

“INDIRECT EXPROPRIATION”  
IN U.S. FREE TRADE AGREEMENTS:  
THE U.S. TRADE ACT OF 2002 AND BEYOND

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*ABSTRACT*

*This article addresses the debate regarding indirect expropriation in the US Free Trade Agreements (FTAs). Departing from NAFTA, this study presents the main arguments that provoked a change in the usual US FTAs takings provision in order to assure that foreign investors are not granted “greater rights” than those available to US local investors. This change, achieved through a set of guidelines contained in the US Trade Act of 2002, has been applied in subsequent negotiations of FTAs between the USA and eleven countries or regional groups. Although the adjustment to US domestic*

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*standards appears as an imposition over other alternatives, it seems to offer a sound approach to a topic that lacks coherence and symmetry at the international level.*

*The study presents a further analytical review of the relevant provisions of the U.S.-Chile and U.S.-Singapore FTAs, the first two treaties containing the new approach. It concludes that the problems of the expropriation provision of NAFTA have been confronted but only partly solved. This conclusion is reached after comparing the new provisions with the principles and standards of the Fifth Amendment of the US Constitution and its jurisprudential developments. Finally, this article advocates the process of enhancement of the norm in future negotiations while it presents a non-exhaustive list of domestic policies that might be considered by host states to strengthen their own institutions and legal systems before the entry into force of an FTA containing indirect expropriation protections.*

*Keywords: Indirect expropriation, regulatory takings, NAFTA Article 1110, US Free Trade Agreements, investment protection, US Trade Act of 2002.*

## RESUMEN

Este artículo desarrolla el tema de la expropiación indirecta o *regulatory takings* en los Tratados de Libre Comercio (TLCs) de los Estados Unidos de América (EE.UU.). Partiendo desde NAFTA, este estudio presenta los principales hechos y argumentos que produjeron un cambio en la norma sobre expropiación indirecta contenida en los tratados firmados por los EE.UU., con el fin de evitar que inversionistas extranjeros gocen en el futuro de mejores y mayores derechos que inversionistas locales. Este cambio, logrado a través del “*US Trade Act of 2002*”, ha sido aplicado a las negociaciones que desde el año 2002 adelanta los EE.UU. con diferentes países o grupos regionales.

El estudio presenta un análisis de las normas relevantes en los TLC de EE.UU. con Chile y Singapur, al ser éstos los dos primeros tratados en firme que contienen el nuevo esquema de protección a la expropiación indirecta. Tras comparar las nuevas normas con los principios de los *regulatory takings* en el derecho de los EE.UU., se concluye que el problema no ha sido resuelto totalmente y que aún quedan vacíos que pueden ser aprovechados por inversionistas para objetar regulaciones expedidas de buena fe por el Estado. Finalmente, este artículo expone unas pautas para el proceso de fortalecimiento de la norma en futuras negociaciones y propone una serie de políticas internas con el fin de aminorar los efectos generados por una amplia protección a inversionistas extranjeros en casos de expropiación indirecta.

Palabras clave: Expropiación indirecta, *regulatory takings*, Tratados de Libre Comercio de los EE.UU., NAFTA Art. 1110, inversión extranjera, “US Trade Act of 2002”.

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## I. INTRODUCTION

Foreign direct investment (FDI) has assumed a talismanic role among developing countries that perceive the inflow of foreign capital as the cure for all the diseases that day by day seem to devour their economic, political and social systems. Nowadays, governments are prepared to do anything in order to get the most of an elixir that promises progress, technology, employment, financial resources and managerial transfer. Paradoxically, a few years ago developing countries were vehemently opposed to the conquest of transnational corporations and the expansion of the FDI from developed countries within their jurisdictions. Citing the dependency theory and the Calvo Doctrine, academics and politicians contested this re-colonisation, as it was considered a threat to the independence and development of the new nations. However, the panorama is different today. FDI is seen as a necessity rather than a chronic disease, and states compete amongst themselves to attract it, creating better legal frameworks and improving their general economic and political performance.

This competition for investment has involved, among many other strategies, the enactment of legal protections against acts of direct or indirect expropriation. The former has been understood as the physical taking of the investor's property by the host government either by its seizure or its transfer of title, and the latter as the regulatory or police interference on the use of the investor's property that diminishes the value and/or the enjoyment of that property. The inclusion of these protections was a consequence of the wave of expropriations (or takings, in the US legal jargon) that characterised the policies of some developing countries in their post-colonial period, especially during the course of the 20th century. Nowadays, takings provisions are boilerplate provisions in any treaty related to investment promotion and protection.

Since the 1980s, the topic of direct expropriation has lost importance, due to the evanescence of this phenomenon from the foreign investment arena. Conversely, the issue of indirect takings

has become the new centre of academic and political attention. The latter has gained in importance because of the usage of this creeping way as a discrete medium to deprive investors of their rights and expectations within the host state. This issue has acquired special relevance after the enactment of the North American Free Trade Agreement (NAFTA) in 1993, and specifically after the first investor-state disputes claiming compensation for regulatory actions of one of the Parties.

Chapter 11 of the treaty, and particularly Article 1110, which regulates the expropriation issue, have provoked an immense debate about the limits of investor protections and the governmental right to regulate in areas such as environment, health, and safety. The NAFTA approach has been accused of granting to foreign investors “greater rights” than those afforded to domestic investors. This has created a “super-national treatment” condition for aliens within the host state, leaving local investors at a disadvantage when claiming state liability for presumed takings. As a solution, the US Congress enacted in 2002 a new Trade Act (USTA02), which gave strict guidelines to negotiators to avoid the NAFTA problems in future free trade agreements (FTAs). Although these objectives do not affect the current expropriation provision contained in Chapter 11, they will have a direct impact on the outcome of the negotiations that are currently underway between the USA and eleven countries or regional groups.

This article intends to expose the underpinnings of the enactment of the USTA02, together with a critical analysis of the guidelines contained therein and an assessment of their application in subsequent FTAs, in particular those concluded with Chile (USCFTA) and Singapore (USSFTA). The analysis observes that although the new approach has elevated the threshold to determine the existence of an indirect taking, the USA has not fully implemented the guidelines. Consequently, some loopholes remain in the legal text which might still be exploited by foreign investors compromising public interest regulations. This study exposes how this situation, partly produced by a contradictory US policy that wishes to develop multilateralism whilst simultaneously maintaining higher

protections for US investors abroad, needs to be counter-attacked by states in two ways. Firstly, by working for an improvement of the template in future negotiations and, secondly, by adopting certain domestic policies that allow them to prepare their legal and political systems for the arrival of an FTA that protects indirect takings.

