Foreign Investor Litigation Against the United States Under NAFTA and Other International Investment Agreements

John D. Echeverria
Georgetown Environmental Law & Policy Institute
Georgetown University Law Center

Education Program
Conference of Chief Justices' Mid-Year Meeting
January 29, 2003
Williamsburg, Virginia

Thank you for the opportunity to speak to you today about litigation brought by foreign investors against the United States under existing – and potential future – international investment agreements.

I will start by addressing directly the questions raised by Chief Justice VandeWalle, Chief Judge Kaye and others during the brief discussion of this issue earlier in the conference. First, are federal as well as state court rulings subject to review as a result of this process? The answer is yes, absolutely: the judgments and other orders of both federal and state courts can be challenged under international investment agreements.

A brief anecdote may help highlight the point. Several months ago I was invited to attend a public briefing at the office of the U.S. Trade Representative. During the Q & A period, I asked the senior presiding official what he thought the likely public reaction would be the first time a panel convened under the North American Free Trade Agreement declared that a ruling of the U.S. Supreme Court was inconsistent with international law and, as a result, awarded a foreign claimant millions of dollars in compensation from U.S. taxpayers. His response was that he hoped to be in retirement by the time that occurred.... While the remark was obviously offered in jest, it illustrates what a remarkable litigation process has been established – one that few public officials are willing to defend openly.

The second question was: what has become of the nation's sovereign immunity, that is, have the various legal doctrines protecting the federal and state governments from monetary liabilities been rendered irrelevant? The answer is that NAFTA completely disregards and, therefore, apparently, abrogates sovereign immunity. One can certainly question whether NAFTA and its implementing legislation actually contain the kind of unmistakable statements required to waive sovereign immunity. But the conventional understanding of NAFTA is that it purports to expose the United States to money claims based on government actions at the federal, state and local levels without regard to U.S.

sovereign immunity, the Eleventh Amendment, or any other governmental immunity defense that might normally be raised in U.S. courts.

The third question, raised by Chief Justice VandeWalle, was whether this represents a possible "chicken little" problem – meaning, I take it, whether the investment agreements raise a horrific prospect, but one which is so hypothetical or remote that it is simply not worth worrying about. On the one hand, there is some basis for this viewpoint; it is an important fact, for example, that while foreign investors have brought a number of claims in the eight years since NAFTA went into effect, no claim against the United States has yet succeeded. On the other hand, a number of claims have been filed, including claims directly challenging state (though not yet federal) court rulings. Moreover, defenders of investment provisions contend, ironically enough, that many of the questions now being raised about these provisions, including their effect on sovereignty, were raised and resolved decades ago, for example during negotiations over the several dozen "bilateral investment agreements" the United States has entered into with various countries. In other words, according to this viewpoint, it is very late in the day to be raising questions about the foreign investor litigation process.

The bottom line is that it appears to be neither too early nor too late for the Conference of Chief Justices to address this issue. In the next several months, the U.S. Congress is expected to consider approving new investment agreements with Chile and Singapore. In the years ahead, more extensive investment agreements may be considered in the context of the proposed Free Trade of the Americas Agreement or World Trade Organization negotiations.

To start at the beginning, this issue involves lawsuits by foreign firms or foreign nationals who have investment interests in the U.S. and who sue the U.S. – based on special legal rules, and before special, quasi-judicial tribunals – based on actions of federal, state or local government which adversely affect the value of their investments. While this litigation occurs entirely outside the U.S. judicial process, it results in monetary awards against the United States which, under the terms of the international treaty dealing with enforcement of arbitration awards, U.S. courts are ostensibly bound to recognize and enforce with few if any questions. The range of government actions which have been, and which could be, challenged through this process is as broad as the lawyer's imagination will allow -

garden variety land use regulations, public health measures, tax policy, state court management of a jury trial, and so on and on.

