NAFTA's Chapter 11 and the Environment: Addressing the Impacts of the Investor-State Process on the Environment

Executive Summary

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Foreign Direct Investment and Sustainable Development

Foreign direct investment, or FDI, is critical to achieving sustainable development in developing countries. In the last two decades it has eclipsed official development assistance. Between one-third and one-half of all private investment in developing countries now comes from FDI. These flows are needed to replace unsustainable industries and infrastructures with sustainable ones. They may also bring spin-off benefits: investing firms may build up technological and management capacity in the host states, increasing their ability to sustainably manage their natural resources.

But without the right policy framework, FDI can also pose significant risks to sustainable development. Investors, after all, are motivated by profits, not by public interest. If FDI is to achieve its potential sustainability benefits it will have to be both environmentally sustainable in its effects and sustained in its growth and distribution. International investment agreements can contribute toward both these ends, though traditionally they have concentrated on the latter, helping to ensure the predictability and security that will increase investment flows. Avenues for ensuring environmental sustainability include creating investor responsibilities and strengthening or protecting the host country's environmental regulation and enforcement.

NAFTA's Chapter 11 on Investment and the Environment

The North American Free Trade Agreement (NAFTA), completed in 1992 by Canada, Mexico and the United States, was the first regional or multilateral investment agreement to grapple with these issues. The focus in those negotiations was on enhancing investor security. Where the environment was considered, the focus was mainly on the enforcement of environmental laws and assuring that NAFTA would not lead to the creation of so-called pollution havens or a general "race to the bottom" for environmental standards.

Acknowledgements

Howard Mann is lead author of the report. He is a senior lawyer and consultant in Ottawa, Canada, specializing in international law for sustainable development, including trade and environment law. Howard's clients include government and non-governmental agencies in Canada and abroad. He is an Associate with IISD's Trade and Investment Program.

Konrad von Moltke is the associate author. He is a Senior Fellow at the Institute for International Environmental Governance at Dartmouth College. Konrad is also an adjunct professor at Dartmouth College in the US and at the Institute for Environmental Studies at the Free University of Amsterdam. He is a Senior Fellow with IISD's Trade and Investment Program.

This research benefited from the active assistance of an Advisory Group chaired by David Runnalls (IISD) and consisting of David Schorr (WWF-US), Gustavo Alanis Ortega and Ana Karina Gonzalez (Centro Mexicano de Derecho Ambiental), Dianne Humphries (Pollution Probe, Canada) and Scott Vaughan (North American Council for Environmental Cooperation). Aaron Cosbey of IISD served as Project Manager.

IISD gratefully acknowledges the generous funding for this research made available by the Charles Stewart Mott Foundation (US) and the Walter and Duncan Gordon Foundation (Canada).

The International Institute for Sustainable Development (IISD) is an independent, not-for-profit corporation headquartered in Winnipeg, Canada, established and supported by the governments of Canada and Manitoba. IISD's mission is to champion innovation, enabling societies to live sustainably.

International Institute for Sustainable Development
161 Portage Avenue East, 6th Floor
Winnipeg, Manitoba Canada R3B 0Y4
Tel.: (204) 958-7700 § Fax: (204) 958-7710 § E-mail: info@iisd.ca § Web site: http://iisd.ca

In contrast, during the negotiations and over NAFTA's first two years, little attention was given to the scope and interpretation of the investment protection provisions contained in NAFTA's Chapter 11, and how they relate to environmental protection by the host state. The past few years' experience demonstrates, however, that this is a critical area to consider. The investor protections provided in NAFTA's Chapter 11 have been used repeatedly to challenge the host country's environmental laws and administrative decisions. As a consequence, the provisions designed to ensure security and predictability for the investors have now created uncertainty and unpredictability for environmental (and other) regulators. This in turn has impacts on a broad range of public values and threatens to determine the public perception of the entire agreement.

