Ethyl settlement suggests that Metalclad's claim of a compensable, indirect expropriation is viable. If an expropriation is found, the NAFTA guidelines clearly state that Metalclad is entitled to the fair market value of the property.[58] According to the treaty's valuation criteria, going concern value is a valid basis for determining compensation, so the full amount of US$90 million could be awarded.

Conclusion

If the tribunal follows the formal dictates of international law and accords primary authority to the context, aims and purposes of NAFTA, Metalclad will lose its claim of an expropriation. Chapter 11 of NAFTA was almost certainly not intended to create a right of action for a corporation in Metalclad's position. While the text of the expropriation provision does allow investors to recover for harms resulting from indirect expropriations, the underlying purpose of that section is to protect against arbitrary physical seizure and nationalization of an enterprise or property.

Nonetheless, the tribunal may be influenced by recent expropriation jurisprudence in applying the relevant law. Coupled with the potential persuasive influence of the Ethyl settlement, this approach could result in a successful recovery for Metalclad, notwithstanding any good faith reasons for San Luis Potosi's closure of the toxic waste facility.

If the Mexican government were to enforce this award against San Luis Potosi, this would be an unbearable burden upon this Mexican state and its people, since US$90 million is an amount larger than the combined annual income of every family in the county where Metalclad's facility is located.[59] The only opportunity to appeal the award would be through another ad hoc ICSID tribunal. Any award will be binding under the threat of economic sanctions from other NAFTA states. In light of this, Metalclad's suit appears to be a strong-arm tactic to force the state government into allowing its business to open. Regardless of the outcome, Metalclad v. Mexico will likely have far-reaching repercussions upon North American governments, their constituents, their environment, and the reasoning of arbitrators in similar circumstances.

ENDNOTES

1. North American Free Trade Agreement, drafted Aug. 12 1992, revised Sept. 6, 1992, U.S.-Can.-Mex., 32 I.L.M. 605, (entered into force Jan. 1, 1994) [hereinafter "NAFTA"].

2. No citation to the case exists. Documents stating the claims of the disputing parties are unavailable given the confidential nature of the pending arbitration.

3. The joint venture was valued by one source at US$250 million. Carmelo Lodise, San Miguel's Draining Struggle, Business Mexico, December, 1994.

4. Our Future Under the Multilateral Agreement on Investment, Public Citizen Global Trade Watch Website, 1998.

5. Joel Millman, Metalclad Suit Is First Against Mexico Under NAFTA Foreign-Investment Rules, The Wall Street Journal, October 14, 1997, A2.

6. Id. at A2.

7. Antonia Juhasz, Update on Metalclad Corporation v. Mexico, Globalization and the MAI Information Centre Website, February 2, 1998.

8. Id.

9. Id.

10. Id.

11. Securities and Exchange Commission Filings [hereinafter SEC Filings], 5/15/98, Metalclad Corporation.

12. Juhasz, *supra* note 7.

13. Matthew Nolan and Darin Lippoldt, Obscure NAFTA Clause Empowers Private Parties, The National Law Journal, Monday, April 6,1998, B08.

14. Juhasz, *supra* note 7.

15. Id.

16. Millman, *supra* note 5 at A2.

17. SEC Filings, 5/15/98, Metalclad Corporation.

18. Id.

19. Metalclad Corporation Press Release, September 30, 1998, Metalclad Announces It Has Suspended Construction in Mexico.

20. Juhasz, *supra* note 7.

21. The case of Lucas v. South Carolina Coastal Council greatly expanded the right of property owners to recover damages resulting from the regulatory takings of a government. *See* 505 U.S. 1003 (1992). However, even the majority of the U.S. Supreme Court acknowledged that a government act would have to completely eliminate all of the economic value of the land in order to constitute a viable claim. Id. at 1017. The court admitted this would be an "extraordinary circumstance." Id. at 1017.

22. Juhasz, *supra* note 7.

23. The company also alleges that the Mexican state violated national treatment and most favored nation treatment provisions and prohibitions on performance requirements. Id.

24. Vienna Convention on the Law of Treaties, adopted May 22, 1969 (U.N. Doc. A/CONF. 39/27) 289 [hereinafter "Vienna Convention"]; Statute of the International Court of Justice, entered into force Oct. 24, 1945, 1983 Yearbook of the U.N. 1334 [hereinafter "Statute of the ICJ"].

