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Protectionism or Legitimate Regulation?

A Hope for Clarity in the Murky Waters of Chapter Eleven’s Expropriation Provisions.

INTRODUCTION

How much will you pay for uncontaminated water? How much is clean air worth? Many commentators claim that these are the type of questions North American governments may have to ask their citizens if the Methanex Corporation (Methanex) is successful in its claim against the United States. Methanex has filed a claim under Chapter 11 of the North American Free Trade Agreement (NAFTA), alleging that it is due compensation for what it characterizes as California’s expropriation of its property. The company alleges that California’s decision to phase out the use of Methyl tert-Butyl Ether (MTBE), a gasoline additive used to reduce exhaust emissions from vehicles, resulted in an expropriation of its property right to sell its product. According to Methanex, it is entitled to approximately one billion dollars in compensation for its expropriated property. The state of California claims that this action was taken to protect its water supplies from MTBE contamination. Is one billion dollars an appropriate amount to pay to ensure its water remains uncontaminated? Should a state be required to pay for the right to protect its natural resources? The answer to both of these questions is no. A sovereign state should not have to pay an investor for the right to protect its natural resources from harm due to an investor’s activity. If Methanex’s case proceeds to final arbitration, arbitrators, using the customary rules for treaty construction and applicable rules of international law, must find that Methanex’s claim for compensation based on California’s regulatory action is not sanctioned by Chapter Eleven of the NAFTA because the term “expropriation,” as used in Chapter Eleven of NAFTA, does not include regulatory takings
claims that are based upon legitimate, non-discriminatory environmental regulation aimed at protecting the public welfare.

Before reaching this conclusion, this paper will briefly introduce Methanex’s claim and the circumstances that surround it in section one. Section two will introduce the NAFTA and the relevant Chapter 11 provisions. In section three, this paper will explore the meaning of the term “expropriation” as it pertains to Chapter 11 of the NAFTA. Finally, section four will apply the principles set forth in section three to Methanex’s claim.

Section One: Methanex’s claim

Methanex, the leading global producer and marketer of methanol, is a Canadian Corporation whose sole business is the production, transportation and marketing of methanol [1]. Approximately one third of the methanol it produces is sold to MTBE manufacturers and used to manufacture MTBE [2]. MTBE is primarily used as an oxygenate and a source of octane in gasoline [3]. MTBE is added to gasoline to reduce vehicle emissions [4]. It has been used as an oxygenate since the 1970s; however, the use became widespread as a result of the Clean Air Act Amendments of 1990 (CAA) [5]. The CAAA required gasoline producers to eliminate lead from gasoline by 1996 [6]. MTBE quickly became the oxygenate of choice to replace lead due to factors such as cost, refinery production, blending characteristics, availability, and security of supply [7], although some organizations argue that MTBE was chosen by the oil industry because it offered a greater source of profits, despite the availability of safer, cleaner alternatives [8].

In the mid-1990s, trace amount of MTBE were detected in some of California’s drinking water [9]. On October 9, 1997, the state of California passed legislation appropriating $500,000 to the University of California to conduct a study of the adverse effects and benefits associated
with the use of MTBE as a gasoline additive [10]. The study concluded on November 12, 1998, recommended that the use of MTBE be phased out over a period of years [11]. On March 25, 1999, Governor Gray Davis issued Executive Order D-5-99, citing the study’s conclusion that the use of MTBE poses a threat to groundwater and drinking water as the basis for the action [12]. The Order directed various state agencies to take actions to eliminate the use of MTBE in gasoline within the state [13]. On June 15, 1999, Methanex responded to Executive Order D-5-99 by filing its Notice of Intent to submit a claim to the United States for breach of Article 1110 of the NAFTA [14]. Methanex claims that it is entitled to approximately $1 billion dollars in compensation for the loss of its investments expropriated by California’s action. Methanex claims that, as a result of the California ban, it has suffered a loss of a substantial portion of its customer base and market for methanol, goodwill, reduced global demand and global price for methanol, and a reduction in the price of its stocks [15].

Section Two: Introduction to the NAFTA

The NAFTA officially came into force on January 1, 1994 amidst fervent debate [16].

The primary function of the NAFTA is to promote the economic growth through free trade. The Preamble of the agreement states the Parties’ desire to develop world trade by expanding and securing markets. Article 102 lists the objectives of the NAFTA as the elimination of trade barriers, promotion of fair competition, increasing substantial investment opportunities in the parties' territories, establishing a framework for further trilateral cooperation, and creating procedures for the resolution of disputes [17]. The Preamble also states the parties’ intention to achieve NAFTA’s goals “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 [18].” Some, who characterize the NAFTA as the “greenest” trade agreement to date, saw its enactment as a major victory for
environmentalists[19]. To back this claim, these proponents pointed to the unprecedented language included in the preamble and other substantive provisions of the NAFTA that deal explicitly with environmental protection[20]. Others claim that the NAFTA is a major victory for trade interests, which effectively subverts environmental protection measures.[21] From either viewpoint, NAFTA has been the topic of much speculation and condemnation during the six years it has been in force.

