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Takings Litigation Goes Global:

An analysis of potential constraints on local regulatory authority resulting from international investment agreements

Remarks before
The International Municipal Lawyers Association, International Committee
by
*William T. Waren**

October 4, 2004

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* William Waren is policy director of the Forum on Democracy and Trade, and adjunct professor of law at Georgetown University Law Center, 111 F street NW, Washington D.C. 20001, (202)662-4236, *wtw2@law.georgetown.edu.*

Summary

1. **The controversy over international investment agreements.** Attempts are now being made to resolve the controversy.

    a. State and local officials supported the Kerry Amendment.

    b. The office of the U.S.Trade Representative and the U.S. State Department have launched discussions about how international investment agreements might be reformed.

2. **State and local measures are being challenged under NAFTA's chapter 11.** For example, consider the *Methanex*, *Glamis*, and *Grand River Enterprises* cases.

3. **How investment agreements provide greater rights to "foreign" investors.**

    a. Investment agreements broadly define investor rights.

        (1) "Indirect expropriation"-a kind of international expansion of regulatory takings doctrine.

        (2) Less than "minimum treatment under international law"- a kind of international substantive due process.

        (3) Less than "national treatment"- a prohibition on treatment that favors domestic firms.

        (4) Foreign investors enjoy greater rights because investment agreements make few provisions for deference to local legislatures or domestic courts.

    b. NAFTA panels have confirmed greater rights for foreign investors.

        (1) "Investment" is a broader concept than "property" under U.S. takings law, e.g. loss of market share can be a basis for an international investment claim.

        (2) Regulatory measures that cause a 'significant" economic impact are an expropriation.

        (3) Partial and temporary "takings" claims are permitted under international law.

    c. U.S. negotiators continue to expand investor rights.

        (1) The United States proposal appear to allow American as well as third country companies to use subsidiaries to qualify as foreign investors.

(2) The United States will likely propose elimination of domestic court review of international arbitral decisions.

(3) The United States proposes "most favored nation" provisions in new agreements to invoke the most investor friendly parts of any existing U.S. investment agreement, e.g. as a result any reforms in a future agreement would be superceded as a practical matter by more investor-friendly provisions of NAFTA chapter 11 and similar existing agreements.

4. **Investor-to-state dispute resolution elevates transnational corporations to the same litigation status as nation states for purposes of international arbitration.**

   a. NAFTA chapter 11-type agreements are unique in allowing private corporations and individuals may initiate claims against nation-states.

   b. Massive money damages may be awarded.

   c. Investment tribunal decisions can be effectively enforced against states.

5. **Local governments need to respond.**

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1. Introduction: the controversy over international investment agreements.
NAFTA's chapter 11 on investment and the several bilateral and regional international investment agreements generally based on its model have created a genuine controversy. The drafter of chapter 11, Dan Price who is now a partner at Sidley & Austin, sees international investment rules as a simply a common sense recognition that "it would be unfair to force an investor to bear the entire cost of a change in social policy." By contrast, Bill Greider, the liberal columnist for The Nation, says that, " NAFTA's new investor protections actually mimic a radical revision of constitutional law that the American right has been aggressively pushing for years—redefining public regulation as a government "taking" of private property that requires compensation to the owners."

The problem for the defenders of chapter 11-style investment agreements is that today in contrast to three years ago not all the critics are on the left. Centrists and conservatives, particularly within the community of state and local elected officials, have in a balanced and measured way also raised concerns about these agreements, and as witnessed by the exclusion of a chapter 11-style investment chapter from the recently concluded U.S./Australian Free Trade Agreement are having an influence on policy.

As a consequence, it is at least possible that USTR and moderate elements in the business community may seek to resolve the controversy by crafting a compromise that adjusts the chapter 11 model to address some of the most serious state and local concerns.

a. State and local officials supported the Kerry Amendment. In response to cases like *Methanex, Metalclad, and Glamis,* a large number of state and local officials, including the leaders of such national associations as the National League of Cities, the National Conference of State Legislatures, the U.S. Conference of Mayors, the National Association of Counties, the Conference of Chief Justices, and many others, supported an amendment to the Trade Act of 2002 offered by Senator John Kerry that would have constrained U.S. negotiators from entering into international investment agreements granting greater rights to foreign investors than are enjoyed by U.S. investors under our constitution.

