No. 03-CV-23500
Ottawa Registry

**ONTARIO SUPERIOR COURT OF JUSTICE**

**IN THE MATTER OF AN ARBITRATION PURSUANT TO CHAPTER ELEVEN OF THE NORTH AMERICAN FREE TRADE AGREEMENT ("NAFTA") BETWEEN MARVIN ROY FELDMAN KARPA AND THE UNITED MEXICAN STATES, ICSID ADDITIONAL FACILITY CASE NO. ARB (AF)/99/1**

BETWEEN:

THE UNITED MEXICAN STATES

APPLICANT

AND:

MARVIN ROY FELDMAN KARPA

RESPONDENT

---

# APPLICANT'S FACTUM

---


THOMAS & PARTNERS — **SOLICITORS FOR THE APPLICANT**
30 Metcalfe Street, Suite 360
Ottawa, ON K1P 5L4
J. Christopher Thomas, Q.C.
J. Cameron Mowatt — Counsel
Tel: (613) 232-7522
Fax: (613) 232-7525

AND:

BORDEN LADNER GERVAIS LLP — **SOLICITORS FOR THE APPLICANT**
World Exchange Plaza
100 Queen Street, Suite 1100
Ottawa, ON K1P 1J9
Patrick G. Foy, Q.C.
Lawrence A. Elliot
Robert J.C. Deane — Counsel
Tel: (613) 237-5160
Fax: (613) 230-8842

McCARTHY TÉTRAULT LLP — **SOLICITORS FOR THE RESPONDENT**
Suite 1400, The Chambers, 40 Elgin Street
Ottawa, ON K1P 5K6
Barbara A. McIsaac, Q.C.
Robert Benjamin Mills — Counsel
Tel: (613) 238-2000
Fax: (613) 563-9386

**PART I: NATURE OF APPLICATION**

1. This is an application brought by the United Mexican States ("Mexico") to review a majority arbitral award (Arbitrator Covarrubias dissenting) made on 16 December 2002 in International Centre for Settlement of Investment Disputes (Additional Facility) ("ICSID Additional Facility") Case No. ARB(AF)/99/1 (the "Award") in favour of Marvin Roy Feldman Karpa (the "Claimant").

2. The place of the arbitration was Ottawa, Ontario, and this Court has jurisdiction to review the Award under the *International Commercial Arbitration Act*, R.S.O. 1990, c. I-9 (the "ICAA"). The ICAA implements in Ontario the *Model Law on International Commercial Arbitration* adopted by the United Nations Commission on International Trade Law on 21 June 1985 (the "Model Law").

3. The grounds for the Application are the following:

(a) Mexico was unable to present its case, contrary to Article 34(2)(a)(ii) of the Model Law, because – having informed the parties that it would only draw adverse inferences in the event of a party's failure to comply with its orders – the majority of the Tribunal drew impermissible inferences (in the absence of an order) from Mexico's compliance with its own domestic law governing taxation law enforcement and taxpayer personal privacy protection;

(b) the arbitral procedure adopted by the majority of the Tribunal was not in accordance with the agreement of the parties, contrary to Article 34(2)(a)(iv) of the Model Law, because it conflicted with the mandatory rules for the conduct of investor-State arbitrations under the NAFTA, in particular Article 2105 which prohibited the Tribunal from requiring Mexico "to furnish or allow access to information the disclosure of which would impede law enforcement or would be contrary to the Party's law protecting personal privacy";

(c) by requiring Mexico to pay to the Claimant, as damages, tax rebates to which the Tribunal previously held the Claimant had no legal right, the Award is, as the dissenting Arbitrator found, "repugnant", and is in conflict with public policy, contrary to Article 34(2)(b) of the Model Law.

4. Mexico has organized its Factum into five parts:

(a) in Part I, Mexico will present an overview of Chapter Eleven of the NAFTA, including its specific exceptions from the jurisdiction of investor-State arbitral tribunals (with particular reference to its treatment of taxation measures in Article 2103 and confidential information in Article 2105);

(b) in Part II, Mexico will review the circumstances giving rise to the claims made against Mexico, and the manner in which the Tribunal was constituted;

(c) in Part III, Mexico will outline the manner in which the arbitration proceeding unfolded (with specific reference to the Tribunal's orders regarding the production of documents). Mexico will also summarize the Award and elaborate upon the dissenting arbitrator's objection to the majority's finding that Mexico had failed to accord to the Claimant national treatment in accordance with Article 1102;

(d) in Part IV, Mexico will set out the grounds upon which the Award ought to be set aside under the ICAA and Article 34 of the Model Law; and

(e) in Part V, Mexico will set forth the order it seeks from this Court, namely an order setting aside the Award.

## A. Introduction to the NAFTA's Investment Chapter

5. Chapter Eleven of the *North American Free Trade Agreement* ("NAFTA") grants non-parties to the NAFTA ("investors") direct but limited access to arbitration against each of the three sovereign States who are the NAFTA Parties. Chapter Eleven arbitrations are conducted before *ad hoc* arbitral tribunals.

NAFTA, Articles 1115-1117 (Mexico's Case Book, Volume II, Tab 25).

6. Judicial review (or review by an "*ad hoc* annulment committee", depending upon the choice of the arbitral rules governing the arbitration) is also provided for in Chapter Eleven: if a disputing party objects to the award, it is not enforceable until after a court (or annulment committee as the case may be) has resolved an application to set aside the award and there is no further appeal.

NAFTA, Article 1136(3) (Mexico's Case Book, Volume II, Tab 25).

7. Chapter Eleven is divided into three parts.

8. Section A entitled "Investment" (which contains Articles 1101-1114) sets out the scope and coverage of the chapter and the substantive obligations, including national treatment, most-favoured-nation treatment, the minimum standard of treatment in international law, and a prohibition against expropriation without compensation.

NAFTA, Articles 1101-1114 (Mexico's Case Book, Volume II, Tab 25).

9. Section B entitled "Settlement of Disputes between a Party and an Investor of Another Party" (which contains Articles 1115-1138) sets out the basis upon which the Parties are prepared to submit to investor-State arbitration for alleged breaches of the obligations contained in Section A.

NAFTA, Articles 1115-1138 (Mexico's Case Book, Volume II, Tab 25).

10. Section C contains chapter-specific definitions.

NAFTA, Article 1139 (Mexico's Case Book, Volume II, Tab 25).

## B. The NAFTA's Investor-State Arbitration Mechanism[1]

### 1. The General Mechanism

11. Generally, international law provides that only sovereign States have the legal personality and right to enforce the international treaty obligations that exist *inter se*. However, States can by treaty grant rights of access to tribunals (both arbitral and judicial) to natural or legal persons who are then given the right to enforce obligations otherwise enforceable only by States.

12. This was done in Section B of Chapter Eleven. Pursuant to Article 1122, each NAFTA Party consented "to the submission of a claim to arbitration in accordance with the procedures set out" in the NAFTA.

> NAFTA, Article 1122(1), (Mexico's Case Book, Volume II, Tab 25).

13. A qualifying "investor of a Party" may in specified circumstances commence an arbitral claim against another NAFTA Party (but not its own) for damages for an alleged breach of certain obligations. A claim may allege a breach of the obligations set out in Section A of Chapter Eleven (and two obligations expressly incorporated from Chapter Fifteen). As discussed below, where a claim involves a taxation measure, a tribunal's jurisdiction is limited and does not include all of the obligations in Chapter Eleven.

> NAFTA, Articles 1116-1117 (Mexico's Case Book, Volume II, Tab 25). In addition, for the special case of financial services delivered through an investment, Article 1410:2 expressly incorporates certain of Chapter Eleven's rights and obligations into that Chapter. (Mexico's Case Book, Volume II, Tab 26).

14. Investor-State arbitration was the object of the 1965 ICSID *Convention on the Settlement of Investment Disputes between States and Nationals of Other States*, which provided for consensual arbitral proceedings against a State party to the Convention in respect of "any legal

---

[1] See generally J.C. Thomas, "Investor-State Arbitration Under NAFTA Chapter 11" (1999) *Cdn. Y.B. of Intl. Law* 99 (Mexico's Case Book, Volume II, Tab 30); H.C. Alvarez, "Arbitration Under the North American Free Trade Agreement" (2000) 16 *Arbitration International* 393 (Mexico's Case Book, Volume II, Tab 26).

dispute arising directly out of an investment, between a Contracting State (or any constituent subdivision or agency of a Contracting State designated to the Centre by that State), and a national of another Contracting State, which the parties to the dispute consent in writing to submit to the Centre".

> *ICSID Convention on the Settlement of Investment Disputes between States and Nationals of Other States*, done at Washington, D.C., 18 March 1965; entry into force 14 October 1966; published in 575 U.N.T.S. 159 (Mexico's Case Book, Volume II, Tab 24). Article 25 defines the Centre's jurisdiction.

15. Investor-State arbitration is derived from the long-standing practice of diplomatic protection. Traditionally, if it formed the view that one of its nationals had been mistreated by another State, a State, based upon the link of nationality, could take up its national's complaint as its own and espouse it either in negotiations or in dispute settlement proceedings with the other State:

> "…by taking up the case of one of its subjects and by resorting to diplomatic action or international judicial proceedings on his behalf, a State is in reality asserting its own rights – its right to ensure, in the person of its subjects, respect for the rules of international law."
>
> *Mavrommatis Palestine Concessions* (1924), PCIJ (Series A, No. 2) p. 12 (quoted in Sir Robert Jennings and Sir Arthur Watts, (eds.) *Oppenheim's International Law*, 9th ed. (Longman: London) at 512; excerpt at Mexico's Case Book, Volume II, Tab 35).

16. Diplomatic protection was criticized because of the national's loss of control over the matter; for example, the State might not accept the national's complaint as being serious enough to take up, or it might compromise the claim based on other considerations. The notion of permitting the injured person itself to directly elevate its claim to the international level resulted in the creation of the ICSID Convention and other treaties, such as the NAFTA, which confer this extraordinary remedy.

17. The resulting proceeding is, under the NAFTA, an international law proceeding. Article 1131, the treaty's Governing Law provision, requires a tribunal to "decide the issues in dispute in accordance with this Agreement [the NAFTA] and applicable rules of international law".

> NAFTA, Article 1131(1) (Mexico's Case Book, Volume II, Tab 25).

18. Investor-State arbitration differs in material respects from ordinary private international commercial arbitration. In *The Law and Practice of Commercial Arbitration in England*, Sir Michael J. Mustill and Stewart C. Boyd warn against reliance on generalized authorities to different types of arbitrations:

> Furthermore, when considering a reported case it is necessary always to bear in mind the type of arbitration with which it was concerned. Decisions and statements of principle, which were perfectly valid at the time, and remain good law today, may nevertheless yield completely false results if applied in a different context. A commodity arbitration on quality and a formal reference pursuant to statutory powers are both examples of arbitration, but they are barely recognizable as the same process, and attempts to transfer principles from one to the other will inevitably lead to error.
>
> Sir Michael J. Mustill and Stewart C. Boyd, *The Law and Practice of Commercial Arbitration in England*, 2nd ed. (Butterworths: London, 2001) at 54 (Mexico's Case Book, Volume II, Tab 34).

19. NAFTA tribunals themselves have reflected this view. A recent NAFTA tribunal (in which Lord Mustill participated, along with Sir Anthony Mason (former Chief Justice of Australia) and the Hon. Abner Mikva (former Chief Justice of the Federal Court of Appeals for the District of Columbia) confirmed that fundamental differences exist between private commercial arbitration and investor-State arbitration:

> 233. …Rights of action under private law arise from personal obligations (albeit they may be owed by or to a State) brought into existence by domestic law and enforceable through domestic tribunals and courts. NAFTA claims have a quite different character, stemming from a corner of public international law in which, by treaty, the power of States under that law to take international measures for the correction of wrongs done to its nationals has been replaced by an *ad hoc* definition of certain kinds of wrong, coupled with specialist means of compensation. These means are both distinct from and exclusive of the remedies for wrongful acts under private law: see Articles 1121,1131, 2021 and 2022. <u>It is true that some aspects of the resolution of disputes arising in relation to private international commerce are imported into the NAFTA system via Article 1120.1(c), and that the handling of disputes within that system by professionals experienced in the handling of major international arbitrations has tended in practice to make a NAFTA arbitration look like the more familiar kind of process. But this apparent resemblance is misleading. The two forms of process, and the rights which they enforce, have nothing in common. There is no warrant for transferring rules derived from private law into a field of international law where claimants are permitted for convenience to enforce what are in origin the rights of Party states</u>. If the effects of the change in ownership are to be ascertained we must do so, not by inapt analogies with

private law rules, but from the words of Chapter Eleven, read in the context of the Treaty as a whole, and of the purpose, which it sets out to achieve. [Emphasis added]

*The Loewen Group, Inc. and Raymond L. Loewen* v. *United States of America*, ICSID Case No. ARB/AF/98/3, Final Award (Mexico's Case Book Volume I, Tab 15).

See also: *United Parcel Service of America Inc. v. Government of Canada*, Decision of the Tribunal on Petitions for Intervention and Participation as *Amici Curiae* (17 October 2001) (Mexico's Case Book, Volume II, Tab 19).

20. One principal difference between private international commercial arbitration and investor-State arbitration under the NAFTA is that in the latter proceeding, the agreement to arbitrate is found not in an existing contract or specific *compromis* but rather in agreement formed by the investor's acceptance of the State's treaty-based offer to arbitrate a class of disputes in accordance with the procedures set out in the treaty. An agreement to arbitrate is formed when the investor accepts the offer and issues its own consent to arbitration. Relevant provisions of the NAFTA establish the content of the arbitration agreement. Like other consensual arbitrations, the agreement to arbitrate circumscribes the subject-matter of disputes, who has standing to bring a claim, and establishes other limits on the process.

NAFTA, Articles 1116-1117 (Mexico's Case Book, Volume II, Tab 25).

### 2. Exceptions

21. Like other international trade agreements, the NAFTA contains certain exceptions that permit laws, regulations or other measures that would otherwise be inconsistent with the treaty to be maintained. Some exceptions are chapter-specific, while others, found in Chapter Twenty-One (entitled "Exceptions") apply to the NAFTA as a whole.

NAFTA Chapter Twenty-One (Mexico's Case Book, Volume II, Tab 27)

22. Apart from Article 2103 (dealing with taxation measures) and Article 2105 (dealing with confidential information and law enforcement), both of which will be discussed below, other general exceptions found in Chapter Twenty-One include:

(a) Article 2101, which contains the general exceptions that apply to trade in goods and technical barriers to trade;[2]

(b) Article 2102, the National Security exception, which is modeled on Article XXI of the General Agreement on Tariffs and Trade and states that (subject to two specific provisions of the NAFTA) "nothing in this Agreement shall be construed . . . to require any Party to furnish or allow access to any information the disclosure of which it determines to be contrary to its essential security interests";[3] and

(c) Article 2104, entitled Balance of Payments, which states that "nothing in this Agreement shall be construed to prevent a Party from adopting or maintaining measures that restrict transfers where the Party experiences serious balance of payments difficulties, or the threat thereof, if the restrictions are consistent" with the rules set out in that Article.

NAFTA, Articles 2101, 2102, 2104 (Mexico's Case Book, Volume II, Tab 27)

### 3. Arbitration of "Taxation" Measures – Article 2103

23. In addition to the general limits on a NAFTA tribunal's jurisdiction, where a claim involves taxation measures, as was the case in the arbitration below, a tribunal's subject-matter jurisdiction is specifically circumscribed. Article 2103, "Taxation", is found in Chapter Twenty-One and sets out a general limiting rule:

> 1. Except as set out in this Article, nothing in this Agreement shall apply to taxation measures. [Emphasis added.]
>
> NAFTA Article 2103 (Mexico's Case Book, Volume II, Tab 27).

