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THE TREATMENT OF SPS MEASURES UNDER NAFTA CHAPTER 11: PRELIMINARY ANSWERS TO AN OPEN-ENDED QUESTION

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Abstract: NAFTA Chapter 11 permits eligible foreign investors to use binding international arbitration to seek compensation for the harmful economic impacts of most regulatory measures. This mechanism effectively provides a second avenue of redress for individuals affected by risk regulation, in addition to any remedies that may be available to their governments acting through the WTO. However, because not all risks are equal, neither are all regulations of equal importance. It follows that the international regimes, which regulate the use of these measures, must be able to differentiate between them. In this regard, there is a need to interpret the more general investment obligations of NAFTA to take into account the importance of regulating risks to human, plant, or animal life or health. This article explains the way in which principles drawn from much more detailed WTO sanitary and phyto-sanitary rules can be used to achieve this result.

I have been asked to address the question of how science is regarded within the context of a North Atlantic Free Trade Agreement (NAFTA)¹ Chapter 11 investment dispute. This is a very difficult question because no investment tribunal has answered it within the context of a merit award. Moreover, no such award is imminent. This dearth of relevant case law is not surprising, given that (as of the time of writing) there have only been seven final awards issued during the first nine years of NAFTA's existence. Moreover, less than two dozen NAFTA Chapter 11 disputes have proceeded to arbitration thus far. Although there have been hundreds of disputes launched in the

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¹ North American Free Trade Agreement, Dec. 17, 1992, U.S.-Can.-Mex., 107 Stat. 2057 (1994), 32 I.L.M. 605 (1993) [hereinafter NAFTA].

World Trade Organization (WTO) context, only three have been adjudicated involving the WTO's "trade and science" provisions, which can be found in the WTO Agreement on Sanitary and Phyto-Sanitary Measures (WTO SPS Agreement).²

Nonetheless, considerable concern has been expressed with regard to the way in which a NAFTA Investment Tribunal might deal with an investment dispute given that none of the NAFTA Chapter 11 provisions explicitly address the role of science in disputes involving risk regulation in the fields of human, plant, and animal life or health.³ While the jurisprudence definitely indicates that Sanitary and Phyto-Sanitary (SPS) measures would be subjected to Chapter 11 disciplines, those disciplines do not include even a rudimentary exception provision such as those found in NAFTA Article 2102(1) and General Agreement of Tariffs and Trade (GATT) Article XX(b), much less anything as detailed as the NAFTA or WTO SPS provisions. The purpose of this paper is to address this uncertainty by providing a road map for consideration by future NAFTA tribunals when they are presented with an SPS measure.

I. THE STRUCTURE OF NAFTA

Negotiated simultaneously with and similar in content to the WTO Uruguay Round Agreement,⁴ NAFTA contains several inter-linked sets of obligations grouped by chapter, as opposed to "agreement" in the WTO context.⁵ In addition, NAFTA contains chapters on intellectual property law, technical barriers to trade, and trade in services, all of which bear some connection (if not a strong resemblance) to their WTO cousins. NAFTA Chapter 7B, concerning SPS measures, is no exception. NAFTA Articles 712, 714, and 715 largely cover the same ground covered by Articles 2 and 5 of the WTO SPS Agreement. In contrast, however, there is nothing in the WTO Agreements com-

² Agreement on the Application of Sanitary and Phytosanitary Measures, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization [hereinafter WTO Agreement], Annex 1A, LEGAL INSTRUMENTS—RESULTS OF THE URUGUAY ROUND vol. 1, 33 I.L.M. 1125, 1153 (1994) [hereinafter WTO SPS Agreement].

³ See, e.g., Frank E. Loy, *On a Collision Course? Two Potential Environmental Conflicts Between the U.S. and Canada*, 28 CAN-U.S. L.J. 11, 19 (2002).

⁴ Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Apr. 15, 1994, LEGAL INSTRUMENTS--RESULTS OF THE URUGUAY ROUND vol. 1 (1994), 33 I.L.M. 1125, 1144 (1994).

⁵ NAFTA, *supra* note 1, art. 2102(1).

parable to NAFTA Chapter 11—which was based on the U.S. Model Bilateral Investment Treaty.⁶

Based upon a cursory review of their handiwork, it appears that the drafters of NAFTA carefully addressed potential conflicts and overlaps within NAFTA provisions, and between NAFTA and other treaties. For example, Article 103(2) provides that NAFTA provisions will trump all other treaties to whatever extent may be necessary, unless otherwise provided in NAFTA.⁷ Article 104(1) provides that the provisions of a number of prominent environmental treaties (including the *CITES*, the *Montreal Protocol* and the *Basel Convention*) will trump NAFTA provisions, so long as the least inconsistent approach to compliance with NAFTA obligations has been chosen.⁸

With Article 1101(3), the drafters further specified that Chapter 11 does not apply to measures covered by Chapter 14 (concerning financial services).⁹ By means of Article 1112, they provided that “in the event of any inconsistency between this Chapter and another Chapter, the other Chapter shall prevail to the extent of the inconsistency.”¹⁰ The drafters created Article 710 to ensure that Articles 301 and 309 (requiring national treatment and prohibiting export and import restrictions for trade-in-goods measures) and GATT Article XX(b) (as incorporated into NAFTA Article 2101(1)) do not apply to any SPS measure.¹¹ However, the drafters notably were silent as to what should be done in cases of overlap—as opposed to conflict—between NAFTA obligations.

Numerous NAFTA tribunals have addressed authoritatively the subject of overlap between NAFTA Chapter 11 provisions and between NAFTA provisions and other treaty obligations. In these cases, the NAFTA governments argued that Chapter 11 obligations could not apply to measures that could be addressed more appropriately under a different chapter. For example, in *Pope & Talbot, Inc. v. Canada*, it was argued that the measure at issue—an export quota regime for softwood lumber—was clearly aimed at trade in goods, rather than the regulation of investment. Accordingly, the measures could not be

⁶ *Pope & Talbot, Inc. v. Canada*, para. 111 (NAFTA/UNCITRAL Trib., Apr. 10, 2001) (final merits award), available at <http://www.naftaclaims.com> [hereinafter *Pope & Talbot Final Merits Award*].

⁷ NAFTA, *supra* note 1, art. 103(2).

⁸ *Id.* art. 104(1).

⁹ *Id.* art. 1101(3).

¹⁰ *Id.* art. 1112.

¹¹ *Id.* arts. 301, 309, 710, 2102(1).

addressed under Chapter 11. In rejecting these arguments, the *Pope & Talbot* Tribunal concluded:

It appears to the Tribunal that Canada's arguments fail in two quite different ways:

In the first place, where a quota system is involved of the type here under consideration, it necessarily involves that quota be directly conferred upon or removed from enterprises. It is not a mere linguistic truism to say that such a system directly applies to a particular enterprise, namely each of the relevant softwood lumber producers in the listed provinces. It directly affects their ability to trade in the goods they seek to produce, but it can equally be described as the way that the measures applied to the various enterprises affect the total trade in the relevant products.

In the second place, the fact that a measure may be primarily concerned with trade in goods does not necessarily mean that it does not also relate to investment or investors. By way of example, an attempt by a Party to require all producers of a particular good located in its territory to purchase all of a specified raw material from persons in its territory may well be said to be a measure relating to trade in goods. But it is clear from the terms of Article 1106 that it is also a measure relating to investment insofar as it might affect an enterprise owned by an investor of a Party.¹²

In *S.D. Myers, Inc. v. Canada*, the Tribunal similarly concluded that an investor was not precluded from receiving compensation for business activity harmed in breach of Articles 1102 and 1105 merely because the activity could also be characterised as the cross-border provision of a service under NAFTA Chapter 12.¹³ In *ADF Group, Inc. v. United States*, the Tribunal reached a similar conclusion involving a procurement subsidy dispute over steel to be used in a Virginia highway project.¹⁴

¹² *Pope & Talbot, Inc. v. Canada*, para. 33 (NAFTA/UNCITRAL Trib., Jan. 26, 2000) (award on mot. to dismiss), available at <http://www.naftalaw.org>.

¹³ *S.D. Myers, Inc. v. Canada*, paras. 123-38 (NAFTA/UNCITRAL Trib., Oct. 21, 2002), available at <http://www.state.gov/5/1/c3754.htm>. [hereinafter *Myers Final Award*].

¹⁴ *ADF Group, Inc. v. United States*, para. 155 (NAFTA/ICSID(AF) Trib., Case No. ARB(AF)/00/1, Jan. 9, 2003) (final award), available at <http://www.naftalaw.org> [hereinafter *ADF Group Final Award*].

However, investors will have no claim for the indirect yet harmful effects of a measure that regulates goods for which they only produce an important ingredient. This was the case in *Methanex Corporation v. United States*, where the investor produced methanol, one of the primary ingredients of the gasoline additive methyl tertiary-butyl ether (MTBE).¹⁵ The measure at issue only banned MTBE, making no mention of methanol. The Tribunal's conclusion was essentially a matter of determining whether proximate cause exists under Article 1101(1); this would require that the measure "relate to" investors or investments.¹⁶

Given the potential for overlap between NAFTA obligations, as opposed to outright conflict, it is quite likely that an SPS measure will some day represent the focal point of a NAFTA investment dispute. To date, only four such cases have emerged, one of which settled at a preliminary phase.¹⁷ At the end of this paper, I will consider briefly the facts of the remaining three cases within the context of the appropriate SPS principles. However, first it is necessary to explain how NAFTA Chapter 11 provisions can be interpreted, particularly in light of those principles.

