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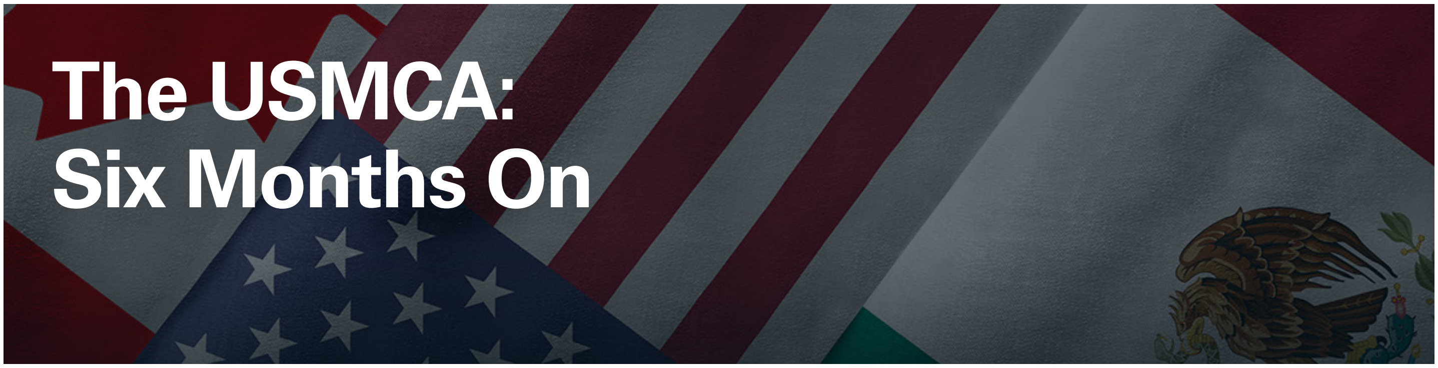
The USMCA: Six Months On



If you have any questions regarding the matters discussed in this memorandum, please contact the attorneys listed on the last page or call your regular Skadden contact.

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In a January 2021 webinar titled "The USMCA: Six Months On," Skadden International Litigation and Arbitration partners **Julie Bedard**, **David Herlihy**, **Timothy G. Nelson** and **Jennifer Permesly** and CFIUS, National Security and International Trade partner **Jeffrey Gerrish** and counsel **Brooks Allen** discussed the United States-Mexico-Canada Agreement (USMCA), six months after its signing.

The USMCA and Trade

Mr. Gerrish and Mr. Allen — both former officials in the Office of the U.S. Trade Representative who helped draft and negotiate the USMCA — kicked off the discussion by explaining the USMCA's automotive rules of origin, a key update to the North American Free Trade Agreement (NAFTA). The agreement raises the percentage of North American-sourced auto content needed to obtain preferential tariff treatment, raising it for passenger vehicles and light trucks from the NAFTA level of 62.5% to 75% over a three-year period. This Regional Value Content (RVC) measures the extent of production that must occur within North America. Mr. Gerrish noted that similar RVC levels apply to many automotive components, including electric vehicle batteries.

Mr. Gerrish also discussed the USMCA's Labor Value Content (LVC) requirements. The agreement mandates a given percentage of auto content that needs to be made by workers earning at least $16 an hour. The percentage is 30% at the treaty's signing, increasing to 40% for passenger vehicles and 45% for trucks by 2023. Mr. Gerrish mentioned that the goal is to drive up wages in North America and make higher-wage U.S. products more competitive vis-à-vis Mexico. He noted that the rules for calculating both RVC and LVC are extremely complex and are accompanied by extensive record-keeping and documentation requirements — all of which are subject to verification.

Mr. Gerrish explained that U.S. Customs and Border Protection will apply a six-month "informed compliance period" for the auto rules of origin for the first half of 2021, advising companies on how to correct compliance errors rather than imposing duties. He thought it was too early to discern the USMCA's impact on auto supply chains and sourcing decisions but said the U.S. will probably see an increase in domestic production.

Mr. Allen discussed several unique provisions of the USMCA, including new state-owned enterprise (SOE) rules that are the toughest in the world. The treaty expands the definition of qualifying entities and adds a variety of subsidy constraints, nondiscrimination obligations and commercial rules that SOEs must abide by. Mr. Allen also covered the treaty's currency chapter (the first ever in a U.S. free trade agreement), with parties pledging to avoid competitive currency devaluations.

Mr. Gerrish addressed the USMCA's Non-Market Economy clause, which requires parties to notify their counterparties if they intend to negotiate a free trade agreement with a "non-market economy." The provision represents an attempt to influence trade relations with China and ensure that China is not able to benefit from the preferences and advantages provided by the USMCA through the back door.

