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NOTICE OF ARBITRATION

TO: Secretary General
International Centre for Settlement of Investment Disputes
("ICSID")
1818 H Street, N.W.
Washington, DC 20433

Marvin Roy Feldman Karpa, a national of the United States of America who is not a Mexican national, files this Notice pursuant to Article 2 of the Arbitration (Additional Facility) Rules and the provisions of the North American Free Trade Agreement

(1) to advise that he wishes to institute arbitration proceedings against the Government of the United Mexican States on behalf of Corporacion de Exportaciones Mexicanas, S.A. de C.V., a company organized under the laws of Mexico ("CEMSA"), and

(2) to request the Secretary General to approve access to the Additional Facility and to register this Notice in the Arbitration (Additional Facility) Register pursuant to Article 4 of the Arbitration (Additional Facility) Rules.

A. *Parties:*

(1) *Claimant:* Marvin Roy Feldman Karpa
Alejandro Dumas 16, Col. Polanco,
Mexico City, DF 11560
Mexico

On Behalf Of:

Corporacion de Exportaciones Mexicanas, S.A. de C.V.
Manuel Gutierrez Najera 249
Col. Transito
Mexico City, DF 06820
Mexico

Claimant's Representative:

Mark B. Feldman, Esquire
Feith & Zell, P.C.
2300 M Street, NW, Suite 600
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(2) *Respondent:* Government of the United Mexican States
c/o Direccion General de Inversion Extranger
Secretaria de Comercia y Fomento Industrial
Avenida Insurgentes 1940, Col. La Florida,
Mexico D.F. 01030

Respondent's Representative:

Tomas Ruiz
Deputy Minister of Revenue
Secretaria de Hacienda y Credito Publico
Ave. Hidalgo No. 77, Modulo 1, Piso 1
Col. Guerrero
Mexico City, D.F. 06300

B. Provisions for Arbitration of the Dispute.

(1) NAFTA

This dispute is subject to arbitration under the provisions of the North American Free Trade Agreement Between The Government of Canada, The Government of the United Mexican States and the Government of The United States of America, entered into force January 1, 1994 ("NAFTA"), including Chapter 11 – Articles 1110, 1117, 1120 (1)(b) and (2), 1122, 1124; and Chapter 21 – Article 2103 and Annex 2103.6. The texts of these provisions are set forth in Exhibit A.

(a) Consent

Respondent, as a party to NAFTA, consents to arbitration by the terms of Article 1122. Claimant consents to arbitration in accordance with Article 1120. The Investor's Consent and Waiver is attached as Exhibit B, and the Enterprise's Consent and Waiver in the form of a resolution of CEMSA'S Board of Directors is attached as Exhibit C. Both documents were delivered to Respondent on April 28, 1999 at the address designated by Respondent pursuant to Annex 1137.2.

(b) Time-related Conditions

Article 1120(1) – More than six months have elapsed since the events giving rise to the claim.

Article 1119 – The Investor delivered written notice of his intention to submit the claim to arbitration to Respondent on February 18, 1998 at the address designated by Respondent pursuant to Annex 1137.2.

Article 1117 – The claim is not barred by lapse of time under the terms of Article 1117(2) which provides:

> An investor may not make a claim on behalf of an enterprise described in paragraph 1 if more than three years have elapsed from the date on which the enterprise first acquired, or should have first acquired, knowledge of the alleged breach and knowledge that the enterprise has incurred loss or damage.

Claimant first learned in December 1997 that Respondent had reversed its decision to allow CEMSA tax rebates on cigarette exports as required by Mexican legislation since January 1, 1992 and by Supreme Court decision since August 23, 1993. Claimant was not officially advised of Respondent's decision to reverse that policy until February 24, 1998. Prior to that date, and since June 1996, Respondent

had permitted Claimant to export cigarettes and had made the tax rebates required by Mexican legislation in force and the Mexican Supreme Court decision of August 18, 1993.

