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S Ripinsky with K Williams, Damages in International Investment Law (BIICL, 2008)

Case summary

Marvin Feldman v. Mexico

Year of the award: 2002
Forum: ICSID AF
Applicable investment treaty: NAFTA

Arbitrators	**Timeline of the dispute**
Prof. Konstantinos D. Kerameus – President Mr. Jorge Covarrubias Bravo Prof. David A. Gantz	30 April 1999 – notice of arbitration 18 January 2000 – arbitral tribunal constituted 16 December 2002 – arbitral award 13 June 2003 – correction and interpretation of the award

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I. Executive Summary

This case concerns a dispute regarding the application of certain tax laws by Mexico to the export of tobacco products by CEMSA, a Mexican company, owned and controlled by Mr. Marvin Feldman, a US citizen. The Claimant alleged that through the conduct of its Ministry of Finance and Public Credit, Mexico's refusal to rebate excise taxes applied to cigarettes exported by CEMSA and Mexico's continuing refusal to recognize CEMSA's right to a rebate of such taxes regarding prospective cigarette exports constituted a breach of NAFTA Articles 1102 (National Treatment), 1105 (Minimum Level of Treatment), and 1110 (Expropriation and Compensation). In total, Feldman claimed in excess of US$ 50 million as compensation.

The Tribunal only found a breach of Article 1102 NAFTA and it compensated Feldman only for the tax rebates that Feldman had actually requested and had not been paid by Mexico. The total amount awarded by the Tribunal was 16,961,056 Mexican pesos (principal amount of 9,464,627 plus simple interest of 7,496,428). The Tribunal rejected Feldman's claim for going concern value (it was not a case of expropriation) and for lost profits (in part because they were covered by the three-year limitation period under Article 1117(2) NAFTA and because the Claimant did not have a viable business and could not have made a profit regardless of whether Mexico had provided the tax rebates).

II. Factual Background and Claims of the Investor

This case concerns a dispute regarding the application of certain tax laws by Mexico to the export of tobacco products by Corporación de Exportaciones Mexicanas, S.A. de C.V. ("CEMSA"), a company organized under the laws of Mexico and owned and controlled by Mr. Marvin Roy Feldman Karpa (hereinafter "Mr. Feldman" or "the Claimant"), a citizen of the United States. The Claimant was suing as the sole investor on behalf of CEMSA. The Claimant alleged that Mexico had breached NAFTA Chapter Eleven through the conduct of its Ministry of Finance and Public Credit (*Secretaria de Hacienda y Credito*, hereinafter "SHCP"). In particular, Mr. Feldman contended Mexico's refusal to rebate excise taxes (*Impuesto Especial Sobre Production y Servicios*, hereinafter "IESP") applied to cigarettes exported by CEMSA and Mexico's continuing refusal to recognize CEMSA's right to a rebate of such taxes regarding prospective cigarette exports constituted a breach of NAFTA Articles 1102 (National Treatment), 1105 (Minimum Level of Treatment), and 1110 (Expropriation and Compensation). It was not disputed that tax rebates were indeed granted in 1992 and between June 1996 and September 1997; and that in December 1997 the IEPS law was formally amended to bar rebates to cigarette resellers such as CESMA.

In total, Feldman claimed in excess of US$ 50 million as compensation.

(1) 64,582,645 Mexican pesos (or US$6,458,264) for IEPS due in the period of October-December 1997;
(2) 90,350,605 Mexican pesos (or US$9,035,060) for lost profits in the period of January 1, 1994 - May 1996;

(3) 148,886,141 Mexican pesos(or US$14,888,614), requesting CEMSA's "going concern value" on the basis of the present discounted value of the future cash flow, and

(4) "in the order of twenty million US dollars" for lost profits after December 1, 1997.[1]

III. Findings on Merits[2]

Feldman's claim focused on Articles 1102 (National Treatment) and 1110 (Expropriation) of NAFTA. While the Tribunal rejected Feldman's claim based on Article 1110, it found a violation of Article 1102.

