Canadian Centre for Policy Alternatives

Briefing Paper Series: *Trade and Investment*

Volume 2, Number 3 June 11, 2001

Canadian government retreats on NAFTA investor-state concerns

by Scott Sinclair

Summary

At the Quebec Summit, Prime Minister Chretien declared that the NAFTA investor-state rules were working "reasonably well." The prime minister's remarks could hardly have come at a worse time for those concerned about corporations' increasing use of NAFTA Chapter 11 to attack public interest regulations.

Chretien's remarks badly weakened the Canadian position just prior to crucial meetings where NAFTA trade ministers are to discuss Canadian concerns about the investment provisions of NAFTA. Worse, the Prime Minister's comments give a green light to more investor-state litigation under the Chapter 11 provisions just as these controversial cases are reaching a critical mass.

While many press reports still cite Mexican opposition as the major obstacle to Chapter 11 reform, it is now becoming clear that U.S. opposition is the main roadblock. The U.S. administration opposes interpretive language to restrict the scope of the NAFTA investment provisions. U.S. Trade Representative Robert Zoellick recently stated that he did not believe that the spate of investor-state cases warranted changes to NAFTA's investment chapter. The most powerful U.S. government foreign economic policy agencies—Commerce, Treasury, and USTR—oppose restricting the NAFTA investment provisions.

The U.S. corporate community has also rallied behind the most extreme interpretations of the investment chapter. In an extraordinary letter released April 19 in Quebec, top U.S. corporations strongly endorsed NAFTA's investor-state dispute provisions, including highly controversial protection against so-called "regulatory takings," or, as the letter puts it, "protection of assets from direct or indirect expropriation, to include protection from regulations that diminish the value of investors' assets."

Discussion

Emerging from an April 22 luncheon meeting with Presidents Bush and Fox, P.M. Chretien was asked about the "status of including Chapter 11-like NAFTA provisions in the FTAA." The P.M. responded, "Some don't like it, but I do think that it is a good (sic), a clause that works reasonably well (Summit of the Americas, transcript of last press conference, April 22, 2001)."

Before the P.M.'s intervention, the Canadian government had been widely perceived as the NAFTA party most deeply concerned about the negative public policy implications of investor-state disputes. Trade Minister Pettigrew and his predecessor, Sergio Marchi, had both stated that the NAFTA investment chapter must be "clarified" to "ensure that government's ability to legislate and regulate in the public interest is protected (e.g., Sergio Marchi, Notes, NAFTA fifth anniversary luncheon, Ottawa, April 23, 1999)."

Pettigrew has been seeking agreement on interpretive language to limit the scope of NAFTA Chapter 11. He had also stated, on

several occasions, that Canada would not seek to replicate the NAFTA investor-state provisions in the FTAA or other agreements.

Late last year, Pettigrew wrote to his NAFTA counterparts asking for their views on the growing use of investor-state claims against public interest regulations. In a December 2000 interview with the **Globe and Mail**, Pettigrew stated that he would not sign an FTAA deal if it includes a Chapter 11 equivalent. "That's my position," he said. "I'm very preoccupied with this." And, appearing before a House of Commons committee on April 5, 2000, he again testified that "On Chapter 11...I can assure you that we are not seeking an investor state provision in the WTO or anywhere else under (sic) agreement."

Chretien's recent statement marked an unmistakable shift in Canadian policy. Speaking in the Commons the week after the Quebec summit, he reaffirmed that Canada has retreated in its efforts to "clarify" Chapter 11. He discounted the possibility of any changes resulting in the near future. "We will always look at it and improve it if it is in the interest of all partners to do so, but Chapter 11 has been there for the past seven years. At this moment there is no likelihood that it will be changed within the next few months."