Respondent's decisions in November 1997

(a) to shut down CEMSA's cigarette export business, and

(b) to refuse to rebate excise taxes on cigarette exports made by CEMSA in October and November 1997 in reliance on Mexican administrative guidance,

were part of a continuing pattern of discrimination against CEMSA and denial of justice dating back to 1991. Moreover, Respondent effectively breached a *de facto* settlement it had reached with CEMSA in June 1996, after three years of insistence by CEMSA, by which Respondent recognized CEMSA's entitlement to tax rebates on cigarette exports. CEMSA did not waive its damage claims for prior years in 1996, but it was prepared not to assert them in consideration of Respondent's recognition of its rights to do business in the future. CEMSA's reliance on that *de facto* settlement suspended, as a matter of equitable right, the running of any applicable period of limitation, and Respondent is estopped by its breach from asserting any such limitation.

Article 2103(6) – NAFTA does not apply to taxation measures except as set out in Article 2103. Paragraph (6) states in substance that Article 1110 (Expropriation) applies to taxation measures, except that no Investor may arbitrate a claim under Article 1110 if the competent authorities designated by the two relevant Parties (senior tax policy officials) agree "that the measure is not an expropriation ...." The Investor has to refer the issue to the appropriate competent authorities. If they do not act within six months, the investor may submit his claim to arbitration.

In this case, the competent authorities have acted. The Investor referred the issue to the competent Mexican authority and to the United States Government on February 18, 1998. Subsequently, the Investor referred the issue directly to the competent U.S. authority on August 18, 1998. After detailed discussions, the competent authorities reached an agreement that is set forth in a letter from Donald Lubick, Assistant Secretary for Tax Policy of the United States Department of the Treasury, dated February 17, 1999, and a letter from Tomas Ruiz, Under Secretary of Revenue of the Mexican Ministry of Finance and Public Credit, dated February 18, 1999 (Exhibit D). This agreement bars NAFTA arbitration of claims based on certain Mexican legislation effective January 1, 1998, but allows the other expropriation claims asserted by CEMSA under NAFTA to proceed to arbitration.

(2) The Additional Facility

This dispute falls within the jurisdiction of the Additional Facility pursuant to Article 2(a) of the Rules Governing the Additional Facility For the Administration of Proceedings by the Secretariat of the International Centre for Settlement of Investment Disputes. This is a legal dispute arising directly out of an investment between an Investor, who is a citizen of the United States of America, and not a Mexican national, and the United Mexican States, a disputing State that is not a party to the ICSID Convention. Claimant asserts violations of NAFTA, Chapter 11, Section A on the part of Respondent.

The Investor, Marvin Roy Feldman Karpa, owns all the stock of the enterprise, Corporacion de Exportaciones Mexicanas, S.A. de C.V.("CEMSA"). The enterprise was organized under the laws of Mexico in May 1988 as a corporation dedicated to foreign trade. (*See* Declaration of Marvin Feldman at Exhibit E).

C. The Claims and Issues in Dispute

This dispute involves claims for compensation and damages of U.S. $ 50 million, plus post-judgment interest, for measures tantamount to nationalization or expropriation and constituting a denial of justice in violation of the rules and principles of international law and NAFTA Articles 1110 and 1105 (1). The claims relate to Respondent's arbitrary, discriminatory and confiscatory actions during the period January 1, 1992-December 31, 1997, with the purpose and effect of suppressing CEMSA'S cigarette export business including, *inter alia*,

(a) Respondent's refusal to allow CEMSA to export cigarettes with rebate of excise taxes as provided by law during the period January 1, 1992 -December 31, 1997, except for the period June 1996- November 1997, when such rebates were allowed;

(b) Respondent's refusal to implement a decision of Mexico's Supreme Court of Justice issued on August 18, 1993 holding that the Mexican Constitution requires the tax authorities to allow CEMSA rebates of excise taxes for cigarette exports on the same basis that such rebates are made to cigarette manufacturers;

(c) Respondent's refusal to rebate 18,975,730 pesos in excise taxes owed to CEMSA in respect of cigarette exports that CEMSA made in October and November 1997 in reliance on the prior approval of the competent Mexican tax authorities;

(d) Respondent's refusal to allow CEMSA to export cigarettes with tax rebates in December 1997; and

(e) Respondent's decision in November 1997 to shut down CEMSA's cigarette export business so as to reinstate an illegal export monopoly for cigarette producers.

(1) Key Facts

The key facts are recited in Marvin Feldman's Declaration at Exhibit E (hereinafter "Dec."). In brief, Mexican law promotes the export of Mexican products by allowing rebates of VAT and other consumption taxes on exports, including the high excise taxes (85%) imposed on sales of processed tobacco. The tax rate applicable to disposals of cigarettes by export is 0%, and full rebates of the cigarette tax are made to exporters after shipment. Generally, the exporter receives the rebate during the month after shipment.

