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School of International Arbitration, Queen Mary, University of London
International Arbitration Case Law
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Award Name and Date: Lion Mexico Consolidated LP v. United Mexican States (ICSID Case No. ARB(AF)/15/2) – Decision on Jurisdiction – 30 July 2018

Case Report by: Inaê Oliveira**, Editor Ignacio Torterola***

Summary: Mexico objected to the Tribunal's jurisdiction, claiming that neither promissory notes nor mortgages were investments under Article 1139 NAFTA, and the Tribunal decided to bifurcate the proceedings to assess the issue. The Tribunal held that promissory notes were not protected investments, but that mortgages qualified under Article 1139(g) NAFTA ("real estate or other property, tangible or intangible").

Main Issues: whether mortgages and promissory notes are protected investments under Article 1139 NAFTA.

Tribunal: Mr. Juan Fernández-Armesto (President), Mr. David J. A. Cairns (Arbitrator), and Prof. Laurence Boisson de Chazournes (Arbitrator).

Claimant's Counsel: Ms. Onay Payne (Lion Mexico Consolidated LP); Mr. Robert J. Kriss (Mayer Brown, Chicago); and Mr. Dany Khayat, Mr. Alejandro López-Ortiz and Mr. José J. Caicedo (Mayer Brown, Paris).

Respondent's Counsel: Ms. Samantha Atayde Arellano, Ms. Cindy Rayo Zapata, Ms. Gabriela Alcántara Torres, Mr. Hugo Gabriel Romero Martínez, and Mr. Aristeo López Sánchez (Mexico, Secretaría de Economía); Mr. J. Cameron Mowatt and Mr. Alejandro Barragán (J. Cameron Mowatt, Law Corporation); and Mr. Stephan Becker (Pillsbury Winthrop Shaw Pittman).

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Digest:

1. Relevant Facts (¶¶52-92)

Lion Mexico Consolidated L.P. ('Lion') is constituted under the laws of Quebec, Canada, and has its main place of business in Texas, U.S. (¶7); it was created and is managed by Clarion Partners, a U.S. company focused on real estate investment management (¶53). Respondent is the United Mexican States ('Mexico') (¶9).

Lion was introduced to Mr. Héctor Cárdenas Curiel, a local businessman, through a company engaged by Clarion to present investment opportunities in Mexico. Mr. Cárdenas sought funds for developing two real estate projects: **(1)** the *Nayarit Project*, which included an oceanfront residential and resort development in Bahía de Banderas, State of Nayarit, and **(2)** the *Guadalajara Project*, which consisted of two high-end mixed-use skyscrapers in the city of Guadalajara, State of Jalisco. Lion agreed to fund the projects subject to certain requirements, including **(i)** granting of mortgages over the land acquired for the projects and **(ii)** issuance of promissory notes as unconditional commitments to repay the loan (¶¶54-58).

For financing the projects, Lion and Mr. Cárdenas made three sets of transactions, each with a loan, a mortgage, and a promissory note (¶¶59-62). The first set of transactions was carried out in February 2007. Lion loaned USD 15,000,000 ('First Loan'); in return, one of the companies owned or controlled by Mr. Cárdenas issued a promissory note in the same amount and conditions ('First Note') and granted the mortgage over the Nayarit Project property to Lion ('Nayarit Mortgage') (¶¶63-70). The second set took place in June 2007. Lion loaned USD 12,450,000 ('Second Loan'); in return, it received a Second Note and the Guadalajara Mortgage 1 (¶¶71-77). The third set was carried out in September 2007. Lion loaned USD 5,355,479 ('Third Loan'); in return, it received the Third Note and the Guadalajara Mortgage 2 (¶¶78-84)

All loans were formalized through Credit Agreements drafted in English and governed by Mexican law (¶¶ 65; 73; 80). All promissory notes (under Mexican law, "*pagarés no negociables*") had remuneration at a fixed interest rate and. The First Note was substituted four times, resulting in a final maturity date as of September 30, 2009 (¶¶67; 75; 82). All mortgages were recorded at the Public Property Registry. (¶¶70; 77; 84)

The initial deadlines for repayment of all three Loans were not met. Mr. Cárdenas requested and obtained a series of time extensions: from March 2008 through July 2009 (¶85). The last payment date on the three transactions was, ultimately, September 30, 2009, and the debtors failed to satisfy the outstanding amounts by that date. (¶86)

In view of the defaults, in February 2012 Lion sought to enforce its rights judicially. In the merits, not addressed in this Decision, Lion alleged that Mexican courts and public registries had engaged in improper conduct, "allowing a fraud based upon a forged loan restructuring agreement, which resulted in the unlawful cancellation of Lion's Mortgages and Notes". (¶91) Based on the cancellation of the mortgages and notes, it claimed that Mexico had breached Articles 1110 (expropriation) and 1105 (minimum standard of treatment) NAFTA. Consequently, Lion asked the Tribunal to issue an award for damages representing the value of its investment, lost as a result of Mexico's breach of NAFTA. (¶92)

2. Procedural History

On 11 December 2015, ICSID received Lion's Request for Arbitration (¶12). For the constitution of the Tribunal, Lion appointed Mr. David J. A. Cairns (a British and New Zealand national) and Mexico appointed Mr. Ricardo Ramírez Hernández (a Mexican national). As the parties did not agree on the presiding arbitrator, the Secretary-General appointed Mr. Juan Fernández-Armesto (a Spanish national) (¶¶16-18).

