

# North American Free Trade & Investment Report

WorldTrade Executive, Inc.

*Biweekly report on legal & financial issues affecting direct investment and cross-border trade in Mexico, the U.S., and Canada*

## Mexico: Procurement Laws

### Recent Modifications and Reforms Made to the Procurement Laws in Mexico: Are There Violations to Constitutional Principles?

By Alejandro López-Velarde (López Velarde, Heftye y Soria, S.C.)

As part of a policy towards more transparency in order to stop corruption in the granting of administrative contracts by Mexican public entities, the Mexican government amended on July 7, 2005, in the Official Gazette of the Federation (*Diario Oficial de la Federación*) the Public Acquisitions, Leases and Service Law (*Ley de Adquisiciones, Arrendamientos y Servicios del Sector Público*) ("Acquisitions and Service Law") and the Public Works and Related Services Law (*Ley de Obras*

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## Regional: Trade

### Canada-U.S. Lumber Dispute Threatens NAFTA Extraordinary Challenge Process

By Charles Owen Verrill, Jr. (Wiley Rein & Fielding)

The softwood lumber dispute between the United States and Canada has evolved into a standoff that threatens the integrity of the carefully structured process for resolving trade disputes under the North American Free Trade Agreement ("NAFTA"). In Softwood Lumber, the Canadian position that the U.S. industry is not threatened with injury by reason of Canadian exports has been vindicated by the Extraordinary Challenge procedures established under NAFTA. However, the United States refuses to acknowledge the NAFTA ruling, instead relying on a technicality to continue the collection of billions of dollars in duties. There are no signs that this dispute, which has put a severe strain on U.S./Canada relations, will be resolved despite the finality that NAFTA negotiators envisioned when they drafted the Extraordinary Challenge procedures.

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## HIGHLIGHTS

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# As We See It

## Mexico's Oil, Gas, and Energy Policy Options

By Sidney Weintraub (Center for Strategic and International Studies)

The difficulties Mexico faces in making decisions on oil, gas, and energy policy are essentially political, not technical. This does not make the problems easier to resolve; indeed, it makes them harder to deal with because technical issues can be approached head on, whereas political obstacles, rooted in the structure of government and society, can be surmounted only by means of complicated strategies. Technical operations of Pemex (Petróleos Mexicanos), Mexico's government-owned oil monopoly, are entangled in political considerations foisted on the company. These contribute to Pemex's low productivity (or, phrased differently, the company's excess employment for the output generated) and its periodic corruption scandals. What follows will deal with Pemex's finances, which are unbelievably complex and chaotic because of political, or should I say extraneous, demands placed on the company.<sup>1</sup>

Pemex, for some years now, has lacked funding to engage in sufficient exploration to find new sources of oil and gas. Deepwater exploration, which is expensive but where the prospects of significant findings are promising, has not been undertaken for want of money. Pemex also lacks the technical expertise for deepwater drilling, but this could be hired if the funding were available. Exploration is urgently needed because at present rates of use Mexico's proven reserves of oil will last only about 12 years. Mexico already imports a considerable amount of natural gas, and the country is in the process of converting the fuel for most of its energy generation from oil to natural gas. The domestic shortage and the high cost of imported gas is reducing the competitiveness of Mexico's high energy-using businesses. But there may well be much gas to be found in the deep waters of the Gulf of Mexico.

There are three main options for dealing with these problems: seek private, necessarily largely foreign, sources of investment for oil and gas exploration and exploitation; reduce the amount of Pemex revenue the

government takes for its own budgetary needs; or continue to muddle through and hope for the best. The third option is stated pejoratively, even though the government did luck out in the 1970s when new oil output came on stream; however, running a government based on an assumption of repeated good fortune is hardly a rational choice. Carrying out the first option involves running roughshod over deeply held emotions stemming from Mexican history, which led

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***Unless something unforeseen happens soon, such as a new oil find or discovering a large deposit of unassociated natural gas, the timing for some action to change oil, gas, and energy policy will probably come some time after the 2006 election, but during the next presidential sexenio (six-year term).***

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to setting up a government-owned monopoly in the first place after foreign owners of oil companies in Mexico rejected government requests. The second option would require changing the entrenched Mexican habit of low tax collections to relieve Pemex of being the cash cow for one-third of the federal government's budgetary needs.

With respect to the fiscal option, the current situation is as follows: Mexico now collects between 11 and 12 percent of gross domestic product in taxes; this amounted last year to about \$80 billion. Pemex provided about 6 percent of GDP, or \$40 billion, to finance the government budget. If the revenue take from Pemex were reduced by, say, one-half, this would leave Pemex with roughly an extra \$20 billion for its own needs. Pemex now obtains much of its needed funds from

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borrowing and is not in a position to increase borrowing much more. Pemex also obtains appropriations from the central government, but this is an uncertain and variable source. Further government appropriations for Pemex might be feasible this year and next because the government calculated its revenue from oil based on a price of \$27 per barrel for the Mexican oil mix, and the actual average export price has risen to almost \$40 per barrel. This kind of financing may not be available year after year.

In other words, in order to let Pemex keep an extra \$20 billion each year, tax collections would have to rise by at least that amount—and probably more, because a budget of 18 percent of GDP is inadequate to meet the need for better education and health care and a safety net for the old and the poor. The question of privatization could be finessed for now *if* Mexico were able to let Pemex operate as a normal company using its own earnings to make and carry out its own investment decisions. The “if” is a big one, but many Mexicans prefer this option in order to keep oil in Mexican hands. Earlier in its history, Pemex was able to make investments from its own revenue even after paying federal taxes, but this has not been the case for several decades.

The Mexican Congress recently passed legislation to reduce the taxes Pemex pays as of January 1, 2006. The bill is complex and the tax imposed on Pemex would vary with the price of oil and gas, but it was an effort to address the problem of Pemex financing. The early indication is that President Vicente Fox will veto the bill, presumably because it does not specify how the Treasury would get the revenue needed to make up the shortfall that would result. The president has until September 1 to act on the bill. If he does exercise his veto, a two-thirds majority in each chamber of the Congress could override it.

Choosing the other option of permitting private investment does not require the privatization of Pemex, only a willingness to allow joint ventures between Pemex and private interests, including foreign direct investment. Mexico would still own the oil in the ground, but the private investment would permit a risk-reward model that does not now exist. This model exists in Canada and Brazil and other countries that have government-owned oil companies. Action like that of Argentina, where the government-owned oil company YPF (Yacimientos Petrolíferos Fiscales) was completely privatized in 1995 during the Menem administration, is not necessary in Mexico. The Brazilian and Canadian models are working well.

The Mexican government could, of course, do both: relieve Pemex of some of its tax burden so that it can operate as a normal oil company; and also accept private-public joint ventures, especially for expensive deepwater exploration. When I last discussed the issue of deepwater drilling,

several Mexican officials and experts said they hoped it would be possible to identify a suitable site that straddled the territorial waters of Mexico and the United States, thereby permitting a joint venture that did not require a constitutional amendment, obviating the need to face the controversial and emotional issue of private investment in Mexico’s oil and gas resources.

The dangers Mexico faces are running out of oil both for domestic use and export in a relatively short period; of having to meet a growing bill for natural gas imports; and of failing to provide energy to all would-be users, or providing it at a cost that is so high as to encourage producers to move to locations where energy is cheaper. Unless good fortune intervenes, the decisions will probably have to be taken in the new administration that comes into office next year. Mexico has shown that it is able to make controversial decisions when it looks as if there will be economic hardship if nothing is done but economic benefit if long-standing policy is revised. One good example of this was the abandonment of import substitution policy—keeping high import barriers in order to protect domestic industries—following the financial collapse in 1982. This led to lowering import protection, joining the General Agreement on Tariffs and Trade, and later entering into the North American Free Trade Area with the United States and Canada. The two issues, trade protection and permitting private risk ventures for oil and natural gas, do not have the same emotional resonance in Mexican history, nor is trade policy a constitutional issue. But both require the readiness to adapt when the economic well-being of the population is at stake.