The issue of foreign investor litigation is sometimes confusingly and misleadingly referred to as a trade issue. This is not surprising because the provisions authorizing this litigation have been included in various trade measures (most notably Chapter 11 of the North American Free Trade Agreement) and, at this juncture, probably will be included in future trade measures. But, as a matter of substance, the debate over the investment provisions has nothing to do with the merits of tariffs and other barriers to trade in goods across borders. In other words, one can be a free trader, as I happen to be personally, and be very concerned about the investment provisions now routinely embedded in trade measures.

The moniker "investment provisions" is also somewhat confusing because it might suggest that the goal of these provisions is simply to promote investment --- a goal which every reasonable person can presumably support. In a sense, invest-ment provisions do promote investment, both by foreign investors in the U.S. and by U.S. investors abroad. But they accomplish this goal by granting foreign investors a unique right to challenge government actions using legal tools which go beyond the legal tools domestic U.S. firms have under U.S. law. Thus, it is equally accurate to describe these provisions, as they are described by the critics, as subtractions from American sovereignty which unfairly confer greater legal rights on foreign firms than U.S. citizens possess.

Why should judges, and state judges in particular, care about foreign investor lawsuits under international investment agreements? In ascending order of importance, there appear to be three potential bases for concern. First, the quasi-judicial tribunals used in this new kind of litigation are, to put it bluntly, invading the jurisdiction of the U.S. courts. Litigation matters which in the ordinary course would be heard in state (or federal) court are increasingly being heard in these alternative forums. To be sure, only a few dozen lawsuits have been filed under NAFTA since it went into force eight years ago. But many of these have been high stakes, significant legal contests. And the future extent of this invasion of jurisdiction is potentially enormous, given that nearly 25% of the investments in the U.S. are held by foreign firms or foreign nationals. The apparent objective of the U.S. Trade Representative is to extend the NAFTA model throughout the world, so that foreign investors from essentially any country can eventually avail themselves of these special procedures.

Second, judges have an institutional interest and a professional expertise in how the judicial function is structured and defended within our society. Thus, state (and federal) judges have an interest and a capacity -- indeed perhaps a responsibility -- to address the important transformations of the judicial function being achieved through the investment provisions in international agreements. If the judiciary will not speak in defense of the independent U.S. judicial system, who will?

Third, the panels organized under investment agreements have assumed the authority to review directly the rulings of U.S. courts to determine whether they conform to the substantive standards of the agreements and, if they are determined not to conform, to order payment of financial compensation to foreign investors aggrieved by U.S. court rulings. This new appellate authority plainly threatens the finality of state and federal court rulings, including but certainly not limited to the rulings of state supreme courts and the U.S. Supreme Court. One ongoing case under NAFTA, the Loewen case, challenges a Mississippi trial court's handling of a commercial fraud action against a Canadian firm, as well as the Mississippi Supreme Court's refusal to waive the requirement of an appeal bond. The case is still pending but the panel hearing the case, in accord with the view of every other investment panel which has considered the question, has already decided that the rulings of the Mississippi courts are measures subject to review in this forum.[1]

---

[1] The Loewen Group v. United States, ICSID Case No. ARB(AF)/98/3, Decision on Hearing of Respondent's Objection to Competence and Jurisdiction (January 9, 2001), at www.state.gov/documents/organization/3921/pdf.

In another recently completed case, Mondev, a NAFTA panel reviewed (but ultimately rejected challenges to) the rulings of the Massachusetts Supreme Judicial Court in a case involving contract and tort claims against the City of Boston and the Boston Redevelopment Agency brought by a Canadian firm.[2] In the Mondev case, the U.S. Supreme Court itself had declined to review the rulings of the Massachusetts Supreme Judicial Court, but that did not deter the NAFTA panel from conducting its own independent review of the rulings by the Massachusetts court.

Thus the precedent under NAFTA is already set: Panels convened to hear investment disputes have comprehensive jurisdiction to review the rulings of U.S. domestic courts and, if they disagree with the rulings, award damages to foreign firms disappointed by the results they have achieved before the U.S. courts. Our highest courts are plainly at risk of being accorded subordinate status in this still emerging and vaguely defined international legal regime of investor protection.

