

Sovereignty & NAFTA Article 1110: A Threat to Domestic Environmental Protection Efforts?

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I. Introduction

In the current age of globalization, it has become increasingly more common for corporations and individuals to invest their money abroad via foreign direct investment. This growth has been at least partially enabled by various free trade agreements that contain provisions specifically designed to facilitate foreign investment. Chapter 11 of the North American Free Trade Agreement (NAFTA) is one such provision. This chapter has generated a great deal of controversy and attention, largely because of its expropriation provision under Article 1110. This provision generally requires compensation for actions that are deemed “expropriation” or “tantamount to...expropriation.” It was designed to address the fear that investments could be nationalized or expropriated outright by the foreign host government, leading to a total loss for the investor.

In practice, however, investors have increasingly used Article 1110 as a sword to attack domestic regulations that negatively impact their investments. Often these attacks are aimed at environmental regulations. This presents a threat to the sovereign power of the United States and Canada to create and enforce domestic environmental regulations.

This article will explore the threat to domestic environmental sovereignty in the United States and Canada that is posed by NAFTA Article 1110. Section II provides a basic discussion of NAFTA’s core principles, its environmental provisions, and a summary of the extent of the United States-Canada trade and investment relationship. Section III discusses the Chapter 11 process and its key terms, compares Article 1110 to United States and Canadian domestic

takings jurisprudence, and outlines a basic understanding of sovereignty. Section IV describes four Chapter 11 arbitrations with significant environmental ramifications, and how those arbitrations impact notions of sovereignty. Finally, section V concludes that while there is a potential threat to domestic sovereignty over environmental regulations, it is not clear that the threat has materialized. Therefore, the time is ripe to take action to prevent future attacks on domestic environmental regulations by curbing them before they have an opportunity to occur.

II. Background

A. NAFTA and the Environment

NAFTA¹ is a regional free trade agreement signed by the United States, Canada, and Mexico that has been effective since January 1, 1994. It creates a free trade area in accordance with the provisions of Article XXIV of the General Agreement on Tariffs and Trade.² Like other free trade agreements, NAFTA's basic goals are to liberalize trade among member countries by lowering barriers to trade, promoting fair competition, and increasing investment.³ NAFTA aims to accomplish this through the application of two core principles of free trade: national treatment and most favored nation (MFN) status. National treatment means that a member country must treat the citizens of other member countries in the same way that they treat their own citizens. MFN status provides that any trade advantage granted by one member country to another member country must also be granted to all other member countries. Together, these principles are designed to promote free trade by fostering an atmosphere of fair and equal treatment among the signatory countries.

¹ North American Free Trade Agreement, U.S.-Can.-Mex., Dec. 17, 1992, 32 I.L.M. 289 (1993)[hereinafter NAFTA].

² *Id.* at art. 101.

³ *Id.* at art. 102.

Generally, one might expect that free trade agreements would be insensitive to the plight of the environment. For example, it is easy to imagine a manufacturing corporation being encouraged by free trade regimes to move its factory to the country with the lowest environmental standards in order to avoid costly regulation. Contrary to this expectation, it has been noted that “NAFTA is one of the most environmentally sensitive trade and investment agreement[s]” in existence.⁴ In fact, NAFTA incorporates environmental protections in several of its provisions. First, the preamble resolves to promote free trade “in a manner consistent with environmental protection and conservation,” to “promote sustainable development,” and to “strengthen the development and enforcement of environmental laws and regulations.”⁵

Second, NAFTA attempts to safeguard the environment, as well as health and safety regulations, under Article 1114.⁶ Subsection (1) of this provision states that Chapter 11 must not “be construed to prevent a Party from adopting, maintaining or enforcing any measure otherwise consistent with this Chapter that it considers appropriate to ensure that investment activity in its territory is undertaken in a manner sensitive to environmental concerns.” Subsection (2) further states that “it is inappropriate to encourage investment by relaxing domestic health, safety or environmental measures,” and that such measures “should” not be waived in order to increase investment.

Third, and perhaps more substantively, NAFTA also contains a side agreement known as the North American Agreement on Environmental Cooperation (NAAEC).⁷ The NAAEC, as administered by the Commission on Environmental Cooperation (CEC), is designed to promote

⁴ Simon Baughen, *Expropriation and Environmental Regulation: The Lessons of NAFTA Chapter Eleven*, 18 J. ENVTL. L. 207 (2006).

⁵ NAFTA, *supra* note 1, preamble.

⁶ *Id.* at art. 1114.