---

[2] It does so in para. 1 by expressly incorporating Article XX of the General Agreement on Tariffs and Trade (GATT) into the article. Para. 2 creates certain additional exceptions in respect of trade in services.

[3] This is almost identical to Article XXI (a) of the GATT which states: "Nothing in this Agreement shall be construed (a) to require any contracting party to furnish any information the disclosure of which it considers contrary to its essential security interests".

24. Paragraph 2 of Article 2103 then establishes the priority of any tax convention over the NAFTA:

> 2. Nothing in this Agreement shall affect the rights and obligations of any Party under any tax convention. In the event of any inconsistency between this Agreement and any such convention, that convention shall prevail to the extent of the inconsistency.
>
> NAFTA Article 2103 (Mexico's Case Book, Volume II, Tab 27).

25. Of relevance to the arbitration below, para. 4(b) of Article 2103 states:

> (b) Articles 1102 and 1103 (Investment - National Treatment and Most-Favored Nation Treatment)... shall apply to all taxation measures, other than those on income, capital gains or on the taxable capital of corporations, taxes on estates, inheritances, gifts and generation-skipping transfers and those taxes listed in paragraph 1 of Annex 2103.4, except that nothing in those Articles shall apply [to a list of exceptions which are not relevant to this proceeding] [Emphasis added.]
>
> NAFTA Article 2103 (Mexico's Case Book, Volume II, Tab 27).

26. According to this provision, therefore, a claimant can assert an alleged breach of national treatment insofar as a taxation measure is concerned. The Claimant was permitted to add such a claim to his original claim in the present proceeding.

> Award, footnote 4 at p. 8 (Record, Volume III, Tab 81).

27. Through the combined effect of Article 2103's paras. 1 and 4, unless a specific Chapter Eleven obligation is expressly listed in Article 2103 as being applicable to taxation measures, it cannot form the basis of an investor-State claim. Thus, for example, Article 1105, the Minimum Standard of Treatment, which is enforceable in investor-State arbitral proceedings involving non-taxation measures relating to investments, does not directly apply in the case of taxation measures. The NAFTA Parties were not prepared to have the actions of their respective tax authorities evaluated by tribunals for their consistency with international law, including fair and equitable treatment and full protection and security. As will be seen, this tribunal considered the Claimant's Article 1105 claim, as part of his Article 1110 claim.

28. Article 2103(6) governs taxation measures alleged to have given rise to an expropriation:

> 6. Article 1110 (Expropriation and Compensation) shall apply to taxation measures except that no investor may invoke that Article as the basis for a claim under Article 1116 (Claim by an Investor of a Party on its Own Behalf) or 1117 (Claim by an Investor of a Party on Behalf of an Enterprise), where it has been determined pursuant to this paragraph that the measure is not an expropriation. The investor shall refer to the issue of whether the measure is not an expropriation for a determination to the appropriate competent authorities set out in Annex 2103.6 at the time that it gives notice under Article 1119 (Notice of Intent to Submit a Claim to Arbitration). If the competent authorities do not agree to consider the issue or, having agreed to consider it, fail to agree that the measure is not an expropriation within the period of six months of such referral, the investor may submit its claim to arbitration under Article 1120 (Submission of a Claim to Arbitration).
>
> NAFTA Article 2103 (Mexico's Case Book, Volume II, Tab 27).

29. Where a U.S. investor brings a claim against Mexico, as in the case below, the competent authorities are the senior officials of the Treasury Departments of the United States of America and Mexico designated in Annex 2103.6: the Assistant Secretary of the Treasury (Tax Policy), U.S. Department of the Treasury, and the Deputy Minister of Revenue of the Ministry of Finance and Public Credit. The officials examine the taxation measure(s) alleged to have given rise to an expropriation and decide whether or not there is an expropriation.

### 4. No Disclosure of Confidential Information – Article 2105

30. In addition to the special rules that govern investor-State claims relating to taxation measures, such arbitrations are also subject to Article 2105, entitled, "Disclosure of Information", which states:

> Nothing in this Agreement shall be construed to require a Party to furnish or allow access to information the disclosure of which would impede law enforcement or would be contrary to the Party's law protecting personal privacy or the financial affairs and accounts of individual customers of financial institutions. [Emphasis added]
>
> NAFTA Article 2105 (Mexico's Case Book, Volume II, Tab 27).

31. Under this provision, nothing in the NAFTA, including the investor-State arbitration process, shall be construed to require a Party to furnish or allow access to certain classes of information.

32. Under Article 1131(2) of the NAFTA, the Parties, acting as the Free Trade Commission, reserve the right to issue binding interpretations of the Agreement. Any such interpretation "shall be binding on a Tribunal established under this Section [B]".

> NAFTA, Article 1131(2) (Mexico's Case Book, Volume II, Tab 25).

33. On 31 July 2001, the Commission exercised this right and issued a Note of Interpretation that clarified and reaffirmed the meaning of certain of Chapter Eleven's provisions. The first part of the Note addressed the transparency of such proceedings. It provided that, in general, nothing in the relevant arbitral rules imposes a general duty of confidentially or precludes the Parties from providing public access to documents submitted to, or issued by, tribunals. Each Party agreed to make public in a timely manner all documents submitted to, or issued by, such tribunals, subject to the redaction of confidential business information, information which is privileged or otherwise protected from disclosure under the Party's domestic law, and information which the Party must withhold pursuant to the relevant arbitral rules, as applied.

34. Having reaffirmed and clarified their approach to transparency of Chapter Eleven arbitral proceedings, the three NAFTA Parties, acting as the Commission, then stated:

> The Parties confirm that nothing in this interpretation shall be construed to require any Party to furnish or allow access to information that it may withhold in accordance with Articles 2102 or 2105.
>
> Note of Interpretation, 31 July 2001, signed by the Hon. Robert B. Zoellick, United States Trade Representative, the Hon. Luis Ernesto Derbez Bautista, Secretary of Economy, and the Hon. Pierre S. Pettigrew, Minister for International Trade.

### 5. Precedence of Exceptions Over Other Provisions

35. The relevant exceptions set forth in Chapter Twenty-One take precedence over all other provisions of the NAFTA applicable to investor-State arbitrations. Article 1112(1), entitled "Relation to Other Chapters" and described colloquially as the "underride" provision, confirms

that, in the event of any inconsistency between the application of Chapter Eleven and another Chapter of the NAFTA (for example, as between Chapter Eleven and Chapter Twenty-One), the other Chapter (Chapter Twenty-One) will prevail to the extent of any inconsistency.

> NAFTA, Article 1112(1) (Mexico's Case Book, Vol. II, Tab 25).
>
> See *Firemen's Fund, Inc.* v. *United Mexican States*, Decision on the Preliminary Question, ICSID Case No. ARB(AF)/02/01 (17 July 2003), where the Tribunal states at para. 71: "It is also to be noted that Chapter Eleven contains an underride clause in Article 1112(1) according to which in the event of any inconsistency between Chapter Eleven and any other Chapter, the other Chapter shall prevail to the extent of the inconsistency". (Mexico's Case Book, Volume 1, Tab 8).

### 6. Applicable Arbitral Rules

36. Chapter Eleven contemplates the claimant submitting its claim under one of three sets of arbitral rules:

(a) the ICSID Convention, provided that both the disputing Party and the Party of the investor are parties to the Convention;

(b) the Additional Facility Rules of ICSID, provided that either the disputing Party or the Party of the investor, but not both, is a party to the ICSID Convention; or

(c) the UNCITRAL Arbitration Rules.

> NAFTA, Article 1120(1) (Mexico's Case Book, Volume II, Tab 25).

37. At present, since neither Mexico nor Canada has acceded to the ICSID Convention, a claimant can only invoke either the ICSID Additional Facility Rules or the UNCITRAL Arbitration Rules.

38. The Claimant invoked the ICSID Additional Facility Rules when he filed his Notice of Arbitration. The Additional Facility was established by the World Bank to resolve disputes between foreign investors and a host State, like Mexico, that is not a signatory to the ICSID Convention.

> Notice of Arbitration, 30 April 1999 (Record, Volume I, Tab 2).

39. Insofar as the review of an award is concerned, the ICSID Additional Facility differs from the ICSID itself. ICSID arbitration is subject to an internal review mechanism known as an "*ad hoc* annulment committee". Article 53(1) of the Convention states that an award "shall not be subject to any appeal or to any other remedy except those provided for in this Convention". (The annulment remedy is set out in Article 52).

> *ICSID Convention on the Settlement of Investment Disputes between States and Nationals of Other States*, done at Washington, D.C., 18 March 1965; entry into force 14 October 1966; published in 575 U.N.T.S. 159 (Mexico's Case Book, Volume II, Tab 24).

40. In contrast, the setting aside of an award made pursuant to the Additional Facility Rules is governed by the law of the forum in which the award is made, including applicable international conventions.

> ICSID Additional Facility Rules, Article 3 (Mexico's Case Book, Volume II, Tab 23).

41. Aron Broches, the former general counsel to the World Bank, Secretary-General of the ICSID, and the principal drafter of the ICSID *Convention* and the ICSID Additional Facility Rules referred to Article 3 of the ICSID Additional Facility Rules and noted:

> This is an explicit reminder that the provisions of the Convention [providing for internal review of ICSID Convention awards by *ad hoc* annulment committees] are not applicable to Additional Facility proceedings. With respect to arbitration proceedings this means, *e.g.*, that awards, unlike awards rendered pursuant to the Convention, are not insulated from national law and that their recognition and enforcement will be governed by the law of the forum, including applicable international conventions.
>
> "The 'Additional Facility' of the International Centre for Settlement of Investment Disputes (ICSID)" (1979) *Y.B. Comm. Arb*. 373 at 376 (Mexico's Case Book, Volume II, Tab 32).

42. Review of a Chapter Eleven award is an integral part of Chapter Eleven. Under Article 1136(3), a disputing party may not seek enforcement of a Chapter Eleven award until after a court has resolved an application to set aside an award and there is no further appeal.

> NAFTA, Article 1136(3) (Mexico's Case Book, Volume II, Tab 25).

## C. Jurisdiction of Arbitral Tribunals and Consent to Arbitration Generally

43. The above provisions, together with the jurisdictional limitations that apply to Chapter Eleven tribunals in the ordinary course of events, apply in the case of an investor's claim based on taxation measures. They form part of the agreement to arbitrate.

44. A cornerstone of the law of arbitration is the requirement that the parties consent to the arbitration. That consent must comprehend not only the fact of arbitration but also the specific issues to be resolved by arbitration and may stipulate the governing law. A tribunal only has jurisdiction over those specific issues that the parties have agreed to submit to it and any award that goes beyond those issues will be susceptible to challenge. The arbitration agreement defines the scope of the submission to arbitration and the tribunal's powers thereunder.

45. Redfern and Hunter, *Law and Practice of International Commercial Arbitration*, state:

> An arbitration agreement does not merely serve to evidence the consent of the parties to arbitration and to establish the obligation to arbitrate. It is also a basic source of the powers of the arbitral tribunal…
>
> … it is the arbitration agreement that establishes the jurisdiction of the arbitral tribunal. The agreement of the parties is the only source from which this jurisdiction can come.
>
> Alan Redfern and Martin Hunter, *Law and Practice of International Commercial Arbitration*, 3rd ed. (Street & Maxwell: London, 1999) at 8 (Mexico's Case Book, Volume II, Tab 36).

46. Redfern and Hunter's comments on jurisdiction are reflected in investor-State arbitral rules. Consent is expressly required by Article 25 of the ICSID *Convention* and was described as the "cornerstone of the jurisdiction of the Centre" in the Report of the Executive Directors that accompanied the Convention when it was submitted to the governments of member States of the World Bank.

> *Report of the Executive Directors on the Convention on Settlement of Investment Disputes Between States and Nationals of Other States, 1965*, reproduced at 1 *ICSID Reports* 23 (Mexico's Case Book, Volume II, Tab 29).

47. The requirement for consent to arbitration applies equally to an ICSID Additional Facility arbitration, like the instant arbitration. In another NAFTA Chapter Eleven proceeding, it was held that:

> The essential constituent elements which constitute the institution of arbitration are the existence of a conflict of interests, and an agreement expressing the will of the parties or a legal mandate, on which the constitution of an Arbitral Tribunal is founded. This assertion serves to confirm the importance of the autonomy of the will of the parties, which is evinced by their consent to submit any given dispute to arbitration proceedings. Hence, it is upon that very consent to arbitration given by the parties that the entire effectiveness of this institution depends.
>
> *Waste Management, Inc.* v. *The United Mexican States*, ICSID Case No. ARB(AF)/98/2, Arbitral Award (2 June 2000) at para. 16 (Mexico's Case Book, Volume II, Tab 20).

48. Given the NAFTA Parties' limited consent to arbitration in Chapter Eleven, the need to carefully confirm jurisdiction has been accepted by NAFTA tribunals.

> *Waste Management, Inc*. v. *United Mexican States*, *supra*, at para. 16 (Mexico's Case Book, Volume II, Tab 20).
>
> *The Loewen Group, Inc. and Raymond L. Loewen* v. *United States of America*, Final Award (Mexico's Case Book, Volume I, Tab 15).
>
> *Firemen's Fund, Inc.* v. *United Mexican States*, Decision on the Preliminary Question, ICSID Case No. ARB(AF)/02/01 (17 July 2003) (Mexico's Case Book, Volume I, Tab 8).

49. This was also accepted by the Supreme Court of British Columbia in *United Mexican States* v. *Metalclad Corp.*, the first judicial review of a NAFTA award. That court applied a correctness standard in its review of the scope of the agreement to arbitrate constituted by Chapter Eleven of the NAFTA.

> *United Mexican States* v. *Metalclad Corp*. (2001), 89 B.C.L.R. (3d) 359 at paras. 70-74 (S.C.) (Mexico's Case Book, Volume I, Tab 17).

## PART II: THE ARBITRATION GIVING RISE TO THIS APPLICATION

### A. The Parties to the Arbitration

50. Mexico is a Party to the NAFTA.

51. The Claimant, Marvin Roy Feldman Karpa, is a national of the United States of America resident in Mexico City. He is the sole shareholder of a Mexican company named Corporacíon de Exportaciones Mexicanas, S.A. de C.V. ("CEMSA").

### B. The Tribunal's Establishment and Subsequent Conduct of the Arbitration

52. The arbitral tribunal that issued the Award (the "Tribunal") was formed as follows:

(a) on 30 April 1999, the Claimant filed a Notice of Arbitration with the ICSID Additional Facility in accordance with NAFTA Article 1120 requesting the Secretary-General to approve and register its application and permit access to the Additional Facility;

Award, para. 24 (Record, Volume III, Tab 81).

Notice of Arbitration, 30 April 1999 (Record, Volume I, Tab 2).

(b) on 27 May 1999, the Acting Secretary-General of ICSID issued a Certificate of Registration of the Notice of Claim granting the Claimant access to the Additional Facility;

Award, para. 24 (Record, Volume III, Tab 81).

(c) on 18 January 2000, the Secretary-General of ICSID deemed the Tribunal to have been constituted. The Tribunal comprised Professor Konstantinos D. Kerameus (President), Professor David A. Gantz, and Mr. Jorge Covarrubias Bravo. The arbitration proceedings were deemed to have commenced; and

Award, para. 25 (Record, Volume III, Tab 81).

(d) on 10 March 2000, the Tribunal determined the place of the arbitration would be Ottawa, Ontario.