It is the investor-state dispute mechanism (ISDM) provided in Chapter 11 of the NAFTA that engenders the most criticism. In order to deliver the economic benefits promised under NAFTA, its drafters created “the most expansive combination of rights and remedies ever given to the private sector in an international agreement[22].” When it was signed, the NAFTA was the only major trade agreement that allowed private investors to enter into binding arbitration with member governments over treaty violations[23]. Before the NAFTA was enacted, these types of disputes were addressed, if at all, through bi-national or tri-national arbitration proceedings[24]. Before NAFTA, an aggrieved investor claiming harm due to a treaty violation had to convince its national government to take action on its behalf, or content itself with recourse to a court of the violating nation[25]. So, the rights accorded private investors under Chapter 11 have been characterized as “revolutionary” and “unprecedented[26].” The problem with the ISDM provided in Chapter 11 “arises from the combination of very broad, but often vague rights along with mandatory remedies[27].”
Chapter Eleven addresses the treatment of international investors by member nations and is divided into two subchapters. Subchapter A enumerates the obligations host nations owe the foreign investments of other member nations. Among these obligations is the duty to compensate investors for expropriated property[28]. In the event that a host nation fails to comply with any of these obligations, Subchapter B establishes a dispute resolution mechanism and, if all requirements are met, allows investors alleging harm as a result of non-compliance to submit a claim for binding arbitration. Under the NAFTA, the federal government of a member nation is responsible for the actions of its states or provinces; therefore, any claim based upon action taken by a state, province or local government must be asserted as an action against the federal government[29]. Standing to bring a claim granted under the Chapter 11 provisions appears to be rather broad. Article 1138 broadly defines an investor as “a Party or state enterprise thereof, or a national or an enterprise of such Party, that seeks to make, makes or has made an investment[30].” Article 1138 also broadly defines the term investment “to include virtually any enterprise and all forms of tangible and intangible property including intellectual property and interest arising from the commitment of capital or other resources[31].” Once a claim is filed, Article 1123 provides for an arbitration panel consisting of three members. Under this provision, each party selects one member of the arbitration panel and the third, presiding arbitrator is selected by
agreement of the parties. If an arbitration panel is not established within 90 days from the date the claim is submitted for arbitration, Article 1124 authorizes the Secretary-General of ICSID to appoint the required arbitrators, upon the request of either party[32]. Article 1135 provides that the decision of the arbitration panel is binding and enforceable in the courts of any member nation. The arbitration panel may award monetary damages or the restitution of property, but it may not award punitive damages[33].

One major problem with the Chapter 11 ISDM is its lack of definition for the term “expropriation.” Article 1110(1) provides that,

No Party shall 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 (d) upon payment of compensation.

If action taken by the government of a member nation is deemed to be "expropriation" with the meaning of Article 1110(1), then the arbitration panel must award the aggrieved investor compensation[34]. The question is: when does government action that adversely affects an investment amount to expropriation under Chapter 11[35]? Clearly, if a government chose to divest an investor of all rights to use its physical property, such action would be expropriation[36]. But, would regulation of industrial or economic activity be an expropriation if it harms
or impinges upon an investor’s use of an investment? At this point, no one seems to know for sure.

This question is significant in that it determines the rights and responsibilities of investors and state actors alike. For an investor, the distinction between measures that require compensation and those that do not may well make the difference between operating in a foreign country and the choosing to forego investment in the first place[37]. For the state, this distinction may define the scope of its rights and obligations, as well as its power to regulate[38]. The governments of member nations, “as environmental regulators, now exist in an atmosphere of uncertainty because they have to consider potential Chapter 11 claims with every significant regulatory change[39].” It is this uncertainty that garners most of the criticism concerning the Chapter 11 ISDM. The potential for crushing liability “or the chilling effect of the number and size of claims that may arise . . . can deter governments from legislating in the interest of the public[40].” In fact, since the NAFTA officially came into force, approximately 16 cases have been filed under its Chapter 11 provisions[41]. Of these cases, approximately ten involve expropriation claims based upon government regulatory action and at least eight involve environmental regulatory action. These cases “demonstrate the lobbying capacity attached to Chapter 11, a capacity never envisaged when the NAFTA negotiations took place[42].” Some commentators have asserted that this regulatory “chilling effect” impinges upon states’ sovereignty
by inhibiting the ability to control their natural resources[43].

Of course, not everyone sees these provisions in a negative light. Some argue that Chapter 11 provides investors the security needed to ensure that time and capital spent investing in a country will be worthwhile[44]. These commentators argue the Chapter 11 ISDM provides safeguards that encourage private investment and that these investments, in turn, can make a positive contribution towards ensuring sustainable development. They argue that increased investment activities, in turn increase economic wealth in an area, which in turn can lead to increased investment in pollution prevention measures[45]. With respect to the sovereignty issues presented, Daniel Price, who represented the United States during the NAFTA negotiations, argues that, “rather than being a threat to sovereignty, NAFTA checks the excess of unilateral exercises of sovereignty[46].” He argues that much of the “furor” surrounding the ISDM in the NAFTA is based upon the novelty of the notion that the United States can be a defendant in one of these cases[47]. His advice to critics, is to “get over it[48].”

Chapter 11 claims for expropriation based upon environmental regulation are “currently a hot topic in United States and Canadian environmental circles,” so it is unlikely that critics are going to “get over it” very soon[49]. However, some measure of resolution may be forthcoming. Barry Appleton, who represented two of the investors that asserted claims for
regulatory expropriation based on environmental actions, explained that the Methanex case is expected to clarify what expropriation means under Chapter 11[50]. As in many of the other cases filed under Chapter 11 of the NAFTA, the success, or failure of Methanex’s claim will depend upon whether arbitrators find that California’s regulation is expropriation within the meaning of the treaty.