⁷ North American Agreement on Environmental Cooperation, Dec. 17, 1992, 32 I.L.M. 1480 (1993)[hereinafter NAAEC].

effective enforcement of the parties' domestic environmental legislation. Accordingly, any individual or group living in a NAFTA country can complain to the CEC that another member is not enforcing its laws.⁸ After reviewing the complaint, the CEC is empowered to publish findings of fact. This factual record can be made publicly available if two-thirds of the CEC Council approve.

But do these provisions really protect our environment from the effects of free trade? After the above discussion, it may sound like NAFTA is an environmentally friendly agreement. This conclusion is erroneous for several reasons. First, the claim that NAFTA is environmentally sensitive is clearly a relative one. Just because NAFTA happens to be more sensitive than other free trade agreements, such as the GATT, does not make it a model of environmental protection. Second, for all of the grand claims in the NAFTA preamble about sustainable development and environmental protection and conservation, there are no substantive environmental protections. Third, Article 1114(2) is noticeably weakened by its use of the permissive "should" rather than the mandatory "shall," and analysis of 1114 is conspicuously missing from the various tribunal opinions discussed herein. Finally, the NAAEC complaint process glaringly lacks any substantive enforcement mechanism. All a complainant can do is hope that a factual record is publicized and embarrasses a member country into enforcing its domestic environmental protections.

B. The Extent of Canada-US Trade under NAFTA

Today, Canada is the United States' largest single trading partner,⁹ and the United States is Canada's largest single trading partner.¹⁰ For the calendar year 2006, the United States

⁸ *Id.* at art. 14-15.

⁹ United States Census Bureau, Foreign Trade Statistics, *Top Trading Partners*, available at <http://www.census.gov/foreign-trade/statistics/highlights/toppartners.html>.

exported approximately \$230 billion in goods to Canada, while importing approximately \$303 billion in goods.¹¹ The dollar value of this relationship has increased substantially since NAFTA became effective at the beginning of 1994. In 1993, the United States exported approximately \$100 billion in goods to Canada, while importing approximately \$111 billion in goods. Clearly, the magnitude of the Canada-United States trade relationship in goods has increased significantly since NAFTA came into effect.

Foreign direct investment (FDI) statistics show a similar trend. From 1993 to 2005, total FDI from Canada to the United States increased from approximately \$40 billion to approximately \$144 billion.¹² Over that same time, the total United States FDI interest in Canada increased from around \$70 billion to around \$235 billion.¹³

Both the magnitude and growth of these numbers illustrate the importance of the US-Canada trade relationship, and how it has grown since NAFTA became effective in 1994. NAFTA may not be the sole cause of the increase in trade volume, but it is certainly responsible for at least some of the growth.

III. Chapter 11, Takings, & Sovereignty

A. Chapter 11 Generally

One provision of NAFTA presents a special and unexpected potential threat to those who want to protect the environment in our globalizing world: Chapter 11 Investment. The threat is to the sovereignty of NAFTA member nations that wish to maintain and improve their existing

¹⁰ Statistics Canada, *Imports, Exports, and Trade Balance of Goods*, available at <http://www40.statcan.ca/101/cst01/gblec02a.htm>.

¹¹ United States Census Bureau, Foreign Trade Statistics, *Trade in Goods with Canada*, available at <http://www.census.gov/foreign-trade/balance/c1220.html#2006>.

¹² United States Bureau of Economic Analysis, *Foreign Direct Investment in the U.S.: Balance of Payments and Direct Investment Position Data*, available at <http://www.bea.gov/international/di1fdibal.htm>. Statistics are expressed on a historical cost basis.

¹³ United States Bureau of Economic Analysis, *U.S. Direct Investment Abroad: Balance of Payments and Direct Investment Position Data*, available at <http://www.bea.gov/international/di1usdbal.htm>.

domestic environmental protection regulations without fear of foreign investors bringing an arbitration claim alleging that domestic laws expropriate their private property without compensation. To understand how such claims are possible, it is necessary to first understand the functioning of NAFTA Chapter 11, with specific emphasis on Article 1110.

Chapter 11 generally grants various substantive protections to “investor[s] of a party,” which are defined as “a Party or state enterprise thereof, or a national or an enterprise of such Party, that seeks to make, is making or has made an investment.”¹⁴ Specifically, Chapter 11 protects these foreign investors by requiring that the host nation provide national treatment, MFN status, and compliance with international law.¹⁵ There is nothing unusual here; these protections are consistent with the provisions of free trade agreements in general, and simply provide free trade protections to non-domestic investors.