II. INTERPRETING NAFTA CHAPTER 11 WITH SPS MEASURES IN MIND

NAFTA Article 1131 provides that tribunals established to hear investors' claims under Chapter 11 "shall decide the issues in dispute in accordance with [NAFTA] and applicable rules of international law."¹⁸ Many tribunals thus far have concluded that, for the purpose of interpreting the text of NAFTA, the applicable rules of international law are the customary international law rules of treaty interpretation.¹⁹ These rules have been codified in Article 31 of the Vienna Convention on the Law of Treaties, which states:

¹⁵ *Methanex Corp. v. United States*, (NAFTA/UNCITRAL Trib., Aug. 7, 2002) (award on jurisdiction & admissibility), available at <http://www.state.gov/documents/organization/12613.pdf> [hereinafter *Methanex Final Award*].

¹⁶ *Id.* para. 147.

¹⁷ *Ethyl Corp. v. Canada*, 38 I.L.M. 708 (1999) (NAFTA/UNCITRAL Trib., June 24, 1998) (award on jurisdiction) [hereinafter *Ethyl Award*]; *Kenex Ltd. v. United States* (NAFTA/UNCITRAL Trib., Jan. 14, 2002) (notice of Intent to submit a Claim to Arbitration), available at <http://www.naftaclaims.org>; *Crompton Corp. v. Canada*, (NAFTA Dispute, Nov. 6, 2001), available at <http://www.naftalaw.org>; *Methanex Corp.*, *supra* note 15.

¹⁸ NAFTA, *supra* note 1, art. 1131(1).

¹⁹ *See, e.g.*, *Mondev Int'l Ltd. v. United States*, para. 43 (NAFTA/ICSID (AF) Trib., Case No. ARB(AF)/99/2, Oct. 11, 2002) (final award), available at <http://www.naftalaw.org> [hereinafter *Mondev Final Award*]; *see also* *Ethyl Award*, *supra* note 17, at paras. 50–51;

1. 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.
2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:
 - a) Any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;
 - b) Any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.
3. There shall be taken into account, together with the context:
 - a) Any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;
 - b) Any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;
 - c) Any relevant rules of international law applicable in the relations between the parties.
4. A special meaning shall be given to a term if it is established that the parties so intended.²⁰

Article 31(1) of the Vienna Convention provides the golden rule of treaty interpretation.²¹ It requires a tribunal to focus on the plain meaning of the text before it while being mindful not only of its placement within the context of the treaty but also of the objects and purposes of that treaty. The textual focus naturally will predominate where the object and purposes of a treaty are not provided explicitly. This is not the case for NAFTA, however, which provides tribunals with considerable guidance in this regard. NAFTA provides both a list

WTO Appellate Body Report on United States—Standards for Reformulated and Conventional Gasoline, WT/DS2/AB/R (May 20, 1996), 35 I.L.M. 603, 624 (1996); or Japan—Taxes on Alcoholic Beverages, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, at 9–12 (Oct. 4, 1996) [hereinafter Japan Alcoholic Beverages].

²⁰ Vienna Convention on the Law of Treaties, May 23, 1969, art. 31, 1155 U.N.T.S. 331, 8 I.L.M. 679 (1969).

²¹ *Id.* art. 31(1).

of its objectives and a prescription for how its text must be interpreted. Article 102 states:

Objectives

1. The objectives of this Agreement, as elaborated more specifically through its principles and rules, including national treatment, most-favored-nation treatment and transparency, are to:

- (a) eliminate barriers to trade in, and facilitate the cross-border movement of, goods and services between the territories of the Parties;
- (b) promote conditions of fair competition in the free trade area;
- (c) increase substantially investment opportunities in the territories of the Parties;
- (d) provide adequate and effective protection and enforcement of intellectual property rights in each Party's territory;
- (e) create effective procedures for the implementation and application of this Agreement, for its joint administration and for the resolution of disputes; and
- (f) establish a framework for further trilateral, regional and multilateral cooperation to expand and enhance the benefits of this Agreement.

2. The Parties shall interpret and apply the provisions of this Agreement in the light of its objectives set out in paragraph 1 and in accordance with applicable rules of international law.²²

The first panel established to hear a NAFTA dispute noted the importance of "the trade liberalization background against which the agreements under consideration must be interpreted" and concluded that "[a]ny interpretation adopted by the Panel must, therefore, promote rather than inhibit the NAFTA's objectives."²³ In *Metalclad Corp. v. Mexico*, the Tribunal echoed this approach, noting in its Final Award that the principle of transparency and the objective of substantially increasing investment opportunities in the North American Free

²² NAFTA, *supra* note 1, art. 102.

²³ Canada—Tariffs Applied by Canada to Certain U.S.-Origin Agricultural Products, CDA-95-2008-01, Dec. 2, 1996, para. 122, available at <http://www.worldtradelaw.net/nafta20/agtariiffs.pdf>. This was an arbitration panel established pursuant to NAFTA Article 2008. *Id.*

Trade Area were both important elements of the interpretative analysis to be used under NAFTA.²⁴

Article 102(1) is very specific in the manner in which it lays out the appropriate context for interpretation of NAFTA's text. It not only sets out the goals of substantially increasing investment opportunities and promoting "conditions of fair competition" in the free trade area, but it also provides that these objectives are "elaborated more specifically through its principles and rules," which include national treatment, most favored nation treatment, and transparency.²⁵ These three "principles and rules" represent the bedrock of international economic law, which can be found within countless treaty provisions and throughout the burgeoning jurisprudence of international economic law, including the reports of WTO panels and the WTO Appellate Body (Appellate Body) described below.²⁶ It is accordingly appropriate for a tribunal to have recourse to other trade and investment treaties, as well as the wider jurisprudence of international economic law, in interpreting the NAFTA text in a manner that is consonant with its broadly liberalizing objectives.

As the Tribunal in *S.D. Myers* stated, the preambular language of a treaty shall be construed as part of the context in which the treaty text is situated.²⁷ In this regard, it is important to note, however, that NAFTA does have objectives other than trade and investment liberalization. NAFTA's preamble includes resolutions to "UNDERTAKE each of the preceding [liberalizing goals] in a manner consistent with environmental protection and conservation; PRESERVE their flexibility to safeguard the public welfare; PROMOTE sustainable development; [and] STRENGTHEN the development and enforcement of environmental laws and regulations."²⁸

This preambular language provides the context within which NAFTA provisions should be interpreted when an SPS or environmental protection measure is at issue. The Appellate Body adopted a similar approach in its Report on United States–Import Prohibition of

²⁴ *Metalclad Corp. v. United Mexican States*, 40 I.L.M. 36 (2001), para. 70 (NAFTA/ICSID(AF) Trib., Case No. Arb(AF)/97/1, Aug. 30, 2000) (final award) [hereinafter *Metalclad Final Award*].

²⁵ NAFTA, *supra* note 1, art. 102(1).

²⁶ *See id.*

²⁷ While covered in the Tribunal's award, the importance of environmental provisions in the NAFTA, including its preambular language, is highlighted in the Opinion of Arbitrator Schwartz, *S.D. Myers, Inc. v. Canada*, paras. 107–18 (Nov. 12, 2000), available at <http://www.naftalaw.org>.

²⁸ NAFTA, *supra* note 1, pmbl.

Certain Shrimp and Shrimp Products, in which the mention of “sustainable development” in preambular language was used to interpret GATT Article XX(g) in a more expansive manner.²⁹ As David Wirth has noted, given that the nascent international law principle of precaution is an essential component of the concept of “sustainable development,” it would seem that the NAFTA Parties essentially have agreed that an appropriate level of precaution should be permitted for regulatory decisions covered under NAFTA as a whole.³⁰ The logical extension of this approach is to read into NAFTA Chapter 11 provisions the same balance of obligations that exists in the provisions of Chapter 7B, concerning the regulation of SPS measures.

As Wirth concluded shortly after NAFTA came into force in 1994, “the presence and integrity of scientific support is a principle touchstone for determining the legitimacy of many national regulatory efforts aimed at ensuring environmental integrity or safeguarding public health.”³¹ The SPS obligations contained within both NAFTA and the WTO Agreement embodied the idea that the discipline of scientific methods could be used to unearth protectionism in measures based on putatively valid, “scientific” claims. While many, including Wirth, have questioned whether science is up to the task, none have argued seriously against this use of science in principle.³²

Considering the provisions contained within NAFTA Chapter 7B and the WTO SPS Agreement, as well as the SPS jurisprudence that has emerged thus far from the WTO, it would appear that there are five fundamental principles that apply in consideration of SPS measures.³³ First, there is a clear recognition of the sovereign right of states

²⁹ WTO Appellate Body Report on United States—Import Prohibition of Certain Shrimp and Shrimp Products, WT/DS58/AB/R (Oct. 12, 1998), 38 I.L.M. 118, para. 129 (1999).