Award, para. 26 (Record, Volume III, Tab 81).

53. The ICSID (Arbitration) Additional Facility Rules (the "Arbitration Rules") prescribe "two distinct phases: a written procedure followed by an oral one". The written procedure (on the merits) consisted of the following pleadings, each accompanied by copies of all documents and witness statements relied on in support of the pleading:

(a) the Claimant's Memorial (filed 30 March 2001);

(b) Mexico's Counter-memorial (filed 24 May 2001);

(c) the Claimant's Reply (filed 11 June 2001); and

(d) Mexico's Rejoinder (filed 25 June 2001).

ICSID Arbitration (Additional Facility) Rules, Article 36 (Mexico's Case Book, Volume II, Tab 23)

Record, Volume II, Tabs 60, 62, 68 and Volume III, Tab 74, respectively.

54. In addition to the substantive submissions, a number of procedural submissions were filed, and a number of procedural orders were made by the Tribunal. These procedural orders are important to this application and are discussed below in more detail.

55. A five-day oral hearing was then held from 9-13 July 2001. Each party was given an opportunity to require the other to produce for cross-examination any person who had submitted a witness statement. The Claimant cross-examined two of Mexico's witnesses, and counsel for Mexico cross-examined three of the Claimant's witnesses. Both parties made opening and closing statements.

56. The Award was rendered approximately eighteen months later on 16 December 2002.

57. On 30 January 2003, Mexico requested the Tribunal to correct and to interpret the Award.

> Letter from Respondent to ICSID, 30 January 2003 (Record, Volume III, Tab 82).

58. The Tribunal received further submissions from both parties. On 30 May 2003, the Tribunal issued a Decision on Correction and Interpretation of the Award. The Tribunal made a correction to the Award sought by Mexico (substituting CEMSA for Mr. Feldman as the party to whom damages were to be paid) but declined to accede to Mexico's request for an interpretation of the Award.

> Decision on Correction and Interpretation of the Award, 30 May 2003 (Record, Volume III, Tab 83).

## C. The Underlying Dispute Between CEMSA and the Mexican Fiscal Authorities Giving Rise to the NAFTA Claim

59. The following recitation of the facts underlying the Award is based upon the findings of the Tribunal. It should not be assumed that Mexico accepts the accuracy of all of the Tribunal's findings; rather, it is not necessary to address the Tribunal's treatment of the facts at this time in these proceedings.

60. The dispute between the parties is summarized by the Tribunal at para. 1 of the Award:

> 1. This case concerns a dispute regarding application of certain tax laws by the United Mexican States... to the export of tobacco products by Corporacíon de Exportaciones Mexicanas, S.A. de C.V. ("CEMSA"), a company organized under the laws of Mexico and owned and controlled by Mr. Marvin Roy Feldman Karpa., a citizen of the United States of America. . . The Claimant, who is suing as the sole investor on behalf of CEMSA, alleges that Mexico's refusal to rebate excise taxes applied to cigarettes exported by CEMSA and Mexico's continuing refusal to recognize CEMSA's rights to a rebate of such taxes regarding prospective cigarette exports constitute a breach of Mexico's obligations under the Chapter Eleven, Section A of the North American Free Trade Agreement... In particular, Mr. Feldman alleges violations of NAFTA Articles 1102 (National Treatment), 1105 (Minimum Level of Treatment) (sic), and 1110 (Expropriation and Indemnification)(sic). Mexico denies these allegations. [Footnotes omitted.]
>
> Award, para. 1 (Record, Volume III, Tab 81).

61. Mexico imposes a tax on production and sale of cigarettes (and certain other products) under the *Impuesto Especial Sobre Produccion y Servicios* (the "Special Tax on Production and Services" or "IEPS") law. The IEPS is a special or excise tax. The tax rebates at issue in the dispute can be available when certain products, including cigarettes, are exported from Mexico. The dispute between the Claimant and the Mexican taxation authorities (the Secretaría de Hacienda y Credito Publica, known by the acronym "SHCP" or as "Hacienda") concerned whether rebates could be claimed only by taxpayers who, in accordance with Article 4 of the IEPS statute, were in possession of invoices which separated out the tax paid on the purchase price or whether other taxpayers, such as CEMSA, could claim rebates on the exportation of cigarettes without having the IEPS tax paid separately stated on the purchase invoice. CEMSA was unable to obtain such invoices due to the Mexican cigarette manufacturers' refusal to sell directly to it and to provide it with invoices with the IEPS tax separately stated.

> Award, para. 7 (Record, Volume III, Tab 81).

62. As in other nations, certain local companies in Mexico have obtained licenses to manufacture cigarettes under internationally recognized brands such as Marlboro. Such licenses are limited to producing for and selling into a particular geographical territory. CEMSA engaged in the "gray marketing" of cigarettes, by purchasing them from volume retailers such as Wal-Mart or Sam's Club, at a price that included the IEPS tax, and exporting them.

> Award, para. 15 (Record, Volume III, Tab 81).

63. The payment of rebates was essential to CEMSA's cigarette exporting business. The Tribunal found that:

> 117. ... In economic terms, it would have been impossible for the Claimant to pay the price of the cigarettes in Mexico, including the 85% excise tax required under the IEPS law, and then sell the cigarettes in any foreign country. (Once the foreign nation added its own excise taxes upon importation, the Mexican cigarettes with both tax amounts included would have been priced far out of the market.)
>
> Award, para. 117 (Record, Volume III, Tab 81).

64. CEMSA began exporting cigarettes in 1990 and claimed rebates. The taxation authorities considered that cigarette resellers such as CEMSA did not qualify for rebates. In 1991 legislation was enacted to specify that a 0% rate applied to final exports by producers of the goods, and by foreign trade companies, as well as by persons entering into contracts with producers, including for sale abroad, as long as they complied with certain requirements to be issued by SHCP. As a reseller, CEMSA was not eligible for rebates.

Award, para. 10 (Record, Volume III, Tab 81).

65. The Claimant initiated a constitutional remedy known as an *amparo* action in the Mexican courts in February 1991 challenging the validity of the amendment. He alleged that it infringed upon the constitutional principle of "equity of taxpayers" by excluding all other exporters from the possibility of obtaining the 0% rate. While the *amparo* proceeding was underway, the Congress amended the IEPS law, effective 1 January 1992, to allow IEPS rebates to all cigarette exporters. CEMSA exported cigarettes and claimed rebates, without invoices, most of that year. In January 1993, according to the Claimant, Mexico shut down CEMSA's cigarette export business for second time because the Claimant could not meet the separate invoice requirements of the IEPS law.

Award, paras. 11-14 (Record, Volume III, Tab 81).

66. According to Article 4 of the statute, the IEPS tax on cigarettes (and all other products subject to that tax) must be stated "separately and expressly on their invoices" for the taxpayer to be able to claim a rebate. Only producers had the capability to separate the amount of the tax on the invoice. Since CEMSA purchased the cigarettes from volume retailers rather than the producers at a price that included the tax but did not have it separately stated on the invoice, CEMSA was unable to obtain invoices separating the tax.

Award, paras. 12-15 (Record, Volume III, Tab 81).

67. In August 1993, the Supreme Court of Justice ruled in favour of CEMSA, finding unanimously that "measures allowing the IEPS rebates only to producers and their distributors violated constitutional principles of tax equity and non-discrimination". The Court did not

discuss or rule explicitly on the other relevant issue, *i.e.*, whether CEMSA was entitled to rebates even though it was unable to produce invoices stating the tax amounts separately.

> Award, para. 16 (Record, Volume III, Tab 81).

68. The parties to the NAFTA arbitration differed as to the precise effect of the Supreme Court's ruling. The Claimant asserted that it confirmed CEMSA's constitutional right to export and claim rebates with or without invoices separately stating the amount of IEPS tax paid. Mexico asserted that the Court's ruling was narrower in scope in that it addressed CEMSA's status as a taxpayer but did not declare that it had an unqualified entitlement to rebates or that it need not otherwise comply with the invoicing requirements of the statute.

69. The Tribunal accepted Mexico's analysis of the Supreme Court's judgment, holding:

> 118. ... it appears to the Tribunal that the Claimant never really possessed a "right" to obtain tax rebates upon exportation of cigarettes, but only a right to the 0% tax rate.
>
> **
>
> 121. The problem for the Claimant is that a careful reading of the *Amparo* Supreme Court decision reveals no mention of Article 4; the discussion is confined solely to the availability of the 0% tax rate under Article 2 of IEPS law to resellers as well as producers, and to a general assessment of the unconstitutionality of discrimination. For various reasons, Article 4 was not raised by the Claimant and was not discussed by the Supreme Court, even though the issue of the 0% tax rate was specifically raised with regard to both alcoholic beverages and cigarettes. There is no indication in the opinion that the Supreme Court intended to abrogate or modify this critical provision of the IEPS law, since it apparently did not even consider the issue, and the Tribunal has no way of guessing what the result would have been had the Article 4 issue been squarely presented to the Supreme Court. In this respect, even the Claimant admits that the court in the *Amparo* case did not review the mechanics of IEPS (reply, paragraph 43). Rather, as noted above, no Mexican court directly addressed these issues until the Claimant brought the April 1998 and March 1999 challenges.
>
> 122. Moreover, the *Amparo* judgment limited to Article 2 (and a parallel *Amparo* decision sought by another company, Lynx) *were* successful in protecting the Claimant's (and Lynx's) rights to export alcoholic beverages, since both the Claimant and Lynx could obtain the necessary invoices from their suppliers due to their ability to purchase alcoholic beverages directly from the Mexican manufacturers and function as eligible taxpayers, and the different IEPS tax structure applicable to alcoholic beverages. Thus, the decision had considerable practical benefit for the Claimant at the time even without

> addressing or resolving the Article 4 question which the Claimant had not raised in the proceeding. In this Tribunal's view, that court decision did not resolve the Claimant's problems with obtaining tax rebates on cigarette exports because the Claimant failed to challenge Article 4 of the IEPS law. [Italics in original, underlining added; footnotes omitted.]
>
> Award, paras. 118, 120, 121, and 122 (Record, Volume III, Tab 81).

70. During the period 1993-1995, the taxation authorities recognized that CEMSA was a taxpayer entitled to the 0% tax rate on cigarette exports, but continued to require that the Claimant meet the invoice requirements of Article 4 of the law. The Claimant alleged that Mexican taxation officials gave him "assurances" in 1995-1996 that rebates would be paid and alleged the negotiation of an oral agreement took place in 1995, confirmed and finally implemented in 1996, which would permit CEMSA to resume exporting cigarettes in large quantities in June 1996. Mexico strenuously denied the existence of any such agreement. The Tribunal found that neither party was able to produce conclusive evidence of the existence or non-existence of such an agreement or understanding.

> Award, paras. 17-18 (Record, Volume III, Tab 81).

71. Mexico directed the Tribunal to a procedure set out in the Fiscal Code that permits a taxpayer to obtain a written ruling as to its entitlement to a particular tax treatment. The Tribunal found that the Claimant should have utilized this mechanism:

> 114. Moreover, the Claimant could have availed himself early on of the procedures available under Mexican law to obtain a formal, binding ruling on the invoice issue from SHCP, but apparently chose not to do so (see prepared testimony of Fernando Heftye, paragraphs 7-9). Despite the legal uncertainties of the issues upon which the success of his business depended, the Claimant asked for clarification of the legal issues under Article 4 of the IEPS law only when effectively forced to do so, in April 1998 after SHCP denied the Claimant's request for tax rebates for the October 1997-January 1998 exports, and in March 1999 when as a result of a tax audit SHCP demanded return of rebates, plus interest, inflation adjustment and penalties, for rebates earlier received in 1996 and 1997. It is unclear why he refrained from seeking clarification, but he did so at his peril, particularly given that he was dealing with tax laws and tax authorities, which are subject to extensive formalities in Mexico and in most other countries of the world.
>
> ***

> 134. Under the circumstances, therefore, the Claimant would have been wise to seek a formal administrative ruling on the applicability of Article 4 of the IEPS, and court review if the ruling were adverse, far before he was forced to do so in 1998, but for whatever reason he chose not to do so. Formal administrative procedures and the courts, according to the record, were at all times available to him, and have not been challenged here as being inconsistent with Mexico's international law obligations. Moreover, in Mexico, as in the United States and most other countries, oral or informal opinions are not binding on the tax authorities... Regardless of the results of the ruling process the Claimant would have been better off. If he had received a favorable ruling on Article 4, it would have been much easier for him to defend his rights under Mexican law and before this Tribunal. If he had lost, he could have at least avoided the uncertainties of his alleged right to rebates during much of the 1992-1997 period, and could have brought a NAFTA claim under Chapter 11 much earlier. [Emphasis added; footnotes omitted.]
>
> Award, at paras. 114 and 134 (Record, Volume III, Tab 81).

72. From June 1996 to September 1997, a total of 16 months, CEMSA applied for and obtained rebates. The Claimant alleged that taxation officials knew that CEMSA was receiving the IEPS rebates on cigarette exports without having obtained invoices separating the tax. Mexico's evidence was that it was standard practice for the finance department to pay requests for tax rebates promptly after they are submitted because SHCP has the legal authority to subsequently audit IEPS tax returns to determine whether the taxpayer has complied with the law's requirements.

> Award, para. 19 (Record, Volume III, Tab 81).

73. The taxation authorities terminated rebate payments to CEMSA on or about 1 December 1997. The Claimant alleged that this was done without prior warning. The authorities refused to pay rebates of US $2.35 million claimed by CEMSA for exports made in October and November 1997.

> Award, para. 20 (Record, Volume III, Tab 81).

74. The taxation authorities also investigated CEMSA's tax returns. They found that, in addition to the failure to provide invoices, CEMSA had grossly overestimated the amount of tax paid by "double-counting" the IEPS. That is, CEMSA was not in possession of invoices separately stating the tax paid and it was claiming roughly twice the amount appeared to be paid

in tax by the original taxpayer. The Tribunal accepted the validity of the invoicing requirements and found that CEMSA was "grossly" over-claiming IEPS rebates:

> 129. … the Tribunal does not consider the invoicing requirements to be a mere formality or patently unreasonable, to be waived easily by officials based on their discretion. The obvious and legitimate purpose of the requirement that the IEPS tax amounts be stated separately on invoices to be submitted to SHCP authorities on demand as the basis of the tax rebate is to make it possible for the tax authorities to determine in a straight-forward manner whether the tax amounts on exported products for which a rebate is sought are accurate and not overstated. This is clearly a rational tax policy and a reasonable legal requirement.
>
> 130. The Claimant himself is an excellent example why this requirement is necessary to protect the revenue. Without invoices, it was of course impossible for the Claimant to know the precise amount of the IEPS taxes included in the selling price of the cigarettes he purchased from Wal-Mart or Sam's Club, for his exports in 1996 and 1997. However, a very close approximation of the IEPS tax amounts could have been made by the Claimant for these years, just as it was in 1992... based on the IEPS tax rate for cigarettes applicable in 1996 and 1997 (85%), by dividing the selling price (inclusive of tax) by 1.85 to determine the price net of taxes, and then subtracting that amount from the selling price determine the tax amounts. For example, if as the Claimant alleges, he paid US$7.40 per carton of cigarettes, and the tax rate specified in the IEPS law was 85%, the tax included in the US$7.40 price was approximately US$3.40.20.
>
> 131. The Claimant apparently used this formula in 1992, and received the rebates. He used a somewhat different formula in 1996, which overstated the rebates. Then, in 1997, he used a completely different formula, which had the effect of grossly overstating the tax amounts, U.S. $6.55 instead of U.S. $3.40 per carton, an overstatement of 93%. The Claimant asserts that this methodology was explicitly approved by Director of Major Taxpayers Jose Riquer Ramos... Mr. Riquer has denied this. . . In the final analysis, the Tribunal does not find the Claimant's testimony on this issue to be credible. It is inconceivable to the Tribunal that even if SHCP officials were prepared to forego the invoice requirement informally during some periods, as appears to be the case, they would have given the Claimant or any other taxpayer carte blanche to overestimate the amount of the rebates, in flagrant violation of the IEPS law. [Emphasis added]
>
> Award, paras. 129-131 (Record, Volume III, Tab 81).