What is surprising is the expropriation and compensation provision of Article 1110:

No Party may directly or indirectly *nationalize or expropriate* an investment of an investor of another Party in its territory or take a measure *tantamount to nationalization or expropriation* of such an investment (“expropriation”), except: (a) for a public purpose; (b) on a non-discriminatory basis; (c) in accordance with due process of law and Article 1105(1); and (d) on payment of compensation in accordance with paragraphs 2 through 6.¹⁶

Essentially, this provision amounts to a guarantee that a member nation will not expropriate or nationalize a foreign investor’s private property unless there is a public purpose, there is no discrimination, due process is provided, and compensation is paid. The key terms “nationalization or expropriation” and “tantamount to nationalization or expropriation” are discussed in detail below. It is important to note that this provision applies not just to the

¹⁴ NAFTA, *supra* note 1, art. 1139.

¹⁵ *Id.* at art. 1102, 1103, and 1105.

¹⁶ *Id.* at art. 1110(1) (emphasis added).

national governments of the United States, Canada, and Mexico, but also to state, provincial, and local governments.¹⁷

When an investor feels that a foreign government has violated Article 1110, Articles 1116 and 1117 grant them the right to seek redress through binding arbitration for any injury or loss suffered.¹⁸ Articles 1118 through 1137 set out the procedures for arbitration. The investor must first try to settle its claim with the host nation through negotiation.¹⁹ If this fails, a disputing investor may request arbitration according to the rules of the ICSID Convention or UNCITRAL.²⁰ Arbitral tribunals are composed of three arbitrators. One arbitrator is selected by each party, and the third presiding arbitrator is selected by agreement of the parties.²¹

B. Tribunal Interpretations of “Expropriation” & “Tantamount to...Expropriation”

Originally, the Article 1110 expropriation ban was included in Chapter 11 because the United States feared that their investments in Mexico would be expropriated or nationalized by the Mexican government.²² Thus, it was originally grounded in a fear of an actual physical taking of property by a foreign government. But the provisions of Chapter 11 extend far beyond simple physical expropriation and nationalization. This is made clear by the various completed arbitration proceedings that have interpreted the key terms “expropriation” and “tantamount to...expropriation.”

“Expropriation” and “tantamount to...expropriation” have relatively simple and well accepted meanings under customary international law, but they are not defined in NAFTA.

First, it is clear that under customary international law, an outright nationalization of a foreign

¹⁷ See Jessica C. Lawrence, *Chicken Little Revisited: NAFTA Regulatory Expropriations after Methanex*, 41 GA. L. REV. 261, 271 (2006) (discussing how Article 1110 applies to sub-national governments via Article 105).

¹⁸ NAFTA, *supra* note 1, art. 1116-1117.

¹⁹ *Id.* at art. 1118.

²⁰ *Id.* at art. 1120.

²¹ *Id.* at art. 1123.

²² Jerry Clark, *Opportunity Knocks – The Role of International Trade Arbitration in Reducing International Trade Barriers and Addressing Environmental Concerns*, 13 INT. TRADE L. J. 41, 45 (2004).

investment constitutes an expropriation.²³ If a NAFTA country were to confiscate the property of a foreign investor, this would certainly fall within the meaning of “expropriation.”

The phrase “tantamount to...expropriation,” however, has been more contentious and difficult to interpret. The debate here has been whether so-called “indirect or creeping expropriations” fall within the domain of Article 1110. Under customary international law, creeping expropriation has been defined to include

actions that have the effect of "taking" the property, in whole or in large part, outright or in stages [including] when [a state] subjects alien property to taxation, regulation, or other action that is confiscatory, or that prevents, unreasonably interferes with, or unduly delays, effective enjoyment of an alien's property.²⁴

Therefore, according to customary international law, creeping expropriations cover what have come to be known as regulatory takings in the United States. That is, the concept includes situations where government regulation injures the value of private property but does not take it outright for its own benefit.

Because NAFTA does not define “tantamount to nationalization or expropriation,” one important issue is whether Chapter 11 adopts the customary international law standard or some other standard. Several Chapter 11 arbitration tribunals have addressed this issue. These tribunals have generally found (1) that the phrase does not broaden the meaning of expropriation under international law, (2) that “tantamount” means nothing more than “equivalent to,” and (3) that creeping expropriations are included in its definition.²⁵ Therefore, these panels interpreted the phrase as having the same meaning that it has under customary international law.

²³ Baughen, *supra* note 4, at 209.

²⁴ Guillermo Aguilar Alvarez & William W. Park, *The New Face of Investment Arbitration: NAFTA Chapter 11*, 28 YALE J. INT'L L. 365, 378 (2003) (citing Restatement (Third) of Foreign Relations Law of the United States § 712 cmt. g (1990)).

²⁵ See *Pope & Talbot v. Canada*, Final Award on Merits (2001), available at http://www.naftaclaims.com/disputes_canada_pope.htm; *S.D. Meyers v. Canada*, Final Award on the Merits, 40 I.L.M. 1408 (UNCITRAL 2000).