Section Three: The Meaning of “Expropriation” Within the Context of the NAFTA

The Methanex arbitration panel must interpret the term, “expropriation,” as used in Chapter 11 of the NAFTA under the method set forth in the Vienna Convention of 1969. Vienna Convention of 1969 is generally reflective of the customary international law on treaty interpretation[51] and the United States accepts it as a correct statement of customary international law[52]. The Vienna Convention places the primary emphasis on examining the “plain language”, or intrinsic meaning of a treaty term[53]. Article 31 of the Convention provides, “[a] treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose[54].” The Vienna Convention instructs that the preamble and any annexes may be considered in order to determine the context of the treaty[55]. It also instructs that, “any relevant rules of international law applicable in the relations between the parties” must be “taken into account, together with the context,” to determine the meaning of the treaty term[56]. Extrinsic, or supplementary evidence of a treaty’s
context or the meaning of a term is generally not used in interpreting treaties[57]. However, recourse to supplementary means of interpretation is permitted in order to confirm the meaning derived from application of Article 31 principles, or where the result derived from the primary application are “ambiguous or obscure” or where it “leads to a result which is manifestly absurd or unreasonable[58].” Under the Vienna Convention, “ambiguity” means “no more than a continuing uncertainty” regarding the meaning of a term[59]. Finally, Article 33 of the Vienna Convention provides that when a treaty that has been authenticated in more than one language, “the text is equally authoritative in each language” and “the terms of the treaty are presumed to have the same meaning in each[60].”

Then, in accordance with the principles of interpretation set forth in the Vienna Convention, the Methanex arbitration panel must first attempt to determine the plain meaning of the term “expropriation.” But what is the ordinary meaning of “directly or indirectly expropriating an investment” in a treaty that states its goals are to develop trade, eliminate trade barriers and promote fair competition in a manner consistent with environmental protection, while also promoting sustainable development and strengthening the development and enforcement of environmental regulation? And what then is “a measure tantamount to expropriation?” It should be noted that, the text of Article 1110 appears to establish three types of expropriation: (1) direct expropriation, (2) indirect expropriation and (3) measures tantamount to
expropriation. However, the NAFTA does not provide a definition of “expropriation,” direct or indirect, anywhere in its text.

Article 1130, however, does direct arbitrators to decide issues before it in accordance with the Agreement and “applicable rules of international law;” therefore, in accordance with the directions in the text, the arbitrators must apply the definition of expropriation found in international law. Rules of international law may be garnered from the body of state practices, treaties and judicial interpretations[61]. It is generally well settled in international law that government action that deprives a person of all use of physical property in their possession is a direct expropriation and requires compensation[62]. “In general, the term ‘expropriation’ carries with it the connotation of a ‘taking’ by a government-type authority of a person’s ‘property’ with a view to transferring ownership of that property to another[63].” Legitimate expropriation, under international law, requires (1) that the government take the property for a public purpose, (2) in a non-discriminatory manner and (3) prompt payment of compensation to the deprived party[64].

However, it is not well settled law that government action that is taken to regulate its natural resources, in a non-discriminatory manner, which indirectly impinges upon an investor’s ability to use its property is expropriation under international rules of law[65]. Under international law, such regulatory takings are known under the rubric of “indirect,” “creeping” or “disguised”
expropriation[66]. Once direct expropriation measures were more frequently addressed in the international forum, government actors began to take less obvious measures to divest foreign investors of control over their investment[67]. Instead of merely taking the property, governments would enact taxation schemes directed at the investment or require the removal of directors in order to allow the state to gain control over the investment[68]. Upon recognition of these measures as means of “disguised expropriations,” international rules were developed to provide foreign property owners protection against them; thus, in some cases, governments were required to compensate property owners for divesting them of their property rights under the guise of regulatory action[69]. “Still, international law continued to maintain the traditional exception for normal regulatory activities under the label of ‘police powers,’ as long as these were non-discriminatory in nature[70].” So, to determine if Methanex’s claim is “indirect expropriation,” the arbitration tribunal will have to determine whether the evolution of the international law on expropriation has evolved to include environmental regulation that indirectly deprives an investor of property rights, and whether the NAFTA itself encompasses these actions within its terms.

International law on expropriation has not yet incorporated legitimate non-discriminatory environmental regulatory takings into the term “indirect expropriation.” “It is an accepted principle of international law that a state is not liable for economic injury which is a consequence of bona-
fide ‘regulation’ within the accepted power of police states[71].” Police powers can be defined as “’[t]he power of states to place restraints on the personal freedom and property rights of persons for the protection of public safety, health, and morals, or the promotion of the public convenience and general prosperity[72].’” Apparently, no international tribunal has directly addressed whether this principle applies to environmental regulatory takings, but it would seem that it does and scholars have assumed that it does[73]. Under international law action taken to regulate anti-trust, consumer protection, securities and other legislation “regarded as essential to the efficient functioning of the state” are not expropriations[74]. In light of the obvious impact of human activities on the environment and the equally clear relationship between environmental health and human health, the logical conclusion is that regulation of the environment and natural resources are at least as legitimate as these other governmental concerns and should be considered to be within the police power of sovereign states[75]. Therefore, under this rationale, if the government offers legitimate environmental reasons for its action and these reasons bear “some plausible relationship to the action taken,” then these acts should not be considered to be an “indirect expropriation” even if they indirectly deprive an investor of property rights[76].

