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CHAPTER 11 AND THE FRANCOVICH DOCTRINE:
COMPARING STATE LIABILITY UNDER
NAFTA AND EC LAW

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At the heart of Chapter 11 of NAFTA is the thorny issue of state liability; that is, the question of whether and when the state should be obliged to pay damages to individuals harmed by the state carrying out public functions in an unlawful way. In common law countries, the (non-contractual) liability of government is circumscribed by requirements of fault or misfeasance on the part of a public body or official.¹ In the United Kingdom, the additional tort of breach of statutory duty is also limited by, for example, the requirement that the duty be intended to benefit a particular class of the public.² In Canada, under the *Charter of Rights and Freedoms*, state liability has extended beyond the common law to encompass violations of constitutionally protected rights, but only in narrowly defined circumstances.³ This state of affairs – characterized by historic limitations on state liability in cases where state agents did not violate the law deliberately or maliciously – is in a state of flux, as a result of North American and European processes of economic integration.

In Canada, state liability has widened significantly through the operation of the investment chapter (Chapter 11) of the *North American Free Trade Agreement*.⁴ In European countries, state liability has similarly widened by the application of the *Francovich* doctrine of the European Court of Justice.⁵ Although the substantive and procedural rules that govern these regimes are far from settled, what is clear is that the current era of globalization has opened the door to state liability for international public law torts in circumstances where it was not previously contemplated.

The aim of this paper is to outline the rules governing state liability under NAFTA Chapter 11 and to examine those rules in light of the *Francovich* doctrine. In this sense, the paper inquires into how different interpretations of Chapter 11, as presently worded, can affect the flexibility and predictability of investment rules in relation to the exercise of government functions. What a comparison to the *Francovich* doctrine reveals is that conditions attached to the non-contractual liability of Member States under EC law are not explicitly present under Chapter 11. Therefore, the Chapter 11 regime appears to constitute a more genuine *no-fault* liability regime whose impact may be both more sudden and less predictable than *Francovich*. In turn, this may generate pressure on Chapter 11 tribunals and the NAFTA states to constrain the scope of state liability under NAFTA. From a functionalist view of the role of state liability in relation to the legal enforcement of North American integration, this would be desirable. However, the interpretive avenues for doing so, based on the early Chapter 11 jurisprudence, are not immediately obvious.

¹ P.W. Hogg and P.J. Monahan, *Liability of the Crown*, 3rd ed. (Toronto: Carswell, 2000) at 147-8.

² M. Lunney and K. Oliphant, *Tort Law* (Oxford: Oxford University Press, 2000) at 501-3, 527.

³ *Guimond v. Québec (Procureur général)*, [1996] 3 S.C.R. 347, 138 D.L.R. (4th) 647. See also K. Roach, “The Limits of Corrective Justice and the Potential of Equity in Constitutional Remedies” (1991) 33 *Ariz. L.R.* 859.

NAFTA CHAPTER 11

General features

Disputes under NAFTA and other trade agreements are generally resolved by a process of state-to-state dispute resolution leading in some cases to the authorization of retaliatory trade sanctions to remedy a state's unlawful conduct under the treaty.⁶ The NAFTA investment chapter – Chapter 11 – is different in that it relies on a special regime of state liability for violations of the treaty's investment rules.⁷ For one, Chapter 11 permits access by individual investors: a NAFTA-based foreign investor may directly initiate a claim for compensation for loss or damage caused by a NAFTA state's breach of the rules. Following a period of mandatory negotiation, the investor-state claim is submitted to a tribunal constituted under the arbitration rules of either the International Centre for the Settlement of Investment Disputes (ICSID) or the United Nations Commission on International Trade Law (UNCITRAL).⁸ Both sets of arbitration rules are incorporated into the domestic law of the NAFTA states, based on the principle of deference by domestic courts to international arbitration. Thus, Chapter 11 awards are, to an extent, insulated from domestic law. Where a Chapter 11 tribunal determines that a NAFTA state violated the investment rules, the tribunal may award compensation in favour of the investor.⁹ Such awards are compensatory in nature and may not include punitive damages.¹⁰ That said, the awards have a punitive and deterrent effect in that they apply a retrospective sanction to state conduct subsequently found to have been unlawful.

Chapter 11, along with two paragraphs of Chapter 15, is the only part of NAFTA that permits individual access and damage awards for purposes of enforcement. Whether one views the primary purpose of this regime as being to compensate investors who have been

⁴ *North American Free Trade Agreement*, 17 December 1992, 32 I.L.M. 296, 605 (entered into force 1 January 1994).

⁵ Cases 6 and 9/90, *Francovich and Bonifaci v. Republic of Italy*, [1991] E.C.R. I-5357, 2 C.M.L.R. 66 (1993).

⁶ State-to-state dispute resolution takes place under Chapters 19 and 20 of NAFTA.

⁷ Under NAFTA, Art. 16, a foreign investor may make a claim that a NAFTA state has breached its obligations under the investment rules. In addition, the investor may claim that the state violated certain rules regarding monopolies and state enterprises under Chapter 15.

