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May 8, 2002

The Honorable Konstantinos D. Kerameus
The Honorable Jorge Covarrubias Bravo
The Honorable David A. Gantz

c/o Alejandro A. Escobar
Secretary of the Tribunal
International Centre for Settlement of Investment Disputes
1818 H Street, N.W.
Washington, D.C. 20433

RE: Marvin Roy Feldman Karpa v. United Mexican States
(ICSID Case No. ARB(AF)/99/1)

CLAIMANT'S RESPONSE TO THE TRIBUNAL'S QUESTIONS

The Tribunal asks the parties to address the following two questions:

Q.1. *How should this Tribunal, in rendering its opinion on the merits, treat the pending, parallel court actions in Mexico (other than the 1993 Amparo proceeding), given that the Mexican courts are considering under Mexican law some of the same issues that this Tribunal is considering under NAFTA and international law?*

Answer to Q.1:

1. The Tribunal should decide the issues in dispute before it in accordance with NAFTA and applicable rules of international law, as required by Article 1131, recognizing that the March 25, 2002 judgment of the Mexican Court of Appeals has eliminated any alleged conflict between the technical requirements of the IEPS Law and Mexico's obligations to Claimant under international law. The 1993 Supreme Court decision stands as the authoritative statement of relevant Mexican law, and Claimant's agreement with Hacienda (1995-96) is binding on Respondent under international law. Respondent may not discriminate in respect of IEPS rebates on exports as between CEMSA and cigarette producers.

2. As previously briefed, the doctrine of exhaustion of local remedies does not apply to proceedings brought under Chapter 11. The Tribunal should decide the case before it without delay.

Q.2. *Are the pending Mexican court proceedings consistent with the waiver requirements of NAFTA Article 1121(2)(b), taking into account, inter alia, the exception of extraordinary relief, and notably the apparent differences between the English and Spanish versions of that article?*

Answer to Q2:

3. Yes, they are consistent. Both parties have so advised the Tribunal. If there is a substantive difference between the texts of Article 1121 (2)(b), the English and French texts better reflect the object and purpose of the Agreement.[1] Claimants are not required to forego recourse to local courts for injunctive relief, because Chapter 11 tribunals do not have competence to grant such relief. Moreover, under Mexican law, a Mexican court can only issue provisional measures in a case in litigation before that court.

4. Claimant's actions in the Mexican courts were not actions for the payment of damages, and the one case pending is purely defensive. Moreover, any conflict that might exist between the waiver and the proceedings in local courts does not affect the Tribunal's jurisdiction. Respondent's remedy would have been to present the waiver to the Mexican courts. Respondent did not do so and has waived any defense based on said waiver in both the Mexican courts and in this proceeding.

Question 1. Treatment of Pending Mexican Court Proceedings.

5. Only one proceeding is pending before the Mexican courts – CEMSA's petition for declaratory and injunctive relief against a $25 million tax assessment imposed by Hacienda on March 1, 1999 following the decision by the Competent Authorities that allowed Claimant to proceed with this arbitration. (This case is discussed in connection with Question 2 below.)

6. The *amparo* issued to CEMSA by the Mexican Court of Appeals on March 25, 2002, has simplified the work of this Tribunal by eliminating any alleged conflict between the technical requirements of the IEPS law and Mexico's obligation under international law not to discriminate against CEMSA in favor of cigarette producers. Such discrimination was held unconstitutional by the Mexican Supreme Court in the 1993 *amparo* proceeding. The whole of Respondent's argument based on previous Mexican court decisions in the CEMSA litigations has been superseded and is no longer relevant.

7. The Court of Appeals confirms the testimony of Claimant's experts and the determination by senior Mexican officials in1995-1997 that CEMSA had a constitutional

[1] As Appendix 1 we are providing the Tribunal a transcript of the three versions.

right to obtain rebate of IEPS taxes on cigarette exports without providing invoices separating the tax which were impossible to obtain from the producers. Specifically, it holds unconstitutional Article 4, Section III of the IEPS law in force in 1996-97 "in the part that establishes that in order for a tax credit to be secured for the special tax paid, the tax should be expressly and separately passed on to the taxpayer on the respective proof of sale ...." DA-4087/2001, CEMSA , Eleventh Chamber of the Federal Circuit Court for the First Circuit (Administrative Matters), March 25, 2002 (Op. Eng. Trans.) at p. 25. The Court based its ruling on the fact that not all exporters can meet this requirement; only first buyers (i.e., purchasers from producers) can get such invoices. This requirement violates Articles 13 and 31, Section IV of the Mexican Constitution because it imposes a formality that discriminates among taxpayers which carry on the same taxed activity. (Op. at p. 22-24).