75. The taxation authorities also discovered that companies in Honduras and El Salvador to which CEMSA had reported it was exporting did not exist. In exhibits filed with the Tribunal, the authorities of the other countries confirmed this at the request of the Mexican taxation authorities.

Counter-Memorial, paras. 441-447 (24 May 2001) (Record, Volume II, Tab 62).

76. The Tribunal accepted that CEMSA had been exporting to at least one fictitious company:

> 201. ... the Claimant had no significant customer base. All of his sales in his best year, 1997, were either to members of the Poblano Group, or to an apparently fictitious company, Dilosa, S.A. which may have been allegedly doing business in Honduras, a low tax jurisdiction for which IEPS rebates were not legally available... In short, the Tribunal is convinced that the Claimant did not have a viable business exporting cigarettes purchased from retailers in Mexico, and could not have made a profit regardless of whether SHCP provided the IEPS rebates, assuming of course that the rebates sought and provided approximated the actual amount of IEPS taxes originally assessed on the cigarettes. [Emphasis added]
>
> Award, para. 201 (Record, Volume III, Tab 81).

77. On 1 December 1997, the IEPS law was amended to bar rebates to cigarette resellers such as CEMSA, limiting such rebates to the "first sale" in Mexico. Articles 11 and 19 of the law were amended to provide that tax rebates were not allowed on sales subsequent to those made to the retailer. The amendments also imposed an obligation on exporters of certain goods, including cigarettes, to register in the Sectorial Exporters Registry in order to be entitled to even apply for the 0% tax its rate on exports. CEMSA was refused registration as an authorized exporter of cigarettes. Without such registration, Mexican Customs authorities will not issue the "*pedimento*" (export documentation) required to export goods from Mexico.

Award, para. 21 (Record, Volume III, Tab 81).

78. On 14 July 1998, the taxation authorities commenced an audit of CEMSA and demanded repayment of approximately US $25 million for IEPS rebates that they asserted CEMSA had received during the 21 month period of January 1996 to September 1997, with interest,

adjustment for inflation, and penalties. The Tribunal found that to avoid forfeiture and criminal sanctions for non-payment, CEMSA challenged the assessment in the Mexican courts. This assessment proceeding was ongoing at the time of the NAFTA arbitration. The separate proceeding, which was concluded, challenged the authorities' denial of CEMSA's rebates for the period October-November 1997.

> Award, para. 22 (Record, Volume III, Tab 81).

### D. Article 2103 and the Permitted Expropriation (Article 1110) Claims

79. As noted above, because the Claimant's allegations involved taxation measures, Article 2103 of the NAFTA, which sets forth special rules for investor-State claims involving taxation issues, applied. Insofar as the expropriation claims were concerned, the Claimant referred three measures to the competent authorities.

80. On 17 February 1999, the competent authorities agreed that one of those measures – an amendment to the relevant Mexican taxation statute which the Notice of Arbitration had alleged constituted an expropriation – was not an expropriation and therefore could not be the subject of a claim.

> Letter from Assistant U.S. Treasury Secretary Donald C. Lubick to Mexican Under Secretary of Revenue Tomas Ruiz (17 February 1999) (Record, Volume I, Tab 1).
>
> Award, para. 116 (Record, Volume III, Tab 81).

81. The competent authorities did not agree whether two other measures referenced could amount to measures of expropriation. The Claimant had alleged that: (i) Mexico's alleged refusal to implement the Supreme Court decision in CEMSA's favour and (ii) Mexico's refusal to provide rebates of excise taxes to CEMSA for cigarettes allegedly exported in October and November of 1997 were also expropriations. Given the authorities' failure to agree that these two measures were not expropriations, Article 2103(6) permitted the Claimant to advance expropriation claims in respect of them.

> Letter from Assistant U.S. Treasury Secretary Donald C. Lubick to Mexican Under Secretary of Revenue Tomas Ruiz (17 February 1999) (Record, Volume I, Tab 1).

## E. The Alleged Violations of NAFTA's Chapter Eleven

82. The Claimant's Notice of Arbitration alleged that Mexico's actions were "tantamount to nationalization or expropriation and constitute[d] a denial of justice in violation of the rules and principles of international law and NAFTA Articles 1110 and 1105(1)". The Claimant sought the following relief:

> (a) Compensation for excise-tax rebates denied, and for lost profits otherwise caused, by Respondent between January 1, 1992 (the effective date of the Mexican legislation authorizing excise-tax rebates for cigarette exporters) and December 1, 1997 (after which date Respondent changed course and refused to rebate the excise taxes paid by CEMSA on cigarette exports during October and November, 1997), not including the period between June 1996 and November 1997 (during which time the Mexican authorities complied with their legal obligations and allowed rebates of the excise taxes paid by CEMSA).
>
> (b) Compensation for lost profits, and lost good will caused by the intentional destruction of CEMSA's export business, after December 1, 1997.
>
> (c) An appropriate adjustment for inflation, such as is provided for in Articles 20-21 of the Mexican Fiscal Code.
>
> (d) Pre-judgment interest at the applicable rate on CEMSA's damages caused by Respondent since January 1, 1992. [Footnotes omitted.]
>
> Notice of Arbitration, p. 11 (30 April 1999) (Record, Volume I, Tab 2).

83. After the Tribunal had held its first meeting with the parties, the Claimant asserted that he believed a Mexican-owned cigarette reseller-exporter had obtained IEPS rebates after the 1 January 1998 amendment to the IEPS law. The Claimant therefore advanced an additional claim alleging a violation of Article 1102 (National Treatment). The Tribunal overruled Mexico's objection that the Claimant had failed to comply with certain mandatory procedural requirements in respect of this claim, holding that it was admissible as an "incidental or additional claim".

> Interim Decision on Preliminary Jurisdictional Issues, para. 59 (6 December 2000) (Record, Volume II, Tab 47).

84. The claim, as originally advanced, focused on the Claimant's contention that he had secured an unconditional legal right to IEPS rebates on exports of cigarettes by virtue of the Supreme Court's decision. He alleged that the taxation authorities failed to comply with the

court's ruling. He alleged further that an oral agreement was later reached with the taxation authorities, which agreement was breached when the authorities audited CEMSA, refused to pay it further rebates, and assessed it for rebates previously paid to it. These actions were alleged to constitute measures tantamount to expropriation under Article 1110 as well as being contrary to Article 1105. The amendment to the IEPS Law in 1998 which was intended to limit the payment of rebates to person making the first sale was also alleged to constitute an expropriation of the Claimant's business.

Notice of Arbitration, pp. 5-8 (30 April 1999) (Record, Volume I, Tab 2).

85. The additional claim concerned the allegation that other cigarette resellers had not been subjected to the same treatment as CEMSA. The Claimant had done business with a Mexican national named Cesar Poblano (sometimes spelled "Poblanno" in certain documents on the record). Poblano, together with other Mexican nationals, owned or controlled a series of companies which also engaged in the reselling of cigarettes and the claiming of IEPS rebates upon export. (The companies in question were Lynx Exportadora, S.A. de C.V. ("Lynx"), then Mercados Regionales, S.A. de C.V., (described as "Mercados I") and then Mercados Extranjeros, S.A. de C.V. (described as Mercados II").) During the 1990s, Poblano's efforts to claim rebates were also opposed by SHCP and a lengthy litigation occurred between his company Lynx and SHCP.

Memorial, paras. 78, 188 (30 March 2001) (Record, Volume II, Tab 60).

Counter-Memorial, paras. 448-484 (24 May 2001) (Record, Volume II, Tab 62).

Reply, paras. 18, 22-23 (11 June 2001) (Record, Volume II, Tab 68).

Rejoinder, paras. 81-87, 152-163 (25 June 2001) (Record, Volume III, Tab 74).

86. The Tribunal refers to this litigation in passing.

Award, paras. 122, 128 (footnote 23) (Record, Volume III, Tab 81).

87. The Claimant provided copies of all available invoices of CEMSA's sales of cigarettes to Mexico. The company's sales to the United States in 1997 were to a number of companies owned or controlled by Poblano (Lynx Exportadora, Compania Exportadora Mexicana, GTO International Trade Co., doing business as GTO Produce Co.).

> Counter-Memorial, paras. 457-484 (24 May 2001) (Record, Volume II, Tab 62).
>
> Rejoinder, paras. 152-163 (25 June 2001) (Record, Volume III, Tab 74).

88. The majority of the Tribunal later found that the evidence showed that Poblano was also both a customer and financier of CEMSA's cigarette exports to the United States:

> . . . It is undeniable that CEMSA and the Poblano Group maintained a business relationship; CEMSA, *inter alia*, was a seller of cigarettes to several of the Poblano Group companies from time to time, and had borrowed working capital from Mr. Poblano...
>
> Award, para. 178 (footnote 39) (Record, Volume III, Tab 81).
>
> … the Claimant had no significant customer base. All of his sales in his best year, 1997, were either to members of the Poblano Group, or to an apparently fictitious company, Dilosa…
>
> Award, para. 201 (Record, Volume III, Tab 81).

89. However, the majority did not find that CEMSA and the Poblano Group were engaged in a common venture.

90. While the majority declined to find that the evidence demonstrated an intertwining of interests between the Poblano Group and the Claimant's company (finding only that Poblano's companies were CEMSA's customers and that Poblano lent working capital to the Claimant to finance his cigarette purchases), the dissenting arbitrator agreed with Mexico that there was substantial evidence of a common venture between the Claimant and Mr. Poblano:

> In the same paragraph 178, the majority asserts that the Respondent, instead of focusing on the information that it should have provided on the Poblano Group, spent a substantial amount of its time seeking to demonstrate that CEMSA and Poblano were related companies and that, even if the Poblano Group firms had not received the IEPS rebates, that evidence of relationship was totally irrelevant.

I do not agree with that conclusion either, since, as I have already pointed out, it is significant that the two companies should be clearly interrelated (*Mr. Feldman was apprised of the opportunity to obtain the IEPS rebates through Mr. Cesar Poblano; they have the same attorney; Mr. Poblano shares in the profits of CEMSA's export business since he funds it*); …

I may assume that, should the information on the Poblano Group IEPS rebates have been available, it would have shown that the treatment of the Poblano Group was similar to that received by CEMSA, that is to say, rebates were sometimes granted to it and sometimes not, as it was so stated by the Claimant himself. [Italics in original]

Dissenting Opinion, paras. 12-13 (Record, Volume III, Tab 81).

## PART III: THE AWARD

### A. The Award

91. After deliberating, the Tribunal issued a Final Award.

#### 1. The Expropriation Claim: Article 1110

92. The Tribunal unanimously dismissed both expropriation claims. It held:

> 111. This Tribunal's rationale for declining to find a violation of Article 1110 can be summarized as follows: (1) As *Azinian*[4] suggests, not every business problem experienced by a foreign investor is an expropriation under Article 1110; (2) NAFTA and principles of customary international law to not *require* a state to permit "gray market" exports of cigarettes; (3) at no relevant time has the IEPS law, as written, afforded Mexican cigarette resellers such as CEMSA a "right" to export cigarettes (due primarily to technical/legal requirements for invoices stating tax amounts separately and to their status as non-taxpayers); and (4) the Claimant's"investment", the exporting business known as CEMSA, as far as this Tribunal can determine, remains under the complete control of the Claimant, in business with the apparent right to engage in the exportation of alcoholic beverages, photographic supplies, contact lenses, powdered milk and other Mexican products -- any product that it can purchase upon receipt of invoices stating the tax amounts -- and to receive rebates of any applicable taxes under the IEPS law. While none of these factors alone is necessarily conclusive, in the Tribunal's view taken together they tip the expropriation / regulation balance away from a finding of expropriation.
>
> Award, para. 111 (Record, Volume III, Tab 81).

#### 2. The Minimum Standard of Treatment Claim: Article 1105

93. The Tribunal unanimously dismissed the Article 1105 claim in the course of deciding the expropriation claims:

> 139. Assuming that Article 1110 must be interpreted in accordance with international law, as Article 1131(1) states, not just any denial of due process or of fair and equitable treatment (the latter through the cross-reference in Article 1110(1)(c) to Article 1105) constitutes a violation of international law. In this

---

[4] *Robert Azinian and others* v. *United Mexican States*, ICSID Case No. ARB(AF)/97/1 (Mexico's Case Book, Volume I, Tab 8).

> instance, the allegations of denial of due process or denial of justice are weakened by several factors. Here, as in *Azinian*, the Claimant does not effectively contend that there was a denial of justice by Mexican courts, either with regard to the Supreme Court's *Amparo* decision or the various lower courts' subsequent determinations in the nullification and assessment cases. Rather, in the instant case the Claimant's assertions of denial of justice relate to actions of SHCP rather than the courts... *Azinian* states that "A governmental authority surely cannot be faulted for acting in a manner validated by its own courts *unless the courts themselves are disavowed at the international level*." *Azinian* further suggests that there must be a showing that the court decision itself is a violation of NAFTA, or that the relevant courts have not accepted the suit, or there is "a clear and malicious misapplication of the law"...
>
> 140. This is a standard that the nullity and assessment decisions almost certainly do not meet. Given as noted earlier that Mexican courts and administrative procedures at all relevant times have been open to the Claimant, the Claimant's victory in the 1993 *Amparo* decision, and the availability of court review in the nullity and assessment decisions filed by the Claimant in 1998, there appears to have been no denial of due process or denial of justice there as would rise to the level of a violation of international law…
>
> 141. While there may be an argument for a violation of Article 1105 under the facts of this case (a denial of fair and equitable treatment), this Tribunal has no jurisdiction to decide that issue directly. As noted earlier, Article 1105 is not available in tax cases, but may be relevant in the cross-reference of Article 1110(1)(c). The Tribunal does not need to decide whether this cross-reference makes a full Article 1105 consideration appropriate in a tax matter. Even assuming, *arguendo*, that the Respondent's actions in the aggregate do constitute a denial of fair and equitable treatment that reaches the relatively egregious level of a violation of international law, this alone does not establish the existence of an illegal expropriation under Article 1110. . . [Footnotes omitted.]
>
> Award, paras. 139-141 (Record, Volume III, Tab 81).

## 3. The National Treatment Claim: Article 1102

### a. The split in the Tribunal

94. The Article 1102 claim concerned the Claimant's allegations that it had been denied IEPS rebates and had been audited and assessed by Hacienda, but other Mexican-owned companies had been paid rebates, and had not been assessed by Hacienda.

> Memorial, paras. 128-130, 193-196, 224-226 (30 March 2001) (Record, Volume II, Tab 60).
>
> Reply, paras. 5-19 (11 June 2001) (Record, Volume II, Tab 68).

95. The Claimant also asserted that CEMSA had been refused registration in the Sectorial Registry for Exporters created in 1998 while other companies in like circumstances had been registered. While the Claimant recognized that one Mexican-owned company, Mercados Extranjeros, had also been refused registration, he asserted this was because Hacienda regarded it as being associated with him.

> Memorial, para. 131-133 (30 March 2001) (Record, Volume II, Tab 60).

