

## 4. Reforming the NAFTA Investment Regime

Gus Van Harten

NAFTA's investment regime should be reformed. This paper elaborates a tiered set of reforms that are designed to (1) encourage foreign investment, while (2) affording appropriate policy space for governments to develop and regulate their economies in a sustainable manner and (3) ensuring equitable governance of investment disputes such that foreign investors are not privileged, procedurally or substantively, over domestic investors and citizens.

The proposals have been tiered according to their feasibility, based especially on whether they would require an amendment of NAFTA.

### I. THE NEED FOR REFORM

#### Investment Protection and Regulation for Sustainable Development

An important aim of NAFTA is to encourage and protect foreign investment in order to create jobs, develop the economy, and support the shift to a green economy. Toward this end, foreign investors are given robust protections, especially by the provision in NAFTA Chapter 11 for compulsory international arbitration to decide investor claims against governments. In various respects, however, NAFTA goes too far in favoring investors over other interests.

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other topics. However, the past decisions of some NAFTA tribunals have interpreted these standards in an overly expansive, pro-investor direction. This calls for clarification that the treaty does not require payment of public compensation to investors where they are affected negatively by laws or regulations passed in good faith for a public purpose.<sup>1</sup>

It is likely that governments in each NAFTA state have been influenced in their regulatory decisions by the risk of a NAFTA claim. Foreign investors have shown clearly that they will challenge virtually any government measure. For example, NAFTA Chapter 11 has to date been used to challenge: measures to control gasoline content and protect groundwater resources; a legislative ban on the export of hazardous wastes; a phase-out of the agricultural chemical lindane; a court decision leading to a large punitive damages award; the creation of an ecological park; the environmental assessment of a quarry project; the regulation of open-pit mining near Native American sacred sites; and, most recently, the implementation of safety standards for foreign trucks.

Various post-NAFTA reforms appear to accept that arbitration tribunals have used their discretion to take investment treaties too far in favor of investors.<sup>2</sup> Likewise, in its review of the *Metalclad* award against Mexico, the British Columbia Supreme Court observed with respect to the tribunal's definition of 'indirect expropriation':

The Tribunal gave an extremely broad definition of expropriation for the purposes of Article 1110. In addition to the more conventional notion of expropriation involving a taking of property, the Tribunal held that expropriation under the 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 property. This definition is sufficiently broad to include a legitimate rezoning of property by a municipality or other zoning authority.<sup>3</sup>

Despite this, the court was unable—under the existing rules of the NAFTA regime—to correct this aspect of the *Metalclad* award.

### **Concerns about Regulatory Chill**

Pro-investor interpretations of indirect expropriation and other standards are troubling because they raise the risk of 'regulatory chill'. They enable foreign investors to entangle governments in international litigation and expose them to costly awards, even where the government has acted in good faith in pursuit of a worthy objective. In the words of one lawyer, the ability to sue under an investment treaty is:

an open invitation to unhappy investors, tempted to complain that a financial or business failure was due to improper regulation, misguided macroeconomic policy, or discriminatory treatment by the host government and delighted by the opportunity to threaten the national government with a tedious expensive arbitration.<sup>4</sup>

Various studies have raised this concern. They have highlighted the danger that NAFTA (and other investment treaties) frustrate government efforts to protect health and the environment, preserve natural resources (such as fresh water), counteract climate change, promote economic development, regulate utilities and deliver government services, make zoning decisions, reform health care, or regulate the financial sector.<sup>5</sup>

It is difficult, if not impossible, to establish definitively that any particular measure was abandoned as a result of a NAFTA claim. But it appears that various government measures have been withdrawn in the face of threatened claims. Documented cases include, for example, withdrawn proposals in Canada to require plain packaging of cigarettes, to establish public auto insurance, and to privatize a water filtration plant.<sup>6</sup>

### **Box 1. The *Ethyl* Case<sup>7</sup>**

Perhaps the clearest case of regulatory chill is the *Ethyl* arbitration. Faced with a NAFTA claim, the Canadian government withdrew its restrictions on a gasoline additive called MMT—restrictions that had been justified on the precautionary basis that burning MMT posed an unacceptable risk of nerve and brain damage in humans and especially in children—after a NAFTA tribunal allowed the manufacturer of MMT to bring its claim under Chapter 11. Besides withdrawing its regulation, the Canadian government also agreed to (1) issue a statement that MMT did not pose a health threat and (2) pay (U.S.)\$13 million in compensation to the manufacturer, an amount that exceeded Environment Canada's annual budget for enforcement and compliance. The case indicates how NAFTA can be used by foreign investors to pressure a government to 'purchase its environmental sovereignty by settling its way out of Chapter XI claims'.