The internal debate on oil, gas, and energy policy is going on, as the recently approved bill on Pemex shows. The head of Pemex has declared that he believes policy change is urgently needed. President Fox tried early in his administration to change tax policy, but he failed to make headway because of congressional opposition. The debate may take on new resonance in the campaign for the presidency once it moves into high gear later this year and early in 2006, but a frontal argument in favor of change is unlikely. Those who seek change will probably seek to frame the debate around economic growth and meeting the country’s social needs, while the opponents will likely emphasize the constitutional question of accepting private investment and advocate spending cuts rather than raising tax collections. The presidential candidates are apt to discuss the future of Pemex but dance around the policy issues involved.

It would be hard, probably suicidal in terms of winning an election, for a presidential candidate to run on a platform that goes against a history of shunning foreign investment in the oil sector or that favors raising taxes. Carlos Salinas

did not run in 1988 on a platform of free trade with the United States. He came to that position subsequently, when it became evident that the needed foreign investment for development would not come from Europe, or elsewhere, without a welcome mat of legal assurance for investment in Mexico and the promise of the large U.S. market. In hindsight, it is clear that Salinas chose the right moment for his free-trade initiative; and he made his case on economic development grounds.

It is hard to predict when these two fundamental criteria—the impending energy shortage and the proper timing—will become simultaneously evident to the Mexican public. Unless something unforeseen happens soon,

such as a new oil find or discovering a large deposit of unassociated (i.e., not associated with oil) natural gas, the timing for some action to change oil, gas, and energy policy will probably come some time after the 2006 election, but during the next presidential *sexenio* (six-year term).

<sup>1</sup> The May 2005 *Issues in International Political Economy*, no. 65, dealt with this theme of politics dominating oil and gas policy in many Latin American countries.

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# MEXICO

## Taxation

### Potential Issues for Mexican Tax Reform Debate

By Marc Schwartz (Schwartz Advisory Services, Inc) and José Juan Miranda (M&V Asociados)

Each year the annual budget the Mexican Congress approves for the following year generally contains amendments to various tax laws.

Since becoming President, Vicente Fox has introduced significant tax reform proposals that have for the most part been rejected by the opposition controlled Congress.

Students of Mexican tax over the past few years have therefore seen more piecemeal changes in the various tax laws, as opposed to an overhaul of any one law.

This article briefly examines some of the potential tax issues that might be debated in Congress later this year.

#### Mergers

In 2004, the Congress passed a law providing that a company would need prior authorization from the Mexican tax authorities if it were to engage in a tax-free merger within five years after a tax-free merger or split-up.

It is possible that there will be further restrictions on such mergers taking place within the five year period.

The major concern of the tax authorities appears to relate to ensuring appropriate use of tax losses in light of the fact that Mexico does not have a rule similar to the U.S. Internal Revenue Code's Section 382 loss limitation.

#### Residency

There is discussion surrounding when and whether an individual may be considered a tax resident in Mexico as well as in a second country.

#### Liability for Unpaid Taxes

There may be an attempt to hold tax advisors jointly liable for a company's unpaid tax when related to a tax opinion drafted by the advisors in cases where the tax authorities hold that the related transaction was primarily tax motivated.

The Executive branch, Congress, the business community in general and the tax community in particular will likely debate the above issues, along with others that arise during the next few months.

Mexico continues to collect tax revenues which comprise a smaller portion of GDP than the majority of its neighbors in Latin America.

The Executive branch and Congress will continue to debate the economic and political issues related to the most "appropriate" way to increase government revenues, improve enforcement and collection of taxes and to drive economic growth. The next few months will provide at least short-term answers.

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## Trade

# Mexico Signs Two New Bilateral Investment Treaties

By Alejandro Faya-Rodríguez

Mexico has recently signed bilateral investment treaties (BITs) with Iceland and Australia, on July 22 and August 23, 2005, respectively. Once approved by the Mexican Senate, these two new instruments will form part of the current group of investment treaties composed of 18 BITs and 11 free trade agreements (having an investment chapter or title)<sup>1</sup> to which Mexico is a party. These treaties grant, on a reciprocal basis, preferential treatment for investment activities with respect to 42 countries.

From the Mexican perspective, the negotiation of international investment agreements is a component of a governmental policy that looks for:

- a greater diversification of investment inflows;
- major stimulation of business initiative;
- a better and more favorable climate for productive foreign direct investment; and
- an improvement of the conditions of Mexican entrepreneurs investing abroad.

These goals are facilitated through the diminution of the levels of non-commercial risks associated with cross-

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***Over the last decade, Mexico has forged an outstanding tradition and capacity for international negotiations.***

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border investment projects and the guarantee by the host State (through a long-term international commitment) to abide by specific standards of treatment with respect to foreign investors and their investments; and precisely, these goals are the objectives of international investment agreements, and more specifically, of BITs. The referred-kind treaties may not increase investment flows *per se*, but they certainly constitute very useful promotion tools and supplementary schemes for that purpose, as they increase the levels of investors' confidence, predictability and legal certainty.

According to UNCTAD reports, at the end of 2004 BITs worldwide had reached 2,392, and the number is likely to

grow (although at a lower pace since most BITs were negotiated in a boom period during the 90s) as many countries of all type -economically and politically- are still actively negotiating and signing these kind of instruments. New BITs, however, tend to be more complex or clearer in their normative content since they take into account experience (reflected in arbitral cases) and the evolution of the international law on foreign investment.

### Content

The BITs signed with Iceland and Australia, as all others signed by Mexico, apply to the "post-establishment" phase of the investment; that is to say, they cover all such investments<sup>2</sup> made by investors<sup>3</sup> of one Contracting Party (regardless of the economic sector involved) and established in the territory of the other Contracting Party (host State or receiver) in accordance to its laws and regulations. Therefore, these BITs are without prejudice of the restrictions and limitations applicable to the foreign investment set forth in domestic laws.<sup>4</sup>

As previous BITs signed by Mexico, these BITs primarily oblige the Contracting States to:

- Accord to investors and/or their investments a non-discriminatory treatment by reason of their nationality, whether with respect to their own nationals (*i.e.* National Treatment) or *vis-à-vis* nationals of a third State (*i.e.* Most-Favored-Nation Treatment). These obligations apply in "like circumstances" and solely with respect to the management, maintenance, use, enjoyment or disposal of investments.
- Guarantee to investments a treatment in accordance with international law, including fair and equitable treatment and full protection and security. Worth to note is that the Contracting Parties expressly recognized and understood this standard as to the minimum standard of treatment of aliens in accordance with customary international law.<sup>5</sup>
- Accord to investors a non-discriminatory treatment in connection to compensations made arising from damages to their investments caused by armed conflicts or civil disturbances.
- Not to expropriate or nationalize an investment either directly or indirectly through measures tantamount to expropriation or nationalization, except for a public purpose, on a non-discriminatory basis, in accordance with due process of law and accompanied by payment of a "fair market value" compensation. The first case refers to direct expropriation, *i.e.* formal transfer of title or outright seizure of the investment, whereas the second (indirect) addresses

an action or a series of actions that have an effect equivalent to expropriation without an actual transfer of title or outright seizure having taken place.<sup>6</sup> This latter concept protects investors against arbitrary acts of the State that deprive the substantial value of an investment or that render it useless.

- Permit all transfers related to an investment to be made freely and without delay.
- Recognize the subrogation rights of a State or an agency thereof with respect to a guarantee or insurance (against non-commercial risks) it may grant to its investors.

