

North American Free Trade Agreement, Case Law

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A. NAFTA Chapter 20 Panel Decisions

- 1 The institutional organization of the → *North American Free Trade Agreement (1992)* ('NAFTA') dispute settlement system is described in a separate contribution (→ *North American Free Trade Agreement, Dispute Settlement*). In this contribution the decisions rendered by the various bodies constituted under that system are described.
- 2 As of 15 July 2009, three decisions have been rendered by panels under the Chapter 20 dispute settlement procedure.

1. Canadian Agricultural Tariffs (Canada v US)

- 3 The first NAFTA claim decided under the Chapter 20 procedure involved an alleged conflict between the → *World Trade Organization (WTO)* and NAFTA obligations (*Tariffs Applied by Canada to Certain US-Origin Agricultural Products*). Prior to entry into force of the NAFTA, Canada maintained certain agricultural quotas. The NAFTA authorized Canada to maintain those quotas by reference to an earlier provision in the Canada-United States Free Trade Agreement ('CUSFTA'). The WTO Agreement on Agriculture (signed 15 April 1994, entered into force 1 January 1995; 1867 UNTS 410) required Canada to eliminate its agricultural quotas, which Canada—as other WTO members—was entitled to accomplish by tariffication. Tariffs would replace quotas. However, the NAFTA provides that its parties may not raise tariffs—including on agricultural products—and when Canada imposed new tariffs on agricultural products from the United States ('US'), the United States objected and filed a NAFTA complaint.
- 4 Canada argued that it was required by the WTO agreement to tarifficate its quotas, and that in any case it was allowed to tarifficate its quotas under the NAFTA because it expressly 'retained' certain rights to restrain agricultural imports negotiated under the General Agreement on Tariffs and Trade ('GATT'; see → *General Agreement on Tariffs and Trade [1947 and 1994]*). The United States argued that the WTO agreement did not obligate tariffication of quotas, it only authorized tariffication. Canada might have eliminated its quotas without imposing tariffs that violated the NAFTA, and without violating the WTO agreement. The United States further argued that the rights that Canada retained under the GATT were limited to those that had been exercised when the NAFTA entered into force, and that Canada could not thereafter adopt new measures that

were inconsistent with the NAFTA. The NAFTA panel had to decide whether Canada's retention of rights under the GATT included the authority to take new action under an old GATT rule.

- 5 The panel observed that the NAFTA uses a variety of terms and formulations to address its relationship to the GATT 1947 and WTO, as well to the CUSFTA. The panel said:

The interpretation of these agreements is complicated by a number of factors. The NAFTA incorporates obligations from other agreements including both the [CUS]FTA and the GATT. The terminology used in the drafting of the various provisions, both within and across these agreements, is not marked by uniformity or consistency. As discussed more fully below, words like "existing", "retain" or "successor agreements", appear in some contexts yet do not appear in others where their presence may have been thought apposite. As a result, the Panel has been faced not only with the task of determining meaning from the presence of certain words, but also with the more difficult task of divining meaning from the absence of particular words (at para. 123).
- 6 The panel ultimately determined that the term 'retain' as used in the CUSFTA, and incorporated by reference in the NAFTA, does not import a temporal limitation on the exercise of rights by Canada. A right that is 'retained' may be exercised in the future. Canada's retained rights under the GATT—and agreements negotiated under the GATT—were not limited to those that had been expressly exercised prior to the NAFTA, but could include rights exercised in the future. Because Canada retained rights to impose agricultural restrictions under the GATT, Canada could tarifficate its agricultural quotas in spite of the NAFTA's prohibition of new tariffs.
- 7 The panel noted at several points that the NAFTA uses the term 'successor agreement' to the GATT when it intends to make clear that Uruguay Round results are to be included in relation to the NAFTA, but the panel also observes that the NAFTA's terminology is sufficiently inconsistent that general guidelines for interpretation are difficult to extract. There is no sweeping conclusion to be drawn from the *Canadian Agricultural Tariffs* panel report in regard to whether the NAFTA generally takes precedence over the GATT 1994. The panel effectively confirms that this matter will require further sorting out in the context of specific cases.

