EnviReform
First Annual Conference

CIVIL SOCIETY PARTICIPATION IN NAFTA
University of Toronto
November 16-18, 2000

Conference Draft

NAFTA CHAPTER 11 AS A CHALLENGE TO ENVIRONMENTAL LAW MAKING— ONE VIEW FROM THE UNITED STATES

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Introduction

Chapter 11 of the NAFTA addresses barriers to investment as a key part of NAFTA's vision of economic liberalization throughout the continent. The Canada-U.S. Free Trade Agreement had similar core liberalization disciplines on investment restrictions, national treatment of investors, and protection of investors from direct or indirect expropriation of their investments. Indeed, the U.S. had pursued throughout the 1980s and 1990s a policy of negotiating bilateral investment treaties (BITs) with countries around the world, and simultaneously with the NAFTA negotiations was pressing for the first multilateral disciplines on investment regulations through the WTO Agreement on Trade-Related Investment Measures. The dispute settlement provisions of NAFTA Chapter 11 also track the U.S. BITs. They allow investors to pursue legal remedies against government measures under the laws of that country, but in the alternative provide the option for investors to bring their claims against a State directly to international arbitration through the procedures and services of several international arbitration entities. In short, NAFTA Chapter 11 was a continuation of US and, to some extent, Canadian trade policy.

In the seven years of NAFTA, at least 12 investors have invoked the investor-State arbitration provisions of Chapter 11 to pursue claims against one of the three governments for compensation for discriminatory treatment or effective expropriation of their investments. In an unexpected turn of events, seven of these 12 cases involve underlying activities by the investors or actions by governments involving natural resources or pollution control. Some of these

Chapter 11 cases have involved large financial stakes and highly publicized environmental measures. The implications so far have been most serious for Mexican and Canadian governments whose environmental measures have been the target of six of the known challenges by American investors under the investor-State Provisions.[1] But the latest case, with potentially the greatest significance for environmental regulation, has been brought by a Canadian firm challenging an environmental protection initiative by the governor of California.

These cases have provoked sharply contrasting views about the investor protection provisions of the NAFTA and the investor-State arbitration process. Are they having a significant chilling effect on the ability of federal, state/provincial, and local governments to protect environmental interests? Or are environmental issues being manipulated by governments in ways that threaten fair treatment of legitimate foreign investments? A U.S. Sierra Club staffer is quoted as saying of NAFTA Chapter 11: "What we can envision here is a wholesale overturning of the regulatory state, which took 100 years to build." [2] Even the U.S. government, in a filing in one case, asserted "If [the investor's argument is] accepted by the tribunal, no NAFTA [country] could carry out its most fundamental government functions unless it was prepared to pay for each and every economic impact."[3] On the other side of the ledger, one U.S. claimant asserts: "Neither Canada nor Mexico has internal protections for private property, and there is tremendous justification for a treaty to override federal, state or local law to provide protections for foreign investment."[4] A Canadian claimant argues that "a business in a NAFTA-member country is entitled to enjoy certain conditions relating to its investments in another NAFTA-member country" including protection against uncompensated expropriation.[5] Another U.S. claimant says that the government action in his case was "destroying this business."[6]

All sides, though, seem to agree with the observation of a Canadian lawyer who has been involved in two of the Chapter 11 proceedings: "No one quite understood or anticipated where it would go."[7]

Overview of NAFTA Chapter 11

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[1] Public Citizen, *School of Real-Life Results: NAFTA Report Card* (Dec., 1998) http://www.citizen.org/pctrade/nafta/reports/5years.htm.

[2] California Lawyer, Sept. 2000, at 25, quoting Daniel Seligman, director of the Sierra Club's Responsible Trade Program.

[3] Peter Morton, "$ 1 B Methanol Battle Fires up This Week," *National Post,* September 5, 2000, page C-1.

[4] Evelyn Iritani, "Trade Pacts Accused of Subverting U.S. Policies," *Los Angeles Times*, Feb. 28, 1999, page A-1.

[5] "Methanex Files Intent to Sue California if State Bans MTBE," *Pesticide and Toxic Chemical News*, June 24, 1999.

[6] Iritani, *supra* note 3.

[7] *Id.*, quoting Barry Appleton.

Before looking into a few of the environment-oriented investment disputes we need to have at least a basic understanding of the substantive standards and procedural rules of Chapter 11. Substantively, Chapter 11 defines its scope, applies basic nondiscrimination trade principles, sets "international" norms for fair treatment of investors and due process, and guarantees compensation for any government expropriation of a foreign investment. Procedurally, it establishes a system of binding arbitration for resolving any dispute between an investor from one NAFTA country and the government of another NAFTA country, the so-called investor-State arbitration.

