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ARTICLE: Stabilizing International Investment Commitments: International Law Versus Contract Interpretation

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I.

Introduction

Stabilization or freezing clauses - meant to restrain a government from subsequently abrogating or otherwise intervening by exercise of state powers in investment agreements concluded with foreign companies - were amply discussed by international lawyers in the 1970s and early 1980s. n1 Much of the discussion was prompted by the large-scale nationalizations and renegotiations of longstanding investment agreements. n2 These by now historical events triggered a series of arbitral awards n3 which required judgments of the relative strength of stabilization clauses in investment agreements as compared with the asserted sovereign right of the host state to invalidate previously concluded agreements protected by specific government guarantees of nonintervention. These arbitral awards, in turn, also triggered lively discussion throughout the 1970s and early 1980s. n4

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n1. See generally Esa Paasivirta, Internationalization and Stabilization of

Contracts Versus State Sovereignty, *60 Brit. Y.B. Int'l L. 315 (1989);* Prosper Weil, Les Clauses de Stabilization ou d'Intangibilite Inserees dans les Accords de Developpement Economique, in Melanges Offerts a C. Rousseau: Communaute Internationale 301 (1974); Nicolas David, Les Clauses de Stabilite dans les 'Contrats Petroliers: Question d'un Praticien, 113 Journal du Droit International
[J. Droit Int'l] 79 (1986); Rosalyn Higgins, Legal Preconditions of Foreign Investment, Energy L. 232 (1986); Erich Schweighofer, Der Einfluss der Neuen Internationalen Wirtschaftsordnung auf das Internationale Konzessionrecht (1991). For earlier discourse on the subject, see generally A.A. Fatouros, Government Guarantees to Foreign Investors (1962); Alfred Verdross, The Status of Foreign Private Interests Stemming from Economic Development Agreements with Stabilization Clauses, in Selected Readings on Protection by Law of Foreign Private Interests 117 (1964).

n2. Thomas W. Waelde, Revision of Transnational Investment Agreements in the Natural Resources Sector, 10 L. Am. 265, 265 (1978); Samuel K.B. Asante, Restructuring Transnational Investment Agreements, *73 Am. J. Int'l L. 335, 340-41 (1979);* Rainer Geiger, The Unilateral Change of Economic Development Agreements, *23 Int'l & Comp. L.Q. 73, 74-78 (1974);* Christopher C. Greenwood, State Contracts in International Law: The Libyan Oil Arbitrations, *53 Brit. Y.B. Int'l L. 27, 59-60 (1982);* Wolfgang Peter, Arbitration and Renegotiation of International Investment Agreements 7-8 (1995).

n3. The most prominent among which were: Saudi Arabia v. Arabian Am. Oil Co. (Aramco), *27 I.L.R. 117 (1963);* Sapphire Petroleum Ltd. v. National Iranian Oil Co., *35 I.L.R. 136 (1967);* Texaco Overseas Petroleum Co./California Asiatic Oil Co. v. Libyan Arab Republic, *17 I.L.M. 1 (1977);* BP Exploration Co. (Libya) v. Libyan Arab Republic, *53 I.L.R. 297 (1979);* Alcoa Minerals of Jam., Inc. v. Jamaica, Y.B. Com. Arb. 206 (1979); Libyan Am. Oil Co. (LIAMCO) v. Libyan Arab Republic, *20 I.L.M. 1 (1981);* Kuwait v. American Indep. Oil Co. (The Aminoil Arbitration), *21 I.L.M. 976 (1982);* AGIP Co. v. Popular Republic of the Congo, *21 I.L.M. 726 (1982);* see also Amoco Int'l Fin. Corp. v. Islamic Republic of Iran, 15 Iran-U.S. Cl. Trib. Rep. 189 (1987); Mobil Oil Iran Inc. v. Islamic Republic of Iran, 16 Iran-U.S. Cl. Trib. Rep. 3 (1987); Phillips Petroleum Co. Iran v. Islamic Republic of Iran, 21 Iran-U.S. Cl. Trib. Rep. 79 (1989).

n4. Among those who have argued in favor of the validity and enforceability of stabilization guarantees under international law are: Weil, supra note 1, at 302-24; Greenwood, supra note 2, at 61; Jean F. Lalive, Contrats Entre Etats ou Entreprise Etatiques et Personnes Privees: Developpements Recents, 181 Recueil des Cours d'Academie de Droit International [R.C.A.D.I.] 60, 86 (1983-III); and Gerard Cohen-Jonathan, L'Arbitrage Texaco-Calasiatic Contre Gouvernement Libyen, 23 Annuaire Francais de Droit International [Ann. Fr. D. Int'l] 452, 474 (1977). Arguing against it are: M. Sornarajah, The Pursuit of Nationalized Property 2-51 (1986); F.V. Garcia-Amador, The Proposed New International Economic Order: A New Approach to the Law Governing Nationalization and Compensation, 12 U. Miami J. Int'l. L. 1, 17-24 (1980); Rosalyn Higgins, The Taking of Property by the State: Recent Developments in International Law, 178 R.C.A.D.I. 233, 235 (1982-III); and Paasivirta, supra note 1, at 338.