2. Broom Corn Brooms (Mexico v US)

- 8 The second case to come before a NAFTA Chapter 20 dispute settlement panel directly raised the question whether NAFTA panels are authorized to adjudicate claims arising under both the NAFTA and WTO-GATT (*US Safeguard Action Taken on Broom Corn Brooms from Mexico; 'Broom Corn Brooms Case'*). In the *Broom Corn Brooms Case*, Mexico objected to the manner in which the United States had imposed safeguard measures against imports of Mexican brooms. Mexico argued that the United States action failed to apply the appropriate injury test under the Art. XIX GATT safeguards provision, which provision contains language equivalent to the language of the NAFTA Chapter 8 safeguards text. Since Art. 802 (1) NAFTA provides that 'Each Party retains its rights and obligations under Article XIX of the GATT or any safeguard agreement pursuant thereto...', Mexico considered that it was entitled to rely on GATT language and dispute settlement precedent under which the US safeguard action was allegedly taken upon an overly narrow definition of injury to domestic industry.
- 9 The panel did not decide whether it was authorized to adjudicate GATT legal claims. It found that the United States had failed to comply with certain procedural rules that are common to the NAFTA and GATT, and that Mexico's claim could be addressed at the present stage by application of the NAFTA alone.

- 10 The text of the NAFTA, including the dispute settlement chapter, allowed for reasoned argument on each side of the issue. The United States relied on portions of NAFTA Chapter 20 referring to ‘this Agreement’ and its standard terms of reference, as well as differences in how references to the GATT are styled in the NAFTA text. The United States accepted that its position would demand that Mexico pursue claims in both the NAFTA and WTO to vindicate rights—or assert defenses—that differ under the two agreements. The Mexican government relied on the fact that the NAFTA parties have authorized claims arising under both agreements to be brought in the NAFTA—or WTO—as evidence that the parties must have intended that the panels charged with deciding cases could apply both sets of rules, particularly in light of language that makes the selected forum the exclusive one.
- 11 It would be difficult on the basis of the NAFTA text to conclude whether the parties intended WTO-GATT rules to be considered by NAFTA panels only in those cases in which the NAFTA appeared to directly incorporate WTO-GATT rules. On a policy level, the US position demands careful forum shopping on the part of a prospective claimant. It would lead to delays in the resolution of disputes as NAFTA parties assert rights to pursue back-to-back claims. It would appear to encourage political friction as parties refuse to reach adjudicated settlement of disputes pending lengthy procedures in two fora.

3. Mexico v United States—Cross-Border Trucking

- 12 The NAFTA obligates the United States and Mexico to open restricted areas near their mutual border to cross-border trucking services three years after the date of signing, and to broadly open their territories to cross-border trucking services 6 years after entry into force of the agreement. Chapter 9 NAFTA sets forth rules applicable to the setting and maintenance of technical standards. Under the technical standards rules, each party is entitled to adopt and maintain measures relating to human safety (Art. 904 (1) NAFTA) at a level it considers appropriate (Art. 904 (2) NAFTA) in accordance with certain risk assessment rules (Art. 907 (2) NAFTA). Mexico alleged national treatment and violations of the → *most-favoured-nation clause* (‘MFN’) with regard to regulatory measures, as well as national treatment and MFN violations with respect to investment.
- 13 The US argued that fundamental disparities between US and Mexican regulatory systems legitimized a blanket restriction on allowing Mexican cross-border trucking into the US. It claimed that it was only required to provide national treatment under ‘like circumstances’, and that deficiencies in the Mexican regulatory system meant that US and Mexican trucks were not in ‘like circumstances’. The United States made a similar argument with respect to the denial of MFN treatment as compared with Canada.
- 14 In its decision, the panel invoked principles established in GATT-WTO jurisprudence, including panel and appellate body reports, as well as customary international law, decisions of the → *International Court of Justice (ICJ)* and expert commentators. The panel stated that the NAFTA and WTO national treatment principles are basically the same, and common to the field of international trade. In looking at conduct by the United States, it indicated it would avoid inquiring into motivation, eg, union pressure on the Clinton Administration.
- 15 The panel rejected the US defence to the claim of national treatment violation, holding the United States is obligated to treat US and Mexican truckers performing similar functions the same way. Each Mexican trucking license application must be reviewed on its own merits, just as are US national applications. The panel said that if harmonization of regulatory systems was required as a pre-condition of national treatment, this would

