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Daniel M. Price

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By DANIEL M. PRICE*

I. Introduction

Chapter 11 of the North American Free Trade Agreement (NAFTA) has been the source of much controversy in recent months. On one side, critics of NAFTA argue that the investment protections in Chapter 11 unduly interfere with legitimate government regulation and should be pared back. On the other side, defenders of NAFTA assert that investment protections pose no great threat to national sovereignty and are necessary to promote economic growth and development.

Regardless of which side of the debate one is on, it is important to understand Chapter 11 in its historical context. It came out of a long and rich tradition of investment treaties and customary international law which spanned decades, and, in some cases, several centuries. Throughout this time, governments and dispute settlement bodies have grappled with precisely the same types of problems that have become the source of so much controversy today. This is not to say that the rules cannot be improved, only that the fears that have been expressed by the more aggressive critics of NAFTA are greatly exaggerated and, to date, unsupported by the evidence.

* Mr. Price chairs the International Practice at Powell, Goldstein, Frazer & Murphy LLP in Washington, DC. He has served as counsel in investor-state disputes and advised governments on investment negotiations. While Deputy General Counsel in the Office of the U.S. Trade Representative, he served as a negotiator of Chapter 11 of NAFTA and numerous bilateral investment treaties. He was also Deputy Agent of the United States to the Iran-United States Claims Tribunal in the Hague. B.A., Haverford College; Diploma in Legal Studies, Cambridge University; J.D., Harvard Law School (where he was Articles Editor of the *Harvard Law Review*). [*Editor's Note:* This essay is based on the transcript of Mr. Price's remarks given at the NAFTA Chapter 11 Symposium Conference at Hastings College of the Law on February 26, 2000.]

Governments and commentators are generally much more familiar and comfortable with rules regulating international trade than they are with international investment rules. As a result, while countries have been successful in negotiating multilateral trade agreements, including the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO) agreements, there are no multilateral investment treaties that approach the same scale and impact.[1] This is at least in part because trade rules are generally perceived as rules regulating border measures and are not perceived as restricting the scope of internal regulations. There are of course trade rules that do regulate inside the border—most notably the national treatment rules codified in Article III of the GATT—but the perception nevertheless remains.

International investment rules share certain objectives with trade rules in that both regimes are designed to open markets and liberalize cross-border transactions. However, there is an important distinction between the two. Trade rules traditionally have been understood as regulating trade flows, not traders. Investment rules, in contrast, have been understood as protecting the enterprise or the investor. This distinction is reflected, for example, in the national treatment obligations in trade and investment treaties. GATT Article III, which sets forth the national treatment rules with respect to trade in goods, addresses whether a measure has an adverse impact on the conditions of competition between imported goods and domestically produced goods. It is not concerned with the impact of a government measure on the foreign trader or producer itself. A national treatment obligation in an investment treaty, by contrast, addresses whether the foreign investor is treated as favorably as the state's own nationals in like circumstances.

In addition, because foreign investors operate within the border of a state, they are subject to the full range of regulatory measures that a state may adopt, not just those affecting trade. All of these measures could, if not applied or administered properly, adversely affect such investors. As a result, certain agencies in the U.S. government have become nervous that international investment rules

1. The WTO Agreement on Trade-Related Investment Measures, which deals with performance requirements, and the General Agreement on Trade in Services, which deals with, among other things, the provision of services through a "commercial presence" in a member's territory, both contain provisions that regulate foreign investment. However, the provisions in these agreements are narrower than those adopted in NAFTA or in bilateral investment treaties (BITs).

will curtail their ability to adopt bona fide environmental, health, safety and other regulations. These concerns are, I believe, unfounded.

I will address three areas that are particularly controversial: the guarantee of fair and equitable treatment, the prohibition of expropriation without compensation, and investor-state dispute settlement.

II. Fair and Equitable Treatment Standard

It is impossible to devise ahead of time a comprehensive list of all government actions that may adversely and unfairly affect an investment. As a result, BITs and the NAFTA include several general protections, including the requirement to ensure fair and equitable treatment, and have left it to arbitration tribunals to apply these principles in specific cases. These protections are not designed to limit legitimate regulatory behavior, but rather to ensure a certain baseline level of protection that would require governments to act fairly, in good faith, and transparently in their relations with foreign investors.

The United States has led the way in advocating the adoption of the general treatment provisions regulating foreign investments. However, the substantive investment protections in Chapter 11 of NAFTA were not written on a blank slate. They evolved over time and were drawn from a large and growing network of international investment agreements. These principles are now incorporated into BITs and other investment agreements of our trading partners and are accepted by much of the developing world.

The application of investment rules to developed countries, such as the United States and Canada under NAFTA, has highlighted more than ever before the complex relationship between such rules and legitimate regulatory activity. Until now, international investment rules have generally been fairly easy to apply. When, for example, Libya or Iran nationalized their oil industries, there was little debate about whether an expropriation had taken place. Such wholesale and direct takings of property are less frequent in modern, industrialized countries and in most of the more advanced developing countries, such as Mexico, South Korea, and Argentina. Investors in these countries are often faced with subtle regulatory measures that may have the same confiscatory effect as outright nationalizations, even if they are different in form. The most damaging aspects of these regimes may fall through the cracks of specific international investment rules, such as those that address expropriation or discrimination. This is where the general treatment protections come into play.

