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Sent: Wednesday, November 17, 2004 3:15 AM
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Subject: NAFTA News Flash - GAMI v. Mexico - Final Award - Weiler's Top Ten List

Dear NAFTA News subscribers:

Yesterday, the Tribunal in GAMI v. Mexico issued its final award, dismissing the investor's claim in its entirety. The following is a tentative evaluation of the Tribunal's reasons for decision. In a nutshell, I believe that the Tribunal (chaired by Jan Paulsson and joined by Professor Reisman and Lic. Lacarte Muro) has issued one of the most adroitly-reasoned and well-written NAFTA awards to date.

GAMI owned approximately 14% of the shares of a Mexican sugar-producing company, GAM. As common throughout the world, the sugar business is highly regulated in Mexico and mightily-dependent upon government intervention in many aspects of the trade, including production, marketing, imports and exports. The nub of GAMI's case was that the Mexican Government had so terribly botched the manner in which it intervened in, and regulated, the sugar trade that its action (or more often its inaction) effectively destroyed the value of its investment in GAM. When the industry collapsed, Mexico expropriated a number of sugar mills throughout the country (including GAM's sugar mills) and it attempted to keep them running. GAMI claimed damages for breaches of Articles 1105 (minimum standard); 1102 (national treatment); and 1110 (full, fair and effective compensation for expropriation).

Having read once through the award, I have scribbled down ten thoughts which I believe reflect the award's most salient aspects. They are recorded in order of their appearance in the Award, rather than in the order of their potential or relative importance for future cases:

1. It is an "indirect claim"
2. No Fork in the Road ... Even for Indirect/Derivative Claims
3. It is all about Investment Expectations in Context – i.e The Sun May Not Come Out Tomorrow
4. Misfeasance in Administration is an Actionable International Delict
5. Mexico Didn't Do It ... at Least Not All by Itself
6. The Three-Pronged National Treatment Test is here to Stay
7. Article 1102(1) Does Not Work for Indirect/Derivative Claims
8. When considering Article 1110, One Must be Careful to Define the "Investment" at Issue
9. Substantial Deprivation Does Not Mean Total Deprivation, but You Must Prove It
10. Costs will not be Awarded Lightly against Claimants

1. It is an "indirect claim"

The Tribunal took pains to note that it was dealing with what it referred to as an "indirect" claim, in that the Investor was claiming for its losses arising from its partial ownership of the investment, which – it was alleged – the Investor suffered directly as a result of the breach. In other words, the Investor did not claim that the way it was treated breached any provision of NAFTA Chapter 11. Rather, the investment in which it held an ownership interest was subjected to the allegedly wrongful treatment and – as required under Article 1116 – the Investor suffered loss and/or damage as a result. In this case the alleged harm was apparently the diminution of the value of the shares held by the Investor in the investment.

The Tribunal's finding was at odds with the arguments of both Mexico and the U.S.A., but I think it made the correct decision. An Investor can bring a claim on its own behalf under Article 1116 or it can bring a claim on behalf of any investment that it owns or controls, directly or indirectly, under Article 1117. There is no reason why an investor can not make a derivative claim for damages arising from harm caused to it through its investment (but only in proportion to its ownership interest).

The test under Article 1116 is straightforward. First, determine if there has been a NAFTA breach in relation to the investor or its investment. Second, determine if the action which was found in breach of the NAFTA caused

harm to the Investor. As the tribunal would later explain, the devil is in the details of proving the breach and causation in respect of the damages claimed.

2. No Fork in the Road ... Even for Indirect/Derivative Claims

In explaining why even a non-controlling shareholder can make a claim under NAFTA Chapter 11, the Tribunal also reaffirmed the accepted wisdom that the NAFTA does not impose a complete “fork in the road” as regards recourse to domestic judicial relief. The Tribunal clearly adheres to what one might call the “separate worlds” paradigm of international law, explaining that GAMI was entitled to bring a claim for compensation under the NAFTA, regardless of whether the controlling investors decided to pursue judicial remedies in respect of the same actions which make up the allegations before a NAFTA tribunal. As stated at paragraph 37 of the award:

“NAFTA Article 1117 would have allowed GAMI as a 100% shareholder of GAM to seek relief for alleged breaches of the treaty by Mexico. GAMI would not have been required to cause GAM to seek relief before the Mexican courts.”

Of course, NAFTA Article 1121 does require the Investor (and usually also the investment) to waive the right to pursue compensation outside of the NAFTA Chapter 11 arbitration, but the question is whether a claim could be pursued where extra-ordinary relief (i.e. not compensation) had NOT been pursued first before a domestic court.

This question arises because Mexico and Canada have consistently argued before tribunals that Article 1105 imposes no more of an obligation on governments than to basically provide investors with recourse to a functioning domestic legal system. Under such a theory, failure to have recourse to a domestic legal system is proof that no breach could have occurred.