Still, with the emergence of the “effects test” the conclusion that there is an exception for regulatory action within a state’s police power is undermined. The effects test
determines whether a regulator action is expropriation by looking at the measure rather than its intent or purpose[77]. Under the effects test, if a measure were to substantially interfere with the operation of an investment, it would be an expropriation and would require compensation[78]. Under the effects test, the significance of the regulatory purpose of a measure is minimalized or eliminated as a factor. Therefore, if the effects test in central to the interpretation of the term “indirect expropriation,” then the exception carved out for regulations enacted pursuant to legitimate use of police power is weakened, if not eliminated[79]. The Third Restatement of the Foreign Relations Law of the U.S., comment (g) of section 712 “recognizes that the distinction between taking and regulation is not always clear but may rest on the degree of the interference with the property interest[80]. Some claim that the language of the NAFTA appears to follow the position set forth in the Restatement[81]. Indeed, Daniel Price, the U.S. negotiator of the NAFTA states that he believes that “a measure that diminishes the value of an investment and does not necessarily transfer ownership to a third party is still treated under the rubric of expropriation[82].” Proponents of this position argue that arbitrators judging disputes under the NAFTA should be bound to the view that the effect of a measure on an investment must determine liability rather than the government’s intent or the nature of the government action[83].
How, then, is possible to say that an arbitrator interpreting the NAFTA must determine that legitimate, non-discriminatory environmental regulatory action is not “indirect expropriation,” even if it harms an investment? Foremost, it must be noted that not all of the language in the Restatement Third is universally accepted as part of the customary international law on expropriation[84]. Then, it must be remembered that under the principles of treaty construction established in the Vienna Convention, an interpreter’s primary goal must be to determine the plain meaning of treaty terms. Interpreters may not consider external evidence, such as the opinion of treaty negotiators unless application of the principles enunciated in Article 32 results in the derivation of an “ambiguous or obscure” meaning. Until an interpreter has exhausted the means of interpreting the ordinary meaning of the term, these sources should have no weight. Moreover, arguments based on the likeness of the language of Article to 1110(1) to that of the Restatement also fail to lead to the conclusion that the effects test should be used to determine whether “indirect expropriation includes environmental regulation. Assertions based on the argument that the language of NAFTA appears to follow the Restatement position must succumb to the explicit textual command in NAFTA that arbitrators interpret its provisions in light of “applicable rules of international law.” Many treaties and agreements use language that is quite similar to that in the Restatement, but do not use the effects test to determine whether the action at issue is an example of
“indirect expropriation.” Moreover, the Restatement itself recognizes an exception for “bona fide” action that is “commonly accepted as within the police power of states, if it is not discriminatory[85].” To the extent that the Restatement position is not in accordance with customary international law, it has no force in interpretations of NAFTA provisions due to the dictates of the Vienna Convention.

While there appears to be no definitive bright line test, most recent tribunals appear to be using a hybrid approach that is a combination of the effects test and the police power exception. This approach recognizes the right of a sovereign state to control its natural resources, as well as the need to protect foreign investors from expropriation “disguised” as regulation. Under this hybrid approach, Tribunals may still adhere to the declarations stated in Resolution 1803, which is considered to be “the most recent consensual statement of international law on the matter of expropriation[86].” Resolution 1803 would seem to tip the balance of any conflict between investors’ rights and states’ rights in favor of the state whenever the state is acting within its sovereign power to regulate its natural resources. The Resolution declares that “[f]oreign investment agreements freely entered into by or between sovereign States shall be observed in good faith; States and international organizations shall strictly and conscientiously respect the sovereignty of peoples and nations over their natural wealth and resources[87].” The hybrid approach also allows tribunals to adapt to the need to
protect the rights of foreign property owners by affording them some latitude to investigate the state’s true purpose in enacting legislation.

The hybrid approach used by these tribunals is an ad hoc balancing of interests. Modern tribunals frequently cite a number of factors similar to those used in the United States when deciding regulatory takings claims under the Fifth Amendment[88]. Factors most commonly cited by these tribunals are the duration of the regulation, the reasonableness of the government’s actions, the severity of the impact on the investor and whether the investor could have reasonably expected the particular impact[89]. Perhaps in deference to the importance of protecting property rights, these tribunals have often stated that the most important factor in deciding whether compensation is required is the degree to which the regulation impacts upon the value of the investment[90]. One recent NAFTA tribunal explained that the degree to which the investor remains in control of the investment is relevant to determining whether the impact is substantial enough to constitute expropriation[91]. Through the use of these factors to determine if an expropriation has occurred, the emerging hybrid approach seems to be able to balance the competing needs of investors and state actors.

There appears to be a tenuous consensus that under the rules of international law, legitimate, non-discriminatory environmental regulation is not expropriation, even if it impacts upon an investor’s property rights. This
conclusion is also consistent when taken in the context of the NAFTA. The balance reached by the ad hoc analysis framework is appropriate to achieve both the trade goals and the parties’ intention to promote sustainable development and strengthen environmental law that are stated in the preamble. It is also consistent with the other provisions relating to the environment in the NAFTA. Article 1114(1) clearly states that [n]othing in this Chapter shall 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.

This language gives the definite impression that a host state has a right to introduce new environmental regulations without opening itself up to liability for expropriation[92]. Moreover, Article 1114(2) states that, “it is inappropriate to encourage investment by relaxing domestic health, safety or environmental measures” and requires parties to enforce its existing environmental laws. An interpretation of the term “indirect expropriation” to require compensation for the economic impact of environmental regulations would also conflict with the provisions of Article 1114 by making it more difficult and costly for governments to adopt new environmental laws or strengthen its existing ones[93]. Finally, this standard is consistent with the additional environmental protection provided in the NAFTA provisions through explicit incorporation of the general exceptions to the General Agreement on Tariffs and Trade (GATT). The GATT provisions incorporated into the NAFTA
provide that a country may place restrictions on trade if the restrictions are “necessary to protect human, animal or plant life” or relate “to conservation of exhaustible natural resources” and provided that the restrictions are “made effective in conjunction with restrictions on domestic production or consumption[94].” The explicit guarantees concerning environmental protection in the NAFTA, the language of the preamble, Article 1114 and incorporation of the GATT provisions should create the presumption that measures taken to protect the environment are not expropriation within the meaning of the NAFTA[95]. More importantly, these provisions strongly support the conclusion derived from the application of the international rules of expropriation that the term “indirect expropriation” used in Article 1110(1) does not include legitimate, non-discriminatory environmental regulations.