Not all NAFTA claims have been successful (many are still pending). But the fact that they can be brought with such ease enables foreign investors to pressure or harass governments and to frustrate important initiatives.<sup>8</sup> An ongoing claim by Dow AgroSciences against Canada, for example—in response to Quebec's restrictions on cosmetic use of the chemical pesticide 2,4-D—appears aimed as much at deterring other governments from taking similar steps to reduce pesticide use for health and environmental reasons, as much as it is meant to win compensation of \$2 million, as claimed, for the incidental impact on Dow's sales in Quebec.

## **The Threat to Financial, Economic, and Environmental Reform**

Beyond NAFTA Chapter 11, foreign investors have used investment treaties to bring more than 250 investor-state claims against countries, usually in the developing world, over the last 15 years. They have challenged a wide range of policies and decisions. Perhaps most ominous are the 46 claims brought against Argentina for its reforms in the face of the country's financial and economic crisis in 2001. These claims have led to hundreds of millions of dollars in awards against Argentina and will likely generate billions more. Moreover, some tribunals have relied on dubious pro-investor readings of the treaties to support awards.<sup>9</sup> In response, Argentina has declined to pay awards, thus calling into question the utility of the system, even for investors.<sup>10</sup>

So long as the U.S., Canada, and Mexico do not take steps to limit their exposure to claims, they continue to put their public treasuries and regulatory processes at risk.<sup>11</sup> Law firms specializing in investment arbitration are currently drumming up business by advising investors on how to bring investor-state claims for losses caused by government reforms in response to the present financial crisis. For example, according to a client pamphlet issued recently by one London-based firm:

States are coming under increasing pressure to take measures to bolster their national economies in response to the global economic downturn. Whilst it may be appropriate for States to take measures to address the financial crisis, foreign investors could be entitled to compensation if such measures are taken in breach of the terms of investment treaties... Since the Argentinean crisis has similarities with the financial difficulties now being encountered around the world, it is instructive to see how claims arising from huge losses suffered at the time are now being resolved...<sup>12</sup>

## **Useful Development Measures that are Specifically Prohibited**

Capital controls and performance requirements are prohibited under NAFTA even though they can play an important role in avoiding financial crises or boosting productivity and employment. Tailored use of such measures should be facilitated based on evidence of their utility to prevent capital flows from undermining financial systems or to ensure that foreign investment contributes to economic development. For policy coherence, the use of these measures could be subject to supervision by a regional commission, rather than by investor-state arbitration.

## Equitable Governance of Investment Disputes

Investment disputes should be resolved fairly, via an independent adjudicative process that is accountable to public decision-makers. Investors may have good cause to seek protection through judicial review, even for apparently legitimate government action. But the investor-state model under NAFTA is overly dependent on a small group of arbitrators in its resolution of important matters of public policy.

For all investors, foreign or domestic, protection should be

(and usually is) provided by domestic courts. Exceptionally, back-up protection may be required at the international level. But international adjudication should be an exceptional remedy, not a first resort. Foreign investors should not be able to circumvent domestic courts that offer a forum for justice that is at least as fair and independent as investor-state arbitration. In this and other respects, foreign investors should not be privileged over domestic investors and citizens, who are also profoundly affected by government decisions, and should be entitled to participate in arbitration alongside investor interests.

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## The Privileging of Foreign Investors over Citizens

Investor-state arbitration in its current form gives foreign investors the tremendous power to force states to submit the decisions of their legislatures, courts, and administrations to intensive review and discipline by arbitrators, outside of any court process.<sup>13</sup> Many disputes that can and should be resolved at the domestic level are thus brought before international tribunals. The system is particularly lopsided in that, while investors can claim tax-funded compensation, they are not themselves subject to regulation through the adjudicative process.<sup>14</sup>

## The Lack of Independence of Investor-state Arbitrators

The use of arbitration to make final decisions in public law—especially where it involves legislative choices or public budgets—undermines judicial independence. Arbitrators are reasonably seen to have an interest to interpret the law in favor of investors so as to encourage future claims and grow the arbitration industry. This apparent bias offers a credible explanation for the surprisingly pro-investor approaches of numerous tribunals (e.g., *Metalclad*; *Pope & Talbot*;

*Tecnicas; Santa Elena; Maffezini; CME; Siemens; Tokios; Occidental; CMS*).<sup>15</sup>

These tribunals have required payment of public compensation for a range of non-discriminatory measures where foreign investors have sustained incidental loss as a result of government action. Moreover, tribunals are insulated from review by independent judges, whether domestic or international.<sup>16</sup>

These are fundamental concerns, especially because NAFTA allows for such broad review of legislative and general policy decisions. Arbitrators are given authority that goes well beyond that of courts and tribunals under other treaties (other than other trade and investment agreements).

## **II. OVERARCHING PRINCIPLES AND GOALS FOR REFORM**

### **The Principle of Sustainable Development**

Investment treaties should allow appropriate policy space for governments to take action, free of the risk of a ruinous damages award, to enact laws and regulations on pressing issues, so long as the measure in question does not target foreign investors in a specific way for abuse or discrimination. This policy space should be widest for legislatures and courts, and for general policy decisions of the executive. Reforms should aim to establish a regime in which states have appropriate options to regulate in good faith without risk of international claims.