96. By a majority, the Tribunal held that Mexico had denied the Claimant national treatment. In making this finding, the majority repeatedly referred to Mexico's "inability or unwillingness" to provide evidence as to its treatment of other taxpayers and drew adverse inferences from this alleged inability or unwillingness.

97. The dissenting arbitrator refused to draw adverse inferences, concluding that there was insufficient evidence of discrimination and that the majority had held Mexico "defenseless" by finding that it had failed to discharge the burden of proof by not disclosing confidential information pertaining to its treatment of other taxpayers.

98. To understand the split in the Tribunal and the nature of this Application, it is necessary to recount the Claimant's procedural submissions concerning disclosure of documents pertaining to Mexico's treatment of other taxpayers and the procedural orders made by the Tribunal.

**b. Mexico's response to the demand for discovery of information relating to its treatment of other taxpayers**

99. From the outset of the Claimant's demands for disclosure of records pertaining to the treatment of other taxpayers, Mexico consistently explained to both the Claimant and the Tribunal the legal constraints imposed upon its taxation authorities by domestic law (Article 69 of the Fiscal Code) with respect to the protection of confidential taxpayer information.

100. The first relevant procedural order made was Procedural Order No 2, issued by the Tribunal on 3 May 2000, which provided as follows:

> 8…a. In accordance with Article 41(2) of the Additional Facility Arbitration Rules, the Tribunal may, if it deems it necessary at any stage of the proceeding, call upon the parties to produce documents, witnesses and experts. In addition,

either party may seek from the other party the disclosure of reasonably specified documents and the production of statements on specific points by identified witnesses or experts. Disputes related thereto will be decided upon by the Tribunal, which may require a party to produce documents and written or oral statements by witnesses or experts. If a party does not comply with such a request by the Tribunal, the Tribunal may draw the appropriate inferences.

b. The Parties are invited to exchange, by May 31, 2000, any specific requests for the production of documents and of written statements on specific points by witnesses or experts, with an indication of their relevance.

c. Each party is called upon to provide to the Tribunal, and to the other party by July 15, 2000, the documents and written statements requested by the requesting party in accordance with paragraph 8(b) above. In the event the requesting party believes that the documents or statements so requested cannot or should not be produced, such party shall as soon as possible inform the requesting party of the reasons therefore. In accordance with paragraph 8(a) above, the Tribunal shall decide any dispute related to such requests for documents or statements.

d. The Tribunal reserves its decision on whether to request either party to produce written or oral statements from any particular witness or experts. The Tribunal also reserves its decision on any questions concerning the time, place and manner in which any oral statements of witnesses and experts, and the eventual examination of witnesses and experts, are to be heard.

e. The Claimant shall submit its Memorial on or by September 1, 2000. The Respondent shall submit its Counter-Memorial on or by November 1, 2000. The parties' pleadings are to be accompanied by the documents and by statements of the witnesses or experts on which they rely, to the extent tsuch documents or statements have not already been produced in the proceeding…

9. With its letter of March 22, 2000, the Claimant submitted a First Request for the Production of Documents. In its letter of March 23, 2000, the Respondent requested the Tribunal to review such First Request and to determine whether it is consistent with the rules governing this proceeding. In view of the foregoing decision of the Tribunal on the schedule of the proceeding, the Tribunal deems that the Claimant' First Request for the Production of Documents has been directed to the Respondent. Accordingly, the parties are referred to paragraphs [8](a) and (c) above… [Emphasis added.]

Procedural Order No. 2 Concerning a Request for Provisional Measures and the Schedule of the Proceeding (3 May 2000) (Record, Volume I, Tab 11).

ICSID Arbitration (Additional Facility) Rules, Article 41(2) (Mexico's Case Book, Volume II, Tab 23)

101. There were ensuing disagreements between the parties as to the proper scope of document production. In general terms, Mexico considered that the Claimant's first request was a very broad American-style discovery demand rather than a specifically-worded request for production of documents appropriate to international arbitration. It noted that the majority of the requests lacked specificity and many were irrelevant to the matters in issue, either because they pertained to matters outside the legally relevant time frame, or to claims made inadmissible by Article 2103.

102. In specific response to the Claimant's request for "[a]ll documents relating to the payment [of the IEPS tax] for cigarette exports to any person or entity, other than …[CEMSA] or Mercados Regionales, S.A. de C.V, and other than producers or manufacturers of cigarettes, for the period January 1, 1992 to date", Mexico noted that it was not able to disclose such documents because of the laws protecting taxpayer confidentiality:

> …the Respondent wishes to note that in Mexico, as in Canada and the United States, confidentiality of tax records is protected by law. Accordingly, the Tribunal should be mindful that the Respondent will not be in a position to produce confidential tax records of Mercados (or any other Mexican taxpayer) without the taxpayer's express consent.
>
> Claimant's Second Request for Production of Documents (31 May 2000) (Record, Volume I, Tab 15)
>
> Letter from Hugo Perezcano Díaz to ICSID at para. 9 (30 June 2000) (Record, Volume I, Tab 21).

103. Mexico's objection to production of documents pre-dating the NAFTA's entry into force led to a motion by the Claimant requesting the Tribunal to determine, *inter alia*, the relevant time period for the purposes of document production. Mexico joined issue, and requested the Tribunal to answer that question and others as preliminary questions pertaining to the Tribunal's jurisdiction. The proceeding on the merits was suspended until 6 December 2000 when the Tribunal rendered its Interim Decision on Preliminary Jurisdictional Issues.

> Procedural Order No. 4, paras. 4-8 (3 August 2000) (Record, Volume I, Tab 33).

104. In its final pleading on the preliminary questions, Mexico noted the ongoing disagreement as to the proper scope of requests for production of documents and witness statements and asked the Tribunal to provide guidance in that regard (as it had earlier in Procedural Order No. 2 after receiving the Claimant's First Request for Production of Documents.) The Tribunal declined to give directions in its Decision, stating that it "has decided to deal with them in a separate procedural order".

> Tribunal's Interim Decision on Preliminary Jurisdictional Issues at para. 23 (6 December 2000) (Record, Volume II, Tab 47).

105. The Claimant's Second Amended Request for Production of Documents sought production of, *inter alia*, "the documents relating to payment of IEPS rebates for cigarette exports to Mercados Regionales S.A. de C.V. ('Mercados I'), Mercados Extrajaneros S.A. de C.V. ('Mercados II') or MEXCOBASA S.A de C.V. ('MEXCOBASA')". In a telephone conference held for the purpose of attempting to agree on the Claimant's requests for production of documents and witness statements, counsel for Mexico explained the difficulty with responding to the Claimant's requests for production of confidential taxpayer records of third parties and sought the Claimant's agreement that it would suffice if Mexico provided a witness statement attesting to the circumstances of IEPS paid to third parties, and any action taken subsequently by SHCP, as an alternative to seeking the written consent of third parties to disclosure of their confidential taxpayer information.

> Claimant's Second Amended Request for Production of Documents (at Request XIII) (14 December 2000) (Record, Volume II, Tab 48)
>
> Letter from Hugo Perezcano Díaz to Mark B. Feldman, at p. 5 (22 December 2000) (Record, Volume II, Tab 49).
>
> Letter from Hugo Perezcano Díaz to ICSID, at para. 4 (11 January 2001) (Record, Volume II, Tab 54).

106. Mexico explained that Article 69 of the Fiscal Code imposed a legal obligation on taxation authorities to preserve confidentiality taxpayer information and that it had agreed to provide instead a statement from a suitably qualified SHCP official attesting to the circumstances of any IEPS rebates paid to cigarette resellers other than CEMSA and any action taken subsequently by SHCP. Mexico suggested that the Claimant be at liberty to seek further

information from it or, if necessary, further directions from the Tribunal, if the statement was considered inadequate.

> Letter from Hugo Perezcano Díaz to ICSID, at paras. 4-5 (11 January 2001) (Record, Volume II, Tab 54).
>
> Letter from Hugo Perezcano Díaz to ICSID and Mark B. Feldman, at p. 6 (16 January 2001) (Record, Volume II, Tab 56).

107. The Claimant informed the Tribunal that he would accept the information requested in the form of a statement in lieu of disclosure of confidential documents "if a thorough search is made of SHCP's files and Respondent acknowledges the IEPS rebates made to resellers other than CEMSA", while reserving the right to insist on written statements from particular officials thought to be directly involved.

> Letter from Mark B. Feldman to ICSID at p. 24 (16 January 2001) (Record, Volume II, Tab 55).

108. In a letter dated 5 February 2001, the Tribunal welcomed what it took to be "common ground" between the parties "as regards the offered production of a written statement by the Respondent in response to the Claimant's requests numbers XIII and XIV" and went on to provide the following "further guidance" to the parties:

> 7. . . .
>
> a. As noted in the Tribunal's Procedural Order No. 5, a party is entitled to confidentiality in this proceeding in regard to the evidence produced by it. In the event, however, that a party wishes to avoid irreparable prejudice to third parties that may result from the production of such a document, the Tribunal sees no reason in principle why information pertinent to the dispute, and arising from such documents, could not be produced in the proceeding by means of statements of officials who could examine such documents and identify them in their statements.
>
> b. The Tribunal appreciates the observations made in the Respondent's letter of January 11, 2001, particularly at paragraph 13, regarding the appropriate wording of requests for documents. The Tribunal would expect both parties to proceed to the further production of documents without the Tribunal having to undertake the adjustment or substitution of the wording of each party's request for documents.

8. The Tribunal reserves its right further to call upon the parties to produce documents or other evidence at any stage of the proceeding, and to draw inferences from any failure of a party to produce documents or other information in its possession which has been requested of it in this proceeding. [Emphasis added.]

Letter from the Tribunal, at paras. 6-8 (5 February 2001) (Record, Volume II, Tab 58).

109. On 5 March 2001, Mexico submitted the first witness statement of Lic. Eduardo E. Díaz Guzmán, SCHP's General Administrator of Major Taxpayers, who attested to the following:

(a) that Article 69 of the Fiscal Code imposes upon all SCHP officials an obligation of absolute secrecy regarding tax information submitted by taxpayers – officials are prohibited by law from providing information regarding other taxpayers;

(b) that SCHP is obligated to pay IEPS and IVA (another tax) rebates within five days of the application of taxpayers who, like CEMSA, are registered as "high volume exporters"

(c) that SCHP has the legal right, for a period of five years, to conduct a verification review and reassess any taxpayer for any IEPS or IVA rebates improperly obtained;

(d) that the identity, nationality and other characteristic of partners or shareholders of corporate taxpayers that apply for or obtain tax rebates is wholly irrelevant to SHCP, and such information is not included in the documents required to be submitted with the rebate application;

(e) that the SCHP data base indicated the following with respect to cigarette exports:

(i) five marketing companies had solicited IEPS rebates upon exportation of cigarettes;

(ii) of these, three were authorized and two were denied;

(iii) three companies received approximately 91 million pesos between them;

(iv) one company received rebates in certain months of 1996, 1997, 1998 and 2000, the second company in certain months of 1999 and 2000, and the third company in certain months of 1996 and 1997.

(v) according to a letter dated 27 October 2000, the General Revenue Administration, through the Local Revenue Administration of Monterrey, was in the process of determining and collecting the reimbursement of illegitimate rebates paid to one of the three companies and the process continued to that date.

(the "First Díaz Guzmán Statement")

First Witness Statement of Eduardo Díaz Guzmán, 5 March 2001 (Record, Volume II, Tab 61). A courtesy translation of the statement, which was provided in Spanish only, is included for use in this Court proceeding.

110. In his Memorial, the Claimant relied on parts of the First Díaz Guzmán Statement to assert that IEPS rebates had been paid to other cigarette resellers during the material time.

Memorial, paras. 194, 225-226 (30 March 2001) (Record, Volume II, Tab 60).

111. The Claimant did not object to the adequacy of this statement or the veracity of its contents. The Claimant did not apply for a further order from the Tribunal in this respect.

112. Mr. Díaz Guzmán provided a second statement, filed with Mexico's Counter-Memorial, in which he explained that the system for payment of IEPS rebates is "based in the honesty and confidence of taxpayers", subject to the taxation authority's right, for a period of five years, to verify and recover amounts improperly paid. He also attested, *inter alia*:

**II. THE LEGAL SITUATION OF OTHER TAXPAYERS**

7. Presently, of the three companies to which approximately 91 million pesos were rebated, there was negative assessment against one, following a review of the documents it supplied, which showed that rebates were improperly given because the IEPS was not creditable for subsequent sales of processed tobacco. The return of these undue amounts was demanded. This taxpayer then resorted to remedies against the determination. A resolution is pending. As to the other two companies, the documents they provided are presently under

> review and the issuance of the respective assessments are pending, through which the return of undue payments will be demanded.
>
> 8. It is important to mention that all three companies in question are registered as "ALTEX" [high volume exporting companies] by the then Secretariat of Commerce and Industrial Promotion. For this reason, the rebates they sought and obtained followed the five day expedited procedure set out in my prior statement. This was without prejudice to the fiscal authority undertaking the review of the supplied documentation in order to determine if such rebates were or were not proper and, in the latter case, to demand reimbursement to Hacienda, as it happened.
>
> 9. It is important to state that in neither of the three cases was there undertaken the exercise of verification (direct audit or study under the provisions of Article 42 of the Fiscal Code of the Federation) as on the basis of the documentation supplied by the companies themselves it was determined that the rebates were improper, and reimbursement demanded, as the case may be. For this reason, it was not necessary to require additional information of them.
>
> 10. It should be noted that that *Secretariat de Hacienda y Credito Publico* is prevented by law from providing greater information or details in respect of the three referred to companies, since the tax authority has to maintain due confidentiality under the provisions of Article 69 of the Fiscal Code of the Federation.
>
> Second Witness Statement of Eduardo Díaz Guzmán (24 May 2001) (Record, Volume II, Tab 63)

113. After receiving the Counter-Memorial, the Claimant requested further production of documents. Noting that one of Mexico's witnesses had described his version of a particular memorandum concerning the investigation and registration of Mercados II in the tobacco exporters registry, and that the Claimant had earlier requested production of the memorandum together with SHCP's records relating to payment of IEPS rebates to Mercados I and Mercados II, the Claimant contended that "Respondent has waived any possible claim by of privilege by providing evidence on these matters" and requested the Tribunal to direct Mexico to produce the memorandum and the other documents comprising SHCP's files relating to the application of the two Mercados companies for registration in the Sectorial Exporters Registry.

> Letter from Mark B. Feldman to ICSID (1 June 2001) (Record, Volume II, Tab 64).

114. Mexico provided a copy of the memorandum, noting that it was inadvertently omitted as an exhibit to the witness statement, Mexico also stated that it had not waived any rights or privileges, or the enforcement of its legal obligations concerning taxpayer confidentially.

> Letter from Hugo Perezcano Díaz to ICSID (1 June 2001) (Record, Volume II, Tab 65). A courtesy translation of the letter, which was provided in Spanish only, is included for use in this Court proceeding.

115. The Claimant returned to the Tribunal, asking for directions that certain files relating to Sectorial Registry applications by two particular taxpayers (represented by file numbers 328 and 333 as noted in the memorandum provided by Mexico) be produced by Mexico.

> Letter from Mark B. Feldman to ICSID (4 June 2001) (Record, Volume II, Tab 66).

116. These files related to the registration of persons in a particular registry maintained by the customs arm of Hacienda only. They were not the sum total of the files maintained by different arms of Hacienda with respect to those persons. (This will become important when the Tribunal's comments regarding these files are examined).

> Transcript, p. 10, ll. 2-8; p. 13, ll. 8-23 (10 July 2001) (Record, Vol. III, Tab 84-B).