Additionally, the BITs provide for a procedural section that sets forth the arbitral mechanisms for the settlement of disputes investor-State and State-to-State. In the former case, those arising from an alleged breach of the Agreement entailing a loss to the investor, and in the latter, for questions of interpretation or application of the Agreement. While the State-to-State disputes arising from BITs are uncommon if not inexistent, the investor-State disputes are quite common and continue to grow steadily. For instance, from three BITs-related disputes submitted at the end of 1994 to the International Centre for the Settlement of Investment Disputes of the World Bank (better known for its acronym, ICSID), at the end of 2004, one hundred and six disputes of that sort had been filed, eighty of which were instituted during the prior three years.

In the light of the foregoing, it would not be a surprise that in most BITs the State-to-State arbitration section is typically quite short whereas the investor-State is much more regulated. Mexico follows that approach, first used in the NAFTA Chapter 11. Such an approach is aimed at providing a minimum of legal certainty to the arbitral process and preventing the submission of frivolous claims by investors. Consequently, the BITs with Iceland and Australia contain provisions that relate, *inter alia*, to the scope and legal standing for the submission of claims, time limits, establishment of the arbitral tribunal, consolidation of multiple claims, place of arbitration, applicable law and awards and enforcement. It is important to emphasize that these BITs, consistent with the others previously signed by Mexico, provide for the settlement of disputes that arise exclusively from alleged *breaches of the treaties*, and not for breaches of domestic investment agreements, that typically have to refer to the domestic judiciary.

### Policy Considerations

Over the last decade, Mexico has forged an outstanding tradition and capacity for international negotiations. With respect to BITs, Mexico takes into account,

for entering into negotiations with a specific country, the following elements, among others:

- a *qualitative* aspect, that is, the relevance of the country to which Mexico has a specific interest, given its geographical location, geopolitical position or economic characteristics; and/or
- a *quantitative* aspect, that considers either the investment flows from the country concerned to Mexico, or from Mexico to such country, or both.

Although the investment flows with respect to Iceland and Australia are rather low (*quantitative element*), such countries present important qualitative elements. For instance, Australia is the fifteenth economy worldwide and a net capital exporter, having invested in the world during 2003 an approximate of 15.1 billion US dollars. Additionally, there are areas of great interest for Australian investors in Mexico, such as food and agriculture, educative services, energy, mining, infrastructure, telecommunications, automotive industry, industrial equipment, as well as health and environmental services. Furthermore, the BIT represents a significant contribution to the efforts made at APEC for improving the conditions for investment in the member economies of such cooperation mechanism.

As regards Iceland, despite its small economy, it is one of the richest countries in the world in relative terms (gross national product per capita), one of the most competitive, and besides it made investments overseas of more than 1.3 billion US dollars between 1998 and 2003. It is also characterized for being a pioneer in highly specialized economic sectors, such as fishing and energy products. Moreover, the BIT also complements the investment provisions contained in the Free Trade Agreement between Mexico and the European Free Trade Association, of which Iceland is a party (apart from Norway, Switzerland and Liechtenstein). Worth mention is that in article 47 of such treaty (Section V, Investment) the Parties committed themselves to foster an attractive and stable environment for reciprocal investment, among other mechanisms, through the signing of bilateral investment treaties; the BIT is certainly a response to that call.

Mexico currently maintains negotiations for investment agreements with key countries of Europe, Latin America and Asia, at the time it is actively participating in such international organizations that deal with foreign investment matters, such as the OECD, WTO, UNCTAD and APEC. There is no doubt that Mexico is a pioneer in the subject of foreign direct investment, not only because it has a strong capacity for attraction of foreign capitals, but also because it has been involved in key arbitration cases and in major international negotia-

tions related to this field. Therefore, Mexico has much to contribute, and it is certainly doing so.

<sup>1</sup> Mexico has BITS in force with Spain, Switzerland, France, Portugal, Greece, Germany, Italy, Czech Republic, Austria, Sweden, Denmark, Finland, the Netherlands, Belgium-Luxembourg Union, Argentina, Cuba, Uruguay and Korea. It also has 11 Free Trade Agreement containing an investment chapter or title with the following countries: NAFTA (Canada, United States), G3 (Venezuela, Colombia), CA3 (Guatemala, Honduras and El Salvador), Costa Rica, Bolivia, Nicaragua, Chile, European Union, European Free Trade Association, Uruguay and Japan.

<sup>2</sup> A broad definition of investment, that includes both tangible and intangible property, intellectual property rights, enterprises, equity and debt securities, and certain loans and claims to money, is included in both BITS.

<sup>3</sup> Such term encompasses natural and legal persons from one Contracting Party. The nationality of a legal person does not follow an "ultimate ownership" approach, but takes into account the place in which such legal person is constituted or otherwise duly organized.

<sup>4</sup> In the case of Mexico, for instance, it is worth remembering that pursuant to the Foreign Investment Law there are activities reserved to the Mexican State (such activities also regulated by the Political Constitution) or to Mexican nationals or Mexican enterprises wholly owned by Mexican nationals, activities subject to maximum percentages of foreign equity

participation, and activities subject to prior approval (of the National Commission for Foreign Investment) in case foreign stockholders pretend to have more than 49% of the enterprise's capital. However, these areas represent less than the 5% of the total economic activities in accordance with different industrial classification codes, thus making the foreign investment legal regime quite liberal.

<sup>5</sup> That is, to such rules of conduct of general and consistent practice followed by States from a sense of a legal obligation. Examples of these rules are the widely recognized principles of denial of justice, due process of law and lack of arbitrariness. This minimum standard evolves from time to time as it reflects effective practice.

<sup>6</sup> This provision does not have (and should not have) the effect (except for in very rare cases) to compensate because of legitimate and non-discriminatory regulation applied by the States, even if it causes an economic harm to the investor. That is a general principle of international law, as recently confirmed by *Methanex v. United States*, the latest NAFTA resolved case on Chapter 11 (Investment).

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*Públicas y Servicios Relacionados con las Mismas*) (Public Works Law)(jointly referred as the “Procurement Laws”).

As Mexico moves from a centralized economy to an open market economy many lucrative opportunities are developing for both domestic and international companies to contract with the Mexican government or its public entities in key economic sectors as oil and gas, telecommunications, railroads, highways, airports and power generation.

The most important State monopolies such as *Petroleos Mexicanos* (“Pemex”) and the Federal Electricity Commission (*Comisión Federal de Electricidad*) are governed by these Procurement Laws, whereby government expenditures related to acquisitions, leases, services and public works represent approximately 22% of the federal budget.

### General Legal Framework

Companies that wish to participate in the bidding process must consider the administrative issues established in the following laws: (i) Political Constitution of the United Mexican States (“Constitution”); (ii) Public Works Law and its Regulation; (iii) Acquisitions and Service Law and its Regulation; (iv) International Treaties such as NAFTA; (v) Budget, Accounting and Public Federal Expenditure Law; (vi) Federal Law on the Responsibilities of Public Servants; (vii) Legal Ordinances and decrees published in the Official Gazette of the Federation pertaining to the public entity involved in the public bidding process; (viii) Legal General Ordinances published by the Federal Controller Bureau (*Secretaría de la Función Pública* (“SFP”)), among others.

Both Procurement Laws are the most important congressional laws developing the Constitutional mandate for contracting with the public sector in Mexico. In fact, article 134 of the Mexican Constitution dictates that acquisitions, leases, services and public works, shall be awarded by public bidding after a public bid tender so that reliable proposals can be freely submitted in sealed envelopes, that shall be opened publicly, for purposes of insuring the State of the best available conditions with respect to price, quality, financing, opportunity and any other pertinent circumstances.

As it is reviewed below, some modifications made to the Procurement Laws may not be in compliance with the constitutional principle above-mentioned.