The fair and equitable treatment standard is closely aligned with, and overlaps, certain fundamental principles of international law—including transparency, procedural fairness, and the duty of good faith—from which other, more specific legal rules emanate. It sets a fairly low bar. If a government measure is a generally applicable, bona fide, and legitimate exercise of regulatory authority (and there is no indication that the measure is discriminatory or has an illicit purpose), the measure will likely survive scrutiny under this standard. Thus, the general treatment principles will not infringe on the government's regulatory authority as long as that authority is exercised in a fair and equitable manner. This is no more than what is generally expected, and most would agree that this standard should be met even in the absence of an international investment agreement.

There is no denying the fact that if a law or regulation does not meet the general treatment standards, then a foreign investor may challenge that law or regulation. However, the circumstances in which a violation of the standard would be found are fairly narrow, which is why there have been only a handful of cases that have applied the standard. It is probably correct to say that the fair and equitable treatment protection will be invoked more frequently in the future as adverse actions take a more subtle or regulatory form.[2] There is no reason to expect, however, that arbitration tribunals will be receptive to attempts to turn the standard into a weapon to attack bona fide regulatory behavior.

III. Expropriation

Under the expropriation provision, a government may have undertaken a measure in good faith and in a non-discriminatory manner, but still be required to pay compensation to an investor whose property was taken or diminished in value as a result of the measure. This is not, however, a startling proposition. The same type of rules exist under the domestic laws of many countries, including

2. Indeed, since the presentation of these remarks at the symposium conference on February 26, 2000, the NAFTA Panel in *Metalclad Corp. v. United States*, Case No. ARB(AF)/97/1, found that Mexico, acting through one of its municipalities, violated the fair and equitable treatment standard with respect to a U.S. investor.

the United States. Governments have adopted these rules because they recognize that it would be unfair to force an investor to bear the entire cost of a change in social policy. These costs, at least under certain circumstances, should be borne by society as a whole.

The question in these cases, of course, is where to draw the line. It is difficult to determine precisely when the cost of a government measure that inflicts harm on an identifiable group ought, in fairness, to be borne by the public as a whole and not by a particular investor. There are several cases where this issue is particularly difficult. For example, assume that an investor undertakes an activity that is approved by society and determined to be beneficial. However, on the basis of new scientific evidence, the government subsequently determines that the behavior is harmful and should be prohibited. It must be decided in this case whether the government should be permitted simply to put the investor out of business without paying compensation—an act which would adversely affect not only the investor but also the employees of the enterprise and possibly the local economy. Alternatively, a tribunal may decide—correctly in the vast majority of cases—that the government must compensate the investor and so spread the cost of the regulatory measure.

Simply designating a government measure as a conservation measure, or a health and safety measure, does not answer the basic question about who should bear its costs, and should not be enough to remove that measure from international investment disciplines. The purpose of the regulation may be very noble, but it is necessary to examine how that purpose is effectuated and the impact on the affected investor. Indeed, the standard formulation of the expropriation norm assumes that the measure in question is nondiscriminatory and for a public purpose. The duty to compensate is imposed as the final requirement ensuring the legality of expropriation.

While I believe that the expropriation provision and other provisions of NAFTA Chapter 11, such as the fair and equitable treatment provision, can accommodate a number of the concerns that have been expressed by the opponents of investment rules, I also recognize that, as a political matter, some may wish additional substantive safeguards built into the system. One possible solution would be to allow every country one or two "irrational" (from the point of view of others) choices when and if a new attempt is made to negotiate multilateral investment rules. For example, Canada may want to create a reservation for certain cultural matters, while France may wish to carve out certain exceptions for agriculture. Governments could be given some latitude to take reservations in the areas that they deem to be most sensitive in addition to those exceptions normally found in investment treaties. However, such reservations ought to be explicit, not buried in a vague exception to a rule, and they should be limited to a negotiated level of economic impact. That is, a treaty party's "irrational" choices should not adversely affect more than an agreed (and limited) percentage of another party's trade or investment.

This approach is far preferable to building sweeping limitations into the basic investment rules. Refining the definition of expropriation to carve out of its scope, e.g., "all generally applicable, bona fide regulations, adopted and applied in a nondiscriminatory fashion, which otherwise constitute a legitimate exercise of traditional police powers," would be oppressive and cumbersome and would inevitably swallow the protection that the expropriation rule was designed to provide.

IV. Dispute Settlement

The dispute settlement provisions in Chapter 11 and BITs are among the most controversial because, unlike the WTO dispute resolution procedures, they (1) expose host states to challenges brought by private investors, and (2) afford damages for past conduct instead of only prospective relief.