8. In addition, by holding unconstitutional Article 2, Section III of the IEPS law (purporting to restrict rebates for exports to low-tax countries), the Court of Appeals has eliminated the basis for Respondent's objection to making rebates to CEMSA on cigarettes shipped to Honduras for export to international markets. The opinion notes that this provision allows arbitrary actions by the collecting authorities (See Op. Eng. Trans., at 10) which is exactly what happened in this case. Thus, CEMSA clearly is entitled to IEPS rebates on all its exports under Mexican as well as under international law.

9. Contrary to Respondent's assertions, Claimant does not ask the Tribunal to decide any question of Mexican law. The Tribunal should take Mexican law as it finds it. Claimant cites Mexican law for two reasons

> (1) to meet Respondent's defense that Mexican law allows discrimination between producers and resellers of cigarettes as regards IEPS rebates on exports, and
>
> (2) to show that Respondent's failure to respect a decision by the State's highest judicial organ constitutes a denial of justice under international law. (See Affidavit of Professor Alan C. Swan, Memorial at Tab 5, ¶¶ 64-69)

Claimant does not found his claim on the proposition that discrimination between cigarette producers and resellers is inherently a violation of international law. Rather, Claimant maintains that Respondent's insistence on such discrimination in disregard of both the Supreme Court decision and the agreement Mexican officials made with Claimant in 1995-96 constitutes discrimination and denial of justice under international law. These abuses are actionable under Article 1110 for the reasons stated in Claimant's Memorial and Reply.

Exhaustion of local remedies.

10. Respondent may argue that it intends to appeal the Court of Appeals decision to the Mexican Supreme Court and may urge the Tribunal to defer its award pending such appeal. The Tribunal should reject any such suggestion.

11. The Tribunal has a duty to decide this case promptly under NAFTA and applicable principles of international law. As noted in the Tribunal's Interim Decision on Preliminary Jurisdictional Issues (¶ 61), the Tribunal can consider Mexican law only as relevant to its responsibility to "decide the issues in dispute in accordance with this Agreement and applicable rules of international law." Art. 1131.

12. Claimant would be entitled to compensation under international law even if the Court of Appeals had decided differently the issues before it. A State cannot assert its domestic law as a defense to a breach of international law. Mexico is responsible under international law for legislative as well as administrative acts, and NAFTA, Article 1110 prohibits measures tantamount to expropriation. If the Mexican courts had ruled that the tax authorities properly followed a legislative command, Respondent would still be accountable in this proceeding because the procedures created by statute were arbitrary, confiscatory and discriminatory.

13. Moreover, Claimant's agreement with Hacienda in 1995 and 1996 is an independent basis for the Tribunal's award of damages under international law. Claimant was entitled to rely on the agreement that was made by Pedro Noyola, Hacienda's Undersecretary for Income, and confirmed and implemented by other senior Mexican officials over a period of sixteen months. The existence and content of the agreement are established by the evidence, written and oral. And Claimant testified that Noyola said that he had prepared a memorandum on the subject for his successor, Tomas Ruiz. Respondent refused to provide a witness statement by Undersecretary Ruiz, and he did not appear at the Hearing. On cross-examination, however, Judicial Administrator Fernando Heyfte finally admitted that Undersecretary Noyola had prepared a report for Undersecretary Ruiz on pending matters, including CEMSA. He said that that was standard practice in the Ministry.

14. "Q. At the time that you left Hacienda and when Dr. Noyola left Hacienda, the matter with Marvin Feldman was still pending; correct?

A. That's correct.

Q. So how would this file be handed over to Tomas Ruiz?

A. When a public official finishes his job, according to Mexican legislation, it's an obligation to give what's called an act of handing over and receiving a document. This action describes all pending matters and all administrative matters. ...