### The Procurement Laws

The general purpose of the Procurement Laws is to regulate acts related to planning, programming, budgeting, cost, execution, conservation, maintenance and con-

rol of the acquisition and leasing of personal property, the rendering of services of any nature and the public works and related services contracted by agencies of the Mexican public sectors. The Procurement Laws are stringent public policy-based laws, which cannot be avoided by parties dealing with administrative contracts. The most important modifications and reforms made on July 7, 2005 in the Official Gazette of the Federation are the following:

#### The Bidding Process

As a general rule, contracts between private parties and the Mexican Government or its public entities for acquisitions, leases, services and public works are awarded through a public bidding process, commonly referred to as “Public Calls”. Public Calls may be domestic and/or international. They must be simultaneously published in a special section of the Official Gazette of the Federation. As part of a policy towards more transparency during the bidding process the following modifications were made:

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### **Now public entities are allowed to account for considerations beyond price in awarding service contracts.**

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- (a) Any individual or corporation will be able to attend any bidding process without having to purchase the bidding guidelines. That is to say, the previous requirements of having acquired the bidding guidelines or having an invitation from the public entity were repealed.
- (b) The terms and conditions established in the contract cannot amend or modify the conditions established in the bidding guidelines.
- (c) Public entities shall publish pre-bidding guidelines on the Internet. The intention is to allow any interested party to participate and provide feedback observations. Nevertheless, it could be seen by participants as a possibility to manipulate the terms and conditions to be established in the final bidding guidelines. Consequently, it is expected that this modification could be challenged by competitors through the appeal process established in the Procurement Laws.
- (d) The officials of the public entities must answer in a clear and straight manner the questions posted by the suppliers during the questions and answers meeting.

- (e) There is a prohibition against establishing requirements with the purpose of directing the award to a specific participant or with the purpose of limiting the participation of other participants.
- (f) Participants will now only present one envelope that contains both the technical and the economic proposal instead of two envelopes. Nevertheless, if a participant delivers its proposals in two envelopes it cannot be disqualified.
- (g) The obligation to observe the principles of the Transparency and Access to the Public Governmental Information Federal Law (*Ley Federal de Transparencia y Acceso a la Información Pública Gubernamental*), which dictates that government entities have an obligation to provide information regarding their activities, financial situation and spending to citizens.
- (h) The use of electronic media to notify not only the participants but also the community regarding all of the bidding process as it is established in the following paragraph.

#### **Time Reduction for the Bidding Process**

One of the most important modifications made to the Procurement Laws is the reduction of the bidding process. Today, it is established that the bidding process will be carried out in two stages instead of three: (i) deliver and opening of the technical and economic proposal; and (ii) notification of the award. Further, public servants with a position of General Manager will be able to solve problems which were previously reserved to the General Director of the public entity providing a quick way to solve problems, make decisions and simplify further administrative proceedings. Further, the bidding process now is ended with the execution of the contract instead of the notification of the award.

#### **Use of Electronic Media**

The modifications aim to encourage the use of electronic media for the publication of the following:

- (a) Public entities annual budget.
- (b) Pre-bidding guidelines.
- (c) Bidding guidelines and further resolutions taken during the bidding process.
- (d) Restricted invitation to at least 3 participants.
- (e) The obligation to bid through electronic media to public entities that have been previously authorized by the SFP while the participants have the choice to do so through the electronic system or personally.

- (f) Contracts will be able to be executed when the system is in place and approved by SFP.

#### **Modification to the Lowest Price Rule**

One of the most important modifications made in the Acquisitions and Service Law concerns the modification to the lowest price general rule for service contracts. Now public entities are allowed to account for considerations beyond price in awarding service contracts including lowest price only account for 50% of the total award methodology value.

Regarding public works the award will be granted to the most convening economic proposal for the State through an award methodology value to be published by the SFP as well.

The above-mentioned modification is the result of a practical and legal need to allow other kind of award methodology since the Constitution and the Procurement Laws establish that contracts shall be awarded by public bidding after a public bid tender so that reliable proposals can be freely submitted for the purpose of insuring the State of the best available conditions with respect to price, quality, financing, opportunity and any other pertinent circumstances. With these modifications it is possible to avoid the rigidity of the Procurement Laws to contract the best price for the State. Now the modifications allow the possibility for the public sector to contract for better services and works even though same could be more expensive avoiding the true notion that "if you pay peanuts you get monkeys". Nevertheless, the SFP's award methodology could be subject to constitutional challenge since the constitutional general principles shall be developed by the Mexican congress through the promulgation of congressional laws. In other words, the President through the SFP does not have authority to issue general legal ordinances whereby the Constitution is interpreted and developed. The President only has the possibility to provide for further guidelines in regulations and general legal ordinances for the correct application of the congressional laws.

In addition to the above-mentioned constitutional challenge questions about corruption will be in the line regarding the discretionary authority provided to the public entities through the SFP's award methodology when a contract is granted to a participant whose bid was higher in price. This will trigger an appeal processes against the public entities.

### **Restricted Invitations and Direct Contracts**

In general, public entities may carry out acquisitions, leases, and public works within the scope of their accountability through a process whereby no less than three participants are invited to bid, when for instance (a) the contract may only be entered into with a specific person because it deals with works of art, patent ownership, copyrights and other exclusive rights; (b) the contract endangers or alters public order, the economy, public services, health, safety or the environment of an area or region of México; (c) acts of force majeure occur or other circumstances exists which may cause losses or significant additional costs; (d) the public contract previously awarded was canceled due to causes attributable to the contractor; (e) two public calls are issued and no reliable proposal has been received in response to either of them, among others. To the above-mentioned list was added with consulting, studies and investigation services.

Regarding direct contracts within the scope of their accountability, public entities may carry out direct awards when the amount of each operation does not exceed the maximum amounts established for such purposes in the Expenditure Budgets of the Federation and the Federal District. Direct contracts for acquisitions, leases, services and public works may be granted by the President of Mexico, when such contracts are performed exclusively for military purposes, the navy or are necessary to safeguard the integrity, independence and sovereignty of Mexico and guarantee national security. To this list classified information was added as a possibility to obtain a direct contract.

It is also established that 50% or more of the total value of the restricted invitations whereby no less than three participants are invited to bid and the direct awards shall be awarded to small and medium corporations. According with SFC's calculation such amount represents 10% of the total acquisition budget of the federal administration.

This modification might be subject to a constitutional challenge since article 134 of the Constitution dictates that public bids are taken in order to insure the State of the best available conditions with respect to price, quality, financing, opportunity and any other pertinent circumstance without taking into consideration if the participants are small or medium size corporations or part of any governmental program aimed to help such companies.

### **National Handicap Treatment**

In case that two participants or more have the same price in a national public call, public entities shall grant the contract to the participant that hire at least 5% of handicap employees. Although this modification is socially fair and convenient, it is not one of the elements contemplated by the Constitution for the evaluation of participants in a bidding process. Hence, it is expected that constitutional challenge will take place.

### **Fines and Suspensions**

Any participant that is economically sanctioned in accordance with the Procurement Laws shall be suspended from participating in future calls until the fine is paid to the Mexican government. Furthermore, the Procurement Laws now expressly establish who

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***The modifications and reforms were the results of a national and international survey including the opinion of commercial chambers, public sector, and the national and international private sector.***

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can and cannot participate in calls, specifying the criteria to determine who is banned from participating in future calls.

### **Contracts**

After having carried out the bidding process the administrative contract is granted to the winner. Administrative contracts have different characteristics than those entered into with private parties. Some of the most important differences that any participant has to keep in mind include (i) limitations to the participation of the parties at the time of creation; (ii) preferential treatment for public entities, as compared to the private enterprise; and (iii) legal effects against third parties. Part of the important modifications includes the following:

### **Budget and Future Contracts**

In exceptional situations public entities will have the possibility to execute contracts even if they have not received budgetary approval at the beginning of the year. Nevertheless, the Procurement Laws dictate that the parties will not be held responsible in the event that the budget is not authorized by the Mexican

Congress making the contract *null ad initio*. This addition to the Procurement Laws are intended to allow public entities to evaluate in advance potential works, acquisitions, leasing and services that need to be provided to public entities during the upcoming year. However, it is questionable that suppliers will take the risk to execute a contract and incur further expenses if budgetary approval is not given the following year.