This new appellate authority can be viewed as undermining the sovereignty of our state and national governments. The state and federal courts are the established judicial arms of our state and national governments. Thus, to the extent these special proceedings undermine the authority of the state and federal courts to resolve the cases which come before them based on state and federal law, they undermine the state and federal governments themselves.

While any money judgments entered by these quasi-judicial panels are intended to be enforceable only against the United States, these awards would have significant consequences for state (and local) governments. It remains unclear to what extent the United States could or would seek reimbursement from a state or local government for actions which produced an award. As a practical matter, however, it seems unlikely that a state or local government could long sustain a policy producing significant monetary liabilities for the United States. In addition, NAFTA indicates that a finding by a panel that a state or local

[2] Mondev International v. United States, ICSID Case No. ARB (AF)/99/2, Award (October 11, 2002), at www.state.gov/documents/organization/14442/pdf.

government action violates an investment agreement would support federal preemption of the state or local action.[3]

Finally, to the extent the quasi-judicial bodies organized to hear investment disputes do not reflect the standards of impartiality and independence which we apply to the U.S. court system -- and I will attempt to show that they do not meet these standards – this new appellate authority undermines the impartiality and independence of the U.S. judicial system as a whole.

To understand the significance of the foreign investor litigation process, in general and for the judiciary in particular, one needs to consider how this new litigation process differs from the traditional U.S. legal process <u>both</u> in terms of the substantive legal standards <u>and</u> the procedural rules and norms which govern these proceedings. I will use the investment provisions of NAFTA as my point of reference. But because NAFTA is currently viewed as the model for future investments agreements, these comments apply more broadly

NAFTA articulates a series of legal standards, sometimes called "investor protection regimes," for government actions affecting foreign investors. For domestic lawyers or judges, the most prominent of these provisions are best understood as reformulations, or recodifications, of some of the basic principles reflected in the Bill of Rights as well in our state constitutions.

Article 1102 of NAFTA, for example, called "National Treatment," requires that each of the parties to the agreement (the United States, Canada, and Mexico) "accord to investments of investors of another Party treatment no less favorable than that it accords, in like circumstances, to its own investors." This is a kind of trans-boundary version of the equal protection clauses found in federal and state constitutions.

Article 1105, called Minimum Standard of Treatment, requires that each party "accord to investors of another Party treatment in accordance with international law, including fair and equitable treatment and full protection and security." This is, in effect, the international equivalent of due process.

---

[3] See 19 U.S.C. 3312(b)(2).

Finally, article 1110 provides that "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, except: (a) for a public purpose; (b) on a non-discriminatory basis; c) in accordance with due process of law and Article 1105(1) [see above]; and (d) on payment of compensation." This provision roughly parallels the takings clauses in the federal and state constitutions.

These provisions cover an enormous amount of legal territory. It is obvious that a reasonably creative lawyer could frame virtually any possible dispute between an investment firm and a government as a claim under at least one of these provisions. Thus, while these provisions may be focused on "investment" from the point of view of the investment community, they provide potential grounds for a very wide variety of challenges to a wide variety of government actions.

The most contentious question has been whether these provisions go beyond U.S. law and, therefore, effectively grant foreign investors greater rights than U.S. firms enjoy under U.S. law. Critics of the investment provisions contend that they create unprecedented legal rights to challenge government action. Defenders, while conceding that these provisions establish distinct legal standards, contend that they do not go significantly beyond U.S. legal standards. This has turned out to be a difficult debate to resolve, partly because the provisions of NAFTA are nearly as delphic as the analogous provisions of our federal or state constitutions and partly because there are a number of conflicting, yet plausible, interpretations of U.S. constitutional law.