A. Expropriation

The Tribunal's rationale for declining to find a violation of Article 1110 can be summarized as follows: (1) As *Azinian* suggests, not every business problem experienced by a foreign investor is an expropriation under Article 1110; (2) NAFTA and principles of customary international law do not *require* a state to permit "gray market" exports of cigarettes; (3) at no relevant time has the IEPS law, as written, afforded Mexican cigarette resellers such as CEMSA a "right" to export cigarettes (due primarily to technical/legal requirements for invoices stating tax amounts separately and to their status as non-taxpayers); and (4) the Claimant's "investment," the exporting business known as CEMSA, as far as this Tribunal can determine, remains under the complete control of the Claimant, in business with the apparent right to engage in the exportation of alcoholic beverages, photographic supplies, contact lenses, powdered milk and other Mexican products--any product that it can purchase upon receipt of invoices stating the tax amounts-- and to receive rebates of any applicable taxes under the IEPS law. While none of these factors alone is necessarily conclusive, in the Tribunal's view taken together they tip the expropriation/regulation balance away from a finding of expropriation. (para. 111)

B. National Treatment

The limited facts made available to the Tribunal demonstrated on balance to a majority of the Tribunal that CEMSA has been treated in a less favorable manner than domestically owned resellers/exporters of cigarettes, a *de facto* discrimination by SHCP, which is inconsistent with Mexico's obligations under Article 1102. The only confirmed cigarette exporters on the limited record before the Tribunal were CEMSA (owned by US citizen Feldman) and the Mexican corporate members of the Poblano Group (Mercados I and Mercados II). According to the available evidence, CEMSA had been denied the rebates for October-November 1997 and subsequently in the 1998-2000 period; SHCP had also demanded that CEMSA repay rebate amounts initially allowed from June 1996 through September 1997. Thus, CEMSA was denied IEPS rebates during periods when members of the Poblano Group were receiving them (para. 173).

[1] This last claim was not discussed by the Tribunal, presumably because it was not argued by the Complainant in the damages phase of the proceedings.

[2] The award was adopted by the 2:1 majority of the Tribunal, with Mr. Jorge Covarrubias Bravo dissenting.

In addition, the Tribunal found that CEMSA had been denied registration as an export trading company, even though three other cigarette export trading companies (including the Poblano Group) had been swiftly granted registration. (para 175)

While it recognized the limited extent of the evidence of discrimination on the record, the conclusion of the majority of the Tribunal was based, first, on the conclusion that the burden of proof was shifted from the Claimant to the Respondent (with the Respondent then failing to meet its new burden) and, second, on a very simple two-pronged conclusion which was not effectively challenged by the Respondent:

> a. No cigarette reseller-exporter (the Claimant, Poblano Group member or otherwise) could legally have qualified for the IEPS rebates, since none under the facts established in this case would have been able to obtain the necessary invoices stating the tax amounts separately.
> b. The Claimant was denied the rebates at a time when at least three other companies in like circumstances, i.e. resellers and exporters apparently including at least two members of the Poblano Group, were granted them. (para. 176)

On the contrary, one member of the Tribunal believed that the evidence on the record was insufficient to prove discrimination (see dissent).

Although the Tribunal noted that there is no requirement in Article 1102 that any departure from national treatment must be explicitly shown to be a result of the investor's nationality, it nonetheless found that in the present case there was evidence of a nexus between the discrimination and the claimant's status as a foreign investor. (para. 182).

IV. Findings on Damages

A. Law Applicable to the Determination of Damages

The Tribunal did not discuss the issue of applicable law specifically in relation to its award of damages. However, in emphasizing that NAFTA provides no guidance as to the proper measure of damages or compensation for situations that do not fall under Article 1110 (Expropriation), the Tribunal made reference to previous NAFTA Tribunals that had dealt with the issue of damages. In so doing, it recalled the *SD Myers* Tribunal's conclusion that in the absence of a special provision, the drafters of the NAFTA intended to leave it open to tribunals to determine a measure of compensation appropriate to the specific circumstances of the case, *taking into account the principles of both international law and the provisions of NAFTA* (para. 195).

B. Burden of Proof

The Tribunal did not discuss the issue of the burden of proof in any general terms. However, it failed two of the three elements of damages claimed by Feldman partially because the Claimant had failed to appropriately and specifically demonstrate those

claims (see below with regard to both claims of 'going concern' and 'lost profits'). (paras. 198-200).

C. Standard of Compensation (and Causation)

Tribunal recalled that NAFTA does not provide much guidance as to the proper measure of damages or compensation for situations that do not fall under Article 1110 (expropriation) leaving it open to tribunals to determine a measure of compensation appropriate to the specific circumstances of the case.