⁸ The ICSID, based in Washington, was created by the *Washington Convention on the Settlement of Investment Disputes* of 1965, mainly to provide a forum for the resolution of investment disputes between investors and developing countries. The UNCITRAL rules are a set of *ad hoc* arbitration rules agreed upon mainly to facilitate international commercial arbitration and the recognition and enforcement of arbitration awards.

⁹ NAFTA, Art. 1135. Arbitrators may award monetary damages and applicable interest. They may also award the restitution of property, in which case the state may pay monetary damages and applicable interest in lieu of restitution.

¹⁰ NAFTA, Art. 1135(3).

wronged or to deter recalcitrant states, Chapter 11 elevates certain violations of the treaty to the status of public law tort. Further, it entails a form of strict liability because tribunals may award damages without requirements of fault, misfeasance, or bad faith on the part of the state. Mere illegality will suffice. In itself, this is an important development. However, the full significance of Chapter 11 naturally depends on the nature and breadth of the investment rules themselves. Generally speaking, those rules are broad in terms of both access and scope, resulting in the delegation of a wide discretion to arbitration tribunals.

Broadly speaking, access to the investor-state process hinges on two elements of Chapter 11. First, an investor must satisfy certain procedural requirements including the submission of a written consent to arbitration and a waiver of the investor's rights to pursue domestic legal proceedings.¹¹ Second, the investor must demonstrate that it is an "investor" and that it has made an "investment". The former may be established by the investor showing that it is a national of another NAFTA Party.¹² The latter may be established by the investor satisfying the tribunal that its foreign assets fall within the definition of "investment" under Chapter 11, which is broadly defined to include, for instance, "an enterprise", "an interest in an enterprise that entitles the owner to share in the income or profits", or "tangible or intangible [property] acquired in the expectation or used for the purpose of economic benefit or other business purposes".¹³ On balance, these requirements have not resulted in stringent limits on access to the investor-state process in Chapter 11 disputes, although in some cases they have operated to bar investor claims.

In terms of the substantive investment rules themselves, the most broadly conceived¹⁴ and potentially far-reaching of the rules require the NAFTA states to:

- treat foreign (NAFTA-based) investors/ investments no less favourably than domestic investors who are "in like circumstances" (the *national treatment* rule);¹⁵
- treat foreign investors/ investments no less favourably than investors of any other state who are in like circumstances (the *most-favoured-nation treatment* rule);¹⁶
- treat foreign investments "in accordance with international law" including "fair and equitable treatment" and "full protection and security" (the *minimum standard of treatment* rule);¹⁷ and

¹¹ NAFTA Art. 1121.

¹² NAFTA, Arts. 1117 and 1138.

¹³ NAFTA, Art. 1138.

¹⁴ The more specific rules not listed here are: the prohibition on various performance requirements (Article 1106) and the requirement to permit international transfers of capital (Article 1109).

¹⁵ NAFTA, Art. 1102.

¹⁶ NAFTA, Art. 1103.

- compensate investors for any direct or indirect nationalization or expropriation of an investment, or any measure “tantamount to” nationalization or expropriation (the *expropriation rule*).¹⁸

Each of these rules is drafted in quite broad terms and, as a result, the full scope of their application is not entirely clear. In addition, the rules apply to all *branches* of government, based on the treaty’s definition of a state “measure”, which includes “any law, regulation, procedure, requirement or practice”.¹⁹ The rules also apply to all *levels* of government by the operation of Article 105²⁰ (with exceptions for sub-national government measures from some of the rules, but not the minimum standard of treatment rule or the expropriation rule).²¹ Early Chapter 11 awards have made clear that a violation of the rules may be found, and liability imposed, based not only on state measures specifically targeted at individual foreign investors or investments, but also on those which apply generally to domestic and foreign investors as a group.²² In this way, Chapter 11 may be viewed as a generalized system of state liability for unlawful conduct, characterizing violations of the treaty as international torts.

Chapter 11 claims to date²³

Chapter 11 lay dormant for a number of years after NAFTA came into effect on January 1, 1994. The first reported Chapter 11 claim was initiated on September 10, 1997. The claim arose out of a prohibition by the Government of Canada, purportedly for public health reasons, on cross-border trade in a gasoline additive called MMT.²⁴ The U.S.-based manufacturer of MMT, Ethyl Corporation, claimed that the prohibition violated national treatment, that it was a prohibited performance requirement, and that it was tantamount to an expropriation of its business.²⁵ After a Chapter 11 tribunal determined that it had jurisdiction over the dispute, a settlement was reached in which Canada reportedly agreed

¹⁷ NAFTA, Art. 1105.

¹⁸ NAFTA, Art. 1110.

¹⁹ NAFTA, Art. 201(1).

²⁰ NAFTA, Art. 105 requires the NAFTA Parties to “ensure that all necessary measures are taken” to give effect to the agreement, including its observance by sub-national governments.

