# INTERNATIONAL COMMERCIAL ARBITRATION AS APPELLATE REVIEW: NAFTA'S CHAPTER 11, EXHAUSTION OF LOCAL REMEDIES AND *RES JUDICATA*

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## I. INTRODUCTION

> "When we debated NAFTA, not a single word was uttered in discussing Chapter 11. Why? Because we didn't know how this provision would play out. No one really knew just how high the stakes would get."
>
> Senator John Kerry[1]

Senator John Kerry is not alone in his concern over Chapter 11, the investment chapter of the North American Free Trade Agreement (NAFTA). Over the last two years arbitral tribunals convened under Chapter 11 have heard two challenges to American court judgments, causing some in the legal community to fear for the sovereignty of the

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[1] Adam Liptak, *Review of US Rulings by NAFTA Tribunals Stirs Worries*, N.Y. TIMES, Apr. 18, 2004, at A20.

U.S. judiciary. Intended by the NAFTA parties to provide an impartial forum for the arbitration of investment disputes between NAFTA member states and investors, the Chapter 11 tribunals have raised serious questions: What exactly is the proper relationship between domestic courts and Chapter 11 tribunals? Can the latter be properly considered an added layer of appellate review? If so, what is the standard of review and what deference is to be paid the domestic court's findings or rulings?

In this paper I attempt to shed some light on these issues. I begin with a background on the history and structure of Chapter 11, paying particular attention to the dispute resolution mechanism and its intended functions. Next I examine three recent Chapter 11 arbitration decisions: *Loewen, Mondev*, and *Azinian*. I analyze in particular the arbitration panels' treatment of prior domestic court proceedings between the parties. Finally, I highlight some of the problems raised by the current Chapter 11 arbitration regime, and consider its future.

## II. CHAPTER 11 WITHIN THE HISTORY OF INVESTMENT TREATIES

On 11 June 1990, the United States and Mexico announced their intention to enter into negotiations toward a free trade agreement.[2] The agreement envisaged by President Bush would replace the existing Canada-United States Free Trade Agreement (CUSFTA),[3] creating a tri-national free trade zone extending from the "Yukon to the Yucatan."[4] Negotiations between Canada, Mexico and the United States on what came to be known as the North American Free Trade Agreement (NAFTA) concluded in 1992.[5] The agreement was signed on 17 December 1992, and entered into force on 1 January 2004.[6] As stated in NAFTA's first Chapter, "The Parties to this Agreement, consistent with Article XXIV of the General Agreement on Tariffs and Trade, hereby establish a free trade area."[7]

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[2] Larry Rohter, *U.S. and Mexicans Cautiously Back Free-Trade Idea*, N.Y. TIMES, June 12, 1990 at A1.

[3] The Canada-United States Free Trade Agreement (CUSFTA) was signed on January 2, 1988 and came into effect on January 1, 1989.

[4] The phrase is attributed to Ronald Reagan. *See* Larry Rohter, *North American Trade Bloc? Mexico Rejects Such an Idea*, N.Y. TIMES, Nov. 24, 1988 at D1.

[5] Reuter's, *3-Way Meeting Starts*, N.Y. TIMES, Feb. 18, 1992, at D4.

[6] NAFTA: Frequently Asked Questions and Answers *at* http://www.nafta-sec-alena.org/DefaultSite/index_e.aspx?DetailID=282#4 (last visited Jan. 16, 2005).

[7] North American Free Trade Agreement, U.S.-Can.-Mex., art. 101, Dec. 17, 1992, 32 I.L.M. 605 (1993) [hereinafter NAFTA].

In many ways NAFTA builds on the CUSFTA model, albeit among three countries rather than two. Both agreements sought to gradually reduce tariffs, eventually create a free-trade zone, and provide general dispute resolution procedures. While both agreements addressed trade-in-services and investment issues, NAFTA's Chapter 11 nonetheless represented a significant departure from CUSFTA.[8]

Chapter 11 was intended to serve three objectives: the establishment of a secure investment environment by laying out clear rules of fair treatment of foreign investment and investors; the removal of barriers to investment by eliminating or liberalizing existing restrictions; and the provision of an effective means for the resolution of disputes between an investor and the host government.[9] The third objective, investment dispute settlement, represents NAFTA's most significant innovation. The rules regarding foreign direct investment are similar to those from CUSFTA, but NAFTA's creation of a separate dispute resolution mechanism was a departure.[10] In CUSFTA, a dispute between Canada and the United States regarding the treatment of a private investor was to be resolved by reference to the general dispute settlement procedure between the states.[11] NAFTA would create a separate mechanism specifically tailored to the emerging concerns of cross-border investors.

As such, NAFTA's dispute resolution mechanism is properly understood as the last in an evolving line of models for investment dispute resolution. The earliest of these was the Friendship, Commerce and Navigation Treaty (FCN), variants of which proliferated in the 1920s and 1930s.[12] Included in FCNs were guarantees of compensation for the expropriation of property and steps for resolving disputes by submission to the International Court of Justice.[13] This was a less-than-ideal remedy for many investors, as it depended largely on the will of an investor's country of residence to espouse his or her claim. In the words of Daniel M. Price, Chief

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[8] Matthew Schaefer, *Proceedings of the Canada-United States Law Institute Conference: NAFTA Revisited: Searching for the Pareto Gains in the Relationship Between Free Trade and Federalism: Revisiting the NAFTA; Eyeing the FTAA,* 23 CAN.-U.S. L.J. 441, 451-52 (1997).

[9] Daniel M. Price, *An Overview of the NAFTA Investment Chapter: Substantive Rules and Investor-State Dispute Settlement*, 27 INT'L LAW. 727 (1993).

[10] Canada-United States Free Trade Agreement, U.S.-Can., arts. 1608, 1806-07, Jan. 2, 1988, 27 I.L.M. 281, 376, 384-85 [hereinafter CUFSTA].

[11] *Id.*

[12] David R. Adair, *Investors' Rights: The Evolutionary Process of Investment Treaties*, 6 TULSA J. COMP. & INT'L L. 195, 196 (1999).

[13] *Id.*

negotiator of Chapter 11 on behalf of the United States:

> The problem was that redress for an investor who suffered significant economic harm was contingent upon the political will (or whim) of its own government. That government may choose not to bring a claim for a variety of reasons. It might have a practice comparable to the measure causing the harm, or it might need the vote in the U.N. of the putative defendant.[14]

Bilateral investment treaties (BITs) emerged to address this concern. The first BITs between the United States and various developing countries were concluded in the 1980s.[15] The greatest innovation of the BITs has been the introduction of investor-state arbitration settlement. For the first time, investors themselves could seek redress against the host government.[16] Says Price, "the idea was that the investor, by having the ability to bring the dispute itself, could resolve the dispute in a way that did not engage the political organs of the two governments."[17] While, in effect, the investor would routinely seek his or her government's assistance first in the event of an investment dispute, "the ultimate decision to go forward now rests in the hands of the private investor."[18] NAFTA's Chapter 11 enshrines this important mechanism for investor-state dispute settlement.

## III. THE RELATIONSHIP BETWEEN DOMESTIC COURTS AND CHAPTER 11 TRIBUNALS

NAFTA Chapter 11 is divided into two parts. Part A lays out the substantive obligations of the Parties.[19] Part B lays out the rules

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[14] Daniel M. Price, *NAFTA Chapter 11 Investor-State Dispute Settlement: Frankenstein or Safety Valve?*, 26 CAN.-U.S. L.J. 1, 6 (2001) [hereinafter *Frankenstein or Safety Valve?*].

[15] The first bilateral investment treaty ever signed was between the Federal Republic of Germany and Pakistan in 1959. *See* RUDOLF DOLZER & MARGRETE STEVENS, BILATERAL INVESTMENT TREATIES 267-326 (1995). The most recently concluded BIT was between the United States and Uruguay. Treaty Between the United States of American and the Republic of Uruguay Concerning the Encouragement and Reciprocal Protection of Investment, *available at* http://ustr.gov/assets/World_Regions/Americas/South_America/asset_upload_file440_6728.pdf (last visited Jan. 16, 2005).

