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Subject: NAFTA News - Final Awards in the Karpa and ADF Cases

Two final awards became available over the past couple of days, in which a claim against the USA was dimissed and a claim against Mexico was accepted. The following are some very preliminary thoughts about each award. In making them, I do not purport to be giving a thorough review of the findings of each Tribunal. These are merely the issues which essentially "caught my eye" upon my first glance. My views may change upon a more thorough reading and further reflection.

A. Group ADF v. USA

The case involved a Canadian company, ADF, that participates in large scale constructions projects, by providing fabricated steel. ADF has a US subsidiary, but some of the steel processing that it normally undertakes, happens in Canada. ADF was precluded from participating in a large highway interchange project in Virginia because the federal funding for this state-government-run project required all steel used in construction to be made in the USA. The USA admitted that these requirements were "performance requirements" which are prohibited under NAFTA Article 1106(1), but saved under an exception in Article 1108 for "procurement by a Party."

The Investor did not claim that the state's procurement violated NAFTA Chapter 11, but rather that the federal funding requirements violated Articles 1102, 1116 and 1105, because they (in and of themselves) were not any kind of procurement (including the kind of "procurement" mentioned in the Article 1108 exception). Virginia did not impose any such requirements, and so the US Government should not have done so as a condition of providing funding for the project. The Tribunal gave short-shrift to the investor's primary argument, and simply concluded that the measures at issue did constitute the kind of procurement which is exempted under Article 1108.

1. Jurisdiction

First, it is interesting to note that the Tribunal seems to have followed the trail set by tribunals in cases such as Ethyl Corp. v. Canada and Pope & Talbot v. Canada, in concluding that it had jurisdiction to hear all of the claims made by the investor. The investor had failed to include a claim for breach of Article 1103 (MFN treatment) in either its notice of intent or its statement of claim. The NAFTA governments all argued that the investor was unable to seek relief under Article 1103 as a result. The tribunal disagreed, concluding that the provisions of NAFTA Articles 1116-1122 were not to be interpreted so strictly or narrowly as to preclude the ability of a tribunal to hear claims which were not submitted in accordance with all of the detailed pleading requirements set out therein. While not referring to the work of other tribunals, the ADF Tribunal appeared to recognize that there is a difference between truly mandatory preconditions to validly launch an arbitration, and merely permissive ones. The claim was validly launched, and the USA could demonstrate no prejudice in having to respond to Article 1103 arguments which were only made by the investor as a result of later developments in the case, in its supplemental memorial. This approach bodes well for future litigation, showing that tribunals will consistently prefer to go straight to the heart of a matter, rather than deal with the more pedantic "jurisdictional" defences asserted by NAFTA governments.

2. National Treatment

Second, the Tribunal made a very important finding concerning the relationship between the regulation of measures affecting trade in good and measures affecting investors and their investments. The Tribunal concluded that Article 1102 (the national treatment provision) required it to consider whether the goods acquired by the investor in the USA (which constituted an "investment" in the USA) were being treated no less favourably than the US-

origin goods of other investors. Just because the measures in question were primarily aimed at goods, does not mean that they could not have an impact upon investors and their investments in relation to such goods.

In application of the national treatment test, the Tribunal concluded that the investor had failed to demonstrate that any US investor had been able to use its "investment" (i.e. its steel) in a way that the investor could not. If a US investor had been able to use Canadian-processed steel in the highway project from which ADF's Canadian-processed steel had been excluded, there would have been a breach of Article 1102. The Tribunal appears to have been willing to entertain the argument that, as a matter of fact, ADF's US competitors would never process their steel abroad because of the nature of the business. However, the Tribunal found that no such evidence was presented (thus making this case distinguishable from the WTO bananas case, were it was concluded that banana wholesalers were, as a matter of fact, quite likely to be importing only bananas from their "own" countries).

This 1102 analysis essentially imposes a very high strategic burden on future claimants to provide evidence of discrimination. Assuming this analysis is adopted (and it really is the same analysis that the WTO Appellate Body applied in the Canada - Autopact case), investors who put goods to some sort of commercial use in another country's market will be able to prove discrimination, but they will not be able to rely on a "goods analysis" to do so. This is because what would constitute a "de jure" breach of the NAFTA's goods provisions in any given case (e.g. a prohibition against the use of foreign goods in a highway project), will only constitute a potential "de facto" breach for investors. IN other words, a measure that is discriminatory, on its face, with respect to the regulation of goods, is only a potential form of discrimination, when one analyses its impact with respect to the people who own those goods in the foreign country.

Accordingly, to be successful in future cases involving the ownership and use of goods as an investment in another country, investors may need to establish some kind of link between the different treatment being accorded to their foreign-sourced goods, and their own foreignness.

3. Article 1105 and the NAFTA Commission Statement

The most disturbing finding of the ADF Tribunal lies in its complete submission to the collective will of the NAFTA governments concerning the interpretation of Article 1105. As readers of previous editions of this newsletter will recall, two NAFTA tribunals have taken the NAFTA governments to task for essentially trying to amend the provision through the issuance of an interpretative note under Article 1131(2). By contrast, the ADF Tribunal inexplicably towed the "NAFTA Party line" without expressing any of the grave concerns expressed by the other tribunals. Acting a little more like a WTO panel than an investor-state tribunal, it simply refused to inquire as to whether the NAFTA governments were acting beyond their authority in issuing their statement on Article 1105 in the summer of 2001. It will be the task of future tribunals to decide which approach is more in keeping with the principles of customary international law.