Substance

Article 1101 of NAFTA immediately declares the broad scope of the chapter: "This Chapter applies to measures adopted or maintained by a Party relating to" investors or investments of another Party. "Measure," defined in NAFTA Art. 201(1), includes "any law, regulation, procedure, requirement or practice." Thus, California Governor Davis's executive order initiating a policy to phase out MTBE use in California constitutes a "measure." The term "investment," defined in Art. 1139, encompasses virtually every conceivable form of investment, including enterprises themselves, equity or debt securities in enterprises, loans, rights to a share of profits, real estate and tangible and intangible property, and contractual or other interests associated with capital commitments. Only claims to money and sales of goods and services or credit associated with such sales are specifically excluded.

Articles 1102 and 1103 establish the familiar core trade obligations of national treatment (nondiscrimination between domestic and foreign investors) and most favored nation (nondiscrimination between investors from different countries). Chapter 11 also assures a "minimum standard" of treatment for foreign investors. Article 1105 obliges the governments to comply with international law, "including fair and equitable treatment and full protection and security." This is understood to encompass, among other matters, minimum standards of administrative and judicial due process. This became an issue in the Metalclad v. Mexico arbitration. Another important substantive rule, Article 1106, protects of foreign investors and investments against "performance requirements," such as minimum export sales, local sourcing of raw materials or supplies, or minimum "domestic content" requirements. There are, however, a couple of exceptions embedded in Article 1106. A country may require the use of a particular technology "to meet generally applicable health, safety or environmental requirements" on a nondiscriminatory basis (Art. 1106(2)). Moreover, the rules against local sourcing and domestic content requirements are subject to an exception for measures "necessary to protect human, animal, or plant life or health" or "necessary for the conservation of living or non-living exhaustible natural resources" (Art. 1106(6)(b) and (c)).

Finally, we come to the substantive rule that provides the key remedy in Chapter 11—the Art. 1110 rule against uncompensated expropriation. First, let's be clear that expropriation itself is not forbidden, by the NAFTA or by any rule of international law. What NAFTA does prohibit is direct or indirect nationalization or expropriation or any "measure tantamount to nationalization or expropriation" of the investment of an investor of another country <u>unless</u> the expropriation is

"(a) for a public purpose;
(b) on a non-discriminatory basis;
(c) in accordance with due process of law and Article 1105(1); and

(d) on payment of compensation in accordance with paragraphs 2 through 6."[8]

Note that all four conditions must be satisfied. That is, even a national measure for a public purpose applied through due process of law and without discrimination may give rise to a claim for compensation if its result is "tantamount to expropriation." The key interpretive question about Art. 1110(1) thus becomes the meaning of the phrase "measure tantamount to … expropriation." Without going into an exhaustive analysis here (see the reports and law review articles cited in the attached bibliography for such analysis), two points are reasonably clear, though they only reframe the interpretive challenge. First, an important source of international law on government measures that are "tantamount to expropriation" is the American constitutional jurisprudence on uncompensated "takings" under the Fifth and Fourteenth Amendments to the U.S. Constitution.[9] Second, under U.S. constitutional law, regulatory exercises of the "police power" of the government are in principle excluded from the notion of "expropriation." But that still leaves the question of defining whether a particular environmental measure is or is not within the scope of that power. In short, evaluation of compensation claims based on environmental regulatory "expropriations" of investments under NAFTA Chapter 11 will be just as fractious and legally complex as the decisions on claims for just compensation for environmental regulatory "takings" in U.S. law, and will turn on the same core issues. This is thorny territory even for U.S. lawyers, and much more so for foreign lawyers and arbitrators.

A final note is in order about Art. 1114, touted as one of NAFTA's "green" provisions. Art. 1114(1) provides:

> Nothing 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. [emphasis added]

Article 1114 was included as an explicit reservation of a sovereign right, already implicit, for laws or policies of general application controlling or regulating or restricting investments so as to preserve or protect the environment. It covers everything from environmental impact assessment requirements to pollution control requirements to generally applicable restrictions on land use or prohibitions on the production of certain chemicals. We have already seen that Art. 1106 also allows governments to impose technology standards for similar reasons. The italicized phrase, however, is critically important. The investor-State disputes under Chapter 11 all involve claims that the government environmental measures in question were taken in ways inconsistent with the substantive provisions outlined above.

Procedure

Under Chapter 11 of NAFTA, foreign investors have legal standing to seek regulatory relief or monetary compensation from a signatory government via binding international arbitration if that government treats the investor or investment unfairly or expropriates the

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[8] Paragraphs 2-6 provide for prompt compensation at fair market value and address currency exchange rate questions.