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Stabilization clauses were reported to have diminished in scope and frequency in contracting practice in the late 1970s. Predictions were made that governments, influenced by the concepts of permanent sovereignty over natural resources, n5 new international economic order n6 (as formulated particularly in UNGA Resolutions 3201, 3202 (S-IV) and 3281 (XXIX) of 1974), n7 and their growing bargaining power with respect to "transnational corporations" n8 would 'no longer accept the attempt to limit their sovereign powers implicit in a promise to freeze the governing law applicable to a project n9 - in this instance the municipal law of the host state. Discussing the relative legal merit of stabilization clauses was, from this perspective, more a matter of dealing with the remainders of an obsolete past.

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n5. Ria Kemper, The Concept of Permanent Sovereignty over Natural Resources and Its Impact on Mineral Contracts, in Legal and Institutional Arrangements in Minerals Development 29, 29-32 (1982); cf. Permanent Sovereignty over Natural Resources in International Law 1 (Kamal Hossain & Subrata R. Chowdhury eds., 1984) [hereinafter Permanent Sovereignty]; Thomas W. Waelde, Permanent Sovereignty over Natural Resources: Recent Developments in the Mineral Sector, 7 Nat. Resources F. 239, 239 (1983); Pierre WTF. A. Legoux, Legal Aspects of Mining Development in Developing Countries, 5 Nat. Resources F. 167, 174 (1981).

n6. Hasan S. Zakariya, Sovereignty over Natural Resources and the Search for a New International Economic Order, 4 Nat. Resources F. 75, 78-84 (1980); Jorge Casta<tild n>eda, La Charte des Droits et Devoirs Economique des Etats, 19 Ann. Fr. D. Int'l 31, 35 (1975). See generally Legal Aspects of the New International Economic Order (Kamal Hossain ed., 1980); Jerzy Makarczyk, Principles of a New International Economic Order 133 (1988).

n7. See Oscar Schachter, The Evolving International Law of Development, 15 Colum. J. Transnat'l L. 1, 3-7 (1976); Ignaz Seidl-Hohenveldern, International Economic Soft Law, 161 R.C.A.D.I. 169, 178 (1979); Rudolf Dolzer, New Foundations of the Law of Expropriation of Alien Property, *75 Am. J. Int'l L. 553, 573-76 (1981);* Pieter VerLoren van Themaat, The Changing Structure of International Economic Law 384 (1981). See generally F.V. Garcia-Amador, The Changing Law of International Claims (1984).

n8. "Transnational Corporations" is the term then used by the U.N. for "multinational" or "international" companies.

n9. Waelde, supra note 2, at 265. See also Juha Kuusi, The Host State and the Transnational Corporation: An Analysis of Legal Relationships 59-60 (1979).

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However, the burial of stabilization clauses now seems to have been premature. In the current scramble for foreign investment encompassing not only less developed countries (LDCs) but also the former (and the few remaining) socialist countries, private and foreign investment is experiencing a strong and positive reappraisal over the state-dominated model of investment of the past. n10 While foreign investment in the former Soviet Union - in particular in petroleum and other minerals - is currently seen as the single great opportunity still left for international companies, the countries within the Commonwealth of

Independent States (CIS) (and most of all Russia itself) are seen as the area of highest political risk worldwide. n11 Elaborate political risk management strategies are now being put in place in Russia, with stabilization clauses featured prominently. This modern practice draws upon both the drafting experience of the 1950s and the legal and arbitral discussion of the 1970s [*218] but adds new features responding to the peculiarities of Russia. n12 As a result - particularly in high-risk transition economies - governments will

'go to considerable lengths to fashion their investment regimes to respond to foreign investor concerns. Promises not to alter a given legislative regime have therefore reemerged, in the most extensive form ever seen, as an important tool of foreign investment promotion policy. n13 The legal value of these governmental commitments is likely to be as suspect and controversial as their simpler predecessors.

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n10. For an analysis of current trends in foreign direct investment (FDI), see generally United Nations Conference on Trade and Development: World Investment Report (1993, 1994, 1995) [hereinafter UNCTAD]. See also Gerald Pollio & Charles H. Riemenschneider, The Coming Third World Investment Revival, 66 Harv. Bus. Rev. 114, 114 (1988); Thomas W. Waelde, Investment Policies and Investment Promotion in the Mineral Industries, 7 ICSID-Rev.-F.I.L.J. 94 (1991).

n11. Russia Competes with Iraq for the World's Highest Country Risk Rating, Economist, Dec. 17, 1994, at 112.

n12. The most extensive stabilization mechanism seen so far was submitted by Shell in 1994 in a proposed production-sharing agreement. It requires the Russian government to ensure that any decisions of the provincial or regional legislative bodies do not apply to the "Salym" project past December 1994, and that the "government shall not extend to the ... project any decisions of the President, the Government of State, the Administration of the Khanty-Mansiysk Autonomous District and local authorities amending Russian laws, subordinate acts and other acts of State Bodies ... (including the interpretation and application procedures thereof) infringing on Investor's right." The state is further required to "ensure the validity ... of all approvals, rights, permits." Finally, the government "shall compensate the Investor for any and all damage suffered by it in connection with unfavorable changes of Russian laws, subordinate acts and other acts of State Bodies (including the interpretations and procedures of application)." Shell Reduces Spending on Salym, Keeps Lobbying in Moscow, Russian Petroleum Investor, Dec. 1994, at 58 [hereinafter Salym].

n13. See George Ndi, Investment Policy Transformation in the Natural Resources Sector: Legal Implications as Regards the Tension Between International Property Rights and Sovereign Rights 165-235 (1994) (unpublished Ph.D thesis, Centre for Petroleum/Mineral Law & Policy, University of Dundee); S.K. Chatterjee, The Stabilization Clause Myth in Investment Agreements, 5 J. Int'l Arb. 97 (1988); Lalive, supra note 4, at 56-61. See also the Southwestern Legal Foundation's October 1993 conference proceedings, in particular papers dealing with investment promotion policy and practice in Latin American countries.