The U.S. Congress did pass a much diluted version of the Kerry Amendment that in broad terms instructed U.S. negotiators not to grant foreign investors greater substantive rights than those enjoyed by U.S. investors, but this language has not effectively constrained U.S. negotiators from including provisions similar to NAFTA's chapter 11 in a series of agreements including the bilateral agreements with Chile and Singapore and the proposed Central American Free Trade Agreement.

Significantly, however, after pressure from U.S. state and local officials, and from Australian states, a NAFTA-style investment chapter was stripped from the text of the U.S./ Australia Free Trade Agreement.

b. The U.S. State Department and the U.S. Trade Representative have launched discussions about how international investment agreements might be reformed.

The U.S. State Department, in response to a mandate in the 2002 Trade Act, has convened meetings of an advisory group of trade association representatives, corporate trade lawyers, representatives of state and local government associations, and environmental groups to discuss proposals for a structure and process for appealing international investment tribunal decisions. Among the ideas being considered by the Bush Administration is a process for convening ad hoc appellate review panels, under the auspices of the World Bank, whose decisions would not be subject to any form of domestic court review of the kind now provided under the New York Convention and United Nations rules for international commercial arbitration. The Administration is expected to release its appellate review proposal sometime in the early fall of 2004.

In response to a proposal by New York Governor George Pataki's trade representative, the Office of the U.S. Trade Representative (USTR) has authorized the creation of a working group on international investment agreements of its Intergovernmental Policy Advisory Committee (IGPAC). IGPAC is the USTR-authorized advisory group that considers the impact of international trade and investment agreements on state and local governments. The members of IGPAC are representatives of the major state and local government associations who have been approved by USTR, who have been cleared in an FBI background investigation, and who are sworn to secrecy about U.S. negotiating positions and other confidential matters, under potential penalty of criminal prosecution for unauthorized disclosure of secret information.

2. State and local measures are being challenged under NAFTA's chapter 11. NAFTA cases, initiated by foreign investors under chapter 11, have resulted in challenges to a broad range of measures, including:

- California's ban on the gasoline additive MTBE (*Methanex v. United States);*
- California regulations related to reclamation of open pit mines (*Glamis v. United States*); and
- Administration of state tobacco settlements (*Grand River Enterprises v. United States*).

In one particularly disturbing case, *Metalclad v. Mexico*, a U.S. corporation brought a chapter 11 claim against Mexico, claiming its property had been expropriated and that it had not been accorded minimum treatment under international law when Mexican state and local governments exercised their environmental zoning and permitting authority to stop Metalclad from opening a waste disposal site located on top of an aquifer that provided drinking water to the local community. A NAFTA tribunal agreed that Metalclad=s property rights had been violated and ordered Mexico to pay over $16 million in damages.

3. How investment agreements provide greater rights to foreign investors. NAFTA's chapter 11, the proposed investment chapter for a Central American Free Trade Agreement (CAFTA), and similar existing and proposed international investment agreements appear to grant foreign investors or the foreign subsidiaries of U.S. investors greater rights than businesses domiciled in the United States enjoy under the U.S. constitution, with respect to the scope of the property interests protected from government regulation.

a.Investment agreements broadly define investor rights. International investment agreements create an international forum for "foreign investors," outside the U.S. court systems, where they may seek monetary compensation from the U.S. government if local law, regulation, or court decisions affect their profits or assets. Foreign investors are entitled to compensation for:

- "Indirect expropriations," a kind of international expansion of U.S. regulatory "takings" doctrine;
- Less than "minimum treatment under international law," a kind of international substantive due process; or
- Less than "national treatment," a prohibition on treatment that favors domestic firms.

(1) Indirect expropriations. NAFTA=s chapter 11 and subsequent agreements modeled on it require member nations to compensate investors if a national or sub-national government Adirectly or indirectly@ nationalizes or expropriates an investment of the other countries' investors in its territory or takes some action that is Atantamount@ to expropriation. The terms of this expropriation article and the concept of Aindirect Aexpropriation, in particular, are undefined and wide open.

(2) Minimum treatment under international law. NAFTA-style investment agreements require member nations to provide other members' investors with

Atreatment in accordance with international law, including fair and equitable treatment and full protection and security.@ All of these terms were undefined, until on July 1, 2001, when the trade ministers of the three NAFTA parties, acting as the Free Trade Commission, issued an interpretation of the meaning of the minimum treatment standard, as the customary international law standard, but again failed to define the elements of that customary international law standard. Nonetheless, it is an absolute standard that is unrelated to how a nation-state treats its own citizens. The net result is that NAFTA tribunals have great discretion to strike at parliamentary acts based on creative readings of customary international law.

