

Memorandum

To: Government of Alberta
From: Claire E. Reade, Arnold & Porter
Date: April 26, 2000
Re: Investor-State Arbitration Proceedings Under NAFTA Chapter 11

You have asked for a review of investor-state arbitration proceedings under NAFTA Chapter 11 (Investment). In addition, because NAFTA Annex II “Reservations for Future Measures” excludes government measures with respect to certain sectors from many of Chapter 11’s obligations, you have requested an outline of how Chapter 11 arbitration proceedings would unfold, if Canada argued that the exclusions in NAFTA Annex II applied.

I. Executive Summary

NAFTA Chapter 11 contains rules protecting NAFTA investors and investments in NAFTA jurisdictions outside the investor’s home country from discrimination and other unfair treatment by NAFTA governments. An investor can trigger arbitration proceedings against a NAFTA government under NAFTA Chapter 11, if NAFTA Chapter 11 rules cover his investment or him, and if he can claim that he has suffered damage resulting from a violation of these rules by a NAFTA government other than his own. If consultations with the affected government do not resolve the claim, arbitration proceeds under one of several internationally recognized sets of arbitration rules, as

modified by NAFTA Chapter 11. (By undertaking a Chapter 11 arbitration, the investor waives his rights to claim damages in any other legal forum.)

If the investor prevails in the arbitration, the Chapter 11 tribunal can award damages, property restitution (or its monetary equivalent), as well as litigation costs. However, the tribunal cannot issue injunctions against the government's action, or recommend amending the NAFTA government's laws, or take any similar action against the NAFTA government party.

Moreover, not all investment issues are subject to NAFTA Chapter 11 arbitration. NAFTA Chapter 11 contains important exceptions to its coverage, and NAFTA Annexes I – IV memorialize certain of these exceptions. In particular, NAFTA Annexes I – IV list certain sectors and activities in each NAFTA country where government measures will not be subject to specified NAFTA Chapter 11 rules. Chapter 11 then builds in safeguards to ensure that the exceptions to Chapter 11 coverage developed by the three NAFTA governments, including those in NAFTA Annexes I – IV, are fully respected by any NAFTA Chapter 11 arbitration tribunal.

The safeguards operate from the outset of a potential case. If an investor tries to make a claim related to a Chapter 11 rule and measure covered by Annexes I – IV, a mandatory three-month waiting period and a suggested consultation process preceding arbitration should eliminate the claim. If, for some reason, the investor pursues the claim nonetheless, and the arbitral tribunal does not immediately dismiss the claim as improper, the affected NAFTA government can take swift action to protect itself. It can require the tribunal to obtain a binding interpretation of the relevant NAFTA provisions from the NAFTA Free Trade Commission within 60 days. The Commission will interpret the

Annexes to determine whether the claim must be dismissed because the measure in question falls within one of the Annex exceptions, and, as noted, the Commission's views will be binding on the tribunal.

Recourse to the Free Trade Commission should be highly effective. The Commission is made up of cabinet-level officials from each of the NAFTA countries, so it will be sensitive to the need to protect the exceptions to Chapter 11 rules memorialized in NAFTA Annexes I – IV. In addition, the Commission generally operates by consensus, which means that its decisions are unanimous. This provides additional reassurance to the NAFTA government defending itself in the arbitration that the Commission's views will take into account all of the NAFTA parties' sensitivities. Finally, since the arbitral tribunal is bound by the interpretation provided by the Free Trade Commission, an opinion from the Commission ensures that the arbitrators, who may not fully appreciate the need to protect the exceptions in Annexes I – IV, will not misinterpret the scope of these provisions.

II. How Investor-State Dispute Settlement Operates Under NAFTA Chapter 11

A. Substantive Rights Provided by NAFTA Chapter 11

NAFTA Chapter 11 contains a number of provisions designed to protect NAFTA investors with investments in NAFTA countries outside their home country from unfair actions by a NAFTA government, and it offers investor-state dispute settlement when a NAFTA government allegedly has violated these rules. Before explaining the arbitration procedures provided for in Chapter 11, it is useful to review briefly the substantive rights conferred by Chapter 11, in order to understand the scope of potential claims that may result in arbitration.

