

Case summary

Metalclad Corporation v Mexico

Year of the award: 2000

Forum: ICSID

Applicable investment treaty: NAFTA

Arbitrators Prof. Sir Elihu Lauterpacht – President Mr. Benjamin R. Civiletti Mr. José Luis Siqueiros	Timeline of the dispute 2 October 1996 – notice of arbitration 19 May 1997 – arbitral tribunal constituted 30 August 2000 – arbitral award 2 May 2001 – judicial review by a domestic court
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I. Executive Summary

Metalclad, a U.S. corporation operating through its Mexican subsidiary (investment), received from the Mexican federal government the permit to construct a hazardous waste landfill in Guadalcazar, Mexico. Five months after construction began, Metalclad was notified by the Municipality of Guadalcazar that it was unlawfully operating without a municipal construction permit. Metalclad applied for a municipal permit and, in the meantime, completed construction of the landfill.

The Municipality turned down Metalclad's application effectively barring the operation of the completed facility. In addition, later the Governor issued an Ecological Decree declaring a protected natural area which encompassed the landfill site and thus permanently closed the landfill.

Before the ICSID Tribunal, Metalclad claimed violations of NAFTA Articles 1105 ("Minimum Standard of Treatment") and 1110 ("Expropriation") and requested compensation.

The Tribunal determined that Metalclad was denied fair and equitable treatment by Mexico because the municipal government had no authority to deny the construction permit on environmental grounds and also because of the absence of clear rules and procedures governing the municipal construction permit which amounted to a failure on the part of Mexico to ensure transparency required by NAFTA. The Tribunal also found that the same actions of the local government amounted to an indirect expropriation. Further, the Tribunal held that the Ecological Decree alone also constituted an act of expropriation.

The Tribunal determined that Metalclad's investment was completely lost as a result of Mexico's actions and proceeded to estimate the fair market value of the investment. The Tribunal held that the award of lost profits was not appropriate in this case because the landfill had never started its operations. The amount of compensation was determined on the basis of the actual investment made by Metalclad, as evidenced by Metalclad's tax filings and independent audit documents. The damages were estimated at US\$ 16.7 million, including 6% interest (compounded annually) up to the date of award. Post-award interest was to be compounded monthly.

The Tribunal's award was reviewed by the British Columbia Supreme Court which set aside the Tribunal's findings on Article 1105 and partly on Article 1110. However, the award was upheld on the basis of expropriation resulting from the Ecological Decree and in terms of compensation was left virtually unchanged.

II. Factual Background and Claims of the Investor

The claim brought by Metalclad, a US corporation, related to the allegedly wrongful treatment by Mexico of the the Metalclad's investment, an indirectly owned Mexican company "Coterin".

In January, 1993 Mexico's National Ecological Institute (INE) issued a federal permit to Coterin to construct a hazardous waste landfill in the valley of La Pedrera, Municipality of Guadalcazar, State of San Luis Potosi, Mexico. Shortly thereafter, Metalclad entered into an option agreement to acquire Coterin, together with its permits, in order to construct and operate the facility. In May 1993, the State of San Luis Potosi granted Coterin a land use permit for the landfill. Both the INE's president and the director-general of Mexico Secretariat of Urban Development and Ecology advised Metalclad that, except for a federal operating permit, all required permits for the facility had been secured by Coterin. In August 1993, INE issued the landfill federal operating permit, and after that Metalclad exercised its option to purchase Coterin.

In May 1994 Metalclad commenced construction of the landfill. In October, 1994, the City of Guadalcazar ordered a halt to construction, allegedly for failure to obtain a municipal construction permit. Metalclad applied for a municipal construction permit and, having received INE approval for completion of the facility, resumed and finished construction of the landfill.

The opening ceremony of the facility was impeded by the demonstration of a local population who raised environmental concerns. As a result of additional negotiations with Mexican federal authorities Metalclad signed with them a "Convenio" assuming thereby additional obligations with respect to operation and maintenance of the facility.

13 months after Metalclad's application for municipal construction permit, the Guadalcazar city council denied it, without giving Metalclad an opportunity to participate in the process. In addition, in September 1997 the Governor of San Luis Potosi issued an Ecological Decree establishing a protected natural area that included the landfill site, thereby effectively preventing the landfill's operation. Thus, the constructed landfill was never put into operation.

Metalclad alleged that Mexico, through its local governments of San Luis Potosi and Guadalcazar, interfered with the development and operation of a hazardous waste landfill and by doing so violated provisions of NAFTA Chapter 11 provisions on the minimum standard of treatment (Article 1105) and on expropriation (Article 1110). Metalclad requested compensation in an amount ranging from US\$ 40 to 120 million (depending on the valuation method applied).

