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Mexico: Lion award threatens arbitrators' exclusive jurisdiction

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Summary

IN SUMMARY

This article highlights the Federal Electricity Commission's role in the commercial arbitration sector, including the payment in full of the ***Chicoasén II*** award. It also covers Mexico's participation in current and future arbitrations related to politically strategic sectors. We analyse the potential impact of legislative amendments concerning the lithium industry. Finally, the piece examines the award rendered in ***Lion Mexico Consolidated LP v. United Mexican States***. The text analyses whether the arbitration is centred on the most relevant issues for a denial of justice claim, and explores the potential impact the award may have on the current relationship between courts and arbitrators in Mexico.

DISCUSSION POINTS

- Expectations of national and foreign investors doing business with the Federal Electricity Commission following payment of the Chicoasén II award
- Recent victories secured by Mexico in investment arbitrations, and investors lining up future claims
- Lithium industry reform as a catalyst for future arbitration proceedings
- Analysis of the reasoning in the ***Lion*** award on fair and equitable treatment and denial of justice
- Impact of ***Lion*** in the relationship between courts and arbitral tribunals in Mexico and their implied agreement to fully respect each other's jurisdiction

REFERENCED IN THIS ARTICLE

- *Omega Construcciones Industriales et al v Comisión Federal de Electricidad*
- *Eutelsat SA v México*
- Reform to the Mexican Mining Law
- *Lion Mexico Consolidated LP v México*

CFE PAYS CHICOASÉN II AWARD IN FULL

The past twelve months have been full of activity in the arbitration landscape in Mexico. In the commercial arbitration arena, in June 2021 Mexico's Federal Electricity Commission (CFE) paid an LCIA award exceeding US$270 million in favour of a consortium of three Mexican and one Chinese-owned entities regarding a dispute that arose from the failed construction of the Chicoasén II hydroelectric project in Chiapas, Mexico. The consortium initiated the arbitration in October 2016 arguing that CFE breached five obligations of the works contract and sought damages. The consortium also claimed that CFE's conduct during the execution of the project caused social unrest in the vicinity of Chicoasén and led the inhabitants of the region to set up blockades preventing it from carrying out the contracted works. Almost four years later, and after a hearing that involved the examination of 11 experts and 16 fact witnesses, the tribunal rendered its award. It found CFE liable for breach of all five obligations and awarded the contractors damages of US$225 million for the value of the works performed, delay and disruption damages, termination costs, and lost profits, granting

all the relief sought by the claimants.[1] The consortium promptly launched enforcement proceedings before the United States District Court in the Southern District of New York. CFE responded with an annulment petition to a Mexican federal court. In March 2021 the parties began settlement discussions that finally led to the payment of the total amount of the award, plus interest and taxes.

While payment in full of the Chicoasén II award by CFE may seem promising to Mexican and international investors, the authors (as the lawyers that represented the consortium in the arbitration and ensuing negotiations) can confirm that one crucial factor of CFE's decision to comply with the award was the current administration's desire to reactivate the operation of the Chicoasén II hydroelectric project. In March 2022 the Mexican government expropriated 102 acres of land in the municipality of Chicoasén to ensure the resumption of the works. As argued by the consortium in the arbitration, the lack of payment by CFE to the owners of the parcels of land in which the hydroelectric project would be built was one of the reasons why the citizens of Chicoasén prevented the consortium from performing the works years ago. Taking into account that payment of the award was necessary to allow other companies to resume the construction of the project, there are doubts as to whether CFE will honour subsequent arbitration awards rendered against it. In this regard, CFE recently reported on its financial statements for the first trimester of 2022 that it is currently a party to 21 arbitration proceedings.[2] According to major news outlets, CFE made provision of more than US$470 million to face adverse awards.[3] Interestingly, as far we are aware, these proceedings are handled directly by CFE's internal legal department. Before the current administration took office, CFE relied mostly on external law firms for its defence in arbitration.

AN ACTIVE, STRATEGICALLY FOCUSED ARBITRATION HUB

Mexico continues to be one of the pre-eminent arbitration centres in Latin America. Foreign investors have lodged at least four investment arbitration proceedings against Mexico in disputes covering the mining, oil and gas, and water treatment industries. For example, Monterra Energy, a subsidiary of the American investment fund KKR, filed a notice of intent under NAFTA to challenge the unexpected closure of a fuel storage terminal in Tuxpan, Mexico.[4] Regarding previously commenced cases, the past year has yielded positive results for Mexico. For example, Mexico prevailed against French company Eutelsat, which had argued violation of the fair and equitable treatment standard following a decision by the Mexican transport regulatory entity to require that the company reserve a certain amount of radio frequency spectrum for government use exceeding the requirements made of other companies in the sector.