Mr. Allen gave an overview of the USMCA's Agricultural Market Access provisions, including new transparency and control obligations for agricultural biotech. He discussed Canada's controversial milk pricing policies, which allegedly disfavor U.S. and third-country products. The dairy sector already has generated the first enforcement case under the USMCA — a dispute over Canada's administration of dairy tariff-rate quotas (TRQs), which the Biden administration will likely pursue vigorously.

Next, Mr. Gerrish discussed the USMCA's Digital Trade chapter. The Digital Trade chapter prohibits the application of customs duties and other discriminatory measures to digital products; ensures cross-border data transfers and protects against data localization measures used to restrict where data can be stored and processed; applies consumer protections (*e.g.*, privacy protections) to the digital marketplace; promotes government collaboration on cybersecurity challenges; and limits civil liability for platforms hosting third-party content (similar to Section 230 of the United States' Communications Decency Act). Mr. Gerrish explained that for the first time in any U.S. trade agreement, the USMCA includes a prohibition on local data storage requirements for financial services suppliers in circumstances where a financial regulator has adequate access to data to fulfill its regulatory and supervisory mandate.

Mr. Allen introduced the USMCA's IP protections, which far exceed NAFTA in scope and nature. Copyright holders will see generous term extensions and benefit from full National Treatment protection. The USMCA contains very strong civil and criminal trade secret protections and requires parties to apply enforcement measures to the digital environment. Other provisions mandate patent term extension for unreasonable patent office and regulatory delays.

Finally, Mr. Gerrish covered the USMCA's labor provisions, which bolster protection for labor rights. Under the agreement, Mexico commits to specific legislative actions to enhance workers' rights and ensure effective recognition of the right to collective bargaining, and all parties have agreed to adopt and maintain core labor standards recognized by the International Labor Organization, effectively enforce their labor laws, and not waive or derogate from them. Mr. Gerrish highlighted the Rapid Response Mechanism, which allows a dispute settlement panel to conduct an expedited review of an alleged "denial of rights" of free association and collective bargaining at specific facilities in Mexico or the United States. The panel can review petitions, and the parties can impose remedies, including suspension of preferential treatment for goods produced at the target facility or other related penalties.

Changes in Investment Protection: USMCA v. NAFTA

Next, Mr. Nelson discussed the investment protection landscape under the USMCA, highlighting how things have changed from NAFTA. Investment treaties confer certain duties on their state parties with respect to "investments" in their territory made by qualifying nationals. If those investments are mistreated, the investors have certain avenues of legal recourse against the host state.

Before the USMCA entered into force, cross-border investment rights within North America were governed by Chapter 11 of NAFTA. As Mr. Nelson explained, Chapter 11 guaranteed that American investments in Mexico would not be expropriated except upon certain conditions, including that the investor would be paid fair market value compensation. The same guarantees were extended to Mexican and Canadian nationals when they invested in other NAFTA countries. NAFTA also assured investors, among other things, that they would receive fair and equitable treatment (FET) and full physical protection and security (FPS), thereby ensuring that laws or measures that stopped short of "expropriation," but still caused serious prejudice to investments, could be remedied. Chapter 11 also assured "national" treatment (*i.e.*, treatment no less favorable than that given to other NAFTA nationals) and Most Favorable Nation treatment (no less favorable than that accorded to other countries' nationals). The remedy for treaty violations was investor-state arbitration before a three-person independent arbitration tribunal that had power to award compensation.

Chapter 11 remained in force for just over 25 years. It led to a number of arbitrations and a handful of damages awards that were legally significant for investment law generally — Mr. Nelson highlighted some key damages awards against NAFTA member states, such as *Pope & Talbot v. Canada* (an FET case), and *Metalclad v. Mexico* (an FET/expropriation case), as well as claims such as *ADF v. United States and Loewen v. United States*, where the United States defeated investment claims. Some of these early disputes, however, caused unease for all three NAFTA governments, who collaborated on a 2001 opinion from the NAFTA Free Trade Commission that "reinterpreted" NAFTA protections. In particular, the opinion scaled back NAFTA's FET standard, making it harder for investors to prove their treaty rights were violated. Mr. Nelson noted that as new treaties were negotiated, the governments began limiting substantive protections in the treaty texts themselves. When NAFTA came up for renegotiation, there was a widespread appetite to do the same.