²¹ On the basis of both the minimum standard of treatment and expropriation rules, Mexico was held in violation of Chapter 11 through the actions of a state government and a local government in *Metalclad*. *Infra* note 28.

²² See e.g. *Pope & Talbot* and *S.D. Myers*, *infra* notes 32 and 33.

²³ The texts of all Chapter 11 awards are available online: DFAIT <<http://www.dfait-maeci.gc.ca/tna-nac/nafta-en.asp>>; and NAFTALAW.ORG <<http://www.naftaclaims.com>> (date accessed: 20 June 2003).

²⁴ The full name is *methylcyclopentadienyl manganese tricarbonyl*.

²⁵ *Ethyl Corporation v. Government of Canada*, Notice of Intent to Submit a Claim (10 September 1997) and Notice of Arbitration (14 April 1997).

to pay the investor approximately (U.S.) \$10 million, to remove the prohibition, and to declare that MMT was not a threat to human health or the environment.²⁶ The *Ethyl* claim revealed the potential scope of state liability under the Chapter 11 regime and generated a significant amount of controversy in North America and elsewhere.

Since *Ethyl* there have been 28 additional notices of intent by investors to submit a claim under Chapter 11. Of these, 20 have led to formal arbitration proceedings.²⁷ Of these, nine have resulted in final awards, including two against Canada, three against the U.S., and four against Mexico. Of the nine final awards to date, damages have been awarded in two claims against Canada and in two claims against Mexico. The three claims against the U.S. were unsuccessful.

Table 1: NAFTA Chapter 11 claims, proceedings, and awards 1994-2002

Claims By:	Against Canada			Against Mexico			Against the U.S.		
	Claims	Proceedings	Awards	Claims	Proceedings	Awards	Claims	Proceedings	Awards
Canadian investors	--	--	--	0	0	0	8	6	3
American investors	9	5	2	12	9	4	--	--	--
Mexican investors	0	0	0	--	--	--	0	0	0

Below, I briefly review the four successful claims against Canada and Mexico.

In the *Metalclad* award, Mexico was held liable to a U.S. investor based on the treatment of the investor by a Mexican state government and local government.²⁸ The investor had received authorization from the federal government to construct a landfill for the disposal of hazardous waste in the Mexican State of San Luis Potosi. There was strong public opposition to the landfill because of previous illegal dumping of large amounts of hazardous waste at the affected site. A Chapter 11 tribunal found that both the state and local governments interfered with the facility's operations, in part by refusing a municipal construction permit for the project. The tribunal awarded compensation to the investor on two grounds. First, the tribunal concluded that Mexico failed to ensure adequate transparency with respect to its regulation of the investment and that this amounted to a

²⁶ S. McCarthy, "Threat of NAFTA case kills Canada's MMT ban" *The [Toronto] Globe and Mail* (20 July 1998) A1.

²⁷ There have been five claims against Canada (all by U.S. investors), nine claims against Mexico (all by U.S. investors), and six claims against the United States (all by Canadian investors).

²⁸ *Metalclad Corporation v. The United Mexican States*, Award, ICSID Case No. ARB(AF)/97/1 (30 August 2000), [2001] 40 I.L.M. 36.

violation of the minimum standard of treatment. Second, the tribunal concluded that a decision by the Mexican state governor to designate the affected site as an ecological preserve was an act tantamount to expropriation, triggering a duty to compensate.

In a judicial review of the *Metalclad* award before the British Columbia Supreme Court – within whose jurisdiction the arbitration was heard – Tysoe J. overturned the tribunal’s reasoning with respect to the minimum standard of treatment.²⁹ However, Tysoe J. upheld the finding of expropriation on the basis that it was a question of law, with which the Court could not interfere.³⁰ The amount of compensation has not yet been determined by the tribunal.

In the *Pope & Talbot* decision, Canada was held liable to a U.S. investor based on its treatment of the investor under the Canada-U.S. *Softwood Lumber Agreement* of 1996.³¹ Under the *Softwood Lumber Agreement*, Canada agreed to impose a quota on its exports of softwood lumber in order to avoid U.S. trade retaliation. The investor claimed that Canada’s quota system violated a number of the Chapter 11 rules, including both national treatment and the minimum standard of treatment. The tribunal engaged in an extensive review of the quota system and, in the end, found a violation of the minimum standard of treatment on the basis of a Canadian government investigation into the investor’s reported exports, initiated after the Chapter 11 claim was underway. The tribunal awarded damages of (U.S.) \$460,000, and \$120,000 in costs, in favour of the investor.