On 24 August 2016, a few days after the Tribunal had circulated a first draft of the Procedural Order No. 1, Mexico filed a preliminary objection to jurisdiction under Article 45(6) ICSID AF Rules, alleging that Lion's claims were manifestly without merit (¶¶20-21). The parties exchanged written submissions – in the meantime, Procedural Order No. 1, issued on 14 October 2016, established, among other things, that the procedural language would be English *and* Spanish (¶26) – and, on 12 December 2016, the Tribunal dismissed the preliminary objection (¶¶22-29).

On 13 March 2017, Lion submitted its memorial (¶30). On 4 April 2017, Mexico filed a Request for Bifurcation raising two other objections to the Tribunal's jurisdiction, this time under Article 45(2) ICSID AF Rules. Lion opposed, but the Tribunal decided to bifurcate the proceedings in respect of one of the objections: whether it lacked jurisdiction *ratione materiae* because Lion had not made an investment pursuant to Article 1139 NAFTA (¶31-33). Procedural Order No. 3 established a calendar for the jurisdictional phase, with written submissions spanning from July 2017 to January 2018 (¶¶34-40) and a hearing to be held on 22-23 March 2018, in Washington D.C. (¶¶46-51).

On 25 January 2018, Mr. Ricardo Ramírez resigned as arbitrator. Following his resignation, Mexico appointed Prof. Laurence Boisson de Chazournes (French and Swiss national) in replacement (¶¶ 43-45).

3. Positions of the Parties

3.1 Mexico's position

Mexico argued that Lion had only made three short-term loans, which were not investments under Article 1139(d)(ii) NAFTA for failing to meet the three-year maturity threshold; that all loans, mortgages and notes were part of a single legal transaction subject to the three-year maturity threshold; and that neither mortgages nor notes qualified by themselves as investments under Article 1139(g) and (h) NAFTA. (¶¶102)

3.1.1 Lion made three short-term loans only

It was undisputed that the loans themselves did not qualify as investments, as Article 1139(d)(ii) NAFTA requires loans to unaffiliated enterprises to have original maturity of at least three years, which was not the case. (¶100)

3.1.2 Loans, mortgages and notes constitute a single legal transaction subject to the three-year maturity threshold of Article 1139(d)(ii) NAFTA

According to Mexico, had the loans not been made, the notes and the mortgages would not exist either, as their existence and economic value depended on the loan (¶112). As they all

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served the same purpose (formalizing or securing the repayment), loans, notes and mortgages were part of a single legal transaction (¶113). First, Mexico argued that considering them separately would contradict the intention of NAFTA signatories, as it would be possible to circumvent Article 1139(d)(ii) maturity requirement "by just adding a security or an instrument" (¶118). Second, that interpretation pursuant to Article 31(1) VCLT required that paragraphs (d), (g) and (h) be read altogether in cases were mortgages or promissory notes were linked to a loan (¶119). Thus, it concluded that notes and mortgages were also subject to the three-year maturity threshold of Article 1139(d)(ii) NAFTA.

3.1.3 Mortgages and notes are not investments under Article 1139(g) and (h) NAFTA

Even if the mortgages and notes could be considered apart from the loan, they were not investments (¶121). Mexico argued that mortgages are not property rights but rights *in rem* that, by their own nature, cannot be considered "*bienes raíces u otra propriedad tangible o intangible*" under Article 1139(g) NAFTA. Moreover, it argued that the Tribunal should not use the definition of "property" under Mexican law to interpret the provision, but the treaty language itself, pursuant to Article 31 of the Vienna Convention (ordinary meaning; context, object and purpose of the treaty; and *effet utile*) (¶¶122-123).

3.2. Lion's position

Lion argued that the loans, mortgages and notes were three different legal transactions; and that mortgages were investments under Article 1139(g) NAFTA ("real estate or other property, tangible or intangible") and notes were investments under Article 1139(h) NAFTA ("interest arising from the commitment of capital") (¶¶126-127).

