# The United States-Mexico-Canada Agreement: Reduced Investment Protection in Mexico, the United States and Canada

After more than a year of tri-party negotiations marked by tension and trade-offs, the U.S., Canada and Mexico have agreed to the renegotiated terms of the North American Free Trade Agreement (NAFTA), now called the United States-Mexico-Canada Agreement (USMCA).[1] Commentators have suggested that the nations rushed the negotiations in order to agree to a final text before the Mexican president-elect Andrés Manuel López Obrador takes office on December 1, 2018.

**If passed, the USMCA will drastically reduce protections that the NAFTA offered foreign investors, both in terms of the guarantees provided and the investors who will be eligible to bring such claims.**

Whether the USMCA becomes law depends on required domestic legislative review in the U.S., Canada and Mexico, which will not occur, at least in the U.S., until after the U.S. midterm elections in November. Following ratification, the USMCA will replace the current NAFTA after a three-month period. According to Mexican Economy Minister Ildefonso Guajardo, the USMCA could go into effect in the second half of 2019.

As we reported in an earlier *Alert*, the USMCA introduces important changes regarding market entry in the agriculture, automotive, digital commerce and pharmaceutical sectors, expanding and encouraging production within the U.S. The USMCA also contains important provisions related to trade and investment, although the steel and aluminum tariffs will remain in place for now pending further negotiations. In this *Alert*, we focus on significant developments relating to Investor State Dispute Settlement (ISDS), which is a system designed to protect investors with cross-border investments from unlawful government measures. We explain the key changes to the tripartite ISDS system resulting from the USMCA, as well as guidance for affected clients.

**Investor State Dispute Settlement under the USMCA**

To encourage foreign investors to invest overseas, international treaties and free trade agreements like the NAFTA provide valuable guarantees to foreign investors to protect their investments, and allow companies and individuals to bring arbitration claims directly against host governments when those guarantees are violated. President Trump has long voiced his opposition to the NAFTA. Perhaps unsurprisingly then, the new USMCA drastically reduces the protections that the NAFTA offered to foreign investors, both in terms of the guarantees provided and the investors who will be eligible to bring such claims in the future.

**Elimination of Investor State Dispute Settlement with respect to Canada**

- *Elimination of ISDS between the U.S. and Canada.* The USMCA eliminates Canada from the tripartite ISDS system altogether, except for claims initiated prior to the eventual termination of the NAFTA. Where aggrieved by government conduct, Canadian investors in the U.S. and U.S. investors in Canada would have no direct right to commence arbitration against a host government, and instead would have to resort to national courts or petition their government to initiate a state-to-state arbitration. The loss of investment arbitration protection vis-à-vis Canada is significant. According to the latest UNCTAD statistics, Canada is the sixth most frequent investment arbitration respondent state globally (following, among others, Venezuela, Argentina and the Czech Republic).[2] Past claims against Canada have involved environmental or trade restrictions, affecting a wide range of industries, including lumber, mining, pharmaceutical and waste management. There are no other international agreements in place between the U.S. and Canada that would allow investors to pursue claims directly against the host state.

- *Elimination of ISDS between Canada and Mexico.* The USMCA also eliminates ISDS for Mexican investors in Canada and Canadian investors in Mexico. However, such investors may be able to rely on the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), a Free Trade Agreement signed between 11 countries on March 8, 2018 (which has not yet gone into effect).[3] According to the Government of Canada's website, each of the CPTPP parties is currently undertaking its own domestic procedures for implementation and ratification.

**The USMCA provides limited ISDS protection to U.S. investors in Mexico and Mexican investors in the U.S.; however, the extent of these provisions is unclear.**

**Limitations of Investor State Dispute Settlement between the U.S. and Mexico**

The USMCA provides limited ISDS protection to U.S. investors in Mexico and Mexican investors in the U.S. However, the extent of these protections is unclear, which may be a product of the rushed nature of the negotiations. Although the USMCA includes ISDS protections in one section of the treaty, many are then withdrawn or reduced elsewhere in the agreement. As a result, most (if not all) investors are limited to bringing claims over denial of national treatment, most favored nation treatment and direct expropriation. Most investors will no longer be able to bring claims for breach of the minimum standard of treatment, which historically has been the broadest investor protection and the most often successful claim. The following is a summary of the key ISDS changes introduced by the USMCA:

- *Transition from NAFTA to USMCA.* Pending ISDS claims under the NAFTA will continue to proceed under the NAFTA. In addition, investors who made investments covered by the NAFTA prior to its termination may bring claims under the NAFTA for up to three years after the date of NAFTA's termination. These provisions are significant because the investor protections provided by the USMCA are much more limited than those provided under the NAFTA.

- *Narrowed scope of the minimum standard of treatment.* The USMCA includes a clearer limitation on the scope of fair and equitable treatment protection, limiting investors to the protections granted under the minimum standard of treatment required by international law. This may only protect against state acts that are "egregious" and "shocking" — a much higher bar to recovery than recent jurisprudence finding that "arbitrary" or "discriminatory" conduct suffices to breach this standard. The USMCA also precludes claims based on an investor's "legitimate expectations" that the state would treat the investor consistent with the representations made to the investor at the time of their investment. Thus, for example, while prior NAFTA tribunals have found that a significant change to the permitting process represented to investors during a roadshow process would constitute a breach of the fair and equitable treatment guarantee because it violated the investor's legitimate expectations at the time of their investment, this type of claim is now carved out of the USMCA. The USMCA thus will dial back years of jurisprudence issued by NAFTA tribunals and reduce the level of protection afforded to investors.