117. Four weeks later, one week prior to the commencement of the hearing, the Tribunal directed Mexico to produce the two files numbered 328 and 333.

> Letter from Secretary of the Tribunal to Hugo Perezcano Díaz (2 July 2001) (Record, Volume III, Tab 77).

118. Mexico reminded the Tribunal that it had explained the restrictions against disclosure of confidential taxpayer information six months earlier, and explained that an SCHP official who discloses the contents of the noted files could face administrative and criminal liability under federal law. Mexico proposed to refer the matter to a court of competent jurisdiction for a decision whether the information sought could be disclosed and, if so, what safeguards would have to be employed. Mexico cautioned that there was no established mechanism for obtaining such an order and that the court would likely direct that the taxpayers involved be notified and

accorded an opportunity to make submissions, making it unlikely that the matter could be resolved before the commencement of the hearing seven days hence.

> Letter from Hugo Perezcano Díaz to ICSID (2 July 2001) (Record Volume III, Tab 78).

119. The Claimant filed a submission responding that the Tribunal's directive of 2 July 2002 was well-founded and that the Claimant objected to any application to adjourn the hearing.

> Letter from Mark B. Feldman to ICSID (3 July 2001) (Record, Volume III, Tab 79).

120. Mexico responded immediately by again drawing to the Tribunal's attention to the Fiscal Code pointing out that it would be "contrary to basic rules of natural justice to force Mexico to choose between violating its domestic law by disclosing confidential information –with the consequent legal exposure to responsible officials, in respect of which the Tribunal can grant no waiver—or proceeding to a hearing on the Article 1102 issue with the Claimant able to argue that an adverse inference should be drawn from the decision to comply with the domestic law."

121. Mexico also pointed out:

> The Respondent is compelled to note that although it raised this issue some months ago, nothing occurred until the Claimant's June 1st request and then only a week before the hearing, the Respondent was directed to produce the files without any apparent consideration of the position that the responsible officials will be placed in.
>
> Letter from Hugo Perezcano Díaz to ICSID (3 July 2001) (Record, Volume III, Tab 80).

122. In an effort to comply with the Tribunal's direction in good faith, Mexico contacted the persons whose confidential information was contained in files 328 and 333. It was able to obtain consent for limited disclosure and these specific files were provided at the hearing. A Mexican official from a different department of Hacienda, who neither had had prior access to nor seen

the files prior to the hearing, but who had opined on the inclusion of certain persons in the registry, was cross-examined on them.

> Transcript, p. 13, ll. 15-25; p. 14, ll. 1-9 (11 July 2001) (Record, Vol. II, Tab 84-C).

123. According to the agreement of parties and the Tribunal's directions, both parties had the choice of whether or not to call witnesses who had provided written statements for cross-examination during the oral hearing. The Claimant did not call Mr. Díaz Guzmán, the senior Mexican official who provided the statements describing, *inter alia*, Mexico's treatment of other taxpayers, for cross-examination. The Tribunal did not exercise its power under Article 41(2) of the Arbitration Rules to direct Mexico to produce him for questioning by it or by the Claimant.

124. No further directive was issued by the Tribunal requiring further disclosure of confidential taxpayer information.

### c. The majority's reliance on Mexico's alleged "unwillingness" or "inability" to provide evidence relating to the treatment of other taxpayers

125. In its Award, for the first time, the majority's decision repeatedly emphasized Mexico's "unwillingness" or "inability" to provide evidence relating to the treatment of other taxpayers:

> 167. Analysis of these issues in the present case is complicated by the fact that only a limited amount of relevant factual information has been presented to the Tribunal, particularly with regard to the various domestic companies which may be in the business of reselling and exporting cigarettes from Mexico, and the treatment by SHCP of those resellers other than the Claimant. . .
>
> 173. The limited facts made available to the Tribunal demonstrate on balance to a majority of the Tribunal that CEMSA has been treated in a less favorable manner than domestically owned reseller/exporters of cigarettes, a *de facto* discrimination by SHCP, which is inconsistent with Mexico's obligations under Article 1102. The only confirmed cigarette exporters on the limited record before the Tribunal are CEMSA, owned by U.S. citizen Marvin Roy Feldman Karpa, and the Mexican corporate members of the Poblano Group, Mercados I and Mercados II. According to the available evidence, CEMSA was denied the rebates for October-November 1997 and subsequently; SHCP also demanded that CEMSA repay rebate amounts initially allowed from June 1996 through September 1997. Thus, CEMSA was denied IEPS rebates during periods when members of the Poblano Group were receiving them...

174. Even if Mexico is auditing Mr. Poblano, the process was begun long after the audit of CEMSA, and according to the files provided to the Tribunal concerning this audit,[5] there is no documentation that the audit continued after approximately March 2000, or that it even involved IEPS rebates... CEMSA's rebates (before and after audits) have already been denied, and several years later no such action has been taken with regard to the Poblano Group. Arguably, the fact that CEMSA has been audited well before any other domestic reseller/exporters is in itself evidence of discrimination, even if SHCP is legally authorized to audit all taxpayers. If Mexican authorities are auditing or intend to audit other taxpayers who are in like circumstances with CEMSA, the Government of Mexico, as the only party with access to such information, has not been particularly forthcoming in presenting the necessary evidence. The two files presented to the Tribunal during the hearing (designated nos. 328 and 333) are incomplete, indicating no final or even continuing audit action… The only clear knowledge that Mr. Poblano is subject to some sort of audit was supplied by the Claimant (first Feldman affidavit, paragraph 92), and counsel for the Claimant asserts that the evidence in the record demonstrates only that Mr. Poblano is subject to a personal audit for 1997... The Mexican Government has declined to provide any specific information as to the number of other possible taxpayers in like circumstances (resellers). The government's witness, Mr. Obregon-Castellanos, admitted that there were more than 5, and likely more than ten firms registered as cigarette exporters..., but was evasive with regard to tobacco exporter numbers even though he testified confidently and explicitly that there were four hundred registered exporters of alcoholic beverages...

175. The evidence also shows that CEMSA was denied registration as an export trading company, apparently in part because this action was filed, and in part has resulted the ongoing audit of the rebates for exports during 1996 and 1997, even though, as Mr. Díaz Gúzman indicated, three other cigarette export trading companies had been granted registration. An unsigned memorandum which reasonably could have been generated only in SHCP indicates the registration has been denied on the basis of the audit of the Claimant's rebate payments. There is no evidence that any domestic reseller/exporter has been denied export privileges in this manner. Moreover, there appears to have been differential treatment between CEMSA and Mr. Poblano with regard to registration issues as well. According to the Claimant's witness, Mr. Carvajal, taxpayer CEMSA filed its application for export registration status on June 30, 1998; information was still being requested in writing seven months later. For taxpayer Mr. Poblano, information was requested by SHCP orally within 14 days of the date of Poblano's application, and any questions were apparently resolved...

176. The extent of the evidence of discrimination on the record is admittedly limited. There are only a few documents in the record bearing directly on the

---

[5] The files provided to the Tribunal dealt only with the registration of two taxpayers in the Sectorial Registry. No files regarding assessments, audits, or other matters relating to the taxpayers were requested to be provided to the Tribunal, nor were they provided.

existence of differing treatment, particularly the statement of Mr. Díaz Gúzman, the "mystery" memorandum from SHCP's files, and the tax registration statement for Mercados Regionales, owned by the Poblano Group. One member of this Tribunal believes that this evidence on the record is insufficient to prove discrimination (see dissent). The majority's view is based first on the conclusion that the burden of proof was shifted from the Claimant to the Respondent, with the Respondent then failing to meet its new burden, and on an assessment of the record as a whole. But it is also based on a very simple two-pronged conclusion, as neither point was ever effectively challenged by the Respondent:

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

177. On the question of burden of proof, the majority finds the following statement of the international law standard helpful as stated by the Appellate Body of the WTO [citation and quotation omitted]. Here, the Claimant in our view has established a presumption and a *prima facie* case that the Claimant has been treated in a different and less favorable manner than several Mexican owned cigarette resellers, and the Respondent has failed to introduce any credible evidence into the record to rebut that presumption.

178. In weighing the evidence, including the record of the five day hearing, the majority is also affected by the Respondent's approach to the issue of discrimination. If the Respondent had had available to it evidence showing that the Poblano Group companies had not been treated in a more favorable fashion than CEMSA with regard to receiving IEPS rebates, it has never been explained why it was not introduced. Instead, the Respondent spent a substantial amount of its time during the hearing and in its memorial seeking (unsuccessfully in the Tribunal's view) to demonstrate that CEMSA and the Poblano Group were related companies (as there could be no discrimination, presumably within a single company group). Yet, if the Poblano Group firms have not received the rebates, that evidence of relationship would have been totally irrelevant. Why would any rational party have taken this approach at the hearing and in the briefs if it had information in its possession that would have shown that the Mexican owned cigarette exporters were being treated in the same manner as the Claimant, that is, denied IEPS rebates for cigarette exports where proper invoices were not available? Thus, it is entirely reasonable for the majority of this Tribunal to make an inference based on the Respondent's failure to present evidence on the discrimination issue. . .

***

186. It may well be that the size of the domestic investor class here is larger than two -- one Mexican government witness stated that there might be 5-10 or

more registered to export cigarettes -- and it may also be that some of those in other investors have been treated in a manner more similar to the Claimant's treatment than to the more favorable treatment afforded to the Poblano Group. However, in the absence of evidence to this effect presented by Mexico -- the only party in the position to provide such information -- the Tribunal need not decide whether Article 1102 requires treatment equivalent to the best treatment provided to any domestic investors. Presumably, if there was evidence that another domestic investor had been treated in a manner equivalent to the Claimant, in terms of export registration, audit, and granting or withholding of rebates, the Respondent would have provided that evidence to the Tribunal…

187. …For the Poblano Group and for other likely cigarette resellers/exporters, the Respondent has asserted that audits are or will be conducted in the same manner as for the Claimant, and implied that they will ultimately be treated in same way as the Claimant. However, the evidence that this has occurred is weak and unpersuasive…[Emphasis added; footnotes omitted.]

Award, paras. 173-176 (Record, Volume III, Tab 81).

**d. The dissent**

126. Although the majority made no reference to the taxpayer privacy restrictions placed on the taxation authorities by Article 69 of the Fiscal Code, Arbitrator Covarrubias addressed the point directly:

It is true that the Mexican tax authorities, as is the case with tax authorities in most countries[12], are under the obligation not to disclose tax returns or any other information provided by taxpayers. This confidentiality principle is essential to make taxpayers rely on tax administration, thus making tax collection easier. Even though this relates to domestic law, it is clearly a public policy.

[Footnote 12: For instance, the United States of America and Canada, who are Mexico's trade partners in the NAFTA, are also bound to keep the information on their taxpayers confidential. So much so that both countries have entered into a broad Tax Information Exchange Agreement with Mexico to exchange data pertaining to their taxpayers, but undertaking to ensure that the information received from one another will be handled with the same degree of confidentiality as data obtained on the basis of their domestic law. On the matter of the banking secret, attorney-client privilege and the confidentiality of returns and information obtained by the tax authorities, in Spain, Germany and Argentina, see Guilaiani Fonrouge, Derecho Financiero, Vol. 1, p. 549, Ediciones Depalma, Buenos Aires, 2001.]

***

It is also true that, should Hacienda officials have supplied information to this Tribunal regarding the tax returns filed by the Poblano Group companies, the

credit balances shown on them and the tax rebates granted and/or denied, such officials would have incurred personal liability.

Therefore, a procedural matter such as the one being discussed, though in the context of international law, should not disturb that rule. In short, it is not reproachable that the Mexican Government should have refrained from submitting to the Tribunal the tax information and tax documents relating to the Poblano Group kept in its records.

On the other hand, it is not reasonable to conclude that the Claimant's statements are true just because Hacienda has failed to file in these arbitration proceedings the information it had on a particular taxpayer, information which it is legally prevented from disclosing.

***

On this point, paragraph 178 of the Award states: "…*the majority is also affected by the Respondent's approach to the issue of discrimination. If the Respondent had available to it evidence showing that the Poblano group companies have not been treated in a more favorable fashion than CEMSA with regard to receiving IEPS rebates, it has never been explained why it was not introduced*.

The Respondent's position should not have affected the judgment of the other arbitrators, as it did not affect mine, for the following reasons:

a. Because, contrary to what is said in the above transcribed statement, the Respondent did explain its legal impediment at length and on several occasions.

b. Because the Respondent itself has suggested that, in order to be able to provide such information without incurring personal liability, proceedings should be brought before a court of the first instance which should order tax authorities to furnish it. Neither the Claimant made a reply to the suggestion nor the Tribunal adopted any decision on that point.

c. Because the Respondent, despite its impediment, has showed willingness to cooperate with the Tribunal. In its counter-memorial and rejoinder, the Respondent provided information concerning the Poblano Group's cigarette exports on the basis of records prepared by the Ministry of Economy (Secretaria de Economia) (who is not a tax authority). [Footnotes omitted.]

Dissenting Opinion at pp. 10-12 (Record, Volume III, Tab 81).

127. In footnote 13 to his dissenting opinion, Arbitrator Covarrubias cited two of Mexico's letters to the Tribunal, dated 11 January 2001 and 2 July 2001, which explained Mexico's difficulties in providing confidential taxpayer information, having regard to the requirements of

Article 69 of the Fiscal Code. (A third letter, dated 3 July 2001, was not referred to but also demonstrates Mexico's consistent objection to providing confidential taxpayer's information to the Tribunal during the course of the proceeding.)

> Letter from Hugo Perezcano Díaz to ICSID (3 July 2001) (Record, Volume III, Tab 80).

### 4. The Majority's Method of Establishing That Certain Rebates Should be Paid as Damages

128. The majority of the Tribunal ordered Mexico to pay damages to the Claimant in the amount of New Pesos ("NP") NP$9,464,627.40 plus interest to the date of the Award in the amount of NP$7,496,428.47. Including interest, this amounted to approximately US$1.6 million.

129. In order to establish the damages for the breach of Article 1102, the majority decided that certain rebate claims made by CEMSA should be paid to it as damages. However, it found it necessary to adjust CEMSA's rebate claims made during the relevant period. This was due to the fact that the Tribunal as a whole had found that the Claimant had "grossly" overestimated the amount of tax paid and therefore had double-claimed the IEPS. In addition, the Tribunal as a whole acknowledged that the taxation authorities, during the course of their audit of CEMSA, had discovered that it had been exporting cigarettes to a fictitious company, Dilosa, in Honduras.

130. Therefore, even though the Tribunal as a whole had already found that CEMSA had no legal right to IEPS rebates, when it came to assessing damages, the majority proceeded on the basis that CEMSA had such a right and reformed CEMSA's IEPS rebate claims by excluding the exports of cigarettes to Dilosa and eliminating the Claimant's double-counting in order to arrive at the amount of rebates that it considered should be paid to CEMSA by Mexico as damages.

> Award, paras. 203-205 (Record, Volume III, Tab 81).

131. After explaining his objection to the majority's adverse inferences to support liability, Arbitrator Covarrubias pointed out that in light of the finding of the Tribunal as a whole that CEMSA did not have a legal right to be paid IEPS rebates, the majority's decision to order Mexico to pay the adjusted rebate sums as damages (net of the double counting and net of the exports to the fictitious company) was repugnant:

> If, in actual fact, the Claimant is not entitled to IEPS rebates, it is repugnant to grant him a somewhat equivalent amount as compensation for damages, only because he alleges that there is another investor -- *a Mexican investor, in like circumstances* -- who has been granted IEPS tax rebates without being entitled to them either. This issue becomes even more sensitive if we consider, as described above, that the economic viability of CEMSA's business was based on obtaining illegal tax rebates; otherwise, such business was pointless.
>
> If the approach taken in this Award were to prevail, it would suffice for any investor from a NAFTA State to show that another State party to the same Treaty has made only one mistake or miscalculation in the administration of the tax, favoring a single national investor --*whose circumstances are apparently similar*-- to claim and obtain a benefit from that State, to the detriment of its public finance.
>
> Dissenting Opinion, pp. 16-17 (Record, Volume III, Tab 81).