- undermine the concept of national treatment. Regarding the MFN claim, the panel said that the United States was obligated to provide equivalent treatment to cross-border trucking from Canada and Mexico, and that the United States had not done this.
- 16 The US invoked Art. XX (b) GATT analogue of NAFTA to justify failure to provide national and MFN treatment. Regarding the burden of proof, the panel said that, as a general matter, a party alleging an inconsistency with the NAFTA generally has the burden of proof to establish it. It says that the party invoking an exception also has the burden of proof to establish its entitlement. Thus, the US had the burden to show its restrictions on Mexican trucking were ‘necessary’. The panel invoked, inter alia, the WTO appellate body decision in *United States—Import Prohibition of Certain Shrimp and Shrimp Products* ([12 October 1998] WT/DS58/AB/R) to support its holding that the US could have pursued less trade restrictive conduct.
 - 17 In response to Mexico’s claim that the US had failed to permit non-discriminatory national and MFN investment, the US argued that since there was no demonstrated Mexican interest in investing in US trucking, Mexico could not demonstrate violations. The panel said that under WTO law it is not necessary to demonstrate ‘actual’ trade effects—ie nullification or impairment. An imbalance in competitive conditions is adequate.
 - 18 The panel concluded by emphasizing that it was not holding that the United States should lower its trucking safety standards, but rather that it must allow Mexican truckers to demonstrate compliance with them.

B. Chapter 19 NAFTA Panel Decisions

- 19 As of 15 July 2009 approximately 60 Chapter 19 NAFTA panel decisions have been adopted. Only a few of these decisions have generated significant controversy, and these have involved subject matter in contention between Canada and the United States since well before entry into force of the NAFTA. Controversy has been more focused on subsidy-countervailing duty cases that implicate allegedly impermissible government action, rather than on antidumping cases that address conduct by private parties.
- 20 The most controversial decisions, generally referred to as the Canadian Softwood Lumber cases, have involved alleged Canadian subsidization of its softwood lumber industry’s exports to the United States. The US Department of Commerce and International Trade Commission determined that the harvesting or ‘stumpage’ fees assessed by Canadian provincial governments on lumber taken from public lands constituted a subsidy to the Canadian softwood lumber export industry. A series of objections from Canada followed, charging that the United States agencies had failed to follow domestic legislation in applying countervailing duty law (‘CVD’), for example, by failing to make all the requisite findings required for an adverse determination. After a number of iterations of Chapter 19 NAFTA panel decisions—and extraordinary challenge procedures brought by the United States—a Chapter 19 panel sided with Canada in deciding that the United States agencies should have, but did not, making proper findings of material injury to US domestic industry. Following that decision and during a lull in Chapter 19 proceedings, Canada and the United States in late 2006 reached an agreement on resolution of this long-running dispute which (1) required the United States to refund most of the CVDs that had been collected from Canadian exporters, and (2) required Canada to implement a 15% export tax on softwood lumber. The agreement between Canada and the United States continues to be the subject of intense controversy, and it is not clear whether this long-running dispute has finally been resolved.

C. Chapter 11 NAFTA Arbitration Decisions

- 21 Investor-to-State arbitration under the NAFTA Chapter 11 dispute settlement provisions has proven to be the most controversial of the NAFTA dispute settlement mechanisms.
- 22 As of 15 July 2009, approximately 40 cases had been initiated under Chapter 11, and about a dozen decisions had been rendered. Data on Chapter 11 cases was initially more difficult to obtain than data with respect to Chapter 19 and 20 cases because there is no central NAFTA Secretariat database of Chapter 11 actions as there is for Chapters 19 and 20. However, the US State Department has implemented a website listing for Chapter 11 claims filed against each country Party.
- 23 Four notable cases are discussed below, three of which involve environment-related investment claims—one of which also concerns cultural rights—and one of which involves allegations of failure of due process.