So far, with the exception of Gantz (2004), no publication has dealt specifically with the USTA02 guidelines and their application in subsequent negotiations. Nevertheless, Gantz himself adopts a purely historical approach of the Act, combined with an extensive description of the NAFTA's investment chapter as a whole, concluding with a short and vague analysis of the USCFTA. Other authors such as BEEN and BEAUVAIS (2003), KRUEGER (2003), POIRIER (2003), and PORTERFIELD (2004), have tangentially addressed the issue in their studies of NAFTA's Chapter 11. This article, however, differs from the aforementioned works, as it intends to analyse the new US approach in the context of the new boom of FTA negotiations, taking into account the characteristics of the new trade partners, and recognising the underdevelopment of the international expropriation law. In this sense, it will be demonstrated that the US standard is a sound one when compared with other alternatives, even though it is still at a settlement stage. It is criticised, though, both the unilateralist US posture of imposing its standard, and the attitude of the US negotiators of incomplete compliance with the mandate contained in the USTA02. Furthermore, this article avoids the bias visible in the majority of previous publications towards either to an "environmentalist" or a "libertarian" perspective. This study acknowledges the loopholes of the new model but also recognises that the threshold has been elevated, making very difficult the success of frivolous claims and the award of scandalous sums of compensation. It is also concluded that the current debate will tend to decrease because of the process of ripeness of the takings provision, and the capital-importing condition of nearly all new trade partners.

The article is organised as follows. Chapter II introduces the NAFTA agreement and in particular Article 1110, its background, and the effects of its application by arbitral tribunals. Chapter III analyses the guidelines contained in the USTA02 for takings provisions, assesses their

implementation in new FTAs, and recommends a two tier strategy for states in order to improve the conditions of the country for the entry into force of a bilateral regulatory taking protection. Chapter IV concludes.

## II. THE NAFTA TAKINGS APPROACH AT A GLANCE

### A. EMERGENCE OF THE TRADITIONAL US BITS APPROACH

The existence of today's international investment law is, to great extent, a consequence of the development of different investment protections created to confront the wave of takings made to foreign investors' property by developing countries during the last century. Post-colonial governments in newly independent countries, inspired in most cases by nationalist sentiments against former colonisers, initiated expropriation or nationalization processes of foreign property, without considering a clear public interest and without granting compensation for their takings and the losses that they represented to investors. This situation, unacceptable to capital-export countries, started the burning debate regarding the degree of protection that should be guaranteed to investors abroad.

Protection of foreign investors via the laws of the host state, finds its theoretical foundation in the classic economic theory on FDI (SORNARAJAH, 1986, pp. 42-44, and 1994, pp. 38-43). This view suggests that the benefits that a state receives with a flow of FDI justify the high level of guarantees granted to investors through the principles of international law. Consequently, contemporary BITS establish a range of protections for foreign investors, including some to prevent expropriations not made according to international standards.

Nonetheless, during the last century, one of the most difficult topics in international investment law was the achievement of a global consensus concerning the existence and definition of universal standards in the area of compensation for expropriation. The

discussion between industrialised and developing countries over this issue was framed by the differences between the “Hull Formula” and the “Calvo Doctrine”. The former, supported by developed countries, defended a “prompt, adequate, and effective compensation”, while the latter supported an equal treatment between foreign investors and domestic ones. This last view, followed by developing countries, denied the existence of an international law of expropriations and remitted the discussion of the topic to the internal law of the host state (SORNARAJAH, 1994, p. 89 and BEEN and BEAUVAIS 2003, p. 47-48). Calvo’s principles were followed later by the United Nations General Assembly resolutions, in particular by the Charter of Economic Rights and Duties of States (CERDS), adopted in 1974, which provoked enormous discontent and rejection among industrialised countries. As a result, developed nations reacted by introducing BITs in order to balance the discussion in favour of the Hull formula (GUZMAN, 1998 and BEEN and BEAUVAIS, 2003, p. 48).

Today, BITs are common international legal instruments. By 2002, 2181 treaties had been signed, encompassing 176 countries, and popularising the Hull formula even among those countries that had defended the Calvo Doctrine in the past (GUZMAN, 1998, p. 642 and UNCTAD 2002 and 2003, p. 112). The success of these treaties is a consequence of the tension between the interests of developed and developing countries. The former have promoted an expansion of the BITs in order to pressure developing countries into renouncing the CERDS principles, while the latter have struggled for the signature of these treaties as they enhance the conditions to compete for FDI (GUZMAN, 1998, p. 667). This attitude of developing countries reflects the belief that, according to the classic theory of FDI, a secured and stable market for investment is an important economic tool for development and a key policy in a process of economic liberalisation.

Nowadays, physical takings are a strange phenomenon that has been alien to the investment arena since 1986 (MINOR, 1994, p. 178). This change on policy has been produced primarily by a race to attract foreign investors into local economies rather than to scare

them off. Nevertheless, new ways of diminishing the value and ownership of property of investors have been introduced, consciously or otherwise, by states through their taxation, trade, environment, safety, or health regulation policies. This situation has shifted concerns from direct forms of expropriation to the indirect ones (UNCTAD 2000 p. 53 and Dolzer 2002, p.65). Consequently, all BITs today contain protections against both kinds of expropriations (GUDOFISKY, 2000, pp. 285-286, UNCTAD 2003, p. 112). In the specific case of the USA, the indirect expropriation has also been identified as “measures tantamount to expropriations”<sup>1</sup>.

In 1986, the language of the US BITs takings provision was incorporated in the US-Canada FTA, this being the first time that such a norm was included in an FTA and, particularly, in a treaty between industrialised countries. However, it was in 1993 that NAFTA became the first multilateral FTA to combine the BITs template with a full range of guarantees for investors, including an investor-state dispute settlement mechanism. The expropriation and compensation provision was incorporated in Article 1110, which 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 (“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 norm was included into the agreement, ignoring the consequences and effects that it would have in the legal and economic system of the signatory nations. In the period of negotiations of the treaty, areas such as agriculture, environment and tariff barriers were the main concerns while investment rules were agreed quickly and without a major discussion about its terms and conditions (SOLOWAY,

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1 NAFTA arbitral tribunals have clarified that this expression is not an additional kind of expropriation but a repetition of the concept of indirect expropriation.

2003, p. 4). However, time would teach a different lesson about the importance and seriousness of investment provisions within a trade agreement.

## B. ARTICLE 1110 AFTERMATH

The BITs that followed the same NAFTA expropriation template did not generate claims that would have alerted negotiators to the inconveniences of that approach. In the past, BITs were designed to be signed mainly with developing countries that did not offer enough guarantees to US investors because of their political, social, and economical instability. In this sense, although the expropriation protection was designed to guard both US and treaty partner nationals, in practice it was only used to insure US investors against takings made in the territory of the other Party (SHENKMAN, 2002, p. 175 and GANTZ, 2004, pp. 400-401). Put another way, there was not any concern about foreign investors using the treaty rules to claim a violation of property rights by a regulation enacted by the federal US government or any other authority.

However, NAFTA was a different story, owing to the special characteristics of the signatory states (Krueger, 2003, p. 421). Although US investors filed the first claims alleging regulatory takings by acts of the Mexican or Canadian authorities, they were promptly followed by Canadian entrepreneurs who not only decided to use Chapter 11 protections against norms enacted by Mexico, but also against US regulations<sup>2</sup>. This unique situation in US investment history, combined with the “aggressive” language of some arbitral awards, provoked a reaction from the US authorities and academic community.