Nonetheless, there is substantial evidence from the published opinions of the NAFTA panels that they are interpreting the investment provisions more expansively than U.S. courts interpret comparable provisions of U.S. law. For example, in the widely discussed <u>Metalclad</u> case, the Supreme Court of British Columbia, while ruling that it was powerless to reexamine a NAFTA panel's rulings on issues of law, observed that the panel had adopted "an extremely broad definition of expropriation" which would "include a legitimate rezoning of property by a municipality of other zoning authority." A U.S. court likely would reach the same conclusion based on a comparison of the standard applied in <u>Metalclad</u> and the standards of U.S. law. More recently, in the Feldman case, a panel applied an extraordinarily expansive equal protection standard, ruling that a mere showing of differential treatment shifts the burden to the government to justify the challenged measure. Applying this standard, the panel reached the extraordinary conclusion that it was a violation of the "national treatment" provision for Mexican tax authorities not to grant a U.S. investor the same illegal tax rebate which they had allegedly granted a Mexican firm.

Part of the explanation for these expansive readings of NAFTA's investment provisions, as compared to U.S. constitutional standards, is that the NAFTA investment provisions are essentially free-standing. Unlike the provisions in the Bill of Rights, they are not embedded in a larger document which creates other governmental institutions operating within a system of separated powers. Under U.S. law, it is a cardinal principle that the judiciary should generally defer to the policy judgments of the executive and legislative branches. NAFTA, however, creates no parallel representative institutions and its structure does not appear to call for, and it has not been interpreted as requiring, any particular deference to the representative branches of domestic governments.

Indeed, if anything, the investment panels, contrary to the traditions of U.S. courts, operate with a presumption in favor of investors and against government. Article 102 states that NAFTA's objectives include to "increase substantially investment opportunities" in the member countries, and directs that the agreement should be interpreted and applied in accordance with this objective. Some panels have taken this mandate as a charge to read NAFTA with a distinctly pro-investor, anti-government slant. For example, rather than placing the burden on a claimant to show that a government action violates NAFTA, some panels have, in effect, placed the burden on the government to show that it has adopted the "least trade restrictive means" to achieve its objective.

Ultimately, however, because the investment provisions in NAFTA are susceptible to such a wide range of possible interpretations, what NAFTA turns out to mean will depend on the make-up of the panels which interpret and apply these provisions. And it is here that the departures from U.S. legal traditions become even more obvious.

Litigation under NAFTA is heard by three-member panels, with one member appointed by the claimant, the second by the government defendant, and the third either by agreement of the parties or by the Secretary-General of ICSID, the International Centre for Settlement of Investment Disputes. The majority of panelists in cases involving claims against the U.S. are not U.S. citizens and they are not trained in U.S. law. U.S law has no precedential weight in these proceedings, given that the rules of decision are supplied by the provisions of NAFTA itself and vaguely defined principles of customary international law. As if to underscore the irrelevance of U.S. law, the U.S. is represented in these proceedings, not by lawyers from the U.S. Department of Justice, but by a special unit in the U.S. State Department. In theory, a panel decision should have no precedential weight for any future case; in fact, the NAFTA cases are quickly becoming a self-contained body of law. However, it is not necessarily an internally consistent body of law, because there is no appellate mechanism for resolving differences between different panel rulings.

NAFTA panel members lack most of the attributes of office U.S. lawyers and jurists generally view as necessary and appropriate for an independent and impartial judiciary. Panel members' terms are neither for life nor even for fixed terms, but instead last only for the duration of the single proceeding for which they are selected. In addition, service on a NAFTA panel is not generally a panel member's exclusive employment. Individuals who specialize in the field of international investment law commonly switch back and forth between the role of judge in one case and counsel for a party in another.