³⁰ David A. Wirth, *The Role of Science in the Uruguay Round and NAFTA Trade Disciplines*, 27 CORNELL INT'L L.J. 817, 839 (1994).

³¹ *Id.* at 818.

³² *See, e.g., id.* at 833; Alan O. Sykes, *Domestic Regulation, Sovereignty, and Scientific Evidence Requirements: A Pessimistic View*, 3 CHI. J. INT'L L. 353, 354-55 (2002); Jan Bohanes, *Risk Regulation in WTO Law: A Procedure-Based Approach to the Precautionary Principle*, 40 COLUM. J. TRANSNAT'L L. 323, 354-59 (2002).

³³ This jurisprudence is limited to three Appellate Body reports: WTO Appellate Body Report on Japan—Measures Affecting Agricultural Products, WT/DS76/R (Feb 22, 1999), 38 I.L.M. 255 (1999) [hereinafter Japanese Agricultural Products Report]; WTO Appellate Body Report on Australia—Measures Affecting Importation of Salmon, WT/DS18/AB/R (Oct. 20, 1998) [hereinafter Australian Salmon Report]; WTO Appellate Body Report on European Community Measures Concerning Meat and Meat Products, WT/DS26/AB/R, WT/DS48/AB/R (Jan. 16, 1998) [hereinafter Beef Hormones Report].

to formulate, adopt, and maintain SPS measures based on a level of protection that is considered appropriate in the circumstances by those states.³⁴ Second, SPS measures must not be adopted or maintained without sufficient scientific basis and must be based on an appropriate scientific risk assessment.³⁵ Third, SPS measures must only be adopted or maintained when it is necessary to do so.³⁶ Fourth, SPS measures must result neither in arbitrary or unjustifiable discrimination, nor in a disguised restriction on economic activity protected under the treaty.³⁷ Finally, SPS measures must be developed and imposed in a transparent manner.³⁸

In varying degrees, these five principles can be used to interpret the relevant provisions of NAFTA Chapter 11. The general authority for their consideration by a NAFTA tribunal can be found in NAFTA Article 1131(1) and in Article 31(3)(c) of the Vienna Convention. NAFTA Article 1131(1) requires tribunals to decide matters before them in accordance with NAFTA itself and the “applicable rules of international law.”³⁹ In a dispute involving an SPS measure, surely these principles must be considered to be “applicable rules of international law.” The three NAFTA Parties have twice agreed to the provisions (both in NAFTA and also in the WTO). They also have agreed, in the NAFTA preamble, that protection of the environment and sustainable development are necessary elements of NAFTA’s context, to be considered in the interpretation of provisions that are otherwise informed by the broad objectives of trade-liberalization and the promotion of economic competition. This group of five SPS principles reflects the manifestation of that very same balance—between the authority to impose SPS measures and the need to constrain their use to “legitimate cases” in order to experience the economic development that comes from increased trade and investment.

If there was any doubt as to the applicability of these principles, it can be answered by Article 31(3)(c) of the Vienna Convention, which two NAFTA tribunals and various commentators have noted is rele-

³⁴ NAFTA, *supra* note 1, art. 712(1), (2); WTO SPS Agreement, *supra* note 2, arts 2.1, 3.3.

³⁵ NAFTA, *supra* note 1, arts. 712(3), 715; WTO SPS Agreement, *supra* note 2, arts. 2.2, 5.1, 5.2, 5.3.

³⁶ NAFTA, *supra* note 1, 712(5); WTO SPS Agreement, *supra* note 2, arts. 2.2, 5.6.

³⁷ The protected economic activity in the WTO context is trade in goods. For the NAFTA, it appears to include any trade activity (whether goods or services). NAFTA, *supra* note 1, art. 712(4), (6); WTO SPS Agreement, *supra* note 2, arts. 2.3, 5.5.

³⁸ NAFTA, *supra* note 1, art. 718; WTO SPS Agreement, *supra* note 2, art. 7, Annex B.

³⁹ NAFTA, *supra* note 1, art. 1131(1).

vant to the consideration of the impact of external international obligations on the interpretation of treaty text.⁴⁰ In this sense, it might be useful to recall that Article 38(1) of the Statute of the Court of International Justice provides that treaties are a source of “international law” and that the decisions of international tribunals are a legitimate, subsidiary source of “international law.”⁴¹ Accordingly, it is only logical to consider the SPS principles, which can be derived from the texts and jurisprudence of the NAFTA and WTO texts, as being “relevant rules of international law applicable in the relations between the parties” under Article 31(3)(c) and as “applicable rules of international law” under NAFTA Article 1131(1). The alternative—to interpret the provisions in a vacuum, as if these SPS principles did not exist—is simply unacceptable.⁴²

The three types of NAFTA Chapter 11 obligations that are most likely to be invoked with respect to an SPS measure are the following: (1) the prohibition against discrimination under Articles 1102 and 1103 (concerning national treatment and most-favored nation (MFN) treatment, respectively); (2) the minimum standard of treatment under Article 1105; and (3) compensation for expropriation under Article 1110. The first of these obligations provides a comparative analysis designed to provide an effective equality of opportunities between like investors or investments. The second obligation provides a floor below which no regulatory treatment should fall.⁴³ The third provides compensation for the rare case in which a business is completely frustrated due to the imposition of a measure.

⁴⁰ See, e.g., United States—In the Matter of Cross Border Trucking Services, para. 221 (USA-MEX-98-2008-01 Feb. 6, 2001) [hereinafter United States—Trucking]; Ethyl Award, *supra* note 17, para. 51; Gabrielle Marceau, *WTO Dispute Settlement and Human Rights*, 13 EUR. J. INT'L L. 753, 782 (2002); Robert Howse, *The Canadian Generic Medicines Panel: A Dangerous Precedent in Dangerous Times*, 3 J. WORLD INTEL. PROP. 493, 504 (2000).

⁴¹ Statute of the Court of International Justice, Oct. 24, 1945, 832 U.S.T.D. 993.

⁴² It is also useful to note that NAFTA Article 709 connotes an extremely broad purview for the application of the NAFTA's SPS obligations, indicating that they apply to “any such measure of a Party that may, directly or indirectly, affect trade between the Parties.” The implication is that the NAFTA's drafters wanted to stress the importance of the balance they struck between legitimate protection and protectionism, using science as one of the arbitral tests.

⁴³ S.D. Myers, Inc. v. Canada, 40 I.L.M. 1408, para. 260 (NAFTA/UNCITRAL Trib., Nov. 13, 2000) (interim merits award) [hereinafter Myers Interim Merits Award].

III. NON-DISCRIMINATION (ARTICLES 1102–1104)

In order to prove a violation of NAFTA Article 1102, a claimant must demonstrate that a measure has resulted in the investor or investment receiving less favourable treatment than any other domestic competitor, regardless of whether there was any intent on the part of the Government to provide less favourable treatment because the investor or investment was foreign (or, conversely, to provide better treatment to a local competitor because it is local). For Article 1103, the comparator is another foreigner. Article 1104 merely ensures that the best treatment accorded through the application of both of Articles 1102 and 1103 is provided.

Five tribunals have issued awards concerning the interpretation of Article 1102.⁴⁴ Each decision has contributed to a consistent and coherent approach to the non-discrimination obligations contained within NAFTA. This approach has been adopted universally because it provides a familiar touchstone for tribunal members and counsel, who have recourse to a wealth of applicable WTO jurisprudence on non-discrimination. Comparatively, there is a relative dearth of modern (and relevant) jurisprudence available for the interpretation of Articles 1105 and 1110 in a modern regulatory context.

The *Pope & Talbot* Tribunal set the standard for the interpretation of NAFTA's non-discrimination provisions, building upon the analysis found in *Myers* and *US-Trucking*.⁴⁵ This analysis can be reduced to three basic elements:

- (1) Identification of the relevant subjects for comparison;
- (2) Consideration of the relative treatment received by each comparator; and
- (3) Consideration of whether any factors exist which could justify any difference in treatment so found.

The initial comparison is made between the claimant or its investment and any domestic investors or investments operating in the same business or economic sector. For the *Pope & Talbot* Tribunal, the relevant class of comparators was composed of those engaged in the

⁴⁴ *Id.*; Pope & Talbot Final Merits Award, *supra* note 6; United States—Trucking, *supra* note 40; ADF Group Final Award, *supra* note 14; Marvin Feldman v. United Mexican States, (NAFTA/ICSID(AF) Trib., Case No. ARB(AF)/99/1, Dec. 16, 2002) (final award) [hereinafter Feldman Final Award].