In the event that an arbitrator is unsatisfied with this conclusion, extrinsic evidence may be used to verify result. While comment (g) of the Restatement, and the statements made by Daniel Price may weigh against this conclusion, the weight of extrinsic evidence supports it. Interpreting an exception for environmental regulatory measures is consistent with the “polluter pays principle” ensconced in the Rio Declaration on the Environment, to which the United States, Canada and Mexico are all signatories. The polluter pay principle is the idea that entities polluting common resources should bear the burden of paying for the costs of the harm, rather than placing the burden on society at large[96]. Also, U.S., Canadian, and Mexican law “share a common understanding that the government is not obliged to compensate for the economic impact of most legitimate regulatory action[97].” Hence, a contrary interpretation of the term “indirect expropriation” would result in foreign investors receiving greater rights that
those granted nationals under the laws of each member state. Finally, it should be noted that the NAFTA and its side agreement, the North American Agreement on the Environment (NAAEC) were initially intended to be parallel agreements [98]. The NAAEC contains provisions to ensure the strict enforcement of the parties’ existing environmental regulations and provides for coordinated efforts to produce effective remedies against trade-induced environmental degradation [99]. These sources clearly support the conclusion that “indirect expropriation” does not include legitimate, non-discriminatory measures to protect the environment, but the inquiry cannot end here.

Recall that Article 1110(1) sets forth three types of expropriation: direct expropriation, indirect expropriation and “measures tantamount to expropriation.” If direct expropriation is actual interference with physical property and indirect expropriation involves “disguised” takings, what are “measures tantamount to expropriation?” Could it be that the NAFTA intended this phrase to include a new, broader category of expropriation? The Oxford English Dictionary defines the word tantamount to mean “equivalent.” In the authenticated French and Spanish versions of the NAFTA the text reads as “équivalent” and “equivalente” in place of “tantamount.” Since the word “equivalent cannot logically be read to encompass more [100],” the term then must be intended to embrace the concept of creeping expropriation and nothing more [101]. Three NAFTA arbitration panels that have recently considered this issue and all three have rejected the idea that the phrase “tantamount to expropriation” was intended to create a new category of expropriation not already accepted in customary international law [102]. All three panels accepted the notion that the phrase was intended to refer to the concept of “creeping” or “disguised” expropriation, but does this interpretation render the phrase redundant and meaningless?

No, it does not. The NAFTA was drafted against the backdrop of international law. International law, as it pertains to expropriation, is in a state of transition. The recognition
of “creeping” expropriation sparked changes in the state of the law. Significantly, the NAFTA was drafted explicitly to incorporate the rules of international law, including the international law on expropriation. It is likely that the drafters of the NAFTA thought it was necessary to include the phrase “tantamount to expropriation” to clarify that the treaty embraces the modern conception of “creeping” or “indirect” expropriation and rejects the extremely deferential standard used under the police powers exception. Hence, the phrase is not redundant, nor is it meaningless.

Section Four: Application of these principles to Methanex’s Claim

To determine whether Methanex has asserted a cognizable claim for expropriation, the arbitration panel will have to assess California’s action under the hybrid approach. One factor, the reasonableness of the action, will be determinative of this case. Assuming that Methanex has standing to bring its claim, determining whether Methanex has asserted a cognizable claim for expropriation under Chapter 11 will depend largely upon the arbitration panel’s characterization of California’s action. If the arbitration panel concludes that it was unreasonable for California to ban the use of MTBE, as Methanex claims, then the act must be deemed expropriation and the United States may be required to compensate the company for its losses.

Applying the factors under the hybrid approach, California’s action should be considered indirect expropriation of Methanex’s investment if it was unreasonable action to take, since the other factors appear to balance out. The duration of California’s action appears to be indefinite, so that factor must weigh in favor of Methanex. However, the regulation of MTBE and the consequences of its regulation cannot be said to be unexpected. The use of MTBE as an oxygenate originated primarily as a result of the Clean Air Act Amendments of 1990, which required the elimination of lead from gasoline. Since then, MTBE, along with other oxygenates used to replace lead have been the subject of debate and study to assess their
effectiveness and their effect upon health and the environment. Given this regulatory climate, it would have been reasonable for Methanex and other investors in the MTBE industry to expect further regulation; therefore, this factor must weigh against Methanex. The impact of the regulation is of modest severity. It is true that California’s regulation deprives Methanex access to one portion of the market for its product. However, the effect of the ban only diminishes the global demand for its product, methanol, by 6%, according to Methanex. Methanex remains in control over its investments, it directs the daily operations of the investment and has complete autonomous authority to appoint directors and make decisions regarding management and shareholder activities. In sum, Methanex is not “ousted” from full ownership and control over the investment. One NAFTA arbitration panel recently concluded that the interference with an investment must be “sufficiently restrictive to support a conclusion that the property has been ‘taken’ from the owner.” This factor appears to weigh in favor of the conclusion that California’s action does not rise to the level of expropriation. Yet, due to the fact that it is not entirely clear that this is the case, the determination of this claim is likely to depend upon the arbitration panel’s assessment of the reasonableness of California’s action.

Methanex argues strenuously that California’s decision to ban the use of MTBE is not reasonable. Methanex asserts that the decision is politically motivated protectionist regulation designed to promote domestic industry, that it is based upon incredulous science and that it is unnecessary. Foremost, Methanex claims that the primary cause of MTBE contamination is leaking underground storage tanks (USTs). It argues that if California enforced its regulations concerning these USTs to prevent them from leaking in the first place, MTBE would not be released into the environment and, therefore, would not reach water supplies. It cites the University of California Report for the conclusion that, if all the USTs in the state were upgraded in accordance with state and federal laws, gasoline leaks into groundwater would be reduced by up to 97%. Moreover, it argues, the contamination complained of is
minimal. Methanex also argues that the University of California Report (U.C. Report) that the state relied upon in deciding to ban MTBE is “fundamentally flawed.” Finally, Methanex argues that the ban was motivated by a desire to eliminate competition for and promote the use of ethanol, a domestic product whose primary manufacturers contributed over $200,000 to Governor Davis’ campaign fund and engage in extreme lobbying tactics. Methanex claims that the Executive Order imposing the ban is facially discriminatory in that it specifically names ethanol as the replacement oxygenate. Methanex claims that the coalition formed by the state of California and the ethanol industry on this issue is prima facie evidence that the regulation is based upon improper motives.