(3) The standard for Anational treatment.@ Both the NAFTA and WTO cases make clear that national treatment covers not only intentional discrimination, but also neutral laws that have the effect of changing the conditions of competition in favor of domestic firms. This Aeffects test@ for national treatment could be more stringent than limits imposed on legislatures by national constitutions. And, the constraints on legislative and regulatory authority could be significantly more stringent than even that if future tribunals follow the suggestion in the *S.D. Myers* case that Anational treatment@ implies that legislators must choose the Aleast trade restrictive@ means of implementing their policy goals.

b. Foreign investors enjoy greater rights because investment agreements make few provisions for deference to local legislative bodies or domestic courts.

(1) Deference to legislative judgments: Neither NAFTA=s chapter 11 nor any subsequent investment agreement contains a provision requiring dispute resolution panels to show deference to the legislative judgments. Without the codification of principles of deference to legislative judgments in such agreements a real danger exists that tribunals will see broadly worded, vague and undefined international law concepts like Aindirect@ or Acreeping@ expropriation or like Aminimum treatment under international law@ as a source of general and wide-ranging authority to second guess legislative judgments.

(2) Deference to national courts. NAFTA tribunals have determined that national and sub-national court decisions are Ameasures@ subject to their review under chapter 11. If a similar concept of Agovernment measures@ is imported into the decisions of tribunals convened under bilateral and regional investment agreements, it arguably could be a threat to the independence of domestic court systems and the capacity of national, state, and local legislatures to regulate them.

c. NAFTA panels have confirmed greater rights for foreign investors.

(1) The NAFTA definition of investment is far broader than the definition of property under U.S. takings doctrine. NAFTA defines investment very broadly, to include enterprises, equity, debt securities, real estate, certain contracts and concessions, intellectual property, and goodwill. For example, in the *Metalclad* case, the tribunal held that the relevant investment was not just the real property involved, but rather Metalclad Corporation's broader interest in operating a particular type of

business, a hazardous waste facility, on that property. Similarly, the NAFTA definition of investor is based on a residency test and is equally broad.

(2) NAFTA's expropriation provision allows compensation for regulatory measures that merely meet the threshold of a "significant" or "substantial" deprivation of the expected economic benefit of the property. The tribunal in *Metalclad* characterized the NAFTA standard of expropriation as follows: "[E]xpropriation under NAFTA includes not only open, deliberate and acknowledged takings of property, such as outright seizure or formal or obligatory transfer of title in favor 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…"

(3) Partial and temporary takings claims are permitted under NAFTA. According to the NAFTA tribunal deciding the case of *S.D. Myers v. Canada*: "An expropriation usually amounts to a lasting removal of the ability of an owner to make use of its economic rights although it may be that, in some contexts and circumstances, it would be appropriate to view a deprivation as amounting to an expropriation, *even if it were partial or temporary*." This is hardly consistent with concepts of "conceptual severance" in U.S. takings jurisprudence.

d. U.S. negotiators continue to expand investor rights

(1) Suits against the United States by subsidiaries of U.S. corporations. NAFTA article 1113 is unclear as to whether subsidiaries of U.S. corporations organized in Canada and Mexico and doing substantial business there may bring a NAFTA investment claim against the United States, thereby circumventing the U.S. court system. But, article 10.12 on denial of benefit of standing in the recently-concluded Central American Free Trade Agreement would appear to deny standing only to subsidiaries of companies owned or controlled by persons from countries with whom the United States has either broken diplomatic relations or barred commercial transactions.

In a related development, a World Bank ICSID tribunal in the case of *Tokios Tokeles v. Ukraine*, interpreting "denial of standing" language in a Ukraine/Lithuania investment agreement that is not dissimilar in its lack of clarity from CAFTA article 10.12, determined that a Ukrainian-controlled company organized in Lithuania and operating in the Ukraine had standing to bring an investment claim against Ukraine.

(2) Elimination of domestic court review. In response to a mandate in the 2002 Trade Act, the U.S. State Department will likely present to Congress later this month a proposal to create a process for appellate review of international investment tribunal decisions that would prohibit even limited domestic court review of international tribunal actions.

(3) MFN provisions. U.S. negotiators continue to include broad "most favored nation" (MFN) obligations in recently-concluded regional and bi-lateral investment agreements. MFN obligations require each party to an agreement to

accord investors of another party treatment no less favorable than it accords to investors from third party countries. Thus, MFN provisions may be used to invoke the most investor-friendly provisions of any other U.S. investment agreement. As a result, any reforms in a future agreement will be superceded by more investor-friendly provisions of NAFTA chapter 11 and other long-standing treaties and agreements.