⁴⁵ Pope & Talbot Final Merits Award, *supra* note 6, paras. 31–81, particularly para. 78.

production of softwood lumber in Canada.⁴⁶ For the *Myers* Tribunal, the class was composed of Polychlorinated Biphenyls (PCB) destruction firms attempting to operate in Canada.⁴⁷ For the *US-Trucking* Panel, the class was composed of trucking firms who might attempt to operate in the United States.⁴⁸ For the *Feldman* Tribunal, the “applicable universe” of comparable investors and investments was composed of those businesses engaged in the purchase and resale of cigarettes, rather than a wider group that could have included manufacturers.⁴⁹ For the *ADF* Tribunal, the point of comparison was between specialized steel products used by the investor (a steel fabricator) and similar steel products used by domestic competitors, with respect to their potential use in a highway project.⁵⁰ By necessary implication, the *ADF* Tribunal’s comparison focused on firms operating in the steel fabrication business as its “universe” of comparable investors under Article 1102(1).

To examine whether the treatment received was more or less favourable, it is useful to recall that the goal of any non-discrimination obligation essentially is to provide the foreign firm with the promise of an effective equality of competitive opportunities between it and its competitors.⁵¹ To achieve this goal, one considers the question of “treatment” under this test in terms of a comparison between that which has been received by the foreigner and the best level of treatment made available to *any* other domestic investor or investment operating in like circumstances (or any other foreigner under the MFN standard). This comparison also is not limited to an evaluation of whether the treatment received is substantially similar. The focus is on the results of the treatment received.⁵²

Such a rationale was employed by the *ADF* Tribunal in its dismissal of the claim against the United States, and by the *Feldman* Tribunal to conclude that a *prima facie* claim existed against Mexico. For

⁴⁶ *Id.* paras. 73–80.

⁴⁷ *Myers* Interim Merits Award, *supra* note 43, paras. 243–51.

⁴⁸ *United States—Trucking*, *supra* note 40, paras. 253, 286.

⁴⁹ *Feldman* Final Award, *supra* note 44, paras. 171–72.

⁵⁰ *ADF* Group Final Award, *supra* note 14, para. 155.

⁵¹ *See, e.g.*, *United States—Section 337 of the Tariff Act of 1930*, 36 (1989) B.I.S.D. 345, at paras. 5.13–5.14; *Japan Alcoholic Beverages*, *supra* note 19, at 6; WTO Appellate Body Report on *Korea—Taxes on Alcoholic Beverages*, WT/DS75/AB/R, WT/DS84/AB/R (Jan. 18, 1999), para. 119; WTO Panel Report on *Canada—Certain Measures Affecting the Automotive Industry*, WT/DS139/R, WT/DS142/R, para. 10.78 (Jan. 31, 2000), available at http://www.wto.org/english/tratop_e/dispu_e/6100d.pdf.

⁵² *See, e.g.*, *Myers* Interim Merits Award, *supra* note 43, para. 254; *Pope & Talbot* Final Merits Award, *supra* note 6, paras. 41–42, 70.

the *ADF* Tribunal, it was a matter of evidence, or lack thereof. The Tribunal concluded basically that ADF failed to provide "specific evidence concerning the comparative economics of the situation" in order to prove that the competitive position of Canadian-based contractors was disadvantaged, as compared to U.S.-based contractors, because of the imposition of the measure.⁵³

By contrast, Feldman proved to his Tribunal that he was subjected to an audit process which was not imposed similarly on his primary domestic competitors, and that they had received tax rebates that were withheld from him. Accordingly, Feldman established a *prima facie* case of discrimination. It was not necessary for him to prove that he was receiving less favorable treatment *because* he was a foreigner, only that he was a foreigner receiving worse treatment than a comparable investor or investment.⁵⁴

Once a *prima facie* breach of a non-discrimination provision has been established, the onus shifts to the respondent government to justify the difference in treatment. If the government can prove that the treatment was different because the comparators truly were not in "like circumstances," it will have justified the measure.⁵⁵ In *Feldman*, because Mexico failed to provide any explanation as to why it had treated the claimant differently than his competitors, it lost the case.

Chaired by the same person, the *Myers* Tribunal and the *US-Trucking* Panel both treated this final portion of the non-discrimination analysis as a "like circumstances exemption."⁵⁶ In other words, both read into the notion of "like circumstances" the kinds of protection for regulatory activity that only exist under GATT Article XX for the manner of application of the measure (rather than the measure itself). While this approach represents a potential broadening of the scope for exemptions under NAFTA's non-discrimination obligations, neither case actually used the "like circumstances exemption." In *Myers*, the U.S. claimant was shut out of the Canadian market for PCB destruction on the protectionist whim of a Cabinet member who ignored the advice of her own bureaucrats. In *US-Trucking*, no Mexican trucking firms were eligible to apply for permission to operate in the United States, regardless of whether they could prove that they met the same standards which apply to Canadian and American

⁵³ ADF Group Final Award, *supra* note 14, para. 157.

⁵⁴ Feldman Final Award, *supra* note 44, para. 181.

⁵⁵ See, e.g., Pope & Talbot Final Merits Award, *supra* note 6, paras. 78-79; United States-Trucking, *supra* note 40, at 258-60.

⁵⁶ United States-Trucking, *supra* note 40, paras. 258-60.

firms. Both the Tribunal and the Panel accordingly found liability under the national treatment obligation.

A more useful case in demonstrating the manner in which the third branch of the national treatment test should be applied can be found in the Final Merits Award of the *Pope & Talbot* Tribunal. While the facts did not involve an SPS measure, the Tribunal's analysis clearly established that once a prima facie difference in treatment among a class of comparators has been proved, the respondent must prove "whether there is a reasonable nexus between the measure and a rational, non-discriminatory government policy, [and] whether those policies are embodied in statute, regulation or international agreement."⁵⁷ In that case, Canada proved that while its export control regime provided the claimant with worse treatment than other industry members, there was a reasonable connection between the measure and Canada's need to honor an agreement with the U.S. Government, which forestalled the imposition of U.S. anti-dumping duties against all lumber exports from Canada.

For SPS measures, the language of the *Pope & Talbot* Tribunal is reminiscent of two SPS principles: the right of NAFTA governments to develop and impose such measures, and the prohibition against any measure which results in arbitrary or unjustifiable discrimination, or in a disguised restriction on economic activity. In the context of Articles 1102 and 1103, the right to develop and impose an SPS measure is safeguarded in the Tribunal's analysis because it would be a presumptively "rational, non-discriminatory public policy." However, a reasonable nexus must be demonstrated between the impact of the measure and this goal. The Appellate Body has provided an analysis of Article 5.5 of the WTO SPS Agreement which can provide some guidance in this regard. It noted that the obligation would be breached in cases where:

- the government is not requiring comparable levels of protection in comparable situations;
- the failure to do so is arbitrary or unjustifiable (i.e. unreasonable); and
- such measures result in discrimination or a disguised restriction on international trade.⁵⁸

⁵⁷ Pope & Talbot Final Merits Award, *supra* note 6, para. 81.

⁵⁸ Beef Hormones Report, *supra* note 33, para. 214.

By this point of the Article 1102 and 1103 analysis, the first and third elements of this test normally will have been established already. Accordingly, the most interesting element of the WTO SPS analysis is the second prong, concerning what constitutes arbitrary or unjustifiable discrimination. In the Australian Salmon Report, Australia banned all salmon from outside its territory that was not heat-treated in order to protect against twenty-four different fish-borne diseases not native to Australia. However, it did not similarly ban the importation and unregulated use of ornamental fish nor bait fish, even though both activities posed a greater risk of infecting native fish. Australia's explanation was that it had not yet conducted proper risk assessments on those comparable products. The Appellate Body found this justification to be unacceptable. It found that varying degrees of risk between products or situations could provide a valid justification for differences in treatment, but such was not the case here. Australia simply insisted on a conservative risk level for salmon but apparently was indifferent to the greater risks posed by the use of ornamental and bait fish. The additional fact that the measure was modified to eliminate a possible exemption for salmon after the government received input from domestic competitors also did not help to justify the measure.⁵⁹

The Appellate Body's analysis in the Beef Hormones Report is unhelpful in this regard, however, as it concluded that there was no arbitrary or unjustifiable treatment because naturally occurring hormones and administered hormones in food are intrinsically different. It similarly concluded that a difference exists between hormones administered for zoological purposes and those administered for therapeutic purposes.⁶⁰ In doing so, the Appellate Body effectively concluded that there were no valid comparators at issue, but rather that these practices were comparable, though treated differently for a good reason.

With respect to the inclusion of SPS principles in the NAFTA non-discrimination analysis, the bottom line is that Articles 1102 and 1103 allow for an analysis that respects the SPS bargain. An explicit exhortation need not exist in the plain text, because it already exists in the text as interpreted within the context of the NAFTA and the applicable rules of international law. To the extent that differences in treatment cannot be reasonably connected to a rational policy, such as

⁵⁹ Australian Salmon Report, *supra* note 33, paras. 84–85.

⁶⁰ Beef Hormones Report, *supra* note 33, paras. 221–23.

an SPS policy, they will not be justified and compensation will be payable for any damages that flow from their imposition.

IV. NAFTA ARTICLE 1105

Article 1105(1) states that investments must be provided with “treatment in accordance with international law, including fair and equitable treatment and full protection and security.”⁶¹ On July 31, 2001, the NAFTA Parties issued a statement which added the following concepts to any Article 1105 interpretation:

1. Article 1105(1) prescribes the customary international law minimum standard of treatment of aliens as the minimum standard of treatment to be afforded to investments of investors of another Party.