It is important to note, however, that Chapter 11 arbitration panels are not constrained by *stare decisis* as courts in the United States and Canada are. This allows for significant variation in interpretation of key terms like “tantamount to...expropriation.” Thus, in *Metalclad v. United Mexican States* (discussed more thoroughly *infra*), the arbitration tribunal applied a more expansive definition.²⁶ It found instead that

expropriation under NAFTA includes not only open, deliberate and acknowledged takings of property, such as outright seizure or formal or obligatory transfer of title in favour of the host State, but also 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 even if not necessarily to the obvious benefit of the host State.²⁷

The emphasized words, “in whole or in significant part,” can be interpreted as adopting a rule that partial takings can constitute expropriation under Chapter 11. This goes beyond the accepted customary international law definition.²⁸

C. Expropriations vs. Takings

While this is not the proper place for an exhaustive comparative discussion of takings jurisprudence in the United States and Canada, it is nevertheless helpful to briefly compare the scope of such domestic protections with those provided under Article 1110. In the United States, the 5th Amendment provides that private property shall not “be taken for public use, without just compensation.” This has been interpreted to cover not only outright physical seizures of property by the government,²⁹ but also so-called regulatory takings in which government actions are deemed to have gone “too far” towards injuring rights in private property.³⁰

²⁶ Baughen, *supra* note 4, at 220.

²⁷ *Metalclad v. United Mexican States*, Final Award, 40 I.L.M. 36, para. 103 (ICSID 2000) (emphasis added).

²⁸ Baughen, *supra* note 4, at 221.

²⁹ *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419 (1982).

³⁰ *Pennsylvania Coal Co. v. Mahon*, 260 U.S. 393 (1922); *see also Penn Central Transp. Co. v. New York City*, 438 U.S. 104 (1978).

In Canada, there is no constitutional protection against takings.³¹ The government is only limited in its ability to take private property by specific legislation. However, the power to take with compensation is limited by a rule of statutory interpretation that requires compensation where the statute authorizing the taking does not expressly provide otherwise.³² Thus, in some cases, the Canadian courts have applied this rule and found regulatory takings. But such findings are limited because the legislature can avoid the problem outright by providing that no compensation will be paid, and because Canada's courts generally find that regulatory takings are not compensable if no benefit is realized by the government as a result of its action.³³

From this brief overview, one sees that takings law in the United States is more protective of private property rights than its Canadian counterpart.³⁴ But Article 1110's expropriation rule is yet more protective of private property rights than takings jurisprudence is in the United States. That is, the term "measure" in Article 1110 is generally given an expansive interpretation such that it covers almost any governmental action. Further, the term "investment" covers tangible property, intangible property, and nonproprietary interests.³⁵ Finally, given the *Metalclad* judgment, Article 1110 arguable makes partial regulatory takings compensable.³⁶ Thus, Article 1110's expropriation rules create an international takings standard that is more protective of private property rights than the United States or Canada.

D. Sovereignty in the United States and Canada

³¹ See Colleen Austin, *NAFTA "Regulatory Takings" vs. Fifth Amendment Compensation Rights: Tipping the Scales in Favor of Foreign Investment*, 13 INT'L TRADE L. J. 56, 59 (2004).

³² Lawrence, *supra* note 17, at 280.

³³ *Id.*

³⁴ *Id.* at 278.

³⁵ *Id.* at 279-80.

Metalclad v. United Mexican States,³⁶ Final Award, 40 I.L.M. 36, para. 103 (ICSID 2000); *see also* Lawrence, *supra* note 17, at 280 (stating that "unlike American domestic law, NAFTA does not require the near-total taking of property.").

Sovereignty is generally defined as the “supreme and independent power or authority in government as possessed or claimed by a state or community.”³⁷ With regard to lawsuits against foreign governments, this has traditionally meant that a domestic plaintiff is not entitled to sue a foreign government in the domestic courts. For example, a U.S. citizen could not generally make a claim against the Canadian government in a United States district court. Rather, if such a domestic plaintiff wished to make a claim, it had to be brought in the foreign government’s judicial system.

This tradition has been somewhat modified by statutes. In the United States, the Foreign Sovereign Immunities Act of 1976³⁸ generally gives foreign countries immunity from suit in domestic courts. This act provides some exceptions to the general rule, including situations where the foreign government has waived immunity and where the foreign government is accused of various tortious acts.³⁹ Canadian law, as codified by the State Immunity Act,⁴⁰ creates the same general bar against suing foreign countries in its courts, and provides exceptions similar to those granted in the United States.

The combined effect of these statutes is that (1) if a citizen of the United States wishes to sue the Canadian federal government it must do so in a Canadian court, and (2) if a citizen of Canada wishes to sue the United States federal government, it must do so in an American court. Thus, federal sovereignty in both countries is protected.

