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Stabilization Clauses in International Investment Law: Beyond Balancing and Fair and Equitable Treatment

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Abstract

Stabilization clauses add a twist to the general debate about states' legitimate discretion to regulate in the public interest and potentially conflicting investors' rights under international investment law. While this debate is about the legitimate outreach of standards such as fair and equitable treatment (FET) or expropriation in the face of social and environmental regulation, stabilization clauses can go as far as protecting investments from any unfavorable changes in law. This absolute wording could from the outset exclude interpretative reconciliation in conflict of law situations. Recent arbitral decisions seem to confirm this far-reaching legal effect. The paper aims to take a closer look at these decisions and to shed light on interpretative leeway in conflict of law situations that involve stabilization clauses. The authors conclude that today far-reaching general stabilization clauses do not stand up to their goal of investment security but rather generate delegitimizing frictions and uncertainty with respect to international law, and should thus be substituted by carefully tailored provisions that respond better to investors' and states' actual needs.

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Katja Gehne*, Romulo Brillo**

Introduction

Stabilization clauses are provisions in investment contracts that accommodate the risk of regulatory changes for investors[1]. Given their high level of protection, stabilization clauses may cause tensions with conflicting states' regulation to protect human rights or more generally to work towards sustainable development[2]. The debate on stabilization clauses closely relates to the more general call for coherence between investors' rights, legitimate public interest and states' human rights in international investment law[3]. There is increasing public criticism regarding the one-sidedness of investment law, protecting investors' rights without at the same time anchoring investors' responsibilities for human rights and sustainable development[4]. Some start to question the contribution of international investment law to sustainable development[5] and its positive effect on the rule of law, some urge for taking into account the whole picture of societal interest when dealing with international investment law[6]. Investment law today aims, in the first place, at the protection of economic (human) rights[7], such as the freedom to trade, conduct a business or property rights related to business activities. Other human rights issues, highly relevant for development and long term sustainable growth, and interfering with investment

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[1] See below regarding different features of stabilization clauses.

[2] Cotula, Lorenzo (2008a), *Regulatory Takings, Stabilization Clauses and Sustainable Development*, *OECD VII Global Forum on International Investment*. Available at: http://www.oecd.org/dataoecd/45/8/40311122.pdf (visited: 13 June 2013); Amnesty International UK (2003), *Human Rights on the Line: The Baku-Tblisi-Ceyhan Pipeline Project*. Available at: http://www.amnesty.org.uk/uploads/documents/doc_14538.pdf (visited: 13 June 2013), p. 16.

[3] OECD (2004), *Indirect Expropriation" and the 'Right to Regulate' in International Investment Law,* Working Papers in International Investment, No. 2004/4; Kriebaum, Ursula (2007), *Regulatory Taking: Balancing the Interests of the Investor and the State*, 8 Journal of World Investment and Trade, pp. 717-744; Markert, Lars (2011), *The Crucial Question of Future Investment Treaties: Balancing Investors' Rights and Regulatory Interests of Host States*, in: International Investment Law and EU Law, European Yearbook of International Economic Law, pp. 145-171.

[4] Newcombe, Andrew (2007), *Sustainable Development and Investment Treaty Law*, 8 Journal of World Investment & Trade, pp. 357-407, p. 359.

[5] Public Statement on the International Investment Law Regime, 31 August 2010. Available at: http://www.osgoode.yorku.ca/public_statement/ (visited: 10 June 2013).

[6] Cottier, Thomas; Gehne, Katja; and Schultheiss, Maria (2011), *The Protection of Property in International Law: The Missing Pieces*, in König, Doris et al. (eds.), *Coexistence, Cooperation and Solidarity – Liber Amicorum Rüdiger Wolfrum*, pp. 367-397; Gehne, Katja (2011a), *Responsible Investment through International Investment Law: Addressing Rights Asymmetries through Law Interpretation and Remedies*, in: International Land Coalition (ed.), *International Instruments Influencing the Rights of People facing Investments in Agricultural Land*, pp. 88-131. Available at: http://www.landcoalition.org/sites/default/files/publication/903/WTI-SOMO-ON_instruments_web_11.03.11.pdf (visited: 13 June 2013).

[7] Petersmann, Ernst-Ulrich (2008), *Time for a United Nations 'Global Compact' for integrating Human Rights into the Law of Worldwide Organizations: Lessons from European Integration*, in EJIL 2008 Vol. 13 No. 3, pp. 621-650, p. 629.

law, are considered to belong to other domains of international law, such as international social or international environmental law. This delimitation is artificial as these fields do not only overlap but also start influencing as a considerable factor trade and investment issues, such as the investment climate, related risks and (fair) competition. Today, most members of the WTO or parties to international investment agreements (IIAs) belong at least to one of the core human rights treaties[8], and are thus at the same time bound to both legal regimes. The same is true for environmental regulation. While general investment protection standards remain relatively broad and will in the majority of cases leave a margin of interpretation that substantially allows for reconciling conflicting overlapping obligations of states in the social, environmental and investment fields, stabilization clauses create a tighter legal regime for host states that demands specific legal answers and good practices when it comes to the effective application of all international law.

This paper intends to give an insight in the context and debate of stabilization clauses (A), and assesses the content and effect of arbitral decisions which have directly or indirectly dealt with stabilization clauses (B). Against this background, we explore possible interpretative leeway to reconcile potential conflicts with public interest regulation in the field of international obligations of host states (C). We conclude that today stabilization clauses seem to fail their original purpose of investment protection and security but rather cause legal uncertainty due to the frictions in international law that they cause. This is why investors and states should consider to replacing far-reaching general stabilization commitments by carefully tailored provisions that meet their actual interests in investment incentives and effective security for FDI (E).

A. Stabilization clauses: background and debate

I. Current features of stabilization clauses in investor-state contracts

In 2008, a study under the auspices of the Special Representative of the Secretary-General for business and human rights (SRSG) and the International Finance Corporation (IFC)[9] has explored the role of stabilization clauses in practice, in particular regarding their potential to negatively influence host states' and companies' human rights compliance record. The study defines stabilization clauses as "contractual clauses in private contracts between investors and host states that address the issue of changes in law in the host state during the life of the project"[10]. It identifies three main types of modern stabilization practice. First, "freezing clauses" that exempt an investment from the application of new laws, "freezing" the law of the host state, either in its entirety or limited to certain regulatory fields (e.g. fiscal issues); second "equilibrium clauses" that cover the financial loss that relates to changes in law and third, "hybrid clauses" that are combinations of freezing and economic equilibrium clauses, providing in complementing each other "an additional layer of protection for stability of the contract"[11]. Hybrid clauses leave it to the parties to determine whether economic equilibrium is to be achieved through exemption from regulatory change or other forms of "alleviation of the unfavourable impact of changes"[12] such as contract adaptation or compensation. The classification proposed by the

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[8] Choudhury, Barnali; Gehne, Katja; Heri, Simone *et al.* (2011), *A Call for a Ministerial Decision on Trade and Human Rights*, in Cottier, Thomas; Delimatsis, Panagiotis (eds.), *The Prospects of International Trade*, pp. 323-358, p. 328.

[9] In the following: SRSG study.

[10] Shemberg, Andrea (2008), *Stabilization Clauses and Human Rights*, IFC/SRSG Research Paper. 11 March 2008. Available at: http://www.ifc.org/ifcext/sustainability.nsf/Content/Publications_LOE_Stabilization, p. 4 (visited: 13 November 2012)

[11] Maniruzzaman, A.F.M. (2008), *The Pursuit of Stability in International Energy Investment Contracts: A Critical Appraisal of the Emerging Trends*, in JWELB 2008, Vol. 1. Nr. 2, pp.121-157, p. 127.

[12] Hybrid clause example, Shemberg, *op. cit.*, p. 8.

study is a rough description of the characteristics of contract stabilization; it is not necessarily congruent with the terminology in practice[13].

Freezing clauses have been the "classic approach" to contract stability for investors. They "freeze" the law "as in force of" the date of the conclusion of the contract[14] or determine that "laws and decrees which may in the future impose higher rates or more progressive rates of tax or would otherwise impose a greater …tax liability […] shall not apply to the Company". Freezing clauses may also embrace court decisions subsequently in force[15]. Some forms of freezing commitments stipulate that the contract shall apply as "*lex specialis* over current or subsequent legislative enactments", or only if "consistent with the investment contract". Other clauses may "insulate the contractual relationship from any material adverse effect" (MAE)[16]. Even though freezing clauses seem to "freeze" the right of the host state to regulate with respect to the investment contract between the parties and by this turn illegal any adverse state action, these clauses are still "no guarantee against the state's exercise of sovereign authority in the public interest". They can, however, "entitle the aggrieved party to a higher amount of compensation for its violation than in the case where such a clause is absent"[17].

The modern alternative to freezing clauses is economic equilibrium clauses. A great number of these include negotiation provisions, sometimes vested with recourse to a third party (arbitration) to determine adaptation when negotiations fail[18]. Some clauses also leave room for flexibility, such as threshold financial losses, restriction to discriminatory measures, the obligation of the investor to mitigate compliance costs, or the operation of the clause in the investors' and the host states' favour, e.g. with host states sharing benefits in cases of unforeseen raises in profits[19]. From a legal point of view, "economic equilibrium clauses do not seem to pose significant problems, as they do not prevent host state regulation so long as the economic equilibrium is restored"[20], while freezing clauses limit state sovereignty and turn illegal any adverse state action. However, from a political point of view, although providing for flexibility and being at first glance less intrusive with respect to the state's sovereignty, economic equilibrium clauses may prove costly for the state. Restoring the economic equilibrium could lead to a more comprehensive claim for damages and a larger coverage of claims than compensation for the breach of freezing commitments[21]. Other than freezing clauses "economic equilibrium clauses are, however, only triggered where a minimum threshold is met – namely where the economic equilibrium of the contract is affected"[22]. An often cited advantage of economic equilibrium clauses is their contribution to the stability of the investor-state relationship. It is argued that re-adjusting the economic equilibrium and negotiation tool could maintain a negotiation atmosphere when otherwise the tension between host states' regulatory interests and investors' expec-

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[13] Other forms of classification, Alexander, Frank (2009), *Comment on Articles on Stabilization by Piero Bernardini, Lorenzo Cotula and AFM Maniruzzaman,* in 2 JWELB, pp. 243-258, p. 244.

[14] Example, Dolzer, Rudolf & Schreuer, Christoph (2008), *Principles of International Investment Law*, New York: Oxford University Press, p. 75; Shemberg, *op. cit.*, p. 6.

[15] Maniruzzaman, *op. cit*., p. 123.

[16] *Ibid.*, p. 122.

[17] *Ibid.*, p. 126.

[18] *Ibid*., p. 128; Gotanda, John Y. (2003), *Renegotiation and Adaptation Clauses in Investment Contracts, Revisited*, 36 Vanderbilt Journal of Transnational Law, pp. 1461-1473, pp. 1462 et seq.; Shemberg, *op. cit.*, pp. 7, 28. The authors observed that most equilibrium clauses are vested with negotiation tools.

[19] Shemberg, *op. cit.*, p. 8.

[20] Cotula, Lorenzo (2008b), *Reconciling Regulatory Stability and Evolution of Environmental Standards in Investment Contracts: Towards a Rethink of Stabilization Clauses*, 1 JWELB 2008, pp. 158-179.

[21] Maniruzzaman, *op. cit.*, p. 126.

[22] Cotula (2008b), *op. cit.*, p. 166.

tations would have amounted to conflict and contractual breach[23]. This is why some attribute to negotiation clauses the general advantage of leaving the "state's sovereignty more intact" and of "protect[ing] the investor against changes in the law"[24]. Others see the alleged positive influence of economic balancing provisions and re-negotiation clauses more critically, pointing to the fact that they leave an unsettled legal situation open and that re-negotiation may not be as conflict-preventing as it seems[25]. Negotiation and recourse to a third party may put agreed legal obligations in question. According to some commentators, this rather hampers than promotes the contract's stability[26], the more so as the scope of stabilization clauses is often very little specified and leaves room for interpretation[27].

II. Stabilization clauses rationale and practice

The rationale of stabilization clauses is risk management for investments. Stabilization clauses are mostly included in contracts that relate to capital-intensive projects, such as extractive industry, infrastructure or public services' projects (e.g. mining, oil, electricity, water and sewage, telecommunications, transport) and involve concession agreements (CA), production sharing agreements (PSA), and build-operate and transfer agreements (BOT)[28]. These projects typically require large initial capital investments and become profitable over time. According to the SRSG study, credit grantors view stabilization clauses as vital in order to mitigate the financial risk of such investments, particularly for "nonrecourse financing" when the repayment is exclusively linked to the project's performance[29]. Large projects with longer periods to recover the costs and generate profits, such as infrastructure investments, seek guarantees that changing investment conditions do not harm the cost-benefit equilibrium of the investment. Pre-investment cost-benefit calculations may be significantly distorted by later environmental and social legislation, e.g. related to new technology standards or retirement, employment and health care regulation[30]. Host states grant stabilization clauses to accommodate investors' interests and attract future investment by providing a high level of warranty[31]. Their use is fostered by their inclusion in model agreements that set a certain standard of protection for specific sectors or industries, such as, for example, the Energy Charter Model Host Government Agreement (HGA) on Cross-Border Pipelines[32].

As to the frequency in practice of stabilization clauses, the SRSG study has analysed a wide range of industries, such as infrastructure, extractive industries, telecommunication, and health care services, on the basis of 76 contracts and 12 contract models from different regions of the world, including Sub-Saharan Africa, East Asia and Pacific, Middle East and North Africa,

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[23] Gotanda, *op. cit.*, p. 1469; Cotula, Lorenzo (2008b), op. cit., pp. 158-179, p. 176.

[24] Berger, Klaus Peter (2003), *Renegotiation and Adaptation of International Investment Contracts: The Role of contract Drafters and Arbitrators*, 36 Vand. J. Transnat'l.L., pp. 1347-1368, p. 1364.

[25] Gotanda, *op. cit.*, Alexander, *op. cit.*, p. 252.

[26] Gotanda, *op. cit.*, pp. 1463 *et seq*.

[27] Maniruzzaman, *op. cit.*, p. 129.

[28] Cotula, Lorenzo (2007), *Briefing 4: Foreign Investment Contracts,* International Institute for Environmental and Development, Sustainable Markets Investment Briefings, August 2007, p. 1.

[29] Shemberg, *op. cit.*, p. 5; see also Cotula (2007), *op. cit.*, p. 2.

[30] See for the concern of environmental taxes and "costs" for depletion, Wälde, T.W. (1994), *Stabilising International Investment Commitments: International Law versus Contract Interpretation*, CPMLP Professional Paper No. PP13, pp. 1-89, p. 5.