For example, in the recent case of *Maffezini v. Spain*, brought under the *Spain-Argentina Bilateral Investment Treaty*, an investor from Argentina was allowed to bypass initial review of its claim by Spanish domestic courts as required by the Spanish/Argentine agreement because investors from Chile are allowed under the *Spain-Chile Bilateral Investment Treaty* to proceed directly to international arbitration. In the case of *MTD v. Chile* an international investment tribunal made a similar interpretation of MFN obligations under the *Malaysian-Chile Bilateral Investment Treaty*, which were found to incorporate by reference provisions of the *Chile-Denmark Bilateral Investment Treaty*, thus requiring Chile to compensate a Malaysian developer for the refusal of local officials to waive local land use regulations to allow MTD to proceed with a massive commercial and residential development in a protected zone.

5. Investor-to-state dispute resolution elevates transnational corporations to the same litigation status as nation-states for purposes of international arbitration.

a. Private corporations and individuals may initiate complaints against nation-states. Unlike trade complaints, which are controlled by governments, the NAFTA chapter 11 model allows private companies to decide whether and when to initiate an investment complaint based on their own business needs, regardless of the impact on public policy or national interest.

Because investor claims do not have to be brought by a national trade ministry, they are likely to occur with much greater frequency than trade complaints between nations. The number of nation-to-nation disputes under trade agreements is held in check by considerations of public policy, fear of retaliation, and the simple bottle-neck of democratic decision-making. Private parties in investor disputes are under no such restraints.

Private parties, also, are far more likely than governments to make arguments to tribunals based on an expansive reading of international law that places the rights of property far above social values or the prerogatives of democratic institutions

b. Massive claims for money damages may be awarded. Investment agreements on the NAFTA chapter 11 model empower private investors to claim monetary compensation from national governments if the investor can prove a violation of the agreement. Investor-initiated complaints are notable because of the amount of compensation being sought, $1 billion in the *Methanex* case, for example. Such damage claims running into the billions of dollars might be expected if bracketed language allowing damage awards for expected future profits is adopted in the a recent version of the proposed Free Trade Area of the Americas.

c. **Investment tribunal decisions can be effectively enforced against the localities.** NAFTA-style investment agreements may be enforced against by federal government lawsuits to preempt local or state measures (though private suits are barred), or simply by the political pressure resulting from uncapped money damages assessed against the United States. Moreover, the federal government has great leverage over the states and localities through its spending power; it is entirely conceivable that the federal government would seek indemnification from state or local governments should it have to pay damages to satisfy an investment tribunal judgment based on a sub-national government violation of international investment rules.

5. **State and local governments need to respond.** If state and local officials are passive, then NAFTA investment complaints (and investment complaints arising under the similar regional and bilateral investment agreements) could result in a loss of state sovereignty and local autonomy. State and local law related to land-use planning and environmental regulation, in particular, may be at risk. This suggests a three-part response.

   a. **Legal analysis**. The first step is to analyze how international investment obligations compare to U.S. constitutional standards, and in particular to analyze how they compare to U.S. "takings" doctrine. The second step is to identify state and local laws that might violate international obligations. The crucial third step is to identify strategies for defending state and local sovereignty.

   b. **Communication.** A network of state and local attorneys might be organized to raise awareness of the threats and opportunities presented by the NAFTA investment chapter and similar agreements. Perhaps the best way to do this would be to work through existing organizations such as the National Association of Attorneys General and the International Municipal Lawyers Association and then to connect to associations of state and local elected officials such as the National League of Cities and the National Conference of State Legislatures that are already engaged on international investment issues.

   c. **Advising the federal government.** State and local attorneys have an important role in advising the Congress and the President on important issues of intergovernmental relations in the trade-policy arena. There is precedent for this. State attorneys general took the lead in insisting on sovereignty protection measures within the 1994 implementing legislation for the WTO. The International Association of Municipal Law Officers also has been active on so-called local-global issues.

   The U.S. Constitution created the world's first free trade zone. The genius of the Framers, however, is not merely that they reigned-in protectionism. They also struck a durable balance between private property interests and government power. In the global context, the goal should be to promote the original American ideal of balancing democracy and property rights. But, state and local public officials and their attorney-advisors are still in many ways only secondary players in the trade policy debate. They can play a much more important role in preserving state and local governments as "laboratories of democracy" even as the nation evolves with the global economy. .