Q. So without giving any instructions necessary (sic) [necessarily] to Tomas Ruiz, Undersecretary Noyola would, in fact, have formally handed over to his successor Tomas Ruiz a pending case, a pending file relating to CEMSA which would include all of the relevant materials including a report on where the matter stood at the time of his departure from the agency?

A. That is correct. With regard to each one and all of the matters."

Transcript, July 11, 2002, at pp. 57-58.

15. This admission is significant as Respondent denied the existence of any such document throughout this proceeding and failed to produce it despite numerous requests for this specific document and the Tribunal's order to produce specific documents.

16. A Claimant under Chapter 11 is not required to exhaust local judicial remedies, (Reply, ¶¶ 36-38), and domestic court decisions are not *res judicata* for an international tribunal. (Reply, ¶ 51) Originally, Claimant brought two defensive proceedings in the Mexican courts. One of these has been completed. No issue of exhaustion of local remedies arises in respect of this proceeding, and the parties' dispute concerning the meaning of the decisions in that case is no longer relevant in light of the recent Court of Appeals decision.

17. If Hacienda does appeal the March 25 decision, it may take the Supreme Court 18 months or more to decide the issues before it, and the case will be remanded to the lower courts where the proceedings may continue for years.

18. There is no reason to believe that the Supreme Court will change its position on the discrimination issue of concern to the Tribunal as the 1993 decision was based on well established Mexican jurisprudence. See Opinion of Carlos Loperena Ruiz concerning Mexican Law, Memorial at Tab 6.

19. The record in this case shows that Hacienda does not respect Supreme Court decisions where CEMSA is concerned. (Reply, ¶¶ 38, 40) Rafael Obregon Castellanos, Deputy Director General for Special Tax Policy, Respondent's primary witness on the IEPS Law, testified on cross-examination, that the 1993 Supreme Court decision had no effect on Hacienda's administration of the IEPS law. Hacienda ignored it for several years.

"Q. In your opinion then, the Supreme Court decision had no effect?

A. Yes.

Q. Yes, it had no effect; that's your opinion?

A. Yes."

Transcript, July 9, at p.118, lines 14-18.

Claimant is counting on this Tribunal, not the Supreme Court, for effective relief. Hopefully, Respondent will comply with the Tribunal's award.

Question 2. The Mexican Proceedings Are Consistent With Article 1121(2) (b).

20. As noted in our letter of April 22, 2002, there is no issue before the Tribunal concerning the consistency of the legal proceedings brought by CEMSA in Mexico and the waiver requirements of NAFTA, Article 1121(2)(b). Both parties take the position that there is no inconsistency, and Respondent explained its reasons in some detail in the Rejoinder, ¶¶ 46-49. As Respondent concedes, Claimant has not brought an action for damages in the Mexican courts in regard to the measures complained of in this proceeding. Thus, the Rejoinder stipulates: "As the Reply correctly points out ... the waiver required by Article 1121 is limited to damage claims." ¶ 45.[2]

21. This interpretation, which Respondent also maintained in *Metalclad*[3], is consistent with Article 1121 and Chapter 11 as a whole. Moreover, Respondent would be estopped from changing its position in this case at this late date. Also, as pointed out in our letter of April 22, any inconsistency between the waiver and Claimants' proceedings in Mexico would not affect the jurisdiction of the Tribunal. The sole jurisdictional requirement imposed by Article 1121(2)(b) is that both the investor and the enterprise waive their right to initiate or maintain damage actions in other courts. Claimant and CEMSA have complied with that obligation by submitting waivers in the form prescribed to the ICSID Secretariat.

22. Absent a challenge to the waiver itself, which is not the case here, the Tribunal's competence is established. The purpose of the waiver requirement is to provide the disputing Party with the means of quashing a parallel action against it in another court. Respondent has not invoked the waiver in the Mexican courts for its own reasons, including the reason stated in ¶ 48 of the Rejoinder, and its right to do so, if any, is moot.

23. The Tribunal notes "the apparent differences between the English and the Spanish versions of" Article 1121(2)(b), but it is not clear that the difference in

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[2] CEMSA's actions sought only declaratory and injunctive relief. The first action, discussed at ¶ 47 of the Rejoinder, was terminated by CEMSA without appeal to the Supreme Court thus mooting any issue under NAFTA, Article 1121(2)(b).