The question of what protections exist for an investor in "customary international law" under Article 1105 was not resolved by the ADF Tribunal. It merely concluded that the investor had failed to provide sufficient evidence that a customary international law rule exists which would require states to provide "fair and equitable" treatment to an investment. This conclusion may appear somewhat puzzling, given that the NAFTA Parties all agree that "fair and equitable treatment and full protection and security" are indeed required to be given under Article 1105, which constitutes customary international law. What the Tribunal was likely trying to do was to address the actual standards against which state conduct should be judged, under customary international law. It was saying that "fair and equitable treatment," in the broadest sense of those words, was not a standard which the investor had proved should be the standard applied using customary international law. It may be the standard, but the investor apparently failed to prove it. There may be other applicable rules or principles, but the investor apparently failed to introduce or prove them either.

This conclusion makes sense when connected to the investor's alternative argument that it was entitled to "fair and equitable treatment," in the broadest sense, because that is what is required of the US government in other bilateral investment treaties. By virtue of Article 1103 (the MFN provision), whatever treatment the US gives to one set of

investors under one treaty must also be given to others under a different treaty. The ADF Tribunal noted that it would require more evidence to accept the argument that the US had actually agreed to provide "fair and equitable treatment" - in the broadest sense of those words - to other investors under other treaties. (Such an argument is based on the premise that other US investment protection treaties require "treatment in accordance with international law" in addition to other standards of treatment, including "fair and equitable treatment" - which must mean something more than whatever "treatment in accordance with international law" requires.) However, the Tribunal concluded that it did not need to go down this road because - in respect of these particular facts - the investor could not use Article 1103 to get whatever "better" protection might lie in other investment treaties. This is because the procurement exception, provided under Article 1108, precluded recourse to Articles 1102, 1103 or 1106.

Accordingly, arguments as to whatever protection for foreign investors lies in the principles and rules of customary international law (which are all that the NAFTA Parties have agreed can be accessed under Article 1105) will wait for another day, as will arguments as to the applicability of a MFN analysis to Article 1105, as watered-down by the NAFTA Commission.

B. Karpa v. Mexico

The case involved a claim by the investor that Mexico's decision not to provide rebates for significant export taxes paid for the export of cigarettes from Mexico constituted the creeping expropriation of its business in Mexico, which violated NAFTA Article 1110 and resulted in discriminatory treatment between it and domestic competitors under Article 1102 (national treatment).

1. Expropriation

The Tribunal's first finding, that there was no expropriation of the investment appears to be based on a cumulative finding which could be rationalized further than the Tribunal chose to go. It appears that the Tribunal ultimately determined that the impact of the government's action did not sufficiently harm Karpa's investment in Mexico so as to constitute a taking. Karpa's sales/distribution business was still functioning, albeit not in the area of cigarettes, but certainly with respect to the export of other commodities.

The Tribunal probably should have ended its expropriation analysis right there. Nonetheless, it went on to include an "acquired rights" analysis which was based on two premises: (1) that international law did not require the state to permit the "grey market" sale of cigarettes; and
(2) that there was never any "right" (presumably under Mexican law) to export cigarettes. At first blush, these premises appear to ignore the basic principle of freedom of commerce, which is enshrined in the NAFTA. If all a state had to do to escape an expropriation claim was to demonstrate that the investor did not have a positive "right" to engage in the business which was taken (or that, conversely, international law did not positively require the state to permit such business activity), there would be precious little that could not be expropriated without the prompt payment of proper compensation.

We live in an increasingly interdependent world, where foreign investment is no longer operated primarily by way of concession agreement with the host state. While I highly doubt that the tribunal members had anything of the sort in mind when the award was drafted, some aspects of its expropriation analysis could be used to advance a theory that unless a state positively consents to the investment activity of a foreigner (by way of concession agreement or regulatory instrument of general application), it cannot be held liable for taking it. International law surely must provide greater protection against uncompensated takings than that.

2. National Treatment

The tribunal provided a straight-forward, but articulate analysis of Article 1102 (the national treatment obligation) in respect of these facts. One could quibble, however, with the approach taken to determine which investors should be considered to be in "like circumstances" (in order to compare whether different treatment was being provided to

investors who should not be treated differently). The Tribunal seemed to focus more on the character of the businesses involved, rather than on the more fundamental question of who was actually in competition. This may have been a factor of the evidence and pleadings before it, but one would have liked to see a more detailed analysis of the factors of competition at play (much like that which one might see in an antitrust law analysis). Nonetheless, the Tribunal made an important, and correct, finding that Article 1102 definitely protects investors from all discriminatory treatment - whether intended or not. This is a welcome conclusion that is in concert with WTO jurisprudence on the national treatment rule.

Drawing Adverse Inferences as to the Facts of the Case

What is perhaps most interesting about this award is that, in rendering it, the Tribunal became the first to actually apply the well-established international law rule that an adverse inference may be drawn against a government if it fails to provide sufficient evidence to rebut the prima facie facts established by the claimant. Such findings are even rare in the WTO context, although the Appellate Body has approved of the rule itself. In this case, a majority of the Tribunal concluded that Karpa provided enough evidence to show that it had not received tax rebates during the same period that Mexican companies in "like circumstances" were receiving rebates. Mexico simply failed to provide evidence either that there was no effective difference in treatment, or that there was a good reason for the difference. Accordingly, the investor won. The dissenting arbitrator, who was appointed by Mexico, was completely wrong to suggest that such a finding of fact should not be made in the circumstances.

The Karpa award is therefore an important decision, because it indicates that governments must be open and transparent about the way they treat foreigners and their domestic competitors, or be prepared to face the consequences.

Regards,

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