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International Arbitration

Mexico – Trends & Developments

Contributed by
Von Wobeser y Sierra, SC

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MEXICO

The 'Trends & Developments' sections give an overview of current trends and developments in local legal markets. Leading lawyers analyse particular trends or provide a broader discussion of key developments in the jurisdiction.

Trends & Developments

Contributed by Von Wobeser y Sierra, SC

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Von Wobeser y Sierra, S.C has acted as arbitrator and counsel for major multinational companies involved in international commercial disputes. Members of the team have also participated in arbitration proceedings as expert witnesses in Mexican commercial law. Work undertaken includes advising on all commercial arbitration proceedings, including those conducted according to the rules of the International Chamber of commerce, the Inter-American Arbitration Commission, the UNCITRAL and in relation to NAFTA's Chapters 11 (investment) and 19 (review and dispute settlement in anti-dumping and countervailing duty matters).

Trends & Developments

The New Hydrocarbons Law entered into force on August of 2014. Since coming into force, there has been the expectation from both investors and the Mexican government that the revised framework of Energy Law will give rise to multi-billion dollar investments in Mexico, particularly under the new Exploration and Extraction Contracts ("Contracts").

One of the aspects of the Hydrocarbons Law and the Contracts that has raised concerns from investors is the administrative rescission figure and the non-arbitrability of disputes involving its application and consequences. The purpose of this article is to identify these concerns and to make some brief comments with respect to them.

Administrative rescission is an act of governmental authority by which a contract is unilaterally terminated by the State in a mandatory and enforceable manner, and in the cases expressly recognized by statutory law. It is an "exorbitant" contractual remedy under Mexican administrative law and it is exercised by the government agency or company that is a party to the contract being terminated.

The Contracts are executed between investors and the National Hydrocarbons Commission ("NHC"). The NHC can administratively rescind these Contracts based on "serious causes" expressly defined in the Hydrocarbons law or in the Contracts themselves. The consequences of the administrative rescission are not only the termination of the Contract, but also the obligation of the contractor to return the Contract Area* and to pay the corresponding damages and lost profits.

There are two main areas in which investors have expressed concerns:

The "serious causes" identified by article 20 of the Hydrocarbons Law are considered by many to be overly broad, and some investors fear they could be applied by the NHC in an abusive manner.

The administrative rescission and its effects are not subject to arbitration under article 21 of the Hydrocarbons Law. Hence, controversies pertaining to these Contracts, and the multi-million dollar investments made through them, will be resolved by Mexican Courts. In fact, some have even

questioned whether foreign investors could benefit from investment treaty protection considering Mexico's reservations in some of these treaties and the scope of article 21.

The below will address these two concerns:

Serious Causes Giving Rise to the Administrative Rescission of Contracts

Article 20 of the Hydrocarbons Law determines the cases in which the NHC can administratively rescind the Contracts. It reads as follows:

Article 20.- The Federal Executive, through the National Hydrocarbons Commission, may administratively rescind the Exploration and Extraction Contracts when any of the following serious causes occurs:

I. When the Contractor does not begin or discontinues the activities in the Contract Area for a continuous period of more than 180 days, for no just cause nor by the National Hydrocarbons Commission's authorization;

II. When the Contractor, for no just cause, fails to comply with the approved Exploration plan or Extraction development plan, in accordance with the terms and conditions set forth in the Exploration and Extraction Contract;

III. When the operations or the rights conferred in the Exploration and Extraction Contract are assigned partially or totally by the Contractor, without prior authorization, in accordance with article 15 of this Law;

IV. When the acts that gave rise to the contract are invalid;

V. When serious accidents occur because of the Contractor's fraudulent conduct or negligence;

VI. When the Contractor intentionally provides misleading information or repeatedly makes omissions of interferes with the submission of the information and reports, to the Ministry of Energy, the Ministry of Finance and Public Credit or Economy, and to the National Hydrocarbons Commission or to the Agency;

VII. When the Contractor intentionally submits false reports on the production of Hydrocarbons;

VIII. When the Contractor fails to comply with a final resolution of the federal courts, that is already res judicata; and

IX. When the Contractor, for no just cause, fails to make a payment or deliver Hydrocarbons to the State, in accordance with the periods of time and terms established in the Exploration and Extraction Contract.