[31] Shemberg, *op. cit.*, p. 5.

[32] Maniruzzaman, *op. cit.*, p. 135; the Energy Charter HGA model stabilization clause was at the basis of the civil society protest against the Baku-Tblisi-Ceyhan (BTC) pipeline project and the West African Gas Pipeline (WAGP) projects. Since then the model agreement has changed, it now mainly includes an expropriation clause (Art. 37), see the Energy Charter Model Host Government Agreement. Available at: http:/www.encharter.org/index.php?id=182 (visited: 13 June 2013).

Eastern Europe, Southern Europe and Central Asia, South Asia, Latin America, the Caribbean and OECD countries[33]. According to the study's findings, freezing clauses still belong to modern investment contract practice with respect to Sub-Saharan Africa, Eastern and Southern Europe, Central Asia, the Middle East and North Africa, and especially in the extractive industry[34]. In the 1970s and 1980s, in the aftermath of colonialization, the use of freezing commitments came under pressure as the freezing effect considerably reduces the sovereign power of the host state. The UN-General Assembly issued resolutions that emphasized the sovereignty of states, stressing the need for fairness in the share of benefits, solidarity and technology transfer in international investment relations[35]. The study shows that even though freezing clauses are designated "to be outdated"[36], they are still commonly used. Some still consider them to be the best and most secure form of contractual stability[37]. Today, they usually come along in their rather modern form of "*lex specialis*", "intangibility" or "consistency" clauses[38]. Frequent use of freezing clauses by a host state with respect to different investors over time may cause significant administrative complexity: to each investment another law is applicable, creating legal enclaves of which the administration has to keep track[39]. This may be a challenge for developing countries where administration often suffers from scarcity of resources and electronic equipment, problems of governance, and related difficulty in inspection and documentation. In developing countries, fundamental standards of environmental protection or human rights (e.g. health and safety, labor standards) may also be insufficiently regulated. Then, situations of considerable environmental or social harm may persist, the more so, as investment contracts usually stay in force over a long period of time.

Freezing clauses usually do not feature in contracts with OECD countries. Here, limited economic equilibrium clauses addressing specific regulatory risks prevail. In OECD-contracts, their scope is generally restricted to discriminatory regulation and they may exclude regulation on safety, security and other public concerns, such as environmental or social legislation. Conversely, full economic equilibrium clauses covering any regulatory change regardless of its discriminatory effect or *bona fide* motivation, are predominant in contracts with non-OECD countries, e.g. related to the power, water, transportation, infrastructure, and the extractive industry. The difference between the practices of developing and OECD states is explained with the assumption that in OECD countries risks related to change in law are lower than in developing countries, and therefore need less extensive stabilization protection[40].

III. Business' commitment to social responsibility and public-private soft law frameworks

In response to civil society pressure, some businesses and investors took initiatives to publish and limit far reaching stabilization commitments with respect to human rights and environmental concern. An often cited example is the Baku-Tbilisi-Ceyhan (BTC) pipeline consortium's "Human Rights Undertaking" to prevent eventual impacts of the contract's stabilization clause

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[33] Shemberg, *op. cit.,* p. 11.

[34] Shemberg, *op. cit.*, p. 19, Maniruzzaman, *op. cit.*, p. 123.

[35] UNGA Resolution 1803 (XVII), on the Permanent Sovereignty over Natural Resources; UNGA Resolution 3281 (XXIX), Charter of Economic Rights and Duties of States; UNGA Resolution 3201 (S-VI), Declaration on the Establishment of a New International Economic Order.

[36] Shemberg, *op. cit.*, p. 7

[37] Gotanda, *op. cit.,* p. 1468.

[38] Maniruzzaman, *op. cit.*, p. 125.

[39] Maniruzzaman, *op.cit.*, p. 124.

[40] See, for the stability promise as a driver for developing country investments, Faruque, Abdullah (2006), *Validity and Efficacy of Stabilisation Clauses, Legal Protection vs. Functional Value,* Journal of International Arbitration, Vol. 23, No. 4, pp. 317-336, p. 334. This argument is, however, not necessarily consistent with the contract practice, see Shemberg, *op. cit.*, p. 33.

on measures of public concern. Paragraph 2 (d) of the Undertaking stipulates that the BTC consortium "shall not seek compensation under the "economic equilibrium" clause or other similar provisions [...] in such a manner as to preclude any action or inaction by the relevant Host Government that is reasonably required to fulfil the obligations of that Host Government under any international treaty on human rights (including the ECHR), labour or HSE (health, safety, environment) in force in the relevant Project State from time to time to which such Project State is then a party". Paragraph 2 (a) excludes more generally claims against host state measures that are based on human rights, health, safety and environmental aspects, provided that domestic regulation is "reasonably required by international labor or human rights treaties to which the Host Government is a party" and that "domestic law is no more stringent than the highest of European Union standards as referred to in the Project Agreements, including relevant EU directives ("EU Standards"), those World Bank Group standards referred to in the Project Agreements, and standards under applicable international labor and human rights treaties"[41]. This constitutes a formal declaration to exempt from the stabilization commitment measures that reflect the host states' public concerns related to the environment, human rights, and safety[42]. Although the Human Rights Undertaking is a unilateral declaration, it is formally binding as it cannot be revoked without the host states' consent[43].

More generally, a large number of investors and companies have committed to conduct their business in a way that respects human rights and environmental protection, health and safety. Major global business players engage in standard setting activities, such as the Global Business Initiative on Human Rights (GBI)[44]. Self-regulatory or multi-stakeholder initiatives, such as the Extractive Industry Transparency Initiative (EITI) and the Kimberly Process Certification Scheme (KPCS) in the extractive industry or the Roundtable on Sustainable Palm Oil (RSPO) in the agricultural field develop procedures and standards to foster responsible business conduct. Likewise, the financial services sector has developed guidelines to foster respect of sustainable development criteria, including human rights and environmental standards (Equator Principles).

In parallel, companies support international frameworks fostering good business conduct, such as the Global Compact, a UN-framework which issued 10 guiding principles for good business practices, and provides a forum for stakeholders. Members have the right to use an UN-label, provided that they comply with reporting requirements on good business practices. In the financial sector, the UNEP Finance Initiative (UNEP FI) has created a platform for good business practices, and the International Finance Corporation (IFC) established a Sustainability Framework with respect to financial support, following a long stakeholder revision process that culminated in its adoption in May 2011. The framework comprises the previously existing Performance Standards, which form the basis of investors' duty to assess social and environmental risks of an investment project. Another prominent international initiative has been the mandate of the UN Special Representative of the Secretary-General on the issue of human rights and transnational corporations and other business enterprises (SRSG), John Ruggie, which was conducted under the Human Rights Council's special procedures. The aim was to facilitate further development of a business and human rights international framework after the United Nations Sub-Commission on the Promotion and Protection of Human Rights' "Draft norms on the responsibility of trans-national corporations and other business enterprises with regard to human rights" (UN-norms) failed. The result of the mandate was the adoption by the Human Rights Council of Guiding Principles on Business and Human Rights, endorsing and guiding the implementation of the now very popular three prong framework (i) "states' duty to protect

[41] The Baku-Tbilisi-Ceyhan Pipeline Company, BTC Human Rights Undertaking, 22 September 2003. Available at: http://subsites.bp.com/caspian/Human%20Rights%20Undertaking.pdf, (visited: 13 June 2013), para. 2 (a).

[42] Cotula (2008a), *op. cit.*, p. 14.

[43] The Baku-Tbilisi-Ceyhan Pipeline Company, BTC Human Rights Undertaking, para. 6.

[44] See for more information: http://www.global-business-initiative.org/members/ (visited: November 2012).

human rights, (ii) business' responsibility to respect human rights, and (iii) remedy to "investigate, punish and seek redress for abuses"[45]. This framework was the result of a comprehensive stakeholder process that facilitated its recognition and allowed for wide-spread acceptance. The business' responsibility to respect human rights includes a "human rights due-diligence process to identify, prevent, mitigate and account for how [business enterprises] address their impacts on human rights"[46]. Confronted with customer inquiries and investment funds increasingly focusing on compliance with and promotion of human rights and sustainable development, companies are more and more under pressure to respond to these standards. The 2011 revised OECD Guidelines for Multinational Enterprises, a soft law framework for responsible business conduct initially put in place in 1976, have endorsed the due diligence standards, as well as a new chapter on human rights. Thereby, non-compliance may result in complaints before National Contact Points. Although this is a non-legal, mediation-like instrument, there is considerable so-felt pressure for reputational harm. From a business perspective, adverse effects on human rights, public health or environmental concerns constitute business risks (reputational harm, legal insecurity and political instability). Investors with a public profile may pull out of financing a project if they cannot politically afford to resist public pressure of civil society groups. Even though business commitments and initiatives are often broad in scope[47], and in most cases non-binding, their soft-binding effect is non-negligible. Public declaration and positioning of the company with respect to adherence to international standards is – with respect to the principle of good faith - hardly reconcilable with far-reaching stabilization claims on the grounds of laws that implement these same standards.

IV. The political concern regarding stabilization practice

Stabilization clauses in their far reaching forms guarantee recompense for *bona fide* state activities that interfere with the investment. States need, however, to adapt their regulation to keep pace with the needs and challenges they face, including participation in international standard setting, and compliance with or adaptation to international standards. This is particularly true for developing countries. As the arbitral tribunal in *AES v. Hungary* states "[a] legal framework is by definition subject to change as it adapts to new circumstances day by day". For the tribunal in *Feldman v. Mexico* this aspect is crucial for a state's affairs:

> "Governments must be free to act in the broader public interest through protection of the environment, new or modified tax regimes, the granting or withdrawal of government subsidies, reductions or increases in tariff levels, imposition of zoning restrictions and the like. Reasonable governmental regulation of this type cannot be achieved if any business that is adversely affected may seek compensation, and it is safe to say that customary international law recognizes this"[48].

Stabilization clauses do not actually prevent governments from regulating[49]; even freezing clauses do not exclude a host government's exercise of power in the public interest[50]. Even if

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[45] Harrison, James (2009), *Human Rights and Transnational Corporations: Can More Meaningful International Obligations Be Established?* Warwick School of Law Research Paper, October 23, 2009. Available at SSRN: http://ssrn.com/abstract=1493305 (visited: 13 June 2013), p. 16.

[46] Ruggie, John (2003), *Guiding Principles on Business and Human Rights: Implementing the United Nations "Protect, Respect and Remedy" Framework*, A /HRC/17/31, 21 March 2003. Available at: http://www.ohchr.org/Documents/Publications/GuidingPrinciplesBusinessHR_EN.pdf (visited: 13 June 2013).

[47] See Leader, Sheldon (2006), *Human Rights, Risks, and New Strategies for Global Investment*, 9 JIEL, pp. 657-705, p. 670.

[48] *Feldman Karpa v. Mexico*, Award and separate opinion, ICSID Case No ARB(AF)/99/1; IIC 157 (2002); (2003) 18 ICSID Rev—FILJ 488; (2003) 42 ILM 625, despatched 16 December 2002., para. 103.

[49] As the diverging decisions *Texaco Calasiatic (Topco) v. Libya* and *Liamco v. Libya* show, there is legal uncertainty as to the actual "freezing" effect of these clauses. While in the Texaco case the tribunal hold "the sover-

governments violate freezing commitments, this does not hinder change in law but turns it illegal and triggers compensation for unlawful acts[51]. The key consequence of stabilization clauses is that changes in law come with a price to pay, including regulation protecting social and environmental concerns in a way that business is not unreasonably or unnecessarily affected. In particular with respect to large-scale investments (e.g. infrastructural or power projects) and the usual far-reaching extent of the stabilization guarantee under which they operate, changes in law could trigger high amounts of compensation that may come close to significant budget percentages in developing countries. Although economic balancing clauses leave more space for flexibility and negotiation and may be conducive to good practices, they nevertheless provide for systematic compensation or restoration of the equilibrium through adaptation of the contract, including changes for non-discriminatory *bona fide* activities in the public interest. Independent of their actual enforcement, scope or interpretation, these clauses establish legally-protected expectations that could result in compensation claims. Voices from civil society and academia have expressed the concern that this could cause a "regulatory chill effect"[52] that could impair human rights protection and the implementation of environmental standards, and more generally disincentivize states to progress and cooperate with a view to achieving sustainable development.

Absent data and studies that have analyzed the impact of stabilization clauses in practice in terms of their actual enforcement and the related dispute settlement practice, it is difficult to judge the extent of their impact on human rights and the host states' motivation to regulate in the public interest. Generally, the probability of negative influence on states' activities in the public interest will depend on the shape and scope of stabilization clauses (limitations, exceptions, legal embedding, etc.). The question would need closer examination. Some point out that the "chill effect" could be a chimera. States may not be aware of the far reaching effect of stabilization or not care about contractual obligations in the face of public interest regulation[53]. However, it is a matter of fact of modern investment law and arbitration that states that allegedly breach the law are likely to face costly arbitration and compensation claims. The presumption of the "regulatory chill effect" is based on the effect of pre-enforcement compliance which is part of the purpose of law and has an effect that is independent of the actual enforcement of contract rights by the investor[54]. Binding law creates pre-obedience, at least until there is certainty that the enforcement "stick" would not apply. To avoid costs, the state may choose to exempt the investor from the application of new laws. Selective implementation insulating the investor from the scope of application is, however, likely to cause tensions due to discrimination and incoherence at the national level, and may hinder the fulfilment of environmental standards and the protection of human rights, the more so if the investment is important and exempted from these standards over a long period of time.

The situation is specifically delicate where poor developing countries' are the host states. According to the IFC-SRSG-study and given their high risk rating, they are typically involved in the most far-reaching freezing or equilibrium stabilization practice. Developing countries seek investment for development, and they need foreign investment in particular for cost intensive infrastructure projects. Due to lack of control mechanisms, nepotism and power accumulation, government officials or their relatives may profit from investments and accept conditions with not much regard to the public good. Law may often not amount to the state of the art industry

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eign ability of a state to bind itself" valuable, the Liamco decision presumes that freezing clauses do not affect the sovereign right of the state, but trigger compensation.

[50] Maniruzzaman, *op. cit.*, p. 126.

[51] Wälde, T.W. (1994), *op. cit.*, p. 38.

[52] Cotula (2008b), *op. cit.*, pp. 168 *et seq.*

[53] We are indebted to Roberto Echandi and Christian Häberli for enlightening us with practitioners' insights regarding the matter.