Prior to NAFTA, this meant that a foreign investor could generally only seek a remedy in the host nation’s domestic judicial system. But Article 1110 created a second venue for an investor to seek redress – the Chapter 11 arbitration tribunal. This represents a fundamental

³⁷ Webster’s Unabridged Dictionary of the English Language (1989).

³⁸ 28 U.S.C. § 1330, 1332(a), 1391(f), and 1602 – 1611 (2004).

³⁹ 28 U.S.C. § 1604 – 1605 (2004).

⁴⁰ R.S.C. 1985, c. S-18.

threat to the domestic sovereignty of Canada and the United States; the domestic courts are no longer the only place to seek redress.

IV. Article 1110 Claims and Their Sovereignty Ramifications

The following subsections illustrate four Chapter 11 arbitrations that involved Article 1110 expropriation claims. In each of these arbitrations, a corporation challenged an environmental regulation as an action “tantamount to...expropriation.”

A. Ethyl Corp. v. Canada

*Ethy*⁴¹ was the first significant Chapter 11 arbitration involving environmental regulations. The American Ethyl Corporation was manufacturing an octane-enhancing fuel additive called methylcyclopentadienyl manganese tricarbonyl (MMT). MMT is "a highly toxic organo-metallic compound" that contains manganese, a known neurotoxin.⁴² While at the time the specific health effects of MMT were unknown, there were general public health concerns surrounding its use that were significant enough for the EPA to ban its use in the United States in 1995.

In 1997, the Canadian Parliament passed the Manganese-Based Fuel Additives Act, which banned the importation of MMT.⁴³ Up until this point, Ethyl had been producing MMT in the United States, and then shipping it to a wholly owned subsidiary in Ontario for processing and distribution. The new law did not ban use of MMT in Canada. Rather, it banned only importation. So Ethyl would have had to move its manufacturing facility to Canada in order to continue its processing and distribution operations in Ontario.

⁴¹ Ethyl Corp. v. Canada, Award on Jurisdiction, 38 I.L.M. 708 (UNCITRAL 1998).

⁴² Ethyl Corp. v. Canada, Statement of Defence, paras. 29-30 (1997), available at http://www.naftaclaims.com/disputes_canada_ethyl.htm.

⁴³ The facts of the *Ethyl* arbitration are described in full at Ethyl Corp. v. Canada, Award on Jurisdiction, 38 I.L.M. 708, para. 3 – 14 (UNCITRAL 2000).

In response to the importation ban, Ethyl filed a claim under Chapter 11, requesting \$200 million in damages. Ethyl alleged violations of Article 1102 National Treatment, Article 1106 Performance Requirements, and Article 1110 Expropriation.⁴⁴ Canada argued that the claims should be dismissed for lack of jurisdiction. These arguments ultimately failed, and Canada agreed to settle the case rather than proceed with arbitration on the merits. Canada thus agreed to a settlement in which they paid Ethyl \$13 million, issued a statement that they lacked evidence that MMT was a health hazard, and agreed to rescind their ban of MMT importation.⁴⁵

B. Metalclad v. United States of Mexico

Metalclad also involved significant environmental regulations. Metalclad, an American waste disposal company, entered into an option-to-purchase agreement with Mexican corporation Confinamiento Tecnico de Residuos Industriales (COTERIN).⁴⁶ Metalclad wanted to purchase COTERIN outright, and use their property in the Mexican State of San Luis Potosi to construct a hazardous waste landfill. Metalclad exercised its option after COTERIN had received both state and federal permits to construct such a facility. There was significant resistance to the project from local municipality Guadalcazar, but Metalclad decided to begin construction anyway. After several months of construction, Guadalcazar ordered construction stopped for lack of a local construction permit.

At this point, federal officials told Metalclad that their federal permit conferred full authority to build the facility, but suggested that Metalclad apply for a local permit anyway in the spirit of maintaining good will. Metalclad followed this advice, and continued building while their application was pending. Guadalcazar finally denied the permit, but only after Metalclad

⁴⁴ *Id.* at para. 61.

⁴⁵ Vicki Been & Joel C. Beauvais, *The Global Fifth Amendment? NAFTA's Investment Protections and the Misguided Quest for an International "Regulatory Takings" Doctrine*, 78 N.Y.U. L. REV. 30, 132 (2003).

⁴⁶ The facts of the Metalclad Arbitration are described in full at *Metalclad v. United Mexican States*, Final Award, 40 I.L.M. 36, para. 28 – 71 (ICSID 2000).

had completed construction. Efforts to negotiate with Guadalcazar ultimately failed. Finally, the governor of San Luis Potosi issued an ecological decree that transformed the area surrounding the facility into a Natural Area for rare cactus protection, further blocking operation of the facility.