In the near future, it seems that arbitration in Mexico will be largely influenced by legislative reforms related to politically strategic sectors. Concretely, some proceedings will certainly arise from reforms implemented by the López Obrador administration. For example, one legislative action that has gathered international attention is the decision by Mexico's Congress to nationalise the lithium industry. By amending articles 1, 5, 9, and 10 of Mexico's Mining Law, the reform provides that the exploration, exploitation or use of lithium will be entrusted to a state-owned entity, and prohibits all direct private investment and production. This reform was met with heavy criticism by the opposition, the Mexican mining industry and the international business community. For example, the Mexican branch of the ICC highlighted the great uncertainty that looms over the current holders of lithium concessions.[5] There is also great concern over the ability of the Mexican government to successfully exploit and trade lithium, as such activities ordinarily entail significant

capital investment and deep industry knowledge. This abrupt amendment to the regulatory framework in force when the lithium concessions were granted will likely give rise to commercial and investor disputes. On the one hand, the reform may impact the contractual relationships of mining companies and trigger claims for breach of contract, force majeure or material adverse effect. On the other, this legislative amendment may impair or even destroy the economic value of the investments made by international mining companies that could initiate investment arbitration claiming a violation of the protections granted by the bilateral and multilateral investment treaties executed by Mexico.

LION: DENIAL OF JUSTICE BY LACK OF FAIR AND EQUITABLE TREATMENT

The most significant event for the Mexican arbitration scene in the past months was the final award rendered in ***Lion Mexico Consolidated v United Mexican States***.[6] On 21 September 2021, an ICSID Additional Facility tribunal found Mexico liable for denial of justice against a Canadian investor. The case is novel in many respects. First, ***Lion*** is the only occasion in which an arbitral tribunal has found a positive denial of justice in NAFTA disputes. Second, while investment tribunals traditionally focus their analyses on the conduct of the government and legislature, and its effects upon foreign investors, the arbitral tribunal in ***Lion*** based its reasoning exclusively on the judiciary's conduct. Third, by assessing denial of justice through an objective parameter, the arbitral tribunal ruled against Mexico despite the absence of proof of malicious intent – corruption – from the Mexican court and instead focused its reasoning on the state of Jalisco courts' recklessness and overly formalist criteria. Fourth, unlike other disputes in which the investor has invoked a denial of justice such as ***Mondev International v United States of America*** or ***White Industries Australia v Republic of India***, no state organ or entity received a direct benefit from the national courts' actions — in contrast, in ***White Industries***, Indian courts delayed the enforcement of an arbitral award against an Indian state-owned entity for over nine years.

The ***Lion*** case originally stemmed from a dispute between Lion Mexico Consolidated (Lion), a Canadian investment management corporation, and a Mexican businessman, Héctor Cárdenas, who was granted three loans for the development of two real estate projects in Mexico. As described in the award, Mr Cárdenas executed three mortgages over the properties and other guarantees, which served as collateral for Lion. After defaulting on his obligations under the loans, Mr Cárdenas put in motion an elaborate scheme designed to exploit many of the Mexican judiciary's flaws and inefficiencies, to unduly liberate himself from his debt while thwarting any attempt of collection made by Lion. The first step of Mr Cárdenas's plan was forging a settlement agreement by which Lion supposedly agreed to cancel the mortgages and fully release him of his obligations. Mr Cárdenas then requested specific performance of the forged settlement agreement and the cancellation of the mortgages to a local court providing a fake domicile for Lion for service of process. With this commercial trial, Mr Cárdenas obtained a favourable judgment that was unknown to Lion at the time. Finally, Mr Cárdenas filed a spurious ***amparo*** claim on behalf of Lion using stolen IDs to create the impression that Lion was challenging the adverse first-instance ruling within the cancellation trial, but only to have the case thrown out by the competent court for intentional procedural deficiencies. The result of such a scheme was that, when Lion eventually found out the mortgages had been cancelled, it would be virtually impossible from substantive and procedural standpoints to assert its rights before Mexican courts.

After almost three years of fruitless litigation marked by Lion's inability to obtain adequate redress, it decided to initiate an ICSID arbitration arguing that Mexico's judiciary practices

constituted a denial of justice, which in turn violated the fair and equitable treatment investment protection granted by article 1105 of NAFTA. In a nutshell, Lion highlighted that it had been improperly summoned to the commercial trial that eventually led to the cancellation of its mortgages, and was subsequently denied an opportunity to provide evidence of the forgery of the settlement agreement that constituted the basis for the destruction of its investment. In turn, Mexico argued that Lion was the victim of a fraudster and not of the Mexican courts, whose conduct was ordinary and appropriate when confronted with a sophisticated scam, in addition to the fact that there were no allegations of corruption.