Accordingly, NAFTA’s expropriation provisions were accused of granting greater rights to foreign investors than those provided to US domestic ones in accordance to the Fifth Amendment of the

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2 So far there have been 10 NAFTA investor-state claims filed against the USA according to the US Department of State (<http://www.state.gov/s/l/c3741.htm> last visited on 04/08/04).

US Constitution and, in particular, to the jurisprudential development contained in *Penn Central v. New York City* (hereinafter *Penn*).

The Fifth Amendment sets forth that no private property shall “be taken for public use, without just compensation”, while the *Penn* decision established a balancing test of reasonableness (as opposed to a simply effects-based test)<sup>3</sup> to determine when a governmental regulation can produce a taking. The *Penn*’s ad hoc, factual inquiry analysis involves the assessment of factors such as:

(...) the economic impact of the regulation on the claimant and, particularly, the extent to which the regulation has interfered with distinct backed expectations... [and] ...the character of the governmental action. (*Penn*, par. 124).

In addition, the US takings law involves a very limited concept of property, disallowing conceptual severance and limiting the protection to land issues, along with a highly demanding procedural requirement of exhaustion of local remedies (Been and Beauvais 2003, p. 63-86). Article 1110, in contrast, has a broad scope of protected investment, allows conceptual severance, requires a low degree of adverse economic impact, and does not demand an exhaustion of national remedies. These issues will be analysed in the following subsections.

Although there have been several claims related to Article 1110, just a few provide clear guidance in the area of indirect expropriation - i.e. *Pope & Talbot v. Canada* (hereinafter *Pope & Talbot*), *S.D. Myers v. Canada* (hereinafter *Myers*), *Marvin Feldman v. Mexico* (hereinafter *Feldman*), *Metalclad v. Mexico* (hereinafter *Metalclad*), and *Methanex v. The United States of America* (hereinafter *Methanex*). Nevertheless, only *Metalclad* has been decided on the merits, ordering a payment of compensation due to the occurrence of a taking. In this case, a US investor who had purchased a Mexican waste management company, filed a claim against the Mexican government

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3 For an explanation about the differences between these tests see Gudofsky (2000, pp. 259-265)

for breach of articles 1110 and 1105 (minimum standards of treatment), due to the denial of a construction permit of a hazardous waste landfill by the local authorities. Federal officials assured Metalclad that nearly all the permits had been issued and that the remaining few would be promptly processed. However, the municipality eventually denied the permit, resulting in the cessation of the construction works and the start of a formal claim of Metalclad under the ICSID Additional Facility Rules. Furthermore, once the arbitration process had been initiated, the local Governor declared the area a sanctuary for the conservation of rare cactus. This protection of a natural reserve ended any possibility of construction of a waste facility on Metalclad property, consequently generating a taking<sup>4</sup>.

*Metalclad* was clearly controversial, not only because of the final award (circa US\$17 million), but also because of the legal interpretation that the tribunal gave to issues such as scope of protection, the need for compensation, and the relevance of an environment regulation. The relevant part of the decision stated that:

(...) expropriation under NAFTA includes not only open, deliberate and acknowledged takings of property, such as outright seizure or formal obligatory transfer of title in favour of the host state, but also covert incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use or reasonably-to-be-expected economic benefit of property even if not necessarily to the obvious benefit of the host state (*Metalclad*, par. 106).

The results of *Metalclad* and the deficiencies of Article 1110 constitute the cornerstone of the current debate on international takings law. The following subsections critically expose the problems of the NAFTA expropriation norm, based on the *Metalclad* award and complemented with other relevant decisions.

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4 Coe (2003 p. 1432) indicates that *Metalclad* was “a case of complete, permanent de facto taking”.

## 1. WHAT AMOUNTS TO A REGULATORY TAKING?

The answer to this question can be difficult when it comes to international expropriation law and, in particular, NAFTA law. The importance of a solution resides in the fact that it determines the existence of the wrongdoing and the payment of compensation. Unfortunately, the international practice does not clearly indicate where to draw the line dividing indirect expropriation from legitimate regulations. Nor does it define whether governments have to compensate for losses due to bona fides regulations uniformly applied (UNCTAD 2003, p. 111). Commentators such as GUDOFISKY (2000, p. 286), AGUILAR ALVAREZ and PARK (2003, p. 388), POIRIER (2003, p. 903), and the UNCTAD in its World Investment Report (2003, p. 112), argue that not every governmental regulation that diminishes the worth of an investment requires compensation, while others suggest that, due to the language of Article 1110, even a bona-fides regulation carries an obligation to compensate under NAFTA “which as a treaty expands the customary international legal obligations of the NAFTA parties” (EWING CHOW, 2001, p. 762).

In the NAFTA, the divergent approaches taken by tribunals in different cases have produced a confusing body of precedents that does not help to define what constitutes a regulatory taking. Some awards, like *Myers*, suggested that not all governmental regulations constitute a taking and eventually did not concede any compensation. In that case, the *Myers*’ tribunal stated that:

(...) the general body of precedent usually does not treat regulatory action as amounting to expropriation ... [and] ... the term ‘expropriation’ carries with it the connotation of a ‘taking’ by a governmental-type authority of a person’s ‘property’ with a view to transferring ownership of that property to another person, usually the authority that exercised its de jure or de facto power to do the ‘taking’ (*Myers*, pars. 280-281).

In contrast, *Metalclad*, as was shown in the last subsection, went beyond national and international expropriations law, ordering huge compensation and stating that “covert and incidental interference”

which deprives the property owner “in significant part” of its “reasonably-to-be expected economic benefit” can constitute a taking (*Metalclad*, par 103).

Furthermore, as may be concluded from the latter quotes from the *Metalclad* case, the notion of conceptual severance has been expanded towards the libertarian vision that any restriction to the use of property is a taking per se. This position, which clearly contrasts with the US domestic approach, permits the division of the economic interest on the property in order to determine a privation of the use and exploitation of it. *Myers*’ tribunal also suggested that regulatory actions that result only in “partial or temporary” deprivation of property rights could constitute an expropriation (PORTERFIELD, 2004, p. 51), while pending *Methanex* has opened the doors to claims against any kind of product banning. In the latter case, a Canadian producer of Methanol alleges that he was expropriated by a Californian Executive Order banning the petrol additive MTBE, which contains Methanol as one of its components. Methanex argues that this regulation acts as a taking of part of its investments in the USA, in violation of Article 1110.

Along with the problem of conceptual severance, the degree of diminution of value required also grants a higher protection to foreign investors than the one recognised for domestic entrepreneurs. *Metalclad*’s award, as exposed before, stated that a measure has only to cause “significant” interference in the enjoyment of the rights to amount to a taking. Nevertheless, it was not clearly indicated how to determine the degree of “significance”, leaving a loophole in the actual reach of the ruling. Thus, the protection under those terms seems to protect a lower diminution on the value of the investment when compared with the US internal standard, which establishes that a taking is found only in existence of a full or nearly full destruction of the value of the property (PORTERFIELD, 2004, p. 59).