Indeed, many analysts attribute the OECD's failure to conclude a Multilateral Agreement on Investment (MAI) in large part to the failure to properly account for sustainable development concerns, and to the secrecy of process that surrounded all but the late stages of negotiation. Part of the interest in NAFTA's experience with the investor-state dispute mechanisms stems from the possible reincarnation of the MAI negotiations in the WTO, as well as in the negotiations for a Free Trade Area of the Americas (FTAA).

The table below sets out the known Chapter 11 cases initiated to date. (As will be noted below, the absence of any transparency requirements means this list may be incomplete.) Claims have ranged from $10 million to $750 million US. The one case that has been concluded was settled for $13 million, plus the withdrawal of the contested legislation. The cases in boldface are those with a known environmental angle.

Company	Party	Issue
Halchette Distribution Services	Mexico	Unknown
Signa S.A. de C.V.	Canada	Impact of administrative drug approval process on an investor
Ethyl Corp.	**Canada**	**Import ban on gasoline additive MMT for environmental purposes**
Metalclad Corp.	**Mexico**	**State and municipal actions allegedly preventing the location of a hazardous waste facility**
Desona de C.V.	**Mexico**	**Alleged breach of contract to operate a landfill**
Marvin Feldman	Mexico	Unknown
USA Waste ("Acaverde")	**Mexico**	**Believed related to landfill activities**
S.D. Myers	**Canada**	**Temporary ban on PCB waste exports**
Loewen Group Inc.	United States	Award against company following allegedly biased civil court proceeding
Sun Belt Water Inc.	Canada	Allegedly biased treatment by provincial government of US partner in a joint water-export venture
Pope & Talbot	**Canada**	**Allegedly discriminatory export quotas to implement the US-Canada Softwood Lumber Agreement**

The Investor-State Dispute Settlement Process

NAFTA has an extensive investor-state dispute resolution process, which gives foreign investors the right to directly challenge host governments on their compliance with the Agreement. This mechanism was sought by the US and Canada to protect their investors in what was then a suspect Mexican system, and was welcomed by Mexico as a tangible guarantee, sure to increase the flow of investment from the North. As a result of this confluence of economic interests, Chapter 11 of NAFTA contains the most extensive set of rights and remedies ever provided to foreign investors in an international agreement.

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While much of the cause for environmental concern derives from the way the provisions have been argued in the cases to date (examined in greater detail below), there are two characteristics of the dispute-resolution process that compound the substantive concerns.

First, the process allows foreign investors to sidestep procedural or public interest safeguards in favour of a non-transparent, secretive system of arbitration with no right of appeal. While common in purely commercial areas where money is the only issue, Chapter 11 is unprecedented in its reach into critical areas of public policy-making, as the cases to date demonstrate.

Second, the right to initiate cases is unfettered by any need for consent from the parties. The result is a growing and alarming strategic use of the provisions by investors to further private interests, often at the expense of environmental protection and other public policy goals. It is clear from the history of the use of Chapter 11 to date that this strategic tool will be employed both before and after regulations have been adopted. This has changed, and arguably misappropriated, the investor-state provisions from their traditional role as a defensive investor protection mechanism to an offensive strategic tool.

Initiating such suits is virtually cost-free for major companies, costing literally just a few thousand dollars to prepare a notice of intent to arbitrate that starts the process and produces privileged access. Absent clarity on how to interpret the provisions (What constitutes expropriation? What is meant by national treatment?), this is a modest cost to business with a large potential cost to government.

The Substantive Issues

There might be less cause for concern about the dispute-resolution mechanism if there were greater certainty about the scope and interpretation of the provisions on which it rules. The scope of the provisions is alarmingly broad; the definition of "measures" subject to review includes both legally binding and non-binding acts, and even such things as court decisions. This leaves a wide range of measures open to potential challenge, certainly including environmental and other public welfare laws, regulations, policies or administrative actions. One case, settled out of court, argued that government statements about the dangers of the investor's product constituted actionable "measures." The government reversed these statements in the settlement.

