THE NATIONAL LAW JOURNAL

NLPIP CO WWW.NLJ.COM MONDAY APRIL11, 2005

A brave new world for ADR?

In NAFTA arbitration, even high court rulings may one day be set aside.

By Jonathan M. Freiman and
Bruce Jacoby
SPECIAL TO THE NATIONAL LAW JOURNAL
Monday, April 11, 2005

IS THIS ALTERNATIVE dispute resolution—or a new way to turn up the heat when a big battle starts to look bad? That's what American companies doing business in Mexico or Canada should be asking themselves about a little-known arbitration mechanism available under the North American Free Trade Agreement (NAFTA).

Traditional arbitration under the treaty was easy enough to understand: An investor abroad could force a foreign government to enter into binding arbitration before a neutral tribunal to settle disputes about improper treatment by the host government. But recent decisions of NAFTA tribunals suggest that savvy companies could use NAFTA's alternative dispute resolution mechanism in rather unorthodox ways: to pressure hostile foreign regulators into changing or abandoning legislation, for example, or even to ignore an adverse judicial decision.

The rationale behind NAFTA's dispute resolution mechanism— known as Chapter 11— is simple: Mexico, Canada and the United States will move more quickly toward a single market if investors are confident that their money will be just as safe abroad as at home. American companies had seen investments evaporate throughout the 20th century through foreign governments' expropriations, leading to an urge to keep more than the optimal number of investment dollars close to the mattress. It was an understandable urge: The history of expropriations glides through the pages of the U.S. Reports like a long-distance runner, from early Soviet expropriations (see, e.g., *United States v. Belmont*, 301 U.S. 324 (1937)), through Fidel Castro's nationalization of Cuba's sugar industry (*Banco Nacional de Cuba v. Sabbatino*, 376 U.S. 398 (1964)), to the 1978 revolution in Iran (*Dames & Moore v. Regan*, 453 U.S. 654 (1981)). While those cases have become foundations of our constitutional law of foreign relations, they weren't particularly satisfying for the investors.

NAFTA sought to change that. Drawing on the experience of more modest bilateral investment treaties, the NAFTA drafters aimed to create a dispute resolution mechanism strong enough to compensate companies operating abroad that found themselves mistreated by the host nation. Under NAFTA, such companies can turn to the safety of enforced private arbitration whenever they would rather not take on the host nation in its own courts. By guaranteeing the possibility of neutral arbitration, the three signatories ensured that international investors would have access to a neutral adjudicatory system. Management mavens would send capital wherever it had the best prospects, since investments were just as safe "there" as "here."

The breadth of that protective idea found expression in NAFTA's Chapter 11. Article 1110 provides that nationalization of assets without compensation is nearly always prohibited, and Article 1106 guards against export or content quotas. But the treaty goes much further. Article 1102 guarantees foreign investors an equal protectionlike entitlement to treatment in parity with the locals, while Article 1105 assures that they have a due processlike right to be treated in accordance with established principles of international law.

For a good example of a mostly traditional application of NAFTA's investment-protection scheme, consider the arbitration of *Metalclad Corp. v. United Mexican States*, No. ARB(AF)/97/1 (ICSID AF Aug. 30, 2000) (final award). In 1993, Metalclad, a U.S. entity, bought a Mexican company with a Mexican permit to construct a hazardous waste landfill. Three years and $20 million later, with the landfill on the verge of opening, local officials announced that they had denied Metalclad a city permit. State officials then designated an area including the landfill site as necessary for the protection of a rare cactus.

Smelling hostility, Metalclad filed a claim against Mexico under Chapter 11,

claiming violations of the protections against expropriation and unequal national treatment. Mexico argued that it had not denied a permit— state and local officials had— so that Metalclad could not claim adverse "governmental action" necessary to invoke the treaty. It also claimed that the officials' actions were permissible under a provision protecting legitimate environmental legislation from the scope of Chapter 11 claims. The arbitration panel rejected Mexico's claims, awarding Metalclad $16.7 million. As the *Metalclad* case suggests, even old-school NAFTA arbitration can hold enough controversy to prickle sensibilities across the political spectrum, from environmentalists to federalists.

New-school arbitration

New-school NAFTA arbitration may push even further. Recent arbitral filings and decisions present three broad new NAFTA-based challenges to the established domestic legal and political order.

First, companies have begun exploring attacks on services long performed by government agencies. In *United Parcel Service of America Inc. v. Canada* (UNICTRAL, April 19, 2000) (notice of arbitration), for instance, United Parcel Service Inc. is using NAFTA arbitration to take aim at Canada's venerable government postal service, claiming that subsidizing postal service amounts to monopolization. A case of bona fide unfair competition, or an example of UPS' lawyers morphing "What Can Brown Do for You?" into "What Can NAFTA Do for Brown?"

Pushed far enough, this kind of claim could approach the absurd: Could a Mexican bank sue the United States for subsidizing its treasury department? Could the American Arbitration Association sue Mexico for subsidizing its judiciary? Probably not; but no one knows how broadly NAFTA arbitrators will define improper subsidization. The case is still pending. The jurisdictional award— dismissing some of Canada's challenges to jurisdiction— is available at www.dfait-maeci.gc.ca/tna-nac /documents/Jurisdiction%20Award.22Nov02.pdf.