In *S.D. Myers*, Canada was found liable for a prohibition on the export of PCBs from Canada, which prevented the investor from carrying out contracts for the treatment and disposal of Canadian PCBs at its facility in Ohio.³² Canada characterized the prohibition as a measure to implement its obligations under the *Basel Convention on the Control of Transboundary Movements of Hazardous Waste and Their Disposal*. The tribunal disagreed and concluded that the prohibition was motivated by a desire to favour the Canadian PCB disposal industry at the expense of the investor, resulting in a violation of

²⁹ *United Mexican States v. Metalclad Corporation* (2001), 89 B.C.L.R. (3d) 359, 38 C.E.L.R. 284; additional reasons in *United Mexican States v. Metalclad Corporation* (2001), 95 B.C.L.R. (3d) 169, 41 C.E.L.R. 298. Tysoe J. overturned the findings on the basis that the tribunal had grounded them in NAFTA transparency provisions outside of Chapter 11, and therefore beyond the tribunal’s jurisdiction.

³⁰ Although Tysoe J. characterized the tribunal’s definition of expropriation as “extremely broad” and as “sufficiently broad to include a legitimate rezoning of property by a municipality or other zoning authority”. *Ibid.* at para. 99.

³¹ *Pope & Talbot v. Government of Canada*, Interim Award (26 June 2000) and Award on the Merits of Phase 2 (10 April 2001).

³² *S.D. Myers Inc. v. Government of Canada*, Partial Award (12 November 2000), [2001] 40 I.L.M. 1408; and Separate Opinion of B.P. Schwartz (12 November 2000).

national treatment.³³ The tribunal awarded damages of (U.S.) \$6 million, and \$850,000 in costs, in favour of the investor.

In *Feldman*, Mexico was held liable for its refusal to rebate taxes on cigarettes exported by a U.S. investor.³⁴ The investor claimed, in particular, that it was denied tax rebates otherwise available to Mexican cigarette exporters. Although sufficient evidence was not available to conclusively demonstrate discrimination by Mexico, the tribunal nevertheless found a violation of national treatment on the basis that Mexico had failed to provide sufficient evidence to rebut the investor's *prima facie* case against it.³⁵ Thus the tribunal's finding that Mexico violated national treatment turned essentially on its characterization of the burden of proof. The tribunal has not yet quantified damages owing to the investor.

In each of these awards, state liability was imposed based on a finding of illegality on the part of the state. No explicit and additional defence was available to Canada or Mexico based on factors such as inadvertent breach, lack of clarity in the rules, or the legitimate exercise of government discretion. In this regard, liability under Chapter 11 appears to extend beyond the European Court of Justice's *Francovich* line of cases, itself the subject of much debate.

³³ The separate opinion of one arbitrator found a violation of the prohibition on performance requirements (Article 1106) and characterized the violation of national treatment as also constituting a violation of the minimum standard of treatment. *Ibid.*

³⁴ *Marvin Feldman v. Mexico*, Award, ICSID Case No. ARB(AF)/99/1 (16 December 2002); and Dissenting Opinion (16 December 2002).

³⁵ The dissenting arbitrator concluded that there was insufficient evidence to support the majority's finding of liability, and that the burden of proof was prematurely shifted from the claimant to the respondent. *Ibid.*

THE *FRANCOVICH* DOCTRINE

The European Court of Justice's famous ruling in *Francovich* introduced the principle that individuals are entitled to seek compensation for a Member State's violation of EC law.³⁶ The duty of a Member State to compensate is subject to three conditions. First, the result prescribed by EC law must entail the grant of rights to individuals. Second, the content of the rights must be identifiable on the basis of the legal instrument. Third, there must be a causal link between the breach of the Member State's obligation and the harm suffered by the injured party.³⁷ In *Francovich*, the breach of EC law involved a Member State's failure to implement a directive in the face of an ECJ decision condemning the Member State. In subsequent cases, the ECJ clarified that the doctrine encompassed not only the non-implementation of directives, but also legislative acts and omissions³⁸ and administrative decisions that breached EC law,³⁹ as well as acts of sub-national governments.⁴⁰ Thus, the duty to compensate individuals under *Francovich* has emerged as a generalized one, broadly comparable to the NAFTA states' duty to compensate investors under Chapter 11.

In some quarters, *Francovich* was welcomed as an assertion of the effectiveness of EC law and as a vindication of individual rights.⁴¹ In others, the doctrine was criticized as unclear and as a transgression of the ECJ's competence under the EC Treaty.⁴² Four years after the decision, the ECJ clarified the boundaries of *Francovich* liability. In *Brasserie du Pêcheur*,⁴³ in particular, the ECJ looked to its jurisprudence on the liability of Community institutions – under which non-contractual liability in respect of legislative Community actions requires a sufficiently flagrant breach of a superior rule of law for the protection of

³⁶ *Francovich*, *supra* note 6 at para. 35.

³⁷ *Ibid.* at para. 40.

³⁸ Joined Cases 46 & 48/93, *Brasserie du Pêcheur SA v. Germany; Secretary of State for Transport, ex parte Factortame Ltd. and Others*, 1 C.M.L.R. 889 (1996).

³⁹ Case 5/94, *R. v. Ministry of Agriculture and Fisheries, ex parte Hedley Lomas (Ireland) Ltd.*, [1996] E.C.R. I-2553.

⁴⁰ Case 424/97, *Salomone Haim v. Kassenzahnärztliche Vereinigung Nordrhein* (4 July 2000).