**The USMCA will dial back years of jurisprudence issued by NAFTA tribunals and reduce the level of protection afforded to investors.**

- *National treatment and MFN treatment claims no longer permitted regarding the establishment of an investment.* In the past, investors could bring claims against a State resulting from unfair or discriminatory conduct in connection with their acquisition of an investment, such as, for example, favoritism in the awarding of government contracts or the granting of permits. Such claims are now excluded by the USMCA. Thus, investors will now be limited to bringing claims based on government measures that occur after the investment is made.

- *No claims for indirect expropriation.* Under the NAFTA, investors could claim for outright expropriation of their investment as well as indirect expropriation, i.e., where the government takes measures that are tantamount to expropriation because they effectively wipe out the value of the investment. For example, under the NAFTA, a state's ban on a chemical could entitle a company that invested to manufacture that chemical to claim compensation for the loss of its investment, particularly if the ban was imposed for protectionist or other impermissible purposes. Under the USMCA, claims for indirect expropriation will no longer be permitted as between the U.S. and Mexico.

- *Denial of benefits.* Denial of benefits clauses are often included in investment treaties to ensure that only bona fide investors from a covered state are able to claim under a treaty — for example, denying treaty protection to a holding company that does not conduct any economic activity in the state from which it is claiming. USMCA broadens the NAFTA denial of benefits clause to deny protection to companies established for the sole purpose of investment protection. Therefore, any company that is owned or controlled by an investor of a country that is not a member of the USMCA or of the country denying benefits may only assert claims under the USMCA if it has substantial business activities in the territory of the country denying benefits, and in at least one other USMCA country. This means that investors can no longer rely on holding companies to pursue claims under the USMCA, and would need to establish substantial business activity in at least two countries that are party to the USMCA in order to receive protection.

- *Requirement to pursue claims in local courts for 30 months.* The USMCA requires that investors pursue claims in the local courts of the host state for 30 months prior to submitting their claims to ISDS. This is significant because it requires investors to expend considerable resources obtaining judicial relief before the local courts of the host state, which is often futile where courts are biased in favor of the state officials accused of wrongdoing. The USMCA only allows investors to bypass this requirement if litigation in the host state courts would be "obviously futile" or "manifestly ineffective," a high standard that has not yet been defined by investment tribunals. In addition, there is a potential ambiguity for cases against Mexico, as cases submitted to the local courts of Mexico prior to arbitration could imply a waiver of rights under the USMCA.[4] It is difficult to square how an investor can be required to pursue local remedies in the courts for 30 months, and then face the risk of dismissal of its claim in arbitration for having pursued that mandatory step.

- *Covered government contracts in specific sectors.* Many of the above limitations on investment protection will not apply to disputes arising out of contracts with the host government related to oil and gas, power generation, telecommunications, transportation, or ownership and management of infrastructure (roads, railways, bridges, canals or dams). Such investors may take comfort in the fact that some of the above carve-outs, such as the exclusion of claims for indirect expropriation, do not apply to them. This provision apparently is designed to provide additional protections to U.S. investors entering into contracts with Mexican national authorities and state-owned enterprises, particularly in high-risk sectors such as oil and gas. However, other investors signing contracts with foreign governments are not entitled to this additional protection.

While the meaning of the many changes to the USMCA ISDS Chapter still needs to be fleshed out through interpretation and jurisprudence, it is clear that the USMCA significantly narrows the investor protections previously provided by the NAFTA for investors in many sectors. These changes are particularly important for industries susceptible to political interference, such as the oil and gas, mining, automotive and other regulated industries. Companies from the U.S., Canada or Mexico with foreign investments in other USMCA countries should consider the impact of the reduced ISDS protection they will have under the USMCA. Companies concerned about this reduced protection can consider restructuring their investment to gain access to stronger investment protection through third-country investment treaties, or other forms of investment protection.

**Companies concerned about this reduced protection can consider restructuring their investment to gain access to stronger investment protection through third-country investment treaties, or other forms of investment protection.**

[1] English text of the Agreement can be reached through https://ustr.gov/trade-agreements/free-trade-agreements/united-states-mexico-canada-agreement/united-states-mexico

[2] https://unctad.org/en/PublicationsLibrary/diaepcb2017d7_en.pdf

[3] The CPTPP signatory countries are New Zealand, Australia, Brunei Darussalam, Canada, Chile, Japan, Malaysia, Mexico, Peru, Singapore and Vietnam.

[4] Appendix 3 of USMCA provides that U.S. investors cannot make a treaty claim "if the investor or the enterprise, respectively, has alleged that breach of an obligation under this Chapter in proceedings before a court or administrative tribunal of Mexico."

If you have any questions about the matters addressed in this *Kirkland Alert*, please contact the following Kirkland authors or your regular Kirkland contact.

Javier Rubinstein
Kirkland & Ellis LLP
300 North LaSalle
Chicago, IL 60654
www.kirkland.com/jrubinstein
+1 312 862 3220

Mario Mancuso, P.C.
Kirkland & Ellis LLP
655 Fifteenth Street, N.W.
Washington, D.C. 20005
www.kirkland.com/mmancuso
+1 202 879 5070

Lauren Friedman
Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
www.kirkland.com/lfriedman
+1 212 446 4958

Sanjay J. Mullick
Kirkland & Ellis LLP
655 Fifteenth Street, N.W.
Washington, D.C. 20005
www.kirkland.com/smullick
+1 202 879 5111

Lucila I. M. Hemmingsen
Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
www.kirkland.com/lhemmingsen
+1 212 446 5925

Anthony Rapa
Kirkland & Ellis LLP
655 Fifteenth Street, N.W.
Washington, D.C. 20005
www.kirkland.com/arapa
+1 202 879 5019