While its reasoning on this point is not dispositive of GAMI's case, the Tribunal's reasoning nonetheless demonstrates that even circuitous attempts to return to the days of the exhaustion of local remedies rule by NAFTA Party respondents will not be easily accepted outside of cases where a court decision is squarely in play.

3. It's all about Investment Expectations in Context – i.e The Sun May Not Come Out Tomorrow

The Tribunal noted wryly at paragraph 85 that the sun does not perpetually shine on the sugar industry, although there are years when it does. It also noted that “No one has suggested that NAFTA entitles an investor to act on the basis that a regulatory scheme constitutes a guarantee of economic success. In a nutshell, the Tribunal concluded that two factors are always relevant in determining whether a Party has accorded “treatment in accordance with international law, including fair and equitable treatment and full protection and security”: (1) the legitimate expectations of the investor when making or operating the investment; and (2) the regulatory context within which those expectations have been held and/or generated.

The same could apparently be said about Article 1110 (begging the question as to whether the two obligations – 1105 and 1110 – are really that different at all). The task of the tribunal, in understanding these expectations of the investor/investment and the regulatory context, is:

“... to appraise whether and how pre-existing laws and regulations are applied to the foreign investor. It is no excuse that regulation is costly. Nor does a dearth of able administrators or a deficient culture of compliance provide a defence. Such is the challenge of governance that confronts every country. Breaches of NAFTA are assuredly not to be excused on the grounds that a government's compliance with its own law may be difficult. Each NAFTA Party must to the contrary accept liability if its officials fail to implement or implement regulations in a discriminatory or arbitrary fashion.”

The Tribunal was cautious, however, making the four following comments clarifying its understanding of what does, and does not, constitute a breach of the minimum standard of treatment:

- (1) The failure to fulfil the objectives of administrative regulations without more does not necessarily rise to a breach of international law;
- (2) A failure to satisfy requirements of national law does not necessarily violate international law;
- (3) Proof of a good faith effort by the Government to achieve the objectives of its laws and regulations may counter-balance instances of disregard of legal or regulatory requirements; and
- (4) The record as a whole – not isolated events – determines whether there has been a breach of international law.

4. Misfeasance in Administration is an Actionable International Delict

To be clear, however, the Tribunal would have been willing to accept the fundamental allegation made by GAMI: that “an abject failure to implement a regulatory program indispensable for the viability of foreign investments that had relied upon it” would constitute a breach of Article 1105, regardless of whether that failure was the result of action or inaction.

5. Mexico Didn't Do It ... at Least Not All by Itself

The problem, as noted by the Tribunal in the very same paragraph (108) in which the aforementioned quotation appeared, is that GAMI was unable to prove that the failures which led to disaster in the Mexican sugar industry in years past could all (or even mostly) be laid at the door of the Mexican Government. Apparently, the Tribunal accepted Mexico's arguments that its sugar industry regulatory regime – although a bona fide policy failure – was based upon a consensus-driven corporatist model, rather than a command-and-control model. Accordingly, the actions of other industry members, unions, regulators had a contributory role, as did other exogenous political, societal and economic factors, had a role to play in the trouble experienced by companies such as GAM.

6. The Three-Pronged National Treatment Test is here to Stay

I would have liked to see much more from the tribunal on the construction and application of Article 1102, but it said volumes in the few paragraphs it did contribute. The Tribunal essentially skipped right to the third prong of the now-ubiquitous national treatment test for foreign investment law:

- (1) Identify the comparators against which the investor and/or investment should be compared;
- (2) Determine whether better treatment has been given to any one of those comparators than that which was received – in result – by the investor/investment; and
- (3) Determine whether a good reason exists for the difference in treatment identified through application of the first two prongs of this test.

The Tribunal jumped right to the heart of the matter with GAMI, employing a proportionality approach at paragraph 114 which is clearly identifiable as “the third prong.” In denying the claim, it stated:

The arbitrators are satisfied that a reason exists for the measure which was not itself discriminatory. That measure was plausibly connected with a legitimate goal of policy (ensuring that the sugar industry was in the hands of solvent enterprises) and was applied neither in a discriminatory manner nor as a disguised barrier to equal opportunity.”

GAMI had argued that the “measure” was Mexico's decision to expropriate the sugar mills of some investors, but not others. Mexico's reason for doing so was that the ones selected for expropriation were no longer economically viable, and it was therefore in the interests of the thousands of people who relied upon their continued operation, to ensure that they remained in operation. The Tribunal expressed a willingness to show considerable deference to the government in applying this measure – because of the laudable policy goals upon which it was based. I would argue that the Tribunal was likely willing to accord too much deference – given the language it used to explain why it would not second-guess Mexico in this case – but I cannot argue with the result (and would also argue that such language was not necessary to make such a determination) in this case.