## PART IV: GROUNDS UPON WHICH AWARD SHOULD BE SET ASIDE

132. Mexico seeks an order setting aside the Award to the extent that it found a violation of Article 1102.

### A. The Grounds of Review Available under the ICAA

133. Section 2(1) of the ICAA provides that "[s]ubject to this Act, the Model Law is in force in Ontario". As noted above, the reference to the "Model Law" is a reference to the *Model Law on International Commercial Arbitration* adopted by the United Nations Commission on International Trade law on June 21, 1985. The Model Law is a schedule to the ICAA.

134. Article 5 of the Model Law states:

> 5. In matters governed by this Law, no court shall intervene except where so provided in this Law.
>
> Model Law, Schedule to the ICAA, Article 5 (Mexico's Case Book, Volume II, Tab 28).

135. Article 34 of the Model Law then sets out the grounds upon which an award may be set aside:

> (1) Recourse to a court against an arbitral award may be made only by an application for setting aside in accordance with paragraphs (2) and (3) of this article.
>
> (2) An arbitral award may be set aside by the court specified in article 6 only if:
>
> (a) the party making the application furnishes proof that:
>
> (i) a party to the arbitration agreement referred to in article 7 was under some incapacity; or the said agreement is not valid under the law to which the parties have subjected it or, failing any indication thereon, under the law of this State; or

(ii) the party making the application was not given proper notice of the appointment of an arbitrator or of the arbitral proceedings or was otherwise unable to present his case; or

(iii) the award deals with a dispute not contemplated by or not falling within the terms of the submission to arbitration, or contains decisions on matters beyond the scope of the submission to arbitration, provided that, if the decisions on matters submitted to arbitration can be separated from those not so submitted, only that part of the award which contains decisions on matters not submitted to arbitration may be set aside; or

(iv) the composition of the arbitral tribunal or the arbitral procedure was not in accordance with the agreement of the parties, unless such agreement was in conflict with a provision of this Law from which the parties cannot derogate, or, failing such agreement, was not in accordance with this Law, or

(b) the court finds that:

(i) the subject-matter of the dispute is not capable of settlement by arbitration under the law of this State, or

(ii) the award is in conflict with the public policy of this State.

(3) An application for setting aside may not be made after three months have elapsed from the date on which the party making that application had received the award or, if a request had been made under article 33, from the date on which that request had been disposed of by the arbitral tribunal.

(4) The court, when asked to set aside an award, may, where appropriate and so requested by a party, suspend the setting aside proceedings for a period of time determined by it in order to give the arbitral tribunal an opportunity to resume the arbitral proceedings or to take such other action as in the arbitral tribunal's opinion will eliminate the grounds for setting aside.

Model Law, Schedule to the ICAA, Article 34 (Mexico's Case Book, Volume II, Tab 28).

136. By Article 34(2)(a) of the Model Law, the applicant bears the burden of establishing that one or more of the grounds specified in Article 34(2)(a) are present. By Article 34(2)(b), the court may, on its own, conclude that the award is in conflict with public policy in Ontario.

> *Corporacion Transnacional de Inversiones, S.A. de C.V. et al. and STET International, S.p.A. et al*. (1999), 45 O.R. (3d) 183 at 191; aff'd. (2000), 49 O.R. (3d) 414 (C.A.); application for leave to appeal dismissed, [2000] S.C.C.A. No. 581 (Mexico's Case Book, Volume II, Tabs 5 and 6).
>
> Model Law, Schedule to the ICAA, Article 34 (Mexico's Case Book, Volume II, Tab 28).

137. Section 13 of the ICAA provides that, in interpreting and applying the Model Law, the Court may have regard to two commentaries:

(a) the Report of the United Nations Commission on International Trade Law on the work of its eighteenth session (June 3-21, 1985); and

(b) the Analytical Commentary contained in the Report of the Secretary General to the eighteenth session of the United Nations Commission on International Trade Law.

> ICAA, s. 13 (Mexico's Case Book, Volume II, Tab 28).

**B. Basis for Seeking Relief**

138. As noted, the grounds for the Application are the following:

(a) Mexico was unable to present its case, contrary to Article 34(2)(a)(ii) of the Model Law, because – having informed the parties that it would only draw adverse inferences in the event of a party's failure to comply with its orders – the majority of the Tribunal drew impermissible inferences (in the absence of an order) from Mexico's compliance with its own domestic law governing taxation law enforcement and taxpayer personal privacy protection;

(b) the arbitral procedure adopted by the majority of the Tribunal was not in accordance with the agreement of the parties, contrary to Article 34(2)(a)(iv) of the Model Law, because it conflicted with the mandatory rules for the conduct of investor-State arbitrations under the NAFTA, in particular Article 2105 which prohibited the Tribunal from requiring Mexico "to furnish or allow access to information the disclosure of which would impede law enforcement or would be contrary to the Party's law protecting personal privacy";

(c) by requiring Mexico to pay to the Claimant, as damages, tax rebates to which the Tribunal previously held the Claimant had no legal right, the Award is, as the dissenting Arbitrator found, "repugnant", and is in conflict with public policy, contrary to Article 34(2)(b) of the Model Law.

## C. The General Principles Applicable to Annulment of Arbitral Awards Under the Model Law.

139. The Supreme Court of Canada has recently considered the principles applicable under the Model Law to annulment of consensual domestic arbitration awards.

> *Desputeaux v. Editions Chouette (1987) Inc*., 2003 S.C.C. 17; (2003), 223 D.L.R. (4th) 407 (S.C.C.) (Mexico's Case Book, Volume I, Tab 7).

140. In that decision, the Supreme Court of Canada confirmed that:

(a) an arbitrator must act in accordance with the agreement to arbitrate;

(b) annulment is available where the rules of natural justice are violated;

(c) it is not open to the Courts to annul an award based on simple review of error of law made by the arbitrator.

> *Desputeaux*, paras. 2, 16, 22, 65-71 (Mexico's Case Book, Volume I, Tab 7).

141. So far as it goes[6], this approach is consistent with international practice involving the review of investor-State awards. A recent ICSID *ad hoc* annulment committee likewise stated:

> 62. Although the issue of the proper role of an annulment committee in the ICSID system must necessarily inform the analysis and the conclusions of this Committee, relatively little needs to be said about the issue for the reason that there seems to be little disagreement between the parties. Claimants and Respondent agree that an *ad hoc* Committee is not a court of appeal and that its competence extends only to annulment based on one or other of the grounds expressly set out in Article 52 of the ICSID Convention. It also appears to be established that there is no presumption either in favour of or against annulment, a point acknowledged by Claimants as well as Respondent. [Emphasis added; footnotes omitted.]
>
> *Compania de Aguas del Aconquija, S.A. and Vivendi Universal (formerly Compagnie Generale des Eaux) v. Argentine Republic*, ICSID Case No. ARB/97/3, Decision on Annulment (Mexico's Case Book, Volume I, Tab 4.)

### 1. Stepping Outside the Arbitrator's Terms of Reference

142. In *Desputeaux*, LeBel J. speaking for the Court, said:

> The parties to an arbitration agreement have virtually unfettered autonomy in identifying the disputes that may be the subject of the arbitration proceeding. As we shall later see, that agreement comprises the arbitrator's terms of reference and delineates the task he or she is to perform, subject to the applicable statutory provisions. The primary source of an arbitrator's competence is the content of the arbitration agreement… If the arbitrator steps outside that agreement, a court may refuse to homologate, or may annul, the arbitration award…[Emphasis added.]
>
> *Desputeaux, supra*, at para. 22 (Mexico's Case Book, Volume I, Tab 7).

---

6 There are, in some contexts, significant differences between review of domestic awards and investor-State awards. For example, the powerful presumption of jurisdiction referred to in domestic proceedings is inapplicable where a sovereign State is involved. As noted in *Southern Pacific Properties (Middle East) Limited* v. *Arab Republic of Egypt*, supra, in its award on jurisdiction, dated 14 April 1988, the Tribunal stated: "Clearly, then, there is no presumption of jurisdiction – particularly where a sovereign State is involved – and the Tribunal must examine Egypt's objections to the jurisdiction of the Centre with meticulous care, bearing in mind that jurisdiction in the present case exists only insofar as consent thereto has been given by the Parties. [Emphasis added.] *Southern Pacific Properties (Middle East) Limited* v. *Arab Republic of Egypt*, ICSID Case No. ARB/84/3, at p. 143. Mexico's Case Book at Volume I, Tab 11.

143. As to the conduct of the arbitration and the rules of natural justice:

> . . . The methods by which evidence may be heard are flexible and are in control by the arbitrator, subject to any agreements between the parties….Nonetheless, the arbitrator clearly does not have total freedom in respect of procedure. Under . . . [the Model Law], an arbitration award may be annulled where "the party against whom the award is invoked was not given proper notice of the appointment of an arbitrator or of the arbitration proceedings or was otherwise unable to present his case".
>
> *Desputeaux, supra*, at paras. 70-71 (Mexico's Case Book, Volume I, Tab 7).

## D. Overview

144. In Mexico's submission, the majority of the Tribunal prevented Mexico from presenting its case and failed to conduct the arbitration in accordance with the agreement of the parties including Article 2105 of the NAFTA. The majority imposed liability on Mexico by basing its decision on Mexico's perceived "unwillingness" or "inability" to adduce evidence, or for not being "particularly forthcoming in presenting the necessary evidence," for having "declined to provide any specific information as to the number of other possible taxpayers in like circumstances" for having "failed to introduce any credible evidence into the record to rebut that presumption" and for "never explain[ing] why it was not produced." The majority repeatedly noted that Mexico had in its possession relevant information regarding the treatment of other taxpayers but was "unwilling or unable to produce it" (Final Award, paras. 6, 23, 167, 173, 174, 176, 177, 178, 186, 187.) The majority held that the Claimant had established a *prima facie* case of discrimination contrary to NAFTA Article 1102 and that Mexico had "failed to introduce any credible evidence into the record to rebut that [case]".

> Award, para. 177 (Record, Volume III, Tab 81).

---

[8] Mexico takes the position, however, that regardless of which method is applied, the relief sought in the Application ought to be granted.

### 1. Article 34(2)(a)(ii) – Inability to Present Case

#### a. Applicable Law

145. Article 34(2)(a)(ii) of the Model Law allows the Court to set aside the Award if it finds that Mexico was unable to present its case. Article 34(2)(a)(ii) is tied to Article 18, which provides that "[t]he parties shall be treated with equality and each party shall be given a full opportunity of presenting his case". While the Tribunal had the right to control its own procedures, albeit in accordance with the parties' agreement, Article 18 is intended to guard against, *inter alia*, "injudicious conduct by a Tribunal".

> *Desputeaux, supra*, at para. 71 (Mexico's Case Book, Volume I, Tab 7).
>
> *Re Corporacion Transnacional, supra*, at 194 (Sup.Ct.) (Mexico's Case Book, Volume I, Tab 5).
>
> *Re Corporacion Transnacional, supra*, at 416 (C.A.) (Mexico's Case Book, Volume I, Tab 6).

146. An example of a Tribunal failing to give an opportunity to present a case can be found in the decision of the United States Second Circuit Court of Appeals in *Iran Aircraft Industries v. Avco Corp.*, where the Court set aside an award delivered by the Iran-United States Claim Tribunal.

147. At a pre-hearing conference, the Tribunal indicated to Avco that it would not be required to produce all of its invoices, but rather could rely upon summaries of them. Avco proceeded on that basis and attached a summary to its supplemental memorial. By the time of the oral hearing in Avco, two of the three arbitrators had been replaced. In its award, the majority rejected Avco's claim, holding that "[t[he Tribunal cannot grant Avco's claim solely on the basis of an affidavit and a list of invoices, even if the existence of the invoices is certified by an independent audit". Judge Brower dissented, holding:

> I believe the Tribunal has misled the Claimant, however unwittingly, regarding the evidence it was required to submit, thereby depriving Claimant, to that extent, of the ability to present its case. . .
>
> . . . .

> Since Claimant did exactly what it previously was told to do by the Tribunal the denial in the present Award of any of these invoice claims on the ground that more evidence should have been submitted constitutes a denial to Claimant of the ability to present its case to the Tribunal.
>
> *Iran Aircraft Industries*, 980 F.2d 141 at 143-144 (2nd Cir. 1992) (Mexico's Case Book, Volume I, Tab 9).

148. The Second Circuit agreed with the dissenting Judge and refused to enforce the Award under the *New York Convention*, invoking the parallel ground to ICAA Article 34(2)(a)(ii):

> At the pre-hearing conference, Judge Mangard specifically advised Avco not to burden the Tribunal by submitting "kilos and kilos of invoices". Instead, Judge Mangard approved the method of proof proposed by Avco, namely the submission of Avco's audited accounts receivable ledgers. Later, when Judge Ansari questioned Avco's method of proof, he never responded to Avco's explanation that it was proceeding according to an earlier understanding. Thus, Avco was not made aware that the Tribunal now required the actual invoices to substantiate Avco's claim. Having thus led Avco to believe it had used a proper method to substantiate its claim, the Tribunal then rejected Avco's claim for lack of proof.
>
> We believe that by so misleading Avco, however unwittingly, the Tribunal denied Avco the opportunity to present its claim in a meaningful manner. Accordingly, Avco was "unable to present [its] case" within the meaning of Article V(1)(b) and enforcement of the Award was properly denied.
>
> *Iran Aircraft Industries*, *supra*, at 146 (Mexico's Case Book, Volume I, Tab 9).

149. Where the ground specified in Article 34(2)(a)(ii) of the Model Law is established, there can be no "harmless error": "[i]n itself, a breach of due process is considered to be sufficiently important to justify such redress without the need for the party invoking it to establish actual damage". In this case, however, it is clear the outcome of the proceeding was affected by harmful error.

> Gaillard and Savage, *Fouchard, Gaillard, Goldman on International Commercial Arbitration* (London: Kluwer, 1999) at para. 1698 (Mexico's Case Book, Volume II, Tab 33).

### b. Application of the Test

150. Mexico was unable to present its case with respect to the allegation of breach of Articles 1102 and the treatment accorded to CEMSA in comparison with other taxpayers. From the time of the initial requests for the production of other taxpayers' records, Mexico repeatedly adverted to the legal constraints imposed upon its taxation officials and its consequent inability to respond fully to the demands for document production. Mexico proposed, and the Tribunal accepted, that the way to deal with the problem was to allow summary evidence to be given and that no adverse inferences were to be drawn absent a failure to comply with a ruling of the Tribunal.

Procedural Order No. 2 (3 May 2000) (Record, Volume I, Tab 11).

151. At no time prior to the issuance of the Final Award did the majority intimate that the summary evidence approach would be insufficient, or make any formal order under Article 41(2) of the Arbitral Rules calling upon Mexico to produce documents, as it stipulated it would before it would "draw the appropriate inferences", and Mexico complied with every order made by the Tribunal. The witness who summarily testified as to the treatment accorded to other taxpayers was not required to attend the hearing for questioning by the Claimant or by the Tribunal and, according to the rules adopted in the proceeding, having supplied his statement, Mexico had no right or obligation to re-tender his evidence. A review of the transcript shows that at no time during the oral hearing did the Tribunal indicate that this approach would be insufficient.