Metalclad ultimately filed a \$90 million Chapter 11 claim, alleging violations of Article 1105 Minimum Standard of Treatment and Article 1110 Expropriation.⁴⁷ The tribunal first held that Mexico had violated Article 1105 by engaging in “unfair and inequitable treatment.” The tribunal also found that the government actions were tantamount to expropriation.⁴⁸ Specifically, they found that expropriation can include “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.”⁴⁹ The tribunal also noted that Metalclad had reasonably relied on the federal government’s representations regarding its authority to permit, and that the federal government possessed exclusive authority to permit hazardous waste facilities.⁵⁰ As a result, Metalclad was awarded \$16 million in compensation.⁵¹

C. S.D. Meyers v. Canada

S.D. Meyers, an American waste disposal company, specialized in remediation of polychlorinated biphenyls (PCBs).⁵² It wanted to expand its business by importing PCBs from Canada to the United States for treatment. Both countries were aware of the dangers of PCBs, which bioaccumulate through the food chain and are known to be carcinogenic. It was Canada’s policy at the time to allow exports of PCBs to the United States only if the Environmental

⁴⁷ *Id.* at para. 72.

⁴⁸ *Id.* at para. 104.

⁴⁹ *Id.* at para. 103.

⁵⁰ *Id.* at para. 105-107.

⁵¹ *Id.* at para. 131.

⁵² The factual background of *S.D. Meyers* is recounted at *S.D. Meyers v. Canada*, Final Award on the Merits, 40 I.L.M. 1408, para. 88 – 128 (UNCITRAL 2000).

Protection Agency (EPA) approved. Since 1980, PCB imports and exports had generally been barred by the United States Toxic Substance Control Act (TSCA) and the Canadian Environmental Contaminants Act. In 1995, as a result of lobbying efforts by S.D. Meyers, the EPA agreed to exempt S.D. Meyers from these restrictions.

But a month after the EPA made this decision, the Canadian Minister of the Environment banned PCB exports from Canada. The Canadian government then changed its mind again in February of 1997 when they decided to rescind their prior PCB export ban. However, S.D. Meyers' ability to get PCBs from Canada was short lived. In July of 2007, a Ninth Circuit decision permanently closed the U.S. border to PCB importation.

S.D. Meyers thus filed a Chapter 11 claim, alleging violations of Article 1102 National Treatment, Article 1105 Minimum Standard of Treatment, Article 1106 Performance Requirements, and Article 1110 Expropriation.⁵³ They sought \$20 million in compensation for the period of time when the Canadian border was closed to PCB exports and the United States border was open to PCB imports.

S.D. Meyers' Article 1110 claim ultimately failed.⁵⁴ The tribunal found that whether a regulation rises to the level of an expropriation is a matter of degree, and that because the Canadian border closure at issue was temporary, it was not an expropriation.⁵⁵ However, S.D. Meyers won its claims under Articles 1102 and 1105,⁵⁶ and was awarded \$4.8 million.

D. Methanex v. United States

Methanex is the most recent completed Chapter 11 arbitration. Canadian corporation Methanex produces methanol and sells it for various purposes. One such purpose was for use in the

⁵³ *Id.* at para. 129 – 143.

⁵⁴ *Id.* at para. 279 – 288.

⁵⁵ *Id.* at para. 282 – 284.

⁵⁶ *Id.* at para. 256, 268.

fuel additive methyl tertiary-butyl ether (MTBE).⁵⁷ MTBE is intended to reduce the pollution that results from burning gasoline. It is “a synthetic, volatile, colourless and organic ether, with a turpentine-like taste and odour.”⁵⁸ California ordered a phase out of MTBE in 1996 in response to drinking water contamination from leaking underground fuel storage tanks. A University of California study had found that MTBE contamination carried significant risks, and that costs for its treatment and removal would be significant.⁵⁹

Methanex was a large supplier of methanol to MTBE manufacturers in California. They responded to the phase out by bringing a Chapter 11 claim for \$970 million. The claim alleged violations of Articles 1102, 1105, and 1110.⁶⁰ Essentially, they argued that the regulation decreased their investment profits and significantly reduced their market share, good will, and customer base in California.

The tribunal did not find any of these arguments meritorious. Rather, it dismissed all three claims for lack of jurisdiction; the California regulation of MTBE was not “relating to” Methanex’s investments as required by Article 1101. With regard to the expropriation claim, the tribunal adopted a narrow interpretation of “tantamount to...expropriation”:

But as a matter of general international law, a non-discriminatory regulation for a public purpose, which is enacted in accordance with due process and, which affects, inter alios, a foreign investor or investment is not deemed expropriatory and compensable unless specific commitments had been given by the regulating government to the then putative foreign investor contemplating investment that the government would refrain from such regulation.⁶¹

Thus, according to the *Methanex* tribunal, an expropriation cannot occur unless the relevant government committed itself to not enacting such regulation prior to investment.