3.2.1 Loans, mortgages, and notes constitute three different legal transactions

Although related, the loans, mortgages and notes were different legal transactions (¶126). As to the mortgages, Lion argued that (i) it was subject to a different legal regime, as it was a right over property, effective *erga omnes* (¶127); (ii) the principal interest (underlying transaction) and the accessory interest (mortgage to secure the loan) require separate treatment under Article 1139 NAFTA (¶128); (iii) compared to a loan, a mortgage creates different rights and economic interests – more than a procedural avenue to claim the underlying debt, a mortgage creates a substantive right over the asset, which has its own economic value regardless of the solvency of the debtor (¶¶129-130).

3.2.2 Mortgages and notes are investments under Article 1139(g) and (h) NAFTA

As to the mortgages, Lion argued that since NAFTA itself does not define "real estate" and "property", the definition of "real estate" as set out under Mexican law should be applied (¶¶133-134). Under Mexican law, all rights over property (rights *in rem*) are "real estate". That interpretation is reinforced by Mexico's treaty practice (¶¶136-137). Moreover, under international law the meaning of "property" includes both "things and rights over such things" (¶140), which encompasses mortgages (¶138-142). Thus, mortgages are "real estate or other property" within the meaning of Article 1139(g) NAFTA.

As to the notes, Lion argued that they were interests of economic nature arising out of commitment of capital for developing an economic activity in Mexico; thus, a self-standing investment pursuant to Article 1139(h) NAFTA (¶¶145-147). Had the NAFTA signatories

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wanted to intertwine paragraphs (g) and (h) to paragraph (d), which refers to loans and contains a duration requirement, they would have made a cross-reference, as they did in other categories (¶¶149-151). Similarly, being an exception, the duration requirement should be interpreted restrictively and not applied to paragraphs where it is not expressly written (¶¶152-153).

4. Tribunal's analysis

The Tribunal defined the legal issue in dispute as "whether non-negotiable promissory notes formalizing, or mortgages securing short-term loans, can still qualify as NAFTA protected investments under Arts. 1139(h) or 1139(g), even if the loans fail the three-year maturity test under Art. 1139(d)" (¶163) and observed that the parties had not referred to any previous decision deciding that same question (¶164). It held that the promissory notes did not qualify as protected investments (4.1.), but that the mortgages were "intangible real estate" under Article 1139(g) NAFTA (4.2.).

4.1 The promissory notes do not qualify as investments

"The Tribunal, without hesitation, side[d] with Respondent" (¶170). First, the Tribunal explained the nature of promissory notes under Mexican law; then, it reasoned why promissory notes failed to meet Article 1139(h) NAFTA requirements.

Under Mexican law, the notes were "*pagarés no negociables*", a special category of "*títulos de crédito*" – documents that formalize the issuer's unconditional promise to pay a certain amount of money, on a certain due date, to the document's holder. "*Pagarés*" are normally related to obligations arising from contracts concluded between the issuer and the original document's holder. The *pagarés*-contract relationship can be "*abstracto*" or "*causal*" (¶¶175-178).

When the relationship is "*abstracto*", in the event the holder endorses the "*pagaré*" to a third party, the issuer cannot rely on defences arising out of the underlying contract against the third party. When the relationship is "*causal*", the issuer can rely on contractual defences against whoever holds the "*pagaré*". "*Pagarés no negociables*", such as the ones Lion held, could not be endorsed to third parties (hence, *no negociables* or, in English, non-negotiable) and had a "*causal*" relationship with the underlying contract (¶¶179-180).

Having explained the nature of promissory notes under Mexican law, the Tribunal analysed the requirements for investment protection under NAFTA, praising Article 1139 as "a sophisticated and precise definition of protected investments" (¶182). It reasoned that Article 1139 comprises eight categories of "interests" as protected investments, divided in two groups. The first group, from paragraphs (a) to (f) plus sub-paragraph (h.ii), relates to situations where the foreign investor "owns or finances 'enterprises' located in the host state" (¶184). The second group, in paragraph (g) and sub-paragraph (h.i), relates to two different situations – while paragraph (g) refers to real estate or other property, sub-paragraph (h.i) refers to contracts in which the investor commits capital or other resources to economic activity in the host state (¶¶185-186).

Considering that Article 1139(h.i) covers "contracts involving the presence of an investor in the territory of the Party" and, to clarify its meaning, refers to turnkey contracts, construction contracts and concession, the Tribunal found that Article 1139(h.i) had no relationship with the case under discussion. "*Pagarés no negociables*, where the underlying contract is a loan, do not imply the presence of an investor's property in the host state, and have no relationship with

turnkey contracts, construction contracts, and concessions" (¶198). Considering that Article 1139(h.ii) covers "contracts where remuneration depends substantially on the production, revenues or profits or an enterprise", and that the notes had remuneration at a fixed interest rate, the Tribunal held they did not satisfy Article 1139(h.ii) requirements as well (¶199).