[16] *Frankenstein or Safety Valve?, supra* note 14, at 6.

[17] *Ibid*.

[18] *Id*. at 17.

[19] NAFTA, *supra* note 7, at ch. 11A.

respecting the investor-State dispute resolution procedure.[20] According to the text of the treaty itself, the purpose of Part B is to establish a "mechanism for the settlement of investment disputes that assures both equal treatment among investors of the Parties in accordance with the principle of international reciprocity and due process before an impartial tribunal."[21] This is a most significant innovation: it allows an investor from one NAFTA state-party to directly sue another NAFTA state-party in which that investor has an investment. NAFTA was the first multilateral trade agreement to include such a provision.[22] Furthermore, NAFTA represents the first time Mexico entered into an international agreement providing for investor-state arbitration, as well as the first time any of the twenty-eight members of the Organization for Economic Cooperation and Development (OECD) included this kind of provision in an agreement with another member.[23] The inclusion of the investor-state mechanism addressed the different concerns of the parties: Mexico anticipated that it would encourage foreign direct investment (FDI),[24] while the U.S. saw it as a necessary measure to protect against government expropriation of U.S. assets.[25] According to Price, the dispute settlement mechanism is "one of the key achievements of the investment chapter."[26]

Action under Chapter 11 must be brought after six months but within three years of the occurrence of the act giving rise to the claim.[27] A three-person *ad hoc* arbitral tribunal is constituted for each different case, comprising one arbitrator appointed by the investor, one appointed by the respondent State, and a presiding arbitrator appointed by agreement of the disputing parties.[28] The Secretary-General of the International Centre for Settlement of Investment

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[20] *Id*. at ch. 11B.

[21] *Id.* at art. 1115.

[22] Stefan Matiation, *Arbitration with Two Twists: Loewen v. United States and Free Trade Commission Intervention in NAFTA Chapter 11 Disputes*, 24 U. PA. J. INT'L ECON. L. 451, 464 (2003).

[23] Daniel M. Price, *An Overview of the NAFTA Investment Chapter: Substantive Rules and Investor-State Dispute Settlement*, 27 INT'L LAW. 727, 731 (1993) [hereinafter *Overview of the NAFTA Investment Chapter*].

[24] Frederick M. Abbott, *The Political Economy of NAFTA Chapter Eleven: Equality Before the Law and the Boundaries of North American Integration*, 23 HASTINGS INT'L & COMP. L. REV. 303, 306 (2000).

[25] *Overview of the NAFTA Investment Chapter*, *supra* note 23, at 732.

[26] *Id*. at 731.

[27] NAFTA, *supra* note 7, at art. 1120.

[28] *Id.* at art. 1124.

Disputes ("ICSID") appoints the third arbitrator from a roster of previously approved arbitrators in the event that the parties cannot agree upon one.[29] The governing law consists of NAFTA and the "applicable rules of international law."[30] These rules are identified in Article 1120 as either (a) the Convention on the Settlement of Investment Disputes between States and Nationals of other States (ICSID Convention)[31]; (b) the Additional Facility Rules of the ICSID Convention[32]; or (c) the UNCITRAL Arbitration Rules.[33]

The provisions of NAFTA's Chapter 11 are only significant insofar as a party chooses to seek redress through investor-state arbitration. But there are other remedies to redress grievances that arise from alleged breaches of the treaty, namely the filing of actions in domestic courts. Chapter 11 provides the arbitral tribunals as one possible remedy to state-investor disputes, but does not close the door completely on domestic litigation.[34] In this way NAFTA's dispute remedy mechanism is somewhat different from those found in most bilateral investment treaties. BITs typically require that the investor choose the forum at the start of proceedings.[35] Once the investor has decided to pursue the claim in a domestic court or an arbitration tribunal, there is no turning back; that investor will have no further recourse to the second choice forum. Such provisions are known as "fork-in-the-road clauses,"[36] and were historically a feature of US bilateral investment treaties.[37] A typical fork-in-the-road clause will

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[29] *Id.*

[30] *Id*. at art. 1131(1).

[31] Provided that both the host country and the investor's home country are parties to the Convention. As neither Mexico nor Canada has yet ratified the ICSID Convention, this option has heretofore been effectively precluded.

[32] Provided that either the host country or the investor's country is a party to the Convention.

[33] NAFTA, *supra* note 7, at art. 1120(1)a-b.

[34] Indeed, Chapter 11 arbitral tribunals are understood to have been intended as a last resort. *See* William S. Dodge, *Waste Management, Inc. v. Mexico,* 95 AM. J. INT'L L. 186, 190 n.38 (2001) (arguing that "Article 1121 is structured to encourage investors to pursue local remedies before resorting to Chapter 11") [hereinafter Dodge, *Waste Management*].

[35] Carlos G. Garcia, *All the Other Dirty Little Secrets: Investment Treaties, Latin America, and the Necessary Evil of Investor-State Arbitration*, 16 Fla. J. Int'l L. 301, 314 (2004).

[36] Mark W. Friedman et al., *Developments in International Commercial Dispute Resolution in 2003*, 38 INT'L LAW. 265, 281 (2004).

[37] *See, e.g.*, the Treaty between the United States of America and the Czech and Slovak Federal Republic Concerning the Reciprocal Encouragement and Protection of Investment, entered into on 22 October 1991; Treaty between the United States of America and the Argentine Republic concerning the Reciprocal Encouragement and

require a waiver of the right to "initiate" domestic court proceedings as a condition precedent to the commencement of arbitration.[38] Once a foreign investor has launched domestic court proceedings, that investor is precluded from subsequently submitting a claim to arbitration.[39]

Chapter 11 on the other hand, represents a departure from this model. Articles 1121(1)(b) and 1121(2)(b) require that a foreign investor waive their right to:

> ...initiate or continue before any administrative tribunal or court under the law of any Party, or other dispute settlement procedures, any proceedings with respect to the measure of the disputing Party that is alleged to be a breach...except for proceedings for injunctive, declaratory or other extraordinary relief, not involving the payment of damages, before an administrative tribunal or court under the law of the disputing Party.[40]

However, an investor is not prohibited from bringing a domestic court suit and, if unsatisfied with the judgment, bringing a subsequent NAFTA claim through arbitration. Indeed, many cases that are ultimately resolved through a Chapter 11 tribunal are first litigated in domestic court. Thus, a problem presents itself that was less likely to arise under BITs: How should a NAFTA tribunal treat a domestic court's ruling or judgment on the issue now before the arbitration tribunal?[41]

In answering this question, it is instructive to examine the objectives behind Chapter 11. Chapter 11 tribunals were not, strictly speaking, intended to serve as appellate courts. Rather, the signatories aimed to provide "both equal treatment among investors of the Parties in accordance with the principle of international reciprocity and due

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Protection of Investment. November 14, 1991, in force from October 20, 1994; Agreement between the Argentine Republic and the Republic of France for the Promotion and Reciprocal Protection of Investments Signed on July 3, 1991, approved Argentine Law No. 24.100, Boletin Official, July 14, 1992.

38 J. Steven Jarreau, *Anatomy of a BIT: The United States – Honduras Bilateral Investment Treaty,* 35 U. MIAMI INTER-AM. L. REV. 429, 492 (2004).

39 *Id*.