The definition of investor and investment is equally broad, including virtually any form of equity participation, debt security, many loans to an enterprise, property acquired in the expectation of an economic benefit, other interests arising from a commitment of capital, and so on. Minority shareholders in a company, certain bond holders, and other "passive" investors can exercise the rights of an investor under Chapter 11, in some cases without having the consent of the company itself. It is foreseeable that a foreign component might be strategically added to an otherwise domestic investment simply to have access to the extraordinary rights and remedies found in Chapter 11.

There are five disciplines to which the Parties must adhere:

- national treatment;
- most-favoured nation treatment;
- minimum international standard of treatment;
- prohibitions against certain performance requirements on investors; and
- provisions governing expropriation.

The best known of these in the environmental community are the provisions on expropriation. But the other provisions are also troubling from a sustainable development perspective. The existing Chapter 11 challenges against Canada alone have already raised all five of these disciplines in seeking damages for Canadian environmental measures. As argued below, each discipline is fraught with uncertainties that have significant negative impacts on sustainable development.

Arts. 1102, 1103: National Treatment and Most-Favoured Nation (MFN). These are comparative standards that require a host country to treat a foreign investor in a manner that is "no less favourable" than the way in which they treat their own investors or investors from any other country. This seems straightforward, but its actual application raises a number of questions. First, what does "no less favourable" mean to an environmental regulator? Does it mean that a foreign investor must receive the best treatment of any other company? Does it require average treatment, if this can be measured? Can the comparison be against a domestic company receiving the least-favourable treatment of all domestic companies? A pending case argues that the investor has received less favourable treatment than some domestic firms, since it is subject to softwood lumber export quotas in its province of operation (as are domestic firms in that province), but such restrictions are not present in some other provinces. In another case, an investor argued that even though there were no domestic firms producing its product (MMT, a gasoline additive), an import ban violated its rights since it amounted to treatment less favourable than a domestic producer would have received.

Second, it is unclear whether there may be some legitimate reasons for treating a foreign investor differently. The "no less favourable" treatment to be accorded foreign investors is to occur "in like circumstances," a phrase which has been defined in laws covering trade in goods. But defining it in the context of long-term investments is a different kettle of fish. If a foreign investor is denied permission to build a polluting plant because emissions from the existing plants in that area have already reached regulatory thresholds, are the potential investor and the existing firms in "like" circumstances? And, while "like circumstances" for goods producers has come to be judged by the commercial substitutability of the goods, such a test may be too limited for environmental regulators, who will also need to consider the environmental impacts of production, consumption and disposal of the goods.

Art. 1105: Minimum standard of treatment in accordance with international law. This discipline requires minimum standards of "international law, including fair and equitable treatment and full protection and security," to be met. The existing cases that cite this provision argue a fairly consistent theme of lack of due process and/or a denial of justice. From a sustainable development perspective, this is the least worrisome of the five Chapter 11 provisions.

Art. 1106: Performance requirements. This discipline prohibits certain types of requirements governments might try to impose on investors. For example, governments may not demand that firms source their inputs domestically, or export a certain percentage of their output. Nor may they demand that investors transfer a particular technology or proprietary knowledge as a condition of investment. There is an environmental exception for measures "necessary" to "protect human, animal or plant life or health" or for the conservation of natural resources, but the traditional interpretation of "necessary" in trade law exceptions suggests this may be a tough hurdle to clear.

One worrying uncertainty is whether this provision might be used against any measure that restricts the import or export of goods, or imposes any quotas or tariffs, whether or not related to a specific firm or as a condition of investment. In the case of Canada's import ban on MMT, for example, the complainant argued that the ban had the effect of a performance requirement, since it effectively forced the firm to produce the product domestically rather than import it. Canada protested that this argument would make every border measure a performance requirement, but conceded that the issue could be decided on the merits. The case was settled out of court in the complainant's favour, perpetuating the uncertainty.