[9] *See, e.g.,* RESTATEMENT OF THE LAW OF FOREIGN RELATIONS OF THE UNITED STATES THIRD, Sec. 712, Reporter's Note 6 (1987).

foreigner's investment.[10] The investor-State arbitration provisions of NAFTA build on a process first established by the World Bank in 1965, subsequently incorporated into many of the bilateral investment treaties of the United States and Canada, and then included in the U.S.-Canada Free Trade Agreement that preceded the NAFTA.[11] Thus, the NAFTA extends previous practice and scope by bringing Mexico into the investor-state arbitration system.

Investor-State arbitration is neither exclusive nor mandatory; it is initiated at the option of an investor in one of the NAFTA parties, either on his own behalf or on behalf of an enterprise, where that investor has a claim that a NAFTA government breached one of the substantive rules described above and that it thereby "incurred loss or damage." There is a three-year statute of limitations on bringing a claim under this process. Art. 1118 imposes an obligation on both sides to first attempt to settle the claim through negotiation or consultation. In submitting a claim under Art. 1120, the investor must consent to the arbitration procedure, and must waive her right to initiate or pursue any administrative or judicial process involving the same claim.

Once a claim is submitted, the process proceeds under one of three international arbitration systems, at the choice of the investor (Art. 1120). Under any of these systems, the disputants first seek agreement between themselves on the composition of the three-person arbitral tribunal. If they cannot reach agreement, the ICSID will make appointments. In the cases to date where a tribunal has been formed, each has consisted of a distinguished practitioner or scholar from each of the disputing countries and a third eminent scholar or expert from a third country, typically a European.

Civil Society Participation

One general concern about the investor-State arbitration process that has particular relevance to environmental cases is its inherently secretive nature. There is not even a formal or public process for notification that an investor has filed a notice of intent to submit a claim, or that such a claim has been submitted. Even environmental officials and trade officials in the federal governments may have no knowledge that a claim has been brought, thwarting any invocation of the trade-environment intergovernmental consultation procedures under Article 10(6) of the North American Agreement on Environmental Cooperation. Once a tribunal has been appointed, the representations of the parties and the deliberations of the tribunal all take place behind closed doors. There is not even a requirement that the tribunal's decision be made public. Any information we have about these cases comes from voluntary releases of information or documents, typically by the private investors.

The claims of secrecy in the process can, however, be exaggerated. In an interim procedural ruling, the arbitral tribunal in Metalclad v. Mexico ruled that neither the NAFTA nor the international arbitration rules provide for any restriction on public disclosures by the parties

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[10] Usually under international trade agreements only a national government can bring a suit in front of an international tribunal and the only remedy is to impose corrective or punitive tariffs or quotas on products from the violating nation. Under NAFTA, for example, most trade disputes are to be resolved through government-to-government procedures set forth in Chapter 20. There is one other exception to this general approach—the provision in NAFTA Chapter 19 for binational panels to review final national decisions on the application of anti-dumping or countervailing duties in lieu of judicial review in the courts of the nation that made the decision.

[11] This history is drawn from a paper by Prof. J. Anthony VanDuzer, University of Ottawa, titled "Investor-State Dispute Settlement under NAFTA Chapter 11: The Shape of Things to Come?"

to the arbitration, so parties are free to publicize any details they wish. The full texts of arbitral awards and of many briefs by the parties have become available through these informal channels. The private parties have also made active use of the media to get out at least their side of the story. Nevertheless, the Metalclad tribunal cautioned the parties to act with restraint, noting that one of the hallmarks of arbitration is settlement of disputes outside the glare of publicity.

In the case of Methanex v. U.S., two NGOs are looking for another opening in the veil of secrecy. The International Institute for Sustainable Development, a Canadian organization, and Friends of the Earth have separately petitioned for the opportunity to file *amicus curiae* briefs. The NAFTA and the arbitration rules are silent on the question of amicus briefs. The arbitral tribunal has asked the governments to file their comments on these requests and is expected to rule on the question before the end of the year.

Another concern about the routinely closed nature of the arbitration process has to do with the effective representation of the real parties in interest. Because state/provincial and local government actions may give rise to an investor's claim while the federal government is the defending entity, the states and localities are unable to fight their own battles to protect their environmental actions against foreign investors. They fear that the federal governments, influenced more strongly by economic and foreign policy considerations, may not aggressively or effectively represent their interests. In short, constitutions give significant rights tosubfederal governments, whereas under NAFTA it is up to the federal authorities to defend those rights against attack by foreign investors. Ultimately, will national economic policy trump state environmental measures? In the United States, at least, the State of California is pleased so far with the level of coordination between the state government and the federal officials handling the Methanex arbitration.

Environmental Issues in Chapter 11 Arbitrations

A brief review of a few of the recent investor-state awards and pending claims illustrates the current tension that exists in the NAFTA era between the sovereign right of a government to achieve its environmental objectives and the right of a foreign company to secure its investments. Not discussed here are two other major proceedings by U.S. companies against Canadian actions related at least indirectly to environmental policy—S.D. Meyers v. Canada and Pope & Talbot v. Canada.