1. Metalclad v Mexico (30 August 2000) (ICSID Additional Facility)

- 24 Metalclad, a US enterprise, initiated a claim against the government of Mexico arising out of the alleged taking of its investment in a hazardous waste storage facility in Mexico (*Metalclad Corporation v United Mexican States*). Metalclad acquired control over investments previously undertaken by Mexican nationals. Metalclad received approval from Mexico's federal authority for continued construction and eventual operation of this facility. However, municipal authorities where the facility was located refused to approve continued construction and operation, which was intensively opposed by local residents. Federal government authorities had apparently assured Metalclad their approval was sufficient for construction and operation of the facility, but the federal authorities apparently were not justified in their assurances. Immediately prior to departure from office, the governor of the province in which the facility resided signed an 'ecological decree' which placed the waste facility within a protected ecological zone, preventing its completion and operation.
- 25 The panel found against Mexico on two principal grounds. First, it found that by failing to properly apprise Metalclad regarding the legal requirements for constructing and operating the facility, Mexico had breached a duty of transparency that was implicit in the protection of investment guaranteed to foreign investors by the NAFTA investment chapter. Second, it found that the regulatory action taken by the provincial and municipal governments, and especially the ecological decree, constituted an impermissible expropriation of property under the international legal standards incorporated in the NAFTA investment chapter. The panel awarded approximately US\$ 16.8 million to Metalclad.
- 26 Mexico brought an action in the Supreme Court of British Columbia, Canada, seeking to annul the award. Mexico and Metalclad had agreed on Vancouver as the place of arbitration. The Canadian court determined that the International Commercial Arbitration Act of Canada provided the standards of review for the appeal. The court ultimately decided that the arbitration panel had exceeded the scope of its authority by incorporating an alleged, but non-existent, customary international law rule of transparency into the NAFTA investment chapter rules on expropriation. While this might have resulted in annulment of the award, the court upheld the decision on grounds that the ecological decree in fact constituted an impermissible regulatory taking. It ordered a modest reduction in the amount of the award to reflect its determination that the taking occurred

later than the panel had found, so that the interest amount on the award should be adjusted downward.

2. Loewen v United States (26 June 2003) (ICSID)

- 27 Loewen was a Canadian operator of funeral homes which had entered into a contract to purchase a small Mississippi funeral home operator. The contract had a value of about US\$ 4 million. Loewen was alleged in a state trial court civil action in Mississippi to have breached the contract. The jury in the case found in favor of the local Mississippi operator and awarded him US\$ 500 million in damages, including US\$ 75 million for emotional distress and US\$ 400 million in punitive damages. In order to appeal award, Mississippi law required Loewen to post a bond of 125% of the damage award within seven days, totaling US\$ 625 million. Loewen sought relief from this requirement from the Mississippi Supreme Court, which denied the request. According to Loewen, this effectively foreclosed its route of appeal and forced it to enter into a settlement agreement with the local operator in the amount of US\$ 175 million. Loewen sought damages from the United States for violation of Chapter 11, most particularly its national treatment and due process requirements (*Loewen Group Inc v United States of America*).
- 28 The panel found that a gross miscarriage of justice had occurred in Mississippi as counsel for the local operator had repeatedly sought to inflame jury sentiment against Loewen by referring to it as a ruthless foreign enterprise intent on taking advantage of an unsophisticated local Mississippi businessman, and the trial court judge had failed to control this misconduct. The panel further found that there was no rational basis for the award of a US\$ 500 million judgment, which effectively amounted to a denial of due process under customary international law standards. However, the panel also found that Loewen had not carried its burden of proof in demonstrating that it had exhausted its rights of appeal in the US national court system, including by filing a petition for certiorari before the US Supreme Court. Because the takings measure of the United States was not final, Loewen had failed to demonstrate that the United States was responsible for a violation of customary international law (this was not a question of exhaustion of local remedies prior to initiation of a claim under Chapter 11; instead, the question was whether an unlawful takings action had been completed). The panel went on to decide that because Loewen, subsequent to the commencement of the Chapter 11 proceeding, had transferred control of its business to a US-based enterprise, it was no longer in a position to pursue a Chapter 11 claim because the NAFTA requirement of diversity of nationality requirement was no longer satisfied. In sum, no relief for Loewen.

3. Methanex v United States (3 August 2005) (UNCITRAL Rules)

- 29 Methanex is a Canadian corporation that is a leading producer of methanol, which is a principal component of a gasoline additive known as MTBE. California had required gasoline producers to include MTBE in product sold within the state as a means to reduce environmental pollution. However, scientific evidence subsequently emerged that MTBE may be a carcinogen. As a consequence, California decided to ban the use of MTBE as a gasoline additive. Methanex claimed that it suffered significant economic harm as a result of this decision because its US-based affiliates were major suppliers of product to the California gasoline additives market. Methanex argued that California's ban on MTBE was not based on legitimate regulatory concerns, but was instead motivated by an interest in protecting and advancing the interests of competing US suppliers of ethanol, including

the interests of Archer-Daniels-Midland ('ADM'), which it alleged impermissibly sought to influence the decisions of California's then governor. This, according to Methanex, constituted a denial of national treatment, and an impermissible regulatory taking without public purpose.