Since Quebec, a chastened Pettigrew has also toed the new uncritical line. In the Commons and elsewhere, he has reiterated that:

1 the NAFTA investment chapter works "reasonably well;"
2 in proportion to overall Canada-U.S. trade flows, the impact of the investor-state disputes is small;
3 for the foreseeable future, there will be no changes in NAFTA investor-state; and
4 Canada continues to support investor-state as a key element in trade and investment agreements.

Even before the P.M. deliberately distanced himself from the Trade Minister's position, it was clear that senior DFAIT officials were uncomfortable with their minister's earlier, "off-script" comments on Chapter 11.

The US opposes change

Canadian backpedaling reflects firm U.S. resistance to any interpretive language limiting the scope of NAFTA Chapter 11 provisions or the authority of investor-state tribunals. NAFTA Article 1131 provides for the NAFTA Commission, comprised of the three trade ministers, to make binding interpretations of NAFTA provisions. But the U.S. is unwilling to take this step.

Investor-state dispute settlement and protection against expropriation, as broadly defined by international law, have been longstanding objectives of U.S. foreign economic policy and key features of bilateral investment treaties (BITs) that it has pursued with trading partners around the world (see, for example, "Communication from the United States, Elements of Traditional Investment Agreements," WTO, WT/WGTI/W/29, March 24, 1998). U.S. Trade Representative Robert Zoellick recently told U.S. environmental groups that he did not believe that the investor-state provisions of NAFTA needed to be changed (*Inside US Trade*, April 20, 2001).

While the Environmental Protection Agency and the Department of Justice have reportedly been open to proposals to restrict the scope for challenging public interest regulation under the NAFTA investment chapter, the more powerful Departments of Treasury and Commerce, as well as the USTR, have strongly resisted such suggestions (*Inside US Trade*, Jan. 15, 1999).

In the view of the U.S. foreign economic policy agencies, such interpretive language attached to NAFTA might weaken investment protection provisions in U.S. bilateral investment treaties and create uncertainty about the applicability of the body of BIT case law to future NAFTA cases. Also, the U.S. corporate community is evidently pleased with the ex-

traordinary rights it acquired under the NAFTA investment chapter and will strongly resist any efforts to limit them. In its April 19 letter (attached) released at the Summit of the Americas, the corporate community embraced an extreme interpretation of protection against expropriation that clearly goes well beyond domestic law in all three countries. The partial setting aside of the Metalclad award by a B.C. court has provoked calls from the U.S. business community to strengthen the NAFTA investment provisions (*Inside US Trade*, May 11, 2001).

Trade ministers discussed NAFTA investment issues at a May 8 trilateral meeting, and the issue is on the agenda again at the next meeting of the NAFTA Commission in July. But it is now quite unlikely that any significant reforms will result. Even at this late date, it is not clear what concrete proposals the Canadian government will put to its NAFTA counterparts. The U.S. administration may possibly be more open to reforms to improve the transparency of the investor-state process than to substantive interpretive notes.

"Clarifying" the NAFTA investment chapter?

With Canada's retreat, there are now no serious official prospects for limiting the scope of NAFTA's investment chapter or investor-state dispute settlement procedures in the near-term. But even Canada's now attenuated proposals, while they might limit some of the worst tribunal excesses, would not adequately protect governments' right to legislate and regulate in the public interest.

Canadian trade officials have never called for any substantive changes to the NAFTA investment chapter. They insist that all that is required is interpretive language to "clarify the intentions of the NAFTA drafters." While tribunals have interpreted certain NAFTA investment provisions (such as Article 1105, Minimum Standard of Treatment) in unexpected ways, it is highly implausible that the NAFTA drafters never intended the chapter to be used by investors to challenge public interest regulation.

NAFTA Chapter 11 (Article 1122) clearly stipulates that the three NAFTA parties give their unconditional prior consent to submit any matter raised by a NAFTA investor to binding commercial arbitration. Furthermore, Article 1136(7) deems any claim submitted to arbitration to "arise out of a commercial relationship" even if, as with most of the current NAFTA disputes, there is no privity of contract between the government and the disputing investor. As the government of Mexico argued succinctly, but without effect, in the B.C. courts, the relationship between Metalclad and Mexico was not commercial, it was a "relationship between government and the governed, between legislator and the subject of legislation (Mexico's Outline of Argument, Supreme Court of B.C., Jan. 22, 2001, para. 145)."