Ethyl

There is a complex chronology and factual situation in this case.[12] Ethyl Corporation, a U.S. company, manufactures the manganese-based gasoline additive MMT, an octane booster that enhances fuel efficiency. In 1994, the Minister of Environment Canada announced her intention to have MMT removed from Canadian gasoline by August, 1995. She was apparently motivated to do so by public health concerns. At just this time, the US EPA was being forced under court order to allow the production and use of MMT in the US after years of prohibition. Despite widespread concern about the effects of inhalation of manganese, scientific studies of MMT's health effects in both Canada and the US at the time were inconclusive. Indeed, given the ambiguous scientific evidence available, under Canadian environmental law the environment minister could not legally impose a ban on MMT on health grounds.

[12] See Julie A. Soloway, *Environmental Trade Barriers under NAFTA: The MMT Fuel Additives Controversy*, 8 MINN. J.GLOBAL TRADE 55 (1999).

Lurking in the background of the controversy over MMT in both countries are the competing interests of alternative additives, especially ethanol, and the long-running battle between automobile manufacturers (who tend to oppose MMT) and fuel suppliers (who favor it) in allocating responsibility for automotive pollution control and performance of emission control systems. This latter conflict took on inter-provincial aspects in Canada, pitting the fuel-producing provinces like Alberta against the auto-manufacturing industry centered in Ontario.

Looking for another avenue of control of MMT beside a health-based prohibition on its use, the federal government submitted a bill in Parliament in 1995 to ban the importation of and inter-provincial sale of MMT. Ethyl was the sole supplier of MMT to the Canadian market. Because it blended MMT in Ontario and then sold the MMT to refiners in other provinces, the bill would effectively prevent Ethyl from continuing to sell MMT in Canada. The 1995 bill died, but was resubmitted to a new Parliament a year later. The ban on trade in MMT under bill C-29 ultimately took effect in June, 1997. By this time, Ethyl had already submitted its claim under Chapter 11.

While the NAFTA claim was pending, the province of Alberta initiated a domestic challenge to the interprovincial trade ban under the Canada's Agreement on Internal Trade. The panel that heard that dispute in 1997 ruled in Alberta's favor in June,1998, finding that the MMT trade ban was an undue burden on internal commerce in Canada not justified by the pursuit of a legitimate objective, protection of the public health. It did not directly question the public health purposes of the measure, but found that there was no urgency to the health concerns and therefore the federal government could have met its legitimate objective through less trade restrictive means.

A month after the AIT ruling, the Canadian government agreed to settle Ethyl's Chapter 11 claim. It dropped the trade ban on MMT and paid Ethyl a reported US$13 million of legal expenses and lost profits. As part of the settlement, the government publicly declared that there was no scientific basis to prohibit MMT on health grounds. (Although MMT is also a legal product in the US, most refiners have responded to public and environmental group pressure and have voluntarily agreed not to use it in their gasoline products).

The preceding description reveals three prominent characteristics of the Ethyl case:

1) There was persistent uncertainty about the possible health hazards of MMT. This uncertainty drove the government to use a trade measure rather than an environmental regulation to control MMT and then undermined the federal government's case in the AIT proceeding. In the settlement with Ethyl, the government abandoned the health basis for its action altogether.
2) There were multiple conflicting commercial and regional interests involved in the MMT debate within Canada which were not directed at Ethyl but which had the effect of distorting the internal decisions within Canada in such a way that Ethyl's investment interest in Canada became an incidental victim. Part of the reason for protections for foreign investors is precisely because they are not effectively represented in the political decisions of the host country that may affect their interests.
3) The federal government tried to regulate MMT by imposing trade restrictions on it that were not supportable even under Canadian internal trade law. The ruling in the AIT proceeding, like similar rulings in the United States in cases involving environmental regulation affecting interstate commerce, upheld a system of balance between free movement of goods and local or even federal environmental objectives that requires an element of what the Europeans call "proportionality" between an the

> environmental purpose being served (objectively viewed) and the restriction on interprovincial/interstate commerce.

These three characteristics raise significant doubt that Ethyl's challenge to the Canadian trade ban constitutes a serious threat to Canadian environmental policy, and help explain why the Canadian government chose to settle this case rather than pursue the arbitration process on the merits.

Metalclad

Metalclad is a Newport Beach-based waste disposal company. It submitted a Chapter 11 claim for $90 million in lost profits against the Mexican government because the local government of Guadalcazar and the state government of San Luis Potosi (SLP) had acted to prevent the operation of a hazardous waste landfill that Metalclad had constructed.[13] The arbitral tribunal announced its decision at the end of August, 2000, awarding Metalclad compensation of $16.7 million, the amount of Metalclad's investment in the landfill.