#### **Foreign Currency and Payments**

In order to avoid currency exchange losses the Acquisitions and Service Law establishes that for international tenders, and for foreign suppliers, public entities will now be allowed to pay foreign contractors abroad in the currency stipulated in the contract. Nonetheless, if the payment is made in Mexico, it will be made in Mexican pesos.

On the other hand, the Public Works Law dictates that contracts that require payment in foreign currencies will now include mechanisms to review and adjust costs as necessary.

#### **Advance Payments**

In the event of executing an agreement which modifies the original contract, public entities will be able to grant advance payments up to the percentage established in the original contract.

#### **Finiquito of Contracts**

With the purpose of accelerating the delivery of the works and payment to the contractor, the modifications expressly establish that no longer than 60 natural days counted from the conclusion of the works, or the rescission of the contract, or the early termination, the *finiquito* of the contract shall be executed between the parties.

#### **Liquidated Damages**

The Procurement Laws establish liquidated damages in the event that the contractor for causes which are imputable to it, does not deliver the equipment or materials or carry out the work within the terms specified in the Contract. Further, the Procurement Laws authorize the payment of liquidated damages for administrative rescission or for not having delivered the proper documentation. The new modifications to the Public Works Law authorizes to public entity to choose one of the following options: (i) to apply the liquidated damages established in the contract; or (ii) to apply the over cost produced for the rescission of the contract. Regardless of

any of the options chosen by the corresponding public entity, pursuant to the Civil Code, the imposition of any of the above penalties must comply with the following rules:

- (i) Penalty clauses cannot exceed the principal amount obligation either in value or in amount.
- (ii) When the parties agree upon the establishment of liquidated damages, there can be no further claim for losses and damages. In other words, public entities cannot impose two monetary sanctions for the same event otherwise one of the two sanctions will be considered *null ad initio*.

#### **Conciliation**

Parties will be able to request additional time to resolve any controversy raised in the contract. Further, parties will be able to appoint an expert under their own cost to resolve the controversy.

#### **Bidding Guidelines vs Contracts**

An important modification to the Procurement Laws is the express stipulation that the terms and conditions established in contracts cannot amend or modify the conditions established in the bidding guidelines.

#### **Conclusion**

The Mexican government has made an important effort to provide more transparency in the bidding processes regulated by the Procurement Laws. The Procurement Laws represent two of the most important legal ordinances in the Mexican legal system is considerably that an important part of the federal budget is spent through their bidding processes.

The modifications and reforms were the results of a national and international survey including the opinion of commercial chambers, public sector, and the national and international private sector. Some of the modifications favor small and medium size corporations as well as participants that hire handicap employees. Further, the laws change traditional principles such as the "Lower Price Rule". However, part of such modifications could be subject to appeal process and constitutional challenge for possible violation of the bidding process principles established in the Mexican Constitution.

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# CANADA

## Trade

### Bicycles Global Safeguard Inquiry: CITT's Decision Signals Need for Surtax on Bicycles

By Greg Kanargelidis, Ken Purchase and Cliff Sosnow (Blake, Cassels & Graydon LLP)

On September 1, 2005, the Canadian International Trade Tribunal (CITT) published its Final Report in the Global Safeguard Inquiry into Bicycles.<sup>1</sup> The CITT has determined that imports of bicycles are a principal cause of "serious injury" to Canadian bicycle manufacturers and has recommended that the government of Canada impose a surtax on certain bicycles that are imported into Canada of 30% in the first year of application, 25% in the second year, and 20% in the third year. The surtax as recommended is to apply to bicycles, assembled or unassembled, with a wheel diameter greater than 38.1 centimeters (15 inches) with an FOB of CAN\$225 or less (equivalent to CAN\$400 retail).

However, the CITT has also recommended that certain bicycles imported into Canada be excluded from any surtaxes, including:

- (a) bicycles imported from countries with which Canada has entered into free trade agreements, namely, the U.S.A., Mexico, Israel or another CIFTA beneficiary, and Chile;
- (b) bicycles imported from "developing countries" other than China, the Philippines, Thailand, and Vietnam; and
- (c) certain types of bicycles specifically excluded from the CITT's recommendations.

Although the CITT received 26 exclusion requests covering a broad spectrum of bicycle types, the exclusions apply only to painted bicycle frames, bicycles with an FOB selling price exceeding CAN\$225 and folding tandem or recumbent bicycles.

#### Government of Canada to Decide on Next Steps

The CITT's recommendations must be adopted by the Canadian Government before duties will be applied to bicycle imports. It is too early to tell whether the Canadian government will take any action, and if

so, whether the federal government will impose surtaxes at the levels recommended by the CITT. If safeguards are imposed, they should be imposed on a prospective rather than retroactive basis. The government also must be prepared to negotiate concessions of equivalent value to the exporting countries affected. Therefore, while safeguard measures should serve to provide some degree of protection to Canada's

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***If the federal government implements the CITT's recommendations in whole or in part, the price of imported bicycles will very likely increase substantially and this will impact negatively foreign producers, importers, distributors, retailers, and in particular consumers.***

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bicycle industry, the trade concessions or compensation could harm other companies or sectors of the Canadian economy. The federal government will have to weigh the benefits and costs of taking safeguard measures and balance the interests of the bicycle producers with the interests of other Canadians.

In addition, safeguard measures are intended to be temporary. In this connection, the measures are being contemplated for a period of three years; however, the WTO Agreement on Safeguards permits such measures to be extended in certain circumstances for a total overall period of 8 years. Finally, safeguards are intended to be applied to imports irrespective of source. The CITT's recommendation to exclude Canada's free-trade partners could form the basis of a WTO challenge if the recommendations are adopted. Significantly, in every case in which safeguard measures have been challenged before the WTO, the measures were found to violate WTO rules. Therefore, it is likely that a vigorous debate and lobbying efforts will continue for some time following the September 1, 2005 release of the CITT's Final

Report. It is also possible that a decision by Canada to impose safeguard duties will result in a WTO challenge.

#### Planning Essential for Affected Traders

If the federal government implements the CITT's recommendations in whole or in part, the price of imported bicycles will very likely increase substantially and this will impact negatively foreign producers, importers, distributors, retailers, and in particular consumers. Affected companies should carefully consider the CITT's Final Report to determine whether the bicycle products they deal in are affected by the CITT's determinations and recommendations, or are excluded. In the case of companies whose business may be affected by the CITT's determinations and recommendations, legal options available should be considered and acted upon if thought warranted. Options include domestic remedies, negotiations and advocacy efforts with Canadian government officials on the scope of recommended exemptions, as well as consideration of remedies available under international trade rules.

<sup>1</sup> The CITT's Final Report is available from the CITT's website at [http://www.citt-tcce.gc.ca/safeguard/global/finalrep/gs2e001\\_e.asp](http://www.citt-tcce.gc.ca/safeguard/global/finalrep/gs2e001_e.asp)

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## Trade Action Against U.S. Exports of Grain Corn to Canada Appears Imminent

By Kim D.G. Alexander-Cook (Stikeman Elliott LLP)

On August 31, 2005, a coalition of corn producers associations from Ontario, Quebec and Manitoba ("Canadian Corn Producers") announced that they had filed a domestic trade remedy complaint under Canada's *Special Import Measures Act* (SIMA) alleging injurious subsidization and dumping of grain corn exported from the United States. According to the announcement, the Canada Border Services Agency (CBSA), the Canadian authority charged with dumping and subsidy investigatory power under SIMA, has already determined that the Canadian Corn Producers' complaint is properly documented. Assuming this is so, a further decision by the CBSA as to whether it will initiate an investigation based on the complaint will be made before the end of September, 2005.

If and when an investigation is launched, U.S. exporters and Canadian importers of U.S. grain corn will receive investigatory questionnaires from the CBSA requesting information on which to base a preliminary determination as to the dumping and subsidization claims. Depending on the CBSA's timing, provisional duties on imports into Canada of U.S. grain corn could face provisional duties before the end of 2005.