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Privatization of state enterprise assets - particularly in the natural resources and energy sector - has reintroduced foreign investors, both in the former socialist countries (which nationalized in the 1920s and 1930s n14) and in LDCs (which nationalized in the 1970s). n15 Sentiments on the desirability of foreign investment and, thus, control over national assets considered vital have historically been volatile; indeed, a cycle of desirability (when investment is needed) and rejection (when investment is carried out and foreign control is negatively viewed) can be readily identified. It is quite plausible to assume 'that nationalist, if not socialist, reactions to foreign investment might reemerge in those countries suffering the pangs of transition without experiencing the fulfillment of capitalism's promises. n16 Thus, the revitalized, extensive, and increasingly novel stabilization commitments currently being negotiated are indeed very likely to resurface in arbitration and academic writing.

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n14. Thomas W. Waelde & James L. Gunderson, Legislative Reform in Transition Economies: Western Transplants - A Short-Cut to Social Market Economy Status?, *43 Int'l & Comp. L.Q. 367 (1994).*

n15. Illustrative examples include Peru, where, following the IPC/BELCO nationalization, there has been a massive return of foreign investors since the mid-1980s; Guyana, where private investors are now back following the Alcan nationalization; Argentina, Venezuela, and other Latin American countries which are experiencing a change in attitudes towards foreign investment. For a discourse on developments in the energy sector, see Maria Kielmas, Oil Investment in Latin America, in International Oil & Gas Investment: Moving Eastward? 133, 143 (Thomas W. Waelde & George Ndi eds., 1994) [hereinafter Moving Eastward].

n16. See Thomas W. Waelde, The Russian Oil & Gas Industry and Foreign Investment, 25 OPEC Bull. 21, 25 (1994).

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Moreover, in the last ten to twenty years, stabilization clauses have undergone a substantial evolution. In the main, contemporary stabilization commitments are negotiated with state enterprises rather than with the state as such. Instead of targeting the legislative power of the state founded on sovereignty, these commitments are designed to set up a contractual mechanism of allocating the financial effect of political risk to the state enterprise. Their nature is thus moving from that of a sovereign and state-related promise to a mechanism of commercial contracting with regard for the implications of damages for breach of obligation - a move from a predominantly public law perspective to one based [*219] primarily on commercial contract law. Furthermore, negotiations often produce hybrid contractual mechanisms combining stabilization with renegotiation provisions. This modern practice is not reflected at all in the extensive international law literature and the arbitral awards. The reason is simple. Arbitral awards and theoretical analyses, mostly written in the context of discussing such awards, deal typically with contractual practice of the past; for example, the arbitration practice underlying the Libyan cases of the late 1970s was based upon 1950s contracting practice.

This Article provides an up-to-date survey of contractual practice and a legal appraisal of the functional value and implications of modern stabilization commitments. It focuses not only on the traditional international law perspective - where the analysis of stabilization commitments is very much linked to concepts of state responsibility, protection of foreign property against nationalization, and breach of proprietary contractual interests by the state - but expands this classical approach to incorporate methods of interpretation of international economic contracts. We believe that the issue has so far been viewed exclusively as a problem of public international law, 'when it has increasingly and predominantly become a problem of transnational commercial contract law. Our present analysis provides an integrated appraisal of the role of stabilization clauses in the particular negotiating situation and context of government policies interacting with company strategies - an approach which lays the foundation for the task of contract interpretation. It will also discuss the particularly useful but limited role of stabilization clauses in the overall menu of political risk-management strategies. The Article likewise examines the concepts and methods developed by the law and economics school to determine their application to the legal problems posed by stabilization clauses. This approach may at least provide the rationale for legal arguments in the debate over these problems, even if it sheds little light on the economic implications.

The first part of the Article focuses on the use of the contractual form as a major defensive tool in the overall toolbox of political risk-management techniques available to international companies. The thrust of this analysis will be directed at provisions in the agreement intended to stabilize or freeze the contractually formalized fiscal regime. This part also seeks to explain the importance of tax stabilization, particularly in the context of international energy and mineral investment (where the long-term, capital-intensive nature of the investment creates a hostage effect especially susceptible to political risk). n17 The Article surveys the use of the contract per se and specific contractual provisions in current practice. The discussion also extends further to the unusually controversial and unsettled legal implications of stabilization clauses in national and international law. Finally, this part reaches some conclusions as to the functional utility of stabilization provisions and their impact, both in terms of ongoing negotiation and of renegotiation and arbitration in case of open conflict.