CEMSA has been registered as a foreign trade company since 1988 and began exporting cigarettes in 1990. In 1991, Mexican law was amended to disallow tax rebates on cigarette exports except for exports by cigarette producers. CEMSA and another export company challenged this measure in two separate actions, and the Mexican Supreme Court ruled unanimously in both cases that the 1991 amendment violated constitutional principles of tax neutrality and non-discrimination. The Supreme court's 15-0 decision in CEMSA's favor was issued on August 18, 1993. (Dec. ¶ 6.) Extracts from the Mexican Supreme Court decision are attached as Exhibit F.

Mexican legislation was amended in 1992 to make the cigarette tax rebate available to all exporters. (Dec. ¶5) Three letters to CEMSA from Mexican government officials confirming that CEMSA was entitled to export cigarettes at a 0% tax rate under legislation in force from January 1, 1992 through December 31, 1997 are attached at Exhibit G. Notwithstanding the legislation, the Supreme Court's decision and official letters, Mexican tax authorities did not make the rebates ordered by the court until March 1994 and did not permit CEMSA to resume cigarette exports until June 1996. In fact, Mexican tax officials told Marvin Feldman that the court decision was wrong and that they would not follow it. (Dec. ¶ 9, 21) They took the position that CEMSA was required to produce invoices from its vendors which expressly "separated the taxes," *i.e.*, stated the amount of tax included in the purchase price.

This was a "Catch 22" for CEMSA, because the tax authorities refused to make the cigarette manufacturers comply with their obligation under Mexican law to separate the taxes for their customers. CEMSA's vendors, *e.g.*, Sam's Club and the Price Club, cannot separate the taxes for CEMSA, or any purchaser, because the manufacturers

do not separate the taxes for them. The manufacturers have never separated the taxes for their customers as required by law, and high Mexican officials have said on more than one occasion that they will not require them to do so. (Dec. ¶¶ 9, 11, 14.)

Although CEMSA received written confirmation from Mexican officials that it was entitled to have the tax separated on its invoices as required by Mexican law (Dec. ¶¶ 5, 11), CEMSA did not dare export without assurances that it would be allowed to separate the taxes itself if the manufacturers failed to do so. (It stood to lose the high tax incorporated in the purchase price of cigarettes.) Thus, for several years, CEMSA petitioned the tax authorities either to make the producers separate the taxes as required by law or to allow CEMSA to apply for rebates without such documentation, *i.e.*, to separate the taxes itself. (Dec. ¶¶ 8, 11-12.)

Finally, in the Spring of 1996, after the U.S. Embassy wrote a letter to the Finance Ministry invoking NAFTA , the Mexican government decided to allow CEMSA to export cigarettes without the impossible-to-obtain invoices separating the tax. (Dec. ¶ 14.) A Mexican tax official told Marvin Feldman that CEMSA should separate the tax itself, and Mr. Feldman confirmed this instruction with other officials before purchasing cigarettes for export. (Dec. ¶ 14.) Over sixteen months, June 1996 – September 1997, CEMSA exported large quantities of cigarettes and received $ U.S. 10,766,559.00 in tax rebates. However, the tax authorities changed course in December 1997 and denied CEMSA's applications for 18,975,730 pesos (now U.S. $ 4.2 million)[1] in rebates for shipments made in October and November 1997. Subsequently, the Mexican tax law was modified again to eliminate cigarette tax rebates for resellers effective January 1, 1998. That measure is being challenged in the Mexican courts.

The official explanation for Mexico's confiscatory refusal to rebate the taxes owed CEMSA for October-November 1997 exports was the "Catch 22" that CEMSA needs to provide an invoice from its vendors expressly separating the tax – the same issue that was resolved in CEMSA's favor by the Ministry of Finance in 1996. (Dec. ¶ 20.) Informally, a senior tax official, Ismael Gomez Gordillo, told Claimant that Carlos Slim, his friend of twenty years, had asked him to stop CEMSA from exporting cigarettes and that the Supreme Court decision was wrong. Carlos Slim is a member of the Phillip Morris Board of Directors and the former majority owner of Phillip-Morris' Mexican subsidiary, CIGATAM. (Dec. ¶ 19.) Claimant has had other indications that the Mexican government is withholding the rebates owed for 1997 to force CEMSA to stop exporting cigarettes and to give up its legal rights. (Dec. ¶ 22.)