Early investment treaties preserved the idea that disputes over international investment obligations were matters to be resolved only by states. Thus, historically, investors were protected by the cloak of the crown's authority. Any injury to the investor or its property, if unremedied by the domestic courts of the host government, was considered an injury to the foreign investor's crown. Under the doctrine of espousal, the foreign crown could take action to remedy such injury. If a host government injured a foreign national and failed to compensate him, then the foreign sovereign could bring a claim against the state responsible for the injury. If there were no forum in which to bring a claim, then the foreign sovereign could unilaterally determine that a breach of international law had occurred and could take measures against the injuring state.

The first widespread international investment agreements—Friendship, Commerce and Navigation (FCN) Treaties and Treaties of Amity—embody more clearly than does NAFTA this residual notion of investor rights stemming from, and enforced by, the investor's sovereign. Some FCNs set up a regime whereby investors could submit disputes to special courts. In most cases, however, only a government party could challenge a breach of the FCN treaty by the other government party.

The rise of BITs changed the regime for investor protection and introduced the concept of investor-state dispute settlement. The idea behind this change was to depoliticize investment disputes by taking them out of a state-to-state forum and empowering investors to seek redress in their own right. By allowing the investor to litigate its claim directly, the investor's sovereign could distance itself from the dispute. Investors also welcomed this development because it gave them the opportunity to seek redress without being held hostage to their own government's political will or whim. The investor's claim would be decided on the merits and would not be subsumed within a larger political or foreign relations dialogue between its government and the host government.

The predecessor to NAFTA, the Canada-United States Free Trade Agreement (CUSFTA), did not incorporate investor-state dispute settlement, nor did it incorporate a number of essential provisions, starting with the definition of investment. In the CUSFTA, investment was defined much more narrowly and restricted to controlling interests in an enterprise. It was not the broad asset- and enterprise-based definition you see in NAFTA. Chapter 11 of NAFTA significantly improved the investment protections in the CUSFTA and adopted wholesale most of the investment protections that had been developed through BITs, including the dispute settlement mechanism.

While some governments and interest groups have expressed alarm over the dispute settlement procedures in NAFTA and BITs, there is little or no evidence to show that these procedures have been abused or used to subject governments to harsh or unwarranted punishment. To a large extent, trust in international investment rules will require trust in the dispute settlement tribunals that are tasked with applying those rules. Arbitration tribunals are judicial bodies governed by the rule of law. If they function correctly, they will understand the purpose and intent of the investment rules in NAFTA and BITs and will not permit the process to be abused by arbitrarily striking down legitimate regulations.

It is, of course, possible that frivolous claims will be brought. But frivolous claims are brought every day in our national judicial systems, and they do not threaten our democracy or our sovereignty. Dispute resolution tribunals may also make incorrect or erroneous decisions from time to time. However, neither our polity nor our judicial system is so frail that it cannot withstand the odd erroneous decision.

Whenever a country enters into an international agreement, it restricts its sovereignty in some measure. In fact, the very purpose of international agreements is to require or prohibit government action. To claim that any such restraint is impermissible or unwise is to call into question the entire international legal order. Furthermore, if international agreements are to have any practical meaning, then they must include a mechanism for holding governments accountable for their actions. This is what the dispute settlement mechanism in BITs and in NAFTA seeks to achieve, and this is neither new nor threatening.

V. Conclusion

Allowing recourse to, and accepting decisions of, international dispute settlement bodies underpins the international economic order. The United States benefits significantly from broad-based recognition of the legitimacy of international arbitration awards and decisions of the WTO dispute panels and of the International Court of Justice. For these reasons, it would be wise to continue on the course that we have followed to date and preserve the integrity of the dispute settlement system.

If the United States backed away from its commitment to international investment rules, it would reverse fifty years of U.S. leadership in the progressive development of international investment protection and raise serious questions about our commitment to fundamental principles of international law. Moreover, the United States has traditionally been not only the champion but also the beneficiary of international investment rules. The United States has itself frequently invoked dispute settlement provisions to break down trade barriers or redress injuries to investors. Indeed, of the approximately thirty claims under BITs that have come before the International Centre for Settlement of Investment Disputes (ICSID), about one-third have been brought by U.S. investors. In addition, five NAFTA claims have been brought by U.S. investors.

Eliminating or weakening key investment protections would, furthermore, harm the competitiveness of U.S. companies abroad and significantly reduce the protections that the United States has worked so hard to achieve. The harm to U.S. investors would be acutely felt in the coming years as developing countries move away from highly-regulated, centralized economies to market-oriented, free enterprise systems. Hundreds of new privatization initiatives and other economic opportunities arise each year. Without the full range of protections codified in current investment treaties, U.S. investors may lose significant investment opportunities to foreign competitors shielded by stronger, more comprehensive, treaties.

It would be ironic and regrettable if the United States, which has been the chief proponent for subjecting sovereign actions to scrutiny under international law, were now to lead the retreat from the international principles it worked so hard to enshrine.

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