Finally, it is alleged that NAFTA’s Chapter 11 grants a “less procedurally demanding forum for regulatory takings challenges” (BEEN and BEAUVAIS, 2003, p. 83. See also PORTERFIELD, 2004, p. 62). Evidently, compared to the US Takings Clause, there is not

any requirement to exhaust local remedies before filing a claim; there is no need to obtain a final determination of permissible property uses; and no need to seek resolution of state law issues in state courts. Moreover, the NAFTA includes a “no-U-Turn” rule that allows investors to switch between domestic courts and international arbitration without chance to go back to local judges. This contrast to the US BITs standard that contains a “fork-in-the-road” rule, which requires an initial and definitive selection of decisional regime, without any opportunity of subsequent jump from one to another (BJORKLUND, 2004, p. 256).

## 2. THE BROADNESS OF THE LEGAL TEXT AND ITS IMPACT UPON PUBLIC VALUES

The problems of NAFTA’s Article 1110 do not emerge only from the awards of arbitral tribunals, but also from the language of the legal text. The governmental actions that can provoke a regulatory taking and the scope of protected property interest are concepts broadly defined in the agreement. The investor protection provisions apply to “measures adopted or maintained by a party relating to ... investors of another party; [and] investments of investors of another Party in the territory of the Party”. Measure, in turn, is defined as “any law, regulation, procedure, requirement, or practice”<sup>5</sup> (NAFTA, Article 1101 (1)). Consequently, any pronouncement of the state has the danger of being used as a departure point of a claim for regulatory expropriations. This might produce a genuine regulatory chilling where even well advised and researched regulations in issues of public interest are unlikely to be enacted in order to avoid any potential disputes, the massive costs of legal proceedings, and the probability of payment of huge damages (AGUILAR ALVAREZ and PARK 2003, p. 386 and UNCTAD 2003, pp. 111 and 112).

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5 Two NAFTA arbitral awards (AZINIAN and LOEWEN v. The United States) suggested that judicial decision are also a “measure” for the effects of NAFTA’s article 1101 (1).

The scope of protected property interest also appears broader than domestic regulations. Article 1139 includes in the protection any “real state or other property, tangible or intangible, acquired in the expectation or used for the purpose of economic benefit or other business purposes”. It also includes any enterprise, equity or debt security of an enterprise, loan to an enterprise or interest in an enterprise that entitles the owner to a share in income or profits or a share in the assets upon dissolution<sup>6</sup>. Finally, it includes any “interests arising from the commitment of capital or other resources in the territory of a Party to economic activity in such territory”. This concept differs from the US domestic standard, which only includes land and property typically defined in the law, excluding “more generalised economic interests, such as ‘business in the sense of the activity of doing business or the activity of making a profit’ [which] are not considered “property” subject to the prohibition on uncompensated takings” (PORTERFIELD, 2004, pp. 44-45).

The NAFTA debate has resulted in the emergence of a global interest for the topic of regulatory takings. This has been materialised, for instance, in the debate concerning the Multilateral Agreement on Investment (MAI), which failed due to the opposition of NGOs to the introduction of overprotective provisions for investors that would compromise the regulatory capacity of states. Likewise, NAFTA’s Free Trade Commission enacted a Note of Interpretation of Article 1105 to clarify that the concepts “fair and equitable treatment” and “full protection and security” do not provide protection beyond what is considered international customary law (Laird 2004). This open defence of the right to regulate has also been included in the GATS (preamble), the WTO Doha Ministerial Declaration (Paragraph 22), and inspired the content of the USTA02 guidelines, as will be outlined in the next chapter.

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6 Article 201 (1) defines enterprise as a “corporation, trust, partnership, sole proprietorship, joint venture, or other association or entity organised under applicable law”.

It is necessary to clarify that despite the campaign of NGOs and other public interest groups<sup>7</sup>, there has not been any decision on indirect expropriation within the NAFTA agreement so far. *Metalclad* is arguably a case of direct expropriation that, due to the expansive language used by the tribunal, has been identified as the best example for the broadness of the treaty in relation to regulatory takings (GANTZ, 2004, 420). Other NAFTA relevant decisions have dealt with indirect expropriation, but have not decided on the merits about the issue therein (SEE, p. 10). There is no doubt, though, that the discussion about the regulatory power of the states over topics of public interest is crucial. However, it is necessary to critically recognise that the treatment of the issue has been magnified, mainly by environmentalist and anti-trade groups (GUDOFKY, 2000 and SOLOWAY, 2003). A correct understanding of this situation will give the correct perspective to one of the most important debates in contemporary international investment law.

### III. THE POST-NAFTA ERA

#### A. THE US TRADE ACT OF 2002: BACKGROUND AND THOUGHTS

The US legal and political arena has not been unacquainted with the heated debate about the effects of NAFTA's Chapter 11. This topic has evidently polarised the political environment in the USA in relation to the future of the takings provision in post-NAFTA FTAs (KRUEGER, 2003, p. 426 and GANTZ, 2004, p. 397). On the one hand, a large business community within the US has campaigned for the preservation of the guarantees granted by the actual NAFTA text (D'AQUINO, *et al.* 2003 and NAM 2004, p. 4). This group highlights that the interest of US investors will be compromised if the language

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7 As an example of the work of the NGOs and other members of the civil society around the NAFTA's Chapter 11 see GUDOFKY (2000, p. 301-303), IISD (2001), CIEL, (2001) and Atik (2004). See also GRAHAM, E. (1998, p. 603) who explains the opposition of NGOs to the inclusion of takings provisions in the MAI.

that has been used in the NAFTA is narrowed or modified in favour of a more relaxed regulatory power of the states. Important guilds with great lobbying capacity have backed this proposal and, as will be shown in the next section, have succeeded in the task of convincing the US Trade Representative (USTR) to maintain a wide expropriation protection in subsequent FTAs.

On the other hand, the majority of the members of the US Congress<sup>8</sup>, together with state and local governments, have decided to support a variation in the traditional FTA's expropriation template in order to match it with the US domestic takings standards. In 2002, thanks to the pressure exercised by environmentalists and public interest organisations, this group gained the necessary political support to provoke a change in the way future FTAs' investment chapters would be negotiated. This was achieved through the USTA02, which granted the Trade Promotion Authority (former fast-track authority) to the executive, and included a set of guidelines to improve future investment provisions in several topics including expropriation.

The USTA02, in the part related to takings, provides that:

Recognizing that United States law on the whole *provides a high level of protection for investment, consistent with or greater than the level required by international law*, the principal negotiating objectives of the United States regarding foreign investment are to reduce or eliminate artificial trade-distorting barriers to foreign investment, while ensuring that foreign investors in the United States are *not accorded greater substantive rights* with respect to investment protections than United States investors in the United States, and to secure for investors important rights comparable to those that would be available under United States legal principles and practice, by ... (D) seeking to establish *standards for expropriation and compensation for expropriation, consistent with United States legal principles and practice*. (USTA02, Section 2102(b)(3), emphasis added).