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[1] Including the inflation adjustment mandated by Articles 20-21 of the Mexican Fiscal Code.

(2) *The Law – Measures intended to force CEMSA out of the business of exporting cigarettes are actions tantamount to expropriation under NAFTA.*

Mexico's actions in this case are tantamount to expropriation in violation of international law and NAFTA Article 1110, because they are arbitrary, discriminatory, and confiscatory. These are not general tax measures intended to raise revenue – none is raised – but measures specifically targeted against CEMSA intended to shut down its cigarette export business and to give the producers a monopoly on exports. Moreover, Mexico's Supreme Court declared such a monopoly to be unconstitutional in 1993. The government's failure to respect that decision, as well as its refusal to make rebates for October-November 1997 exports made with prior administrative approval, constitutes both an expropriation and a clear "denial of justice" under traditional principles of international law.

State responsibility for denial of justice -- the international law equivalent of a violation of due process -- is a treaty obligation under NAFTA Article 1105 and is arbitrable under Article 1110(c). NAFTA provides that :

> Each party shall accord to investments of investors of another Party treatment in accordance with international law, including fair and equitable treatment and full protection and security. (NAFTA, Art. 1105 (1))

Expropriation is to be effected in accordance with international law principles including non-discrimination, due process and full compensation:

> (1) No Party may directly or indirectly nationalize or expropriate an investment of an investor of another Party ... or take a measure tantamount to nationalization or expropriation ... except:
>
> (a) for a public purpose;
>
> (b) on a non-discriminatory basis;
>
> (c) in accordance with due process of law and Article 1105(1); and
>
> (d) on payment of compensation in accordance with paragraphs 2 through 6. (NAFTA, Art.1110)

A state is responsible for economic injury to nationals of another state due to takings or other "arbitrary or discriminatory" actions that impair property or economic interests of foreign nationals, *Restatement (Third) of Foreign Relations Law of the United States ("Restatement")* § 712 (A.L.I. 1987), and the words "tantamount to expropriation" in NAFTA Article 1110 cover indirect expropriations as in this case. In international law, the phrase "expropriation" is understood to apply "not only to avowed expropriations in which the government formally takes title to property, but also to other actions that have the effect of 'taking' the property, in whole or in large part, outright or in stages ('creeping expropriation'). A state is responsible for an expropriation of property ... when it subjects alien property to taxation, regulation, or other action that is confiscatory, or that prevents, unreasonably interferes with, or unduly delays, effective enjoyment of an alien's property ...." *Restatement*, §712, cmt. g.

(a) Confiscation

A state is not responsible for economic injury resulting from bona fide general taxation that is not discriminatory, but it is liable for confiscatory tax measures, such as those intended to cause the alien to abandon the property or to sell it at a distress price. *See Too v. Greater Modesto Insurance Associates and the United States of America*, Case No. 880, 23 Iran-U.S. Claims Tribunal Reports 378 (1989). The latter rule applies here where Mexico's actions had one purpose only – to terminate cigarette exports by CEMSA by excluding it from the tax rebates granted to exporters approved by the state.

(b) Discrimination

Discrimination is a separate basis of illegality under international law. *Restatement*, § 712. This principle applies not only to discrimination on the basis of nationality, but also to discrimination against particular aliens. *Id.* cmt. f. In this case, the question of discrimination has been decided by the Mexican Supreme Court, which held unconstitutional the 1991 amendment disallowing cigarette tax rebates for resellers on the grounds that the law

> violates the principles of tax generality and equality ... before such amendment, the exception was granted by taking into consideration the definitive exportation of the taxed goods in an objective manner isolated from any personal relationship, regardless of who carried it out ... now the application of the 0% rate is limited ... the zero rate thus becomes a privilege of a few subjects, since it does not give the same treatment to all the persons carrying out the same export activities. (Exhibit F)

(c) Denial of Justice

Finally, government action that violates international standards of due process, including failure to implement a judicial decision protecting an alien, constitutes a denial of justice under traditional principles of international law. NAFTA Article 1110 (c) refers specifically to "due process" and expressly incorporates Article 1105 (1).