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n17. On the "hostage" effect in contracting, see Oliver Williamson, The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting 180 (1985); Antony Dnes, The Economic Analysis of Franchising and Its Regulation, in Franchising and the Law 133, 137 (C. Joerges ed., 1991). This effect is reflected in the comparatively strong showing of energy/mineral investment in political risk insurance (e.g., Multinational Investment Guarantee Agency (MIGA)) and arbitral cases. See Abba Kolo, State Regulation of Foreign Property Rights 128-131 (1994) (unpublished Ph.D. thesis, Centre for Petroleum/Mineral Law & Policy, University of Dundee); Ndi, supra note 13, at 186; Yahya Al-Samaan, The Legal Security of Private Foreign Investment in Saudi Arabia, 174-76 (1993) (unpublished Ph.D. thesis, Centre for Petroleum/Mineral Law & Policy, University of Dundee).

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The second part of the Article examines the implications of contract interpretation for government guarantees of stability contained in international investment agreements. This discussion is set against the background of the specific requirements of the mineral and [*220] petroleum industries and their logic of investment. The unavoidable, natural tendency of governments to seek adjustments to long-term investment relations in response to both political pressure and the evolution of circumstances also provides a backdrop to the debate.

These issues continue to be dominated by interests, attitudes, and the economic and technical logic of the industry. The Article is therefore addressed to international lawyers - not often very much aware of the business implications of their debates - to elucidate the industrial, technical, economic, strategic, and bargaining implications of stabilization provisions. It is addressed also to industry and government negotiators, in order to clarify the legal implications of stabilization provisions that may surface in the process of subsequent legal opinions and arbitration arguments. Finally, it is addressed to those who sit in judgment over stabilization clauses: judges and international arbitrators seeking to understand the background, objectives, and implications of stabilization clauses in their negotiating context and trying to come to grips with the interpretative challenges and difficulties of these stipulations.

II.

Negotiating Context of Stabilization Clauses

A.

Controlling the Future: Playing God With the Stabilization Clause

The function of stabilization clauses - their specific formulation and legal value - is best understood in the context of the negotiation and subsequent operation of a foreign investment project. The relative stability of key investment conditions responsible for the economic and financial performance of the investment venture is at the heart of investor concerns, and is therefore at the center of both the negotiation of a specific contractual regime and the proper design of a standard regulatory regime. This is particularly so for natural resource and energy projects where duration and risk exposure is particularly long, capital investment particularly intensive, and project risk (geological, commercial, political) particularly acute. Stability of the fiscal regime (again particularly in natural resources where the fiscal regime covers not only standard taxes but usually specific payments for depletion of non-renewable resources) is probably the key issue for stabilization concerns. Other factors with a strong linkage to investment recovery - the ability to maintain contractual and proprietary rights and titles (tenure), in particular after discovery and development (hostage effect), the ability to sell, the ability to retain and repatriate foreign exchange earned, and the ability to operate the project under reasonably foreseeable conditions consistent with international standards (labor, safety, environmental) come next. Any other government-imposed obligation that is likely to disrupt the financial returns in

a significant way - and governments have an infinite variety of ways to do this - is the object of stability concerns and may therefore be covered by a stabilization commitment.

Life is inherently uncertain and can neither be completely predicted nor squeezed into a human plan for eternity. Nevertheless, it is the time-honored tradition of lawyers to try to regulate the behavior of the parties to a deal in extreme detail and for a very long period. There may sometimes be excessive zeal on the part of lawyers wishing to "play God" with contract drafting under the illusion that the draftsman can draft away all the vagaries of the future. This prediction underlies investment agreements and, in particular, stabilization clauses. Admittedly, there is a cultural element involved; common law 'practitioners have always preferred to regulate in utmost detail, depth, and scope the salient behavior of, preferably, the other party to an agreement, n18 either because of the absence of relatively [*221] specific, comprehensive, and credible law, because of a tradition of narrow and literal interpretation, or simply for reasons of habit and precedent. Conversely, in societies such as Asia, where law is not such an important regulator of commercial relationships and the contract is rather a statement of good will and the start-up of a relationship, n19 stabilization provisions are uncommon. Since the stabilization provision's basic function is to reinforce the claim to long-term rigid regulatory power of contract - a kind of meta-contract - they have little use where the contract's claim to absolute rule over the future is not much appreciated.

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n18. For a comparison of civil and common law jurisdictions, see Dominique Blanco, Negocier et Rediger un Contrat International 6-8 (1993).

n19. See Dan F. Henderson et al., Contract in the Far East - China and Japan, in International Encyclopedia of Comparative Law 6-1 (1979). See generally Stewart Macauley, Non-Contractual Relations in Business: A Preliminary Study, 28 Am. Soc. Rev. 69 (1963).

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B.

The Governmental Dimension of Stabilization Guarantees

The attempt to use the contractual mechanism and its meta form, the stabilization promise, to control the future is an attempt to minimize some risks. It is clear that there are many other risks which cannot be controlled through the contractual device. Commercial risk (price volatility), financial risk (interest rate volatility), geological risk (no economically viable deposit identified), technical risk (failure of the installations to function as envisaged), managerial risk, or natural risk (natural disasters) cannot be dealt with by stabilization promises, though other methods of risk management are available - at a price. n20 The stabilization clause is specifically directed at one type of risk: political risk. It constitutes one of the many tools available to international companies to manage the political risk dimension of investment projects.

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n20. Examples include gold loans, forward sales, or fixed-term interest loans for commercial and financial risks and completion guarantees for technical risks.