This Act, and its motivation, generate some important thoughts. Firstly, the outcome of the USTA02 implicitly recognises the

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8 The inclusion of a norm "no greater rights" norm passed the Senate by a 98-0 vote (PORTERFIELD, 2004, p. 41)

difficulties and vagueness of the international law of expropriations. The new guidelines introduce a redefinition of the terms and obligations which just years ago seemed to constitute established doctrine among BITs parties. Moreover, this new approach has been made by the country with the largest flow of outwards and inwards investment in the world, a situation that will certainly generate an impact in what is considered the “international law of expropriations”.

Secondly, and in accordance with the latter idea, the USTA02 guidelines constitute a dramatic change of policy of the US in relation to investment protection<sup>9</sup>. For decades, US negotiators have aimed to achieve the broadest catalogue of guarantees for their investors abroad. However, as was explained in the previous chapter, NAFTA claims showed the dangers of this overprotection and the subsequent crisis in the regulatory power of the Parties. As a result, the USA decided, through the USTA02, to redefine its scope of protection, limiting it to the US domestic principles and standards and, consequently, limiting the tools that its own nationals could use abroad against foreign governments. This reflects a crisis in the pure classic theory of foreign investment and in the US libertarianism, whilst it shows FDI to be a destabilising mechanism in regulatory processes within host states. Ultimately, the USTA02 is restructuring an old policy of broad protection that has rebounded against its own creator: the USA.

Thirdly, although the USTA02 indicates that the USTR shall ensure that foreign investors in the USA are not accorded “greater substantive rights” than those granted to US domestic investors, the guidelines do not require any adjustment to the procedures related to the US internal takings law - i.e. exhaustion of local remedies<sup>10</sup>. This is a consequence

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9 This confirms the argument of KRUEGER (2003 p. 421) who states that “the widespread criticism surrounding Chapter 11 is an undeniable reversal of earlier attitudes toward its provisions”.

10 The Explanatory Statement of the Conference Committee on the USTA02 (House of Representatives), highlights that the Act “applies to substantive protections only and is not applicable to procedural issues, such as access to investor-state dispute settlement”.

of opposition from the US business community which has been reluctant to accept a compulsory attendance to “biased” national courts (POIRIER, 2003, p. 914). Consequently, final texts or drafts of all post-USTA02 FTAs but one<sup>11</sup> contain an investorstate arbitration mechanism that does not require a previous decision of a national judge as a prerequisite for filing a claim. Fourthly, as Poirier (2003 p. 911-913) suggests, the USTA02 is a plain confirmation that the USA can only adjust itself to its own standards and, what is more, that it does not care to impose them to other countries. This is also a materialisation of what HIGGOTT (2003, p.12) has called “idealistic-unilateralism”, whereby “in absence of a better alternative and few constraints on its behaviour, the USA should develop a *Pax Americana*, (...) global in scope and [that aims] to create a world that accepts and/or acquires American values”. Indeed, the solution of the Congress harmonises with this US policy whilst supporting a sort of legal egocentrism that dismisses any other potential alternatives. Under these terms, the US has closed the doors to take into account, for instance, the real necessity of property protection in cases where the trade partner offers sound domestic rules to deal with regulatory takings. Echoing this concern, the USTR’s Trade and Environment Policy Advisory Committee (TEPAC), in its Report on the USCFTA and USSFTA, presents the dissenting opinion of three of its members, who highlight that:

No evidence had been provided to TEPAC that investment rules are necessary in bilateral relations with Chile or Singapore. As far as is known, there is no publicly available information that would suggest that either jurisdiction has mistreated US investors in recent years or that either Chile or Singapore’s judicial systems are incapable of resolving the complaints of US investors (TEPAC 2003a, p. 9 and 2003b, p. 10).

Nonetheless, despite the antipathy produced by the regulatory impositions of the USA, their domestic regulatory takings standard might be an acceptable alternative in the quest for certainty and

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11 The US-Australia FTA set a precedent for being the first agreement without investor-state dispute mechanism after the negative of the Australian negotiators to permit a by-pass of the domestic legal system which they consider “robust and developed”.

justice. Although this appears to be in contradiction with the idea outlined in the last paragraph, the takings clause contained in the Fifth Amendment of the US Constitution, particularly the *Penn* balance test, offers an adequate and narrowed protection to investors while leave enough room for state regulation. The suitability of the US domestic takings law has been underlined not only by US scholars and officials but also by the NGOs that traditionally have criticised NAFTA's Chapter 11 (WASKOW, 2003). Indeed, the USTA02 guidelines limit the investment protections at the US domestic level, which contains a higher standard than those offered in many other jurisdictions<sup>12</sup> and which aims to equilibrate the rights of private investors and public interest. In addition, it would permit other countries to argue that US multinationals cannot enjoy "greater rights" than those granted by the US legal system, as has occurred in liability cases with the application of home state rules (UNCTAD 2003, p. 156)<sup>13</sup>. This does not mean, however, that the US domestic approach is perfect and that it offers an unequivocal standard that should be considered as a prototype for international takings law. This is only a municipal expropriation law that, notwithstanding its stage of settlement, offers a higher degree of sophistication than other available alternatives. In no way does this excuse the US policy of imposing its standard upon new trade partners. Possibly the USTA02 alternative may be the one eventually agreed by the negotiators, but in its actual terms it is just a unilateral model.

## B. ASSESSMENT OF THE NEW APPROACH

### 1. IMPLEMENTATION OF THE GUIDELINES IN NEW FTAS

On paper, the USTA02 offers a feasible way to correct the problems generated by NAFTA. However, its real success can only be assessed

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12 Thus, for instance, the Chilean expropriation rules (Art. 19, n° 24 of the Constitution and Act D.L. No. 2186) does not give any clear parameter to determine a regulatory taking.

13 For a specialised study of the suitability of U.S. standards in an international context see SHENKMAN (2002).

after evaluating the application of the guidelines in recently negotiated and signed FTAs. So far, after the enactment of the USTA02, the USA has entered or concluded trade negotiations with Chile, Singapore, Australia, Central America<sup>14</sup>, Morocco, Bahrain<sup>15</sup>, the Andean<sup>16</sup>, Panama, the Southern African Customs Union<sup>17</sup>, Thailand and the Free Trade Area of the Americas (FTAA)<sup>18</sup>. Only the two first agreements are in force while the next four have already been signed but are waiting for the fulfilment of the relevant approval procedures within the trade partner and the USA. All others remain in negotiation.

Following the instructions of the USTA02, a new takings provision template was introduced identically in the USCFTA and USSFTA, converting it to the model to apply in all the subsequent negotiations enunciated above. For this reason, and due to the fact that those FTAs are the only two “new generation” agreements currently in force, the following part of the article will focus on the relevant provisions of those treaties and particularly on the Chilean one.

Article 10.9.1 of the USCFTA, provides that:

Neither Party may expropriate or nationalize a covered investment either directly or indirectly through measures equivalent to expropriation or nationalization (“expropriation”), except: (a) for a public purpose; (b) in a non-discriminatory manner; (c) on payment of prompt, adequate, and effective compensation in accordance with paragraphs 2 through 4; and (d) in accordance with due process of law and Article 10.4(1) through (3)<sup>19</sup>.