[54] See, for the importance of this aspect with respect to stabilization clauses, Faruque, *op. cit.*, pp. 334 *et seq*.

practice and/or administration may lack capacity to enforce the law. This is why, from the outset, developing countries' standards need to evolve significantly to meet basic international standards. Even if most developing states are bound to human rights instruments and international environmental standards, their state of implementation is often embryonic and requires progressive implementation over time to become fully effective. Poor states are particularly vulnerable to high compensation costs that could be triggered by progressive social and environmental legislation. Additionally, due to weak or lacking institutions, non-existing or non-effective participatory processes, individual citizens of these countries barely have access to remedy when adversely affected by investment projects[55].

B. Stabilization clauses in international arbitration

In the following, tendencies in case law that dealt with stabilization clauses will be examined. The scarcity of reported investment disputes that involve stabilization clauses poses a challenge when attempting to identify trends in their interpretation by arbitrators. The picture that will be presented in the following paragraphs may thus not be complete[56]. The findings that relate to stabilization clauses in investment jurisprudence that we are aware of can be divided into three main categories. The first category, more abundant, concerns early cases addressing the question whether stabilization clauses could indeed bind sovereign power to a commitment not to expropriate or whether they constitute specific protection against arbitrary unilateral state action. The second category refers to cases in which stabilization clauses were indirectly referred to in *arguendo* to dismiss claims against alleged regulatory action on the basis that in those cases there was no specific commitment to stabilization. Finally, the third category addresses disputes where stabilization clauses were directly at issue. In all cases the validity of stabilization clauses was not put into question by arbitrators. On the contrary, it has been noted that ICSID tribunals, for instance, have adopted a favourable attitude to such clauses[57]. The tribunal in *AGIP v. Congo* sought to place stabilization clauses as part of international law[58], and the tribunal in *LETCO v. Liberia* observed that such clauses must be respected[59]. More recently, in *CMS v. Argentina*, the tribunal, after noting that the discussion concerning stabilization clauses was well known in international law, asserted that these clauses ensure a right that can be properly invoked by investors.[60]

I. Legality of stabilization clauses

The first category of cases dealing with stabilization clauses is to be examined in the context of nationalizations and expropriations in the 1970s and 1980s. These involve the legality and binding nature of stabilization clauses.[61] Legal arguments revolve around the sovereignty of the host

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[55] Cottier *et al.*, *op. cit.*

[56] Shemberg, *op. cit.*, p. xi.

[57] Schreuer, Christoph, *et al.* (2009), *The ICSID Convention, A Commentary*, Cambridge University Press, p. 589.

[58] *AGIP v. The Popular Republic of Congo*, Award, 30 November 1979, 21 ILM 1982 (hereinafter, "*AGIP v. Congo*"), paras. 86-88, ILM 1982.

[59] *Liberian Eastern Timber Corporation (LETCO) v. Republic of Liberia*, ICSID Case No. ARB/83/2, Final Award, 31 Mar 1986, 2 ICSID Reports 368.

[60] *CMS Gas Transmission Company v. Argentina*, Award, ICSID Case No ARB/01/8, IIC 65 (2005), signed 12 May 2005, (hereinafter, "*CMS v. Argentina*"), para. 151. Although the validity of stabilization clauses was not questioned by arbitrators, it has been noted by commentators that such clauses would not be generally enforceable under the domestic laws of common law countries and might also be difficult to enforce in civil law jurisdictions. See Wälde, Thomas, *op. cit.*, p. 37 *et seq.*; Cotula (2008a), *op. cit.*, p. 8.

[61] Cotula (2008a), *op. cit.*, p. 7.

state and the extent to which stabilization clauses would "contract out" its sovereign power. The arbitral practice is divided in this regard. The questions have never been fully settled[62]. In the *Texaco v. Libya* case, the tribunal held that stabilization clauses limit the host state's sovereignty as the host state in exercising its sovereignty committed to its waiving[63]. The tribunal referred to the UN General Assembly Resolution 1803 on the Permanent Sovereignty of States over Natural Resources as expressing customary international law and to the principle *pacta sunt servanda*[64]. In contrast to this reasoning, the tribunal in the *Liamco v. Libya* upheld the state's sovereign right to nationalize as being lawful, however, provided that it is accompanied by adequate compensation[65]. The arbitral decision in the *Aminoil v. Kuwait* case goes in a similar direction. The tribunal presumed that the limitation of a state's sovereignty was a "particularly serious undertaking", at least if for a long period of time, and thus could only be presumed if explicitly provided for.[66] In the *LETCO v. Liberia* case (ICSID) the tribunal similarly held that the main purpose of stabilization clauses was to protect against arbitrary actions of the contracting government and could not totally impair the sovereign power of states[67]. Some commentators draw the conclusion, that "stabilization clauses are not thus a guarantee against lawful nationalization and for that matter lawful expropriation. They impose on the state an obligation to act in good faith and give rise to an obligation to compensate in case of their breach"[68]. Regarding the outcome, there is not much difference among the divergent tribunal approaches to the matter. In both cases, the obligation to pay compensation is the result of states breaching stabilization clauses. Even though the *Texaco* case stated a wrongful act that requires "restitution in integrum" this did not prove enforceable in practice[69]. Differences can, however, occur in terms of the extent of compensation for lawful and unlawful acts[70].

Another branch of jurisprudence has been dealing with the legality of stabilization clauses under domestic law. National constitutional principles may stand in the way of stabilization clauses, depending on which law is applicable to the investor-state contract[71]. The choice of domestic law can secure sovereign power of the state to change the law, at least "in so far as a due diligence effort by the investor would have indicated serious doubts over the government's ability to grant such a guarantee effectively under national law"[72]. However, given the international character of arbitration and the international rules applicable to aliens, tribunals may nevertheless rely on international law when adjudicating the case[73]. An illustrative case is the *Revere Copper v. OPIC* case. The case concerns a stabilisation clause that prohibited increase in tax and levies and stipulated that no derogation from its right to operate would occur[74]. The government of Jamaica nevertheless issued a "bauxite levy" and an increase in the royalties to be paid by Revere. The Jamaican Supreme Court had declared the contractual stabilization

[62] Dolzer & Schreuer, *op. cit.*, p. 75.

[63] 17 ILM 1978, p. 1

[64] *Texaco v. Libya*, 17 ILM 3 (1978), para. 88, Dolzer & Schreuer, *op. cit.*, p. 76.

[65] Dolzer & Schreuer, *op. cit.*, p. 76.

[66] 21 ILM 1023.

[67] 26 ILM 666-7; Maniruzzaman, *op. cit.*, p. 140; other similar arbitral reasoning is to be found in the *AGIP v. Congo*, paras. 735-736; *Aramco v. Saudi Arabia*, 27 I.L.R, para. 168; Wälde, *op. cit.*, pp. 36-37.

[68] Maniruzzaman, *op. cit.*, p. 141.

[69] Cotula (2008b), *op. cit.*, p. 165.

[70] Faruque, *op. cit.*, p. 230.

[71] Cotula (2008b), *op. cit.*, p. 164.

[72] Wälde, *op. cit.*, p. 31.

[73] Dolzer & Schreuer, *op. cit.*, p. 74; Maniruzzaman, *op. cit.*, p. 124.

[74] *Revere Copper & Brass, Inc. v. OPIC*, AAA Award of August 24, 1978, 17 ILM 1321 (1978). See Delaume, George R. (1981), *State Contracts and Transnational Arbitration*, 75 AJIL, Vol, 75, No. 4, pp. 784-819, pp. 802 *et seq.* Available at: http://www.jstor.org/stable/pdfplus/2201354.pdf?acceptTC=true (visited: 10 June 2013).

clause "*void ab initio*". The arbitral tribunal held that application of domestic law does not "preclude the application of principles of public international law which govern the responsibility of States for injuries to aliens", particularly if the question is "whether actions taken by a government contrary to and damaging to the economic interests of aliens are in conflict with undertakings and assurances given in good faith to such aliens as an inducement to their making the investment affected by the action". Moreover, the tribunal argued that the international character of the contract arose from the fact that the contract was "part of a contemporary international process of economic development, particularly in the less developed countries", that required "contractual guarantees" for the security of private parties, and that "governments of developing countries in turn are willing to provide such guarantees in order to promote much needed economic development". This was, in the eyes of the tribunal, confirmed by the fact that the home government of the private parties "are very much interested in such agreements and in promoting their conclusion" and in this case even "provided its own guarantees for the investment". On this basis, the tribunal upheld the legality and binding nature of the clause and emphasized that "under international law the commitments made in favour of foreign national share are binding notwithstanding the power of parliament and other governmental organs under the domestic constitution to override or nullify such commitments"[75].

II. Indirect reference to stabilization clauses

In contemporary investment arbitration the possibility of having claims of expropriation based on stabilization clauses would be increasingly remote as expropriation standards are now well established at the international level, in particular with a view to the increasingly spreading network of IIAs. Nonetheless, as some commentators have observed, the application by host states of new legislation to an investment covered by a stabilization clause could be seen as an expropriation of the contractual right not to be subject to such new legislation without compensation.[76] As it has been argued, it is well established in investment law practice that rights arising from contracts may amount to investments[77], and thus be subject to the protection against expropriation envisaged by IIAs. The potential legal value of stabilization clauses with regard to investment treaty arbitration involving expropriation is reflected in the case *Methanex v. United States*. In this case, a commitment such as a stabilization clause was linked to the notion of a measure tantamount to expropriation.[78] The tribunal in that case held that a

> "non-discriminatory regulation for a public purpose, which is enacted in accordance with due process and, which affects a foreign investor or investment is not deemed expropriatory and compensable *unless specific commitments had been given by the regulating government (...) that the government would refrain from such regulation*"[79]. (emphasis added)

The latter part, although not using the expression "stabilization clause", virtually summarizes its underlying design. The tribunal relied on the lack of any such commitment as one of the grounds on which to dismiss the expropriation claim. Other indirect mentioning has been made with respect to the fair and equitable treatment standard, more precisely to delimit the extent of

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[75] *Revere Copper & Brass, Inc. v. OPIC*, AAA Award of August 24, 1978, 17 ILM 1321 (1978).

[76] Marshall, Fiona (2010), *Climate Change and International Investment Agreements: Obstacles or Opportunities?* International Institute for Sustainable Development. Available at: http://www.iisd.org/pdf/2009/bali_2_copenhagen_iias.pdf, (visited: 13 June 2013) p. 50; Shemberg, *op. cit.*, p. 38.

[77] Dolzer & Schreuer, *op. cit.*, p. 126.

[78] *Methanex Corporation v. United States*, Final Award on Jurisdiction and Merits, Ad hoc—UNCITRAL Arbitration Rules; IIC 167 (2005), signed 03 August 2005 (hereinafter, "*Methanex v. United States*"). See Marshall, *op. cit.*, p. 50; Cotula (2008a), *op. cit.*, p. 7.

[79] *Methanex v. United States*, part IV, Chapter D, Rn.7

the "legitimate expectations" of the investor. In *AES v. Hungary*, an Energy Charter Treaty case, the ICSID tribunal saw the lack of a stabilization clause as an element to help it determine that there could be no legitimate expectations that the applicable regulation would not be changed by the government. The claim that the investor's legitimate expectations were frustrated was inserted into a broader claim of failure by Hungary to accord fair and equitable treatment to the investor. In the said case, in view of the facts, the tribunal found that there could be no legitimate expectations that administrative pricing would not be reintroduced.[80] The tribunal went on to say that the duty to provide a stable environment for investment is not to be confused with a stabilization clause, noting that:

> "It is also common ground that the 2001 Settlement Agreement does not contain a so-called "stabilization clause" – i.e. a covenant not to change the relevant law […][81]. In these circumstances, the Tribunal concludes that Claimants cannot legitimately have been led by Hungary to expect that a regime of administrative pricing would not be re-introduced.[82] […] A legal framework is by definition subject to change as it adapts to new circumstances day by day and a state has the sovereign right to exercise its powers which include legislative acts".[83]

A similar approach was followed in *Parkerings v. Lithuania*. The ICSID tribunal first acknowledged that the investor's expectations are legitimate if the host state has made an explicit promise or an implicit promise which was taken into account by the investor when making the investment.[84] The tribunal then dismissed the claim that Lithuania had failed to accord fair and equitable treatment to the investor, asserting that:

> "It is each State's undeniable right and privilege to exercise its sovereign legislative power. A State has the right to enact, modify or cancel a law at its own discretion. Save for the existence of an agreement, in the form of a stabilisation clause or otherwise, there is nothing objectionable about the amendment brought to the regulatory framework existing at the time an investor made its investment. As a matter of fact, any businessman or investor knows that laws will evolve over time. What is prohibited however is for a State to act unfairly, unreasonably or inequitably in the exercise of its legislative power".[85]

III. Direct application of stabilization clauses

The third category of cases refers to those in which stabilization clauses were at the core of the dispute. The case *CMS Gas Transmissions v. Argentina*, an example involving the conjunction between stabilization and umbrella clauses, suggests that violations of investor-state contractual stabilization obligations constitute a breach of the inter-state investment agreement[86] The Claimant relied on a specific undertaking that the tariff structure would not be frozen or subject to further regulation or price control, as well as on the commitment that the basic rules govern-

[80] *AES Summit Generation Limited and AES-Tisza Erömü Kft v. Hungary*, Award, ICSID Case No ARB/07/22; IIC 455 (2010), signed 17 September 2010 despatched 23 September 2010 (hereinafter, "*AES v. Hungary*"), paras. 9.3.25-6.

[81] *AES v. Hungary*, para 9.3.25.

[82] *AES v. Hungary, p*ara 9.3.26.

[83] *AES v. Hungary*, para. 9.3.29.

[84] *Parkerings-Compagniet AS v. Lithuania*, Award on jurisdiction and merits, ICSID Case No ARB/05/8; IIC 302 (2007), signed 14 August 2007 despatched 11 September 2007 (hereinafter, "*Parkerings-Compagniet AS v. Lithuania*"), para. 331.

[85] *Parkerings-Compagniet AS v. Lithuania*, para. 332.