Most fundamentally, Chapter 11 mandates national treatment and most favored nation status for NAFTA investors and investments under Articles 1102 and 1103. Chapter 11 also requires NAFTA governments to avoid other kinds of unfair treatment of these foreign entities. For example, Article 1105 requires “fair and equitable treatment and full protection and security” in accordance with international law. Article 1106 prohibits the imposition of performance requirements, such as the requirement that an investment achieve a minimum level of domestic content in its production, or that it export a minimum percentage of its output. Article 1107 prohibits the NAFTA government from requiring the senior management of an investment enterprise to be of a certain nationality, (although a NAFTA government can, under certain conditions, require the majority of the board of directors to be citizens of a particular country). Article 1109 requires the NAFTA government to allow the free transfer of monies generated by the investment, and Article 1110 prohibits the direct or indirect expropriation of an investment, unless certain conditions are met, and the affected investor receives fair compensation in a prompt fashion.

B. Rules For Arbitrating Chapter 11 Claims

(1) Limits on Access to Chapter 11 Arbitration

If a NAFTA investor suffers loss or damage because a NAFTA government (other than the investor’s own government) has violated Chapter 11’s rules, Chapter 11 may allow the investor to launch arbitration proceedings against that government. However, there are limits to this right. First, the investor himself must qualify for Chapter 11 protection. In most cases, this requirement does not pose any issues. However, if the investor is controlled by a non-NAFTA country with whom the NAFTA government

involved in the dispute does not have diplomatic relations, that government can deny the investor all the benefits of Chapter 11.¹

Second, to trigger arbitration rights, the claim must involve damage to a NAFTA investor or his investment. Chapter 11 defines the term “investment” to exclude simple claims for money under a contract.² Since this type of contract claim is not an “investment,” it would not be subject to Chapter 11’s rules on investment, and thus it could not trigger arbitration rights under Chapter 11.

In addition, as noted above, a Chapter 11 arbitration can only go forward if the investor and the NAFTA government concerned bear a certain relationship to each other. Specifically, the investor cannot use Chapter 11 arbitration to resolve a claim if he is a citizen of the NAFTA country he is complaining about. Article 1116 states: “An investor

¹ Article 1131(1) incorporates this exception, as follows:

A Party may deny the benefits of this Chapter to an investor of another Party that is an enterprise of such Party and to investments of such investor if investors of a non-Party control the enterprise and the denying Party:

- (a) does not maintain diplomatic relations with the non-Party; or
- (b) adopts or maintains measures with respect to the non-Party that prohibit transactions with the enterprise or that would be violated or circumvented if the benefits of this Chapter were accorded to the enterprise or to its investments.

² Article 1139’s definition of investment states, in part:

[I]nvestment does not mean,

- (i) claims to money that arise solely from
 - (i) commercial contracts for the sale of goods or services by a national or enterprise in the territory of a Party to an enterprise in the territory of another Party, or
 - (ii) the extension of credit in connection with a commercial transaction, such as trade financing, other than a loan covered by subparagraph (d); or

of a Party may submit to arbitration ... a claim that another Party has breached an obligation” (Emphasis added.) By using the term “another Party,” Article 1116 clearly excludes claims made against the investor’s own government from Chapter 11 arbitration.

Furthermore, Article 1108, read together with NAFTA Annexes I - IV, allows specified government measures to be exempted from certain Chapter 11 rules. Obviously, if a Chapter 11 rule does not apply to a particular government action, an investor cannot claim that this rule has been broken and use Chapter 11 arbitration to obtain damages. Article 1108 both sets out the particular Chapter 11 rules that can be avoided in a particular circumstance and refers to the appropriate NAFTA Annex where the exception must be memorialized in order to be effective. Thus, for example, Article 1108 allows national treatment, most favored nation status, and several other Chapter 11 rules to be waived for government measures in certain sectors, if the concerned NAFTA government lists the desired exceptions in the appropriate NAFTA Annex (I - IV). NAFTA Annexes I – IV list the sectors where particular government measures will not be subject to certain Chapter 11 rules and then list the specific rules that will not be applied to those measures.³

-
- (j) any other claims to money, that do not involve the kinds of interests set out in subparagraphs (a) through (h).

³ For example, Annex II-C-2 states:

Type of Reservation: National Treatment (Article 1102)

Description: Investment

Canada reserves the right to adopt or maintain any measure relating to residency requirements for the ownership by investors of another Party, or their investments, of oceanfront land.

Article 1138, the other major provision setting forth exceptions to Chapter 11's rules, takes a different approach from Article 1108. Instead of relieving certain government actions from Chapter 11's substantive obligations, Article 1138 provides simply that selected national security measures and other measures listed in Annex 1138.2 are not subject to Chapter 11 arbitration.⁴ Thus, even if a certain national security measure has violated all of Chapter 11's rules, an investor cannot successfully use Chapter 11 arbitration to pursue a grievance related to those violations.