Art. 1110: Expropriations. The provisions on expropriation have received the most public attention, given their significant potential impacts on environmental regulation. Article 1110 states in part:

> *"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 nondiscriminatory basis; (c) in accordance with due process of law and Article 1105(1); and (d) on payment of compensation…"*

This article serves a valuable purpose; foreign investors need protection from unfair expropriation of their physical property. They also need protection from less extreme or obvious actions with the same intent, such as the removal of directors or excessive taxation. Most of the disputes brought to arbitration under this article will be of the latter type, complaining that some government measure, by constraining the commercial activity of the investor, constitutes *indirect* nationalization or expropriation, or is *tantamount* to it. The concern is that this article may be interpreted so as to prevent governments from regulating commercial activity to protect the environment, or human health and safety—exercising the "police powers" that are not traditionally considered expropriation under international law.

In the United States, this question has become a heated issue under the title of "regulatory takings." This is a constitutional issue arising from the protection of private property, and one that has particular significance for environmental laws because of their impact on land and property use. If Article 1110 (1) is successfully used to challenge government actions, it will amount to a short-circuiting of the ongoing US process for resolving this still controversial issue.

Most worrying in the NAFTA context is the lack of clear guidelines to help distinguish between takings subject to compensation and regulation that is not. Analysts of the present state of international law generally hedge their bets on the distinction, even for measures of general application and absent any discriminatory or abusive factors. This is in part because increasingly, even where the *intent* or *purpose* of a measure is laudable, the measure's actual *effect* is the test used in determining liability. This "effects test" creates even more uncertainty in the context of the changing nature of environmental regulation, which necessarily involves targeted measures, based on site-specific activity. Such regulations, permits or administrative decisions are bound to be uneven in their economic effects across the regulated sector.

The uncertainty that prevails in general international law on this question is compounded in the NAFTA context by a number of provisions unique to the Agreement. These include the expansive definition of "measures," discussed above, and a specific exception for certain measures of general application (implying a willingness to contemplate a broader range of application than normally prevails). The Agreement also breaks new ground in applying the Chapter 11 provisions to general measures of taxation, and in including three separate threshold tests for compensability: expropriation, indirect expropriation, and measures tantamount to expropriation.

In the final analysis, it is difficult to predict which of the broad range of existing or proposed environmental measures in the NAFTA countries might be found to amount to expropriation. This has troubling implications for environmental policy. FDI, unlike trade in goods, is a long-term process, often extending several decades. The prospect of paying compensation for changes in environmental regulation over the life span of a foreign investment has the potential to create "regulatory freeze." It is worth noting that the Chapter 11 challenges against Canada have now addressed the only two new legally binding environmental measures with a significant impact on business operations adopted by the federal Government of Canada since NAFTA came into force.

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It would be highly inappropriate to systematically pay compensation for regulatory adjustments. This would amount to taxpayers' money being required to pay for the right of a government to protect the environment, an entirely perverse result in light of the ascendancy of the polluter-pays principle in national and international environmental law. As well, it is inconsistent with the objectives of

NAFTA: to promote sustainable development and upward harmonization of standards.

The Procedural Issues

As troubling as the substantive risks detailed above is the secrecy that surrounds the initiation and conduct of investor-state disputes—NAFTA's so-called "Cone of Silence." There are no requirements to provide the public with information at various stages of the process, such as the notice of intent to litigate, the consultation process, or the initiation of litigation. Governments are not required to make public the pleadings of the parties, and can even maintain secrecy of final awards. The secrecy has begun to be reversed by at least two of the three governments, but the process of change remains *ad hoc*.

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The negative impact of this lack of transparency is aggravated by at least two key factors in the NAFTA case. First, the scope of the measures covered by NAFTA, and the uncertainties of interpretation of the provisions, mean that many cases will go beyond narrow commercial disputes to core issues of public policy. Second, Chapter 11 allows negotiations on such issues to take place solely between the government and foreign investors, in a privileged and secret context.