While there is a general mandate in the ICSID rules that panel members should be persons "who may be relied upon to exercise independent judgment," the potential for conflicts of interest is pervasive and serious. Including party-appointed members on the panel raises obvious potential problems of bias. The Model Rules of Professional Conduct generally bar a lawyer who is a former judge or arbitrator from representing anyone in connection with a matter in which he or she served as a judge or arbitrator. However, the model rules provide an exception in the case of a former arbitrator selected as a partisan of a party in a multi-member arbitration panel, illustrating that a party-appointed panel member is not expected to serve as an impartial decision maker in the first place. In addition, a number of major law firms advertise their experience as both NAFTA panel members and counsel for claimants, creating the risk of at least the appearance that a member of a firm will be helping to make decisions that could be of potential value to present or future clients of the firm.

As I mentioned, NAFTA provides that, in the event the two parties cannot settle on a presiding officer, the Secretary General of ICSID can make the selection, which he or she is supposed to make from a roster comprised of nominees forwarded by members countries. A recent U.S. nominee to this roster is one of the chief spokesman on behalf of the business community on foreign investment agreements. So far as I know, this individual has not been appointed to sit on any arbitration panels. If he were to sit on NAFTA panel, however, it would be something like the general counsel of the chamber of commerce or the political director of the trial lawyers association serving as guest for a day on a state supreme court – a prospect which no one could accept as consistent with maintenance of a court's reputation for independence and impartiality.

The final question, of course, is what to do? The potential answers fall into at least two categories: constitutional and legislative. Resolution of the constitutional problems created by the investment agreements is likely to ultimately require U.S. Supreme Court intervention. But the constitutional issues are of potential relevance to the state courts and others as well.

First, there is a substantial question whether investment agreements violate Article III of the U.S. Constitution. Article III provides that the federal judicial power shall be vested in the U.S. Supreme Court and such inferior courts as Congress may create, and that judges exercising the Article III function must possess lifetime appointments and lifetime salary protection. Did Congress, in enacting NAFTA, make an improper allocation of the federal judicial power to officers who do not meet the requirements of Article III? NAFTA panels which hear claims against the United States certainly appear to be exercising judicial powers and the panel members obviously do not have the attributes of Article III judges. The answer to this question ultimately turns on analysis of the difficult and confusing Supreme Court precedents interpreting Article III and how the application of these precedents should vary (if at all) in a foreign commerce context. For present purposes it suffices to observe that the issue is serious and unresolved.

Second, there is a substantial question whether NAFTA was properly adopted by Congress in the form of a so-called congressional-executive agreement, which requires only majority approval by Congress, or whether instead NAFTA should have been adopted pursuant to the Treaty Clause, which requires approval by two thirds of the Senate. No less a constitutional luminary than Lawrence Tribe of Harvard Law School has taken the position that NAFTA is unconstitutional because it was adopted in violation of the Treaty Clause. Other scholars have taken a different view. A treaty clause challenge to NAFTA has been rejected by a federal district court in one case, but neither the federal appeals courts nor the U.S. Supreme Court has addressed the issue on the merits.

A third question is whether Congress violates the federal equal protection clause by granting foreign investors operating in the United States greater legal rights than U.S. citizens possess in their own country. Of course, such a claim would be evaluated under the deferential rational basis test. Nonetheless, a colorable equal protection claim could be mounted against NAFTA and other similar investment agreements. No one has seriously contended that U.S. federal and state courts cannot or will not deliver fair and impartial justice to foreign investors operating in the U.S. Thus, granting foreign investors greater procedural and substantive rights than U.S firms cannot be justified on the ground that U.S. courts might discriminate against foreign firms. If there is a plausible argument in favor of foreign investment provisions, it is that granting foreign investors greater rights in this country is a necessary quid pro quo in order for U.S. negotiators to obtain agreements to allow U.S. investors to circumvent the allegedly corrupt and/or incompetent courts in certain other countries. But it is far from clear that it is actually necessary for the United States to offer foreign investors greater rights in order to protect U.S. investors abroad. Many foreign countries, in order to further their own self interest in attracting investments by U.S. firms, would likely agree to submit disputes with U.S. investors to foreign investor panels, regardless of whether their own investors were granted the (relatively useless) opportunity to circumvent the U.S. legal process. Furthermore, if the United States were compelled to offer some quid pro quo in order to obtain legal protections for U.S. investors abroad, the United States presumably could offer something in exchange other than subversion of the American judicial system, for example reduced agricultural subsidies or increased foreign aid.