Mr. Nelson then covered the USMCA's updated investment protections, showing how the treaty is more restrictive than its predecessor and more explicitly deferential to state regulation. It delineates a "common understanding" for what is and is not an expropriation, and sands down FET and FPS protections by tethering them to the international minimum standard of treatment — a low bar that (in the view of some) prevents only shocking or outrageous government misconduct. The treaty also limits investors' ability to "import" more favorable substantive standards or dispute resolution procedures from other treaties. Overall, Mr. Nelson noted, USMCA leaves states with substantially more room to regulate — government measures that merely contradict an investor's expectations (without more) likely will not be actionable.

The USMCA and Investor-State Arbitration

Ms. Permesly discussed the USMCA's changes to investor-state arbitration procedures, which are considerable. Under the USMCA, investor-state arbitration is no longer available at all to Canadian investors in the U.S. and Mexico or for American and Mexican investments in Canada. These investors are left with only local remedies or perhaps state-to-state dispute resolution at the government level.

For Mexican and U.S. investors, the USMCA creates two different regimes: one for so-called "covered" investors and another for noncovered investors. Investors are considered "covered" if they (i) hold a covered government contract and (ii) operate in a covered sector of the economy. Covered government contracts are "written agreement[s] between a national authority of a Party and a covered investment or investor of another Party, on which the covered investment or investor relies in establishing or acquiring a covered investment other than the written agreement itself, that grants rights to the covered investment or investor in a covered sector." Covered sectors are oil and gas, electric power generation (any type, including solar and nuclear), telecommunications, transportation, and ownership and management of certain infrastructure projects (such as roads, railways, bridges or canals).

Covered investors can bring the full suite of investor-state arbitration claims in arbitration under the USMCA at any time within three years from the date they discovered (or should have discovered) the breach. Noncovered investors, however, lose most meaningful access to investor-state arbitration. As Ms. Permesly explained, they must litigate any claims in Mexican courts for 30 months before they can bring an arbitration. Even if they make it through, they can never assert FET or indirect expropriation claims in international arbitration. They are limited to claims for direct expropriation or discrimination (national treatment or MFN).

Ms. Permesly outlined one other dispute category: the USMCA's provisions for NAFTA legacy claims, which may be brought for three years after NAFTA is terminated. Investments made in the NAFTA era may still carry NAFTA protection for this time period. However, Ms. Permesly pointed out that covered investors cannot bring NAFTA legacy claims at all — instead, they must proceed under the USMCA. This may set up a conundrum for covered investors: Proceed under NAFTA (and its more favorable protections) and you may be perceived as having waived an argument that you are entitled to covered status under the USMCA. Alternatively, the state may deny your NAFTA legacy claim as inadmissible, insisting that you proceed under the USMCA as a covered investor.

Why does the USMCA so heavily restrict investor-state arbitration? Mr. Allen stepped in to provide some insight, noting widespread concerns over traditional investor-state arbitration led the parties to tighten access. Covered investors have a better time because they operate in sectors with intensive on-the-ground activities that frequently give rise to disputes. The legacy provisions ensure investors who relied on NAFTA when making their moves can still continue to assert NAFTA claims for a certain period of time. Mr. Allen explained that the Biden administration could continue to prioritize state-to-state dispute settlement over investor-state arbitration, at least in countries with stable judiciaries and relatively low economic risk.

Challenging State Regulation Under the USMCA

Mr. Herlihy addressed regulatory threats to renewable energy investors in Mexico, considering them through the framework of the USMCA. He explained that 2014 energy reforms spurred an influx of foreign investment in renewable energy, opening a massive market in Mexico. More than six years on, the Mexican government has soured on renewable energy and stared curtailing investor activity, using technical claims about grid security as a means to stop new renewable projects from testing and connecting to the grid. Investors have challenged the measures in Mexican courts, but the moves have created great uncertainty in the regulatory landscape, making investors nervous. Mr. Herlihy noted that the U.S. has protested Mexico's energy moves, but it is unclear whether the issue will be resolved at the state-to-state level. If the situation continues, NAFTA legacy claims or claims under the USMCA may be of value to affected investors.

Mr. Allen covered recent draft measures from Mexican regulators that require electronic payment providers who outsource their cloud computing services to maintain "backup" computing capacity in a separate jurisdiction (either in Mexico or a third country). Mr. Allen noted that these regulations are styled as an attempt to guarantee service continuity in Mexico and ensure information access for Mexican authorities, but they may violate USMCA commitments against data localization. The measures are already troubling some U.S. lawmakers, who have written to USTR in protest.

Key Takeaways

At the conclusion of the webinar, the panelists discussed the future of U.S. trade and investment policy after the USMCA. All agreed that the USMCA will be a critical benchmark moving forward and future U.S. free trade agreements will draw heavily on the treaty.

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