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Stabilization guarantees obtained (although sometimes "extracted" may be a more correct description) from a government or public agency are a feature of a very particular government/foreign investor relationship. Developed Western nations rarely contract with foreign investors under a specific, individual investment regime derogating from the generally applicable law. n21 In the

'mineral (oil, gas, mining) field, there are more frequently license agreements or concession contracts establishing, usually in a very standardized and regulated way, the conditions for the company exploiting the state's resources. n22 These concessions or licenses (if they can be qualified as primarily contractual as contrasted with purely administrative law-based rights) rarely if ever deal with the issues covered by the stabilization clause such as taxes, investment guarantees, and privileges. Here, questions regarding the relationship between such an agreement n23 and subsequent legislation changing the economic framework, underlying conditions, and perhaps even specific clauses of such agreements have sometimes, though very rarely, arisen. n24 [*222] However, we know of no case where Western governments have concluded contracts purporting or explicitly considered to be safe from future legislative intervention or where such legislative intervention was held to be invalid due to prior contractual commitments of the government. So why are there stabilization promises, given in mostly contractual form, and mainly by governments in a weak bargaining position? n25

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n21. On the contrary, regulatory instruments such as the 1984 Danish Model Licence for the Exploration and Production of Hydrocarbons (39.1) expressly make allowance for the application of future amendments to the law of investment agreements. See Petroleum Legislation: Europe (Supp.75).

n22. See generally Keith W. Blinn et al., International Petroleum Exploration and Exploitation Agreements: Legal, Economic and Policy Aspects (1986); Peter Fischer, Die Internationale Konzession (1974); Richard W. Bentham, The Acquisition of Natural Resource Interests by the State in the United Kingdom and International Law, 5 J. Energy & Nat. Resources L. 49 (Supp. 1987).

n23. In French or German legal tradition they would most likely be considered as "public law" or "administrative" agreements. See infra at notes 22-27.

n24. Terence C. Daintith & Ian-Townsend Gault, Pacta Sunt Servanda and the Licensing and Taxation of North Sea Oil Production, Cambrian L. Rev. 27, 27-29 (1977). See generally Michael Crommelin, Acquisition of Natural Resource Interests by the State: The Australian Position, 5 J.E.R.L. 3 (Supp. 1987); Ola Mestad, Acquisition of Natural Resource Interests by the State: The Norwegian Ekofisk Royalty Case, 2 ICSID Rev.-F.I.L.J. 139 (1987) (discussing the Norwegian Phillips/Ekofisk case). It should perhaps be mentioned that the U.K. situation

did not concern changes of license terms as such; it involved tax increases which might underlie the license, but were not covered by the license per se. It is our view that in the U.K. and in Norway, petroleum licenses are subject to general tax law, and that changes in tax law could thus be said to affect such licenses in a regular (and legal) way. See also Kolo, supra note 17, at 258; Peter Cameron, Petroleum Rights and Sovereign Rights 113 (1983). The renegotiation of offshore petroleum licenses in the U.K. in 1974 did not concern taxes, which were outside the scope of the license, but government participation. The issue of "coercion" was raised at that time. See Kolo, supra note 17, at 258.

n25. We have not seen or heard of reports of stabilization promises by Third World governments with strong institutional and bargaining power, e.g., Saudi Arabia, Abu Dhabi, Mexico, Brazil, Nigeria, or Indonesia. Rather, we have encountered it mainly in those nations with weak bargaining power, which in 'the past included the Gulf States. Countries which currently extend such guarantees to foreign investors include Albania, Guyana, Bolivia, Ecuador, Peru, Ghana, Sierra Leone, Tunisia, and some of the Francophone West African States, to name but a few.

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The reason is not too difficult to surmise. Investors are unlikely to insist on (for if they would, they would not succeed) stabilization guarantees from developed, Western countries as the concern over the political risk for foreign investment in these countries is usually not perceived to be acute. n26 This does not mean that a prudent investor would not identify political risk in developed countries and try, in ways which are legally and politically acceptable, to manage them. n27

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n26. Though such a perception may be wrong, perhaps due to cultural prejudices, a realistic analysis will usually identify risks such as increases in taxation, changes in tax regulation that are detrimental to the investor (i.e., changes in loss carry-forward, exploration and investment incentives, amortization and depreciation of ring-fencing, and related fiscal rules), and environmental opposition as major "political" risks.

n27. Political risk management in developed countries has not been extensively analyzed or discussed. For example, in lieu of stabilization commitments obtained from a federal or central government, a demand probably regarded as ludicrous, investors can and frequently do negotiate for concessions on public subsidies which otherwise would remain basically hidden, including local taxes and infrastructure charges (for improvements to land, roads, electricity, buildings, etc.). A wary foreign investor might wish to associate with a national company and perhaps encourage the national company to assume the political risk of a tax increase or other regulatory burden which is likely to be imposed on the contract in the future. It would be interesting to see if political risk management equivalent to stabilization commitments might not be inherent to many investment agreements negotiated with state or local authorities, regional public business development enterprises (e.g., "Scottish Enterprise"), and other investment promotion agencies often employed in "underdeveloped" regions of developed countries. London merchant bank Morgan

Grenfell offers a tax swap protecting against increases in U.K. taxation. See Andrew Jack & Tracy Corrigan, New Swap Provides a Hedge Against Higher U.K. Taxes, Fin. Times, Aug. 17, 1994, at 15. It is also likely that insurance coverage is becoming available for unidentified environmental liability based on subsequent legislation, interpretation, and application of existing legislation and through the emergence of new technical standards. See Leyla Boulton, Insurers Ponder Environmental Risk Management, Fin. Times, May 17, 1996, at 3. We know of no case of insurance coverage sought or offered against future tax risks. However, such developments in Western countries' political risk management are not unthinkable.