[86] *CMS v. Argentina*, paras. 296 *et seq.*

ing the license would not be changed without the licensee's consent.[87] The tribunal found that such undertakings were valid[88] and enforceable based on the umbrella clause in the relevant IIA:

> "[…] there are in particular two stabilization clauses contained in the License that have significant effect when it comes to the protection extended to them under the umbrella clause. The first is the obligation undertaken not to freeze the tariff regime or subject it to price controls. The second is the obligation not to alter the basic rules governing the License without [the licensee]'s written consent".[89]

Similarly, the tribunal in *LG&E v. Argentina*, after noting that there was no contractual stabilization clause in that case[90], found that failure by Argentina to observe statutory stabilization provisions would give rise to liability under the umbrella clause:

> "As such, Argentina's abrogation of the guarantees under the statutory framework – calculation of the tariffs in dollars before conversion to pesos, semi-annual tariff adjustments by the PPI and no price controls without indemnification – violated its obligations to Claimants' investments. Argentina made these specific obligations to foreign investors, such as LG&E, by enacting the Gas Law and other regulations, and then advertising these guarantees in the Offering Memorandum to induce the entry of foreign capital to fund the privatization program in its public service sector. These laws and regulations became obligations within the meaning of Article II (2) (c), by virtue of targeting foreign investors and applying specifically to their investments that gave rise to liability under the umbrella clause".[91]

The cases show that international enforcement of stabilization clauses may be based on umbrella clauses in international investment treaties. The purpose of such clauses is to put contractual commitments entered into by the state with foreign investors under the protective "umbrella" of the international investment agreement[92]. Commentators have observed the great diversity both in the interpretation given by arbitral tribunals to such clauses as well as in the wording they present themselves in[93]. Consequently, there is no single concept of umbrella clauses but rather

[87] *CMS v. Argentina*, paras. 145-6.

[88] *CMS v. Argentina*, para. 151.

[89] *CMS v. Argentina*, para. 302. It should be noted however, that the part of the CMS award addressing the tribunal's finding concerning the umbrella clause was later annulled by the ad hoc Committee, on the grounds that the tribunal failed to make it clear how it got to the conclusion that CMS, as a minority shareholder of the licensee, could claim based on obligations undertaken toward the licensee (and not CMS itself). Nonetheless, the validity of a stabilisation clause as such was never put into question or even challenged by Argentina in the annulment proceeding. The ad hoc Committee ruled that: "[i]n the end it is quite unclear how the tribunal arrived at its conclusion that CMS could enforce the obligations of Argentina to TGN [the licensee]. (…) In these circumstances there is a significant lacuna in the Award, which makes it impossible for the reader to follow the reasoning on this point. It is not the case that answers to the question raised 'can be reasonably inferred from the terms used in the decision'; they cannot. Accordingly, the tribunal's finding on Article II(2)(c) [the umbrella clause] must be annulled for failure to state reasons". *CMS Gas Transmission Company v. Argentina*, Decision on Application for Annulment, ICSID Case No ARB/01/8; IIC 303 (2007), signed 21 August 2007, paras. 96-7.

[90] "In short, one must also recall that between Argentina and LG&E there is no binding contractual agreement. The existence of such relationship would have allowed the parties to agree on stabilization clauses in the event of changes in certain circumstances. But, in the absence of such agreement, one is bound to resort to a legal system regulating those events". *LG&E Energy Corp and ors v. Argentina*, Decision on Liability, ICSID Case No ARB 02/1; IIC 152 (2006); (2007) 46 ILM 36, signed 03 October 2006 (hereinafter, "*LG&E v. Argentina*"), para. 98.

[91] *LG&E v. Argentina*, para. 175.

[92] Dolzer & Schreuer, *op. cit.*, p. 153.

[93] Wackernagel, Clemens (2009), *Das Verhältnis von Treaty und Contract Claims in der internationalen Investitionsgerichtsbarkeit*, in: Beiträge zum Transnationalen Wirtschaftsrecht, Heft 32, p. 17.

multiple umbrella clauses[94] and with this more or less extensive reading of their scope[95]. It very much depends on the wording and context of an umbrella clause to which degree its reach can be generally understood to elevate contractual commitments to the level of the international treaty protection[96]. Another example of the role stabilization clauses could play here is the *El Paso v. Argentina* case. The ICSID tribunal, when faced with the task of drawing the boundaries of umbrella clause coverage, found it useful to make reference to stabilization clauses as an illustration:

> "[i]nterpreted in this way, the umbrella clause (…) will not extend the Treaty protection to breaches of an ordinary commercial contract entered into by the State or a State-owned entity, but will cover additional investment protections contractually agreed by the State as a sovereign – such as a stabilization clause – inserted in an investment agreement"[97].

In the tribunal's view, a stabilization clause thus represents an additional protection undertaken by the state as a sovereign. In this way, failure by the host state to observe such a commitment would give rise to a claim under the relevant IIA for which the tribunal would consequently have jurisdiction. This interpretation has been criticized for being not far reaching enough. For example, commenting on this decision, *Campbell McLachlan et al.* criticized the narrow interpretation given to the umbrella clause as an instrument to secure jurisdiction under IIAs, advocating that purely contractual claims, undertaken by the state as a merchant, would also follow under the scope of the clause. In this sense, the authors argue that "[the tribunal's] conclusion does not appear to be warranted by the language of the treaties or by any necessary restriction on the jurisdiction of an investment arbitral tribunal. This is particularly so of the notion that, in order to gain the benefit of the clause, an investor would have to have persuaded the host State to grant a contractual stabilization clause. Investment treaties are designed to provide a predictable framework for all investors as a result of mutual guarantees exchanged between the contracting States. The operation of those guarantees should not be dependent upon individual contractual bargaining for a type of clause which was never popular with States, and was in any event a blunt, and at times unpredictable, instrument for stability of contract. However, the underlying concept that the clause might protect from the abuse of State power is a valuable one. If, then, there were a clear basis for contending that the State had made subsequent changes in its law which undermined its undertakings to the investor, that would constitute an exercise of sovereign authority, and would found a basis for a treaty claim, irrespective of any contractual jurisdiction clause"[98].

Another case that involved stabilization clauses addressed the nature and extent of the scope of protection of stabilization clauses. In *Duke Energy v. Peru*, the ICSID tribunal determined that the stability envisaged by stabilization clauses goes beyond the mere protection against future changes in legal texts and also applies to changes in legal interpretation:

> "[…] The Tribunal must now determine whether legal stability covers not only the formal text of the laws and regulations that were in place at the time the Egenor LSA

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[94] Maniruzzaman, *op. cit.*, p. 152.

[95] See for an overview Crawford, James (2007), *Treaty and Cotnacts in Investment Arbitration*, 22nd Freshfields Lecture on International Arbiration, 29 November 2007, cited after Maniruzzaman, *op. cit.*, p. 152.

[96] *Salini Costruttori SpA and Italstrade SpA v. Jordan*, Decision on Jurisdiction, ICSID Case No ARB/02/13; IIC 207 (2004), signed 15 November 2004, ILM 569 (2004); Cotula (2008b), *op. cit.,* p. 163, Dolzer & Schreuer, *op. cit.*, p. 153 et seq.

[97] *El Paso Energy International Co v. Argentina*, Decision on Jurisdiction, ICSID Case No ARB/03/15; IIC 83 (2006), signed 27 April 2006, para. 81.

[98] McLachlan QC, Campbell; Shore, Laurence; and Weiniger, Matthew (2007), *International Investment Arbitration: Substantive Principles*, Oxford University Press, pp. 116-117.

[the Legal Stability Agreement entered into between Peru and Claimant] was executed, but also their specific interpretation and application at that time.

[…][I]f, at the time when the guarantee was granted, the application of the existing rules resulted in a consistent interpretation, such interpretation must be deemed to be incorporated into the guaranteed stability. In a broad sense, stability is the standard by which the legal order prevailing on the date on which the guarantee is granted is perpetuated, including the consistent and stable interpretation in force at the time the LSA is concluded. The Tribunal is convinced that the maintenance of such stable interpretations of the law, existing at the time the LSA was executed, is part of the continuity of the existing rules".[99]

The tribunal further held that even in the absence of a stable pre-existing interpretation of the relevant legal provision, against which it could judge subsequent developments, the stabilization clause would still allow it to make an assessment of the allegedly new interpretation in the light of the standard of reasonableness.[100] That is to say that, in the tribunal's view, even when a consistent and stable interpretation cannot be established by the contending parties, as a matter of proof, although arbitrators may not determine what would be the "correct" interpretation of the domestic legal provision, they may nonetheless put the allegedly new interpretation given to it by the domestic authorities through a reasonableness test.[101]

In another case, *Burlington v. Ecuador*, the ICSID tribunal was faced with a tax stabilization clause in several oil and gas Production Sharing Contracts that read as follows:

> "Modification to the tax system: In the event of a modification to the tax system or the creation or elimination of new taxes not foreseen in this Contract, which have an impact on the economics of this Contract, a correction factor will be included in the production sharing percentages to absorb the impact of the increase or decrease in the tax[102]".

Commentators have referred to such a contractual undertaking as a stabilization clause, more specifically as a species of the economic equilibrium genre or "stipulated economic balancing provision".[103] The tribunal, nonetheless, chose to refer to this provision as a "tax indemnification clause".[104] This designating distinction seemed to suit the tribunal's will to regard the clause as something that could be agreed upon by two private parties in similar circumstances and not as a guarantee afforded by the state as such, in view of its taxation power. This categorization of the clause by the tribunal would also suit its decision to consider that invoking the clause did not raise "matters of taxation", which would fall outside the scope of the tribunal's

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[99] *Duke Energy International Peru Investments No 1, Ltd v. Peru*, Award and Partial Dissenting Opinions; ICSID Case No ARB/03/28; IIC 334 (2008), signed 25 July 2008 dispatched 18 August 2008 (hereinafter, "*Duke v. Peru*"), paras. 210-219; see Cotula, Lorenzo (2010), *Pushing the Boundaries vs. Striking a Balance: Some Reflections on the Stabilization Issue in Light of Duke Energy International Investments v. Republic of Peru*. Available at: http://www.transnational-dispute-management.com/article.asp?key=1571 (visited: 13 June 2013).

[100] *Duke v. Peru*, para. 223.

[101] Arbitrator Tawil goes even further in his Partial Dissenting Opinion, asserting that in such a case – where proof of a prior consistent and stable interpretation is absent – it would fall under the jurisdiction of the tribunal to determine the appropriate interpretation of the relevant domestic legal provision. *Duke v. Peru*, Partial Dissenting Opinion, paras. 7-9.

[102] *Burlington Resources Inc v. Ecuador*, Decision on Jurisdiction, ICSID Case No ARB/08/5; IIC 436 (2010), despatched 02 June 2010 (hereinafter, "*Burlington v. Ecuador*"), para. 24.

[103] Such clauses would provide for automatic amendment of the contract in a stipulated fashion in case of changes to the previous terms. In this case, the amendment would operate through the automatic readjustment of the oil split between the parties to the Production Sharing Contract. See Maniruzzaman, *op. cit.*, pp. 127 and 131.

[104] *Burlington v. Ecuador*, para. 24.

jurisdiction by virtue of a US-Ecuador BIT express provision.[105] The Claimant had raised the non-observance of the stabilization clause as a violation of the treaty umbrella clause, which was accepted by the tribunal for the purpose of determining its jurisdiction:

> "Indeed, Respondent's indemnification obligation under the PSCs is unrelated to its taxing power as a sovereign state. The contract indemnification clauses bind the investor just as much as they bind Respondent[106]. […]
> Thus, two private parties who have no power whatsoever over taxes could enter into an indemnification clause identical to those contained in the PSCs, i.e. if there is a tax increase, the contract price is reduced, and vice versa. And if one of the parties were to seek enforcement of the indemnification clause, it would not mean that that party is challenging the tax that prompted the application of the clause; rather, it would simply invoke the tax to substantiate its claim for indemnification. This logic does not change when the State is one of the parties subject to the clause. Hence, the Tribunal is of the view that this claim does not raise "matters of taxation".[107]

The view of the clause as a "banal" contractual provision rather than a tax stabilization clause may well have brought legal consequences in the *Burlington* case. But what is of more relevance to this study is that the state's role in terms of the stability clause is reduced to that of a private party.

IV. Conclusion

In view of the case law involving stabilization clauses, as indicated above, one must conclude that, in spite of the scarcity of publicly available awards dealing with the issue and of the different approaches adopted by arbitrators, in all three categories of decisions their validity has always been implicitly or explicitly recognized, giving rise to, at least, the right to compensation, irrespective of the *bona fide* character of the change in law and the public purpose of the motivation behind the change. This may include health and environmental standards as well as aspects of human rights' protection. However, it is worth noting that so far the decisions that dealt directly with stabilization clauses (third category) revolved around taxation issues and tariff readjustment. Arbitrators were not faced with the more troublesome cases touching upon stabilization clauses in the context of human rights or environmental regulation. Nonetheless, tribunal's decisions suggest that stabilization clauses may well fix the investors' position to no flexibility and zero risk. This changes the nature of the legal relationship between the investor and the state.

In general IIA practice, when it comes to expropriation or FET, the sovereign role of the state is usually the starting point of reasoning. In recent arbitration this has led to a limited principle & balancing approach when conflicting public interests were involved. Arbitral tribunals have referred to the jurisprudence of the European Court of Human Rights (ECtHR), e.g. in *Tecmed*, *Azurix* and *LG&E* to interpret the expropriation standard[108]. If "there is a reasonable relationship of proportionality between the charge or weight imposed on the foreign investor and the aim sought to be realized by any expropriating measure"[109], the state's measure is not to be

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[105] As observed by the tribunal, "[u]nder Article X of the Treaty, 'matters of taxation' are as a rule excluded from the scope of the Treaty". *Burlington v. Ecuador*, para. 168.

[106] *Burlington v. Ecuador*, para. 182.

[107] *Burlington v. Ecuador*, paras. 181-183.

[108] *Sporrong/Lönnroth v. Sweden*, ECHR (1982) Series A No. 52, para. 69, see for the proportionality requirement also James and Others, ECHR (1986) Series A, paras. 50 and 63, and *Técnicas Medioambientales Tecmed, S.A. v. The United Mexican States*, ICSID Case No. ARB(AF)/00/2), Award of 29 May 2003, para. 121.

[109] Tribunal cites European Court of Human Rights, *Mellacher and Others v. Austria*, judgment of December 19, 1989, 48, p.24; *Pressos Compañía Naviera and Others v. Belgium*, judgment of November 20, 1995, 38, p. 19. Available at: http://hudoc.echr.coe.int (visited: 13 June 2013).

considered expropriatory and thus would not prompt compensation[110]. Even if some tribunals seem to go beyond when considering "legitimate expectations" of the investor as a generally protected position, at large, the standards as they are applied within the framework of general IIA protection today leave room for conciliative interpretation. For example, with respect to alleged "frustration of the investor's legitimate expectations", the tribunal in *Saluka v. Czech Republic* pointed out that if "taken too literally" this „would impose upon host States' obligations which would be inappropriate and unrealistic". The tribunal therefore deployed a proportionality test, weighing "the Claimant's legitimate and reasonable expectations on the one hand and the Respondent's legitimate regulatory interests on the other"[111]. Other tribunals introduced a counter-balance by conditioning legitimate expectations guarantees upon "due diligence" on the side of the investor. The arbitrators in *Parkerings v. Lithuania* state:

> "The investor will have a right of protection of its legitimate expectations provided it exercised due diligence and that its legitimate expectations were reasonable in light of the circumstances. Consequently, an investor must anticipate that the circumstances could change, and thus structure its investment in order to adapt it to the potential changes of legal environment"[112].