2. The concepts of “fair and equitable treatment” and “full protection and security” do not require treatment in addition to or beyond that which is required by the customary international law minimum standard of treatment of aliens.

3. A determination that there has been a breach of another provision of the NAFTA, or of a separate international agreement, does not establish that there has been a breach of Article 1105(1).⁶²

Three awards were rendered in 2002 that addressed the interpretation of Article 1105. Despite some initial misgivings, tribunals have concluded that the statement is binding upon them under NAFTA Article 1131(2).⁶³ Accordingly, if any investors (such as Methanex) were hoping to rely upon the breach of a WTO obligation as an automatic breach of the “international law” referred to in Article 1105, such hopes have essentially been dashed.⁶⁴

On the other hand, based upon the jurisprudence that has evolved since the NAFTA Parties released their statement on interpretation, it also would appear that particular hopes shared by the

⁶¹ NAFTA, *supra* note 1, art. 1105(1).

⁶² North American Free Trade Commission, *Notes of Interpretation of Certain Chapter 11 Provisions* (NAFTA Free Trade Commission, July 31, 2001), at http://www.dfait-maeci.go.ca/tha-nac/NAFTA-Interpr_en.asp. (last visited Mar. 14, 2003).

⁶³ *See, e.g., Pope & Talbot, Inc. v. Canada*, para. 51 (NAFTA/UNCITRAL Trib., May 31, 2002) (damages award), available at www.naftalaw.org [hereinafter Pope & Talbot Damages Award].

⁶⁴ *See, e.g., Mondev Final Award*, *supra* note 19, para. 121.

NAFTA governments similarly have been dashed. For example, the United States hoped that the statement on interpretation would restrict claimants to making Article 1105 claims only based on fully-crystallized rules of customary international law—of which there are very few.⁶⁵ NAFTA Governments also have been disappointed because their arguments concerning the threshold of treatment covered by the reinterpreted Article 1105 have been unanimously rejected. They argued that the only circumstances that could breach Article 1105 would be those which fell below an extremely high threshold, articulated in a 1926 dispute with Mexico: “to an outrage, to bad faith, to wilful neglect of duty or to insufficiency of government action so far short of international standards that every reasonable and impartial man would readily recognize its insufficiency.”⁶⁶

Instead, the approach to Article 1105 that has been adopted recently by two high-calibre tribunals can be summarised as follows. First, the standard of treatment imposed by Article 1105 is a “floor” under which no conduct should fall.⁶⁷ Second, not all acts of pettiness or unfairness will rise to the level of an international wrong, particularly in deference to the sovereign right of States to protect their citizens.⁶⁸ Third, the content of the minimum standard in any given case is highly contextual.⁶⁹ Finally, it is important to rely upon any relevant source of international law (including treaty obligations) to prove the content of that minimum standard in any given case.⁷⁰

For the purposes of reviewing most regulatory measures under NAFTA Article 1105, there are two customary international law doctrines which can inform a tribunal’s interpretation: denials of justice and the abuse of rights. Professor Garcia-Amador’s work on the minimum standard of treatment of aliens is regarded widely as an authoritative statement of the customary international law standard as it existed thirty years ago. With respect to denials of justice, Professor Garcia-Amador included numerous judicial, quasi-judicial, and ad-

⁶⁵ ADF Group Final Award, *supra* note 14, para. 185.

⁶⁶ United States (L.F. Neer) v. United Mexican States, 4 R.I.A.A. 60, 3 I.L.R. 213, para. 4 (1927) (US-Mexico Claims Commission 1926) [hereinafter Neer]. Neer was rejected, for example, by the *Mondev* Tribunal in its Final Award. *Mondev* Final Award, *supra* note 19, para. 115. The Neer claim involved an allegation of denial of justice because Mexico had allegedly failed to prosecute those who had murdered Mr. Neer.

⁶⁷ Myers Final Award, *supra* note 13, para. 260.

⁶⁸ *Id.* para. 263.

⁶⁹ See *Mondev* Final Award, *supra* note 19, para. 118.

⁷⁰ See ADF Group Final Award, *supra* note 14, paras. 184–85.

ministrative or regulatory bodies within the scope of a denial of justice claim, noting:

A decision or judgment of a tribunal or an administrative authority rendered in a proceeding involving the determination of the civil rights or obligations of an alien or of any criminal charges against him, and either denying him recovery in whole or in part or granting recovery against him or imposing a penalty, whether civil or criminal, upon him is wrongful:

- a) if it is a clear and discriminatory violation of the law the State concerned;
- b) if it unreasonably departs from the principles of justice recognized by the principal legal systems of the world; or
- c) if it otherwise involves a violation by the State of a treaty.⁷¹

The right to hold property has been recognized explicitly by the NAFTA Parties through its ratification of the NAFTA, which provides for protection of a wide range of property interests included in the definition of “investment” under Article 1138. Accordingly, it is largely beyond dispute that a government decision that affects the right to enjoy property could attract international responsibility to a state. This does not mean, however, that a mere error of domestic law or a minor procedural defect will constitute a denial of justice. There must be something more,⁷²

The hallmark of a substantive denial of justice can be found in the arbitrariness of the decision in question. A decision is arbitrary, and a denial of justice, if it is “manifestly unjust or one-sided.”⁷³ Numerous arbitral decisions consider applicability of customary minimum standards of treatment in terms of the arbitrariness of the government actions in question. For example, in *British Petroleum Exploration Co. v. Libyan Arab Republic*, the sole arbitrator found that the state’s actions violated public international law because its taking of the investor’s property “was made for purely extraneous political

⁷¹ V.F. GARCIA-AMADOR ET AL., RECENT CODIFICATION OF THE LAW OF STATE RESPONSIBILITY FOR INJURIES TO ALIENS 196 (1974).

⁷² See ADF Group Final Award, *supra* note 14, paras. 190–91; Mondev Final Award, *supra* note 19, paras. 127, 156.

⁷³ This is the formulation of a substantive denial of justice provided by Vattel, *Le Droit des Gens* (1758) Book II, Chapter 18, para. 350; translated by C.J. Fenwick in: J.B. Scott, ed., *Classics of International Law* (Washington, Carnegie Institution: 1916).

reasons and was arbitrary and discriminatory in character."⁷⁴ Substantive denials of justice such as this one also could be considered an abuse of right under international law. As Bin Cheng noted in his renowned treatise on the principles of international law, the doctrine of abuse of rights stems from the principle of good faith. He summarized his view of the doctrine as follows:

[D]iscretion must be exercised in good faith, and the law will intervene in all cases where this discretion is abused. . . . Whenever, therefore, the owner of a right enjoys a certain discretionary power, this must be exercised in good faith, which means that it must be exercised reasonably, honestly, in conformity with the spirit of the law and with due regard to the interest of others.⁷⁵

. . . .

The exercise of a right—or a supposed right, since the right no longer exists—for the sole purpose of causing injury to another is thus prohibited. Every right is the legal protection of a legitimate interest. An alleged exercise of a right not in furtherance of such interest, but with the malicious purpose of injuring others can no longer claim protection of the law.⁷⁶

. . . .

The principle of good faith requires every right to be exercised honestly and loyally. Any fictitious exercise of a right for the purpose of evading either a rule of law or a contractual obligation will not be tolerated. Such an exercise constitutes an abuse of the right, prohibited by law.⁷⁷

In addition to these customary international law doctrines, which generally should be applicable to any regulatory action, NAFTA tribunals also should consider the relevant SPS principles when necessary. For Article 1105, such principles include: (1) the right of governments to impose SPS measures; (2) the procedural principle expressed in NAFTA Article 712(3), that a measure be based upon scientific principles, not maintained when the scientific basis for it no longer exists, and based upon a risk assessment; and (3) that the

⁷⁴ *British Petroleum Exploration Co. Ltd. v. Libyan Arab Republic*, 53 I. L. R. 297, 329 (1973) (final award of Arbitrator Lagergren).

⁷⁵ BIN CHENG, *GENERAL PRINCIPLES OF LAW* 132–34 (1987).

⁷⁶ *Id.* at 122.

⁷⁷ *Id.* at 123.

measure be developed and implemented in a transparent manner (which is reflected in NAFTA Article 718). Given the nature of Article 1105, these principles should be applied in a manner that accords considerable deference to governmental authority, while ensuring that such authority is not exercised in a truly unreasonable or arbitrary manner.⁷⁸

The ultimate purpose of the NAFTA Parties' SPS obligations is to reduce or eliminate the ways in which failures of transparency and procedural uncertainty abet inappropriate regulatory conduct.⁷⁹ If an economic actor understands the kind of regulatory system at work, and can see how it generates a certain result, this will reduce the capacity for a government, or official, to abuse regulatory discretion. Normally, an improper exercise of discretion can be hidden, and even if it is not hidden, it can be evidenced only in the apparent arbitrariness of—or lack of rationality behind—a given regulatory decision. As Professor George Schwarzenberger once noted (long before the establishment of the WTO or the NAFTA SPS regimes), these abuses of discretion form the “hard core” of the doctrine and must be rooted out, no matter how difficult the task:

Arbitrariness in any form is—or ought to be—abhorrent to *homo juridicus*. His whole professional outlook is dominated by the attitude that, in the eyes of the law, equal situations require equal remedies.⁸⁰

Yet, anybody who is acquainted with the techniques by which judicial precedents are applied and distinguished is aware of the element of subjectivity which is inseparable from deciding, even on a judicial level, what situations are supposed to be equal.