Furthermore, the Tribunal reasoned that for relying solely on the *chapeau* of Article 1139(h) and disregarding its sub-paragraphs (i) and (ii), Lion's argument (any "interests arising from the commitment of capital" are protected) was unconvincing (¶¶200-204). The *chapeau* could not be read by itself, as "NAFTA does not extend protection to any 'commitments of capital', but only to those which exhibit certain features", which are defined "through two illustrative examples in sub-paragraphs (h.i) and (h.ii)" (¶205). For the Tribunal, as a common feature both sub-paragraphs refers to *contracts*. Thus, it found that "it is safe to conclude that a minimum requirement of 'commitments of capital' protected by paragraph (h) is to be formalized as contracts" (¶205).

4.2 The mortgages qualify as investments

First, the Tribunal explained the nature of mortgages under Mexican law; then, it reasoned why mortgages are protected investments under Article 1139(g) NAFTA, which covers "real estate or other property, tangible or intangible, acquired in the expectation or used for the purpose of economic benefit or other business purposes" (¶208).

Under Mexican law, mortgages are regulated by the Civil Code of the State where the real estate is located. Thus, the Nayarit Mortgage was subject to the Civil Code of Nayarit and the Guadalajara Mortgages 1 and 2 to the Civil Code of Jalisco (¶216).

Both Civil Codes defined mortgages as a "*derecho real de garantía*" (*in rem* guarantee) that encumbers a real estate to guarantee the payment of an obligation. The mortgage follows the asset even if the asset is transferred to a third party and, in the event the guaranteed obligation is breached, it affords the mortgagee the right to be paid the price resulting from the sale of the asset in a public auction. As the mortgage always secure an underlying obligation, it is said to be an "accessory" despite being a separate legal transaction. Also, the mortgage value does not necessarily coincide with that of the underlying obligation, since it depends of the worth of the mortgaged real estate while the obligation fluctuates with the solvency of the debtor (¶¶217-221). Also, both Civil Codes, following a long tradition of extending the concept of "*bienes inmuebles"* (immovable property) to certain intangible rights over real estate, defined mortgages as "*bienes inmuebles*" (¶¶222-225).

Since NAFTA does not define "intangible real estate", the Tribunal, relying on *Emmis v. Hungary* (2014) – which affirmed that "public international law does not create property rights. Rather, it accords certain protections to property rights created according to municipal law" – concluded that it should apply Mexican law to the issue (¶231). Considering the municipal law definition, the Tribunal held that mortgages were explicitly and unequivocally within the category of "intangible real estate", thus meeting Article 1139(g) first requirement (¶¶233-234). The second requirement was also fulfilled because Lion had acquired the mortgages for economic benefit and with a business purpose (¶236).

In support of its conclusion, the Tribunal also noticed that Mexico had a consistent treaty practice – Art. 2 Mexico's Model BIT and at least 22 BITs signed by Mexico – that refers to

"*derecho real*" as a category of protected investment and to mortgages as a specific type of "*derecho real*" within the scope of protection (¶238).

The Tribunal also specifically addressed each one of Mexico's counter-arguments (¶¶244-259).

First, Mexico had argued that Lion had not invested in mortgages and that Article 1139(d) NAFTA definition of "loans" includes "loans secured by mortgages" (¶245). The Tribunal dismissed it, because it understood that the structure of Article 1139 NAFTA, which does not define investment in an abstract manner, but rather states that "investment means" different categories of assets listed in separate paragraphs, each subject to specific requirements, had an "important implication" (¶248). "To be considered as a protected investment, an asset or interest must meet the requirements of one of the eight categories" (¶248). When an investor holds distinct interests, some may individually enjoy protection (in this case, the mortgages) and some may not (in this case, the loans and the notes) (¶250). For the Tribunal, that conclusion was unaffected by the fact that mortgages are accessory transactions. Compared to the loans, the mortgages resulted from separate declarations of consent (different persons, times and documents) and, from an economic point of view, their values were not identical (¶¶252-253).

Second, Mexico argued that the mortgage was a security created in real property that only confers a preferential right to the creditor to be paid the proceeds of the sale of the mortgaged property (¶254). The Tribunal concurred that mortgages are security rights in real estate (¶255), but concluded that Mexico's own municipal law, which defines mortgages as intangible real estate, contradicted its argument (¶256).

Third, Mexico argued that admitting a separate protection for mortgages would allow the protection of any loan, regardless of its maturity, by mere addition of a security (¶257). The Tribunal remarked that Mexico's argument was based on the misconception that the mortgage protection would be automatically extended to the loan, which was not the case (¶258). As separate categories of interest, loans and mortgages are subject to different requirements to be considered protected investments (¶259).

5. Costs

The Tribunal reserved the decision on costs for future determination (¶266(3)).