⁴¹ J.E. Hanft, "*Francovich and Bonifaci v. Italy: EEC Member State Liability for Failure to Implement Community Directives*" (1991/1992) 15 *Fordham I.L.J.* 1237; M.L. Ogren, "*Francovich v. Italian Republic: Should Member States Be Directly Liable for Nonimplementation of European Union Directives?*" (1994) 7 *Transnat'l Law*. 583.

⁴² C. Harlow, "Francovich and the Problem of the Disobedient State" (1996) 2 *E.L.J.* 199; J. Dutheil de la Rochère, "Member State Liability for Infringement of European Community Law" (1996) 11 *Tulane Euro. & Civil L.F.* 1; and Weir, *supra* note 6 at 416-22.

⁴³ *Brasserie*, *supra* note 39.

an individual – in order to clarify the scope of *Francovich* liability for the Member States.⁴⁴ In doing so, the ECJ made clear that *Francovich* liability was subject to the condition that a Member State's breach of EC law be "sufficiently serious" before any liability would be imposed. Various factors were identified by the ECJ as relevant to the issue of whether a breach was sufficiently serious, including:

- the clarity and precision of the rule breached;
- the measure of discretion left by that rule to the national or Community authorities;
- whether the infringement and the damage caused was intentional or involuntary;
- whether any error of law was excusable or inexcusable;
- the fact that the position taken by a Community institution may have contributed towards the omission; and
- the adoption or retention of national measures or practices contrary to Community law.⁴⁵

Subsequently, in *Bergaderm*,⁴⁶ the ECJ unified the conditions upon which Community institutions and Member States could be liable for a breach of EC law. In *Bergaderm*, the ECJ also reiterated – within the rubric of 'sufficiently serious breach' – that "the decisive test" for state liability is whether the Member State "manifestly and gravely disregarded the limits of its discretion" under EC law.

This evolution of the *Francovich* doctrine may be understood as responding to concerns expressed by the EC Member States, many of whom participated in the extensive legal proceedings leading to the *Brasserie* decision, about the prospect of an overly broad definition of state liability under EC law.⁴⁷ The German government, for example, argued in *Brasserie* that state liability should be limited by the condition that the state has acted intentionally or negligently. The French government argued that state liability could arise only from a serious breach of EC law, where the damages go beyond the bounds of the risks inherent in the business activities of traders in the sector concerned, and where the damages affect only a limited number of injured parties. The European Commission itself,

⁴⁴ Case 5/71, *Zückerfabrik Schoppenstedt v. Council*, [1971] E.C.R. 975; and Case C-352/98 P, [2001] E.C.R. I-5291. See also T.C. Hartley, *The Foundations of European Community Law*, 3rd ed. (Clarendon, 1994) at 486-98.

⁴⁵ *Brasserie*, *supra* note 39, 1 C.M.L.R. at 990.

⁴⁶ Case 352/98, *Laboratoires Pharmaceutiques Bergaderm and Goupil v. Commission* (4 July 2000).

⁴⁷ *Brasserie*, *supra* note 39, 1 C.M.L.R. at 1047-61.

which has a mandate to advance the integration project generally, took the position that the obligation to pay compensation should exist only when the authorities should have known, and could have had no excuse for not knowing, that they were taking action in areas covered by EC law and that they were encroaching on rights conferred by that law.

The evolution of the *Francovich* doctrine to reflect these concerns highlights a number of the underlying issues regarding state liability as a means to enforce economic integration. In the first place, the doctrine has had to confront the inescapable issue of state discretion in the implementation of international rules. That is, in a project of regional integration, Member States must at a certain point be relied upon to carry out the specific requirements of implementation of the rules of integration. Accepting this, the *Francovich* doctrine has afforded room for error in state interpretation of the rules. To do otherwise could make efforts to harmonize the rules difficult or unworkable by exposing states to excessive litigation risk in carrying out their obligations.

Underlying the evolution of *Francovich*, therefore, are pressures to place limits on the potential liability associated with the exercise of government in the EU and to deter speculative claims. Also, the ECJ's limitation of *Francovich* reflects pressures to avoid undue interference with public functions and legislative choices, within the boundaries of harmonized standards. The task faced by the ECJ has been to balance the remedy of state liability to an ambivalent purpose, linked both to the compensation of individuals and to deterrence of unlawful conduct by Member States. If the primary task is the latter, then damages as a remedy are a rather blunt instrument. In cases of inadvertent breach, a factor recognized by the ECJ, culpability might be very low; in cases of vagueness or inconsistency of the rule, culpability may be non-existent. Imposing strict liability for violations of rules that are vague or obscure, as Harlow points out, "renders punitive liability untenable" and "puts the ECJ in danger of breaching the fundamental principles of *nulla poena sine culpa*".⁴⁸ Or, as the Danish and UK governments stated in *Brasserie*, "Unblameworthy legal mistakes should not lead to liability to make reparation".