Many facts of this case are controverted, but the basic story seems to be as follows.[14] A Mexican company, COTERIN, had an authorization from the Mexican federal government to build and operate a hazardous waste transfer facility in Guadalcazar, and operated that transfer facility for some time. In 1993, Metalclad took an option to buy COTERIN just as it was seeking construction and operating permits for a full-fledged hazardous waste landfill on the same site. Based on the granting of the construction and operating permits by the federal environmental authorities and supposed assurances of support for the project by the state of SLP, Metalclad exercised its option and bought COTERIN. Shortly thereafter, the governor of SLP began to oppose the facility, and the municipality of Guadalcazar declined to act on Metalclad's application for a local construction permit. Metalclad proceeded with construction nevertheless, and received extensions of its federal permits. In 1995, when construction was complete, the federal authorities audited the facility and then entered into an agreement with Metalclad under which Metalclad would be allowed to operate the facility so long as it undertook certain site remediation actions to clean up waste remaining on the site from its earlier use and created an environmental buffer zone around the facility.

After the federal environmental authorities and Metalclad concluded this agreement, the municipal council of Guadalcazar, without any notice to Metalclad or opportunity for it to be heard, voted to deny the long-pending municipal construction permit. (Its authority to deny the permit on environmental grounds under Mexican law is disputed. It is possible that the local construction permit is based only on technical and safety factors of design, materials, and construction methods.) Subsequently, the Governor of SLP issued an Ecological Decree declaring a 600,000-acre zone for the protection of rare cactus species.[15] This zone surrounds

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[13] The Metalclad suit was heard before the International Center for the Settlement of Investment Disputes ("ICSID") on August 30, 1999. *Large U.S. Handler of Toxic Wastes To End Mexican Operations After NAFTA Suit*, 29 Env't Rep. (BNA) No. 51 at 2578 (Mar. 30, 1999).

[14] This account is drawn primarily from the description of the facts in the final award decision of the arbitral tribunal. The award decision is available from the website of the attorney for Metalclad: http://www.pearcelaw.com/metalclad.html

[15] Public Citizen, *Our Future Under the Multilateral Agreement on Investment* (visited Mar. 9, 1999) http://www.tradewatch.org/nafta/cases/metalclad.htm.

and includes the Metalclad facility site, and effectively precludes Metalclad from operating the facility.

The arbitral tribunal looked at two legal issues under Chapter 11. First, it considered whether Metalclad had been denied "fair and equitable" treatment as required by NAFTA Art. 1105. On this question, the tribunal found a violation of Art. 1105 based on two conclusions. One conclusion, disputed by some experts on Mexican law, held that the municipality acted unfairly and inequitably because it had no authority to withhold the municipal construction permit on environmental grounds. The second conclusion was that the manner of the municipal decision on the permit, in a hastily-convened meeting without notice to the applicant or opportunity to appear, was procedurally deficient.

On the question of expropriation under Art. 1110, the tribunal held as follows:

> By permitting or tolerating the conduct of Guadalcazar in relation to Metalclad which the Tribunal has already held amounts to unfair and inequitable treatment breaching Article1105 and by thus participating or acquiescing in the denial to Metalclad of the right to operate the landfill, notwithstanding that the project was fully approved and endorsed by the federal government, Mexico must be held to have taken a measure tantamount to expropriation in violation of NAFTA Article 1110(1).

On this basis, the tribunal award Metalclad compensation in the amount of its direct investment in the facility.

It must be said that the reasoning of the tribunal in finding a violation of Article 1110 is hard to follow, even though the result is probably correct. In the paragraph just quoted, the tribunal reaches a valid conclusion that the blockage of Metalclad's operation of the facility it had constructed was tantamount to an expropriation based on certain facts, without explaining how those facts connect legally with its conclusion. From the tribunal's language and from the paragraphs that follow the quoted statement, it appears that the tribunal determined that Metalclad's investment was made in reasonable expectation that it had legal permission, under Mexican law, to construct the facility and that, if the construction met federal environmental standards, it would be allowed to operate that facility. It is worth articulating the apparent rationale. If Guadalcazar had acted correctly and within its clear authority in withholding the construction permit, thwarting Metalclad's operations would not have been an expropriation because Metalclad would have lacked any foundation for its belief that it was making its investment within the framework of local law. It is only because Guadalcazar's action in withholding the construction permit was contrary to Metalclad's reasonable investment-backed expectations that the resulting denial of operation becomes "tantamount to expropriation." Similarly, if Metalclad had invested in the facility without construction and operating permits in hand from the federal authorities, or had failed to meet the known requirements of those permits, then a denial of its right to operate would not have been "tantamount to expropriation," but rather an appropriate exercise of environmental enforcement power to prevent a violation of federal environmental law. But with clear permission at every stage from the federal authorities, the unexpected developments that then thwart Metalclad's reasonable investment-backed expectations become tantamount to an expropriation. Put another way, Metalclad has no legitimate "investment" to be protected from "expropriation" if it had behaved in disregard of or with indifference to the established domestic legal requirements governing its investment.