152. Without notice to Mexico, the majority then characterized the summary evidence as insufficient and drew impermissible inferences from Mexico's compliance with its domestic law governing taxation law enforcement and taxpayer personal privacy protection. The dissenting arbitrator pointed out that Mexico had repeatedly advised the Tribunal of its legal constraints and that Mexico had made a good faith effort to respond to the Claimant's demands within the constraints of its domestic law.

153. It warrants noting that Mexico's approach to dealing with this issue was consistent with international practice. Although they were not expressly adopted as governing this proceeding, the IBA *Rules on the Taking of Evidence in International Commercial Arbitration* set out two rules of general application:

> 6.6. The Arbitral Tribunal shall, in consultation with the Parties and in timely fashion, consider the Request to Produce and the objections. The Arbitral Tribunal may order the Party to whom such Request is addressed to produce to the Arbitral Tribunal and to the other Parties those requested documents in its possession, custody or control as to which the Arbitral Tribunal determines that (i) the issues that the requesting Party wishes to prove are relevant and material to the outcome of the case, and (ii) none of the reasons for objection set forth in Article 9.2 apply.
>
> ***
>
> 9.2 The Arbitral Tribunal shall, at the request of a Party or on its own motion, exclude from evidence or production any document, statement, oral testimony or inspection for any of the following reasons:
>
> (b) legal impediment or privilege under the legal or ethical rules determined by the Arbitral Tribunal to be applicable;
>
> (f) grounds of special political or institutional sensitivity (including evidence that has been classified as secret by a government or a public international organization) that the Arbitral Tribunal determines to be compelling. [Emphasis added.]
>
> *IBA Rules on the Taking of Evidence in International Commercial Arbitration*, adopted by a resolution of the IBA Council 1 June 1999 (Mexico's Case Book, Volume II Tab 22).

154. The Rules confirm further that an adverse inference can be drawn only where a party fails to produce a document that the tribunal, having followed the Rules and applied the reasons for objection, nevertheless stills orders documents be produced and they are not:

> 9.4 If a Party fails without satisfactory explanation to produce any document requested in a Request to Produce to which it has not objected in due time or fails to produce any document ordered to be produced by the Arbitral Tribunal, the Arbitral Tribunal may infer that such document would be adverse to the interests of that Party. [Emphasis added.]
>
> *IBA Rules on the Taking of Evidence in International Commercial Arbitration*, adopted by a resolution of the IBA Council 1 June 1999 (Mexico's Case Book, Volume II, Tab 22).

### 2. Article 34(2)(a)(iv) – Arbitral Procedure Not in Accordance with Agreement

#### a. Applicable Law

155. Article 34(2)(a)(iv) of the Model Law provides that an award may be set aside where the arbitral procedure was not in accordance with the parties' agreement. An award will be set aside on this ground provided that the breach of the parties' agreement is substantial.

> *Shenzhen Nan Da Industrial and Trade United Co. Ltd. v. FM International Ltd*. (1993), *XVIII Yearbook Commercial Arbitration* 377 (Mexico's Case Book, Volume I, Tab 13).
>
> *Compagnie des Bauxites de Guinée v. Hammermills Inc*., 1992 WL 122712 (D.D.C. 1992) (Mexico's Case Book, Volume I, Tab 3).

156. Unlike an ordinary commercial relationship, where the contracting parties may agree to provide for the arbitration of disputes arising under a contract, in the case of investor-State arbitration under the NAFTA, the arbitration agreement is established by the claimant's acceptance of the State Party's offer to arbitrate an investment dispute made in Article 1122. The NAFTA Party's consent is expressly conditioned. Article 1122 states:

> 1. Each Party consents to the submission of a claim to arbitration in accordance with the procedures set out in this Agreement.
>
> Article 1122 (Mexico's Case Book, Volume II, Tab 25).

157. The procedures set out in the NAFTA include the substantive and procedural limitations imposed by Article 2105. An arbitration which is not conducted in accordance with procedures set out in the Agreement vitiates the Party's consent and therefore must be set aside under Article 34(2)(a)(iv) of the Act.

### b. Application of the Test

158. As noted above, NAFTA Article 2105, entitled, "Disclosure of Information", states:

> Nothing in this Agreement shall be construed to require a Party to furnish or allow access to information the disclosure of which would impede law enforcement or would be contrary to the Party's law protecting personal privacy or the financial affairs and accounts of individual customers of financial institutions. [Emphasis added]
>
> Article 2105 (Mexico's Case Book, Volume II, Tab 27).

159. Article 2105 has general effect: *Nothing* in the NAFTA, including Chapter Eleven's substantive obligations and its mechanism for enforcing them through investor-State arbitration, "shall be construed to require a Party to furnish or allow access to information the disclosure of which would … be contrary to the Party's law protecting personal privacy…".

160. This is a mandatory rule governing all Chapter Eleven arbitrations and cannot be ignored by a tribunal. A tribunal cannot find a breach of NAFTA in circumstances in which, in order to avoid liability, a Party would be required to furnish or allow access to information the disclosure of which would be contrary to its law protecting personal privacy. A tribunal lacks the power to require such information to be disclosed, and it must equally lack the power to base a finding of liability on an adverse inference drawn from a Party's inability to lawfully provide that information.

161. A corollary of a Party's inability to lawfully disclose confidential information must be that an adverse inference cannot be drawn when that incapacity is invoked as an explanation for the absence of the information.

> *R. v. Jolivet*, [2000] 1 S.C.R. 751 at paras. 22-29 (Mexico's Case Book, Volume I, Tab 11).
>
> *Blatch v. Archer* (1774), 1 Cowp. 63, 98 E.R. 969 at 65 (Mexico's Case Book, Volume I, Tab 2).

162. Consistent with the approach recommended by Mr. Justice Tysoe in the *Metalclad* case (at paras. 131-132), once apprised for the first time that the majority had drawn impermissible inferences, Mexico drew the Tribunal's attention to Article 2105 and gave the Tribunal the opportunity to supplement its reasons.

> Letter from Hugo Perezcano Díaz to ICSID (20 January 2003) (Record, Vol. III, Tab 82)

163. The Tribunal considered this to be a request to change its Award and refused to consider it. In the course of its refusal, the Tribunal declared that it considered that it had acted consistently with Article 2105 ("it never at any time imposed an obligation on the Respondent to release information covered by NAFTA Article 2105") and observed that to the best of its recollection Mexico had not raised that Article before it during the proceedings.

> Decision on Correction and Interpretation of the Award, 30 May 2003 (Record, Volume III, Tab 83).

164. Leaving aside that a tribunal cannot ignore the arbitration agreement that governs its proceeding and defines its powers and jurisdiction, Mexico did not refer to Article 2105 until after the Award because at no time prior to the issuance of the Final Award did the Tribunal ever intimate that the process agreed upon to protect taxpayer confidentiality would be considered insufficient.

165. From the very beginning of the Claimant's demands for disclosure of information relating to the treatment of other taxpayers, Mexico informed the Tribunal and the Claimant of Article 69 of the Fiscal Code of the Federation. The Tribunal ruled on this issue and expressly approved the agreement that Mexico provide a statement from a suitably senior official as to information that could not otherwise be disclosed. In reliance on the Tribunal's proposal, Mexico provided such statements from a senior official. The Tribunal reserved the right to draw adverse inferences in the event of either party's failure to comply with a Tribunal's ruling. At no time prior to the issuance of the Award did the Tribunal in any way indicate that Mexico had not complied with all rulings or that summary statements aimed at being responsive to the allegations but not running afoul of the domestic legal prohibition would be considered insufficient.

166. The dissenting arbitrator, Arbitrator Covarrubias, expressly recognized and accepted that Article 69 of the Fiscal Code inhibited Mexico's ability to provide information relating to its treatment of other taxpayers and that Mexico consistently directed the Tribunal to this impediment.

### 3. Article 34(2)(b)(ii) of the Model Law – Award in Conflict With Public Policy of Ontario

#### a. Applicable Law

167. Article 34(2)(b)(ii) of the Model Law provides that the Court may set aside the award where it is in conflict with the public policy of Ontario. The *Report of the United Nations Commission 1985,* describes what was intended by the addition of a ground for review based on the relationship between the Award and the public policy of the State in which the Award was sought to be set aside:

> 296. In discussing the term "public policy", it was understood that it was not equivalent to the political stance or international policies of the State but comprised the fundamental notions and principles of justice…
>
> 297. … It was understood that the term "public policy", which was used in the 1958 New York Convention and many other treaties, covered fundamental principles of law and justice in substantive as well as procedural respects. Thus, instances such as corruption, bribery or fraud and similar serious cases would constitute a ground for setting aside. It was noted, in that connection, that the wording "the award is in conflict with the public policy of this State" was not to be interpreted as excluding instances or events relating to the manner in which an award was arrived at.
>
> "Report of the United Nations Commission on International Trade Law", *supra*, paras. 296-97 (Mexico's Case Book, Volume II, Tab 30).

168. The "public policy" ground was intended by UNCITRAL to allow reviewing courts to set aside awards where those awards violated the "fundamental principles of law and justice, both questions on the merits and procedural issues". Indeed, in *Corporacion Transnacional*, the Court of Appeal upheld the conclusion of Lax J. that Article 34(2)(b)(ii) "is to be interpreted to

include procedural as well as substantive justice and is not to exclude the manner in which an award is arrived at".

> "Report of the United Nations Commission on International Trade Law", *supra*, paras. 296-97 (Mexico's Case Book, Volume II, Tab 30).
>
> *Re Corporacion Transnacional*, *supra*., at 190 to 193 (Sup.Ct.); aff'd. (2000), 49 O.R. (3d) 414 (C.A.) (Mexico's Case Book, Volume I, Tabs 5 and 6, respectively).
>
> See also: *Arcata Graphics Buffalo Ltd. v. Movie (Magazine) Corp*., [1993] O.J. No. 568 (Gen. Div.) (Mexico's Case Book, Volume I, Tab 1).
>
> *Transport De Cargaison (Cargo Carriers) (Kasc-Co) Ltd. v. International Bulk Carriers In*c., [1990] R.D.J. 418 (Que. C.A.), application for leave to appeal to S.C.C. dismissed April 4, 1991 (Mexico's Case Book, Volume I, Tab 16).

169. In *Desputeaux, supra*, LeBel J. confirmed that this ground of review does not generally entitle the Court to determine whether the arbitral tribunal reached the correct decision on the merits but rather requires an assessment of whether the award as a whole, and the manner in which it disposes of the parties' dispute, undermines principles of public policy.

> *Desputeaux, supra*, at paras. 52-54 (Mexico's Case Book, Volume I, Tab 7).

170. The aspects of public policy engaged by the Model Law are not closed. In *Navigation Sonamar Inc.* v. *Algoma Steamships Ltd*., Gonthier J. (sitting as a Justice of the Quebec Superior Court) in the first decision to consider the Model Law reviewed the *UNCITRAL Analytical Commentary* and Report and considered the meaning of "public policy". He held that the "fundamental principles of law and justice" inherent in the Model Law's use of the term "public policy" included the principle that a tribunal was not permitted to exceed its jurisdiction in the course of its inquiry, and that it constitute jurisdictional error to reach a result by a process of reasoning that is patently unreasonable.

> *Navigation Sonamar Inc.* v. *Algoma Steamships Ltd*., [1987] R.J.Q. 1346; (1995), 1 M.A.L.Q.R. 1 (Que.S.C.) (Mexico's Case Book, Volume I, Tab 10).

### b. Application of the Test

171. The majority's approach plainly raised issues of public policy in Arbitrator Covarrubias' view. The Tribunal as a whole had found that CEMSA had no legal right to claim IEPS rebates and that CEMSA's business depended upon the receipt of such rebates (as it was not economically viable without them). This finding was addressed by Arbitrator Covarrubias:

> **2. CEMSA HAD NO RIGHT TO THE TAX REBATE**
>
> For the reasons stated in the Award, CEMSA has never been entitled to claim tax rebates from the Government of Mexico, due to its admitted inability to show invoices issued by the supplier stating separately and expressly the amount of the tax. This requirement has never been met. CEMSA's right to tax rebates is not provided for in the law, in the decisions of any domestic tribunal or in any determination of the tax authorities. Furthermore, all regulations on this issue included in Mexico's domestic law are against CEMSA.
>
> On the other hand, it is true, as stated in the Award, that Mexican tax policy has a rational, valid reason for requiring from a taxpayer invoices that separately state the IEPS tax amounts as a condition for receiving rebates, since such rebates are therefore only granted in practice to cigarette producers (or their related resellers) and not to independent resellers in general. [Footnotes omitted.]
>
> Dissent, at pp. 1-2 (Record, Volume III, Tab 81).

172. Arbitrator Covarrubias therefore asked why, if a Mexican-owned company was unlawfully obtaining rebates, an international tribunal should order Mexico to pay rebates to an equally legally unqualified investor who happened to be American-owned:

> If, in actual fact, the Claimant is not entitled to IEPS rebates, it is repugnant to grant him a somewhat equivalent amount as compensation for damages, only because he alleges that there is a another investor *–a Mexican investor, in like circumstances* -- who has been granted IEPS rebates without being entitled to them either. This issue becomes even more sensitive if we consider, as described above, that the economic viability of CEMSA's business was based on obtaining illegal tax rebates; otherwise such business was pointless.

> If the approach taken in this Award were to prevail, it would suffice for any investor from a NAFTA State to show that another State party to the same Treaty has made only one mistake or miscalculation in the administration of a tax, favoring a single national investor -- *whose circumstances are apparently similar* -- to claim and obtain a benefit from that State, to the detriment of its public finance.
>
> Dissent, at p. 16 (Record, Volume III, Tab 81).

173. It is submitted that the dissenting arbitrator correctly identified the defects in the majority's finding of liability and the reason why the finding offends public policy in Ontario. The implications of this finding for all three NAFTA Parties go far beyond the modest damages award obtained by the Claimant. If future tribunals can ignore the legal constraints imposed by domestic law on each Party's taxation authorities in circumstances where the NAFTA clearly does not permit tribunals to do so (*viz.* Article 2105), and end up ordering a Party to rebate taxes that should never have been rebated in the first place, the potential for damage to the public finance is obvious.

174. Although Arbitrator Covarrubias did not go further, he could have done so: in addition to the points made above, the Tribunal as a whole found that the Claimant substantially over-claimed the IEPS and was exporting to a fictitious company in Honduras, yet still ordered Mexico to pay him an adjusted amount of rebates. It need hardly be said that faced with over-claims of tax rebates and claims based on transactions with fictitious companies made by a person who was not legally entitled to such rebates, the Canadian tax authorities would find it equally repugnant to be ordered to pay rebates to a U.S. investor just because some other taxpayer succeeded in avoiding compliance with the law.

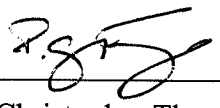
## PART V: NATURE OF ORDER REQUESTED

175. Mexico seeks an order setting aside the Award as it relates to Article 1102 of the NAFTA. The defects identified below taint that aspect of the Award as a whole, and it cannot stand. Mexico also seeks its costs of this proceeding.

176. Mexico reserves the right to initiate an application, or respond to any application that the Claimant may make, in respect of Article 34(4) of the Model Law.

**All of which is respectfully submitted.**

Dated: 29 September 2003



J. Christopher Thomas, Q.C.
J. Cameron Mowatt
(THOMAS AND PARTNERS)

Patrick G. Foy, Q.C.
Lawrence A. Elliot
Robert J.C. Deane
(BORDEN LADNER GERVAIS LLP)

Counsel for the Applicant, The United Mexican States