In addition, Annex 10-D of the same agreement introduces an innovative shared understanding of the terms of the expropriation provision, providing that:

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- 14 Conformed by Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and Dominican Republic.
  - 15 This FTA will not include investment provision due to the existence of a previous BIT between the Parties.
  - 16 Conformed by Colombia, Ecuador and Peru.
  - 17 Conformed by Botswana, Lesotho, Namibia, South Africa, and Swaziland.
  - 18 Conformed by all the countries of the Americas except Cuba.
  - 19 The USSFTA contains exactly the same provision (with different cross references) in Article 15.6.

The Parties confirm their shared understanding that:

1. Article 10.9(1) is intended to reflect customary international law concerning the obligation of States with respect to expropriation.
2. An action or a series of actions by a Party cannot constitute an expropriation unless it interferes with a tangible or intangible property right or property interest in an investment.
3. Article 10.9(1) addresses two situations. The first is direct expropriation, where an investment is nationalized or otherwise directly expropriated through formal transfer of title or outright seizure.
4. The second situation addressed by Article 10.9(1) is indirect expropriation, where an action or series of actions by a Party has an effect equivalent to direct expropriation without formal transfer of title or outright seizure.
  - (a) The determination of whether an action or series of actions by a Party, in a specific fact situation, constitutes an indirect expropriation, requires a case-by-case, fact-based inquiry that considers, among other factors:
    - (i) the economic impact of the government action, although the fact that an action or series of actions by a Party has an adverse effect on the economic value of an investment, standing alone, does not establish that an indirect expropriation has occurred;
    - (ii) the extent to which the government action interferes with distinct, reasonable investment-backed expectations; and
    - (iii) the character of the government action.
  - (b) Except in rare circumstances, non discriminatory regulatory actions by a party that are designed and applied to protect legitimate public welfare objectives, such as public health, safety, and the environment, do not constitute indirect expropriations<sup>20</sup>.

## 2. BREAKTHROUGH OR STEP BACKWARD?

In general terms, the new template constitutes an improvement upon the highly criticised areas of the NAFTA investment chapter and sets a higher threshold for the procedure of establishment of a regulatory taking. Accordingly, some scholars have optimistically welcomed the new legal development, recognising that:

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20 The USSFTA contains the same text on the "Exchange of Letters on Expropriation".

[t]his is a truly remarkable effort to provide detailed guidance –and constraints– for future tribunals seeking to distinguish compensable expropriations from valid government regulations, particularly in light of the self-restraint under Article 1110 shown by most NAFTA tribunals to date (GANTZ, 2004, p. 422).

Similarly, the majority of the TEPAC members affirmed that:

(...) the Agreement's investment protection and dispute resolution provisions are an improvement over those in NAFTA [and those norms] reduce the possibility that there will be successful challenges to attempts to implement more stringent bona fide environmental controls while simultaneously protecting investment (TEPAC 2003a, p. 9, and 2003b, p. 10).

Nonetheless, the new FTA's text is not the complete panacea. On the contrary, it still leaves some doors open that might be astutely used by foreign investors to file claims against a host state for presumed regulatory takings. This situation has been acknowledged by a minority of the TEPAC members in their reports on the USSFTA, USCFTA, CAFTA, Australia and Morocco<sup>21</sup>, 23 who consider that those agreements do not reflect the objectives pursued by the USTA02.

In any case, the existent gaps are not only a testimony to the weaknesses and imperfections of a confusing legal area, but also evidence of the lack of commitment of the USTR in the full adoption of the USTA02 guidelines. Certainly, the pressure exercised by some members of the US business community who insist upon keeping the broad NAFTA investment protection have proved to have some effect in the behaviour of the US trade negotiators. In this way, Porterfield (2004, p. 53) indicates how, shortly after the enactment of the USTA02, the USTR declared to the WTO that "investment agreements must have a broad, open-ended definition that includes all types of investment". This postulate definitely clashes with the mandate of the US Congress and confirms both the contradictions of the US policies and the protective paternalism of the current government over the US industries abroad (KRUGMAN, 2003).

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21 So far, no reports have been issued in the other negotiations.

Eventually, this commitment to keep broad investment definitions has successfully come into effect in the new FTAs through the adoption of a description of investment that practically covers all kinds of economic interest (USCFTA, art. 10.27 and USSFTA, art. 15.1.13).

The new generation of FTA's expropriation provisions has been materialised, as shown in the last subsection, in an article and an explanatory annex. The text of the USCFTA's Article 10.9.1 does not present any major changes to the NAFTA provision, except for an attempt of clarification in the language through the modification of the expression "measures tantamount" for "measures equivalent" to expropriation. Annex 10-D, however, is considered by many as the major innovation, and as the real application of the USTA02 guidelines (GANTZ, 2004, p. 421).

Numeral 1 of the Annex starts by indicating that the language of Article 10.9.1 "is intended to reflect customary international law concerning the obligation of states with respect to expropriation". This explanation prevents a replication of cases such as *Pope & Telbot* where the claimant alleged that NAFTA's takings provision went beyond customary international law. Hence, the inclusion of this norm pretends to circumscribe the debate to those protections offered by international standards and to avoid the inclusion of anything beyond that benchmark<sup>22</sup>. However, although the intention is positive, a referral to international customary law in the area under study is a sort of referral to a pandemonium of theories and practices. This is confirmed by different academics who have indicated that "Customary international law—even under the Hull rule—provides little protection for the investor against these less extreme actions [regulatory takings] by the host" (GUZMAN 1998, p. 644), and that "there is little agreement about what the preexisting customary international law had to say about the issue of regulatory takings" (BEEN and BEAUVAIS, 2003, p. 53). In addition, part of the TEPAC members, referring to the U.S.-Australia

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22 This also intends to solve concerns of academics such as GUZMÁN (1998, p. 644), who argues that modern BITs provide investment protections that exceed those offered by the customary international law.

FTA, stated that the references to international law in the agreement leave “substantial interpretative room for arbitrators to exploit” (TEPAC 2004a, p. 12). Thus, a point of clarity has been made, but it will do little to help the work of arbitration tribunals in cases of indirect expropriation.

The biggest innovation is located in numeral 4 of the Annex, which in its chapeau defines indirect expropriation as the event “where an action or series of actions by a Party has an effect equivalent to direct expropriation without formal transfer of title or outright seizure”. This concept clearly develops the idea expressed by the *Myers*’ tribunal, which considered that an indirect expropriation usually implied the taking of property with a view to the transfer of its ownership. This equivalence between direct and indirect takings might elevate the threshold for the establishment of the latter, setting aside frivolous and unrelated claims - e.g. *Methanex*, which was filed by a company that was not producing the banned product but just one of its components (See p. 12).

To reinforce the concept of indirect expropriation, numeral 4(a) establishes a sort of *Penn Central* balancing test, aimed at helping the tribunals to establish the existence of a compensable regulatory taking according to the US standards<sup>23</sup>. This is the first time, with the exception of the European Community law, that a balance test has been introduced in an international level in order to establish the occurrence of an indirect taking (BANKS, 1999, pp. 506-507, BEAUVAIS 2002, p. 282 and FREEMAN 2003 p. 212). Although the text contributes significantly in terms of reducing the gap of disinformation about the parameters to follow when dealing with an indirect expropriation, this is probably one of the pieces that has been most criticised by public interest groups,

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23 BANKS (1999, p. 507) reports that only the European community law has applied a balancing test before.