The United States has not yet replied to these new allegations; however, its defense may be readily anticipated from facts known about the case. First, the basis for California’s action, as stated in the Executive order is the conclusion that it is necessary to protect state resources from the significant risk posed by the use of MTBE. The Executive Order was issued pursuant to Senate Bill 521. The Bill directed the University of California to assess the health and environmental risks and benefits associated with MTBE in comparison to other oxygenates. The Bill also authorized the Governor to take “appropriate actions” if the MTBE was found to pose significant risks to human health or the environment. The University of California Report (U.C. Report) estimated that 0.3 to 1.2% of public water supplies in California are contaminated with detectable levels of MTBE. The U.C. Report recommended consideration of phasing out of MTBE over an interval of several years.

In its reply, the United States can be expected to argue that increased UST enforcement alone would be an unsatisfactory method of addressing the MTBE contamination problem because of the problems presented by MTBE’s chemical composition. The United States should point to the fact that MTBE is highly corrosive of metals, thus, contributes to the tendency for USTs to
Also, this ignores other substantial forms of release into the environment, such as tanker spills. In addition, once it does enter the environment, MTBE binds tightly to water, moves rapidly through soil and biodegrades slowly. Its chemical properties make remediation of MTBE contaminated sites extremely costly. For the state of California, these properties necessitated more drastic measures. As to the argument that the actual level of contamination is minimal, the state can be expected to argue that any contamination is too much given the uncertainty that surrounds the potential health adverse effects associated with MTBE. Moreover, it should argue, as sovereign over its natural resources, a state should be free to establish a zero tolerance policy, if it determines such a policy is warranted.

Each side has cited numerous scientific studies and claim these studies support their respective positions. Methanex claims that these studies have produced no evidence that MTBE causes acute health effects. It cites evaluations conducted by the European Union, the International Fuel Quality Center and the German Environmental Protection Agency as examples of unbiased political bodies that have assessed the adverse effects and the benefits associated with the use of MTBE and concluded that MTBE should not be banned. The United States points to the United States Environmental Protection Agency’s (USEPA) classification of MTBE as a potential human carcinogen and the recommendation of USEPA’s Blue Ribbon Panel that the use of MTBE should be reduced to minimize threats to posed to drinking water. In short, if there is consensus among the scientific community concerning the effects of MTBE use, neither party has been able to identify its source.

The lack of consensus within the scientific community concerning the effects of using MTBE should weigh in favor of the conclusion that California’s regulation is legitimate and not expropriation. Where there is credible doubt, or a lack of consensus, the government actor should be given the benefit of doubt. It is reasonable to require that the risk that a measure is designed to prevent be real and supported by scientific evidence; however, the government actor
should not be required to show that its action is supported by the most correct, most accepted or best science. “Such a requirement is contrary to the precautionary principle and inconsistent with the nature of science [127].” The precautionary principle is the widely accepted notion that sovereigns have the right to regulate activities to protect the environment, even if the scientific evidence supporting the regulation is inadequate, inconclusive or controversial [128]. It is “based on the premise that science does not always provide the information or insights necessary to take protective action effectively or in a timely manner, and that undesirable and potentially irreversible effects may result if action is not taken [129].” More importantly, a government’s ability to adequately protect its resources is “meaningless unless governments are permitted a full range of responses to legitimate environmental risks [130].” For these reasons, an arbitration tribunal “should limit its inquiry to determining whether the science underlying the risk determination has the minimal attributes of scientific inquiry [131].” Since the studies underlying the U.C. Report and the conclusions of the USEPA are generally accepted as scientifically valid studies, the arbitration panel should grant the state of California the benefit of its doubt, even though the conclusions of the Report and the USEPA remain controversial.

If Methanex is to be successful in its claim, it must prove that California’s actions were politically motivated since the scientific evidence is inconclusive and arguments concerning the effectiveness of alternative measures are refutable. To support this claim, Methanex cites a litany of news articles, press releases and even a court case to demonstrate the strength, vigor and effectiveness of the ethanol lobby. The company alleges that to compensate for its inability to compete in an open market, the ethanol industry uses political contributions and misinformation to eliminate its competition and take over markets. The company further alleges that this is the underlying reason for California’s ban of MTBE. Methanex claims that Governor Davis, biased toward the ethanol industry, used the measure to eliminate MTBE and promote the use of ethanol in California.
Methanex first points out MTBE, the main competitor of ethanol, is a far superior product. Methanex points out that ethanol is a heavily subsidized product and that, without these subsidies, ethanol would be entirely too expensive to produce to be considered a competitive alternative [132]. The company continues to explain that ethanol is protected, not for its environmental benefits, which it considers suspect, but rather for the purpose of increasing farm income and reducing U.S. dependence on imported oil [133]. It asserts that domestically produced ethanol is even protected from ethanol imports as proof of this purpose [134]. Methanex claims that without the subsidies ensured by the ethanol lobby, ethanol would disappear from the market altogether [135].

As further proof of the superiority of MTBE, Methanex cites articles and studies that conclude that ethanol may, in fact, be environmentally harmful and energy inefficient. Methanex point out that corn, the primary crop used to produce ethanol, is an energy intensive stock to grow and transform into alcohol and that ethanol production may actually consume more energy than it produces [136]. The company also notes that the National Academy of Sciences found that ethanol use may be detrimental to air quality because it may increase hydrocarbon emissions by up to 50% and nitrous oxide emissions by 15%, hence, actually contributing to the production of smog. Moreover, notes Methanex, ethanol’s own water solubility and its known carcinogenic effect may increase the risk of cancer if used as an oxygenate[137].