Similarly, the tribunal in *MTD v. Chile* held that the host state's liability for frustrating the investor's legitimate expectations should be partially offset by the investor's own lack of diligence. The tribunal found that although the host state was responsible for breaches of the fair and equitable treatment standard, MTD had contributed to the damages suffered as a result of its negligent conduct.[113] After making these assertions, the tribunal went on to say that "BITs are not an insurance against business risk"[114]. Therefore, the more expansive notion of the protection of legitimate expectations "may be circumscribed by the notion of the "investor conduct", reflected in various investor duties such as (i) the duty to refrain from unconscionable conduct, (ii) the duty to invest with adequate knowledge of risk and (iii) the duty to conduct business in a reasonable manner"[115].

Against this backdrop, and given the broad scope of international investment protection standards there is room for an interpretative approach that takes into account public interests and individual rights in 'hard cases' when principles are colliding and no clear rule determines the case[116]. This changes when stabilization clauses come into play. Here, the stabilization clause provides a clear rule that changes in law are forbidden and/or trigger negotiation and/or compensation. Cases like *Methanex* or *Parkerings* suggest that stabilization clauses turn the nature of investment protection upside down. While the tribunals have made clear that investors bear the risks of "non-discriminatory regulation for a public purpose" (*Methanex*) or the fact that "laws will evolve over time" (*Parkerings*), they have explicitly stated that host state commitments such as stabilization clauses put the financial burden of ex post investment regulation entirely on the state[117]. Thereby, the general presumption of a right to regulate at no price under the general standard of international investment law turns into a general obligation to compen-

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[110] The critical issue here is deference of the tribunal to the states' determined level of protection.

[111] *Saluka Investments BV v. Czech Republic*, Partial Award, PCA—UNCITRAL Arbitration Rules; IIC 210 (2006), signed 17 March 2006, para. 306.

[112] *Parkerings-Compagniet AS v. Lithuania*, para. 333.

[113] *MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Republic of Chile*, ICSID Case No. ARB/01/7, Award of May 25, 2004 (hereinafter, "*MTD v. Chile*"), para. 178.

[114] *MTD v. Chile*, para. 178.

[115] Maniruzzaman, *op. cit.*, p 149.

[116] See for the "rights thesis" working with principle and rights approaches in so called "hard cases" when no settled rule dictates a decision either way, Dworkin, Ronald, *Hard Cases*, in Harward Law Review 1975, Vol. 88, No. 6, pp. 1057-1109, 1060.

[117] See above.

sate for regulation under stabilization commitments[118]. The public law character that is reflected in arbitral practice concerning expropriation and FET is thus turned into the nature of a private *inter-se* relationship ignoring the state's role as a public entity (*Burlington v. Ecuador*). With this, the investor is let off the hook of the balancing game between private rights and the public interest of which he would be part in a public relationship. Thereby, the investor-state private law relationship may be "elevated to the international level"[119] of IIA protection through umbrella clauses in investment treaties or on the basis of the internationalizing effect of stabilization clauses, as expressed in the *Revere Copper v. OPIC* case[120].

C. Dealing with conflicts – exploring interpretative avenues

Arbitral tribunals have to our knowledge not yet dealt with cases that juxtaposed in opposition investor's rights on the basis of stabilization clauses on the one hand and progressive public regulation on the basis of international environmental or social standards on the other. Each individual case will very much depend on the specificities of the facts and the content of the stabilization clause in question. As described above, stabilization clauses come along in very different forms and features[121]. They are tailored to a specific sector or project or are subject to specific thresholds and exemptions. Our attempt is to shed light on interpretative avenues that allow for introducing an element of balancing the positions of the host state and the investor in cases of conflicts with respect to social, mainly human rights, or environmental international standards.

As a footnote, before exploring interpretative avenues below, we would like to recall the nature of these conflicts: due to the nature of stabilization commitments in the context of the state's sovereignty to regulate, they are no legal conflicts *strictu sensu*. According to the ILC study group on fragmentation of international law,

> "A strict notion [of conflict] would presume that conflict exists if it is possible for a party to two treaties to comply with one rule only by thereby failing to comply with another rule. This is the basic situation of incompatibility. An obligation may be fulfilled only by thereby failing to fulfil another obligation"[122].

Mainly in terms of equilibrium clauses regulation itself does not violate the stabilization commitment. The obligation is to compensate for changing the equilibrium. Following the decisions *Aminoil v. Kuwait* and *Liamco v. Libya* this is also true for freezing clauses: the obligation is to pay for breaching the freezing clause. There is thus no "surrendering" of human rights or environmental standards or "contracting out" of international law obligations via stabilization clauses. The argument that the international obligation to protect human rights or comply with previously established or newly emerged widely accepted international law obligations conflicts with the application of stabilization commitments[123] is thus not about the admissibility of regulation under stabilization commitments but rather about the legitimacy of the compensation

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[118] Maniruzzaman, *op. cit.*, p. 146.

[119] Hirsch, Moshe (2009), *Investment Tribunals and Human Rights: Divergent Paths*, in: Pierre-Marie Dupuy *et al.* (eds.), *Human Rights in International Investment Law and Arbitration*, pp. 97-114, p. 109.

[120] See above; Faruque, *op. cit.*, p. 326.

[121] See for example, Alexander, *op. cit.*, p. 249, who points at the fact that most investor-state agreements in the oil extractive industry contain exceptions regarding an evolving international environmental protection standard.

[122] Koskenniemi-Report (2006), *Fragmentation of International Law: Difficulties Arising from the Diversification and Expansion of International Law*. Report of the Study Group of the International Law Commission. A/CN.4/L.682, para. 24.

[123] Cotula (2008b), *op. cit.*, p. 172.

claim when regulation is based on internationally recognized standards to which the host state is committed. The ILC study group on fragmentation of international law has classified these kinds of "policy-conflicts" as equally relevant for the problems involved in the fragmentation of international law[124]. As the ILC study group puts it:

> "A treaty may sometimes frustrate the goals of another treaty without there being any strict incompatibility between their provisions"[125].

I. The argument of implicit "compliance with international law exceptions"

One interpretative avenue that some suggest to resolve conflicts between stabilization commitments and legitimate policy goals is to exclude social and environmental public interest regulation from the scope of stabilization clauses. The argument goes that stabilization clauses are implicitly limited by "compliance with international law exceptions"[126]. As "state sovereignty is limited by the international obligation to realize fundamental human rights […] the host state cannot impair the human rights held by individuals and groups that may be affected by the investment project"[127]. Stabilization clauses could thus not "prevent genuine host state action to progressively realize human rights"[128]. "States may not contract out of compliance with their obligations und international law"[129].

There is a clear case for human rights as almost all states are bound to at least one of the eight core human rights treaties[130]. This equally applies to principles and standards with respect to environmental protection. Principle 2 of the Rio Declaration which has been widely recognized in international law, underlines the duty of the sovereign authority of states not to harm the environment. In the arbitration regarding the *Iron Rhine Railway (Belgium vs. Netherlands)* the tribunal stated the state's "duty to prevent, or at least mitigate" environmental harm[131], referring to respective developments in international environmental law[132].

Does this, however, allow for the argument "that states may not contract out of compliance with their obligations under international law"? As we have seen above, from a legal point of view, *strictu sensu*, stabilization clauses do not hinder states to adopt public interest measures. They provide in the first place for compensation for loss due to changes in law. There is thus no "contracting out" of international law obligations. Host states do not "commit themselves to rights they do not have – such as a right to exercise sovereignty in a way that does not take account of international obligations"[133]. The underlying problem is not the dilemma that states are not allowed to act according to international obligations but far reaching compensation commitments that may frustrate regulation and related claims in the domain of internationally protected public interest - a scholarly example of what the ILC study group designated as "poli-

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[124] *Ibid.*

[125] Koskenniemi Report, para 24.

[126] Cotula (2008b), *op. cit.*, p. 172.

[127] *Ibid*.

[128] *Ibid*.

[129] *Ibid*., p. 173.

[130] See above.

[131] Arbitration Regarding the *Iron Rhine ('Ijzeren Rijn') Railway (Belgium/Netherlands)*, Permanent Court of Arbitration, 24 May 2005. Available at: http://untreaty.un.org/cod/riaa/cases/vol_XXVII/35-125.pdf (visited 12 May 2012), para. 59.

[132] Birnie, Patricia *et al.* (2009), *International Law & the Environment*, Oxford University Press, p. 131.

[133] Cotula (2008b), *op. cit.*, p. 173.

cy-conflicts"[134]. This is why the argument of an implicit "compliance with international law" clause is from a legal point of view *strictu sensu* difficult to make. It seems to be too inflexible to capture all dimensions of the policy conflict between different international legal regimes at stake. Moreover, "international law" is a vague legal concept, raising a lot of questions, thereby generating itself a great deal of legal uncertainty.

II. The argument referring to general law

Another entry door to more flexible law interpretation of stabilization commitments could be a broad reading of the "changes in law" term. Stabilization clauses may, for example, stipulate compensation for "any changes in the applicable laws"[135]. But what is meant by "applicable law"? Does this automatically include any measure that changes regulation? What about international obligations, existing at the time of the contract or national constitutional principles being the motivation for the change? One could, for example, argue that measures based on international obligations or constitutional principles that did exist at the time the investment contract was concluded but have not yet been fully implemented by the host state do not constitute a "change in applicable law" but rather implementation of law that existed at that time. Independently of the school that classifies international law as part of national law (monism) or as part of external obligations that are to be implemented or observed on the national level (dualism)[136], international obligations belong to the law in force which binds the host state and determines its legal order. If the host state takes measures to implement these international or national constitutional obligations, it applies these norms but does not change the previously existing law. Such reading could foster coherence in law, as this allows for taking into account the levels of international obligations and constitutional law.

The typical counter-argument would be that law is only applicable if sufficiently concrete to form a behavioural norm. Thus, change in behavioural norms or *lex specialis* automatically falls under the scope of stabilization clauses. Change in behavioural norms is precisely the risk against which the investor seeks protection. The majority of state measures could be interpreted as somehow fulfilling general obligations, given their wide scope, so that stabilization clauses – which protect against this kind of risks – would nearly become void[137]. This argument does, however, exclude the normative basis of the legal order which forms the backbone of behavioural law. As the ILC study group notes:

> As an interpretative guideline, *lex specialis* does articulate important concerns: the need to ensure the practical relevancy and effectiveness of the standard as well as to preserve what is often a useful guide to party intentions. These need, of course, to be balanced against countervailing ones: the hierarchical position of the relevant standard and other evidences of State intent. But however the "balance" is conceived, all of this takes place within an argumentative practice that seeks to justify its outcomes less in terms of technical applications than as contributions to a purposive system of law"[138].

General norms of international or constitutional law generally set a core normative baseline as a "purposive system of law" and leave it up to the state how the norm is implemented (e.g. fundamental rights). One could argue that the benchmark of "change in law" should refer to the minimum requirement that is necessary to not violate the core of the general norm so that changes in the level of protection or way of implementation would still be covered by stabiliza-

[134] Koskenniemi-Report, *op. cit.*, para. 24.

[135] Shemberg, *op. cit.*, p. 8.

[136] Schweitzer, Michael (2010), *Staatsrecht III*, C.F. Müller, 10th edition 2010, § 2, paras. 24 *et seq.*

[137] Cotula (2008b), *op. cit.*, p. 174.

[138] Koskenniemi-Report, para. 40.

tion clauses. State measures implementing the minimum requirements of constitutional law or international obligations of the state that existed at the time when the contract was concluded would then not be covered by the clause and thus not be subject to compensation. This, however, still "frustrates" the goals that are inherent in broad and aspirational general rights and objectives, typical of modern constitutions and international standards: the progressive state of law.

III. The argument referring to national law

Another leeway to introduce more flexible interpretation of stabilization clauses could be reference to national law. Stabilization clauses do not necessarily need to fall under the regime of international law. They could also be governed by national law. This may include fundamental environmental and social standards. However, "stabilization of contractual relationship is often sought by providing for international law or the general principles of law as the governing law in the contract"[139]. Additionally, as was shown above, some international investment treaties contain umbrella clauses which might lift stabilization commitments to the level of international law protection.

According to Article 27 of the VCLT a party to an international treaty may not invoke the provisions of its internal law as justification for its failure to perform its obligations under a treaty. Article 46 VCLT provides an exception to this, for cases when "violation was manifest and concerned a rule of the state's internal law of fundamental importance". Thereby, a "manifest violation" is to be presumed if "it would be objectively evident to any State conducting itself in the matter in accordance with normal practice and good faith". Applied to the investor-state relationship[140] one could think of the argument that there are internal rules of fundamental importance which "a diligent investor should be aware of before concluding contracts with the host state"[141]. In cases involving constitutional principles, such as fundamental rights, or widely recognized and well established standards of international law to which the state has committed or is bound, this could be a "way around" the international law obligation inherent in stabilization clauses[142], as this could include the violation of the principle of separation of powers, if, for example, the government had signed an investor-state contract with far-reaching stabilization commitments without the constitutionally required consent of the Parliament[143]. However, it is argued that "(as under most, if not all, developed systems of law) the binding force of contracts is recognized, so long as the contracts in question are validly made and do not offend public policy (*l'ordre publique*)"[144]. In the *Revere Copper vs. OPIC*, the arbitral tribunal underlined that the commitments in favour of foreign nationals are binding, independent of the power of Parliament or the Government[145].

IV. The argument referring to evolutionary "new norms and standards"

Another approach that could soften the interpretative rigidity of stabilization clauses is the "issue of evolutionary interpretation"[146]. This mainly refers to the ruling of the International Court

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[139] Maniruzzaman, *op. cit.*, p. 124, *Revere Copper vs. OPIC*, p. 1343.

[140] As far as the VCLT applies to investor-state-contracts. In this sense an analogy could be drawn following the *argumentum a fortiori* of *a majore ad minus*, given that the VCLT, as stated in its preamble, is a codification and development of previous customary international law.

[141] Cotula (2008b), *op. cit.*, p. 165.

[142] Cotula (2007), *op. cit.*, p. 3.

[143] Cotula (2008b), *op. cit.*, p. 165.

[144] Lauterpacht, Elihu (ed.), *International Law Reports*, Vol. 89, 1992, p. 339.

[145] See above, *Revere Copper v. OPIC*, p. 1343.