Denial of justice occurs whenever an alien is denied an effective administrative or judicial remedy by action of any branch of government -- judicial, executive or legislative. Charles L. Hyde, *International Law Chiefly as Interpreted by the United States*, vol. 1, 491 (1922); *see also Restatement*, § 711, cmts. a and e and § 712, cmt. j. In particular, "[i]t appears to be a well-established principle of international law that a denial of justice may be predicated on the failure of the authorities of a government to give effect to the decisions of its courts." *H.G. Venable* (U.S. v. Mex.) Opinions of the Commissioners, United Nations, *Reports of International Arbitral Awards*, Vol. IV, 219, 245-46(1927) (citations omitted).

Denial of justice can also arise from arbitrary and contradictory actions by administrative officials. After years of delay, and over objections by cigarette manufacturers, Mexican tax authorities agreed in June 1996, to allow rebates for CEMSA. This practice continued for sixteen months through September 1997, and CEMSA relied on it in purchasing cigarettes for export in October-November 1997. Due to the manufacturers' continued resistance, changes in personnel in the Finance Ministry and ambiguous legislation at the end of 1996, CEMSA wrote senior officials in January 1997 seeking confirmation that the policy towards CEMSA had not changed. (Dec. ¶ 16.) In March 1997, CEMSA received a letter from the tax authorities which reiterated, *inter alia*, that since 1992 any exporter could apply the 0% rate. (Letter from Miguel Gomez Bravo, March 16, 1997 at Exhibit G) Moreover, the Mexican authorities continued to rebate taxes for CEMSA through September 1997. (Dec. ¶ 17.)

In December 1997, the Mexican Government reversed course without any prior warning to CEMSA and refused to rebate taxes on cigarette exports made in October-November 1997. Retroactive reversal of tax policy in these circumstances is "harsh and oppressive" and constitutes a clear violation of due process of law and denial of justice. *See Eastern Enterprises v. Apfel*, 118 S. Ct. 213, 214 (1998) (imposition of severe, disproportionate and extremely retroactive pension liability held to be a taking under Fifth Amendment). In this case, CEMSA relied on administrative guidance from the tax authorities and a consistent course of administrative conduct over more than sixteen months. There is no doubt that this action, tantamount to expropriation of CEMSA's cigarette export business, was done for the benefit of Mexican producers including CIGATAM, Phillip Morris' Mexican subsidiary. Arbitrary action by public officials to block one company's business opportunity for the benefit of another is

inconsistent with fundamental notions of fairness and legality, particularly when such action is retroactive.

D. Damages

CEMSA will establish its entitlement to, and hereby requests, a total arbitration award of approximately 475 million pesos, which, assuming an exchange rate of 9.5 pesos to the U.S. dollar, equals $U.S. 50 million. In addition, CEMSA requests post-award interest on this arbitration award, to be computed at the applicable rate of interest, as well as any other legal or equitable relief the arbitrator deems just and warranted.

CEMSA's requested arbitration award is based on the following:

(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).[2]

(b) Compensation for lost profits, and lost good will caused by the intentional destruction of CEMSA's export business, after December 1, 1997.[3]

(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.

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[2] CEMSA is entitled to damages and lost profits caused by Respondent's conduct beginning in 1992, notwithstanding Article 1117(2)'s three-year limitations period, for the reasons stated above in Section B(1)(b) ("Time-related Conditions").

[3] As is discussed above, CEMSA is not requesting in this Notice arbitration of expropriation claims based on Mexican legislation, effective January 1, 1998, which purports to disqualify CEMSA from the benefits of the excise-tax rebate on cigarettes. See *supra* at Section B(1)(b); see also Exhibit D. Nonetheless, CEMSA does request compensation for profits lost after December 1, 1997 and for good will (*i.e.*, the value of CEMSA as a going concern in December 1997) lost by virtue of the intentional destruction of CEMSA's export business caused by Respondent's conduct prior to January 1, 1998.

E. Conclusion

For the reasons stated above, Claimant, by its undersigned counsel and representative, respectfully requests the Secretary General to approve access to the Additional Facility and to register this Notice in the Arbitration (Additional Facility) Register pursuant to Article 4 of the Arbitration (Additional Facility) Rules.

Mark B. Feldman

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Signed this 30 day of April, 1999