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In most developing countries and transition economies, this scenario is entirely different. First, until the 1960s, there was a period of substantial investor superiority in terms of bargaining power, skill, and know-how; it was 'in this period that stabilization clauses seem to have emerged, usually intended
and stipulated as direct constraints upon the legislative power of governments. This type of stabilization clause was at issue in the arbitration cases of the 1970s and still much discussed in academic literature. Concern over political risk, often accentuated by a past history of nationalization, other undue political [*223] interference, and/or frequent reporting of indicators of an "uncivilized" situation n28 (insecurity, civil war, endemic corruption, lack of effective rule of law and public order, general noncompliance with law, and rebellious sub-central powers) makes company negotiators insist on stabilization guarantees. Weakness (typically in terms of perceived bargaining power, combined with the desire to attract investment which outweighs sentiments favoring national sovereignty) makes LDCs and transition governments accept what developed countries would not consider.

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n28. The concept of "civilized" nations seems to have disappeared from the parlance of international law, where it was used amply in the past to connote those nations whose law and customs were regarded as acceptable and suitable references for arbitration. For an example of past use of the concept in scholarly writings, see Lord Arnold D. McNair, The General Principles of Law Recognized by Civilized Nations, *33 Brit. Y.B. Int'l L. 1, 6 (1957).* Nevertheless, this usage remains alive, albeit hidden, in the minds of lawyers, arbitrators, and negotiators when they try to distance an agreement's applicable law from its natural reference point, i.e., the host country where the investment project is in effect to be implemented.

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But this explanation can be pushed even deeper into the normally taboo zone of current international discourse. States which typically are made to commit to stabilization guarantees are states which possess the claim and trappings of sovereign statehood but lack an effectively functioning internal mechanism of statehood. The central government's power is often very limited, law and order is outside its control, and the judicial system lacks the attributes of a modern Western judicial system (independence, due process, proper functioning, reasonable absence of corruption). They are, in the parlance of Robert Jackson,

"quasi-states." n29

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n29. Robert H. Jackson, Quasi-States: Sovereignty, International Relations and the Third World 21 (1990).

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The foreign investor approaches these quasi-states with a lack of confidence in their ability to deliver what they promise. Naturally, then, the objective would be to make them commit to more than a developed proper state would accept. First, because it is possible since these proto-states, cognizant of their weakness, are ready to accept what fully-fledged states will not; and second, because the investor seeks to substitute the contract-based law, safeguarded and reinforced with stabilization and arbitration provisions, for the volatile legal and institutional system of the host state which the foreign company (often quite legitimately) does not trust.

While it is unlikely that the civilized/uncivilized dichotomy will be resurrected, one wonders if there is not a continuity between these now abandoned terms n30 and the more recent concept of the quasi-state. Stabilization clauses - and the concomitant approach of political risk management - are therefore a part of a particular view which international companies, and states themselves, hold of quasi-states, both in LDCs and among the transition economies. They represent a view of international law addressed primarily at states formerly considered "uncivilized" and now sometimes termed instead as quasi- states. Since these countries and governments do not possess a "civilized" system of law and institutional foundations, they are made to assume the risk of this weakness which would otherwise be borne by the foreign investor.

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n30. See *id. at 73-75* (discussing the classical notion of a "civilized state," embodied in the League of Nations Permanent Mandates Commission as a "sacred trust of civilization").

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C.

Money in the Dynamics of Government/Investor Interaction

Governments with apparently promising but undeveloped projects (such as unexplored mineral properties) will go a long way to encourage foreign investors to carry out high-risk exploration and development. They will, in most circumstances, be very understanding of [*224] investors' key concerns and requirements: rapid investment recovery by accelerated depreciation and amortization; long loss carry-forward periods; reasonable royalty rates responsive to mineral prices; and a flexible system of income or cash-flow-based taxation triggered only after investment recovery. Even more so, they will be asked to (and usually have to) grant guarantees that foreign exchange earned by mineral sales (at home or abroad) or by sale of assets will either be

repatriated or kept in a protected offshore trust account. n31 These governments will often agree that there will be no taxes other than those specified in the agreement, that expatriate employees will either be exempted from income taxes or will not be fully taxed on their total earnings. They will structure a tax regime that will allow the investor to reap maximum home country tax credit and provide an exemption from import duties on imported capital goods, fuel, and services. These promises will be made sometimes in the form of administrative orders and regulations, but more often they are made in specific agreements, either between the government and the investor, or between a government agency or public enterprise and the investor. The promises are often made on the basis of contracting authority spelled out in legislation (or approved by the legislature), n32 but are sometimes embodied in a specific contract law. Usually, the fiscal regime is specific to the particular industry, or even specific to a particular large-scale project. Some provisions may increase the tax burden over the standard fiscal regime. This is typically the case of exploitation of non-renewable natural resources (e.g., royalty and cash-flow-based special income taxes). But other provisions (such as accelerated depreciation/amortization, foreign exchange repatriation and offshore account facilities, and import duty and expatriate income tax exonerations) constitute a preferential tax facility not available to domestic enterprises. Hence, they 'are easily perceived as discriminatory favors only granted to foreign companies.