Some have commented with concern on another paragraph of the Metalclad tribunal's award. In opening its discussion of the "tantamount to expropriation" question, the tribunal paraphrases the Article 1110 language as follows:

> Thus, expropriation under NAFTA includes not only open, deliberate and acknowledged takings of property … but also covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use or reasonably-to-be-expected economic benefit of property ….

If one focuses in isolation on the phrase “incidental interference with property,” then there would be cause for consternation. Governments act in many ways that result in “incidental interference with property,” and it would be alarming to think that every such action might give rise to a claim for compensation from a foreign investor under Chapter 11. But from the context it is clear that the tribunal has not opened such a loophole. The reference to “incidental interference with property” goes inseparably with the following qualification—“which has the effect of depriving the owner, in whole or significant part, of the use or reasonably-to-be-expected economic benefit of property.” This brings us back within the realm, fairly well defined in U.S. “takings” jurisprudence, that recognizes the functional equivalence between regulation that deprives an owner of all or nearly all use of the property and the clearly impermissible direct physical appropriation of the property by the government without compensation.

In light of the peculiar facts of the case, it is hard to see the Metalclad award as a threat to the legitimate exercise of either local or federal authority to regulate for environmental protection purposes. Metalclad was victimized by one of three possible behaviors, none of which should be imagined as legitimate exercises of environmental authority. One possibility is that the local and state officials were acting in a xenophobic way. Having tolerated a Mexican-owned operation, they were perhaps determined not to allow a “foreign” company to take over. One of the purposes of Chapter 11 is to shield investors against such discrimination based on their nationality. Another scenario—more likely in my view as at least a partial explanation—is that Metalclad confronted a NIMBY (not in my back yard) mentality at the local level. The issue then becomes one of the relationship between local and federal control under Mexican law. If Mexico wishes to empower local communities to reject unwanted facilities, it may do so. But the tradition in Mexico, as reflected in the Metalclad facts, is that the federal authorities retain most of the legal authority to make final decisions. Investors have a reasonable right to be shielded from actions by local officials that are contrary to or outside of their legal authority under national law, regardless of the virtue of the sentiment motivating such behavior. The third possibility—also a likely factor, especially with respect to the governor’s actions—is that there was a personality and/or political power struggle going on between the local/state officials on the one hand and the federal authorities on the other. In this case as well, Mexico is free to establish whatever allocation of authority it prefers between federal and state/local jurisdictions. Mexico could, for example, arrange its affairs along the Canadian model, giving the states broad powers with only weak and limited powers at the federal level. But that is not its current practice or historical preference. On the contrary, centralized power is the norm. Metalclad dealt with the central authorities and had every reason to believe that they had full power to authorize the construction and operation of the landfill. If Mexico wishes to allow the state governor, nonetheless, to declare an ecological zone that has the effect of preventing the facility’s operation, that is Mexico’s prerogative, but it should not ask the foreign investor, after having made its investment, to suffer that last-minute change in the rules without compensation.

The Metalclad case has environmental policy implications beyond the issue of the individual facility. Mexico's federal government is under intense pressure given the high-costs and negative publicity associated with challenges by foreign investors under NAFTA. In particular, the government needs foreign investment in its environmental industry. Since Metalclad's announcement that it was not only filing a claim but also discontinuing its operations in Mexico, six major foreign environmental investment projects have been either delayed or discontinued.[16] Under the weight of this reality, environmental advocates fear that the federal government's environmental policy responses will be less responsible and environmentally protective in order to appease foreign investors and avoid future legal battles. In turn, state and local governments may be pressured by the federal government to do the same. Currently the Mexican Constitution provides that municipalities are free to make policy decisions on the management of their public services; NAFTA's Investor-State Provisions may prove to be a direct threat to that sovereignty.

A counter-example, though, should reassure environmental interests. Another Chapter 11 arbitral tribunal turned down the compensation claim of American investors who complained that their contract for waste collection services had been improperly cancelled by a Mexican municipality. They had pursued their claim first in Mexican courts. The court ruled that the municipality had acted within the scope of its authority under a valid federal law. The arbitral tribunal said that it was not its role to act as a court of appeal from a domestic court. It thus reframed the Chapter 11 question as one of whether the court's decision was somehow contrary to the Art. 1105 obligations of fair and equitable treatment. It concluded that there was no evidence that the court had breached the Chapter 11 standards, and therefore the investors' claim failed.[17]

Methanex

In addition to the major cases of Ethyl and Metalclad that have been resolved on the merits, the pending case of Methanex v. United States raises fundamental issues about the relationship between Chapter 11 and environmental regulation. The Methanex case is complex and politically sensitive. It has some of the attributes of the Ethyl case, but can be distinguished from Ethyl in important ways.