[3] "Article 1121(2)(b) provides that a disputing investor may submit a claim *for damages* under the NAFTA if the investor and the enterprise waive their rights to initiate or continue *damages* claims before the domestic tribunals. This article applies to *damages* claims only. It expressly contemplates the investor initiating and continuing "proceedings for injunctive, declaratory or other extraordinary relief, not involving the payment of damages." (emphasis in the original) Mexico's Outline of Argument before the Supreme Court of British Columbia, § 291, *United Mexican States v. Metalclad,* 2001 BCSC 664 and 2001 BCSC 1529.

terminology is substantive. The Spanish text does not use the phrase "medidas provisionales de proteccion" as in Article 1134.

24. There could be a difference between the Spanish text, on the one hand, and the English and French texts, on the other, if the Spanish phrase "medidas precautorias" is read very narrowly to exclude applications for injunctive, declaratory or extraordinary other than as provisional measures ancillary to the arbitration. The Mexican Government has never interpreted the Spanish text in this way, however, and any such interpretation would not fit with the rest of Chapter 11 or with Mexican legal procedures. (Respondent used the English text in the *Metalclad* litigation in British Columbia.)[4]

25. In the event of such a conflict, moreover, the terms of a treaty are presumed to have the same meaning in each authentic text, Vienna Convention on the Law of Treaties, Article 33(3), and "the meaning which best reconciles the texts, having regard to the object and purpose of the treaty, shall be adopted." Id., Article 33(4). See *Kingdom of Belgium v. The Federal Republic of Germany*, 59 I.L.R. 499, 548-550 (German External Debts, May 16, 1980). Otherwise, parties to the same treaty would have different rights and obligations as a consequence of technical errors by the draftsmen. (In this case, claimants against Mexico would have more limited rights than claimants against Canada or the United States.)

26. NAFTA, Article 2206 provides that the English, French and Spanish texts are equally authentic. Thus, all three texts must be construed the same so as to give effect to the object and purpose of the agreement. The fact that two texts agree (English and French) suggests that the Spanish text should be read to conform with the other authentic texts. More important, however, a narrow reading of these texts would not conform with other provisions of Chapter 11 or with judicial procedures in Mexico.

27. NAFTA, Article 1135 empowers a tribunal to award monetary damages and to order restitution of property, but Article 1134, while authorizing a tribunal to order interim measures of protection for certain purposes, states that, "A Tribunal may not order attachment or enjoin the application of the measures alleged to constitute a breach referred to in Article 1116 or 1117." Not surprisingly, the Parties did not want to encroach that far upon a State Party's sovereign authority to regulate activity on its territory and left such relief to local law and national courts. Since claimants were denied these remedies under Chapter 11, it would be unfair and illogical to require them to waive the right to seek such relief in local courts. NAFTA does not do so. On the contrary, the English and French texts of Article 1121(2)(b) are clearly drafted to preserve that right, and there is no reason to interpret the Spanish text differently.

28. In addition, it makes no sense to construe the Spanish text – let alone the English and French texts – as limiting a claimant's recourse to local courts to provisional measures, such as a temporary injunction, because Mexican law precludes Mexican courts from granting such relief unless the case is before that court for decision on the merits.

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[4] Id.

29. The Mexican courts cannot grant interim measure of protection in support of international arbitration alone, *i.e.*, to preserve the status quo pending issuance of the tribunal's award. Only the tribunal can issue such interim measures, and it is not clear that a Mexican court would have authority even to enforce such orders issued by the tribunal. Thus, it would be unreasonable to conclude that the Mexican officials who participated in drafting the NAFTA texts intended to preserve a remedy that does not exist in Mexican courts. Respondent's position in this and other NAFTA cases precludes any such interpretation.

The Pending Proceeding

30. Finally, as Respondent acknowledges, CEMSA's pending amparo action is consistent with its Article 1121 waiver. (Rejoinder, ¶¶ 47-48)

31. On February 16, 1998, Claimant provided Respondent notice of intent to submit his claim to arbitration proceedings under NAFTA Chapter XI. On July 14, 1998 (five months after Claimant filed the Notice of Intent), Hacienda commenced an audit of the activities of *Corporación de Exportaciones Mexicanas, S.A. de C.V.* (CEMSA). On February 17, 1999, the Competent Authorities issued a decision under NAFTA, Article 2103(6) which allowed this arbitration to proceed.