⁷⁸ See, e.g., Myers Interim Merits Award, *supra* note 43, para. 263, which provides:

The Tribunal considers that a breach of Article 1105 occurs only when it is shown that an investor has been treated in such an unjust or arbitrary manner that the treatment rises to the level that is unacceptable from the international perspective. That determination must be made in the light of the high measure of deference that international law generally extends to the right of domestic authorities to regulate matters within their own borders. The determination must also take into account any specific rules of international law that are applicable to the case.

Id.

⁷⁹ Howse, *supra* note 40, at 2336, although he does not explicitly recognize the role of legal certainty in combination with transparency.

⁸⁰ GEORGE SCHWARZENBERGER, INTERNATIONAL LAW AND ORDER 100 (1971).

In the fields of quasi-judicial, administrative or political decisions, it is even more difficult to verify the arbitrary exercise of discretion. The wider the scope of discretion, the easier it is to find plausible arguments to hide irrelevant or objectionable reasons. If discretion is exercised within a wide framework of territorial jurisdiction, only the most potent abuses of sovereignty could possibly be caught by any prohibition of the arbitrary use of sovereign right.⁸¹

SPS regimes provide an answer to this dilemma. They provide the certainty and transparency that come from structuring discretion. It is in this sense that "sound science" can be a tool of considerable importance to the trade or investment lawyer.

However, as Wirth indicates, SPS principles provide no panacea. They also do not extend to the process of second-guessing the scientific judgment of the regulator. The principle that a measure must be based on "scientific principles" and be discontinued where there is "no longer a scientific basis" merely asks whether such judgment was actually exercised.⁸² Science accordingly can be seen as a necessary component of the regulatory review process, rather than the only relevant factor. Within the context of this principle, as imbedded in Article 1105, a tribunal is called upon only to consider whether sufficient evidence exists to indicate that science is properly informing the political exercise of risk management. It is not supposed to consider whether "some threshold of scientific proof or certainty [exists] below which democratic judgments about risk regulation are illegitimate."⁸³

In the Beef Hormones Report, the Appellate Body interpreted Article 5.1 of the WTO SPS Agreement (which is akin to NAFTA Article 712(3)(c)) as implying the need for a justified, rational basis for a measure based upon a risk assessment conducted prior to its imposition. All that would be required to satisfy this obligation, as received into Article 1105, would be sufficient evidence of a nexus between the risks identified in a valid assessment procedure and the operation of the measure.⁸⁴ A valid risk assessment will exist wherever a government has: (1) identified a problem and its possible biological and

⁸¹ *Id.* at 100–01.

⁸² See Wirth, *supra* note 30, at 855 (although his prescription would be even more deferential than the one provided by the Appellate Body and advocated here). See *id.*

⁸³ Howse, *supra* note 40, at 2341.

⁸⁴ *Id.* at 2342 (citing Beef Hormones Report, *supra* note 33, para. 194).

economic consequences; (2) evaluated the likelihood of the introduction of the agent for this problem; and (3) evaluated the impact of the proposed measure upon the risk so identified.⁸⁵ Because the European Union (EU) had not conducted a risk assessment for one of the hormones at issue in that case, and because it had not conducted an assessment related to the risk upon which its measures were based (i.e., the risk from improper veterinary practices in respect of the other five hormones at issue in the case), the EU was found to have failed to base its measure on a valid risk assessment.⁸⁶

In Australian Salmon Report, Australia failed to meet this test because it was found only to have complied with its first prong. This is because Australia did not undertake a quantitative assessment or a qualitative assessment of the probability of the introduction of the fish-borne diseases that its measure targeted, or an analysis of how the measure would impact upon such probabilities. While the Appellate Body's analysis here is certainly something more than merely inquiring as to whether something that a government labels a "risk assessment" exists, it does not go so far as to question the ability of a government to make SPS decisions. It may do so as long as the assessment is undertaken properly, no matter how low the appropriate level of risk ultimately becomes.

Similarly, a measure could run afoul of this basic SPS principle if the claimant could prove that no rational relationship exists between the risks identified in the assessment and the measure as designed and imposed. For example, in the Japanese Agricultural Products Report, the Appellate Body concluded that Japan's de facto requirement, that all foreigners demonstrate the efficacy of quarantine and fumigation measures for every variety of plant imaginable, was not rationally connected to the available risk assessments. No causal link had been established between differences in plant variety and differences in the efficacy of quarantine treatment because the available scientific evidence simply did not address the issue. While a government would be perfectly entitled to base its decision on conflicting scientific evidence, a rational relationship between that evidence and the measure must nonetheless exist.⁸⁷

As demonstrated by the doctrine developed and applied by the Appellate Body in these cases, David G. Victor has concluded that the

⁸⁵ Australian Salmon Report, *supra* note 33, para. 121.

⁸⁶ Beef Hormones Report, *supra* note 33, para. 200.

⁸⁷ Japanese Agricultural Products Report, *supra* note 33, paras. 76–85.

requirement for a measure to be “based on science” and a “valid risk assessment” likely will result in “a convergence in procedures that countries follow when setting SPS policies but not necessarily convergence in particular regulatory outcomes.”⁸⁸ To the extent that such a convergence can be considered state practice, this SPS principle should become even more firmly ensconced in the applicable international law which will be available whenever a NAFTA tribunal interprets Article 1105.⁸⁹

It also should be noted that failures in transparency have already been found by one NAFTA tribunal as relevant to its finding of a breach of Article 1105.⁹⁰ Recall that NAFTA Article 102(1) provides that transparency is a primary lens through which NAFTA’s liberalizing objectives must be focused, in aid of a tribunal’s interpretation of any NAFTA provision. The failure of a NAFTA government to meet its obligations under NAFTA Article 718 or Article 7 of the WTO SPS Agreement does not constitute a *per se* breach of NAFTA Article 1105; however, in the words of the *Myers* Tribunal, it certainly can provide evidence of a failure to accord the necessary amount of “fair and equitable treatment” to an investment in any given case.⁹¹

The Appellate Body already has concluded that the manner in which the Japanese varietal testing requirements were imposed (without sufficient publication or notification, but rather through the accumulation of various *de facto* requirements) violated the principle of transparency.⁹² The significance of this finding should not be underestimated. Without sufficient transparency, science-based regulatory disciplines cannot function because the lack of transparency acts as an impediment to fully-informed (and therefore rational) democratic decision-making.⁹³ Similar failures could lead to a determination that Article 1105 has been breached if they result in harm to an investor or investment.

⁸⁸ David. G. Victor, *The Sanitary and Phytosanitary Agreement of the World Trade Organization: An Assessment After Five Years*, 32 N.Y.U. J. INT’L L. & POL. 865, 872 (2000).

⁸⁹ See ADF Group Final Award, *supra* note 14, para. 184.

⁹⁰ Metalclad Final Award, *supra* note 24, paras. 88, 99. This aspect of the Tribunal’s award was the subject of a judicial review proceeding in which a British Columbia judge inappropriately substituted his opinion of how Article 1105 should be interpreted for that of the Tribunal. As I have explained elsewhere, it is unlikely that the judge’s opinion will sway many international lawyers in the long run. See generally Todd Weiler, *Metalclad v. Mexico: A Play in Three Parts*, 2 J. WORLD INVEST. 685 (2001).

⁹¹ *Myers* Interim Merits Award, *supra* note 43, para. 264.

⁹² Japanese Agricultural Products Report, *supra* note 33, para. 108.

⁹³ See Howse, *supra* note 40, at 2336–37.

V. NAFTA ARTICLE 1110

While certainly the centerpiece of concern for environmentalists, as well as free trade opponents, NAFTA Article 1110—by which NAFTA governments promise to provide full, fair and effective compensation whenever they directly or indirectly “take” an investment—has had a largely unremarkable existence. So far, only one tribunal has found a breach of Article 1110 and ordered compensation to be paid.⁹⁴ Why the concern with Article 1110? Article 1110(1) provides as follows:

1. No Party may directly or indirectly nationalize or expropriate an investment of an investor of another Party in its territory or take a measure tantamount to nationalization or expropriation of such an investment (“expropriation”), except:

- (a) for a public purpose;
- (b) on a non-discriminatory basis;
- (c) in accordance with due process of law and Article 1105(1); and
- (d) on payment of compensation in accordance with paragraphs 2 through 6.

This expropriation obligation covers direct confiscations as well as indirect, or “creeping,” expropriations of investments—but nothing more. It includes regulatory measures, such as SPS measures. However, unless the degree of government interference with an investment is found to be sufficiently “substantial,” a finding of expropriation cannot be made. Substantial interference involves the kind of deprivation that would lead a tribunal to conclude that the investor has lost its ability to use, enjoy or dispose of an investment, whether it effectively has been confiscated or not.⁹⁵ There is nothing particularly notable about this state of the law. Expropriation only applies to the “nuclear warheads” of government regulation, which can lay waste to an investment without the payment of compensation.