The substantive NAFTA investment protections are broadly worded, inviting tribunals to interpret them accordingly. Article 1110, for example, includes protection against "direct," "indirect" and "measures tantamount to" expropriation, creating remedies far beyond those available under domestic law. The B.C. Supreme Court judge in the Metalclad review confirmed this, stating: "The panel gave an extremely broad definition of expropriation for the purposes of Article 1110. In addition to the more conventional notion of expropriation involving taking a property, the tribunal held that expropriation under NAFTA includes 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 the property. This definition is sufficiently broad to include a legitimate rezoning of property by a municipality or other zoning authority (The United Mexican States vs. Metalclad Corporation, B.C. Supreme Court, May 2, 2001, para. 99)." The judge was clearly

uncomfortable with this extreme view, but had no authority to interfere with it.

Furthermore, the NAFTA framers did not allow any reservations (country-specific exemptions) to exempt government measures, such as municipal planning or zoning, from this specific article (Article 1110). Nor did negotiators include any general exceptions in the investment chapter to insulate government public interest measures from such challenges.

The broad intentions of NAFTA's drafters are therefore reasonably clear, and tribunals have not hesitated to give them effect. The NAFTA investment chapter and investor-state are being used more or less as their framers intended, or at least as competent negotiators should have clearly anticipated. It is not credible for trade officials to now feign surprise that investors have aggressively exploited these recklessly worded provisions.

Conclusion

Because of Canada's retreat, continuing U.S. resistance, and vigorous corporate lobbying, the near-term prospects that the NAFTA governments will, of their own accord, implement meaningful reforms to restrict the scope of investor-state and the NAFTA investment provisions are quite poor.

The decisions by Mexico and Canada to review the Metalclad and S.D. Myers tribunal rulings in the domestic courts are a positive development. These reviews, which can be appealed to the Supreme Courts, will increase the time, effort and financial risk to investors who invoke the NAFTA process. But, as the B.C. Supreme Court decision revealed, the scope of these judicial reviews is strictly limited.

Although the standards of review depend on the applicable domestic legislation, courts generally cannot make their own findings of fact or revisit substantive points of law decided by the tribunal. On most matters, the courts must defer to the tribunal and are usually confined to considering issues such as whether the tribunal exceeded its jurisdiction or was corrupt. Some North American jurisdictions provide for the automatic enforcement of commercial arbitration awards, and complainants can now be expected to insist on such favourable jurisdictions as the place of arbitration. State and provincial governments should be pressed to change their legislation governing the review of NAFTA arbitral awards to give domestic courts greater authority to set them aside.

But to fully remove the threat to the governments' right to regulate and legislate in the public interest, the NAFTA investment chapter must be fundamentally changed. Now that its extreme policy consequences are clear, investor-state should be excised from NAFTA and other investment treaties. On sensitive matters such as expropriation, foreign investors should not have rights beyond those available to everyone else under domestic law, which already provides for prompt and effective compensation in cases of genuine expropriation.

Governments must somehow be compelled to act, even over the objections of multinational corporate lobbyists. Therefore, corporate support for investor-state and the extreme interpretations of NAFTA's investment chapter must be publicly criticized and weakened. For example, the major auto companies were among the signatories to the April 19 letter. Are the major auto companies asserting that regulation to combat global warming or to reduce auto emissions are equivalent to expropriation if they reduce the value of the companies' assets? Is this the auto manufacturers' view of good corporate citizenship and sustainable development? Is this how they wish to be publicly branded?