32. Shortly thereafter, on March 1, 1999 (more than one year after Claimant filed the Notice of Intent), Hacienda issued a tax assessment against CEMSA in which it determined that CEMSA should pay approximately US$25 million for supposedly improper IEPS rebates CEMSA received in 1996-1997, plus interest and penalties.[5] Due to subsequent inflation adjustments plus additional interest and penalties, Hacienda now claims $45 million from CEMSA.[6]

33. On May 4, 1999 CEMSA filed an annulment petition before the *Tribunal Federal de Justicia Fiscal y Administrativa* requesting that the tax assessment be declared invalid as a matter of Mexican law. (It should be noted that the Tax Court does not belong to Mexico's judicial system; it is part of the executive branch.) This action, which culminated, after several steps, in the Court of Appeals decision of March 25, 2002, sought declaratory and injunctive relief, not damages. It was a purely defensive and necessary response to Hacienda's tax assessment.[7]

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[5] Paragraph B. 5 of the Reply mistakenly refers to the "1998" tax assessment. 1999 is the correct year.

[6] As Appendix 2 we are providing the Tribunal with Hacienda's statement to that effect, dated February 14, 2002.

[7] The first judgment by the Tax Court in favor of CEMSA was set aside and remanded by the Court of Appeals. On remand, the Tax Court ruled against CEMSA. But after new counsel appealed the case on grounds argued before this Tribunal, the Court of Appeals held the IEPS Law unconstitutional, set aside the second judgment by the Tax Court, and remanded the case to the Tax Court for a new judgment consistent with the Constitution.

34. CEMSA had no alternative under Mexican law but to challenge this assessment in court. Hacienda was not required to sue CEMSA to establish its alleged liability for the IEPS Law. Under the Mexican Fiscal Code (Codigo Fiscal de la Federacion), resolutions by the tax authorities are presumed to be legal unless set aside by a competent court (Article 68), and Hacienda could have executed the assessment without judicial proceedings if CEMSA did not pay within 45 business days. (Articles 65, 145, 173) If Claimant had not protected CEMSA's rights by challenging the assessment in court, we can be sure that CEMSA would no longer exist.

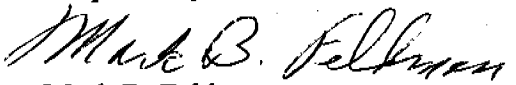
35. Moreover, the challenged assessment asserts that CEMSA claimed and received tax rebates that it was not entitled to claim. As the corporation's personal representative, Claimant could have been prosecuted criminally for such conduct and sentenced to 3-9 years in prison. In the case of "false declarations to obtain illegal tax rebates" the applicable prison term is increased by 50%. (See Articles 26, 95 and 108 of the Fiscal Code.) If left uncontested, the charges contained in Hacienda's resolution of March 1, 1999, would have been taken as proven with disastrous consequences for Claimant and CEMSA.

36. Article 1121(2)(b) cannot be interpreted to deny Claimant the right to protect his interests and CEMSA's in the circumstances described. Otherwise, Respondent could effectively opt out of Chapter 11 by initiating domestic proceedings against a claimant and forcing him to abandon arbitration under NAFTA in order to preserve his property (and liberty) in Mexico. Article 1121(2)(b) should not be an issue on the facts of this case.

Request for Relief from the Tribunal

37. Claimant reiterates his request (Memorial, at p. 128) that the Tribunal adjudge and declare that Respondent is not entitled, under NAFTA and applicable principles of international law, to recover rebates paid to CEMSA in respect of cigarette exports in 1996-1997. CEMSA's right to such rebates is the same throughout 1996 and 1997 and is supported, independent of the pending Mexican litigation, by the 1993 Supreme Court decision and Hacienda's agreement with Claimant. Respondent is estopped by that agreement, as a matter of international law, from contesting CEMSA's entitlement to IEPS rebates. Further, to protect its own authority and the integrity of this proceeding, the Tribunal should order Respondent to pay any damages and costs awarded by the Tribunal free and clear of any other amounts in dispute with either CEMSA or Claimant.

Respectfully submitted,



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