Second, NAFTA arbitration could be used as a potent lobbying tool to influence foreign legislatures. That possibility was latent in the very first invocation of Chapter 11, an arbitration known as *Ethyl Corp. v. Canada* (UNCITRAL, Sept. 10, 1996) (notice of intent). Ethyl Corp., a U.S. manufacturer of a fuel additive, filed a notice of intent to compel arbitration against Canada, claiming that proposed Canadian legislation that would have banned the import and trade of the fuel additive violated NAFTA. After arbitrators refused to deny the claim on procedural grounds, Canada settled, paying Ethyl $13 million and issuing a statement that no scientific evidence existed to justify banning the additive. With *Ethyl Corp.* as precedent, lawyers may now consider the strategic use of NAFTA arbitration in order to derail hostile legislation.

Or perhaps to send a warning shot across the bow of future legislation, as the still-pending *Methanex* case augurs. Methanex Corp., a Canadian company, manufactures methanol, the prime ingredient in the gasoline additive MTBE. While MTBE was developed to reduce noxious emissions, it was blamed for poisoning thousands of water wells and subsequently banned in California. Methanex fought the ban by filing a Chapter 11 proceeding against the U.S. seeking nearly $1 billion, raising fears that a Methanex success would make state and federal legislatures reluctant to enact— or enforce— important environmental laws. *Methanex Corp. v. United States* (UNCITRAL, July 2, 1999) (notice of intent).

NAFTA as appellate review

These cases reflect significant tension between free trade and the political powers of sovereign nations. But a third type of challenge is probably jangling the most nerves: the possibility that NAFTA's private arbitration scheme would allow a tribunal to effectively overturn the final judgment of a court— even the highest court of one of the three signatories.

Two companies have sought to do just that, both in the United States. In *Mondev Int'l Ltd. v. United States*, a Canadian company sued Boston and its Redevelopment Authority involving development of a shopping mall. Mondev prevailed in state court, but Massachusetts' highest court reversed, finding among other things that the redevelopment authority was immune from suit for intentional tort under a state statute. When the U.S. Supreme Court declined to review the decision, Mondev brought a Chapter 11 proceeding seeking $50 million in damages, claiming a violation of the minimum standard of treatment.

While the tribunal ultimately rejected Mondev's claim, it made clear that minimum standard claims of "denial of justice" will receive real review. Arbitrators should ask whether there are "justified concerns as to the judicial propriety of the outcome, bearing in mind on the one hand that international tribunals are not courts of appeal, and on the other hand that Chapter 11 . . . is intended to provide a real measure of protection." *Mondev Int'l Ltd. v. United States*, No. ARB (AF)/99/2 (ICSID AF Oct. 11, 2002) (final award), ¶ 127. The guidelines for determining whether "judicial propriety" was present are "generally accepted standards of the administration of justice" as they exist "at an international level." Id. This is not de novo appellate review, but nor is it the "manifest disregard" standard that

most U.S. jurisdictions use when judges review arbitral awards.

If that sounds a bit like a second bite of the apple, well, bon appétit. At least that's what the Loewen Group may have said when it found itself slapped with a $500 million jury verdict, the largest ever awarded in a Mississippi state court. Loewen, a Canadian consortium, was sued for unfair trade practices related to its competition with local funeral homes. Rather than posting a state-mandated bond of $625 million to appeal, Loewen settled for $175 million, waiving appellate review, then initiated a NAFTA arbitration against the United States seeking compensation for violations of "national treatment" and "minimum standards." See *Loewen Group Inc. v. United States*, No. ARB(AF)/98/3 (ICSID AF June 26, 2003) (final award).

Unlike *Mondev*, which grew out of a suit involving local government bodies, *Loewen* emerged from a purely private dispute. The United States seized on that difference, arguing that a jury verdict in a private dispute could not possibly be a "measure . . . adopted or maintained" by a signatory state. Wrong, the tribunal held. NAFTA's broadly worded definition of "measure" holds governments responsible for judicial decisions— even in disputes between private parties.

The arbitrators found that Loewen had made out its minimum-standards claim, concluding that "the whole trial and its resultant verdict were clearly improper and discreditable and cannot be squared with minimum standards of international law and fair and equitable treatment." Unfortunately for Loewen, the panel also found that it should have filed a petition for U.S. Supreme Court review in light of the state appellate bonding requirement, and that its failure to do so deprived it of the ability to seek redress for a violation of "customary international law"— so that no NAFTA violation had ultimately occurred.

Mondev and Loewen lost, but it may be only a matter of time before a company successfully uses NAFTA to challenge a host nation's judicial decision as a violation of procedural guarantees under customary international law. To frame that in the most startling terms: A panel of NAFTA arbitrators could set aside a decision by the U.S. Supreme Court, the highest court of a state or their counterparts in Canada and Mexico. Most lawyers— and most clients— logically think of a Supreme Court decision as an end. But in the still-uncharted world of NAFTA, it may be just the beginning.

Only a few dozen Chapter 11 cases have reached arbitration tribunals, and many questions remain unanswered: What does international law require by way of a minimum standard of treatment for a company in a foreign court? Does the equal protectionlike right of NAFTA's "national treatment" clause require strict scrutiny— or is something like the deferential rational basis test enough? Is seeking all available local court review a necessary prerequisite to filing arbitration— or is it harmful, potentially forcing arbitrators to pay greater deference to the local nation's courts? The answers will come in time. In the meantime, NAFTA's growing pains may provide lawyers with a brave new world of possibilities for alternative dispute resolution and, when it suits their clients' needs, alternative dispute provocation as well. NLJ

Jonathan M. Freiman is an associate in the national appellate practice group of New Haven, Conn.'s Wiggin and Dana, and a visiting lecturer at Yale Law School. Bruce Jacoby is an associate in the firm's intellectual property group. They can be reached at jfreiman@wiggin.com and bjacoby@wiggin.com, respectively.