Methanex is a Canadian-based manufacturer of methanol, with operations in the United States and other countries. In the Chapter 11 case, Methanex is challenging the March 25, 1999 Executive Order of California Governor Gray Davis ordering steps to phase out the use in California of the methanol-based gasoline additive MTBE by December 31, 2002.[18] Emerging

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[16] *Large U.S. Handler of Toxic Wastes To End Mexican Operations After NAFTA Suit, supra* at note 4.

[17] Emmanuel Gaillard, "NAFTA Dispute Arbitration Under Auspices of the International Center," *New York Law Journal*, Aug. 3, 2000, discussing the award in Azinian v. Mexico (also known as DESONA v. Mexico).

[18] *NAFTA Used to Attack California Clean Water Move*, Environment News Service (June 24, 1999) http://ens.lycos.com/ens/jun99/1999L-06-24-04.html. Author's note, Methanex was already in deep financial trouble and its stock price was falling rapidly before the California decision on MTBE. There is thus the strong suspicion that the Chapter 11 filing was simply a short-term ploy to boost investor confidence.

health concerns surrounding exposure of MTBE were the impetus for California's ban. It is well-established that MTBE, when leaked into soil from gasoline tanks, moves very rapidly through soil and into groundwater or surface water, including sources of drinking water. This characteristic has caused considerable alarm because some recent scientific studies link MBTE to tumors and nervous disorders in rats and mice, and it has been classified a possible cancer-causing agent by the U.S.EPA.

The governor's order would cause Methanex to lose one of its largest US markets for methanol. Its claim is for over $900 million, based on lost profits and also lost stock value as a result of the regulatory action. The Chapter 11 grounds for its claim are that, following Davis' Executive Order, California was no longer affording it fair and equitable treatment, and the ban was tantamount to expropriation, giving rise to an obligation for payment of compensation. The circumstances surrounding this claim are noteworthy. Methanex has suffered a general reversal of fortunes in recent years. The world price of methanol declined in the late 1990s, and Methanex share prices were in decline just prior to the Chapter 11 action.

As with the other environmental Chapter 11 arbitrations, Methanex's claim has set off alarms in the environmental community. They argue that Methanex's "expropriation" argument misconstrues NAFTA provisions that were intended to only compensate foreign investors for actual seizures of property. David Schorr, director of the World Wildlife Fund's Sustainable Commerce Program, stated: "To call a country's effort to protect the environment 'an expropriation' is absurd. It's like saying we should pay polluters every time the government asks them not to pollute."[19]

A more dispassionate analysis of Chapter 11 and the awards already made under it, however, suggests that Mr. Schorr's view is too simplistic, and his example is wide of the mark. It seems clear that Methanex does have a substantial investment in California that goes beyond the mere contracts for the purchase of its product. It also seems clear that the State's move to ban MTBE will reduce the value of that California investment to zero, or nearly so. Like Ethyl with MMT in Canada, Methanex is the sole supplier of methanol for the MTBE used in the California gasoline market, so the value of its California investment will be substantially if not completely reduced by action of the governor. Although Methanex has significant US business activity outside California, it is not implausible for Methanex to consider its California operations as a single investment distinct from the rest.

That brings us to the question whether the government action closing that market is "tantamount to expropriation" of Methanex's investment. The key point is not the degree of impairment of the value of the investment; let's assume for the purposes of argument, that the value will be completely extinguished. The more fundamental question is whether that extinguishment of value constitutes a compensable "expropriation." If the decision to ban MTBE can be rightly characterized as an exercise of the police power of the state to protect the people and the environment and the public resources of California from contamination by a hazardous product, then many commentators and a considerable body of U.S. constitutional law would conclude that the action is not an expropriation, or "taking." The loss of a business opportunity resulting from the exercise of the sovereign's police power to prevent harm from a certain business activity is simply not a compensable property interest recognized by the law. Another way to look at it is that Methanex has no reasonable expectation, as an investor, that it will be allowed in perpetuity to sell a product that has been discovered to cause significant risk to health or the environment. To overcome the expected defense that California's decision falls

[19] *Id*.

within the police power, Methanex would need to show either that the state had no legitimate basis for concern about the harmful effects of MTBE or that the interests being protected by the ban on MTBE are too diffuse or abstract to come within the police power.

According to news accounts, one argument that Methanex is making is that the state had less drastic alternatives for managing MTBE in water supplies than a ban on the substance. In particular, Methanex argues that the contamination of water by MTBE can best be prevented by full enforcement of existing rules on leaking underground storage tanks, rules that were not strenuously enforced in California according to a state auditor's report. Such an argument, known in trade circles as the "necessary" or "least trade restrictive" test, might be a persuasive argument if the state's measure were a trade measure being tested under trade law standards. A similar argument prevailed in the AIT dispute within Canada over the ban on interprovincial trade of MMT. But a prohibition on a product because of its hazards, although clearly having trade effects, is not a trade measure, and is not subject, under NAFTA Chapter 11, to a "necessary" test.