(2) Chapter 11 Arbitration Procedures

The procedures to be followed in a Chapter 11 arbitration are fairly straightforward. An investor must launch a Chapter 11 arbitration within three years following the date he knew (or should have known) he suffered loss or damage from the government's alleged breach of its Chapter 11 obligations. (Article 1116). The investor must notify the concerned government of his intention to file a claim at least 90 days before the claim is submitted. (Article 1119).

If consultations between the investor and the government do not resolve the claim, and at least six months have elapsed since the claimed damage occurred, the investor can submit his claim to arbitration under one of several sets of international arbitration rules. (Article 1120.) Submission of a claim to Chapter 11 arbitration

⁴ Article 1138 states:

1. Without prejudice to the applicability or non-applicability of the dispute settlement provisions of this Section or of Chapter Twenty (Institutional Arrangements and Dispute Settlement Procedures) to other actions taken by a Party pursuant to Article 2102 (National Security), a decision by a Party to prohibit or restrict the acquisition of an investment in its territory by an investor of another Party, or its investment, pursuant to that Article shall not be subject to such provisions.

2. The dispute settlement provisions of this Section and of Chapter Twenty shall not apply to the matters referred to in Annex 1138.2. (Article 1138)

requires the investor to waive any right to seek damages in any other administrative or judicial forum. Moreover, if the investor wishes to launch any action for injunctive relief, these claims cannot be heard under Chapter 11. They can only be heard by a tribunal governed by the laws of the country defending against the investor's claims in the Chapter 11 arbitration. (Article 1121(1)(b) and Article 1121(2)(b)).⁵

Once an arbitration is requested, three arbitrators are selected -- one by the investor, one by the disputing government, and normally, the third by agreement of both parties. (Article 1123)⁶ The arbitration proceeds under the international procedural rules selected by the investor, and the tribunal decides the case using the NAFTA and other international law rules. (Article 1131(1))⁷

⁵ Article 1121(1)(b) articulates the basic rules as follows:

1. A disputing investor may submit a claim under Article 1116 to arbitration only if:
 - (b) the investor and, where the claim is for loss or damage to an interest in an enterprise of another Party that is a juridical person that the investor owns or controls directly or indirectly, the enterprise, waive their right to initiate or continue before any administrative tribunal or court under the law of any Party, or other dispute settlement procedures, any proceedings with respect to the measure of the disputing Party that is alleged to be a breach referred to in Article 1116, except for proceedings for injunctive, declaratory or other extraordinary relief, not involving the payment of damages, before an administrative tribunal or court under the law of the disputing Party. (Article 1121(1)(b))

⁶ Article 1123 allows the parties to the arbitration to use a different number of arbitrators or to appoint the arbitrators using a different approach from what article 1123 outlines, but this is only allowed if all parties to that arbitration agree. If the parties fail to agree on an arbitral panel within 90 days from the date the claim is submitted, Article 1124 provides that the secretary-general of ICSID will appoint the arbitrators. This ensures that the arbitration will proceed without undue delay.

⁷ Article 1131(1) states:

A Tribunal established under this Section shall decide the issues in dispute in accordance with this Agreement and applicable rules of international law.

The only potential forms of relief available to an investor through a Chapter 11 arbitration are damages, property restitution and the award of costs. As Article 1135(1) states:

Where a Tribunal makes a final award against a Party, the Tribunal may award, separately or in combination, only:

- (a) monetary damages and any applicable interest;
- (b) restitution of property, in which case the award shall provide that the disputing Party may pay monetary damages and any applicable interest in lieu of restitution.

A tribunal may also award costs in accordance with the applicable arbitration rules.

The arbitral tribunal cannot award punitive damages (Article 1135.3), and it cannot recommend or order changes in the affected government's laws or enjoin any government action that was the basis of the investor's claim. As Article 1134 explains:

A Tribunal may order an interim measure of protection to preserve the rights of a disputing party, or to ensure that the Tribunal's jurisdiction is made fully effective, including an order to preserve evidence in the possession or control of a disputing party or to protect the Tribunal's jurisdiction. A Tribunal may not order attachment or enjoin the application of the measure alleged to constitute a breach referred to in Article 1116 or 1117. For purposes of this paragraph, an order includes a recommendation.