III. Findings on Merits

A. Minimum Standard of Treatment (Article 1105)

Article 1105(1) requires to treat foreign investments “in accordance with international law, including fair and equitable treatment and full protection and security.” The Tribunal interpreted this provision to require inter alia “transparency” of all relevant legal requirements at all stages of the investment process. (para.76)

The Tribunal found that Mexican legislation contained no clear rule as to the requirement or not of a municipal construction permit; furthermore, there was no established practice or procedure as to the manner of handling applications for a municipal construction permit. This, in Tribunal’s view, amounted to a failure on the part of Mexico to ensure transparency required by NAFTA. (para. 88).

In addition, the Tribunal found that Metalclad relied on the representations made by the Mexican federal government officials that no other permits were required. The Tribunal also noted, as a procedural defect, that the meeting of the Guadalcázar Town Council, where it took a decision to refuse the grant of the construction permit, was held without notice to the Metalclad, and the latter was given no opportunity to appear. The totality of these circumstances lead the Tribunal to the conclusion that Mexico was in breach of its obligations under Article 1105(1).

B. Expropriation (Article 1110)

The Tribunal held that in denying the construction permit the Municipality acted outside its authority and effectively and unlawfully prevented the Claimant’s operation of the landfill which, together with the representations of the Mexican federal authorities and the absence of a timely, orderly or substantive basis for the denial of the construction permit, amounted to the indirect expropriation.

The Tribunal went on to find that the Ecological Decree (which included the landfill site into an ecological preserve and had the effect of barring forever the operation of the landfill), alone, also constituted an act tantamount to expropriation.

The Tribunal thus concluded that Mexico violated Article 1110.

IV. Findings on Damages

A. Law Applicable to the Determination of Damages

The Tribunal referred to Article 1131(1) of NAFTA which provides that investor-State tribunals shall decide the issues in dispute in accordance with NAFTA and applicable rules of international law. (para.70) In the damages part, the Tribunal based itself on relevant NAFTA provisions and, where specific NAFTA provisions were absent, it also referred to international law rules as formulated by international courts and tribunals.

B. Standard of Compensation

The Tribunal held that the same standard of compensation (“fair market value” of the lost investment as provided for in the NAFTA article on expropriation) applied to both breaches of NAFTA because both situations involved the complete frustration of the operation of the landfill and negated the possibility of any meaningful return on Metalclad’s investment. In other words, Metalclad’s investment was lost completely. (para.113)

C. Heads of Damages and Valuation

Metalclad proposed two alternative methods for calculating damages:

- 1) to use a discounted cash flow (DCF) analysis of future profits to establish the fair market value of the investment (approximately \$90 million);
- 2) to value Metalclad’s actual investment in the landfill (approximately \$20–25 million).

1. Future profits and DCF analysis – rejected

With reference to authorities, the Tribunal stated that “[n]ormally, the fair market value of a going concern which has a history of profitable operation may be based on an estimate of future profits subject to a discounted cash flow analysis.” (para.119) However, the Tribunal continued, “where the enterprise has not operated for a sufficiently long time to establish a performance record or where it has failed to make a profit, future profits cannot be used to determine going concern or fair market value.” (para.120)

Because in this case the landfill had never been operative, the Tribunal decided that any award based on future profits would be wholly speculative. (para.121) It rejected this approach.

2. “Actual expenses” approach – adopted

The Tribunal decided that in this case fair market value was best arrived “by reference to Metalclad’s actual investment in the project.” In other words, the value of the expropriated property was to be determined by the Tribunal by estimating the claimant’s investment in that property. (para.122)

In the Tribunal’s view, this approach was consonant with the dictum in the *Chorzow* case whereby any award to the claimant should, as far as is possible, wipe out all the consequences of the illegal act and reestablish the situation which would in all probability have existed if that act had not been committed (the *status quo ante*). (para.122)

3. Evidence

Metalclad based its assessment of its actual investment on its United States Federal Income Tax Returns and Auditors' Workpapers of Capitalized Costs for the Landfill. Mexico challenged these documents as inappropriate evidential sources and argued that each expense item claimed should be supported by documentation properly proving the expenditure. The Tribunal disagreed with Mexico and found that "the tax filings of Metalclad, together with the independent audit documents supporting those tax filings, are to be accorded substantial evidential weight and that difficulties in verifying expense items due to incomplete files do not necessarily render the expenses claimed fundamentally erroneous." (para.124) Thus, the Tribunal accepted Metalclad's evidence as appropriate.

4. Valuation

Metalclad's evidence showed that it had invested approx. US\$ 20.5 million in the landfill project. Calculations submitted by Metalclad included landfill costs that Metalclad claimed to incur from 1991 through 1996 for expenses categorized as the "Coterin" acquisition, personnel, insurance, travel and living, telephone, accounting and legal, consulting, interest, office, property, plant and equipment. (para.123)

In principle, the Tribunal agreed with this calculation but excluded the following costs from the overall amount of compensation:

- Costs incurred by Metalclad prior to the year in which Metalclad purchased Coterin (1991-92), as "too far removed from the investment for which damages are claimed";
- "Bundling" costs claimed by Metalclad, as not appropriate in this case;¹
- Future costs that Mexico would have to bear to remediate the landfill site.