E. Potential Environmental Sovereignty Threats

⁵⁷ The factual background of *Methanex* is recounted at *Methanex Corp. v. United States*, Final Award of the Tribunal on Jurisdiction and Merits, 44 I.L.M. 1345, pt. II(D) (UNCITRAL 2005).

⁵⁸ *Id.* at pt. I, para. 1.

⁵⁹ *See id.* at pt. III, para. 1.

⁶⁰ *Id.* at pt. II(D)(4).

⁶¹ *Id.* at pt. IV(D) para. 7.

There are several important threats to national sovereignty that can be gleaned from these cases. One such threat is the possibility that Article 1110 has a “chilling effect” on domestic environment regulations. For example, in *Ethyl*, Canada simply wanted to regulate a chemical that had significant environmental and health risks associated with its use. Article 1110 provided an avenue for Ethyl Corp. to challenge this regulatory decision. In the face of the threat of a \$200 million judgment, Canada elected to rescind its importation ban. In the absence of Chapter 11, Canada would have retained the sovereign right to review the ban solely in its own domestic judicial system.

Ethyl illustrates the possibility that regulatory efforts can be chilled by Article 1110 expropriation claims. But *Ethyl* also implies another, perhaps less obvious, manifestation of the chilling effect concept. That is, domestic environmental regulations may also be chilled by the mere threat of an Article 1110 claim. While difficult to verify, it is easy to imagine a situation in which a government wants to create new regulations to address an environmental concern, but believes that such a regulation will be challenged by foreign investors in the NAFTA Chapter 11 system. In such a situation, the government may decide that the potential costs of a challenge outweigh the benefits of the regulation, and elect not to go forward in the first place.

The comparison of American and Canadian takings jurisprudence with Article 1110 expropriations points to another potentially significant threat to sovereignty over domestic environmental regulation. Given that Article 1110 essentially creates an international takings standard that is broader than that under Canadian or American domestic law, an aggrieved NAFTA investor can potentially receive a remedy from a Chapter 11 tribunal that it could not receive if it brought its claim in a domestic court. For example, a Canadian corporation with

investments in the United States could be entitled to compensation for a partial taking under *Metalclad* that it would not be entitled to in United States District Court.

This broader international takings standard also creates a potential second bite at the apple for investors. Meaning, a foreign investor that brings a claim under domestic law and loses has a second chance at receiving compensation from a Chapter 11 tribunal.⁶² For example, at least one arbitration tribunal has indicated that domestic court decisions may be reviewed by NAFTA tribunals and found to be expropriations under international law.⁶³ Thus, a Chapter 11 panel decision could potentially find a regulatory taking that was denied by the United States Supreme Court or the Supreme Court of Canada.

It is likely, however, that these threats to sovereignty have been mitigated somewhat by the outcomes of *S.D. Meyers* and *Methanex*. While *S.D. Meyers* did prevail on its overall claim, it is noteworthy that its expropriation claim failed because the regulation did not go far enough. And various commentators have noted that the *Methanex* decision should help alleviate concerns about broad regulatory takings protections under Article 1110.⁶⁴

Analyzing all NAFTA Chapter 11 cases as a whole also tends to show that the threats to sovereignty may not be as significant as many people claim. As of February, 2005,⁶⁵ there were 42 total claims brought under Chapter 11. Of these 42 claims, eleven were in active arbitration, six had been dismissed by the tribunal, and only five had ended with a positive result for the investor. The five positive investor outcomes consisted of one settlement (*Ethyl*), one victory on expropriation grounds (*Metalclad*), and three victories on non-expropriation grounds (including

⁶² *NAFTA's Threat to Sovereignty and Democracy: The Record of NAFTA Chapter 11 Investor-State Cases 1994 – 2005*, Public Citizen (2005), available at <http://www.citizen.org/documents/Chapter%2011%20Report%20Final.pdf>.

⁶³ *Id.* (discussing the *Loewen v. United States* Chapter 11 arbitration).

⁶⁴ *See, e.g.,* Sanford E. Gaines, *Methanex Corp. v. United States: Partial Award of Jurisdiction and Admissibility*, 100 AM. J. INT'L L. 683, 685 (2006).

⁶⁵ *See NAFTA's Threat to Sovereignty*, *supra* note 62. No additional arbitration proceedings have been completed subsequent to the *Methanex* decision.