In response to the Methanex case, anti-MTBE interests are trying to use state and federal legislation to address these issues.[20] The California Senate recently approved SR 20, which directs California's Attorney General to seek damages from responsible parties to clean-up MTBE-contaminated water if Methanex's NAFTA claim forces the states to use MTBE beyond the Dec. 31, 2002 deadline designated by Davis.[21] SR 20 also urges the United States Congress to take action to protect America's natural resources by prohibiting foreign intervention under the NAFTA provisions.[22] Meanwhile, on 17 July, 2000, the NAFTA-related Commission for Environmental Cooperation dismissed the merged Methanex and Neste Submissions on Enforcement Matters.[23] The CEC Secretariat determined that it would not proceed further in its review of the submissions because the matter is the subject of the pending arbitration proceeding initiated by Methanex.[24]

The arbitration tribunal for the Methanex case has been appointed, but an award decision is not expected any time soon.[25] One cause for delay is the initiative by two NGOs to file petitions with the tribunal seeking amicus status in the arbitration process. Chapter 11 and the rules of the arbitration process neither permit nor prohibit amicus participation. The tribunal has agreed to receive the petitions and rule on them. It has sought response to the petitions not only from the United States and Methanex, but also from the governments of Canada and Mexico

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[20] *Methanex Pursues Nafta Claim as States Tries to ensure Decision*, Oxy-Fuel News, (Oct. 4, 1999).

[21] *Id.*

[22] *Id.*

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[24] *Id.*-

[25] Kristie Watthuber, *Methanex's Nafta MTBE ban claim creeps forward*, Chemical News & Intelligence, June 23, 2000. (Brad Boyd, Methanex spokesman, said, "although an arbitration panel has been established, I don't anticipate this claim will be decided until some time next year.")

because its disposition of the petitions might establish a precedent under Chapter 11. Briefing will be complete by the end of this year, with a ruling by the tribunal some time thereafter.

Where Do We Go From Here?

Perhaps because of the early high-profile Ethyl case, Canada shows the most sensitivity to the investor-state arbitration process and its impingement on environmental policy. Canadian critics of Chapter 11 seem most alarmed by the threat the provisions pose to provincial authority to manage natural resources. The nature of the binding, international arbitration process is another area of serious concern. Because provinces and municipalities are not directly involved in the process, there is no assurance that the federal officials representing Canada will advocate their interests. The lack of direct access by subfederal governments is compounded by the fact that the arbitration proceedings can be secretive and the records are not publicly accessible through regular channels.[26]

One approach at the federal level in Canada seems to be to avoid future Chapter 11 claims by counseling provincial and municipal governments not to take certain actions that might conceivably trigger Chapter 11 claims. On another front, Canada has asked Mexico and the United States to work with it to develop a consensus interpretive statement on the most controversial provisions of Chapter 11 that could help shape the decisions of future arbitral tribunals. It is quite likely, though not certain, that an agreed understanding of what is included or excluded by the term "expropriation" issued by the NAFTA Free Trade Commission (the three trade ministers) could influence the use of Chapter 11 in environmental regulation cases. Thus far, however, the other NAFTA parties have shown no official interest in such a strategy.

From the United States perspective, we alone among the NAFTA countries have constitutional law doctrines about "takings" of property that have been construed in some cases to require compensation to domestic property owners when environmental protection measures are adopted. To that extent, American officials are not discomfited by the Chapter 11 outcomes thus far. Ironically, though, the argument by environmentalists and many Canadians is precisely that NAFTA Chapter 11 should not be allowed to extend U.S. takings doctrine to the treatment of foreign investors throughout North America. There is also a fear that arbitral tribunals will be tempted to go beyond the U.S. doctrine and protect investors even further against impairment of their businesses by local regulators. Chapter 11 has certainly given foreign investors, through their self serving interpretation of Chapter 11, an opening to create a NAFTA "takings" law much broader than anyone realized when NAFTA was being negotiated. The world will be watching the national and international efforts of Canada, Mexico, and the United States to resolve the seemingly conflicting commitments of environmental protection and trade investment in the NAFTA era.

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[26] *See Ethyl Corporation v.s. Government of Canada: Now Investors Can Use NAFTA to Challenge Environmental Safeguards*, *supra* note 1.

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Award on Jurisdiction, June 24, 1998, 38 INT'L LEGAL MAT'LS 708 (1999).

Full text of the award in Metalclad v. Mexico is available from the Web site of the attorney who represented Metalclad, at http://www/pearcelaw.com/metalclad.html