40 NAFTA, *supra* note 7, at arts. 1121(1)(b), 1121(2)(b).

41 The problem was not completely avoided by BITs. An investor could still bring a claim for "denial of justice" to an arbitral panel, notwithstanding an earlier election to seek domestic remedies. However, NAFTA's Chapter 11 appeared to present the investor for the first time with an option to litigate domestically while still retaining the right to submit the same or similar issues to arbitration at a later date.

process before an impartial tribunal."[42] The drafters recognized the concern on the part of litigants that they may be subject to local prejudice or less-than-neutral treatment at the hands of the domestic courts of the opposing party. As the Court wrote in *Amco v. Indonesia*, "one of the reasons for instituting an international arbitration procedure is precisely that parties – rightly or wrongly – feel often more confident with a legal institution which is not entirely related to one of the parties."[43]

Furthermore, arbitration panels recently convened under Chapter 11 have themselves reiterated that they do not consider themselves to be appellate bodies. The Panel convened in *Loewen Group, Inc. v. United States* stated in its award:

> ...It is unlikely that the Parties to NAFTA would have wished to encourage recourse to NAFTA arbitration at the expense of domestic appeal or review when, in the general run of cases, domestic appeal or review would offer more wide-ranging review as they are not confined to breaches of international law.[44]

Similarly, the panel convened in *Mondev Int'l Ltd. v. United States* rejected claimant Mondev International Ltd.'s assertion that a question of fact should be remanded by the arbitration panel to domestic court.[45] The panel ruled that only a domestic court was empowered to remand such a question.[46] "On the approach adopted by Mondev," said the panel, "NAFTA tribunals would turn into courts of appeal, which is not their role."[47]

These statements and others notwithstanding, the relationship between Chapter 11 and domestic court decisions is far from clear. While the arbitral panels may not consider themselves appellate courts in a traditional sense, the structure of Chapter 11, as outlined above, still allows claimants under certain circumstances to seek arbitral

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[42] NAFTA, *supra* note 7, at art. 1115.

[43] Amco v. Indonesia, 1 ICSID Rep. 413, 460 (1993) (Award, Nov. 20, 1984), [hereinafter *Amco v. Indonesia*].

[44] The Loewen Group, Inc. v. United States, ICSID Case No. ARB(AF) 98/3, Award (June 26, 2003) at para. 162, *available at* http://ita.law.uvic.ca/documents/Loewen-Award-2.pdf (last visited Jan. 16, 2005) [hereinafter *Loewen v. U.S.*].

[45] Mondev Int'l Ltd. v. United States, ICSID Case No. ARB(AF)/99/2, Award (Oct. 11, 2002), at para. 136, *available at* http://ita.law.uvic.ca/documents/Mondev-Final.pdf (last visited Jan. 16, 2005) [hereinafter *Mondev v. U.S.*].

[46] *Id.* at para. 136.

[47] *Id.*

"review" of domestic court decisions. Is there a consistent standard, then, for the treatment of domestic court decisions by Chapter 11 panels? If so, what is that standard?

In order to answer these questions, a closer examination of recent Chapter 11 decisions is instructive. The tribunals in *Mondev* and *Loewen,* as well as that in the *Azinian v. Mexico* decision, all considered Chapter 11 claims that had, to varying degrees, already been considered by domestic courts. The *Mondev* and *Loewen* panels examine the merits of "denial of justice" claims brought under NAFTA Article 1105, requiring both panels to consider the customary international law norm of local remedies.[48] The *Azinian* panel examined an expropriation claim brought under Article 1110, the substance of which had already been considered by Mexican courts.[49] As such, the panel had to determine the proper *res judicata* effect, if any, to be granted the findings and rulings of the Mexican court system.[50]

### *A. Local Remedies*

The so-called "local remedies rule" calls for the exhaustion of all remedies provided for by the laws of the host state in advance of recourse to international arbitration. Professor Brownlie cites the practical considerations behind the rule as:

> The greater suitability and convenience of national courts as forums for the claims of individuals and corporations, the need to avoid the multiplication of small claims on the level of diplomatic protection, the manner in which aliens by residence and business activity have associated themselves with the local jurisdiction, and the utility of a procedure which may lead to classification of the facts and liquidation of the damages.[51]

Another important rationale for the local remedies rule, and one that is of particular importance to an investor-state action, is the following: A state cannot be held responsible for an alleged infringement on an individual's rights if the state has not first had an

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[48] *Mondev v. U.S.* at para. 96*; Loewen v. U.S.* at para. 141.

[49] Azinian v. Mexico, 14 ICSID REV. FOR. INV. L.J. 535 (1999), at para.75, *available at* http://naftaclaims.com/Disputes/Mexico/Azinian/AzinianFinalAward.pdf (last visited Jan. 16, 2005) [hereinafter *Azinian v. Mexico*].

[50] *Id.* at para. 78.

[51] IAN BROWNLIE, PRINCIPLES OF PUBLIC INTERNATIONAL LAW 473 (6th ed. 2003).

opportunity to remedy it.[52] Thus, the claimant must first seek redress through appeal within the domestic court system.

One of the earliest applications of the rule in international arbitration was in the *Finnish Ships* case of 1934.[53] In that case, Finnish ship-owners whose property was seized by the Russian government and placed at the disposal of the Allied effort during the First World War brought an action against the British government seeking compensation.[54] After an adverse ruling before a British court, the claimants submitted their claim to an arbitrator, only to have the British government assert that the Finns had not exhausted the avenues of appeal within the British system.[55] The arbitrator disagreed, ruling that an appeal to a British court was bound to fail.[56] The Finns had therefore exhausted all reasonable local remedies.

Another landmark case associated with the local remedies rule is the *Interhandel* case of 1959. The ICJ stated in that case that the grounds on which this rule "is based are the same, whether in the case of an international court, arbitral tribunal, or conciliation commission."[57] That the ICJ saw the rule as applicable to all such situations indicates its importance in international law, and particularly to arbitral tribunals of the sort convened under NAFTA's Chapter 11. The case most frequently associated with the local remedies rule is more recent, that of *Elettronica Sicula S.p.A. (ELSI)*.[58] In that case the ICJ stated that the exhaustion of local remedies is "an important principle of customary international law," and that it cannot "be held to have been tacitly dispensed with, in the absence of any words making clear an intention to do so."[59] While the *ELSI* panel upheld the importance of the local remedies rule as an important international law principle, it also expressly recognized that the rule may be derogated from, qualified, or varied by virtue of any binding treaty.[60]

The local remedies rule is central to the jurisprudence of the European Court of Human Rights, the Inter-American Commission on Human Rights and the Human Rights Committee established

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[52] *Id.*

[53] *Finnish Ships Arbitration* (Fin. v. U.K.), 3 R.I.A.A. 1479 (1934).

[54] *Id.* at 1484.

[55] *Id.* at 1488.

[56] *Id.* at 1543.

[57] Interhandel Case (Switz. v. U.S.) 1959 I.C.J. 6, 29.

[58] Case Concerning Elettronica Sicula S.p.A. (ELSI) (U.S. v. Italy), 1989 I.C.J. 15, 42 (July 20).

[59] *Id.* at 50.

[60] *Id.* at 50.

under the International Covenant on Civil and Political Rights.[61] While not universally applied in cases of international arbitration,[62] the principle is still an important tenet of international law. The United States government has recently asserted the local remedies principle in two proceedings before the International Court of Justice. In the *LaGrand Case (Germany v. U.S.)*, Germany sought to exercise diplomatic protection with respect to two German nationals convicted of murder, Karl and Walter LaGrand.[63] The United States argued against Germany's exercise of diplomatic protection on the ground that the LaGrands had not exhausted all local remedies before seeking espousal of their claim by the German government.[64] The United States argued that if diplomatic protection applied, so should the customary rule of exhaustion of local remedies governing diplomatic protection.[65] The Court, however, rejected this argument, pointing out that the United States, in failing to carry out its obligation to inform the LaGrands of their right to consult with their consular representatives, had prevented them from pursuing those very local remedies that were available to them.[66] The Court therefore upheld the principle that local remedies must be exhausted before commencement of international proceedings, but recognized the practical limitations on the LaGrands' access to those remedies.[67]

The United States has most recently asserted the rule of exhaustion of local remedies in the *Avena* case of 2003. The case *Avena and Other Mexican Nationals (Mex. v. U.S.)* concerned 52 Mexican nationals facing death sentences in the United States, none of whom had been advised of their rights to consular assistance throughout their criminal proceedings.[68] Arguing in support of a bar to their claims, the United States cited the failure of the convicts to exhaust local remedies according to the requirements of customary international law.[69] The court agreed on this point, ultimately finding

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[61] BROWNLIE, supra note 51, at 481.