[146] Cotula (2008b), *op. cit*., p. 176.

of Justice (ICJ) in the *Gabcikovo-Nagymaros* case[147]. The ICJ stated that in the field of sustainable development "new norms and standards have been developed, set forth in a great number of instruments during the last two decades. Such new norms have to be taken into consideration, and such new standards given proper weight, not only when States contemplate new activities but also when continuing with activities begun in the past"[148]. Other tribunals, such as the WTO Appellate Body in *US Shrimp* and the arbitral tribunal in the *Iron Rhine* case took similar approaches of evolutionary interpretation with respect to sustainable development[149]. In the *Gabcikovo-Nagymaros* case, the ICJ stated that the conflicting parties have the obligation to renegotiate the contract to find a "satisfactory solution" to the environmental concerns at stake, even though these were originally not the subject of the treaty[150]. The "evolutionary interpretation" thus softens the *pacta sunt servanda* principle.

This approach could be translated into contractual obligations between the investor and the state[151]. With respect to stabilization clauses the question is to what extent changes in law on the basis of "new standards and norms" could fall out of the scope of the stabilization commitment. On the one hand, these norms could be considered to belong to well-known standards of international law, so that the investor cannot legitimately presume that the host state would refrain from implementing them. On the other, it is not very clear which kinds of norms fall under the scope of "new standards and norms" and could thus be subject to ''evolutionary'' interpretation. This lack of legal certainty goes against the investor's need for stability. After all, stabilization clauses precisely protect against this evolutionary risk. In the *Gabcikovo-Nagymaros* case the ICJ imposed a consensual approach as a way out of the dilemma of pacta sunt servanda versus the normative power of newly established and widely recognized standards in the field of public interest. The ICJ recognized the claim on the basis of the international agreement but still ruled that new norms that are relevant to the context are to be respected at the same time. The court concluded that the parties to the contract need to negotiate a "satisfactory solution" against the backdrop of the concept of sustainable development.

Sustainable development is a well-known legal concept today and has been recognized by various international decision making bodies[152]. The normative responsibility inherent in the concept of sustainable development is addressed to states and businesses alike[153]. One of the salient features of the concept of sustainable development is that economic interests are to be reconciled with needs in the social and developmental domain[154]. These "domains" (economic, social, and environmental) are normatively expressed in international standards and principles that have been carved out over time[155]. This includes international investment law in the eco-

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[147] ICJ, *Gabcikovo-Nagymaros* (*Hungary v Slovakia*). Judgment of 25 September 1997, ICJ Rep 1997, 7–84. Available at: http://www.icj-cij.org/docket/files/92/7375.pdf (visited: 13 June 2013).

[148] ICJ, *Gabcikovo-Nagymaros*, para. 140.

[149] WTO Appellate Body, *United States — Import Prohibition of Certain Shrimp and Shrimp Products*, WT/DS58/AB/R, adopted 6 November 1998, and WTO Panel Report, *United States – Shrimp – Recourse to Article 21.5* by Malaysia, WT/DS58/RW, adopted 15 June 2000; Arbitration Regarding the Iron Rhine (''Ijzeren Rijn'') Railway (Belgium/the Netherlands), Permanent Court of Arbitration (PCA), Award of 24 May 2005. Available at: http://www.pca-pa.org/showpage.asp?pag_id=1155 (visited: 12 November 2012).

[150] ICJ, *Gabcikovo-Nagymaros*, para. 140.

[151] See for this argument Abba Kolo and Thomas Wälde, cited after Cotula (2008b), *op. cit.*, p. 176.

[152] International Law Association (2006). *Report of the seventy-second conference, Toronto*, Committee on International law on Sustainable Development, London/Aberystwyth, pp. 467-522, p. 472 *et seq.*

[153] UN General Assembly, Resolution 42/187, 11 December 1987, Report of the World Commission on Environment and Development; United Nations, Report of the United Nations Conference on Environment and Development, A/Conf.151/26/Rev.1 (Agenda 21).

[154] See PCJ, Iron Rhine, para. 59. See for efficiency in regulation in this respect Gehne, Katja (2011b), *Nachhaltige Entwicklung als Rechtsprinzip*, Mohr-Siebeck, pp. 132, 156.

[155] Gehne (2011a), *op. cit*, p. 82 *et seq*.

nomic domain but imposes to strike a balance with conflicting environmental or social issues at stake. New norms and standards in the field of sustainable development could thus relativize what has been negotiated among the parties to an international contract[156]. According to the ICJ, these norms and standards are to be observed not only "when continuing with activities begun in the past" (evolutionary) but also "when States contemplate new activities. This means that the observation of these norms is also a condition to all future contractual relations[157]".

The ICJ approach recalls the re-negotiation provisions that accompany modern economic equilibrium clauses[158]. The constellation is, however, different in nature: while in the case of economic equilibrium clauses the negotiations are about re-balancing the economic equilibrium and thus due compensation for public interest regulation, the case of evolutionary norms is about negotiating the balance to be struck between social, environmental and economic factors determining the public interest in the domain of sustainable development. The weak point of the negotiation approach is the presumption of good faith negotiations and consent. What happens if the parties do not achieve an agreement, abstain from negotiation or block negotiations in bad faith? The ICJ held that "the parties are under an obligation to conduct themselves in a way that ensures that the negotiations are meaningful, which will not be the case when either of them insists upon its own position without contemplating any modification of it"[159]. The ICJ did not, however, clarify what happens if negotiations failed. Negotiation clauses coming with equilibrium clauses may provide for arbitral decision if the parties cannot achieve an agreement.

V. The argument of good faith and the investor's due diligence

The main instrument allowing for equity and respective flexibility in law interpretation is the use of the principle of good faith[160]. According to Article 31 VCLT "a treaty shall be interpreted in *good faith* in accordance with the ordinary meaning to be given to the *terms of the treaty* in *their context* and in the light of its *object and purpose*". In this context, good faith has been interpreted as being "at once a general principle of law and a general principle of international law"[161]:

> … A reasonable and bona fide exercise of a right in such a case is one which is appropriate and necessary for the purpose of the right (i.e., in furtherance of the interests which the right is intended to protect). It should at the same time be *fair and equitable as between the parties* and not one which is calculated to procure for one of them an unfair advantage in the light of the obligation assumed. A reasonable exercise of the right is regarded as compatible with the obligation. But the exercise of the right in such a manner as to prejudice the interests of the other contracting party arising out of the treaty is unreasonable and is considered as inconsistent with the bona fide execution of the treaty obligation, and a breach of the treaty. … (emphasis added)[162].

[156] This is to be distinguished from *rebus sic stantibus*, see ICJ, Gabcikovo-Nagymaros, para 104.

[157] ICJ, Gabcikovo-Nagymaros, para. 140.

[158] See Cotula (2008b), *op, cit.*, p. 176 who states that the evolutionary approach of the ICJ is in line with the logic of economic equilibrium clauses.

[159] ICJ, *Gabcikovo-Nagymaros*, para. 141.

[160] "Good faith is the principle which is most often invoked in international law", Brownlie, Ian (1998), *The Rule of Law in International Affairs, International Law at the Fiftieth Anniversary of the United Nations*, Martinus Nijhoff Publishers, The Hague, pp. 15−19.

[161] WTO-Appellate Body, *US-Shrimp*, para. 158.

[162] *Ibid.*, Fn. 156 citing Bin Cheng, *General Principles of Law as applied by International Courts and Tribunals* (Stevens and Sons, Ltd. 1953), Chapter 4, in particular, p. 125.

Given the public-private hybrid character of international investment law, there are two conceptually different entry points for the good faith principle to gain effect in international investment law: within the realm of public (international) law as a principle applying to the state, and from a private law perspective applying to the investor. The private law perspective was for example put forward by the tribunal in the above mentioned *MTD vs. Chile* case. The tribunal developed a due diligence restriction of the investor's legitimate expectations under the FET standard[163]. It held that the notion of "legitimate expectations" was limited on the basis of various (good-faith) duties. These can be framed as "(i) the duty to refrain from unconscionable conduct, (ii) the duty to invest with adequate knowledge of risk and (iii) the duty to conduct business in a reasonable manner"[164]. While the normative origin and content of the FET standard are difficult to trace, it can hardly be denied that FET is an expression of equity[165]. The FET standard plays a similar role in international investment law than the complementation of specific rules in a civil law system with a "general clause of good faith as an overarching principle that fills gaps and informs the understanding of specific clauses"[166]. One can thus conclude, that "the substance of the standard of fair and equitable treatment will in part overlap with the meaning of a good faith clause in its broader setting"[167]. From an international public law perspective, the principle of good faith could also be invoked independently of the FET standard, as a principle of international law and interpretative tool to allow for examination of the investor's legitimate expectations from a broader perspective. As such, it may also influence the application of the FET standard.

To achieve interpretive flexibility of a general contractual stabilisation commitment in the public-interest sphere, one could thus invoke the investor's diligence with respect to human rights obligations or international environmental standards, mainly if the state has been bound to respective agreements at the time the contract was concluded. If a state adheres to international obligations widely recognized in the international community[168] or forming part of fundamental standards of international law, there is space to invoke lack of good faith on the part of the investor if the latter expects the state not to observe these standards. This may even apply to ex-post adherence of a host state to international obligations which are widely recognized[169], and is also true for progressive improvement of social and environmental law with respect to widely recognized international standards. Investors cannot expect states to compensate for regulation that implements widely recognized international standards in the public interest – and thus reflect an international standard of "good governance".

Moreover, new developments in international law point to investors' responsibility to not harming human rights when conducting their business. It is true that private actors are not bound by human rights under international law[170]. However, on the basis of the framework which was elaborated by the former UN Special Representative for Business and Human Rights, John Ruggie, and the on-going work of the newly established UN-Working Group building up on his work, a new standard of businesses' responsibility to respect human rights seems to be emerging in international law[171]. Additionally, as mentioned above, an increasing number of compa-

[163] *MTD v. Chile*, para. 178.

[164] Maniruzzaman, *op. cit.*, p. 149.

[165] See for a more general due diligence approach, Wälde, *op. cit.*, p. 31.

[166] Dolzer & Scheurer, *op. cit.*, p. 122.

[167] *Ibid*.

[168] This will be the subject of the section below.

[169] Cotula (2008b), *op. cit.*, p. 175.

[170] Schaub, Martin (2009), *Die Regulierung multinationaler Unternehmen. Rechtliche, politische und wirtschaftliche Grundlagen*, Dissertation, University of Zürich, p. 149 *et seq*.

[171] The so-called "Protect, Respect and Remedy" framework as it has been developed by the SRSG on business and human rights, John Ruggie, has been widely recognized, including the human rights due diligence requirements for transnational enterprises. See for the framework: Ruggie, John (2008). *Report of the Special Repre-*

nies, mostly large transnational enterprises, have committed themselves to this standard. In this regard, an investor's claim challenging a host state's measure which aims to fulfil human rights obligations, such as core labour rights, working hours, health and safety, etc., could thus be deemed a case of *venire contra factum proprium* and "illegitimate" in the broader context of good faith. The same holds true for international standards in other fields of public interest that are widely recognized, for example as part of standard setting international bodies (e.g. FAO).

This does, however, not mean that every public measure that is related to human rights or environmental public interest is automatically exempt from compensation. Good faith works for both sites, generating the often cited necessity of balancing different rights and obligations in law interpretation when no distinct rule settles a case but a principled conflict of law needs to be resolved[172]. This is where the public law perspective of good faith steps in, reviewing the legitimacy of public authority action encroaching upon a private person's legally protected rights and related interests. In the case of investors, these rights may derive from human rights, other international obligations of the state, and contractual relationships with the state. Consequently, different rights could apply.

One of the common interpretive principles in the context of good faith that steps in when two opposing rights collide – in this context investors' rights and rights' of others that are protected by the host state measure - with "no settled rule [that] dictates a decision either way"[173] is the principle of proportionality. This principle has been used in mainly German and European law tradition, and is also applied in international law. It may serve as a legal reasoning instrument to reviewing the efficiency of reconciliation of conflicting norms so that both interrelated (legitimate) positions may attain their best effectiveness in the given context[174]. The criteria of suitability, necessity and reasonableness of a measure in relation to its aim pursued[175] legally capture the balancing requirement involved in the task to reconcile or optimize different equally important and legally binding colliding principles which could include political objectives or legal obligations (e.g. environmental protection and investment protection). In this sense, the proportionality principle can serve as an interpretive instrument to achieve coherence regarding the "policy-conflict"-fragmentation of international law as it has been described by the ILC[176]. It can also be a conflict-preventing decision-making tool for governments to design policy measures in a balanced way, including in the domain of sustainable development[177]. In international investment law, the proportionality principle has been applied with a view to balancing

sentative of the Secretary-General on the issue of human rights and transnational corporations and other business enter-prises: Protect, Respect, and Remedy: a Framework for Business and Human Rights. Human Rights Council. A/HRC/8/5. The concept has been integrated in the revised OECD guidelines for multinational enterprises which have been adopted on the occasion of the OECD ministerial meeting in May 2011, see OECD (2011), *Guidelines for multinational enterprises, recommendations for responsible business conduct in a global context*, 25 May 2011, Chapter IV.

[172] Dworkin (1975), *op. cit.*, p. 1060.

[173] *Ibid.* Schill, Stephan and Kingsbury, Benedikt (2010), *Public Law Concepts to Balance Investors' Rights with State regulatory Actions in the Public Interest – the Concept of Proportionality*, in: Schill, Stephan (ed.), *International Investment Law and Comparative Public Law*, Oxford University Press, pp. 75-106, p. 79 et seq.

[174] Alexy, Robert (1985), *Theorie der Grundrechte*, Suhrkamp. p. 101; in the context of sustainable development Gehne (2011b), *op. cit.*, p. 225.

[175] Free translation of the German terminology "Verhältnismäßigkeit im engeren Sinne".

[176] See above, Koskenniemi-Report, para 24, van Aaken, Anne (2009), *Defragmentation of Public International Law through Interpretation: A methodological Proposal*, Indiana Journal of Global Legal Studies, Vol. 16, No. 2, pp. 483-512, p. 502.

[177] Gehne, Katja (2010), *Das Nachhaltigkeitskonzept als rechtliche Kategorie im Spannungsfeld zwischen staatlichen Regulierungsinteressen und Investorschutz*, in: Bungenberg, Marc et. al. (eds.), *Internationaler Investitionsschutz und Europarecht*, Nomos, pp. 271-292, p. 285.

rights and obligations, for example in the context of FET or expropriation[178]. A concern that is raised here is the extent of arbitral tribunals' jurisdiction when reviewing host state measures. Given the principles of sovereignty and democracy, the review should be subject to "judicial self-restraint"[179]. This means deference to the state's prerogative to choose policies or the level of protection which it deems appropriate[180], unless a chosen measure is evidently not suitable, necessary or proportionate with respect to its aim pursued.