Finally, because the foreign investor litigation process creates broad new rights to sue over state and local government actions, this process also raises serious federalism concerns. To be sure, any financial liability under investment provisions falls, at least in the first instance, on the United States rather than state or local governments. But, as discussed, any decision that the investment provisions of NAFTA have been violated provides the basis for federal preemption of state or local government action. This potentially massive intrusion on state and local prerogatives appears to violate at least the spirit of modern Supreme Court jurisprudence protecting the sovereign authority of the states.

Setting aside potential constitutional concerns, the second question is whether international investment agreements authorizing foreign investor lawsuits represent sound public policy or whether they can be modified in the future to address some of the legitimate concerns which have been raised. These, of course, are questions appropriately addressed to Congress.

Last summer, Congress passed new legislation authorizing the U.S. Trade Representative to negotiate additional trade and investment agreements with other nations based on the NAFTA model. As I mentioned, negotiations with Singapore and Chile have proceeded apace, and so-called fast track legislation to approve these agreements may be presented to Congress in the next several months.

One of the major challenges facing the U.S. Trade Representative is how to implement the requirement inserted in the trade bill that future investment agreements should ensure that foreign investors have "no greater substantive rights" than U.S. investors. In the words of then Senate Finance Committee Chair Max Baucus, the sponsor of the amendment adding this language, "the rights of U.S. investors define the ceiling. Negotiators must not enter agreements that grant foreign investors rights that breach that ceiling." For the reasons discussed above, if the NAFTA model is followed in future investment agreements, it appears inevitable that foreign investors would end up with greater rights. The current language of the investor protection provisions encourages this result. Moreover, granting foreign investors the option to forum shop between U.S. courts and investment panels not governed by U.S. law, not manned by judges trained in U.S. law, and not subject to review in U.S. courts, would necessarily mean that foreign investors would end up with greater substantive legal rights.

One alternative, supported on a bipartisan basis by three dozen state Attorneys General, would be to state clearly that the legal ceiling for the purpose of investment agreements is U.S. law as defined by the U.S. Supreme Court and the supreme courts of the respective states, AND to empower U.S. courts to invalidate panel decisions that breach this ceiling. Short of eliminating the foreign investor litigation process altogether, it is difficult to see what other options are available to give the no greater rights mandate real teeth.

A second, more modest option would be to exempt the rulings of U.S. courts from the foreign investor litigation process. While this step would not eliminate the apparent unfairness of granting foreign investors greater legal rights than U.S. investors, it would at least avoid direct interference by investment panels with the U.S. judicial system.

CONCLUSION

It may be useful by way of conclusion to place this issue in a broader context. The United States obviously faces important and difficult choices in an era of increasing globilization. European countries, faced with a similar challenge, are effectively subordinating their national sovereignty in order to create a new European Community, complete with a parliament, a judicial system, and perhaps a president. The United States could seek to follow that model and, for example, promote the creation of a new State of the Americas. Following the European model, this would involve, for example, the creation of a hemispheric-wide legislative body and a fully functioning judicial system. Such a proposal would no doubt create a host of concerns. But this approach would at least compel a full and open debate about how to create a legislature that meets American ideals of representative democracy and a judicial system which meets our standards of independence and impartiality. With international investment agreements, however, the United States has embarked on an unbalanced, ill-considered program of abdicating American sovereignty in favor of international institutions. This agenda is being pursued for the benefit of relatively narrow interests and with essentially no attention to the larger implications for the democratic process and the judicial function. A certain loss of traditional

American sovereignty may be inevitable in an era of increasing globilization. But our sovereignty should not be sacrificed without careful consideration of the potential costs and careful study of possible alternatives that would help preserve U.S. constitutional values and traditions.