Perhaps the most realistic hope for significant change is that the growing number of investor-state cases, and their extreme policy implications, will result in a public outcry that governments will be unable to ignore. If more

cases are targeted against the U.S., or if it loses an important case, then the pressure on the U.S. administration to accept change will grow. Sub-national governments, and in particular the governments of large U.S. states, may play an important role. As awareness of the risks to public policy grows, state, provincial and local governments could become part of a broader public groundswell insisting on change.

The next couple of years will be a critical period. The number of known NAFTA investor-state cases (now approximately 20) has reached a critical mass. The success of the early claimants in getting substantial awards ensures that corporate law firms will now advise their clients to consider the NAFTA investor-state option. The costs of bringing an investor-state case are small in comparison to the potential financial and policy payoffs. Without strong political action to choke off this litigation, the number of cases will grow, public liabilities will mount, and regulatory chill will deepen. Canada's policy retreat therefore could hardly have come at a worse time.

Scott Sinclair is a Senior Research Fellow with the Canadian Centre for Policy Alternatives. He can be reached at sinclair@isn.net.

Appendix

April 19, 2001

The Honorable Robert Zoellick
United States Trade Representative
600 17th St. NW
Washington, DC 20508

Dear Ambassador Zoellick:

We are writing to affirm the business community's support for the inclusion of effective investment provisions in the proposed Free Trade Agreement of the Americas (FTAA) and in free trade agreements with Chile and Singapore.

International investment is a sine qua non for U.S. firms to compete successfully in today's globalized economy. Investment is a principal catalyst for economic growth in developing countries and helps to ensure that globalization is an inclusive, rather than an exclusive process.

Investment agreements facilitate this objective by helping to create stable business environments, which in turn generate substantial growth opportunities. To that end, we endorse investment provisions, modeled on NAFTA, to achieve the following:

- removal of barriers to entry;
- 100 percent foreign ownership of investments permitted;
- non-discriminatory and fair and equitable treatment guaranteed;
- elimination of performance requirements;
- protection of assets from direct or indirect expropriation, to include protection from regulations that diminish the value of investors' assets;
- guarantee that investor disputes with host governments can be brought to arbitration panels such as those offered by the World Bank's Center for Dispute Settlement; and transparency in government rulemaking.

Recently, U.S. investment agreements have come under attack. Citing recent cases, critics argue that NAFTA's investment rules, and the findings of "secret" arbitration panels impede a government's ability to promote environmental protection.

We respectfully disagree. Investment treaty provisions are no bar to, but can compliment strong, effective, and transparent regulations to protect the environment, as well as worker safety and health. Indeed, investment treaty protection serves to encourage international investment which frequently includes the transfer of environmental technologies and practices. We would be pleased to work with you to develop ideas to address these issues.

Identical letters are being sent to Secretaries Powell, Evans, and O'Neill.

Thank you for consideration of our views.

Sincerely,

American Chemistry Council
American Forest and Paper Association
Caltex Corporation
Chevron
Chubb Corporation
Daimler-Chrysler
The Dow Chemical Company
E.I. Du Pont De Nemours and Company
Eastman Chemical Company
Emergency Committee for American Trade
The Estée Lauder Companies, Inc.
Ford Motor Company
General Electric
General Motors Corporation
Hills and Company
Honeywell International Inc.
International Paper
3M
Metalclad Corporation
Motorola Inc.
National Association of Manufacturers
National Foreign Trade Council
Pacific Basin Economic Council, U.S. Committee
PricewaterhouseCoopers LLP
Procter & Gamble
Texaco Inc.
U.S. Chamber of Commerce
United States Council for International Business
United Parcel Service

(published in *World Trade Online,* the electronic service of *Inside U.S. Trade*)

Canadian Centre for Policy Alternatives
Suite 410-75 Albert Street, Ottawa, ON K1P 5E7
tel: 613-563-1341 fax: 613-233-1458
email: ccpa@policyalternatives.ca web site: www.policyalternatives.ca

CAW 567
OTTAWA