Five years ago, the Manitoba Corn Growers Association was unsuccessful in a similar dumping and subsidy action concerning U.S. grain corn. In that case, while the CBSA found both dumping and subsidization of U.S. grain corn to have occurred, the Canadian International Trade Tribunal (CITT) did not find sufficient evidence that "all or almost all" of the industry in Western Canada suffered injury (including retardation and threat of injury) as a result of the dumping and subsidization.

However, in that regional market case, domestic complainants faced the higher burden of demonstrating before the CITT material injury to "all or almost all" of the regional industry. Based on the fact that the current complainants include producers in Manitoba, Ontario and Quebec, it would appear that this new complaint will allege injury to the Canadian industry as a whole. On this basis, domestic corn producers may face only the lower burden of demonstrating "material injury to the domestic industry".

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### Competition

## Canadian Competition Bureau Seeks Tougher Rules for Dominant Firms

By Kim D.G. Alexander-Cook (Stikeman Elliott LLP)

The Canadian Commissioner of Competition (the Commissioner) has recently filed the Memorandum of Fact and Law (the factum) in her appeal to the Federal Court of Appeal of the Competition Tribunal's February, 2005 dismissal of an abuse of dominance and exclusive dealing case against Canada Pipe Ltd.<sup>1</sup> At the heart of the Commissioner's appeal, the Commissioner argues that the Tribunal "conflates the distinct statutory tests" for a practice of anti-competitive acts and preventing or lessening competition substantially in a relevant market.

In doing so, she argues, the Tribunal has failed to appreciate that for dominant firms, exclusivity discount and loyalty programs such as the Stocking Distribution Program (SDP) at issue in the Canada Pipe case are anti-competitive by definition. She then seems to argue that the program in question should be assumed to have anti-competitive effects.

Taken together, the arguments of the Commissioner seem to urge the Federal Court of Appeal toward treating certain business practices of dominant firms as *per se* illegal. Should the Commissioner succeed, the impact on business conduct of firms with large market shares could be significant.

### Competition Tribunal's Decision

The main conduct at issue was a loyalty program comprised of rebates and purchase discounts to distributors who offered Canada Pipe's Bibby Ste-Croix division exclusivity in supplying their cast iron drain, waste and vent (DWV) requirements. The Commissioner alleged that this program worked to substantially prevent competitors from gaining access to Canada Pipe's distributors and sought an order that would eliminate the program.

Under s. 79 of the *Competition Act* (the Act), there are three criteria to be satisfied for the Tribunal to issue an order: (i) the exercise of "market power" or "control" in the relevant market; (ii) a practice of anti-competitive acts; and (iii) the practice having had, having or likely to be having the effect of preventing or lessening competition substantially in a relevant market.

The Tribunal accepted that Canada Pipe held a dominant position (*i.e.*, exercised market power) in the relevant markets, but concluded that Canada Pipe's conduct was not intended to have a negative effect that was predatory, exclusionary or disciplinary as regards competitors, and that it did not prevent or lessen competition substantially and was not likely to do so.

### Commissioner's Appeal

The Commissioner argues that the Tribunal erred in determining whether SDP comprised a practice of anti-competitive acts by focusing largely on the effects of the SDP, rather than on the primary question of whether the purpose of the SDP was "predatory, exclusionary or disciplinary". The Commissioner argues that the SDP was "exclusionary on its face" and that, given Canada Pipe's dominant position, the "prac-

tice of anti-competitive acts" criterion of s. 79 of the Act is thereby satisfied.

As for the s. 79 criterion of a substantial lessening or prevention of competition, the Commissioner argues that the correct question for the Tribunal to ask is not "would markets be competitive but for the impugned act(s)", but rather, "... would markets — in the past, present or future — be substantially more competitive but for the impugned act(s)?" In urging the Federal Court of Appeal to apply this test, the Commissioner then argues, as has been argued successfully before the European Commission in *British Airways*<sup>2</sup>, that it should be assumed that a loyalty program such as the SDP by a dominant firm such as Canada Pipe necessarily has an anti-competitive effects in the relevant markets.

Should the Commissioner succeed before the Federal Court of Appeal in this case, the result could represent a significant shift in just what sales and distribution practices by dominant firms in Canada are permissible. Given that EC-style fines for abuse of dominance may soon be in place in Canada as well, firms with large market shares in Canada will watch this case closely.

<sup>1</sup> *Commissioner of Competition v. Canada Pipe Ltd.*, 2005 Comp. Trib. 3 (Competition Tribunal).

<sup>2</sup> *British Airways (Virgin /British Airways, O.J.L. 30/1 of 04-02-2000 (aff'd European Court of Justice (First Chamber), T-219-99 (17 December 2003).*

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# UNITED STATES

## Legislation

### Bankruptcy Act Facilitates Cross-Border Insolvencies and Has Benefits to Foreign Corporations

By Trey Wood, Courtney Tippy and Jennifer Stewart  
(Bracewell & Giuliani)

International insolvency has been subject to many inefficiencies and problems due to the absence of a comprehensive cross-border insolvency framework. However, on April 20, 2005, President Bush took a big step towards addressing this problem by signing the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

This legislation represents the largest overhaul of the United States Bankruptcy Code since its enactment in 1978.<sup>1</sup> While the Act largely impacts consumer and domestic bankruptcies, it also has important implications for cross-border insolvencies. The Act deleted Section 304 of the Bankruptcy Code, which governed cases ancillary to foreign proceedings, and replaced it with a new Chapter 15 devoted to cross-border insolvencies.

This chapter incorporates the Model Law on Cross-Border Insolvency (the "Model Law") which was promulgated by the United Nations Commission on International Trade Law ("UNCITRAL") in 1997 and provides for more efficient administration of cross-border insolvencies.

#### Revised Chapter 15 of the Bankruptcy Code

Under Section 304, valuable resources were wasted because of conflicts between legal systems, legal obstacles constrained foreign representatives and creditors' access to U.S. courts, and disparate treatment was accorded foreign and domestic creditors. Chapter 15 provides a simpler and more pragmatic legal framework for guiding parties through many of the issues that arise in the international insolvency context than did its predecessor, Section 304. As a result of this Act, more foreign companies will likely seek access to the United States Bankruptcy Courts.

In this article, we will highlight some of those provisions which should help the new Chapter 15 provide for a more coherent and efficient international insolvency program.

#### 1) Chapter 15 affords equal treatment to foreign and domestic representatives

Most importantly for foreign representatives, Chapter 15 mandates that foreign creditors be afforded, at a minimum, the same level of treatment as general unsecured domestic creditors. In other words, under Chapter 15, foreign creditors cannot be relegated to worse treatment solely on the basis of their foreign status. Foreign creditors and other parties in interest can be assured that, under a Chapter 15 case, they will be protected from adverse treatment in bankruptcy proceedings.

Chapter 15 also requires that whenever notice is provided to local creditors, such notice shall also be given to foreign creditors.

By informing the foreign creditors of the commencement of a proceeding, the notice requirement will provide foreign creditors with the opportunity to file their claims and will lead to an increase in foreign investment by assuring investors that, in case of default, their investments will be protected. Because of the statutized equality and notice requirements, foreign representatives should feel confident in utilizing the U.S. Bankruptcy Courts for their insolvency proceedings.

#### 2) Chapter 15 provides foreign representatives with greater access to U.S. courts

Under Chapter 15, a foreign representative can gain direct access to U.S. courts by filing a petition for recognition of the foreign proceeding directly with the court. If a court recognizes the foreign representative's case, a foreign representative may then sue or be sued in a court in the U.S. and may apply directly to a U.S. court for appropriate relief. At the same time, foreign representative can also be assured that the mere fact that it files an insolvency petition will not subject the foreign representative to the jurisdiction of the U.S. court for any other purpose. Therefore, U.S. courts will not assume jurisdiction over all the debtor's assets solely because the foreign representative filed a petition for relief.