[62] The Algiers Accords establishing the Iran-United States Claims Tribunal in 1981 largely dispensed with the requirement, maintaining that it was not applicable to the claims of nationals before the Tribunal. *See* David D. Caron, *The Nature of the Iran-United States Claims Tribunal and the Evolving Structure of International Dispute Resolution* 84 AM. J. INT'L L. 104, 133-34 (1990).

[63] LaGrand Case (F.R.G. v. U.S.), 2001 I.C.J. at para. 10 (June 27).

[64] *Id.* at para. 58.

[65] *Id.*

[66] *Id.* at para. 60.

[67] *Id.*

[68] Avena and Other Mexican Nationals (Mex. v. U.S), 2003 I.C.J. (June 20).

[69] *Id.* at para. 38.

for Avena and the others on alternate grounds. "Only when that process is completed and local remedies are exhausted," said the court, "would Mexico be entitled to espouse the individual claims of its nationals through the procedure of diplomatic protection."[70]

These are but a few examples of modern application of the local remedies rule. Whether and how an appellate court or international arbitral panel applies the rule is dependent largely on whether it is treated as substantive or procedural in nature. There are circumstances in which the exhaustion of local remedies is a substantive requirement before recourse to international arbitration, while in others the rule acts merely as a procedural bar to submitting a dispute to international arbitration. This distinction has important implications for Chapter 11 review of domestic court rulings, particularly in cases of alleged denial of justice. Professor Dodge maintains that Chapter Eleven does not require the exhaustion of domestic remedies as a procedural requirement, but points out that, "[f]or some Chapter Eleven claims, like denial of justice, the exhaustion of local remedies may be a substantive requirement of the claim."[71]

Denial of justice, discussed further below, alleges that a State's judiciary failed to provide the claimant an adequate remedy. Generally, the State's judiciary must be shown to have failed to comply with basic standards of international law. While the standard for denial of justice is somewhat fluid, many commentators have remarked that exhaustion of local remedies is a substantive requirement before a denial of justice claim can be brought.[72]

### 1. *Mondev Int'l Ltd. v. United States*

The recent case *Mondev Int'l Ltd. v. United States* presents an example of the Chapter 11 arbitral regime's treatment of the principle of exhaustion of local remedies. In 1992, real estate developers Lafayette Place Associates (LPA) filed a suit in the Massachusetts Superior Court against the City of Boston and the Boston Redevelopment Authority (BRA).[73] The dispute arose out of a real estate contract whereby LPA was granted an option to purchase a

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[70] *Id.* at para. 40.

[71] William S. Dodge, *National Courts and International Arbitration: Exhaustion of Remedies and Res Judicata Under Chapter Eleven of NAFTA*, 23 HASTINGS INT'L & COMP. L. REV. 357, 376 n.87 (2000).

[72] *See generally* J.E.S. Fawcett, *The Exhaustion of Local Remedies: Substance or Procedure?*, 31 BRIT. Y.B. INT'L L. 452 (1954).

[73] *Mondev v. U.S.*, *supra* note 45, at para. 1.

piece of land known as the Hayward Parcel by January 1, 1989, at a price calculated by a formula in the contract.[74] LPA brought suit when the City of Boston and BRA, believing the parcel to be undervalued in light of an intervening surge in real estate prices, allegedly frustrated LPA's exercise of the option.[75]

At trial LPA prevailed against the City of Boston, but BRA was found to be immune to suit.[76] Both Boston and LPA appealed to the Massachusetts Supreme Judicial Court (SJC), which upheld BRA's immunity and further upheld Boston's appeal, leaving LPA with a loss against each of the original defendants.[77] LPA's writ of *certiari* to the United States Supreme Court on its contract claim against the City of Boston was denied.[78] Canadian corporation Mondev International Ltd., owner of LPA, then brought Chapter 11 claims against the United States, claiming that due to the Massachusetts Supreme Judicial Court's decision and the acts of the City of Boston and BRA, the United States breached its NAFTA obligations.[79] In particular, Mondev alleged violations of NAFTA Articles 1102 (National Treatment), 1105 (Minimum Standard of Treatment), and 1110 (Expropriation and Compensation).[80]

The tribunal dismissed the alleged expropriation in violation of Article 1110 and the alleged discrimination in violation of Article 1102, as both had occurred prior to NAFTA's entry into force on January 1, 1994, and NAFTA is not retroactive.[81] The tribunal suggested that these claims would have in any case been barred by NAFTA's three-year statute of limitations.[82] The panel cited NAFTA Article 1116(2): "An investor may not make a claim if more than three years have elapsed from the date on which the investor first acquired, or should have first acquired, knowledge of the alleged breach and knowledge that the investor has incurred loss or damage."[83]

That left only Mondev's Article 1105 claim for violation of the Minimum Standard of Treatment. Article 1105 requires a NAFTA state to accord to "investments of investors of another Party treatment

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[74] *Id*. at para. 38.
[75] *Id*. at para. 39.
[76] *Id*. at para. 1.
[77] *Id*. at para. 2.
[78] *Id*. at para. 1.
[79] *Id*. at para. 2.
[80] *Id*.
[81] *Id*. at paras. 57-75.
[82] *Id*.
[83] NAFTA, *supra* note 7, at art. 1116(2).

in accordance with international law, including fair and equitable treatment and full protection and security."[84] In using this language, NAFTA's drafters intended that those asserting a denial of fair and equitable treatment would have to demonstrate that the denial was a violation of international law.[85] There is no universally agreed-upon standard for a denial of justice claim, but it is widely regarded as "a particular category of deficiencies on the part of the organs of the host state, principally concerning the administration of justice."[86] The "organs of the state" considered by Chapter 11 panels will most often be those of the domestic judiciary of the host state. The *Mondev* panel, and that in *Loewen*, discussed below, each contribute to a limited degree to a developing definition of the concept of "denial of justice" in the context of Chapter 11 arbitration.

In considering whether Mondev had in fact experienced a denial of justice, the tribunal began by providing formal sanction to the clarifications of Article 1105(1) adopted by the NAFTA Free Trade Commission (FTC) on 31 July 2001.[87] The tribunal noted, however, that the phrase "customary international law" as used in the FTC's clarifications "refers to customary international law as it stood no earlier than the time at which NAFTA came into force."[88] The tribunal therefore recognized the evolving nature of the standard, rejecting Canada's suggestion that the minimum standard be limited to the extremely high bar set by the Mexican Claims Commission in the *Neer* case.[89] That panel concluded in 1926 that "the treatment of an alien... should amount to an outrage, to bad faith, to willful neglect of duty, or to an insufficiency of governmental action so far short of international standards that every reasonable and impartial man would readily recognize its insufficiency."[90] The Mondev tribunal, in rejecting this definition in favor of the newly-revised FTC clarifications, acknowledged that a lesser judicial infraction could still amount to a denial of justice.

The tribunal went on to endorse a definition pronounced by the

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[84] *Id.* at art. 1105(1).

[85] Daniel M. Price & P. Bryan Christy, III, *An Overview of the NAFTA Investment Chapter: Substantive Rules and Investor-State Dispute Settlement*, *in* THE NORTH AMERICAN FREE TRADE AGREEMENT: A NEW FRONTIER IN INTERNATIONAL TRADE AND INVESTMENT IN THE AMERICAS 174 (Judith H. Bello et al. eds., 1994).

[86] BROWNLIE, *supra* note 51, at 506.

[87] *Mondev v. U.S.*, *supra* note 45, at para. 101.

[88] *Id*. at para. 125.

[89] *Id*. at para. 114.

[90] Neer Case (U.S. v. Mex.), United States and Mexico General Claims Commission, *reproduced in* 1927 AM. J. INT'L. L. 555, 556.