> *"The investment law process allows corporate actors to choose the issues to be litigated, and the facts best suited to achieving a business-oriented interpretation of the applicable provisions, and allows them to do so under the Cone of Silence."*

The combination of these two factors serves to erode the democratic legitimacy of the process, a fundamental aspect of promoting and achieving sustainable development. On issues of broad public interest, such as the environment, health and safety, multi-stakeholder consultations are needed so the government can balance the diverse interests to determine appropriate policy. Chapter 11 disputes, however, involve a secretive process in which the government is litigating public interest measures based on the interests identified by one actor, and the remedies available only to that one type of actor. This gives foreign private interests an unhealthy privileged access to the policy-making process, without even the accountability that comes from public release of the pleadings. The investment law process allows corporate actors to choose the issues to be litigated, and the facts best suited to achieving a business-oriented interpretation of the applicable provisions, and allows them to do so under the Cone of Silence. It even allows them to choose one of the three arbitrators.

The Recognition of the Issues by the NAFTA Parties

The three NAFTA parties have recognized, though to varying degrees, the importance of these substantive and procedural issues. Trade officials considered the issues in the fall of 1998 with follow-up meetings in December, January and March 1999. While these discussions did not produce results, the need to continue them was recognized by the ministers after their meeting in Ottawa in April 1999.

Environment ministers have also recognized the need to address the problems, though less directly. They have acknowledged that the Chapter 11 challenges "may raise important environmental issues," and noted that officials are working to define the role of the North American Council for Environmental Cooperation (CEC) as it might relate to the Council of NAFTA's Free Trade Commission. While there is not yet consensus on a role for the CEC, there is at least recognition of the importance of the issues and the need to consider how it might contribute.

> *"In that context, the chair of the negotiations clearly and unequivocally stated the need to address what were referred to as the unintended consequences of the NAFTA language."*

All three NAFTA Parties also participated in the failed

MAI negotiations in the OECD. In that context, the chair of the negotiations clearly and unequivocally stated the need to address what were referred to as the unintended consequences of the NAFTA language.

Conclusions and Recommendations

Our analysis indicates that the Chapter 11 provisions, designed to ensure security and predictability for the investors, have now created uncertainty and unpredictability for environmental (and other) regulators. A number of factors contribute to this result: the unfettered ability of an investor to initiate an action; the uncertainty of interpretation in the provisions; and the expansive definitions of measures covered, and of investors able to use the process. The risk brought by such uncertainty, augmented by the growing strategic use of the provisions by private interests, makes the job of the environmental regulator more difficult and may lead to a regulatory freeze. Addressing these issues is fundamental to gaining and maintaining public support for future efforts at trade liberalization and negotiations on investment, particularly given the swelling tide of sentiment against globalization.

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The wait-and-see approach is not recommended. The legal uncertainties in the Chapter 11 disciplines are inherent in the scope and language of the provisions adopted by the negotiators, and are unlikely to be significantly reduced by pending arbitrations. In any case, panels are not bound by the interpretations of previous panels, and it is possible that final arbitral decisions may not even be released for consideration, making any kind of consistent case law difficult.

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It is equally important to address the procedural issues, opening up a process that affects issues of broad public interest to normal standards of transparency and accountability. Continued secrecy under Chapter 11 will intensify public mistrust of other international trade and investment processes, such as the FTAA and possible Millennium Round negotiations in the WTO. The unwillingness of governments to adequately address sustainable development issues is already credited in the failure of two key trade and investment processes: the OECD's MAI negotiations, and the granting of "fast-track" negotiating authority in the US—a prerequisite to meaningful international trade negotiations.

Clearly, the parties must reduce the uncertainty created by Chapter 11's substantive and procedural provisions. This should be done by means of an interpretive statement for specific provisions of Chapter 11. This is a mechanism specifically referred to in NAFTA, and it would be legally binding on all future arbitration panels. Importantly, such an interpretive statement does not require an amendment to NAFTA, and does not raise any risks to any other chapters or sections of the agreement.