Methanex uses these two points, that ethanol is not a competitive product without subsidies and the possibility that it may produce adverse environmental and human health effects, to support its conclusion that the ethanol lobby has been successful. Methanex uses an extensive portion of its amended complaint to detail the lobbying efforts of the ethanol industry and its main proponent, Archer-Daniels-Midland Corporation (ADM). Among the exploits allegedly engaged in by ADM lobbyists, Methanex cites political contribution, publication of misinformation about
MTBE through organizations represented as “grassroots” environmental organizations, and criminal conviction for price fixing [138].

Methanex argues that, here, the ethanol lobby influenced Governor Davis’s decision making and, as a result, enacted a regulation that effectively took its investment and gave it to the ethanol industry [139]. The company claims that the Executive Order is facially discriminatory in that it “not only banned MTBE, but also sought to establish an ethanol industry in California [140].” Moreover, claims Methanex, Governor Davis was the recipient of over $200,000 in contributions from ADM and ADM allies during his campaign for Governor in 1998 and 1999. More significantly, Methanex points to a “secret meeting” held between ADM and Governor Davis at ADM’s headquarters in Illinois in August of 1998, during the middle of his campaign. Methanex argues that the contributions and the August meeting are particularly meaningful because, at the time, the ethanol industry had virtually no presence in the California oxygenate market [141]. However, approximately two and a half months after the Executive Order was issued, ADM announced plans to distribute ethanol in California and build an ethanol facility in the state [142]. The company also cites the labeling requirement imposed by the state indicates the discriminatory intent of the action because it requires only fuel pumps containing MTBE to be labeled [143].

Methanex uses these allegations to support its conclusion that the Governor and the ethanol industry have formed an alliance to achieve improper goals. It then uses the “bootlegger-Baptist” argument to conclude that California’s ban of MTBE is really protectionist regulation in environmental disguise [144]. A “bootlegger-Baptist” coalition occurs when an industry that is seeking to promote its own goals through discriminatory application of laws and regulations aligns itself with a public interest organization in order to promote its interests under the guise of positive social policy [145]. It is the presence of this form of coalition that Methanex argues is a
“prima facie” indication that protectionist concerns have led to disguised discrimination against investments and trade [146].”

In furtherance of this argument, Methanex attempts to analogize its case to two others filed under Chapter 11 of NAFTA; however, these analogies fail to strengthen its argument. The Ethyl case was settled before arbitration [147]. In contrast, the S.D. Myers claim was decided by an arbitration panel. That panel determined that the challenged measure was designed to inhibit the use of the foreign corporation’s investment [148]; however, this determination was based upon the clearest of evidence. The panel had heard testimony that the acting official, the Minister of the Environment, clearly stated on several occasions in front of numerous witnesses, that the handling of Canada’s PCB wastes should be done “in Canada, by Canadians.” This statement was repeated to the House of Commons, in Parliament, and in a speech to the Canadian Bar Association. In addition, the arbitration panel was presented a letter that clearly demonstrated that the PCB industry requested the Minister of Environment to act on its behalf to protect it from the foreign corporation. Finally, the S.D. Myers panel had documentary proof that the statements made by the Minister of the Environment concerning the handling of PCBs by Canadian corporations was considered when drafting the challenged measure. On such clear evidence, the panel could hardly have reached another conclusion.

Under the facts alleged in this case, the arbitration panel should not conclude that California’s ban of MTBE was designed to promote protectionist trade interests. Without proving more, Methanex has not clearly shown that Governor Davis acted for an improper purpose when he issued the Executive Order. Certainly, on the facts alleged by Methanex, an inference of improper motivation could be drawn; however, since Methanex is the claimant, it must bear the burden of proof [149]. It is entirely possible that Governor Davis meet with ADM in anticipation of the report. It is possible that Governor Davis was exploring the optional available to the state in the event that it was necessary to eliminate MTBE. While the dubious nature of
this theory may seem evident to some, Methanex has not come close to disproving it. Unless it produces clearer evidence of improper motivation on the part of a state actor, the arbitration panel should grant the government the benefit of doubt; thus, Methanex does not appear to have a cognizable claim for compensation under Chapter 11 of NAFTA.

**Conclusion**

Under this analysis, Methanex does not have a cognizable claim for compensation because California’s ban of MTBE is a legitimate regulatory action, not expropriation. Under the rules of international law, legitimate, non-discriminatory environmental regulations are not expropriation unless it can be demonstrated that the measure goes too far under one or more of the factors under the hybrid approach adopted by modern tribunals. Here, although the regulation appears to be permanent, Methanex has not shown that severity of the impact caused California’s regulation is severe enough to justify compensation. Methanex has also failed to demonstrate that that the regulation was unreasonable or adopted for an improper purpose. Moreover, the regulatory climate surrounding oxygenate regulation should have put Methanex on notice of the possibility of its prohibition. On balance, the state of California must be given deference and latitude to take action under its police powers to protect its natural resources because Methanex has failed to adduce evidence that it needs protection from a disguised regulation. Under the rules of international law, only a showing of need on the part of the investor will outweigh the presumption in favor of the state’s exercise of its police powers.

If the commentators are correct that the Methanex case will provide some insight into the meaning and operation of the Chapter 11 ISDM, then the resolution of this case may help put this particular dispute to rest. If the arbitrators of the Methanex case use an analysis similar to this one, and reach a similar conclusion on this point, then the resolution of this case may help allay fears that Chapter 11 will be used to prevent the governments of member nations from taking
needed environmental measures. It may also help assure government officials of their power and ability to take these actions and reduce their level of uncertainty. Finally, resolution of this case may also help investors in their evaluations concerning the risk exposure caused by investing in foreign member nations.