If the arbitration tribunal awards damages to the investor, the award can be enforced in any of the NAFTA territories. (Article 1136.4) In addition, the NAFTA government whose investor was party to the arbitration can use NAFTA Chapter 20 procedures to press for enforcement, using the arbitration provisions set forth in NAFTA

Chapter 20. (Article 1136.5) Finally, the investor can use international arbitration enforcement rules to ensure enforcement of his claim. (Article 1136.6.)

III. How To Raise The Defense That NAFTA Annexes I-IV Preclude Making A Valid Chapter 11 Claim

As discussed above, NAFTA governments have excluded measures respecting certain sectors from many of Chapter 11's rules by listing exceptions in NAFTA Annexes I - IV. An investor cannot obtain damages under Chapter 11 if his claim falls within these exceptions. To minimize confusion in determining what is and is not covered by Chapter 11 rules, Chapter 11 includes some basic procedures to assist in raising the defense that a government action is not subject to Chapter 11 arbitration.

A. Forestalling Arbitration Proceedings Entirely

Two Chapter 11 provisions provide a means at the outset of a case to avoid litigating a claim that falls outside the Chapter's scope. First, Article 1119 requires the investor to notify the concerned government of the proposed claim at least 90 days before the claim is submitted. This prior notice gives the government the opportunity to meet with the investor and communicate the fact that a claim is excluded from Chapter 11 coverage. Article 1118 then reinforces the opportunity to resolve the case early by urging the disputing parties to settle claims rather than launching any formal litigation: "The disputing parties should first attempt to settle a claim through consultation or negotiation."

B. Raising The Chapter 11 Exclusions Once An Arbitration Commences

If formal arbitration proceedings commence nonetheless, the disputing government can, of course, simply ask the arbitral tribunal to end the case on the basis of

the defense that the claim is not valid, given the terms of Annexes I – IV. In most cases, this request should lead the tribunal, after due consideration of the point, to dismiss the errant claim. However, to avoid the risk of any tribunal confusion concerning how the exceptions in Annexes I – IV should be interpreted, Article 1132 outlines additional procedures to allow a government’s defense based on NAFTA Annexes I-IV to be evaluated quickly and fairly. Specifically, Article 1132(1) allows the government to request a formal interpretation on the issue from the NAFTA Free Trade Commission (“FTC”). This interpretation must be submitted in writing within 60 days following receipt of the request.⁸

Article 1131(2) and Article 1132(2), read together, then clearly establish that the FTC’s interpretation of the Annexes’ exceptions will be binding on the arbitral tribunal hearing the claim. Article 1131(2) states: “An interpretation by the Commission of a provision of this Agreement shall be binding on a Tribunal established under this Section.” This establishes that the FTC can issue binding interpretations of any NAFTA provisions. The first sentence of Article 1132(2) then reinforces this general point with respect to the specific interpretation of reservations and exceptions set out in NAFTA Annexes I – IV: “Further to Article 1131(2), a Commission interpretation submitted under paragraph 1 [concerning the scope of Annex I-IV exceptions and reservations] shall be binding on the Tribunal.”

⁸ These requirements are described in Article 1132(1) as follows:

Where a disputing Party asserts as a defense that the measure alleged to be a breach is within the scope of a reservation or exception set out in Annex I, Annex II, Annex III or Annex IV, on request of the disputing Party, the Tribunal shall request the interpretation of the Commission on the issue. The Commission, within 60 days of delivery of the request, shall submit in writing its interpretation to the Tribunal.

Although it may not be obvious on the surface, Article 1132 offers significant protection to the disputing government by ensuring that the NAFTA Annexes will be interpreted as intended by their drafters, i.e., the NAFTA governments. An arbitral tribunal may or may not be sensitive to the language and structure adopted by the NAFTA parties in developing the NAFTA Annex exceptions. The tribunal also may not appreciate the political sensitivities that require careful interpretation of the Annexes, so that no NAFTA government is uncomfortable with the impact of an interpretation on the exceptions it has requested through the Annexes.

Article 1132 recognizes these areas of concern and therefore makes the FTC responsible for interpreting the Annexes, if any disputing government requests use of this resource. The FTC is composed of cabinet-level representatives of each NAFTA country. It therefore is both politically sophisticated and able to make sensitive, high-level policy decisions. The FTC also operates by consensus under Article 2001(4), so its decision making will reflect a viewpoint acceptable to all NAFTA governments. In short, use of the FTC as the source of definitive guidance to the arbitral panel on how interpret the Chapter 11 exceptions included in NAFTA Annexes I-IV provides strong reassurance to all the NAFTA governments that measures respecting the sectors excluded from Chapter 11's rules, in fact, will not be subjected to Chapter 11 arbitration claims.