- 30 The panel found that that Methanex had failed to prove its claims. The panel found that the California legislature and executive had acted on the basis of substantial scientific evidence, and that California had a justified legislative interest in taking the steps that it did. The panel also found that Methanex had failed to prove that California's governor had been improperly influenced by ADM. The panel essentially found implausible Methanex theory that it was the victim of a grand conspiracy to substitute US-Midwest produced ethanol for Canadian produced methanol.

4. Glamis Gold v United States (8 June 2009) (UNCITRAL Rules)

- 31 Glamis Gold is a Canadian national enterprise that acquired gold mining rights on certain federal land in southeastern California. Glamis claimed that the federal and state (California) governments of the United States unlawfully expropriated its investment in acquiring mining rights and preparing to mine through a series of legislative and regulatory measures that effectively deprived it of the value of its investment. Glamis had initiated the 'Imperial Project' in 1994 and effectively terminated the project in 2003, alleging that land-use/environmental conditions and delays made continuation economically unfeasible.
- 32 The panel decision includes an illuminating introductory discussion of the role and jurisprudential charter of Chapter 20 dispute settlement panels. It observes that while NAFTA ad hoc investment arbitration panels are not bound by decisions of prior panels, they nonetheless operate within a public environment that encourages consistency in the development of rules, which tendency may also be seen in other dispute settlement bodies.
- 33 The panel rejects the expropriation claim on two principal grounds. First, it determines that Glamis failed to show that the value of its investment was so severely diminished as to constitute the subject of a regulatory taking within the meaning of Art. 1110 NAFTA. Glamis had put the value of the Imperial Project at US\$ 49.1 million, and the panel determined that even taking into account the complained of legislative and regulatory measures, the value of the project should be in excess of US\$ 20 million. The panel did not regard this as a sufficient adverse regulatory impact.
- 34 A good part of the panel decision is devoted to ascertaining the meaning of, and the customary international law standard for, 'fair and equitable treatment' as used in Art. 1105 NAFTA. The panel found that the standard articulated in *LFH Neer (USA) v United Mexican States* ([1926] 4 RIAA 60) remains of the relevant standard, stating (at para. 22):
- Given the absence of sufficient evidence to establish a change in the custom, the fundamentals of the *Neer* standard thus still apply today: to violate the customary international law minimum standard of treatment codified in Article 1105 of the NAFTA, an act must be sufficiently egregious and shocking—a gross denial of justice, manifest arbitrariness, blatant unfairness, a complete lack of due process, evident discrimination, or a manifest lack of reasons—so as to fall below accepted international standards and constitute a breach of Article 1105(1). Such a breach may be exhibited by a “gross denial of justice or manifest arbitrariness falling below acceptable international standards;” or the creation by the State of objective expectations *in order to induce* investment and the subsequent repudiation of those a expectations. The Tribunal emphasizes that, although bad faith may often be present in such a determination and its presence will certainly be determinative of a violation, a finding of bad faith is not a

requirement for a breach of Article 1105(1). The Tribunal further finds that although the standard for finding a breach of the customary international law minimum standard of treatment therefore remains as stringent as it was under *Neer*; it is entirely possible that, as an international community, we may be shocked by State actions now that did not offend us previously.

D. Observations and Assessment

- 35 As discussed in the encyclopedia entry on the NAFTA dispute settlement system, the modest role so far played by Chapter 19 and 20 panels is consistent with the role intended by the NAFTA parties. The NAFTA dispute settlement system was not modelled on the European Court of Justice. It was not intended to create a strong institution. As far as Chapter 19 and Chapter 20 decisions are concerned, there has been rather limited political controversy.
- 36 The potential role of Chapter 11 NAFTA panels has raised the most questions. But the arbitrators have acted with appropriate restraint and so far this has ameliorated concerns. The political institutions in the three parties are not anxious to see their regulatory powers substantially constrained—or threatened—by international arbitration, and public interest-oriented non-governmental organizations likewise do not support policy intervention by arbitrators.
- 37 One unanticipated aspect of NAFTA dispute settlement is that a plurality of Chapter 11 claims has been directed against the United States (16), with a lower volume of claims directed against Canada (12) and Mexico (12). This might be explained by the fact that the United States is a substantially larger destination for foreign direct investment and provides a richer arena for disputes to arise.

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