### **The Principle of Equitable Governance**

To ensure equitable governance, NAFTA adjudication must be insulated from inappropriate influence by investors and other private actors. The process should defer to the democratic legitimacy of legislatures, the independence of domestic courts, and the expertise of executive agencies.<sup>17</sup> Foreign investors should not be allowed to circumvent domestic courts where the courts offer justice. NAFTA arbitration itself should offer an independent and fair process, both for the investor and the state, consistent with principles of judging in the constitutional traditions of the NAFTA states and in international law.<sup>18</sup>

## **III. RECOMMENDED INSTRUMENTS, POLICIES, AND PROVISIONS**

Recommended reforms to NAFTA, and their key components, are summarized below. Notably, many of the revisions adopted in post-NAFTA treaties are based on the May 10th Agreement in the U.S. Congress and Administration. This post-NAFTA position is an important starting point for NAFTA reform. For reasons discussed above, though, it falls short, especially because it does not address (1)

the danger that arbitrators will continue to interpret the treaty—however carefully it is re-worded—in an unduly pro-investor way or (2) the procedural privileges that investor-state arbitration unfairly provides to foreign investors.

The recommended reforms are summarized as follows:

### **Reform the Dispute Settlement Regime**

- consider the option of removing the investor-state regime outright from NAFTA (requires amendment);
- provide for standing in the process for persons or entities whose interests are directly affected by an investor-state dispute, and allow states to bring counter-claims against foreign investors for breaches of their own duties or obligations (requires amendment);
- establish a regional adjudicative body to replace or supplement the role of private arbitration, and to ensure independence and enhance coherence in the decision-making process (requires amendment);
- provide for the members of the regional adjudicative body to develop rules to govern the resolution of investor-state disputes (requires amendment);
- as a temporary measure to ensure independence, and as provided for in NAFTA Article 1124(4) itself, designate a roster of experts—preferably sitting judges—from which presiding arbitrators must be chosen (does not require amendment of the NAFTA text);

### **Ensure that Investor-State Arbitration is an Exceptional Remedy**

- take steps to limit forum-shopping and ‘claims of convenience’ by non-NAFTA investors (may not require amendment);
- preclude foreign investors from circumventing domestic courts where the courts offer justice (may not require amendment);
- expand NAFTA’s screening mechanism to ensure flexibility and predictability in key fields of regulation, such as financial regulation and health/ environmental protection (requires amendment);

### **Clarify Broadly-Framed Substantive Standards**

- limit the concepts of indirect expropriation and ‘fair and equitable treatment’ to preclude their application to non-discriminatory measures that are adopted

in good faith for a public purpose, based for example on the awards in *Methanex*<sup>19</sup> and *Glamis Gold*<sup>20</sup> (does not require amendment);

- clarify that national treatment requires evidence of either (1) intentional discrimination or (2) *de facto* discrimination against foreign investors as a group, based for example on the *ADF* award<sup>21</sup> (does not require amendment);
- clarify that most-favored-nation treatment does not defeat exceptions in NAFTA or extend to dispute settlement provisions of other treaties, based for example on the *Plama* award<sup>22</sup> (does not require amendment);

### **Check the Discretion of Investor-State Tribunals**

- direct tribunals to defer to legislative and judicial decisions, and to policy decisions of the executive, where the decision does not target foreign investors for abusive or discriminatory treatment (does not require amendment);
- clarify that tribunals should defer to the shared views of the NAFTA governments participating in an investor-state arbitration regarding the proper interpretation of NAFTA (does not require amendment);
- clarify that tribunals may award partial damages, or simply a costs award or declaratory award, as adequate satisfaction for a foreign investor, and that any damages award should account for the degree of blameworthiness of the respondent state (does not require amendment);

### **Provide Exceptions to Protect Legitimate Regulation**

- incorporate exceptions from post-NAFTA treaties that aim to safeguard the financial system (may not require amendment);
- allow for tailored use of capital controls and performance requirements where justified to maintain financial stability or boost productivity and employment (requires amendment);
- extend NAFTA's general exceptions to its investment chapter (requires amendment);

## Revise the Treaty's Statement of Objectives

- revise the statement of objectives of both NAFTA and its investor-state regime by referring, among other things, to the equitable governance of investment disputes based on judicial openness, independence, and accountability (requires amendment).

Not all of these reforms require amendment of NAFTA. NAFTA authorizes the Free Trade Commission—made up of Cabinet-level representatives of each NAFTA state—to make interpretations of the treaty that are binding on tribunals.<sup>23</sup> This is an important tool to clarify the treaty. That said, other reforms that require amendment should also be pursued in order to address key concerns.

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