The Exploration and Extraction Contract will establish the causes for its termination and rescission, without prejudice to the events for an administrative rescission as established in this article.

The NHC has published a model contract which terms are non-negotiable and that will be used in the corresponding public biddings leading to the execution of the Contracts for the exploration and extraction of oil. The grounds for administrative rescission under this model contract are the same as the ones established in article 20 above.

From our perspective, the terms of article 20 are vague. Just to mention some examples:

Section II: How serious should the contractor's failure to comply with the Exploration and Extraction plan be? Should it be based on a substantive failure or should the administrative rescission be imposed based on minor failures?

Section IV: What constitutes a serious accident and how is it different from an ordinary accident? If there is a bodily injury would this qualify as serious?

Section IX: Should the failure to make payments or to deliver Hydrocarbons in time need to be substantial? What if the deadline was missed by one day? Can the CNH administratively rescind the Contract on this basis?

Despite this vagueness, we consider that article 20 of the Hydrocarbons Law should be applied by both the NHC and the Mexican Courts restrictively and interpreted in a manner favorable to the contractor based on the pro-persona principle applicable to all sanctions imposed by the government, which in our view includes the administrative rescission imposed by the NHC.*

Further, we consider there are arguments to hold that contractors subject to an administrative rescission proceeding should be presumed innocent of any contractual failure, and that the burden of proof of any breach to article 20 of the Hydrocarbons Law should be transferred to the NHC.* Furthermore, the NHC is bound to apply article 20 in a non-abusive manner. If the application of the administrative rescission is abusive, we are of the opinion that there would be arguments to hold that the resolution imposing the termination of the Contract is null and void as it is not in accordance with the public interest finality of all administrative acts.*

The Non-Arbitrability of the Administrative Rescission and its Implications

Article 21 of the Hydrocarbons Law establishes that controversies relating to the application of the administrative rescission and its consequences are not subject to arbitration. The specific terms of article 21 are the following:

Article 21. The controversies related to the Exploration and Extraction Contracts, except for the provisions of the preceding article - Administrative Rescission -, may be resolved through alternative mechanisms, including arbitration agreements in accordance with the provisions of Title IV Book V of the Commercial Code, international treaties on arbitration, and dispute resolution to which Mexico is a party.

The manner in which this article was drafted has raised some questions from investors. If this article is interpreted a contrario sensu, it would appear as if administrative rescission related controversies are not subject to alternative dispute resolution mechanism, including arbitration in accordance with international treaties. There are two implications to this:

Contractors will not benefit from arbitration as an alternative method to resolving their disputes with the NHC regarding the applications and consequences of the administrative rescission. And inconveniently, it is the decision of the NHC to decide whether to exercise this rescission. What would happen if a Contractor decides to initiate arbitration alleging a breach of contract by the NHC and the NHC defends itself by initiating an administrative rescission proceeding? This is exactly what occurred in the case COMMISA v. PEMEX.

What is the intention of Congress by making reference to arbitration in accordance with international treaties? Did Congress intend to exclude the protection of foreign investors under investment treaties? Can Congress do this?

Under international law, it is clear that a State cannot argue the application of domestic law to breach its international obligations.* Hence, it is clear that if a treaty grants unrestricted protection to foreign investors doing business in Mexico, any act of Congress is insufficient to take this protection away from the investor. Hence, any restriction to foreign investor protection would necessarily come from the treaty itself.*

Finally, some investors have raised concerns on whether article 21 of the Hydrocarbons Law is in breach of article 2022 of Chapter XX (NAFTA)*, by which Mexico assumed the obligation to "encourage and facilitate the use of arbitration and other means of alternative dispute resolution." However, this article refers to alternative dispute resolution methods between private parties. The NHC is not a private party.