As another expression of good faith, finally, the FET standard itself applies in international investment law when determining the legitimacy of the state's measure in the field of environmental and social public interest regulation under international investment law; here, issues like transparency, stability, and the investor's legitimate expectations – and, as we have seen, proportionality - step in[181]. Other aspects of good faith under the FET standard have concerned due process, predictability or de jure changes in law. Good faith may include the responsibility of states to conduct consultations or negotiations with investors before enforcing legislation. As an example, referring to the chapeau of Article XX GATT, and to the principle of good faith, the Appellate Body classified as "unjustifiable discrimination" the "failure of the United States to engage the appellees, as well as other Members exporting shrimp to the United States, in serious, across-the-board negotiations with the objective of concluding bilateral or multilateral agreements for the protection and conservation of sea turtles, before enforcing the import prohibition against the shrimp exports of those other Members"[182]. This could similarly be translated in the investor-state context.

VI. Conclusion: applying systemic integration & harmonized law interpretation

The legal avenues to balanced law interpretation in the face of general stabilization commitments show that there are possibilities to overcome fragmentation and policy-conflict in the face of far-reaching, general stabilization clauses. The interpretative objective to seek a balance between legitimate rights of host states and investors in the field of environmental and social regulation is expressed in the principle of harmonized law interpretation as it was developed by the ILC study group on fragmentation of international law. For the study group "treaty interpretation is diplomacy, and it is the business of diplomacy to avoid or mitigate conflict"[183]. The group underlines that:

> Whether there is a conflict and what can be done with prima facie conflicts depends on the way the relevant rules are interpreted. This cannot be stressed too much. […]."Rules appear to be compatible or in conflict as a result of interpretation". Sometimes it may be useful to stress the conflicting nature of two rules or sets of rules so as to point to the need for legislative intervention. Often, however, it seems more appropriate to play down that sense of conflict and to read the relevant materials from the perspective of their contribution to some generally shared - "systemic" - objective[184].

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[178] *Azurix Corp. v. Argentine Republic*, ICSID Case No. ARB/01/12, Award, 14 July 2006, para. 311; *LG&E Energy Corp., LG&E v.* Argentina, para. 195; Schill & Kingsbury, *op. cit.*, p. 88.

[179] See Brownlie, Ian (2008), *Principles of Public International Law*, 8th edition, Oxford University Press, p. 289.

[180] In the context of the WTO this has been explicitly stated by the WTO Appellate Body, see for example WTO-Appellate Body Report, *Korea - Various Measures on Beef*, WT/DS161/AB/R; WT/DS169/AB/R, 11 December 2000, para. 176; WTO-Appellate Body Report, *EC-Asbetos*, WT/DS135/AB/R, 12 March 2001, para. 168.

[181] Dolzer & Schreuer, *op. cit.*, p. 133; Schill & Kingsbury, *op. cit.*, p. 96.

[182] WTO-Appellate Body, *US-Shrimp*, para. 166.

[183] Koskenniemi-Report, paras. 24, 37.

[184] *Ibid.*, paras. 24, 412.

In terms of stabilization clauses and potential conflicts with other host state's obligations, one should thus either clarify the scope of these clauses by "legislative intervention" or seek to "play down" the conflict through systemic law interpretation. The ILC study group refers to the technique of "mutual supportiveness" and "harmonized law interpretation" which starts out from a "thumb-rule" involving the "presumption that the parties intend something not inconsistent with generally recognized principles of international law or with previous treaty obligations towards third States"[185]. "Well-worn legal pathways" of law interpretation should be applied to seek a maximum of harmonized law interpretation and mutual supportiveness of conflicting norms[186]. These involve "references to normal meaning, party will, legitimate expectations, good faith, and subsequent practice, as well as the "object and purpose" and the principle of effectiveness" or "if a definite priority must be established, this may" […] be achieved through three criteria: (a) specificity (lex specialis); (b) temporality (lex posterior), and (c) status (ius cogens, obligations erga omnes and Article 103 United Nations Charter).[187] The above explored interpretative avenues may serve as further entry points for harmonized law interpretation in the field of stabilization commitments.

The application of the principle of harmonized law interpretation in cases of policy-conflicts is, however, not a given fact. It very much depends on the approach to legal reasoning and deference to states' decision-making prerogative if or if not a stabilization commitment is taken as simple *lex specialis* overriding any other interpretation in the face of policy-conflicts in the field of public interest regulation, or as a right to be balanced against the background of conflicting underlying rights and principles[188]. Given the existing features of international dispute settlement practice, with law interpretation and legal reasoning being very much influenced by the composition of the investment tribunal[189], for systemic integration interpretation to be effective in international investment law there seems to be a need for harmonizing interpretation principles and methodologies, not least to enhance legal certainty and predictability.

E. Summary, conclusion and outlook

Looking at the current practice of stabilization clauses as far as we can oversee it, it is first of all to note that there are many forms of stabilization commitments, often tailored to the specific situation of the contract. Stabilization clauses are today commonly used in international investment contracts as a tool to cushion investment risks related to regulatory change in the host country. In academic literature, stabilization clauses have been classified in three main tendencies: freezing clauses shielding companies from changes in law, economic equilibrium clauses providing for compensation for ex post states' measures, and hybrid forms of these. The clauses can also vary from freezing to economic equilibrium and hybrid clauses with different features and levels of protection in certain issue areas (e.g. tax law). There is no monolith type of stabilization clauses. Recent tendencies show that there is still some practice with respect to general freezing clauses, and there are modern forms of far-reaching all-including economic equilibrium clauses, e.g. in the transnational pipeline industry. While contracts with OECD countries usually contain equilibrium clauses that focus on non-discrimination, clauses in contracts with developing states tend to be far more comprehensive. Some even explicitly include changes in labour or environmental legislation. There is rare account of the public need of regulatory change or consideration of social responsibility and due diligence on the side of the investor. Especially with regard to developing countries' frequently lower standards and thus needs of progress in social

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[185] *Ibid.*, paras. 24, 38.

[186] *Ibid.*, paras. 24, 412.

[187] *Ibid.*

[188] See for the different effects of „positivist" or „principled" approach to legal reasoning in the context of sustainable development and law, Gehne (2011b), p. 278.

[189] Van Harten, Gus (2010), *Perceived Bias in Investment Treaty Arbitration*, in: Waibel, Kaushal *et al.* (eds.), *The Backlash against Investment Arbitration*, pp. 433-454, 441.

and environmental legislation and enforcement of law, this is often felt like investment and competition between countries that seek to attract investment at the cost of social and environmental standards. Protests by civil society groups in the pipeline industry have led to changes in model agreements and agreements as to the inclusion of general exceptions to stabilization commitments with respect to human rights and environmental protection. In some industry branches (e.g. petroleum) one finds exemptions regarding environmental, health, or safety regulation.

Recent arbitration decisions that directly or indirectly involved stabilization clauses are mixed in their tendencies. Older as well as recent investment tribunals' awards suggest that this practice is considered a widely recognized investment protection tool to which host states chose to commit in their effort to attract investment. No tribunal put the validity and the binding nature of the clause into question, or called for a balanced approach to it. This could be deemed problematic mainly with respect to possible and widely discussed "hard cases", when investment rules and other fields of international law (e.g. human rights or rules of environmental protection) overlap. There has, however, to our knowledge, never been a case that involved conflicts between stabilization commitments and international environmental or social standards. There are two main tendencies to be detected: on the one hand, there is strict recognition of far-reaching stabilization commitments (e.g. *Methanex v. U.S.*, *AES v. Hungary*, *CMS Gas Transmissions v. Argentina*, etc…) and even tendencies of extent that raise questions with regard to constitutional principles such as the separation of powers or basic features of public-private relationships (*Duke Energy v. Peru*, *Burlington v. Ecuador*). On the other, arbitration tribunals have taken into account the investor's due diligence in the matter to judge the case (*Saluka v. Czech Republic*, *Parkerings v. Lithuania*, *MTD v. Chile*).

Generally, evolutionary dynamics of international law allow less and less for an isolated reading of international investment protection standards. The growing body of international law generates overlaps of social, environmental and economic fields of international regulation; there is a need for coherence in international law to ensure legal certainty, and there is a need to balance social, environmental and economic concerns at the international level. Civil society pressure, including customers' and financial investors' pressure on companies, does not allow for isolated approaches to the protection of investors' interests anymore. Deficiencies in the protection of social and environmental concerns, mainly with respect to human rights, are increasingly addressed by private actors and global initiatives, enterprises taking over social responsibilities to sustain their "license to operate"[190]. Mainly regarding respective emerging and new standards of international law, various interpretive avenues are available that open up loopholes in the rigid legal morphology of stabilization clauses. As the study group of the ILC Report on Fragmentation noted: "conflict-resolution and interpretation cannot be distinguished from each other. Whether there is a conflict and what can be done with *prima facie* conflicts depends on the way the relevant rules are interpreted"[191]. We have described some legal avenues that are discussed in terms of harmonized law interpretation in this way (implicit compliance with international law exception, reference to general law, reference to national law, evolutionary approach, and good faith). They show that balanced approaches to general stabilization commitments are possible on the basis of legal reasoning.

I. Lack of legal certainty and legitimacy

It follows that the legal security which has been sought by general stabilization clauses has given way to a situation of uncertainty. Even though international arbitral tribunals have quite coherently supported the far-reaching investment protection effect of general stabilization clauses, other cases could provoke different legal arguments. Deficiencies of far-reaching general stabilization practice to secure investment stability are three-fold: first, due to unsettled interpretative questions, stabilization clauses do not live up to their purpose of legal certainty and security any more. Second, the pursuit of unfettered business interests for the sake of economic growth increasingly fails to meet societal acceptance, not least by customers, consumers, financial investors and markets. Third, if underlying policy-

[190] Ruggie (2008), *op. cit.*, para. 54.

[191] Koskenniemi-Report, para. 412.

conflicts are ignored, stabilization clauses cause friction in international law that risk to harm the acceptance and legitimacy of international investment law and arbitration.

Lack of legal certainty not only follows from a variety of interpretative approaches exempting social or environmental change in law from compensation, but also from the design of stabilization clauses that are often characterized by very broad scope and wording with no clear definition (e.g. "adversely affected", material adverse change or effect, MAC or MAE)[192]. Although these provisions may come in handy as "escape hatch" for re-negotiation or ending deals in times of uncertain economic developments, their open terms leave a lot of room for interpretation[193].

The legitimacy problem is anchored in the fact that ignoring states' needs to regulate in the public interest by shielding of investors' financial risks related to social responsibility meets civil society resistance. Lacking acceptance of international investment law may harm the rule of law at the international level[194]. Additionally, the negligence of social responsibility on the side of the investor entails the risk of being confronted with civil society protests and local uproar. For companies, this can grow into a costly problem when confronted with local protests, litigation, and respective host government reaction. Investment security, reputation and brand may suffer considerably. The trend towards socially responsible financial investment involves financial risks (for example in the cases of Hermes guarantees by the German government or the International Finance Corporation's performance standards). For an investor, counting on far-reaching stabilization commitments, means to camouflage risks and to neglect due diligence with respect to social and environmental standards. Corporate responsibility has become a risk factor which companies need to take into account in their operations. In sum, far-reaching, general stabilization clauses have not only the potential put at risk the investment project but also delegitimize international investment law and arbitration that enforce them.

II. Are general stabilization clauses still necessary to protect foreign investment?

Today, a quite solid ground of international investment protection standards is in place through customary international law and the widespread growing network of IIAs. Most IIAs typically share the same features of investment protection standards (for example non-discrimination, expropriation, most-favored nation, and fair and equitable treatment). Normally, other than it is the case for stabilization clauses, under international investment law "simple non-discriminatory bona fide regulation does not trigger compensation". This changes, however, with "the presence of a stabilization clause" that "can make such action compensable"[195]. The existence of stabilization clauses in investor-state contracts implies a much broader protection of the business – mainly if elevated to the protection of the international investment law regime through umbrella clauses or respective law interpretation. Notwithstanding the above described negative effects of far-reaching general stabilization commitments for investment security, investors, and more generally the legitimacy of international investment law, most authors who raise concerns about these effects, still seem to consider stabilization clauses effective instruments for investment risk management[196]. Hardly anyone questions today's effectiveness of stabilization clauses as an appropriate risk management tool for investments[197]. There are, however, pertinent questions in this regard: which criteria are decisive for an investors' cost benefit and risk

[192] Maniruzzaman, *op. cit.*, p. 130.

[193] *Ibid.*, p. 131.

[194] Echandi, Roberto (2011), *What Do Developing Countries Expect from the International Investment Regime?* In: José E. Alvarez; Sauvant, Karl P., *et. al* (eds.), *The Evolving International Investment Regime*, pp. 321, 10.

[195] Maniruzzaman, *op. cit.*, p. 131.

[196] See above; see conclusion of Cotula (2008b), p. 179.

[197] See, however, Howse, Robert (2011), *Freezing Government Policy: Stabilization Clauses in Investment Contracts*, International Institute for Sustainable Development (IISD), Investment Treaty News, April 4 2011. Available at: http://www.iisd.org/itn/2011/04/04/freezing-government-policy-stabilization-clauses-in-investment-contracts-2/ (visited: 13 June 2013).

analysis today[198]? According to which market determinants – or in relation to which public regulation fields? Given the considerable negative effects of stabilization clauses (fragmentation of law, lack of legitimacy, legal certainty and investment security) these questions should be looked at more closely.

Stabilization clauses as they are designed and understood today not only go far beyond their original function of shielding against nationalization and unfair treatment of an investor exposed to the sovereignty of a foreign state. Given their general approach "compensation for regulation" instead of "compensation for unfair treatment" they also go far beyond the idea of due risk management between states and investors. Therefore, at least in their general forms and approaches and against the backdrop of the already existing high standard of international investment protection, stabilization clauses seem questionable. With the "compensation for regulation" principle at the basis of an investor-state contract, it will always be difficult to achieve fair and balanced stabilization of an investment project, as the right to regulate of the state is generally bound to compensation. In this regard, there is non-flexibility for regulation from the outset. Even if the contract defines exemptions to that rule that may allow for certain thresholds and flexibility, these remain exemptions, to be interpreted narrowly. Additionally, exemptions need to be explicitly stated to apply. They will necessarily not catch overall regulatory need in the public interest.