*ELSI* panel: "a willful disregard of due process of law... which shocks, or at least surprises, a sense of judicial propriety."[91] The *Mondev* tribunal recognized that this definition was formulated to determine whether administrative conduct was "arbitrary," but deemed the definition nonetheless "useful also in the context of denial of justice."[92]

The tribunal finally articulates the revised standard for denial of justice as follows:

> In the end the question is whether, at an international level and having regard to generally accepted standards of the administration of justice, a tribunal can conclude in the light of all the available facts that the impugned decision was clearly improper and discreditable, with the result that the investment has been subjected to unfair and inequitable treatment.[93]

Applying this newly-articulated standard to Mondev's claim, the panel found no denial of justice. "There is nothing here to shock or surprise even a delicate judicial sensibility," said the tribunal.[94] The Massachusetts Supreme Judicial Court's (SJC) dismissal of LPA's contract claim against the City was simply an application of existing Massachusetts law.[95] Even if the SJC decision represented judge-made law, it would have "fallen within the limits of common law adjudication" according to the tribunal.[96]

The panel took a similarly deferential approach to the sovereign immunity decision, stating that "within broad limits, the extent to which a State decides to immunize regulatory authorities from suit for interference with contractual relations is a matter for the competent organs of the State to decide."[97] Having found the United States doctrine of sovereign immunity to be within these "broad limits," the panel recognized the Massachusetts judiciary's duty to adhere to the doctrine:

> The United States' courts, operating in accordance with the rule of law, had no choice but to give effect to a statutory immunity existing at the time the acts in question were performed and not subsequently repealed, once they had

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91 *Mondev v. U.S.*, *supra* note 45, at para. 127.

92 *Id*.

93 *Id*.

94 *Id*. at para. 133.

95 *Id*.

96 *Id*.

97 *Id*. at para. 154.

> concluded that the statute in question did apply. It is not disputed by the Claimant that this decision was in accordance with Massachusetts law, and it did not involve on its face anything arbitrary or discriminatory or unjust, i.e., any new act which might be characterised as in itself a breach of Article 1105(1).[98]

It is important to note that *Mondev* concerned an investor who had already taken his claim to the highest levels of state court. As such, the standard articulated by the panel may only be applicable insofar as the claimant has exhausted all available local remedies.[99] The panel stated that, "it is one thing to deal with unremedied acts of the local constabulary and another to second-guess the reasoned decisions of the highest courts of a State. Under NAFTA, parties have the option to seek local remedies. If they do so and lose on the merits, it is not the function of NAFTA tribunals to act as courts of appeal."[100] Mondev presented a case that had (a) been adjudicated to the full extent of the local judiciary, and (b) did not present the panel with "clearly improper and discreditable" findings.[101] Given this combination of circumstances, the tribunal deferred to the findings of the Massachusetts Supreme Judicial Court. What is unclear, however, is the outcome of the *Mondev* case in the event that local remedies had not been exhausted: The panel nowhere pronounces a *requirement* that the claimant exhaust local remedies. The *Loewen* case, discussed below, presents a contrast.

### 2. *Loewen Group, Inc. v. United States*

*Loewen* began as a Mississippi state court case between a local funeral home owner, Jeremiah O'Keefe, and Loewen Group, Inc. (LG), a large chain of Canadian funeral homes that had made

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[98] *Id*. at para. 156.

[99] While LPA petitioned for a rehearing before the SJC on both the sovereign immunity and the contracts claims, LPA only sought certiorari to the United States Supreme Court on its contract claim. Therefore, the Chapter 11 panel seemed to treat LPA as having exhausted all available local remedies, when in fact the sovereign immunity claim never went beyond the SJC. It is unclear whether the panel would consider a petition all the way to the United States Supreme Court to be a necessary step in exhausting one's local remedies. The panel's pronouncement against second-guessing "the reasoned decisions of the highest courts of a State" could as easily refer to the State of Massachusetts as to the United States.

[100] *Mondev v. U.S.*, *supra* note 45, at para. 126.

[101] *Id*. at para. 127.

substantial inroads in the United States.[102] O'Keefe prevailed at trial, but the proceedings were fraught with irregularities. Specifically, the Mississippi state court judge who presided over the case repeatedly allowed O'Keefe's attorneys to make references to LG's foreign nationality, race-based distinctions between O'Keefe and LG's owner Raymond Loewen, and class-based distinctions between multinational LG and local business owner O'Keefe.[103]

Upon the jury's award of $500 million to O'Keefe, LG sought to appeal. Per Mississippi law, LG was required to pay bond totaling 125% of the judgment to stay execution of the judgment pending appeal.[104] LG petitioned the court to lower the required bond, a challenge not to the bond requirement itself, but to the bond requirement as applied, given the high cost entailed.[105] Both the trial court and the Mississippi Supreme Court refused to reduce the appeal bond, requiring LG to post a $625 million bond within seven days or else see immediate execution of the judgment.[106] Under conditions that LG described as "extreme duress," LG declined to petition for certiorari, and instead entered into a settlement with O'Keefe under which they agreed to pay $175 million.[107]

LG and its owner, Raymond Loewen, then brought claims against the United States under NAFTA Chapter 11, claiming that the trial court violated Article 1102's national treatment provision and Article 1105's minimum standard of treatment provision by allowing the jury to consider prejudicial comments made at trial, that the $500 million verdict and the failure to waive the bond requirement were also violations of Article 1105, and that the court's award ultimately constituted expropriation as defined by Article 1110.[108]

In its award on the merits, the tribunal concluded "that the conduct of the trial by the trial judge was so flawed that it constituted a

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102 O'Keefe v. Loewen Group, Inc., No. 91-677-423 (unpublished decision).

103 *Loewen v. U.S.*, *supra* note 44, at para. 4.

104 *Id.* at para. 5.

105 *Id.* at paras. 5-6. "Mississippi law requires an appeal bond for 125% of the judgment as a condition of staying execution on the judgment, but allows the bond to be reduced or dispensed with for "good cause". 6. Despite Claimants' claim that there was good cause to reduce the appeal bond, both the trial court and the Mississippi Supreme Court refused to reduce the appeal bond at all and required Loewen to post a $625 million bond within seven days in order to pursue its appeal without facing immediate execution of the judgment. According to Claimants, that decision effectively foreclosed Loewen's appeal rights." *Id.*

106 *Id.* at para. 6.

107 *Id.* at para. 7.

108 *Id.* at para. 8.

miscarriage of justice amounting to a manifest injustice as that expression is understood in international law."[109] The tribunal specifically cited the allegedly prejudicial comments and references allowed by the trial judge,[110] as well as the trial judge's failure to properly instruct the jury with respect to damages.[111] The tribunal dismissed LG's 1102 claim for lack of evidence,[112] and dismissed the 1110 claim as "add[ing] nothing" to the 1105 claim.[113] LG's 1105 claim was also rejected, specifically on the grounds that LG had failed to seek United States Supreme Court review of the bond requirement.[114] Ultimately, despite having found "a miscarriage of justice" at trial, the tribunal dismissed the entire claim on jurisdictional grounds: LG's filing for bankruptcy and subsequent reorganization as a United States corporation deprived the Chapter 11 tribunal of the authority to issue a judgment.[115] Citing NAFTA's Chapter 1101(1)'s "diversity of nationality" requirement, the tribunal determined that LG ultimately lacked the standing to bring a NAFTA claim at all.[116]

While the panel dismissed the NAFTA claims, they nonetheless left the door open for future Chapter 11 review of domestic court claims. Indeed, the panel offered some suggestions as to what the standard should be for such review. The panel offered suggestions in two areas of review: One relating to the merits of a NAFTA claim, and one relating to a Chapter 11 panel's jurisdiction over such claims.

With regard to the merits of an 1105 (minimum standard of treatment) claim, the panel borrowed from two other NAFTA arbitration decisions in setting its standard.[117] The tribunal first cited the "clearly improper and discreditable" standard formulated by the *Mondev* tribunal.[118] The *Loewen* panel then cited with approval the *Pope & Talbot* decision, which itself borrowed from the ICJ's ruling in *ELSI* in articulating the standard for denial of justice: "It is a willful disregard of due process of law, an act which shocks, or at least

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[109] *Id.* at para. 54.

[110] *Id.* at paras. 56-70.

[111] *Id.* at paras. 88-91.

[112] *Id.* at para. 140.

[113] *Id.* at para. 141.

[114] *Id.* at para. 215.

[115] *Id.* at para. 1.