Such arrangements are likely to arouse political criticism against the government negotiators and the negotiating process. Capitulation to foreign demands, or excessive concessions made to foreigners, is a quite familiar if not universal attack on such investment agreements in the national debate. n33

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n31. See generally UNCTAD, supra note 10.

n32. See e.g., the stabilization commitments included in various Chilean investment agreements based on the Decreto-Ley No. 600 of 1976; see Peter Fischer & Thomas W. Waelde, Collection of International Concessions and Related Instruments 195, 481 (1981). Current (1994) Kazakh oil & gas (arts. 50a, 57) and Russian production-sharing (art. 17(2) of Duma draft) legislation provides for stabilization guarantees, both in legislation and by way of legislative authority for the inclusion of such guarantees. Compensation requirements also provide for such guarantees in the event of a breach of such an obligation. See Law of the Republic of Kazakhstan on Oil (Excerpts), Russian Petroleum Investor, Dec. 1994, at 75; Draft Law of the Russian Federation on Production Sharing (Excerpts), Russian Petroleum Investor, Dec. 1994, at 77.

n33. In Latin America, this practice is known as entregismo (capitulation). For a vivid articulation of such views in what is by far the most ardent historical indictment of the role of foreign capital in "under-developing" Latin America, see E. Eduardo H. Galeano, Open Veins of Latin America: Five Centuries of the Pillage of a Continent 12 (1973).

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Once an agreement is signed and becomes effective, n34 substantial investment is committed on the basis of such agreement. If and when a significant mineral deposit has been found and eventually developed, the

government of the day, often succeeding the government which has negotiated the deal, tends to have second thoughts concerning the [*225] fiscal regime negotiated, granted, and enshrined in the investment agreement. n35 Political pressure and the aftermath of a foreigner-bashing campaign by the former opposition that becomes the government-in-power add force to such ideas. In addition, the bargaining power of the foreign company - often very strong when contemplating high-risk investment - may have waned dramatically once the deposit has been discovered. Information on it becomes easily available, especially after major investment has been sunk into the project. The by now classic concept of the "obsolescing bargain" n36 highlights the hostage effect of sunk investment. The company becomes vulnerable to a government which may seek to exploit this shift in bargaining power by requesting renegotiation under some legitimate or flimsy legal concept. n37

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n34. The conditions required by companies for effectiveness increasingly reflect political risk concerns, and thus provide auxiliary support for stabilization clauses. The Shell Salym Draft Production-Sharing Agreement requires approval by the Russian government, legislature, and by the legislative and executive bodies of the Khanty-Mansiysk district, the guaranteeing of export licenses, an agreement settling liability for prior environmental damage, and

'requires that Shell be paid compensation before any other organization can work the contract deposit. See Salym, supra note 12, at 58. These "conditions for effectiveness" are not stabilization clauses in the strict sense, but they are part of the expanding instrumentation orchestrated around the stabilization commitment to deal with the political risk of transition economies. Id.

n35. E.g., Papua New Guinea's demands for 30% equity in the Lihir, Porgera, and other projects for the development of gold deposits in the country. See Gold Review, Mining J., Apr. 12, 1992, at 397. The Papua New Guinea government has also sought to alter established ground rules for participation agreements involving the State and foreign companies in the petroleum sector, with the Prime Minister describing existing arrangements as being "unequal and exploitative." See Petroleum Economist, Feb. 1993, at 48. In Azerbaijan, the government has sought to revise established arrangements for the development of oil and gas fields in the Caspian Sea with a view towards increasing its share of profits from 71% to 85%. For a recent case dealing with the subsequent alteration of investment terms and conditions by a state, see generally Ad Hoc Arbitral Tribunal: Partial Award and Final Award in the Matter of an Arbitration Agreement Between Wintershall A.G., et al., and the Government of Qatar, *28 I.L.M. 795 (1989).*

n36. But see P.W. Hawley et al., Competitive Bidding Tactics for New Exploration Concessions, in Moving Eastward, supra note 15, at 63-65 (criticizing this view).

n37. See also Thomas W. Waelde, Stabilite du Contrat, Rev. de l'Arbitrage 206, 206-10 (1981). Renegotiation is no government prerogative. Companies will use renegotiation concepts just as easily when they feel that a shift in bargaining power is in their favor and an adjustment of the contract is commercially imperative or at least beneficial. For case studies of renegotiations, including examples of pro-company revisions of investment

agreements, see Peter, supra note 2, at 33-74. See also Charles Tibone, Renegotiation of the Selabi-Phikwe Contract in Botswana, in United Nations Legal and Institutional Arrangements in Minerals Development 193 (1982) [hereinafter Arrangements].