If the arbitration panel reaches a conclusion on this issue that is similar to the one here, it may go a long way toward proving that the NAFTA ISDM is a workable structure, capable of addressing the competing needs of the parties. A similar resolution would tend to show that NAFTA provides enough flexibility for sovereigns to take necessary actions, while providing an important check on the unilateral exercise of sovereign power. Either way, resolution may bring much needed clarity to this issue.


[2] Id.

[3] Id. at 5.

[4] Id. at 5-6.


[6] Id. at 507.

[7] Id. at 508.

[8] Id. at 507.


[18] NAFTA, Preamble.


[22] Howard Mann, supra note 16, 403.


[25] Cite to article with the section about U.S. section 302.

[26] Julia Ferguson, supra note 5, 503.

[27] Howard Mann, supra note. 16, 403.

[28] NAFTA, Article 1110, section (1)(d).

[29] CITE

[31] Julia Ferguson, supra note 5, 504.

[32] NAFTA, Article 1124(2).


[35] Id. at 38.

[36] Id. at 38.


[38] Id. at 471.


[39] NAFTA, Article 1124(2).

[40] Samrat Ganguly, supra note 24, 119.

[41] There may be more cases. Under the NAFTA, investor-state arbitrations are modeled after commercial arbitrations that have taken place for decades and, in accordance with the commercial model, Chapter 11 provides that the arbitration proceedings are kept confidential. The confidentiality provided makes it difficult to discover cases and information relating to the cases. Moreover, Chapter 11 provides that arbitrations may proceed under either the rules established by the World Bank’s International Center for the Settlement of Investment Disputes (ICSID) or the United Nations Commission on International Trade Law (UNCITRAL) Rules. Article 1120(1)(c). Since there is no authority or body that keeps records pertaining to arbitrations conducted under the UNCITRAL rules, it is extremely difficult to discover information concerning arbitrations conducted under these rules, unless one of the parties makes the information publicly available. But See www.naftaclaims.com for what appears to be a rather complete list.

[42] Howard Mann, supra note 16, 405-406.

[43] CITE.


[45] Id. .


[47] Id.
[48] Id.


[50] Id.


[55] Id. at Art. 31(2).

[56] Id. Art. 31(3).


[59] Alan C. Swan, supra note 52, 163 –164.


[64] Samrat Ganguly, supra note 24, 135.


[66] Howard Mann and Konrad von Molke, supra note 34, XX.

[67] Id.

[68] Id.

[69] Id.

[70] Id.

[72]Howard Mann and Konrad von Molke, *supra* note 34, XX


[74]Id.

[75]Id. at 528.

[76]Id. at 517.

[77]Howard Mann and Konrad von Molke, *supra* note 34, 41.

[78]Id.

[79]Id.

[80]Pope & Talbot, 35.


[84]Id. at 133-134.


[89]Id. at 520-525.

[90]Id. at 536.

[91]Pope & Talbot, at ¶ 100.


J. Martin Wagner, supra note 37, 470.

Id. at 502.

Howard Mann, supra note 16, 393.

Raymond MacCallum, supra note 19, 395.

S.D. Myers, at 70.

Id. at 70-71.


It should be noted that the United States has challenged Methanex’s standing to bring its claim as “too remote.” The United States claims that Methanex has no “legally significant” connection to the California action. Furthermore, argues the United States, the jurisdiction granted under Articles 1116 and 1117 does not extend to Methanex because the California measure does not “relate to” its investment, methanol, but rather to MTBE. United States, Statement of Defense, supra note 11, ¶ 5, 6, 114 –128, 136-138 (August 10, 2000).

Also, the breadth of the definition of investment under Article 1138 makes it extremely likely that the panel will determine that Methanex’s market share, market access and goodwill are “investments” under Chapter 11. Two recent NAFTA arbitration panels faced with similar claims have concluded that these types of “intangible property” are cognizable investments in a Chapter 11 claim. Pope & Talbot, at ¶96. S.D. Myers, at ¶232. Thus, this threshold matter is unlikely to bar Methanex’s claim.

Julia Ferguson, supra note 5, 507.


Methanex, Amended Complaint, supra note 1, 36.

Pope & Talbot, at ¶ 102.

Methanex, Amended Complaint, supra note 1, 24-28.

Id. at 25.

Id. at 33.

Id. at 30-31.

Id. at 21-24.

Id. at 47.

Id. at 38.


[117] Methanex, Amended Complaint, supra note 1, 33.

[118] United States, Statement of Defense, supra note 11, ¶ 75.

[119] Julia Ferguson, supra note 5, 508.


[121] Id. at ¶ 60-61.

[122] Julia Ferguson, supra note 5, 508.

[123] Methanex’s Amended Complaint, supra note 1, 7.

[124] Id. at 34-35.

[125] United States, Statement of Defense, supra note 11, ¶ 51.

[126] Id. at ¶ 106.


[128] Id.

[129] Id.

[130] Id. at 533.

[131] Id. at 534.

[132] Methanex, Amended Complaint, supra note 1, 7-8.

[133] Id. at 8.

[134] Id.

[135] Id. at 9.

[136] Id. at 10.

[137] Id. at 11.

[138] Id. at 21-24.

[139] Id. at 70.
[140] Id. at 47.

[141] Id. at 30.

[142] Id. at 33.

[143] Id. at 32.

[144] Id. at 39.

[145] Id.

[146] Id.


[148] To be clear, the arbitration panel in the S.D. Myers case determined that the challenged measure was designed to impact the foreign corporations use of its investment, but the panel did not find that expropriation occurred. The panel found that the duration of the regulation and the nature of the impact were too minimal to rise to the level of expropriation.

[149] Moreno, Rubin, Smith, Young, supra note 19, 405, n.65.