As I have said, a fundamental reason for limiting state liability under *Francovich* flows from the recognition that a level of state discretion is inherent in the implementation of international rules, and in government functions generally. Thus, in his Opinion in *British Telecomm*,⁴⁹ Advocate General Tesaurò's sought to offer guidance regarding the nature of a 'sufficient serious breach', and concluded that the test should require a failure by the state to comply with clear and precise obligations, the existence of interpretive guidance from the ECJ in "doubtful legal situations", and a "manifestly wrong" interpretation on the

⁴⁸ Harlow, *supra* note 43 at 209.

⁴⁹ Case 392/93 *R. v. Treasury ex parte British Telecommunications*, [1996] 3 W.L.R. 203.

part of national authorities. Further, in its decision in that case, the ECJ linked the limitation of *Francovich* liability to the existence of Member State discretion, concluding that:

A restrictive approach to state liability is justified.... in particular [because of] the concern to ensure that the exercise of legislative functions is not hindered by the prospect of actions for damages whenever the general interest requires the institutions or member states to adopt measures which may adversely affect individual interests....⁵⁰

In light of these considerations, the *Francovich* doctrine appears to have emerged as an exceptional remedy for use in egregious cases of flaunting of EC law by Member States.⁵¹ Confining liability in this way, to cases of substantial culpability, shifts *Francovich* back into the general orbit of fault-based liability. It also leaves space for reliance on alternative legal or political means, other than damage awards, to ensure Member State compliance with EC law. On the whole, the evolution of the *Francovich* doctrine has been motivated by a functionalist conception of the role of state liability under EC law, rather than the normative view that individuals should be compensated in all circumstances where they have suffered harm from unlawful state conduct. As discussed below, I consider the functionalist approach to be the more appropriate one in relation to state liability under Chapter 11.

⁵⁰ *Ibid.* at para. 40; citing Joined Cases 83, 94/76, 4, 15, 40/77 *Bayerische HNL Vermehrungsbetriebe GmbH v. Council and Commission* [1978] E.C.R. 1209 and *Brasserie*, *supra* note 39 at para. 45.

⁵¹ Indeed, this reflects a certain continuity with the *Francovich* decision, in which the failure of Italy to implement a Directive had already been the subject of Article 169 proceedings by the Commission in which Italy had been condemned (Case 22/87 *Commission v. Italy* [1989] E.C.R. 143); and with *Brasserie*, in which a claim against Germany arose from a German law on the purity of beer that had been previously annulled by the ECJ (Case 178/84 *Commission v. Germany*, [1987] E.C.R. 1227).

CHAPTER 11 IN LIGHT OF *FRANCOVICH*

What stands out about Chapter 11, in doctrinal terms, is that it imposes state liability without attaching explicit limitations akin to those under *Francovich*. As a result, the exposure of the NAFTA states to strict liability is more extensive. Below, I examine Chapter 11 in light of the primary conditions that limit liability under *Francovich*. These are, in particular, the conditions that there be an intention to create rights for individuals, and that there be a ‘sufficiently serious breach’ of international rules on the part of the state. I then discuss some of the prospects for the emergence of similar limitations on state liability under Chapter 11.

Conditions to limit liability

Chapter 11 does not explicitly require that an investment rule reflect an intention on the part of the NAFTA states to create individual rights for investors. Presumably, such an intention is inherent to the treaty text, in that all of the NAFTA rules subject to the investor-state process are deemed, in and of themselves, to create such rights. This assumption is plausible enough. However, it tends to exaggerate rather than diminish concerns about the legitimacy of establishing ‘investor rights’ under international law and about the appropriateness of private adjudication of investor rights claims. These concerns have generated a great deal of criticism of Chapter 11.⁵² In my view, the operation of NAFTA would benefit from an interpretive approach to Chapter 11 that minimizes these legitimacy concerns as much as possible, while remaining true to the intentions of the NAFTA Parties as reflected, above all, in the treaty text.

In this spirit, an alternative view of Chapter 11 is that it represents a public international law instrument that permits private access to dispute resolution for the purpose of enforcement, and that its use was intended for exceptional cases of targeted abuse of foreign investors. This view rejects the claim that Chapter 11 establishes quasi-constitutionalized ‘investor rights’. Instead, it emphasizes the legal-historical context for Chapter 11, emerging from the international law of investor protection, and from the objective of the NAFTA states to facilitate international capital flows by restricting

⁵² See e.g. H. Mann and K. von Moltke, “NAFTA’s Chapter 11 and the Environment: Addressing the Impacts of the Investor-State Process on the Environment”, Working Paper (International Institute for Sustainable Development, 1999) at 19-23, online: IISD <<http://www.iisd.org/trade/chapter11.htm>> (date accessed: 25 April 2003).

national economic policies of foreign investment screening, nationalizations, capital controls, performance requirements, and so on.