[116] *Id.* at paras. 1-2.

[117] Article 1105(1) provides: "Each party shall accord to investments of investors of another party treatment in accordance with international law, including fair and equitable treatment and full protection and security." NAFTA, *supra* note 7, at art. 1105(1).

[118] *Mondev v. U.S.*, *supra* note 45, at para. 127.

surprises, a sense of juridical propriety."[119]

In formally endorsing these two standards, the *Loewen* panel rejected Respondent United States' claim that there need be "bad faith or malicious intention" in order for a denial of minimum standard of treatment to be shown.[120] Insofar as the *Loewen* panel sided with "respondent" Loewen on this point, this may be seen as appellate review of a US court decision, contrary to the stated aims of the panel itself.[121] However, it is impossible to know how a higher US court would have ruled on this point. LG's failure to seek review within the US court system means that the Chapter 11 panel, rather than having an opportunity to "overrule" a US court decision, has merely reviewed a claim that was never subject to US appellate court scrutiny. The *Loewen* panel's Article 1105 ruling nonetheless represents a further refinement of the proper standard to be applied by future Chapter 11 panels in considering denial of justice claims.

The *Loewen* panel's decision on the issue of jurisdiction, however, has important implications for the local remedies rule, and provides an alternate model of Chapter 11 tribunal review of domestic court rulings than that presented in *Mondev*. The *Loewen* panel ultimately rejected LG's Article 1105 claim on grounds of "finality": The panel determined that the last domestic treatment of the case – that of the Mississippi Supreme Court – lacked the requisite "finality of action" that would allow for the panel's exercise of jurisdiction.[122] In making this determination, the panel draws an important distinction between the principle of finality and that of exhaustion of local remedies.

The Article 1105 claim at issue in *Loewen* was a case in which the "alleged violation of international law is founded upon a judicial act."[123] In the words of the panel, "no instance has been drawn to our attention in which an international tribunal has held a State responsible for a breach of international law constituted by a lower court decision when there was available an effective and adequate appeal within the State's legal system."[124] In other words, the erroneous decision of the United States courts would need to have been a final one for the Chapter 11 tribunal to find a violation of international law. This is the so-called "finality" requirement: No

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[119] *Loewen v. U.S.*, *supra* note 44, at para. 131 (*citing* Pope & Talbot, Inc. v. Canada, Award on the Merits of Phase 2 (April 10, 2001)).

[120] *Id.* at para. 130.

[121] *See supra* note 44 and accompanying text.

[122] *Loewen v. U.S.*, *supra* note 44, at para. 144.

[123] *Id*. at para. 165.

[124] *Id*. at para. 154.

international wrong has been done until the judicial system as a whole – all the way to the court of last resort – has acted.

Loewen pursued its case domestically all the way to the Mississippi Supreme Court, but ultimately decided to forgo an appeal to the US Supreme Court by entering into a settlement with plaintiff O'Keefe.[125] As a result, the *Loewen* panel found finality lacking. "Loewen failed to present evidence disclosing its reasons for entering into the settlement agreement in preference to pursuing other options," stated the panel, "in particular the Supreme Court option."[126] The result, of course, is that "Loewen has not shown a violation of customary international law and a violation of NAFTA for which Respondent is responsible."[127] On its face, then, the *Loewen* panel based its jurisdictional ruling on the issue of finality.

However, the panel's ruling on finality necessarily implicates the rule of exhaustion of local remedies. Essential to a "finality" determination is a showing that there was indeed no further remedy available to the claimant. The *Loewen* panel acknowledged this, stating that, "the pursuit of local remedies plays a part in creating the ground of complaint that there has been a breach of international law."[128] This is essentially the so-called substantive "exhaustion of local remedies" requirement, as applied in the context of judicial decision-making.[129] When the panel states that "Loewen failed to present evidence disclosing its reasons for entering into the settlement agreement in preference to pursuing other options," the unmistakable implication is that Loewen had an obligation to exhaust its domestic remedies before submitting to NAFTA arbitration.[130]

The panel therefore established a finality rule, but one which effectively required exhaustion with respect to court actions. Arguably, however, NAFTA does not establish an obligation to

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[125] The *Loewen* panel's decision raises an important issue that is outside the scope of this paper: Whether a petition to the United States Supreme Court is required in order to show finality. Given the small number of cases taken up by the Court each term, a petition for *certiorari* is in most cases all but futile. The panel indicated that if forgoing a petition to the US Supreme Court is the only course a party "could reasonably be expected to take," then such a showing would be sufficient for the purposes of finality. Loewen failed to make such a showing, however, having had the Supreme Court option "under active consideration and preparation until the settlement agreement was reached." *Id.* at para. 215.

[126] *Id*. at para. 215.

[127] *Id*. at para. 217.

[128] *Id*. at para. 165.

[129] *See* notes 63, 64 and accompanying text.

[130] *Loewen v. U.S.*, *supra* note 44, at para. 215.

exhaust local remedies, at least as a procedural bar to pursuing Chapter 11 arbitration.[131] As noted above, Articles 1121(1)(b) and 1121(2)(b) require only that a foreign investor waive their right to "initiate or continue" domestic court proceedings prior to initiating NAFTA arbitration.[132] Furthermore, commentators now acknowledge that a requirement to exhaust local remedies was never intended by NAFTA's drafters.[133] Indeed, Loewen relied on this very argument, stating that Article 1121 presented an obligation to waive local remedies rather than to exhaust them.[134] Specifically, Loewen argued that (1) Article 1121 "eliminates the necessity to exhaust local remedies provided by the host country's administrative or judicial courts," and (2) that "the so-called substantive principle of finality is no different from the local remedies rule and that international tribunals have reviewed the decisions of inferior municipal courts where the exhaustion requirement has been waived or is otherwise inapplicable."[135]

The panel, however, took Respondent's position that the "substantive requirement of customary international law for a final non-appealable judicial action" is distinct from "international law's procedural requirement of exhaustion of local remedies ('the local remedies rule')."[136] The panel rejected Loewen's "waiver" argument, stating that "if Article 1121 were to have that effect, it would encourage resort to NAFTA tribunals rather than resort to the appellate courts and review processes of the host State, an outcome which would seem surprising, having regard to the sophisticated legal systems of the NAFTA Parties."[137] Thus, the panel upheld the exhaustion of local remedies rule, albeit in dicta, and was careful to characterize the exhaustion requirement as "procedural" in nature rather than substantive.[138]

We see then that while the *Loewen* panel based its decision on finality, the quite separate issue of exhaustion was heavily implicated: The finality requirement as expressed by the panel can only be met

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131 *See* notes 63-64 and accompanying text.

132 *Supra*, note 41 and accompanying text.

133 Andrea K. Bjorklund, *Waiver and the Exhaustion of Local Remedies Rule in NAFTA Jurisprudence*, *in* NAFTA INVESTMENT LAW AND ARBITRATION: PAST ISSUES, CURRENT PRACTICE, FUTURE PROSPECTS 253, 278-79 (Todd Weiler, ed., 2004) [hereinafter Bjorklund, *Waiver and Exhaustion*].

134 *Loewen v. U.S.*, *supra* note 44, at para. 145.

135 *Id.*

136 *Id.* at para. 143.

137 *Id*. at para. 162.