To limit the application of this obligation further, so far two tribunals have concluded that any interference caused by a measure that affects merely a portion of the business undertaken by an investment generally will not be considered sufficient enough so long as the in-

⁹⁴ Metalclad Final Award, *supra* note 24, para. 112.

⁹⁵ Pope & Talbot, Inc. v. Canada, paras. 101-02 (NAFTA/UNCITRAL Trib., 2000) (interim merits award), available at <http://www.naftalaw.org>.

vestment enterprise (which constitutes the “investment” under Articles 1110 and 1139) continues to operate.⁹⁶ Accordingly, the larger the company, the more unlikely it is that it will be able to prove an expropriation, unless it structures its investments as a discrete number of separate businesses.

Moreover, the *Feldman* Tribunal has gone even further, by noting:

No one can seriously question that in some circumstances government regulatory activity can be a violation of Article 1110. For example, in *Pope & Talbot*, Canada argued that “mere interference is not expropriation; rather, a significant degree of deprivation of fundamental rights of ownership is required.” That tribunal rejected this approach:

“Regulations can indeed be characterized in a way that would constitute creeping expropriation Indeed, much creeping expropriation could be conducted by regulation, and a blanket exception for regulatory measures would create a gaping loophole in international protection against expropriation.”⁹⁷

The *Feldman* Tribunal went on to conclude:

[N]ot all government regulatory activity that makes it difficult or impossible for an investor to carry out a particular business, change in the law or change in the application of existing laws that makes it uneconomical to continue a particular business, is an expropriation under Article 1110. Governments, in their exercise of regulatory power, frequently change their laws and regulations in response to changing economic circumstances or changing political, economic or social considerations. Those changes may well make certain activities less profitable or even uneconomic to continue.⁹⁸

Based upon these preliminary comments, the *Feldman* Tribunal entered into a detailed and highly contextualized analysis of the regulatory scheme in question and of the investor’s rights and entitlements under it. It did so under the aegis of determining whether an “expropriation” (as mentioned in the *chapeau* of Article 1110(1)) had

⁹⁶ See *Feldman* Final Award, *supra* note 44, para. 152.

⁹⁷ *Id.* para. 110.

⁹⁸ *Id.* para. 112.

even taken place. In the Tribunal's opinion, sub-paragraphs (a) through (d) of Article 1110(1) added very little to the analysis, and accordingly did not need to be given "excessive weight."⁹⁹ This was particularly true because most measures can be subjected to review under NAFTA's non-discrimination and "fair and equitable treatment" provisions.¹⁰⁰

In this case, Feldman apparently failed to prove that the business interest that he claimed was taken from him was actually an economic right to which he was entitled. His business relied upon a grey market created by the operation of the tax regime. The government appeared to have a long-standing tax policy against the operation of such businesses, and while its enforcement was flawed (in that some businesses were able to take advantage of the grey market much longer than others), it was justified in principle. Accordingly, while Mexico may have violated Article 1102 in application of its tax regime, it did not perpetrate a compensable taking merely because finally it closed some of the loopholes through which the investor had been profiting.

How this analysis would apply to the facts of an environmental taking is an open question, but certainly it would appear that a detailed analysis of whether the claimant legitimately possesses an acquired right to operate its business (in the face of environmental impacts or regulation) will be front-and-center in future cases, regardless of whether Article 1110(1) seems to provide otherwise.

If the Article 1110 analysis involves an SPS measure, the matter becomes even more delicate. This is because Article 1110 protects fundamental ownership rights in a manner different from Articles 1102, 1103, and 1105. Whereas these provisions protect against some degree of interference with an investor or investment, Article 1110 deals with the more serious issue of the fundamental deprivation of the basic right to operate one's investment in the territory of a NAFTA Party. On the other hand, there remains the fundamental right of governments to protect their citizens, in this case through the development and imposition of SPS measures.

In such a context, the SPS principles discussed above should come into play in determining whether compensation must be paid under Article 1110. In addition, the necessity of the imposition of the SPS measure must be considered. Rob Howse has argued that the

⁹⁹ *Id.* para. 135.

¹⁰⁰ See Pope & Talbot Damages Award, *supra* note 63, para. 111.

WTO obligations that contribute to this principle (Articles 2.2 and 5.6 of the WTO SPS Agreement) do not permit a WTO panel to apply a proportionality test in determining whether the measure truly was necessary. Using such a test would invite a tribunal to consider possible trade-offs between the chosen level of protection and the harmfulness of the economic impacts of the measure designed to achieve that level of protection. This would be an unacceptable intrusion into state sovereignty. Rather, applying Howse's analysis to the investment context, the SPS necessity principle only requires: (1) that the measure is applied in a manner consistent with its stated objectives (which, in turn, are rationally connected to an appropriate risk analysis); and (2) that an alternative avenue of fully addressing that risk—which would have been less harmful to the ownership interests at stake—did not exist.¹⁰¹

As the Appellate Body noted in the Australian Salmon Report, a three-pronged test can be used to determine whether an alternative measure exists (which, by definition, would render the measure at issue “unnecessary” and thus improperly imposed). The alternative measure must: (1) be “reasonably available taking into account technical and economic feasibility;” (2) achieve “the appropriate level” of protection; and (3) be “significantly less restrictive” than the measure chosen.¹⁰² Such an alternative still might cause harm to the investment, but it should not result in a near-total deprivation of the right to operate the investment and derive economic benefits from it.

Accordingly, the analysis of an SPS measure under Article 1110 is somewhat less deferential than it would be under Articles 1102, 1103, or 1105, owing to the far more serious nature of the interference in question. However, to receive compensation under Article 1110, the claimant would have to prove: (1) that an extremely high level of interference had taken place; (2) that one or more of the SPS principles described above had been violated; (3) that the business of the investment was not so damaging to humans, plants, or animals as to be worth little to a notional purchaser-for-value under Article 1110(2);¹⁰³ and (4) that the circumstances of the investment demonstrated that the investor had reason to believe its investment was operating on solid regulatory ground (unlike the investor in *Feldman*,

¹⁰¹ See Howse, *supra* note 40, at 2354–56.

¹⁰² Australian Salmon Report, *supra* note 33, paras. 180–81.

¹⁰³ For an elucidation of this condition, see Todd Weiler, *A First Look at the Interim Merits Award in S.D. Myers, Inc. v. Canada*, 24 HASTINGS INT'L COMP. L. REV. 173, 187–88 (2001).

who was essentially taking advantage of flaws in a tax regime that ultimately were corrected to his detriment).¹⁰⁴

VI. SPS PRINCIPLES IN APPLICATION

In order to consider how these SPS principles might be applied in actual cases, it is useful to consider some of the existing NAFTA disputes that have yet to reach arbitration. One such case is *Kenex Ltd. v. United States*, which involves a proposed U.S. ban on all hemp food products.¹⁰⁵ Kenex is a Canadian-based hemp products producer that established a business in the United States with plans for expansion. In Canada, it manufactures industrial hemp products, including whole hemp grain, hemp grain derivatives (such as refined hemp oil, hemp nut, and hemp meal), hemp fiber, and certified hemp seed. It markets and distributes these products throughout North America.

Industrial hemp is a variety of the plant species known as *cannabis sativa L.* Another variety of this plant species is marijuana. However, whereas marijuana typically contains between 3% and 15% of the psychoactive substance tetrahydrocannabinol (THC), industrial hemp contains only non-psychoactive trace amounts of THC (i.e., less than 0.3%). For its products, Kenex has even subscribed to the industry's "Test Pledge" standards, which limit its products to no more than 1.5 parts of THC per million in shelled hempseed and 5 parts per million in hemp oil for food.¹⁰⁶

While marijuana and synthetic THC have been controlled substances for decades, industrial hemp products always have been exempted from control under U.S. federal legislation. As a result, sterilized hempseed has been imported legally every year since the U.S.

¹⁰⁴ This last condition could be referred to as a legitimate expectation or an acquired right which was capable of protection under international law. For more information about these concepts, see IGNAZ SEIDL-HOHENVELDERN, *INTERNATIONAL ECONOMIC LAW* 133-39 (3rd ed. 1999).

¹⁰⁵ *Kenex Ltd.* *supra* note 17.