S.D. Meyers). The remaining 20 claims were either pending, abandoned by the investor, or otherwise idle for unknown reasons. Thus, only two of 42 arbitrations can be considered successful expropriation claims. Together, these two claims resulted in only \$29 million in compensation and the rescinding of one regulation. These costs pale in comparison to the benefits of increased investment that have been realized under NAFTA.

V. Conclusions and Potential Solutions

Is there a real threat to sovereignty, and therefore to domestic environmental regulations, resulting from Article 1110? The possibility of a chilling effect (both seen and unseen) and the broad international regulatory takings standard tend to answer this question in the affirmative. But the combination of the *Methanex* decision and the fact that only two expropriation claims can be considered successful tend to answer in the negative. The question is thus difficult to answer, but it is clear that there is at least some potential threat to sovereignty from NAFTA Chapter 11. And this potential threat is magnified by the lack of *stare decisis* before arbitration tribunals. There is always the possibility that subsequent tribunals could interpret investor protections broadly and thereby create a real threat. This danger warrants a discussion of safeguards that could be implemented now, before a significant threat ever materializes.

One such solution is available under Article 1131(2).⁶⁶ That provision allows the NAFTA Free Trade Commission (FTC),⁶⁷ a body created to administer NAFTA, to issue a clarification that “shall be binding on a tribunal established under this Section.” The FTC used this power to clarify the meaning of Article 1105 while *Methanex* was being decided.⁶⁸ It could

⁶⁶ NAFTA, *supra* note 1, art. 1131(1).

⁶⁷ The Free Trade Commission is comprised of cabinet level representatives of Mexico, Canada, and the United States, is created under Article 2001, and is generally charged with overseeing the implementation of NAFTA.

⁶⁸ Gaines, *supra* note 64, at 688.

use this clarification power again to define exactly what Article 1110 means when it refers to actions “tantamount to...expropriation.”

Alternatively, NAFTA could be amended outright to define an expropriation standard. Article 2202⁶⁹ allows member countries to “agree on any modification of addition” to NAFTA, subject to approval “in accordance with the applicable legal procedures of each Party.” Thus, any formal amendment would have to be ratified via the process normally used in each member country for international treaty ratification. However, because Article 1131 interpretations can be made without this large procedural hurdle, a clarification is probably preferable to an amendment.

One possible standard of expropriation can be found in the Dominican Republic-Central American Free Trade Agreement (DR-CAFTA). The DR-CAFTA was signed in 2004, and creates a free trade agreement among the United States, the Dominican Republic, Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua.⁷⁰ The DR-CAFTA has expropriation provisions (Article 10.7(1)) analogous to those in NAFTA Article 1110. But it also has an annex that lists the factors tribunals should consider when they entertain expropriation claims. Specifically, the annex requires a “case-by-case, fact-based inquiry” that must consider:

(i) the economic impact of the government action, although the fact that an action or series of actions by a Party has an adverse effect on the economic value of an investment, standing alone, does not establish that an indirect expropriation has occurred; (ii) the extent to which the government action interferes with distinct, reasonable investment-backed expectations; and (iii) the character of the government action.⁷¹

It also includes a specific exception for government regulations that are “designed and applied to protect legitimate public welfare objective, such as public health, safety, and the environment.”⁷²

⁶⁹ NAFTA, *supra* note 1, art 2202.

⁷⁰ Rachel D. Edsall, *Note: Indirect Expropriation Under NAFTA and DR-CAFTA: Potential Inconsistencies in the Treatment of State Public Welfare Regulations*, 86 B.U. L. REV. 931, 938 (2006).

⁷¹ *Id.* (citing DR-CAFTA, Annex 10-C(4)(a)).

⁷² *Id.* at 938-39 (citing DR-CAFTA, Annex 10-C(4)(b)).

This is but one of many standards that could be used under Article 1110, either by clarification or amendment, to force tribunals to make more uniform decisions.

There is also a third, and clearly very drastic, solution to the sovereignty threat. Article 2205⁷³ authorizes any party to withdraw from NAFTA after providing six months written notice. Such an extreme solution would eliminate the sovereignty threat completely, but is both politically and economically problematic for obvious reasons.

Of the three options discussed, Article 1131 clarification seems like the most likely solution to the sovereignty issue. But it is certainly not a 100% solution. NAFTA tribunals will still be empowered to hear regulatory takings claims that could otherwise be heard only in domestic courts, and they will still have substantial leeway in interpreting any new standard adopted by a clarification. The reality is that there is no perfect solution to this problem because a key element of any international trade agreement is that its parties must give up some of their sovereignty in order to enjoy the benefits of free trade.

⁷³ NAFTA, *supra* note 1, art. 2205.