7. Article 1102(1) Does Not Work for Indirect/Derivative Claims

At paragraph 115 the Tribunal appeared to suggest that its proportionality approach was unnecessary because it was dealing with a derivative claim where the measure did not “have any connection to GAMI's participation in GAM; nor were they geared towards treating GAM in a different mode because of GAMI's participation in theory social capital.” Given that the tribunal said, at paragraph 33 – that “the fact that a host state does not explicitly interfere with share ownership is not decisive...” of whether there has been a NAFTA breach – it is more likely that the Tribunal was merely noting that GAMI had no claim under Article 1102(1), which concerns treatment of “investors” qua investors. Whether it had a valid claim under Article 1102(2), which concerns the treatment of “investments,” would naturally be treated the same as a claim under Articles 1105 or 1110, which also concern the treatment of “investments” rather than investors (qua investors).

In other words, it is likely that paragraph 115 was determinative of a GAMI claim under Article 1102(2) and paragraph 116 was determinative of a GAMI claim under Article 1102(1).

8. When considering Article 1110, One Must be Careful to Define the “Investment” at Issue

The Tribunal included a thoughtful analysis of the expropriation obligation, even though it did not appear to have need to do so. It was already acknowledged as fact that a domestic court had reversed three expropriations of GAM facilities, and that compensation would soon be paid by Mexico for the other two facilities taken from GAM. It was also acknowledged that GAMI continued to hold shares in GAM. Nonetheless, the Tribunal took the time to focus on the nature of the “investment” which would have been the subject of an expropriatory measure. The implication of its reasoning is clear: claimants must be very careful about exactly how they characterise the “investment” which was allegedly been subjected to an expropriatory measure.

In this case GAMI had very little room to move. It held shares in a Mexican company, and those shares were the only “investment” which GAMI held in the territory of another NAFTA Party. It is interesting to note that Article 1110 imposes this territorial requirement, whereas other provisions – such as Article 1102 and 1103 – do not. GAMI did not have an enterprise in Mexico (which it majority-owned and/or controlled); nor some form of tangible or intangible property or debt instrument. It just held shares. Accordingly, it was GAMI’s enjoyment of those shares which would be considered in application of the Article 1110 obligation. Obviously, as a result, it was going to be very difficult – although not impossible – for GAMI to prove expropriation in this case.

The characterisation of the “investment” will likely continue to be of great importance in future cases as well.

9. Substantial Deprivation Does Not Mean Total Deprivation, But You Must Prove It

In a statement that may well be taken out-of-context by some alarmists, the Tribunal also confirmed that – when it comes to the expropriation obligation – the “substantial interference” does not necessarily mean “total deprivation.” In other words, the deprivation caused by an expropriatory measure does not need to be total or complete to rise to the level of a measure tantamount to expropriation. Interference with the proprietary rights held in an investment must be more than “merely ephemeral” but – as the Tribunal quoted from the Tribunal in the *Santa Elena* Case – so long as the measure “effectively freezes or blights the possibility for an owner reasonably [exploiting] the economic potential of the property...” full, fair and effective compensation will need to be paid for its imposition.

The simple problem for GAMI, apparently, is that it did not prove its allegation that anything Mexico did to GAM or GAMI destroyed the “whole value” of its investment. One might ask – given that total deprivation is apparently not necessary – why GAMI was held to this standard it apparently set for itself? The Tribunal’s bottom line appeared to be that GAMI failed to fully come to terms with the regulatory context in which its claim was based. It did not satisfactorily address the simple fact that GAM apparently would be compensated for the expropriations of two of its mills, and would regain possession of its three other mills. The loss of these three mills was supposed to underlay GAMI’s claim for the complete diminution of the value of its shares in GAM.

10. Costs Will Not be Awarded Lightly Against Claimants

Finally, the Tribunal identified two factors which it considered in exercising its discretion under the UNCITRAL Rules to award costs. The rules include a default “loser pays” rule, but tribunals have consistently exercised their wide grant of discretion, under those same rules, not to award costs against an unsuccessful claimant. It appears that in cases where States lose, there is a stronger possibility that the “loser” will be made to pay at least a portion of the costs – but when the State wins, the claimant is rarely left holding the bag.

The two reasons for not awarding costs in this case were: (1) that Mexico had pursued a vigorous, but unsuccessful jurisdictional argument that required a separate hearing; and (2) that GAMI’s grievances were “serious” (i.e. credible) because “it raised disquieting questions with respect to regulatory acts and omissions.” Given that both of these factors have been present in the vast majority of NAFTA cases, it only makes sense that claimants should not normally expect to be forced to pay costs in the event of a hard-fought, but professionally-executed, arbitration.

Conclusion

The GAMI Award was an enjoyable first read, although not certainly for the claimant. The reasons for decision offered by the Tribunal members provide a useful addition to the growing jurisprudence of NAFTA Chapter 11 law, and to bilateral investment treaty law generally.

Kindest regards,

TJW