138 *Id.* at paras. 150-71.

through exhaustion of domestic judicial remedies. The tribunal concludes its decision with the following explanation:

> ...We find nothing in NAFTA to justify the exercise by this Tribunal of an appellate function parallel to that which belongs to the courts of the host nation. In the last resort, a failure by that nation to provide adequate means of remedy may amount to an international wrong but only in the last resort...Too great a readiness to step from outside into the domestic arena, attributing the shape of an international wrong to what is really a local error (however serious), will damage both the integrity of the domestic judicial system and the viability of NAFTA itself.[139]

The *Loewen* panel's explanation is not altogether conclusive on the issue of appellate review of domestic court decisions. The arbitrators, in refusing to find NAFTA jurisdiction, drew a bright-line rule: As is the practice in US courts, lack of jurisdiction will trump a claim's merits – no matter how meritorious they may be. Still, the panel's final admonition that Chapter 11 panels should only serve as a "last resort" leaves the door open to appellate review of domestic court decisions – provided all local remedies have been exhausted.[140]

### *B. Res Judicata*

Also relevant to a discussion of the relationship between domestic courts and Chapter 11 tribunals is the issue of *res judicata*. *Res judicata* is the doctrine that an earlier and final adjudication by a court is conclusive in subsequent proceedings involving the same subject matter or relief, the same legal grounds and same parties. These three criteria are known as the "triple-identity" of the case, and traditional *res judicata* doctrine requires that all three be met in order for the prior case to preclude re-litigation.[141] It is important to note, however, that the strictness with which the doctrine is applied varies greatly between jurisdictions. The issue of privity of parties in particular is subject to various interpretations; in the United States, for instance,

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[139] *Id.* at para. 242.

[140] *Id. See generally* Andrea K. Bjorklund, *Reconciling State Sovereignty and Investor Protection in Denial of Justice Claims*, 45 VA. J. INT'L L. 809, 854-58 (2005) (discussing finality determination in *Loewen*). [hereinafter Bjorklund, *Reconciling State Sovereignty*].

[141] Interim Report: "Res judicata" and Arbitration, (International Law Association, Berlin Conference on International Arbitration (2004)), at 2, *available at* http://www.ila-hq.org/pdf/Int%20Commercial%20Arbitration/Report%202004.pdf (last visited Jan. 16, 2005).

this requirement has been relaxed somewhat to allow third parties to assert *res judicata*.[142] Furthermore, it is not uncommon for a corporation or organization to litigate, followed by subsequent litigation of the same or similar issue or claim by a member or affiliate of the original claimant. The policies behind the principle are twofold: There is a societal interest in bringing litigation to an eventual conclusion, while the individual litigants have a right not to be haled into court repeatedly for the same reasons.

*Res judicata* is also widely accepted as a norm of international law.[143] In the words of the panel in the recent international arbitration case *Waste Management v. Mexico* (2002): "There is no doubt that *res judicata* is a principle of international law, and even a general principle of law within the meaning of Article 38(1)(c) of the Statute of the International Court of Justice."[144] The doctrine's place within customary international law has also been confirmed in a number of ICJ decisions, e.g. Société Comerciale de Belgique (1939), the Corfu Channel Case (1949) and Barcelona Traction (1964).[145]

However, the customary international law rule of *res judicata* extends only to the effect of the decision of one international tribunal on a subsequent international tribunal.[146] The decisions of domestic courts, by contrast, have not been given *res judicata* effect by international tribunals.[147] As the tribunal in *Amco v. Indonesia* wrote, "an international tribunal is not bound to follow the result of a national court."[148] This principle notwithstanding, in at least one recent Chapter 11 decision, discussed below, an arbitration panel has paid considerable deference to the decisions of a domestic court.

### 1. *Azinian v. Mexico*

The claimants in *Azinian* were shareholders in Desechos Solidos

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[142] *Id*. at 3.

[143] SHABTAI ROSENNE, THE LAW AND PRACTICE OF THE INTERNATIONAL COURT, 1920-1996, at 1655-61 (1997).

[144] Waste Management, Inc. v. Mexico (U.S. v. Mex.), Award on Jurisdiction, 2002 Case No. ARB(AF)/00/3 (June 26), at para. 39, *available at* http://www.state.gov/documents/organization/12244.pdf (last visited Jan. 16, 2005).

[145] Société Comerciale de Belgique (1939) P.C.I.J., Ser. A/B, no. 78; Corfu Channel Case (Compensation) 1949 I.C.J. rep. 244; Barcelona Traction Case (Preliminary Objections) 1964 I.C.J. rep. 6; ENCYCLOPAEDIC DICTIONARY OF INTERNATIONAL LAW 434 (Clive Parry et al. eds., 2004).

[146] United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, June 10, 1958, 330 U.N.T.S. 38.

[147] *Id*.

[148] *Amco v. Indonesia*, *supra* note 43, at 460.

de Naucalpan S.A. de C.V. (DESONA), a Mexican company that had entered into a concession contract with the city of Naucalpan to provide waste collection services.[149] Upon a new administration's take-over of the government of Naucalpan, the concession contract was annulled.[150] When DESONA brought suit, a State Administrative Tribunal upheld the annulment, finding that the concession contract had been induced by fraud and that the contract was not valid under Mexican law.[151] The annulment was upheld by the Superior Chamber of the Administrative Tribunal, and a petition for review was rejected by the Federal Circuit Court.[152] The shareholders, among them Robert Azinian, then brought Chapter 11 claims on behalf of themselves and on behalf of DESONA, alleging expropriation on the part of the City of Naucalpan.[153] The ensuing arbitration, then, represents a challenge not to the proceedings of the Mexican judiciary, but to the acts of the local government.

The Mexican domestic courts having made significant factual findings at trial and rulings on appeal, the Chapter 11 tribunal had before it a solid precedent.[154] Predictably, claimants Azinian et al. argued that the tribunal was not bound by these findings or rulings.[155] Specifically, they stressed the *Amco* pronouncement that "an international tribunal is not bound to follow the result of a national court."[156] The panel at first acknowledged this precept, and pointed out that it would be "unfortunate if potential claimants under NAFTA were dissuaded from seeking relief under domestic law from national courts, because such actions might have the salutary effect of resolving the dispute without resorting to investor-state arbitration under NAFTA."[157]

But ultimately the panel rejected Azinian's argument that the findings of the lower court should be ignored. The panel pointed out that the decision of the State Administrative Tribunal to annul the contract had itself been reviewed and upheld on the basis of the

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149 *Azinian v. Mexico, supra* note 49, at para. 1.

150 *Id*. at para. 17.

151 *Id*. at para. 20.

152 *Id*. paras. 21, 23.

153 *Id*. at paras. 24, 36.

154 This in contrast to the Article 1105 claim raised by LG in *Loewen*, the facts of which had not been subject to appellate review within the United States prior to the parties' seeking NAFTA arbitration.

155 *Azinian v. Mexico*, at para. 86.

156 *Id.*

157 *Id.*

Mexican law governing the validity of public service concessions.[158] "A governmental authority surely cannot be faulted," said the panel, "for acting in a manner validated by its courts unless the courts themselves are disavowed at the international level."[159] The panel went on to articulate a denial of justice standard, despite that Azinian et al. had not actually alleged one:

> *What must be shown is that the court decision itself constitutes a violation of the treaty*. Even if the Claimants were to convince this Arbitral Tribunal that the Mexican courts were wrong with respect to the invalidity of the Concession Contract, this would not per se be conclusive as to a violation of NAFTA. More is required; the Claimants must show either a denial of justice, or a pretence of form to achieve an internationally unlawful end.[160]

In the words of the panel, "the question is whether the Mexican court decisions themselves breached Mexico's obligations under Chapter Eleven."[161] While the parties themselves did not challenge the findings and rulings of the Mexican courts, the panel chose to express in dicta what a denial of justice standard should require.[162] In so doing, the panel's ruling showed deference to the Mexican courts, all the while retaining the future authority to throw out decisions that rise to the level of denial of justice.

The panel then went on to make its own factual determination that the concession contract had been induced by fraud.[163] Based on its earlier dictum that "*what must be shown is that the court decision itself constitutes a violation of the treaty,*" we can only assume that the panel would have found for Mexico even if its factual determinations had been contrary to those of the Mexican courts.[164] In other words, the panel should have found for Mexico even if they were to discover that there was not in fact fraud, so long as the errors of the Mexican courts did not rise to the level of denial of justice. In this way the *Azinian* decision further defines the place of *res judicata* in international commercial arbitration: While the panel retained the authority to

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158 *Id*. at para. 99.

159 *Id.*

160 *Id.* [emphasis in original].

161 *Id*. at para. 97.

162 *Id*. at para. 100 ("[t]he Claimants have raised no complaints against the Mexican courts; they do not allege a denial of justice. Without exception, they have directed their many complaints against the [acts of the local government].").