#### 3) Under Chapter 15, recognition of a foreign proceeding by U.S. courts will be a simple and efficient process

Under Section 304, a foreign representative could originate an ancillary proceeding in the United States courts if there was a foreign proceeding outside the United States

involving the debtor. However, under Section 304, recognition of a foreign insolvency was often a cumbersome and costly process. While the procedural and substantive application of Chapter 15 will not significantly differ from Section 304, commencing a Chapter 15 case will be much easier than under Section 304 and should provide an additional incentive to foreign representatives to utilize U.S. courts in international insolvency proceedings.

A Chapter 15 case will be commenced by filing a petition for "recognition" of a "foreign main" or "nonmain" proceeding, which should be accompanied by proof that the foreign representative is approved in a foreign proceeding. Either formal certificates or certified copies of the foreign court's decision may accompany the petition.

Chapter 15, with its focus on cooperation and efficiency, allows a court to presume the authenticity of any document submitted in conjunction with the recognition process regardless of the legalization of such document.

By establishing such simplified proof requirements for recognition and relief for foreign proceedings, Chapter 15 reduces recognition to a simple documentary process and facilitates cooperation and coordination by making fast action possible, thereby preventing the dissipation of assets.

Although recognition under Chapter 15 is intended to be an efficient process, a U.S. court can also provide provisional relief while the application is pending. Such relief may include issuing a stay on execution against the debtor's assets or entrusting the administration of the debtor's U.S. assets to the foreign representative. Such temporary relief

will prevent the dissipation of assets and lead to the maximization of their value. Finally, once the foreign proceeding is recognized, additional forms of relief to the foreign representative may be provided.

#### 4) Chapter 15 mandates cooperation between courts and parties

Finally, Chapter 15 mandates that the courts and domestic representatives "shall cooperate to the maximum extent possible with a foreign court or a foreign representative." By demanding such cooperation, courts of the affected countries should be able to achieve the optimal results of value maximization, fraud prevention, and asset destruction by utilizing U.S. Bankruptcy Courts for their international insolvency matters.

### Conclusion

The benefits of Chapter 15's uniform, coherent framework to international insolvencies are great news for foreign corporations. Because Chapter 15 promotes equal treatment of all domestic and foreign creditors, cooperation between international parties and courts, and efficiency, as well as provides clear guidelines for determining what type of relief can be expected, foreign parties can expect greater legal certainty in international insolvencies.

<sup>1</sup> Most of the provisions, including those discussed herein, apply only to those cases filed on or after October 17, 2005.

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#### ➤ *Lumber, from page 1*

NAFTA Chapter 19 adopts a unique, optional procedure for review of antidumping and countervailing duty determinations by the administering authorities of one NAFTA Party involving imports from another Party. At the request of a Party, review of trade remedy decisions is entrusted to binational panels, composed of non-governmental experts in trade remedy law who are instructed to apply the law of the country imposing the remedy in reviewing decisions of the administering authorities. Thus, on appeal from U.S. decisions, the binational panels take the place of the Court of International Trade ("CIT"), an Article 3 Federal Court that otherwise has jurisdiction to review trade remedy decisions.

While panels are directed to follow the law of the NAFTA party imposing a trade remedy, there is no opportunity to appeal to panel decisions that is comparable to the

options available when a CIT decision is contested by a party to the litigation. Under Section 1596 of the U.S. code, CIT decisions can be appealed to the Court of Appeals for the Federal Circuit ("CAFC"), which has the obligation to apply anew the statutory standard applied by the CIT to the agency's decision.<sup>1</sup> Under that standard, the CAFC reviews a final administrative action to determine whether the agency determination, reasons and conclusions were supported by substantial evidence on the record or are otherwise in accordance with law.<sup>2</sup> The statute also provides that "the decision of the administering authority is presumed to be correct."<sup>3</sup>

This carefully constructed appellate procedure is not available when a NAFTA party contests a Chapter 19 determination by a binational panel. Instead, the losing party can only request review before a three member

Extraordinary Challenge Committee (“ECC”), which is selected from a roster of 15 retired or sitting judges, five from each NAFTA country. From this roster, the opposing countries each select one ECC member and they then draw lots to determine who gets to choose the third. Where there is an impasse on selection of the third member, the NAFTA Secretariat chooses the judge to complete the panel.

After the ECC is selected, it is charged with evaluating whether the panel decision under review shows:

- (i) gross misconduct, bias, serious conflict of interest, or other material misconduct on the part of a panelist;
- (ii) that the panel seriously departed from a fundamental rule of procedure; or
- (iii) that the panel manifestly exceeded its powers, authority or jurisdiction.

If any of these circumstances are found to exist, the ECC must then decide whether the action affected the panel’s decision and, if so, whether that decision threatens the integrity of the binational review process.<sup>4</sup>

The extraordinary challenge system was first adopted in the U.S./Canada Free Trade Agreement and later incorporated, with changes, in NAFTA. Since these agreements went into effect, there have been no successful challenges to panel decisions. All three challenges under the FTA resulted in affirmance of the binational panel. And, since NAFTA was adopted in 1994, there have been three additional challenges, including *Softwood Lumber*, all of which have been denied. The low rate of challenges, which is far below the percentage of trade remedy decisions appealed from the CIT to the CAFC, demonstrates the practical limitation on appellate rights imposed by NAFTA Chapter 19. This limitation is evident from the reasons for the failure of all these challenges under NAFTA.

In *Gray Portland Cement and Clinker from Mexico* (ECC-2000-1904-01 USA), the ECC failed to find evidence of gross misconduct, serious conflict of interest, or other wrongdoing despite “serious issues with regard to the particular determination of the panel....” The ECC concluded:

“[E]ven if the Binational Panel may have erred in its determination that the product definition in the Final Results was not supported by substantial evidence and that the agency failed to apply all the factors set forth in the relevant statutory provision, the Binational Panel did not act in a manner that violates the provisions of NAFTA Annex 1904.13. Rather, the ECC determines that the Panel proceeded precisely in the manner contemplated by the NAFTA binational review provisions. The ECC concludes that it is apparent that the Panel understood and applied the substantial evidence standard, as well as the *Chevron* doctrine of great deference to agency decisions, in its analysis, even if the manner in which it applied these

standards to the factual issue that is the subject of this petition appears to be erroneous from the perspective of the United States....”

In short, because the panel understood the law and applied the statutory standard, it was not relevant that in the opinion of the ECC, the “Panel erred in its legal determination that the Department of Commerce product definition was not supported by substantial evidence . . . and that the agency did not apply all the relevant statutory factors....”

The ECC’s approach in *Gray Portland Cement* is similar (without attribution) to the U.S. rule applicable to the enforcement of arbitral awards. Under the U.S. legislation that implements the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, the criteria for setting aside or refusing to enforce an award are similar to those applied by an ECC. The one criteria that is significantly different from the ECC procedures is the provision that awards will be refused if the “enforcement would be contrary to the public policy of that country.” (Article V.3.b.) In the United States, the public policy exception is, at least in theory, applied when the arbitrators have shown a “manifest disregard” for the applicable law. See *Wilko v. Swan*, 346 U.S. 436. The *Wilko* formulation has been criticized as dicta, but is said to be applicable when “the arbitrators understood and correctly stated the law but proceeded to ignore it.” *Sigal v. Titan*, 779 F.2d 891 (2d Cir. 1985). This seems to have been the unstated principle that led the ECC to uphold the panel decision in *Portland Cement*. That is, the ECC found that panelists correctly stated the law, and could not be faulted for improper application of it.