The Tribunal noted that the only detailed measure of damages specifically provided in Chapter 11 is in Article 1110(2-3), "fair market value," which necessarily applies only to situations that fall within that Article 1110. In case of discrimination that constitutes a breach of Article 1102, what is owed by the responding Party is the amount of loss or damage that is *adequately connected* to the breach. In the absence of discrimination that at the same time constitutes indirect expropriation or is tantamount to expropriation, a claimant would *not* be entitled to the *full market value* of the investment which is granted by NAFTA Article 1110. (para. 194)

D. Heads of Damages and Valuation

As noted before, the Claimant asked for three elements of compensation:

(1) 148,886,141 Mexican pesos(or US$14,888,614), requesting CEMSA's *going concern value* on the basis of the present discounted value of the future cash flow;
(2) 90,350,605 Mexican pesos (or US$9,035,060) for *lost profits* in the period of January 1, 1994 - May 1996, calculated on the expected exports applying a profit margin of 62.4%; and
(3) 64,582,645 Mexican pesos (or US$6,458,264) for *IEPS due* in the period of October-December 1997.

The sum of he three elements amounted to 303, 819, 391 Mexican pesos (or US$30,381,938).

It should be highlighted that from the facts of the case it appears that Feldman's cigarettes export business was only profitable and thus operational if the Mexican government was granting tax rebates.

1. Going concern

Apparently on the basis of the general finding that the Claimant was not entitled to the full market value of the investment (in cases other than those involving expropriation), the Tribunal dismissed Feldman's claim relating to CEMSA's going concern value. 'For reasons stated earlier, of the three elements of damages sought for by the Claimant, the third one representing CEMSA's "going concern value" is to be dismissed because this item requires a finding of expropriation, which is not the present case.' (para. 198)

In a related footnote, the Tribunal also noted that "even if there had been an expropriation, there is inadequate proof in the record to demonstrate that CEMSA had more than negligible going concern value. As noted in footnote 15, there is no statement of CEMSA's physical assets in the record, other than an assertion of an initial capitalization of 510,000 Mexican pesos at the time of formation in 1988, without any indication as to what percentage of this was paid in. The going concern value of an enterprise which earns 90% of its alleged revenues from gray market sales of cigarettes[3] is also suspect. As discussed in para. 201, *infra,* after selling and financing costs, this operation could not have been profitable, and a money losing business seldom has significant value as a going concern." (footnote 41).

2. Lost profits

With respect to the claim for lost profits in the period of January 1, 1994 - May 1996, the Tribunal noted that this was covered by the three-year limitation period under NAFTA Article 1117(2) (as explained in the Interim Decision on Preliminary Jurisdictional Issues of December 6, 2000). In that Interim Decision, the Tribunal held that the cut-off date of the three-year limitation period is April 30, 1996. Even if the Claimant asked for lost profits for one month (May 1996) coming immediately after the cut-off date, the Tribunal noted that "the claim does not specify its amount with regard to that particular month and, in any case, has not convinced the Tribunal with respect to both existence and extent." (para. 199). However, even had there been greater specificity on the part of the Claimant, the Tribunal was not convinced on the basis of the evidence in the record that CEMSA's operations would have been profitable, even if CEMSA had received the IEPS rebates during the relevant time in the proper amounts. The Tribunal noted as follows:

> When the IEPS tax rate was 85%, the Claimant erroneously treated 85% of the invoice price as taxes subject to rebate. (In fact, only approximately 45.95% of the invoice price was properly attributable to taxes.) If the gross price to Sam's was US$7.40, and it is assumed that the IEPS rebate is 85% of the gross price, the net price (less the rebates) would be US$4.00 (7.40/1.85). This produces a gross margin of only US$0.05 from an export selling price of US$4.05, which could not possibly cover the Claimant's expenses, including but not limited to the 14% interest on his loans from the Poblano Group (see Feldman affidavit, paras. 6, 72). Even if these approximations are slightly off, there is simply insufficient gross margin to cover normal operating expenses, let alone profit, unless of course, the Claimant can obtain IEPS tax rebates from SHCP, as he did in 1996 and 1997. (para. 200)
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> […] Moreover, the Claimant had no significant customer base. […] the Claimant did not have a viable business exporting cigarettes purchased from retailers in Mexico, and could not have made a profit regardless of whether SHCP provided the IEPS rebates, assuming of course that the rebates sought and provided approximated the actual amount of IEPS taxes originally assessed on the cigarettes. (para. 201)

[3] Cigarette exports by unauthorized resellers are referred to as 'gray market sales'.