25. It is important to note from the outset that, as is the case with all of NAFTA, the obligations created by the treaty are binding upon all the political subdivisions of the signatories. However, an investor may only bring claims against a signatory government, even if the claim is based on the alleged transgressions of a political subdivision such as a state or city. Subsequently, a signatory government may demand that a political subdivision pay for any damages that are awarded to the claimant. In the context of the Metalclad case, this means that Metalclad must sue Mexico, even though it is seeking compensation for alleged violations of Chapter 11 by the Mexican state of San Luis Potosi.

26. NAFTA, supra note 1, art. 1110(1).

27. Id.

28. Patrick M. Norton, A Law of the Future or a Law of the Past? Modem Tribunals and the International Law of Expropriation, 85 Am. J. Int'l L. 474, 498; *see* Harry B. Endsley, Dispute Settlement Under the CFTA and NAFTA: From Eleventh-Hour Innovation to Accepted Institution, 18 Hastings Int'l & Comp. L. Rev., 659, 670 (1995); Richard C. Levin and Susan Erickson Marin, NAFTA Chapter 11: Investment and Investment Disputes, NAFTA: L. & Bus. Rev. Am. 82, 98 (1996).

29. Harry B. Endsley, Dispute Settlement Under the CFTA and NAFTA: From Eleventh-Hour Innovation to Accepted Institution, 18 Hastings Int'l & Comp. L. Rev., 659, 678 n. 168 (1995).

30. NAFTA, *supra* note 1, ch. 11, art. 1131 (1).

31. Endsley, *supra* note 29, at 688.

32. Id. at 689.

33. Vienna Convention at 289.

34. Id. at 289.

35. Id. at 289.

36. NAFTA, *supra* note 1, ch. 11, art. 1131 (1).

37. Statute of the 1CJ at 1334.

38. Id. at 1334.

39. Id. at 1334.

40. Patrick M. Norton, A Law of the Future or a Law of the Past? Modem Tribunals and the International Law of Expropriation, 85 Am. J. Int'l L. 474, 498; *see* Harry B. Endsley, Dispute Settlement Under the CFTA and NAFTA: From Eleventh-Hour Innovation to Accepted Institution, 18 Hastings Int'l & Comp. L. Rev., 659, 673 (1995); Richard C. Levin and Susan Erickson Marin, NAFTA Chapter 11: Investment and Investment Disputes, NAFTA: L. & Bus. Rev. Am. 82, 97 (1996).

41. Patrick M. Norton, A Law of the Future or a Law of the Past? Modem Tribunals and the International Law of Expropriation, 85 Am. J. Int'l L. 474, 498.

42. Matthew Nolan and Darin Lippoldt, Obscure NAFTA Clause Empowers Private Parties, The National Law Journal, Monday April 6,1998 p.B08.

43. Id.

44. Endsley, *supra* note 29, at 688.

45. Mexican Constitution, Art. 27.

46. Id.

47. Lawrence Herman, 'Expropriation' Takes on New Meaning: MMT Case Sets Far-Reaching Precedent, The Financial Post, 28 July, 1998, at 1.

48. Id. at 1.

49. Patrick M. Norton, A Law of the Future or a Law of the Past? Modem Tribunals and the International Law of Expropriation, 85 Am. J. Int'l L. 474, 498; *see* Harry B. Endsley, Dispute Settlement Under the QFTA and NAFTA: From Eleventh-Hour Innovation to Accepted Institution, 18 Hastings Int'l & Comp. L. Rev., 659, 672 (1995); Richard C. Levin and Susan Erickson Marin, NAFTA Chapter 11: Investment and Investment Disputes, NAFTA: L. & Bus. Rev. Am. 82, 98 (1996).

50. Our Future Under the Multilateral Agreement on Investment, Public Citizen Global Trade Watch Website, 1998.

51. Id.

52. Patrick M. Norton, A Law of the Future or a Law of the Past? Modem Tribunals and the International Law of Expropriation, 85 Am. J. Int'l L. 474, 498; *see* Richard C. Levin and Susan Erickson Marin, NAFTA Chapter 11: Investment and Investment Disputes, NAFTA: L. & Bus. Rev. Am. 82, 98 (1996).

53. Richard C. Levin and Susan Erickson Marin, NAFTA Chapter 11: Investment and Investment Disputes, NAFTA: L. & Bus. Rev. Am. 82, 97-99 (1996).

54. Id. at 98.

55. Id. at 99.

56. Ch. 11, 1997 S.C. (Can.) sec. 4.

57. Herman, *supra* note 51, at 1.

58. NAFTA, *supra* note 1, art. 1110(2).

59. Id. ■