The arbitral tribunal sided with Lion. In its reasoning, the arbitrators discussed at length the merits of the original case and also rendered their opinion on some Mexican judicial practices and formalisms which, as discussed below, could motivate a debate on the relationship between arbitrators and state courts. The arbitral tribunal first analysed the applicable legal standard concerning a denial of justice, and, following the reasoning of ***Mondev***, found that this issue ought to be assessed from an objective standpoint to determine whether local courts (either negligently or intentionally) acted improperly and egregiously in violation of basic international standards to a degree that shocks the sense of judicial propriety.[7] After setting the applicable standard, the arbitral tribunal found that Mexico's judiciary had committed a denial of justice by, among others, (i) denying Lion access to justice in the original cancellation trial after being improperly summoned to the proceeding, (ii) denying Lion the right to appeal by unduly giving the first instance ruling ***res judicata*** status, and (iii) not allowing Lion to prove in an ***amparo*** proceeding that the settlement agreement was indeed a forgery. Based on the foregoing, the arbitral tribunal found Mexico liable and ordered it to pay Lion damages for the total value of its investment.

In December 2021, the Mexican government filed a petition to vacate the arbitral award before the United States District Court for the District of Columbia. In the vacatur proceeding, Mexico argues that the tribunal acted in manifest disregard of the law because it found that article 1105 of NAFTA granted protections to investors, and not only to 'investments of investors' as submitted by Mexico. Lion replied by defending the tribunal's interpretation of NAFTA and cross-petitioning the confirmation, recognition and enforcement of the award. At the time of writing, the decision on the annulment of the award is still pending.

LION AWARD MUDDIES DISTINCTION BETWEEN COURTS AND TRIBUNALS

In the authors' opinion, the focus of the ***Lion*** decision is misaligned. For instance, in several sections of the award, the arbitral tribunal emphasises that, during the ***amparo*** proceeding, the Mexican court dismissed one of Lion's judicial attempts to provide evidence of the forgery (***ampliación de la demanda de amparo***) under the ground that such motion was signed by Lion's counsel, instead of its legal representative. The arbitral tribunal perceived that such a decision was inconsistent with the fact that while administering the fake ***amparo***, it let the complainant remedy another procedural deficiency, by allowing it to file a series of missing copies. The arbitral tribunal considered that such circumstance resulted in an unfair procedural unbalance that supported its finding of a denial of justice.[8] However, in the authors' view, the reality is that, under Mexican law, these situations are not comparable. On one side, failure to present the requisite copies in an ***amparo*** proceeding is customarily recognised by jurisprudence and trial practice as a minor and curable mistake. On the other, there is binding precedent from the Mexican Supreme Court that the lack of a signature from a person with appropriate representation on behalf of a party filing an ***amparo*** necessarily

entails the dismissal of the ***amparo*** claim for lack of consent. While this sanction is certainly harsh, the fact remains that the Mexican court acted in conformity with the applicable procedural law in connection with this particular issue. At its heart, the tribunal's criticism is directed mainly toward the status of Mexican law itself, rather than the conduct of the Mexican courts.

The same may be true regarding the arbitral tribunal's focus on the impossibility of Lion filing an appeal caused by the first instance court unduly giving ***res judicata*** status to its ruling. While the decision taken by the court is clearly flawed, in reality, it did not have any practical impact on Lion's already precarious position. Even if an ordinary appeal had not been denied, as Lion was not properly summoned and only learnt of the proceedings at a later time, it would not have been able to file the motion to appeal within the applicable legal term and, thus, the first instance ruling would have acquired ***res judicata*** effect nonetheless. While the authors agree with the arbitral tribunal's overall conclusions regarding the existence of a denial of justice against Lion, we also believe that insofar as the arbitral tribunal was effectively judging the actions of numerous state courts, it should have analysed the judiciary's actions in accordance with the specific legal standards that they are bound to observe to conclude whether they had acted recklessly and arbitrarily.