The distinction between an ‘investor rights’ view and a ‘functionalist-historical’ view of Chapter 11 is an important one. Whichever takes precedence will inform an adjudicator’s approach to the interpretation of the scope of Chapter 11 and the reach of its rules. In either case, interpretation of Chapter 11 will involve *Francovich*-type issues regarding the appropriate breadth of state liability and state discretion, the predictability and consistency of the rules, and the degree to which international adjudication constrains domestic politics. That said, a functionalist-historical approach is more amenable to resolving these issues because it emphasizes deterrence rather than compensation, because it is grounded in concrete cases and events rather than an ambiguous normative vision, and because its orientation to the disciplining of states within the process of regional integration is more modest and pragmatic.⁵³

In any event, the most important doctrinal concern under Chapter 11 is that liability may be imposed on the NAFTA states in cases where the rules they are found to have violated were not sufficiently clear and precise in the first place. Indeed, the Chapter 11 rules tend to be just the opposite. According to the tribunal in *Feldman*, the Chapter 11 definition of “investment” is stated in “exceedingly broad terms”, and the language used to define the rule on expropriation is “of such generality as to be difficult to apply in specific cases”.⁵⁴ Further, it is troubling that, among the nine final awards on the merits to date, a number have generated divergent interpretations of certain provisions, especially the minimum standard of treatment under Article 1105.⁵⁵ Yet, even where a NAFTA state is found to have breached an obligation that was vague on its face, or subject to inconsistent interpretation by previous tribunals, the state is nevertheless obligated to compensate investors for any resulting loss or damage.⁵⁶

⁵³ Harlow, *supra* note 43 at 211.

⁵⁴ *Feldman*, *supra* note 35 at 34-35.

⁵⁵ The arbitration awards in *Metalclad* and *Pope & Talbot*, *supra* notes 29 and 32, interpreted the minimum standard of treatment as going beyond standards based on customary international law. This conflicted with the interpretation in *S.D. Myers*, *supra* note 33, which limited the minimum standard of treatment to customary international law. Tysse J. of the British Columbia Supreme Court, *supra* note 30, subsequently rejected the reasoning in *Metalclad* in this regard, and the NAFTA Parties issued an Interpretation that similarly rejected the expansive reading in both *Metalclad* and *Pope & Talbot*. Although only grudgingly accepted by the *Pope & Talbot* tribunal in its award on damages, the Interpretation has been followed in more recent Chapter 11 awards. See NAFTA Free Trade Commission, “Notes of Interpretation of Certain Chapter 11 Provisions” (31 July 2001), online: DFAIT <www.dfait-maeci.gc.ca/tna-nac/NAFTA-Interpr-en.asp> (date accessed 25 April 2003); and the final awards in *Mondev International Ltd. v. United States of America*, Award, ICSID Case No. ARB(AF)/99/2 (11 October 2002) at 41; and in *ADF Group Inc. v. United States of America*, Award, ICSID Case No. ARB(AF)/00/1 (9 January 2003) at 88.

⁵⁶ NAFTA, Art. 1116.

Prospects for limiting liability

Nothing in the early Chapter 11 jurisprudence demonstrates a clear willingness on the part of tribunals to explicitly incorporate *Francovich*-type conditions into the Chapter 11 regime. Indeed, a number of tribunals have been ambivalent in their approach to state discretion in general. In one extreme case, the *Pope & Talbot* tribunal appeared to be suspicious of virtually *any* discretionary decision-making by governments in the exercise of regulatory functions that affect foreign investors.⁵⁷ Other tribunals have ventured into the territory of domestic legal interpretation to determine whether a NAFTA state has violated its international obligations, such as by interpreting Mexican municipal law.⁵⁸ When these forays are linked to an under-appreciation of the role of state discretion, the results can be awkward in the context of both domestic government decision-making and international investment law.

However, the legal avenues available to arbitration tribunals to attach *Francovich*-type conditions to state liability under Chapter 11 appear at first glance to be limited. In terms of both access and scope, as mentioned, Chapter 11 has generally been interpreted broadly by tribunals. Also, no explicit ‘sufficiently serious breach’ limitation appears on the face of the treaty or has emerged from the early arbitration awards. From the perspective of the NAFTA states, perhaps the most reliable limitation has been the requirement that an investor show causation; that is, that an investor demonstrate that it “has incurred loss or damage by reason of, or arising out of” the NAFTA state’s breach of the treaty.⁵⁹ This requirement has operated as a significant limitation on the potential scope of liability, and therefore on the prospect of speculative claims, especially when combined with the high cost of initiating and maintaining a claim. However, practical limitations like these do not square the underlying conflict between state liability and state discretion.

Thus, it is perhaps not surprising that some Chapter 11 tribunals have incorporated limitations on liability within the substantive rules themselves. In *Pope & Talbot*, for instance, the tribunal limited its otherwise broad reading of the national treatment rule by permitting a general exception for state measures that display a “reasonable nexus to rational government policies”.⁶⁰ Likewise, tribunals have tended to read the expropriation rule under Article 1110 to exclude general regulatory measures that incidentally impact on

⁵⁷ In *Pope & Talbot*, the tribunal issued a detailed request to Canada to produce, for example, all documents referring to “any discretionary decision-making” regarding the *Softwood Lumber Agreement* quota system – arguably an overly broad document request that shows little appreciation of the integral role of discretion in governmental decision-making. See *Pope & Talbot*, Interim Award, *supra* note 32 at 43-6.