Thus, the USSFTA and USCFTA are the first extra-European instruments to include such a test. However, in the debate around the MAI, a balance test was proposed as one of the alternatives to unlock to determine the existence of a compensable regulatory taking.

scholars (WASKOW, 2003 and Porterfield 2004, p. 43-62) and a minority of members of the TEPAC (2003a and 2003b). They argue that the mandate of the USTR02 has not been properly fulfilled, because it still concedes greater substantive rights to foreign investors than those available to local ones within the USA. Certainly, when comparing the adopted text with the US domestic takings standards, some loopholes are evident. The USCFTA and USSFTA model does nothing to avoid the use of conceptual severance. This omission evidently leaves the door open to claims from investors who have been partly affected in the use of their property or in the production of a specific product - i.e. *Methanex*. This may lead to a “strategic manipulation of property interests” (PORTERFIELD, 2004, p. 57), whereby investors decide either to incorporate it separately into every jurisdiction where they do business, to diversify their production, limiting it to just few products in order to increase the economic impact of a regulation, or to over-invest in highly regulated industries (Banks 1999, p. 509, SHENKMAN, 2002, pp. 191-194, FREEMAN 2003, p. 213 and POIRIER, 2003, p. 909). This issue needs to be addressed in future negotiations, following, preferably, the US domestic takings model, which has firmly rejected the conceptual severance in most of its forms.

In addition, neither the balance nor the rest of the Annex make clear what degree of diminution of value is required to constitute an indirect expropriation. In this way, the idea that an investor would be entitled to compensation for regulatory measures that decrease the value of the investment but do not destroy it completely or nearly completely still seems to be present. This ignores once more the mandate contained in the USTA02 in terms of adjusting the degree of diminution of the investment value according to US domestic standards, which order compensation only in the case of deprivation of essentially all the value of an investment. This also disregards the trend that the European Court of Human Rights has imposed at an international level, when it ruled that “(...) a property owner must be deprived of all uses of his property in order for the Court to find a *de facto* expropriation” (FREEMAN, 2003, p. 191). However, the innovation contained in the chapeau of the numeral 4 could shed light on this, if it is argued that, after an equalisation of the effects of a direct and an indirect expropriation, it

shall be understood that a full dispossession of any use over the property is necessary to found the occurrence of a regulatory taking. Even so, the uncertainty remains and the discussion of the degree of diminution of value is left to further litigation.

The fact that the new test needs to be applied “case-by-case” has also stimulated some criticism among commentators, who suggest that this provokes uncertainty and lack of precedent creation. However, in the difficult universe of international takings law, it is impossible to create rigid or categorical standards with the intention of being followed as a legal mould by tribunals. FREEMAN (2003, p. 213), analysing the European indirect expropriation regime, states that “The problem in regulatory expropriation claims rests in identifying and defining the grey area between an outright taking and a non-compensable injury. A case-by-case analysis is the most appropriate method for such a calculation”. The author adds that a balancing test is essential in order to succeed in the application of this kind of analysis, an approach that is evidently followed by the new takings model.

Concluding the analysis of the Annex, numeral 4(b) emerges as an answer to the claims of environmentalists and other public interest groups in the sense that it supports the regulatory activity in areas of public welfare such as public health, safety, and environment. The numeral captures a clearer definition of those areas where a police power of the state will be respected and will not amount, except in extreme circumstances, to any liability. This constitutes one of the big achievements of the new model in terms of sustainable development through investment and trade regulation. However, the “rare circumstances” expression presents an ambiguity that can shadow the good intentions of the provision. This irregularity has been highlighted by the TEPAC members who have briefly indicated, that the expression “could even be strengthened for greater clarification” (TEPAC 2003a, p. 6 and TEPAC 2003b, p. 9)<sup>24</sup>. This can be achieved in the future, for

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24 This suggestion is also reported in the FTAs with Australia, Morocco and CAFTA.

instance, replacing “rare circumstances” with a more concrete benchmark such as the destruction of the whole or nearly whole value of the investment (Banks 1999, pp. 507-509).

In sum, the new attempt to improve the takings provision does not entirely reflect the objectives contained in the USTA02. There are still loopholes that can be used by investors to obtain compensation for legitimate regulations of a state. Nonetheless, today the threshold is higher than before, and it seems to be able to dampen a great percentage of claims. Moreover, Paragraph 3 of Article 10.2 provides that in case of inconsistency between the Investment Chapter of the USCFTA and another chapter, the latter trumps the former. This, as the TEPAC acknowledges in the case of environment (TEPAC 2003a, p. 6), permits us to conclude that any bona fide regulation will not be affected by the investment protections exposed above. Thus, in future cases, arbitral tribunals will have a brand new set of tools to decide takings cases and, what is more, will have a testimony of the reluctance of the parties to blindly protect investors and to lose their regulatory capacity over public values. Improvements, though, are necessary in order to reach a more certain legal environment.

### C. A TWO TIER STRATEGY FOR HOST STATES: THE WAY AHEAD

Despite the efforts to solve the NAFTA’s Chapter 11 chaos by the introduction of the USTA02 and the subsequent improvement of FTA’s investment chapters, NAFTA appears to be an unbeatable and suggestive precedent that hardly will be forgotten. Although it is too early to foresee the application and understanding of the new provision template and its explanatory annexes, it is clear that any gap will be promptly used by foreign investors in search of economic compensations from the host state. At that rate, it is strongly recommended that states which are negotiating an FTA with the USA combine in an effort to improve the norm according to the analysis above with the following non-exhaustive set of domestic public policies, in order to avoid the existence or the impact of future takings claims.

To begin with, regulatory takings doctrine is understood as “(...) a formal commitment to protect stability in property expectations” (POIRIER, 2003, p. 906), which means that it serves as a kind of stabilisation agreement between investors and the host state whereby the latter is obliged to keep the legal conditions that existed at the moment of the investment within the country. Unfortunately, this doctrine is based on international legal instruments that, as has been demonstrated in this article, do not offer certainty for both parties. Consequently, countries need to promote the idea of domestic stabilization contracts as tools for the maintenance of rights and expectations of investors within the territory of the host state. These contracts, which today exist in countries such as Chile and Peru, and are currently under congressional debate in Colombia, aim to assure investors that, in case of a modification of some specific norms of the internal legislation, they will be indemnified. The importance of these legal agreements in the context of regulatory takings is based on the fact that the country gives to the investor a domestic stabilisation tool, ruled by an internal Act, drafted, and enacted according to the standards of that particular jurisdiction and with the facilitation of being interpreted by local courts and adjusted by local lawmakers. This arises therefore as an alternative or companion to the broader and more confusing bilateral or multilateral provision.