In order words, if the gross price Feldman was buying the cigarettes was US$7.40, the tax was US$3.40 (ie., 85% of the gross price) and the price net of tax was US$4.00. If Feldman was exporting/selling the cigarettes at US$4.05 per carton, it would have made only a US$0.05 profit. Even if it managed to receive the tax rebates (which he paid when purchasing the cigarettes), the profit margin would still be US$0.05.

3. Tax rebates due

The Tribunal accepted the claim concerning IEPS rebates due in the period of October – December 1997. However, it disagreed with the Claimant regarding the amount of IEPS rebates due to it. While the Claimant argued that those rebates amounted to Mexican Pesos 64,582,645, the Tribunal only awarded Mexican Pesos 9,464,627 for two sets of reason.

First of all, the record demonstrated that during the three months of the relevant period, the Claimant filed only three requests for IEPS rebates for a total amount of Mexican Pesos 18,978,361. Since the Claimant had wrongly calculated the amount of the tax, the Tribunal, following a simple calculation, determined that the correct amount of the tax was Mexican Pesos 10,258,573. Secondly, the Tribunal also excluded the IEPS that corresponded to an exportation to Honduras made in the relevant period, since Honduras was a tax haven jurisdiction and thus this export was not legally subject to an IEPS rebate under Article 2(III) of the IEPS law. Accordingly, the total IEPS amount of 10,258,573 Mexican pesos was reduced by the amount of 793,946 Mexican pesos and the revised total award was 9,464,627 Mexican pesos. (paras. 203-05)

E. Interest

The Tribunal increased the total revised award indicated above of 9,464,627.50 Mexican pesos by simple interest calculated, according to the (domestic) law in force for the rebates, from the date the rebates should have been paid (for 1997, 51 days after the request; for 1998, 41 days after the request) to the date of the award, in accordance with the interest rate paid on Federal Treasury Certificates or bonds issued by the Mexican Government, with a maturity of 28 days. The total interest so calculated is 7,496,428 Mexican pesos. (para. 205)

Thus, as of the date of the decision (16 December 2002), the total amount awarded by the tribunal is 16,961,056 Mexican pesos (principal amount of 9,464,627.50 plus interest of 7,496,428).

F. Costs

Pursuant to Article 59(1) of the ICSID Arbitration (Additional Facility) Rules and taking into account that both parties have partly won and partly lost, and that the percentage of victory and loss did not have any measurable effect on the amount of costs, the Tribunal decided that each party bear half of the costs of the arbitration (fees and expenses of the members of the Tribunal as well as expenses and charges of the Secretariat), as billed by ICSID, and that each party bear its own legal fees and costs in connection with the arbitration (para. 208)

G. Payee (correction of the award)

Following the Respondent's Request for Correction of the award in the sense that the amount granted in the award should be paid to CEMSA, the Tribunal agreed with the parties and corrected para. 211 of the award accordingly.

V. Implications / Initial Analysis

- Contrary to some other decisions, the Tribunal states that since the "full market value" is included in the expropriation provision only, the same **standard of compensation** cannot be used with regard to a breach of, for example, the national treatment provision.
- The Tribunal refused to award the **going concern value** of investment (CEMSA) because no finding of expropriation was made. The Tribunal's apparent logic is that going concern value of investment can only be awarded when there has been a deprivation of investment as a result of expropriation. However, it would make sense to award going concern value if the deprivation resulted from other BIT breaches that do not formally constitute expropriation.
- In footnote 41, the Tribunal seems to indicate that in determining the **'going concern value'** relevant elements may include 'physical assets', 'initial capitalization' (actually paid in capital) and 'profitability'. In particular, to have value as a going concern, an enterprise has to be profitable.
- An order to repay certain tax rebates to the investor seems to constitute **monetary restitution** rather than **compensation** *stricto sensu*. Potentially, in addition to restitution (tax rebates) the Tribunal could also award damages (e.g., lost profits) – this would be an additional measure of compensation for damages caused by the violation.
- The issue of **causation** was treated very briefly ("damage adequately connected to the breach") and there was no factual discussion/analysis of it.
- An issue that is peculiar to NAFTA is that the latter prescribes a **3-year limitation period** for bringing damages claims. This rule might present difficulties in a case of a continuing breach (cf the European law practice on "single and continuous infringement" in competition cases).