Given the foregoing, the reasoning would have been better focused on the actions that most starkly contrasted with the applicable legal standards. For instance, in our opinion, the most scandalous and harmful decision made by the Mexican courts cited in the award was the dismissal of an ancillary proceeding within the ***amparo*** (***incidente de falsedad de documento***). Through this motion, Lion attempted to furnish evidence that the settlement agreement that gave rise to the dispute and served as a basis for service of process was forged. Although such evidence was material to Lion's case, the court dismissed the proceedings on the grounds that the settlement agreement was allegedly not related to the subject matter of the ***amparo***.[9]

In our opinion, the court's reasoning in dismissing the ***incidente de falsedad*** is clearly incompatible with Lion's ***amparo*** as a whole, as the aim of the trial was precisely to combat the inappropriate service of process that summoned Lion to the original commercial trial and that was effectuated in the address indicated in the settlement agreement. The relevance of the settlement agreement being forged, and therefore the importance of the dismissed ancillary proceeding, was later confirmed by the court's final ruling denying Lion its ***amparo***. Indeed, the court ultimately upheld the validity of the service of process in the original commercial trial, relying on its being effected in accordance with the terms supposedly agreed under the forged settlement. Had the court given Lion an opportunity to challenge the settlement's authenticity within the ancillary proceeding, it would have almost certainly found that the service of process in the commercial trial was flawed. In the authors' opinion, had the award targeted this type of egregiously mistaken and illegal decision made by the Mexican courts, the arbitral tribunal's finding of a denial of justice would have been better justified.

While the ***Lion*** case will undoubtedly have a significant impact in Mexico, particularly on the relationship between arbitrators and state courts, we believe there is no straightforward answer on whether it will be positive or negative in the long run. Firstly, ***Lion*** has opened a debate relating to the excessive formalisms that plague the Mexican judiciary. This issue had already been addressed, albeit abstractly, by a recent reform to article 17 of the Mexican Constitution, which now mandates judicial authorities to give preference to matters

concerning the merits over formalisms in their adjudicating processes, provided that parties receive fair and equal treatment. Notwithstanding this reform, the authors have perceived no substantial improvement in practice. In this regard, ***Lion*** could potentially set off a deeper reflection concerning some of the judiciary's daily practices, hopefully promoting much more flexible proceedings and preventing unjust decisions under purely formal grounds. While ***Lion*** will probably incentivise businessmen and dealmakers in Mexico to adjudicate their disputes through arbitration and not local courts, the case serves as a reminder to foreign investors in Mexico that ISDS can be an effective recourse, even when the state misconduct is carried out by the judiciary.

Lion may also impact the relationship between arbitrators and state courts in relation to each other's decisions. In recent years, precedents by Mexican courts have consistently recognised arbitrators' exclusive jurisdiction over the disputes arising from an arbitration agreement, prohibiting state courts from revising ***de novo*** an arbitrator's decision on the merits and setting a very high standard to entertain award annulment actions. In the authors' view, this is the result of an implied agreement between arbitrators and state courts, concerning the role and exclusive jurisdiction each has over their own affairs, in exclusion of the other. This dividing line may be blurred after ***Lion***, in which the arbitral tribunal analysed the substance of certain Mexican state courts' decisions and expressly condemned them. Hence, state courts may perceive that the ***Lion*** tribunal breached the implied agreement, and become more intrusive of arbitrators' jurisdiction while exercising their supervisory functions.

Endnotes

1 See https://jusmundi.com/en/document/decision/en-omega-construcciones-industriales-s-a-de-c-v-mexico-sinohydro-costa-rica-s-a-costa-rica-desarrollo-y-construcciones-urbanas-s-a-de-c-v-mexico-and-caabsa-infraestructura-s-a-de-c-v-mexico-v-comision-federal-de-electricidad-mexico-final-award-monday-22nd-june-2020. ^ Back to section

2 See https://www.cfe.mx/finanzas/reportes-financieros/Documents/2022/1er%20Trimestre%202022.pdf. ^ Back to section

3 See https://expansion.mx/empresas/2022/05/13/cfe-enfrenta-21-arbitrajes-internacionales. ^ Back to section

4 See https://ciarglobal.com/monterra-energy-amenaza-a-mexico-con-arbitraje-por-cierre-de-planta-tuxpan/. ^ Back to section

5 See https://www.elfinanciero.com.mx/empresas/2022/04/27/ley-minera-gobierno-de-amlo-tendria-que-pagar-indemnizacion-a-empresas/. ^ Back to section

6 See https://www.italaw.com/sites/default/files/case-documents/italaw16302.pdf. ^ Back to section

7 See, for example, *Lion Mexico Consolidated v the United Mexican States*, final award, ¶299. Back to section

8 See, for example, *Lion Mexico Consolidated v the United Mexican States*, final award, ¶¶ 512-515. Back to section

9 See, for example, *Lion Mexico Consolidated v the United Mexican States*, final award, ¶ 156. Back to section

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