Secondly, the regulatory competence of both the federal (central) state and its political subdivisions needs to be coordinated in order to avoid contradictory policies that can open a gate for investors’ claims. *Metalclad* has shown how the incoherence between federal and state servants can lead to investment disputes. In that case, while federal officials assured that the investor had all the permits for the project, the Municipality ordered the “cessation of all building activities due to the absence of a municipal construction permit” (*Metalclad*, par. 30 – 44). This kind of situations whets the investor’s appetite for compensatory claims and hurts the country’s expectation to appear as a competitive state in order to attract investment. Moreover, it is the central state which is found responsible for any breach of the obligations contained in a treaty. This generates a financial impact in the state budget and produces

a translocation of the cost-internalisation of the regulatory taking from the original issuer of the measure (region) to the state itself.

Thirdly, the role of investment promotion agencies (IPAs) also needs to be strengthened in terms of the quality and accuracy of the counselling given to potential or existent investors. Although these agencies do not generally enact any kind of regulation that might be conducive to an expropriation, they do play a pivotal role in the construction of investor's expectations within the home state (UNCTAD 2001, pp. 13-15). *Metalclad* is a clear example of how bad advice can generate an scandalous claim, although this case did not involve IPAs but two other Mexican advisory institutions (The National Ecological Institute and the Secretariat of Urban Development and Ecology). These agencies wrongly assured the investor that all the necessary permits had been, or would be, issued, and that, consequently, it was able to undertake a landfill project (*Metalclad*, par. 33 and 80). Ultimately, an essential permit was never granted by the local government.

Counselling contradictions like the one in *Metalclad* cannot be afforded under a treaty scheme that punishes indirect expropriation over foreign investor property. Therefore, an enhancement of the counselling and investment promotion acquires a higher importance today. The inclusion of the "investment backed expectations" as one of the parameters to determine the interference of a governmental action in the new model requires greater attention to the content and quality of counselling, especially when it comes from official agencies or institutions. As *Metalclad* demonstrates, the improvement and accuracy in FDI advisory is also applicable to all counsellors, either public or private, and not only to the more official IPAs. Nevertheless, governments should enhance the role of IPAs as hubs of accurate and studied information for investors.

In fourth place, civil servants involved in rule-making processes need to be trained in the area of indirect expropriation. The concept of regulatory takings is virtually unknown in many of the countries involved in negotiations with the USA. This situation creates the perfect environment for investor claims, and is as dangerous as the loopholes

in a treaty provision. The process of training and awareness needs to be extended to all levels of regulation, even on a federal (central) and regional scale, in order to provide a harmonic and uniform creation of genuine national public policies.

Fifthly, domestic judicial systems need to be enhanced. Undoubtedly, arbitration will remain for the foreseeable future, owing to its role as a guarantee against the deficiencies of unsophisticated and biased domestic judges. However, the strengthening of internal judicial systems is a matter of national morality and a positive sign of legal, political, and economical transition. Mexico, for example, has spent the last decade promoting a judicial reform in order to adjust itself to the rule of law and to establish an appropriate legal infrastructure to support its participation in the global competition for investment capital (DEL DUCA, 2003). Similarly, Australia recently gave a clear lesson to other countries about the importance of having a proficient judicial branch. The South-Pacific giant signed an FTA with the USA without any provision obliging it to arbitrate investment disputes in ad-hoc tribunals, as it has conversely ruled in all others FTAs and BITs. Thus, the ripeness of domestic judicial systems would hopefully lead to future avoidance of compulsory arbitration, along with all its effects of uncertainty.

Last, but not least, states need to define an internal agenda that helps to delineate the content of their national policy space. In the case of the USA, there is a more advanced understanding of those areas which need to be regulated, and thereby protected from the frivolous claims of foreign investors. Unfortunately, developing countries lack comparable awareness. New trade partners need to construct a sound catalogue of agreed national public values and must communicate it, during negotiations, to the US (and other parties if it is a multilateral FTA), in order to prevent future loopholes and misunderstandings about the scope of the values protected.

In sum, the aforementioned policies need to be considered by new US trade partners in order to mitigate the effects of a takings provision in their FTAs. This strategy has been suggested to Mexico

by PEREZNIETO and PUIG (2004, p. 443), after ten years of existence of NAFTA. Accordingly, the authors have stated that:

Mexico's main challenge in the coming years, as a result of its ongoing political and economical transition, is to adapt its institutions and the exercise of its regulatory powers and policies to those demanded by Chapter 11 of the NAFTA, since if it does not, Mexico could very easily become a sitting target for claims amounting to millions of dollars derived from flouting its international obligations.

Therefore, it appears prudent to consider these structural strategies at the outset of the negotiations instead of doing it ten years later, when the consequences of a broad expropriation provision are terribly evident, as was the case with Mexico.

#### IV. CONCLUSION

This article has analysed how the mayhem created by NAFTA's Chapter 11 in the area of international expropriation law has been acknowledged by the USA through the congressional guidelines contained in the USTA02. These objectives appear as an US unilateral imposition for future trade and investment negotiations, as they oblige trade partners to follow the US domestic takings law standards. Nonetheless, despite the difficulties of transplanting an internal model to an international level, the USA provides a clearer and more certain and advanced body of investor protections than those offered by international customary law. In this sense, new trade partners are generally better off when they pursue a US takings style during FTA negotiations than when they struggle for a currently indecipherable international standard.

The list of the USTA02 negotiating objectives that aim to avoid future NAFTA lookalike investment chapters has been considered in recently negotiated and signed FTAs. In the case of the USCFTA and USSFTA, the new norm template appears as a stepping stone on the path to develop a coherent set of rules that permit the enactment of effective

regulations whilst protecting the interest of foreign investors in an analogous way to domestic ones. However, there is still room for improvements, in order to more certainly assure that investors will not use the protective instruments as a weapon to force the host state to renounce its regulatory power.

It can be predicted that the hot debate generated by NAFTA's Chapter 11 in the USA will decrease in relation to new FTAs. This will occur not only because of the process of ripeness of the rules that deals with indirect expropriation but also because of the characteristics of the new trade partners. Unlike the case of Canada and even that of Mexico, all the new signatories of US FTAs, except Australia, are small capital-importing countries that do not represent any major threat to the US regulatory system. Nonetheless, the discussion among the trade partners will continue and, may even increase, as more jurisdictions enter into the awareness of what is involved in these investment chapters. This situation will probably be either a starting point for an articulate construction of international standards in the area of indirect takings, or the beginning of a final entanglement of the issue.

Due to the importance of the topic of regulatory takings for new US trade partners, it is advisable that they start a two tier strategy to deal with potential claims of US investors within their territories. Firstly, the idea of constructing an international model from the US domestic expropriation standards is an acceptable alternative, but trade partners need to apply pressure in negotiations in order to upgrade the level reached so far. Secondly, countries need to formulate a package of measures to prepare their jurisdictions for the arrival of a device that can potentially inspire litigation about the sovereign power to regulate. The attractiveness of the precedents created by NAFTA, which will not stop investors in their endeavour to seek economic compensation, suggests that more than a simple textual improvement is needed. This continuous struggle for a better expropriation framework would balance the current race for FDI with a coherent quest for sustainable investments in a world in development.

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