In the second ECC decision under Chapter 19, *Pure Magnesium from Canada*, Secretariat file no ECC-2003-1904-01 USA, October 4, 2004, the United States argued that the Panel engaged in a de novo review of the factual record. At issue was whether the respondents were likely to resume dumping if the order was revoked or whether the existence of long term contracts and a change in market dynamics made such resumption unlikely. The panel – after the second remand – rejected the Commerce Department’s findings concerning those factors and ordered that the order be revoked. The ECC concluded that the panel’s analysis “consisted in part of legitimate probing” of the Commerce decision on an earlier remand, but also that the panel “clearly based its findings on speculation respecting the long-term contracts and the relative profitability of pure versus alloy magnesium production.” Consequently, the panel “manifestly” exceeded its powers because it drew conclusions from assumptions and extrapolations.<sup>5</sup>

Having concluded that the challenge met the first prong of Article 1904.13, the ECC had no difficulty in finding that the “error had a material effect on Panel’s decision.” The ECC then turned to the question whether the Panel’s action threatened the integrity of the binational review process. Here, timing made all the difference. The Panel had relied in issuing its order on Judge Restani’s decision in Nippon Steel v. U.S. 223 F. Supp. 1349 (CIT 2002), which had been appealed but not decided by the CAFC when the panel’s decision was reached. The ECC concluded that panel’s action in Pure Magnesium resembled Judge Restani’s approach in Nippon, “including substituting its view of the evidence for that of the investigating authority and remanding the matter for remedial action.” And, while Nippon was subsequently overturned on precisely these grounds, Nippon Steel v. International Trade Commission, 345 F. 3d 1379 (CAFC 2003), the lower court decision “represented valid and existing U.S. law” when the Panel acted. (Para. 34) Since the panel applied U.S. law, the ECC found that “the Panel’s decision does not threaten the integrity of the binational review process.” (Para. 36).<sup>6</sup>

Most recently, the United States requested ECC review of the decision by a binational panel which ordered the International Trade Commission (“ITC”) to reach a negative determination in the injury phase of the Softwood Lumber antidumping and countervailing duty determinations. The panel went to great lengths to justify its decision, noting that there is “no” record evidence to support the Commission’s affirmative threat determination” and that it would be an exercise in futility to remand the case to the Commission. . . .” Citing Florida Power & Light Co. v. United States Nuclear Regulatory Commission, 394 U.S. 759, 766 (1969), the panel concluded this was the rare circumstance” where a remand would be an “idle and useless formality.”<sup>7</sup> Accordingly, the panel ordered the Commission to make a determination “that the evidence on the record does not support a finding of threat of material injury. . . .”

Consistent with the panel’s order, the ITC on September 10, 2004, by a 5 to 1 vote concluded as follows: The Panel’s Decision and Order of August 31, 2004, can only be seen as a reversal of the Commission’s affirmative determination of threat of material injury, despite the fact that neither the NAFTA nor U.S. law gives the Panel authority to reverse the Commission’s determination in these circumstances. As such, the Panel’s decision signals the end of this Panel proceeding.

Because the Commission respects and is bound by the NAFTA dispute settlement process, we issue a determination, consistent with the Panel’s decision, that the U.S. softwood lumber industry is not threatened with material injury by reason of subject imports from Canada. In so doing, we disagree with the Panel’s view that there

is no substantial evidence to support a finding of threat of material injury and we continue to view the Panel’s decisions throughout this proceeding as overstepping its authority, violating the NAFTA, seriously departing from fundamental rules of procedure, and committing legal error.

Chairman Koplman dissented, stating that he could not follow the panel’s order which he deemed unlawful.<sup>8</sup>

The ECC convened at the request of the United States upheld the panel decision in an opinion released on August 10, 2005. In its opinion, the ECC concluded that the panel did not manifestly exceed its authority by

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***Following the ECC decision, Canada issued a statement arguing that the “integrity” of NAFTA would be compromised by the continued collection of duties.***

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ordering the ITC to issue a negative determination. The ECC found that U.S. case law permits such actions in those “rare circumstances” where a remand would be an “idle and useless formality.” Since the panel cited this case law and made findings that remand would be “useless”, the ECC concluded that the panel did not exceed its authority. In addition, the ECC found that the U.S. challenge to the integrity of one of the panelists was unfounded.

Because the ITC had issued a negative determination in response to the panel’s direction on September 10, 2004, an action which the ECC affirmed, Canada reasonably expected the United States to revoke the antidumping and countervailing duty orders and refund the billions of dollars collected in duty deposits after the ECC decision. The United States, however, refused to accept the Chapter 19 outcome. Instead, the United States Trade Representative (“USTR”) has asserted that an ITC decision in response to a World Trade Organization (“WTO”) ruling concerning the same ITC threat of injury determination trumps the panel decision and justifies maintaining the duties in effect.

The ITC ruling relied on by USTR was made on November 24, 2004, two months after the negative determination required by the Chapter 19 panel. In the November ruling, the ITC reaffirmed the finding of threat of injury made in the original investigation that had been criticized in a WTO panel decision. Following that decision, the USTR requested the ITC to review its affirmative determination in light of the WTO panel’s critique. After obtaining additional data, and without mention of the earlier negative determination, the ITC again found

a threat of material injury by reason of dumped and subsidized Canadian lumber imports. This decision was appealed to the WTO which, on August 30, 2005, found that the new ITC ruling was consistent with the WTO obligations of the United States.

It is to be emphasized that this maze of rulings all stemmed from the initial determination of the ITC in the injury phase of the antidumping and countervailing duty investigations that led to the imposition of the remedial duties that are still being collected. The current imbroglio resulted after Canada appealed that decision to the WTO Dispute Resolution Body and to the NAFTA panel under Chapter 19 in a two-track attack on the remedial duties.

Following the ECC decision, Canada issued a statement arguing that the "integrity" of NAFTA would be compromised by the continued collection of duties. The United States responded that the remedial duties were justified because ITC's the so-called 129 ruling of November 2004 was all that is needed to satisfy the injury requirement of the WTO subsidies agreement notwithstanding the negative determination in response to the NAFTA panel order. This posture is politically popular

in the United States, but fails to give effect to the NAFTA determinations by the panel and ECC. However, Canada's options would appear to be limited. It could request arbitration under NAFTA Chapter 20 (a step that has not been taken), but it is difficult to envision the legal basis for an attack on the U.S. position.

Ironically, the Canadian decision to follow a two-track strategy of appealing the initial ITC determination to both the WTO and a Chapter 19 panel has – at the end of the day – seemed to have backfired. After all, if the ITC decision had only been challenged pursuant to NAFTA Chapter 19, there would be no basis for imposing duties since the ITC's negative injury determination would be the last word.

<sup>1</sup> *Torrington Co. v. United States*, 82 F3d 1039, 1044 (Fed. Cir. 1996).

<sup>2</sup> Sec. 19 USC § 156 1a(b)(1)(B)(i) (2000)

<sup>3</sup> 19 USC § 2639 (a)(1) (2000).

<sup>4</sup> NAFTA Article 1904.13.

<sup>5</sup> The ECC criticized the Panel for relying on sworn statements of company officers concerning long-term contracts and relative profitability because those statements were in briefs submitted by the parties rather than in the record. According to the ECC the Panel was "not correct in treating these statements as evidence." Para 20. Thus, the ECC found that the panel's decision was in part based on speculation.

<sup>6</sup> In "final observations", the ECC concluded that the difficulties of this "case would have been substantially reduced" if Commerce had followed the Panel's suggestion to reopen the record to take further evidence on the long-term contracts and relative profitability of alloy and pure magnesium. While Commerce agreed it had the power to do so, it did not and "as a result this panel felt compelled to make assumptions and extrapolations based on sworn statements and engage in a certain amount of fact-finding."

<sup>7</sup> The panel also cited *AdHoc Committee of Domestic Uranium Producers v. U.S.*, 162 F. Supp 2d 649 (CIT 2001) and *NTN Bearing Corp of America v. Unites States*, 132 F. Supp 2d 1102 (CIT 2001), as support for the proposition that under certain circumstances a remand is not needed.

<sup>8</sup> **Cite to ITC decision.**

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