(paras.125-127)

The Tribunal thus awarded an amount of approx. US\$ 16.7 million which also included interest (see below). The Tribunal did not provide a breakdown of this figure and did not give details of how it arrived at it.

5. Negative impact on other business operations – rejected

Metalclad submitted an additional claim worth US\$ 20-25 million in order to be compensated for the negative impact of the Mexico's actions on its other business operations, apparently referring to the fact that the price of Metalclad's own shares decreased as a result of the measures at issue. However, the Tribunal decided that the "causal relationship between Mexico's actions and the reduction in value of Metalclad's other business operations [were] too remote and uncertain", because there might be other factors that had affected Metalclad's share price. (para.115) Thus, the Tribunal rejected this claim for the lack of causal link.

¹ The Tribunal explained "bundling" as "an accounting concept where the expenses related to different projects are aggregated and allocated to another project". The Tribunal noted that the concept of bundling might be applicable in other situations, for example in the oil industry where the costs in relation to a "dry hole" might in part be allocated to the costs of exploring for and developing a successful well. (para.126)

D. Interest

1. Pre-award interest

Article 1135(1) of NAFTA stipulates that a Tribunal may award “monetary damages and any applicable interest”. The Tribunal thus concluded that the award of interest was clearly contemplated by NAFTA. The Tribunal also recalled the findings in *Asian Agricultural Products v. Sri Lanka* where it was held that “interest becomes an integral part of the compensation itself, and should run consequently from the date when the State’s international responsibility became engaged” (para. 114).

The Tribunal selected a date on which the Municipality of Guadalcazar wrongly denied Metalclad’s application for a construction permit as a reasonable date on which Mexico’s international responsibility became engaged. (para.128)

The Tribunal stated that the aim of the interest was “to restore the Claimant to a reasonable approximation of the position in which it would have been if the wrongful act had not taken place”. (para.128) On this basis, the Tribunal determined that interest should be calculated at a rate of 6% per annum, compounded annually.

2. Post-award interest

The Tribunal further held that if the compensation was not paid after 45 days from the date of the award, any unpaid sums should yield an interest at a rate of 6%, compounded monthly. (para.131)

V. Review by the British Columbia Supreme Court

As the arbitration had taken place in Vancouver (British Columbia, Canada), Mexico appealed the Tribunal's decision to the British Columbia Supreme Court (the “Court”).

Before the Court, Mexico argued that the Tribunal had incorrectly read transparency requirements into the Chapter 11 “minimum standard” and “expropriation” provisions. The Court agreed with Mexico that there were no transparency requirements in Chapter 11. In the Court’s view, applying transparency obligations to Chapter 11 disputes would be tantamount to creating new obligations, which would clearly be outside the Tribunal's jurisdiction. Thus, the Court held that the Tribunal decided on a matter beyond the scope of the submission to arbitration. The Court also set aside the first part of the Tribunal’s finding on the issue of expropriation, which was also based on the concept of transparency.

However, the Court upheld the Tribunal's award on the basis of expropriation resulting from the Ecological Decree (1997). Accordingly, the arbitral award was not set aside in its entirety but only insofar as it included **interest** for alleged violations by the Mexican government prior to the issuance of the Ecological Decree (in the 1995-1997 period).

VI. Implications / Initial Analysis

- **Standard of compensation.** Where the investment is completely lost (possibility of a meaningful return on investment negated), the expropriation standard can apply, even if no finding of expropriation was made.
- In principle, one needs to choose a valuation method that would best allow achieving the **aim of compensation** as it was formulated in the *Chorzow Factory* case. However, one may be constricted by the insufficiency of the relevant data which may prevent the application of particular methods (e.g., no stock market values, no record of past profitability, no enterprise that would be comparable).
- In principle, the **DCF method** is appropriate for calculating the fair market value of a going concern. However, the Tribunal is hesitant to apply it if an enterprise that is being valued has not operated for a sufficiently long time to establish a performance record or where it has failed to make a profit.
- **Expenses** claimed should not be too far removed from the investment for which damages are claimed.
- **Evidence.** When assessing the value of an investment on the basis of actual expenses/costs, a tribunal may accept and accord evidential weight to such documents as tax filings, together with the independent audit documents supporting those tax filings.
- **Starting date for interest accrual.** Although the Tribunal quoted *Asian Agricultural Products*, it approached differently the date when the State's "international responsibility became engaged". In *Asian*, it was the date when the Claimant filed a request of arbitration; in this case the Tribunal picked a date of the measure at issue. The Tribunal stated that if there are several possible dates, a "reasonable" one should be selected.
- **Compounding of interest.** Pre-award interest compounded annually, post-award interest compounded monthly.