⁵⁸ See e.g. *Metalclad*, *supra* note 29 at 27-8, in which the tribunal interpreted the scope of municipal authority under the *Mexican General Ecological Law of 1988*.

⁵⁹ NAFTA, Art. 1116(2).

⁶⁰ *Pope & Talbot*, *supra* note 32 at 35-36.

the value of an investor's business.⁶¹ It would be a mistake, therefore, to regard Chapter 11 as precluding the type of doctrinal evolution that has occurred under *Francovich*. Yet, it remains remarkable the degree to which the NAFTA states have left questions of this nature to be resolved by international arbitrators. The delegation of adjudicative discretion is perhaps not as far-reaching as in the case of the European Court of Justice since only investors are entitled to make a claim under Chapter 11.⁶² However, the reach of the Chapter 11 rules still encompasses a potentially vast array of legislative and regulatory activities.

⁶¹ See e.g. *Pope & Talbot*, Interim Award, *ibid.* at 33-8, and *Feldman*, *supra* note 35 at 39-42.

⁶² In addition, Chapter 11 is limited by the exemption of certain economic sectors from some of the investment rules, and by the requirement that tribunals not award punitive damages.

CONCLUDING REMARKS

The regimes of state liability under NAFTA Chapter 11 and *Francovich* are located within two very different projects of regional integration. NAFTA Chapter 11 forms part of a free trade agreement that does not include provisions for broader economic and social union. Significantly, NAFTA does not establish international institutions, comparable in stature or independence to the European Commission or the European Court of Justice, to promote harmonization and shepherd the process of integration. Compared to the EU, therefore, the NAFTA vision of integration, and its process for enforcement, is rather modest. In this regard, the NAFTA investment chapter stands out. Its breadth and potency are exceptional in the broader treaty context, creating the prospect of Chapter 11 ‘swallowing’ other parts of the treaty, such as those relating to trade in goods or trade in services, in ways not intended or foreseen by the NAFTA states.⁶³

In terms of their adjudicative structure, another important distinction between Chapter 11 and the EC law of state liability lies in the role each reserves for domestic courts. Under *Francovich*, damages are available only according to the national rules on liability of the Member State responsible for the violation, subject to minimum requirements of non-discrimination and effectiveness.⁶⁴ Based on the principle of procedural autonomy,⁶⁵ domestic courts are afforded an integral role in determining whether liability should be imposed in specific cases.⁶⁶ This has allowed courts in the United Kingdom, for example, to refrain from imposing liability for breaches of EC law out of a fear that claimants “might thereby side-step limitations on liability in domestic tort law”, in the words of two legal commentators.⁶⁷ Recognizing the role of domestic courts cushions the impact of state liability on domestic legal traditions.

Under Chapter 11, on the other hand, the role of domestic courts is circumscribed – although to an as yet uncertain extent – by the NAFTA states’ domestic laws of international arbitration, and by the operation of the Chapter 11 procedural rules. Moreover, Chapter 11 raises the prospect of arbitration awards being recognized and

⁶³ A. Arifalo, “Constitutionalization Through the Back Door: A European Perspective on NAFTA’s Investment Chapter” (2001) 34 *N.Y.U.J.I.L.P.* 1.

⁶⁴ More precisely, the procedural requirements laid down by domestic law must not be less favourable than those relating to similar domestic claims and must not be so framed as to make it virtually impossible or excessively difficult to obtain reparation: *Francovich*, *supra* note 6 at para. 43.

⁶⁵ Case 33/76, *Rewe-Zentral Finanz eG v. Lanschwirtschaftskammer für das Saarland*, [1976] E.C.R. 1989.

⁶⁶ T. Tridimas, “Liability for Breach of Community Law: Growing Up and Mellowing Down?” (2001) 38 *C.M.L.R.* 301.

⁶⁷ Lunney and Oliphant, *supra* note 3 at 524-5.

enforced by a domestic court in a NAFTA state *other than* the state that is actually responsible for the breach. As a result, the position of arbitration tribunals is potentially more isolated from the domestic law of the affected state, making the system as a whole more vulnerable to the view that it intrudes unduly on matters of domestic sovereignty.

State liability for international torts is a novel development in Canada and the United Kingdom. It raises issues that are familiar within the domestic legal context of state liability for public law torts and it has generated corresponding pressures to constrain the effect of such liability on governments. Yet, it does this in an international context that requires a degree of compromise on the part of domestic states in exchange for the perceived benefits of greater economic integration. To date, the ECJ has demonstrated significant flexibility in its approach to state liability under *Francovich*, in light of the relative utility that state liability delivers for purposes of enforcement and harmonization. Whether the dynamic of North American integration will lead to a similar evolution of the Chapter 11 regime is unclear.