The process for achieving solutions is as important as the resolve to do so. The ultimate responsibility to address this issue clearly lies with NAFTA's Free Trade Commission. But the principles of sustainable development and its requirements of transparency and inclusiveness dictate that these issues can be most effectively resolved through an open process that meets NAFTA's own positioning on openness. An obvious collaborator is the CEC, which has a mandate to assist in developing a constructive relationship between trade and environment issues. It can provide useful assistance and important public credibility to the Free Trade Commission in addressing the problems highlighted here.

The recommendations drawn from this analysis are summarized below:

1. The uncertainties surrounding the substantive obligations in Chapter 11 must be addressed. While additional longer-term steps may still need to be considered, it is recommended that a risk-management approach be adopted by the parties to immediately reduce the uncertainties and restore, to the degree possible, certainty and predictability for government regulatory activities.

2. Under Chapter 11, an interpretive statement formally adopted by the three NAFTA parties is the only way to establish a legally binding interpretation of any of the provisions in Chapter 11. It is strongly recommended that all three NAFTA parties pursue this approach aggressively and immediately.

3. There should be two broad policy objectives for an interpretive statement. First, it should ensure that government regulators are given the certainty and predictability to carry out their business without the burden of the high degree of uncertainty now arising from the risks associated with the unknown possibilities of Chapter 11. Second, it should maintain the basic security of the investor to challenge government measures that are discriminatory or lack *bona fides*, or are expropriative in a classic sense of dispossession.

4. These policy goals should be achieved by a statement that:

- clarifies the meaning of the national treatment discipline (and other non-discrimination disciplines) in an environmental context, by providing a sample list of environmental factors that recognize the temporal and spatial context of environmental regulation, and that should be considered in any comparison of whether investors are "in like circumstances";
- clarifies the relationship between environmental trade measures and the performance requirements prohibitions of Chapter 11; and
- clarifies the scope of the expropriation provisions to exclude non-discriminatory environmental measures, thereby deflecting the potential investor-state challenges from expropriation issues to national treatment and minimum international standards disciplines.

5. The risk of a market-based approach dominating the interpretation of the national treatment discipline should be addressed. The goal should be to provide specific points of reference for establishing when conduct is or is not discriminatory, or does or does not constitute treatment "no less favourable." This is very different from establishing a legal exception for when discriminatory conduct is acceptable. The legal policy objective is also to establish when a type of regulation does not constitute a performance requirement or a measure falling under Article 1110 on expropriation.

6. Greater emphasis should be placed on due process issues as a comparative basis as between foreign and domestic investors.

7. A longer-term view should be adopted, with an eye to restricting the potential reach of the investor-state process into environmental and public welfare regulation, and to ensure full transparency and public access to the proceedings.

8. It is urgently recommended that an aggressive short-term course of action be adopted by all three NAFTA parties to apply the existing rules of procedure in favour of transparency and public access on *every* occasion when there is a discretion in how they can be applied. Where secrecy is not expressly required by NAFTA or the associated arbitration rules, the parties should ensure public access and availability of the maximum number of documents and information. The absence of an agreed approach should not hold back each party from unilaterally pursuing these approaches.

9. Where the agreement of the disputing parties or an arbitral panel is required to provide public access to materials, to oral hearings or as friends of the court to submit their own briefs, such agreement should be actively sought by all three NAFTA parties. Individual investors using the system should be forced into a position of defending the secrecy if they so wish. This can be done by agreement of the parties or unilaterally.

10. Each party should establish national working groups involving appropriate stakeholders, and leading to the development of specific proposals by the governments for detailed but timely negotiation.

11. Such negotiations should proceed in a transparent manner, and in cooperation with the CEC. In the absence of an independent and centralized NAFTA Secretariat, the CEC Secretariat can provide an organized secretariat function and appropriate facilities for conducting both public and private meetings aimed at addressing this issue.