¹⁰⁶ *Id.* paras. 3-6. As indicated in Kenex's Notice of Intent: hemp seeds can be used directly as a food ingredient or crushed for oil and meal. Hemp seeds and flour are being used in nutrition bars, tortilla chips, pretzels, beer, salad dressings, cheese and ice cream, and as such are directly competitive with products such as flax, walnut, sesame and poppy seeds. Poppy seeds in particular are in a very similar position to hemp seeds, insofar as poppy seeds contain trace amounts of opiates that are controlled by the Controlled Substances Act in the U.S., but are specifically exempted from control along with their trace opiates. Hemp oil is also used in body-care products such as cosmetics, lotions, moisturizers and shampoos where it competes with emollient ingredients like lanolin and jojoba oil, as well as in nutritional Essential Fatty Acid (EFA) omega-3/omega-6 dietary supplements where it competes primarily with flax, evening primrose and fish oil. *Id.*

Controlled Substances Act went into effect over seven decades ago.¹⁰⁷ Nonetheless, in October 2001, the U.S. Drug Enforcement Agency (DEA) issued an interpretive rule that effectively banned all industrial hemp products capable of human consumption by adding hemp to the list of controlled substances. It also issued a proposed rule that would have the same effect as the interpretive rule, amending the list explicitly to add industrial hemp products. The 9th Circuit Court of Appeals has stayed both of these rules, pending applications by Kenex and other industry members to have them struck as being beyond the scope of the DEA's authority.

Kenex has alleged breaches of NAFTA Articles 1102 and 1105 in its notice of arbitration. Also, according to Kenex, the Government of Canada has expressed concerns to the DEA over this measure and has requested to see any risk assessment conducted prior to its implementation. This request apparently has been rebuffed by the DEA. Such conduct appears to violate NAFTA Articles 1803(2) and 718(1), and accordingly provides evidence of a lack of transparency under Article 1105. More importantly, however, in the absence of evidence to the contrary, it appears that the United States has not based its measures on any sort of rationally-connected risk assessment. Thus, it appears that the United States could be found to have violated basic procedural protections that are likely safeguarded under Article 1105.

Under Article 1102, Kenex must prove that the effect of the U.S. measure has been to place it in an unfavourable competitive position by providing better treatment to its competitors. Under the *Pope & Talbot* test, Kenex's competitors appear to include those businesses that produce competing products such as poppy seeds or flax seed oil. The better treatment is easy to ascertain. It is treatment that does not include an outright ban on all of the investor's products. Accordingly, Kenex should be able to establish a *prima facie* breach of Article 1102, because the measure directly affects its ability to compete in these various industry sectors. Whether the United States will be able to provide a justification for the imposition of its measures is unclear. Assuming that the DEA actually has undertaken a secret risk analysis, and that the risks identified in that analysis can be rationally connected to the aims of the measure, the United States still would be required to prove that its decision to impose an outright ban was not arbitrarily discriminatory. Given that industrial hemp contains such minute trace opiates, it may be difficult to satisfy this requirement;

¹⁰⁷ See Controlled Substances Act, 21 U.S.C. § 802, et seq. (2003).

particularly since poppy seeds have not been similarly banned, even though they similarly contain trace opiates. Accordingly, it is quite possible that the United States will be found to have breached Article 1102 as well.

In another upcoming case, *Crompton Corp. v. Canada*,¹⁰⁸ the claimant has notified Canada that it may commence an arbitration with claims under Articles 1102, 1103, 1105, 1106, and 1110. Crompton is a U.S.-based company with a Canadian subsidiary involved in the production, marketing, and distribution of various pesticide products. One of those products contains the active ingredient lindane, which is banned for use on canola crops in the United States but has been registered for use in Canada since 1978. In October 1999, Crompton reluctantly agreed voluntarily to suspend its use of lindane until the Canadian Government had finished tests concerning its safe use by the end of 2000. Crompton maintained an understanding that it could continue selling the remainder of its existing stock of lindane-based products until July 1, 2001. Instead of completing these planned lindane tests, however, the Government banned the use of Crompton's lindane-based products after July 1, 2001.

If Crompton were to base its Article 1105 case on SPS principles alone, it would experience considerable difficulty. While Canada may not have completed its testing, as alleged, it likely would be able to rely on the portion of the risk assessment undertaken to ban Crompton's products. While Crompton might disagree, or be able to argue that the ban was not rationally connected to the tests undertaken, it is likely that sufficient deference would be paid to Canada to permit the measure to stand. On the other hand, and apart from the SPS analysis, Crompton may be able to prove that it detrimentally relied on its agreement with Canada and is entitled to damages as a result.

With regard to Articles 1102 and 1103, it is too early to conclude whether Crompton has a legitimate claim using SPS principles, but its prospects initially appear weak. While it may be able to prove that competitors have been placed in a better position because of the ban, and that their experience should be compared to that of Crompton, it would appear that Canada has sufficient justification for its measure. If lindane is indeed carcinogenic, and accordingly more dangerous to human, animal or plant life, or health than the products of competi-

¹⁰⁸ Crompton Corp., *supra* note 17.

tors, Canada would be justified in treating Crompton differently than its competitors.¹⁰⁹

Finally, with regard to Article 1110, Crompton appears to have a mixed case. On the one hand, it might well be able to prove that Canada's move was premature (because it was not based on a complete risk assessment) and unnecessary (presumably because less intrusive alternatives existed, such as setting content or usage standards). On the other hand, while Crompton's subsidiary allegedly has lost its primary product line, it is still in business. If the "investment" at issue is this enterprise, Crompton's case could go the way of *Pope & Talbot* and *Feldman*, where the courts determined that the interference was not severe enough because the investment enterprise was still in business (albeit in a different line than before the imposition of the measure in question).¹¹⁰ Moreover, given that lindane was already banned in the United States, it might be argued that Crompton knew it was "trading on borrowed time" and thus could not argue successfully that it possessed a right to produce and market the product indefinitely. However, the matter is far from clear and is difficult to discern at such an early stage.

Finally, with respect to the *Methanex* claim, which was responsible over the past few years for much of the uproar in certain circles against NAFTA Chapter 11, it is unclear whether the case would have succeeded. This would be the case even if Methanex had been a producer of MTBE rather than just a producer of one of its ingredients. This is because California passed legislation that particularly sought to assess the risks of the continued use of MTBE. While Methanex certainly could argue that it was unfair to ban MTBE from California, rather than attacking the root causes of the way in which MTBE contaminated the water supply, the bottom line was that a risk assessment occurred and that there was sufficient notice provided to companies such as Methanex. Accordingly, it is doubtful that Methanex would

¹⁰⁹ Note how, because the focus is on the businesses of competing investors, it is a legitimate inquiry to consider whether the products made by these competitors are actually "like products." I earlier frowned upon the Appellate Body for differentiating between naturally occurring hormones and administered hormones at the justification stage, rather than at the initial stage of comparison, but in that case the goods were the focal point of the analysis, rather than the competitive position of the producers of such goods.

¹¹⁰ This circumstance could be contrasted with the taking of a trademark (e.g., eliminating the right of a tobacco company to market cigarettes in anything other than plain packaging), which would also qualify as an "investment" under the expansive definition contained within NAFTA Article 1139.

have had a successful claim under Article 1105, at least in so far as it would have been based upon SPS principles.

Similarly, it is not clear that Methanex could have succeeded in its national treatment claim on the grounds that a ban on MTBE was arbitrary or unjustifiable. It is not the role of a trade or investment tribunal to second guess the merits of a risk management decision, so long as it appears to be appropriately based upon a valid risk assessment process and explainable in terms of any differential impact on the makers of competing products. If those products contain different profiles or characteristics that relate to the risk targeted by the measure, any differences in treatment will likely be justified as well.

Finally, with respect to Article 1110, Methanex would have faced the same problem Crompton faced, and which stung *Feldman and Pope & Talbot*. While California's decision likely would have dealt a stinging blow to Methanex's investment enterprise, the enterprise would have continued to exist, and thus the decision would not have met easily the high threshold of "substantial interference" required under Article 1110. However, at least in Article 1110, Methanex could rightly debate the necessity of a complete ban on its product (again, assuming that methane was actually banned, rather than MTBE), given the existence of less-restrictive measures that would address completely the risks posed by its entry into the water supply (i.e., better enforcement of underground storage tank regulations and stricter regulation of the use of personal watercraft on reservoirs). The only question would be whether such alternatives would be technically feasible and not too expensive to impose.

As its stands, however, Methanex has been reduced to arguing that it has been treated less favourably than a domestic competitor (U.S.-based Archer Daniels Midland). Specifically, this competitor (the primary producer of ethanol, a competing product) appears to have convinced state officials to impose a ban that favors ethanol, arguing that state officials and the Tribunal should consider Methanex a competitor.¹¹¹ The claim is proceeding on this basis because the parties agreed at the jurisdictional hearing that if the measure was imposed with the intent to treat foreign competitors (such as Methanex) less favorably than domestic competitors, the measure could be said

¹¹¹ See generally *Methanex Corp. v. United States* (Nov. 5, 2002) (second amended statement of claim), available at www.naftalaw.org.

to “relate to” Methanex and its investment under Article 1101, even though it only mentioned MTBE in its text.¹¹²

CONCLUSION

Using a careful, contextual, and purposeful analysis, it is possible to read into the obligations of NAFTA Chapter 11 the same “sound science” bargain that has been struck in NAFTA Chapter 7B and the WTO SPS Agreement. With the jurisprudence of the WTO Appellate Body as their guide, future NAFTA tribunals can employ a scientific method to aid their review processes, without going so far as to second guess the scientific judgment of regulators. The process can work. All we need now are some cases to prove it.

¹¹² Methanex Final Award, *supra* note 15, para. 151.