Today, responsibly acting transnational companies increasingly take into account risks related to environmental and social internationally recognized standards when investing abroad. Apart from risks, sustainable development, of which responsible business conduct in the social and environmental sphere is part, has become a differentiating factor in various markets, guiding the business strategies of a wide range of big transnational companies today. Non-observance of widely recognized international standards potentially harms these companies' brands. Moreover, these players are confronted with "unfair competition" when dealing with irresponsibly acting competitors abroad. This is why the OECD Investment Committee has recently increased effort to spread the OECD Guidelines for Multinational Enterprises to third countries in an aim to foster a "global level playing field" with respect to responsible business conduct[199]. Against this backdrop, investment security rather implies than excludes observation of widely recognized international human rights and environmental standards. As a conclusion, general stabilization clauses "freezing" legislation and hindering legal developments and law application in the social and environmental domain do not necessarily match the interests of investors anymore. Moreover, as described above, they imply the more general risks of legal uncertainty and lacking legitimacy harming investment security as such[200].

III. Seeking legal certainty and legitimacy – an outlook

If the wide-spread practice of general stabilization clauses is not necessarily an ideal tool for investment protection anymore - which is a good way of achieving investment security and investment incentives between international law and individual public-private investment contracts? This question is too complex to be answered without a thorough research basis. There are just some points that we would like to raise here. First, given the fact that states need regulatory space and flexibility to adapt to the requirements of change, we think that this need should be generally respected. This is to accord due account of the naturally progressive state of governance, as it has been recognized by different arbitral tribunals, the progressive state being at the very core of the conceptual backbone of sustainable development which consists of balancing and harmonizing efficiently interests in the societal, economic, and environmental sphere. As the arbitral tribunal in the *Feldman v. Mexico* case states: "Rea-

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[198] See, for stabilization clauses as inefficient means for addressing the risk of regulatory change, Howse, Robert, *op. cit.*

[199] See OECD, *International Investments, and Guidelines for Multinational Enterprises*, http://www.oecd.org/daf/inv/mne/newguidelinestomultinationalenterprisesandtheoecdanti-briberyconvention.htm (visited: 13 June 2013).

[200] See above.

sonable governmental regulation […] cannot be achieved if any business that is adversely affected may seek compensation, and it is safe to say that customary international law recognizes this"[201].

Investors as citizens of a country are part of that game and cannot expect to be let off the hook of their societal responsibility only because they invest abroad. After all, investment protection is about risk management in the public sphere and not about generally shielding firms against business risks[202]. This does not mean that the risk of protectionism, unfair treatment and more generally arbitrary rent-seeking to the detriment of foreign investors and more generally economic wealth is to be neglected. One should, however, avoid to throwing the baby out with the bathwater, thereby ignoring core issues of good governance, such as sustainable development and fair competition. As we have seen, "business at no risk" creates a rent for the firm that distorts market-efficiency, has the potential to disincentivize progressive regulation, and fosters "moral hazard on the part of the firm"[203].

Second, as the above case studies and exploration of interpretive avenues have shown, the wide-spread net of investment protection law generally allows for flexibility and good faith harmonized law interpretation when it comes to balancing investors' and public interest through arbitration decisions. Recent arbitral jurisprudence suggests that the FET standard implies a notion of stability as legitimate expectation of the investor[204]. Some treaties explicitly stipulate investment stability as a goal of the FET standard[205]. So why not taking this basic protection standard that is at the core of all IIAs, as a start and using investor-state contracts to tailor specific complementary provisions with no recourse to general "business at no risk" stabilization that goes far beyond the original protection against unfair treatment?

The major counter-argument is the often cited bias in international investment law and arbitration[206]. A considerable range of scholars criticize the inter-state investment protection regime for generally working to the detriment of host states, mainly due to pro-investor interpretation of investment protection standards. They point at arbitral interpretation of investment protection principles, such as FET, expropriation, corporate nationality, most-favored nation, and non-discrimination that have resulted in compensation for bona fide regulatory change in the public interest[207]. Additionally, IIAs are often said to be generally imbalanced in the sense that they mainly focus on the promotion and protection of foreign investment, granting far-reaching rights to investors. There is hardly any stipulation that considers investors' social responsibilities, e.g. towards human rights[208]. Research has shown that there is evidence of a certain "disregard for other international legal norms, coupled with the high effectiveness of the international investment legal regime" which "tend(s) to give the latter a certain primacy over the rest of international law"[209]. Therefore, some conclude that "investment contracts are preferable to investment treaties as a legal mechanism to supplement domestic law in the regulation of investor-state relations because they "allow for greater care to be taken and greater certainty to be achieved in the framing of the parties' legal rights and obligations"[210]. There is a call for delegitimizing the IIA based international investment regime to stop its biased functioning.

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[201] ICSID, *Feldman v. Mexico*, para. 103.

[202] ICSID, *MTD v. Chile*, para. 178.

[203] Howse, *op. cit*.

[204] Maniruzzaman, *op. cit*., p. 147.

[205] Dolzer & Schreuer, *op. cit.*, p. 122.

[206] See Van Harten (2010), *op. cit.*, p. 433 *et seq*.

[207] Public Statement on the International Investment Law Regime, para. 5, 6.

[208] De Schutter *et al.* (2009), *Foreign Direct Investment, Human Development and Human Rights: Framin the Issues*, in: Human Rights and Legal Discourse, pp. 137-177, p. 165.

[209] *Ibid.*, p. 174.

[210] Public Statement on the International Investment Law Regime, para. 10.

The practice of stabilization clauses in investor-state contracts shows, however, that these may imply precisely what has been criticized with respect to the international investment regime: *lex specialis* provisions that make compensation for bona fide regulation the general rule. Investor-state contracts are generally negotiated confidentially with state officials that may be biased on the grounds of multiple reasons when it comes to an individual investment project and the incentives it may involve. This does not make investor-state contracts a better instrument per se. To the contrary[211]: there is more space for behind-the door favoritism as there is no international audience and no abstract level of international law to frame or guide the parties' negotiations. States' interests when negotiating contracts and peoples' needs in terms of human rights protection and sustainable development cannot necessarily be put on a par[212]. With a weakened international regime, there are no centralized institutions as targets for civil society groups to watch and urge better-suited approaches to investment law protection with more general leverage and publicity effect.

There may be little hope that deficiencies of the current IIA system will change quickly, but there is also no reason to have no hope that there may be a potential for change in a positive way. Recently, most IIAs involving developed countries include language that addresses sustainable or human development, human rights or corporate responsibility, including BITs[213]. Developed countries have been under considerable pressure by civil society in this regard. This provides a basis for harmonized law interpretation. Similar language is, however, missing in IIAs involving developing countries only – human rights and sustainable development not being their major concern. This may be attributed to the principle "economic development first – sustainable development later" that seems to have still effect as a principle underlying international economic law – and that will necessarily equally influence investor-state contract negotiations. This principle derives from the wide-spread hypothesis of the "trickle-down-effect" of economic growth that automatically entails human development. It has been at the core of early development decades' policy of the UN and international financial institutions[214]. It implies that the protection of human rights and the environment should wait before the economic standard is high enough to afford demand for that. This approach to development may to a certain extent explain far-reaching interpretation and understanding of investment protection standards. Economists have raised their voices that this presumption is not efficient, neither in terms of liberal economic theory nor regarding actual development practice[215]. Since the end of the 20th century the paradigm has changed into the integrative approach of sustainable development that mainly seeks to achieve win-win situations between environmental, social and economic needs and concerns[216]. More and more, this approach reaches economic scholarship. Business schools increasingly integrate corporate responsibility and sustainable development approaches to business in their schedules. This should, sooner or later, also influence the understanding of international investment protection and respective interpretive approaches.

Finally, there is no legal reason for the investment regime to be superseding other regimes, quite to the contrary: as we have seen, the superseding effect is mainly a matter of a certain attitude towards legal reasoning and investment law interpretation that casts doubt on the legitimacy of the IIA system. From the point of view of effective law application, interpretation systematically favoring investment pro-

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[211] See also critics by Howse, *op. cit*.

[212] Gehne (2011a), *op. cit.*, p. 95.

[213] Maniruzzaman, *op. cit.*, p. 142, De Schutter *et al. op. cit.*, p. 167.

[214] Gehne (2011b), p. 140 *et seq*.

[215] Stiglitz, Joseph (2001), *Information and Change in the Paradigm in Economics*. Prize lecture, 8 December 2001, Columbia Business School. Available at http://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/2001/stiglitz-lecture.pdf (visited: 13 June 2013), p. 518; Sachs, Jeffrey (2005), *The end of Poverty, Economic Possibilities for our Time*, Penguin; Rodrik, Dani (2007), *One Economics, many Recipes. Globalization, Institutions, and Economic Growth*, Princeton University Press; Gehne (2011b), *op. cit.*, p. 140 *et seq*.

[216] *Ibid.*, pp. 33 *et seq*.

tection fails to take appropriate account of international law[217], a fact that can hardly be neglected. Apart from far-reaching interpretation of FET and legitimate interest of the investor in investment stability, there is jurisprudence that conveys investors' due diligence and responsibility (*MTD v. Chile*, *Feldman v Mexico*, *Saluka v. Czech Republic*, *Parkerings v. Lithuania*), establishing entry doors for a harmonized approach to law interpretation[218]. Generally, there is rather recognition of a general right to regulate than of a general investors' right to compensation for regulation as it is the case for investor-state stabilization practice[219].

There is no doubt that IIA based international investment law displays significant flaws that are to be addressed, not least to keep the promises of the international legal regime. These include local progress, development and benefits[220]. However, if employed well, an international investment regime comes with a non-negligible asset that is inherent in the international rule of law, including for peoples' interests that are not necessarily best protected by the state. The already established IIA system of investment protection should therefore not be given up lightly, but adapted accordingly where it fails its objectives[221]. After all, the network of IIAs is in place and thus difficult to be annulled or amended. Clarification of the scope and extent of investment protection standards through interpretive guidance, including the principle of "compensation for unfair treatment" in contrast to "business at no risk", due diligence responsibility of the investor, transparency, reform of international arbitration, including a centralized instance to review awards, a voice for civil society in arbitration, more efficient remedy for affected people in the context of investments, more distinct respect for local law and the judicial system, exemption clauses for specific governance needs beyond the general right to regulate in flanking investor-state contracts, all these could be elements that merit to be promoted to counterbalance deficiencies in the IIA system. The general tendency of unfair competition and investors' risks in the face of disregard of human rights and environmental standards as well as recent evolution of international law regarding investors' responsibilities with respect to human rights and sustainable development, are trends that could significantly fuel reform in this sense.

On this basis, we are of the opinion that the best way to deal with stabilization clauses is to make them history – by interpreting them in a harmonizing way when applicable and by not deploying them anymore in investor-state contracts. Investment protection should start with general existing FET stability (compensation for unfair treatment), subject to good faith on the side of the state and due diligence on the side of the investor, including social responsibility on the basis of international standards and norms. Against this backdrop, the remaining challenge for investor-state contracts would be to complement the picture where individual contracts "allow for greater care to be taken and greater certainty to be achieved in the framing of the parties' legal rights and obligations"[222]. Part of this could be the goal of achieving a high degree of legal certainty for the particular investment project in a complex field of tension that includes investment security, legitimacy and investment incentives. There will be no one-size-fits all solution similar to stabilization commitments but a challenge to agree a carefully tailored solution for each individual case, based on specific interests involved[223].

Incentives should be agreed upon on a clearly defined basis regarding content, extent and expiration. Share-in-profits should be based on transparency and clearly defined criteria, including adaptation clauses. Interpretative principles or rules should support vague MAE or MAC clauses and should underline the state's right to regulate subject to good faith and fair and equitable treatment as well as the

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[217] Koskenniemi-Report, para. 25.

[218] Muchlinski, Peter (2006), *Caveat Investor? The Relevance of the Conduct of the Investor under the Fair and Equitable Standard*. ICLQ, pp. 530-558, Vol. 55, No. 3, p. 527.

[219] Howse, *op. cit*.

[220] De Schutter *et al.*, *op. cit.*, p. 169.

[221] Cottier *et al, op. cit*; Gehne (2011a), *op. cit*., p. 100.

[222] Public Statement on the International Investment Law Regime, *op. cit*., para. 10.

[223] See Howse, *op. cit*, who mentions the cost-factor of due diligence and general principles of investor-contract negotiations favoring stabilization clauses.

investor's due diligence with respect to international standards. As risk management tools, parties may agree upon *de minimis* thresholds or recognized legal standards as reference frame for regulatory change, as it was the case in the BTC's pipeline consortium's Human Rights Undertaking that referred to "relevant EU directives (EU Standards), those World Bank Group standards referred to in the Project Agreements, and standards under applicable international labour and human rights treaties". The more specific a benchmark gets (e.g. EU-Standards) the more it may, however, considerably restrict the flexibility of the state to adopt different and better adapted solutions in a given situation.

An instrument that could considerably foster transparency, due diligence, and appropriate risk management of investments are dispute prevention mechanisms, such as well-defined mediation and negotiation instruments[224]. A procedural requirement which could help to better frame the general context of an investment in this respect is sustainability impact assessments (SIAs), analyzing thoroughly investors' responsibility and risks against the backdrop of the state of governance of the host state. These should, against the backdrop of the UN-framework on business and human rights, integrate human rights' impact assessments, and ideally also screen (on the side of the state), conditions for development opportunities. SIA require *ex ante* evaluations with respect to social and environmental risks and effects of an investment as well as monitoring and adaptation mechanisms which could integrate a negotiation tool. SIA seek to assess from the outset which risks and opportunities are at stake in relation to the investment. They provide transparency and information to tailor benchmarks of negotiation and adaptation clauses and to identify fields of regulation for which benchmark standards and change in law patterns should be determined to keep pace with societal needs and progress as well as international and constitutional law obligations. For the investor, these impact assessments allow for a more comprehensive approach to business risks with respect to upcoming state measures and civil society pressure. This is particularly true as SIAs normally include stakeholder dialogue which is a clear asset for detecting investment risks and manage them accordingly. Many, mainly developing countries within the foreign aid frame (e.g. World Bank) have already established *ex ante* assessment tools with respect to social and environmental impacts of investment projects. The challenge is to fill them with life to make them effectively working investment risk management tools. From the state's perspective, such a tool could at the same time allow for assessing and monitoring positive impacts, development opportunities and good practices which could help channel development technical assistance and policies. For SIAs to be effective and less cost-intensive, it would be highly recommendable for countries as well as for the private sector, to establish sector-by-sector criteria. Systematic data collection on the environmental and the social situations of countries forms an important part of that[225].

[224] Echandi, Roberto (2013), *Complementing investor-state dispute resolution: a conceptual framework for investor-state conflict management*, in: Echandi, R. & Sauvé, P. (eds.), *Prospects in International Investment Law and Policy*, New York: Cambridge University Press.

[225] Lack of data is a challenge, mainly in developing states, see as example of a private tool providing data for international risk management, http://maplecroft.com/ (visited: 13 June 2013).