163 *Id* at para. 104.

164 *Id*. at para. 99 [emphasis in original].

disregard the findings of the domestic court in the event of denial of justice, it nonetheless granted considerable deference to those findings where no denial of justice was evident.

It is noteworthy that the *Mondev* tribunal, in denying its role as appellate court with regards to domestic court decisions and rulings, cited the *Azinian* decision: "The possibility of holding a State internationally liable for judicial decisions does not, however, entitle a claimant to seek international review of the national court decisions as though the international jurisdiction seised has plenary appellate jurisdiction. This is not true generally, and it is not true for NAFTA."[165]

## IV. THE FUTURE OF ARBITRAL PANEL-DOMESTIC COURT RELATIONS

The *Mondev*, *Loewen* and *Azinian* panels each, in their own way, disavow any role as appellate court to the domestic judiciaries of the NAFTA member-states. In at least one sense, this is true: Not one of the tribunals actually "overturned" a domestic court decision. Yet, this is largely because the disputes so far submitted to the tribunals have not warranted overturning. The ruling of the Massachussets SJC in the *Mondev* case, while unsatisfactory to the Canadian investors, did not rise to the level of "clearly improper and discreditable." *Loewen* represented a "miscarriage of justice," but the case was not submitted to the United States Supreme Court and therefore the US court ruling considered by the tribunal was not final. And since the Mexican court's rulings in *Azinian* did not themselves constitute "a violation of the treaty" in the form of a denial of justice, the panel in that case largely endorsed those rulings.

Still, as investors increasingly avail themselves of the dispute resolution mechanism that Chapter 11 affords them, the tribunals will inevitably encounter disputes that violate the standards that they themselves have set. What then? Each case has provided some guidance as to the proper standard of review of domestic adjudication, but the standard is neither clear nor uniform. Some clarification of the proper relationship between domestic courts and Chapter 11 panels is in order.

With respect to the rule of local remedies, Professor William S. Dodge has suggested that NAFTA be amended to officially require claimants to exhaust domestic remedies before submitting a claim to

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[165] *Mondev v. U.S.*, *supra* note 45, at para. 99.

Chapter 11 arbitration.[166] Article 1121 would have to be rewritten to require an exhaustion of domestic appeals – rather than their waiver – as a condition precedent to submission of a claim to Chapter 11 arbitration.[167] In support of a local remedy exhaustion requirement, Dodge explains:

> Requiring a foreign investor to exhaust its domestic appeals before filing a Chapter 11 claim based on a court judgment would allow the domestic court system to correct its own mistakes. It is safe to predict that in most instances the domestic court systems of the United States and Canada would correct their mistakes because a court judgment that violates Chapter 11 is also likely to violate some provision of domestic law.[168]

Indeed, such a requirement would likely have prevented the unsatisfactory outcome of the *Loewen* decision. Had LG filed for US Supreme Court review of the Mississippi Supreme Court's decision, the tribunal could not have dismissed the Article 1105 claim for lack of finality. Having produced a "final" domestic court judgment, LG would have been entitled to a tribunal decision on the merits. This is true even if LG had been denied a writ of *certiari*, as the rule of exhaustion of local remedies requires only that claimant *seek* all remedies available. It is, of course, far from clear what the tribunal would have provided in the way of redress for LG in such a case, as a Chapter 11 tribunal has not yet had occasion to "vacate" a domestic court's award.

There is an additional component to Professor Dodge's proposed reforms. There may be, from the point of view of the investor-claimant, a "risk" associated with pursuing local remedies. "An investor who does pursue its domestic remedies before turning to Chapter 11," explains Dodge, "runs the risk that the Chapter 11 tribunal will treat the domestic decision as *res judicata*."[169] Dodge cites by way of example the deference paid by the Chapter 11 Tribunal to the Mexican court's findings in *Azinian.*[170] Investors in Azinian's situation, cognizant of the fact that any domestic court findings would be given *res judicata* effect, may choose to forgo domestic litigation altogether. They would instead opt for international arbitration at the

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[166] William S. Dodge, *Loewen v. United States: Trials and Errors Under NAFTA Chapter Eleven*, 52 DEPAUL L. REV. 563, 573-74 (2002).

[167] *Id*. at 573.

[168] *Id*.

[169] Dodge, *Waste Management, supra* note 34, at 190 n.38.

[170] *Id.*

outset, as this is generally seen as more impartial.[171]

In recognition of the fact that an exhaustion requirement may have a chilling effect on the pursuit of local remedies, Dodge proposes, in addition to a requirement to exhaust local remedies, that the outcome of such litigation be given no *res judicata* effect.[172] Dodge further urges the NAFTA member-states to invoke Article 1131(2) to issue binding interpretations of the treaty's text to this effect.[173] "Canada, Mexico, and the United States ought to use this power to resolve differences in interpretation by different tribunals, thus providing guidance and predictability for future cases," Dodge suggests.[174]

Such a reform has implications for the *Mondev* and *Azinian* cases. The Mondev tribunal, at pains not to act as an appellate court,[175] proclaimed a "clearly improper and discreditable" standard that was difficult to surmount. Had there been a binding interpretation to the effect that domestic decisions are not to be given *res judicata* effect, or at least a clear history of such practice, the tribunal may have found otherwise.[176] The same goes for *Azinian*, where the tribunal may have scrutinized the findings of the Mexican courts more closely had there been a clear directive to disregard the outcomes of domestic litigation. More importantly, future cases may arise that present a more questionable trial record than did the *Azinian* case. While the proceedings of the Mexican courts were shown by the *Azinian* panel to be fair, a future case may arise in which the domestic proceedings were less than ideal from the perspective of the investor, and yet not egregious enough to sustain a denial of justice claim. Under such circumstances Professor Dodge's suggested reforms could prove extremely important: A domestic judiciary's review of a local government action would not be given *res judicata* effect, while an investor could still challenge a domestic decision as a denial of justice.

We will never know what the alternative outcomes could have been in cases such as *Mondev* and *Azinian*. If Professor Dodge is to be

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[171] *See generally* Bjorklund, *Reconciling State Sovereignty*, *supra* note 140, at 585 (discussing other possible negative effects of such a change).

[172] William S. Dodge and David D. Caron, *Loewen Group, Inc. v. United States*, 98 AM. J. INT'L L. 155, 163 (2004).

[173] Dodge, *Waste Management, supra* note 34, at 190 n.38.

[174] *Id*.

[175] *See supra* notes 45-47 and accompanying text.

[176] Admittedly, an alternative outcome would have been unlikely. The *Mondev* panel's "clearly improper and discreditable" standard relates to denial of justice claims. As such, even if the panel was compelled to make different factual findings than did the domestic courts, a denial of justice claim would still be difficult to sustain.

believed, the decisions of domestic tribunals must not be given *res judicata* effect if we wish to continue to promote resort to these fora as a prerequisite to pursuit of international arbitration. It warrants mentioning that not all commentators are as sanguine in their predictions. Professor Andrea Bjorklund suggests that Professor Dodge may "overestimate" the likelihood that investors would avoid pursuit of local remedies if the principle of *res judicata* is not explicitly eschewed.[177] Professor Bjorklund cites Loewen by way of example: The panel's criticism of the Mississippi judiciary "leaves open the possibility that denials of justice could in some cases result in international delict."[178]

If future investors are required to exhaust all available local remedies before submitting a Chapter 11 claim to arbitration, and the decisions of the local courts are given no *res judicata* effect, then what we have created is a full-fledged court of appeal. As we have seen, there is much to be said for such a model: Exhaustion of local remedies serves valuable social policies, while eschewing *res judicata* would still allow for disinterested review of domestic decisions. However, to subject a United States Supreme Court ruling to international review would not come without a political cost. While Chapter 11 tribunals have not yet seen a case combining the requisite jurisdictional and factual elements that would allow for such a situation, *Mondev*, *Loewen* and *Azinian* each establish precedent that virtually ensures such an occurrence in the future.

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[177] Bjorklund, *Waiver and Exhaustion*, *supra* at note 133, at 278.

[178] *Id.*