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Quite apart from politics and the dynamics of bargaining power, there are many reasons governments change their minds on taxation of foreign-operated mineral investment projects: the project economics may turn out to be very different from the financial models on which negotiations were based (in particular since company negotiators will generally use marginal project scenarios when bargaining over the fiscal regime n38); quality and quantity of mineral production may be much higher than projected; or prices may shoot beyond the levels contemplated at the time. A typical case is the boom-and-bust cycle of many commodities, such as petroleum, metals (uranium, gold, other rare metals, copper, nickel, other base metals), and minerals (phosphates and potash) evidenced in the 1970s and 1980s. Prices for uranium, for example, varied between seven dollars and fifty dollars per pound. Such price volatility has a massive impact on the economics and the available mineral rent of investment ventures. Contracts negotiated in the trough phase of the mineral price cycles have difficulties in surviving tax-wise during the peak phase. In addition, production methods may change and yield much greater profitability than expected (e.g., a change to bio-technology in metal extraction and processing).

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n38. Consider the 1988 Dominican Republic renegotiation of the Falcondo project, as discussed in Roger L.M. Dunbar, International Renegotiations: The Case of the Dominican Republic and Falconbridge, 15 Nat. Resources F. 258, 263-68 (1991).

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Governments may therefore feel that, under the spirit, philosophy, and the mechanisms of the original agreement, they should benefit from the mineral rent generated by the project to a much greater extent than the actual operation of the contract's fiscal regime allows. New concepts of taxation may also influence public and governmental opinion. These could include: the idea of imposing environmental taxes on environmentally noxious extraction [*226] activities; n39 imposing special new taxes and levies to train the national work force or finance up-to-date health and safety measures; providing security; n40 providing compensation for real and perceived damages to the local environment and to local communities; and paying off opponents among local communities, tribal groups, environmental and social associations, or even insurgency movements which may move against the project's operations. Cash shortages experienced by the government n41 or the need to pay for unforeseen government activities specifically occasioned by the project or the industry may also give rise to calls for an increased contribution by the investor, particularly if the venture is perceived as financially successful.

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n39. See Zhiguo Gao, International Petroleum Contracts: Current Trends and

New Directions 234 (1984).

n40. In Colombia, for example, the government decided to impose new security levies on the oil industry to pay for the increased cost of providing military protection against insurgent attacks on oil and gas installations and pipelines. See Petroleum Intelligence Wkly., June 29, 1992, at 7. See also Kielmas, supra note 15, at 147-48.

n41. See Dunbar, supra note 38.

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D.

The Special Emphasis on Tax Stabilization by Energy/Mineral Investors

Resource and energy projects (oil, gas, mining) have a very acute need for stability which goes beyond the normal stability requirements of other shorter-term industrial projects. It is therefore not surprising that negotiations for energy and resource investment tend to employ very extensively contractual methods of political risk management, including stabilization guarantees. In fact, a review of applicable international arbitration cases indicates a predominance of energy and mineral situations; n42 the same relative over-representation of investment projects in these sensitive sectors is reflected in political risk insurance. It is therefore useful to review these 'industries' requirements and attitudes towards stabilization guarantees in particular.

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n42. Waelde, supra note 2, at 277-79; see also Arthur Nussbaum, The Arbitration Between Lena Goldfields and the Soviet Government, *17 Cornell L.Q. 31, 32 (1950)*. See, with specific reference to the stabilization clause in international oil industry arbitration, the Anglo-Iranian Oil Company Case (U.K. v. Iran), 1952 I.C.J. Pleadings 66, 85; Saudi Arabia v. Arabian Am. Oil Co. (Aramco), *27 I.L.R. 117, 168 (1963)*; Kuwait v. American Indep. Oil Co. (Aminoil), *21 I.L.M. 976, para. 95 (1982)*; AGIP Co. v. Popular Republic of the Congo, *21 I.L.M. 726, 735 (1982)*; Texaco Overseas Petroleum Co./California Asiatic Oil Co. v. Libyan Arab Republic, *17 I.L.M. 1, para. 3 (1977)*; Libyan Am. Oil Co. (LIAMCO) v. Libyan Arab Republic, *20 I.L.M. 1, 28-33 (1981)*; BP Exploration Co. (Libya) v. Libyan Arab Republic, *53 I.L.R. 297, 324 (1974)*; Amoco Int'l Fin. Corp. v. Islamic Republic of Iran, 15 Iran-U.S. Cl. Trib. Rep. 189, 199-240 (1987); Mobil Oil Iran Inc. v. Islamic Republic of Iran, 16 Iran-U.S. Cl. Trib. Rep. 3, 20, 64-67 (1987); Phillips Petroleum Co. Iran v. Islamic Republic of Iran, 21 85 Iran-U.S. Cl. Trib. Rep. 79, 88-89 (1991). See James Bond et al., Mitigating Risk for Private Investors in Energy Development: The Role of the World Bank, in World Bank/Industry & Energy Division Note No. 15 (1992).

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Any team in these industries negotiating an agreement under favorable conditions (superior bargaining power, better knowledge of the industry, comparable terms, technical conditions, data and information) n43 will naturally

wish to do everything to maintain negotiating advantages once a deal is struck. A negotiator will also seek to maintain such advantages for as long as possible, even through all the vicissitudes the future might bring to the relationship. At the same time, an industry team will seek to keep all options for itself as open as possible. Such options will include early termination rights, watered-down exploration and development commitments, ambiguity with respect to all obligations, and absolute clarity and precision with respect to its rights and entitlements. But apart from [*227] such self-evident goals of any negotiator, there are certain objective factors inherent in the logic of mineral development which make the problem of political risk - and thereby the elusive goal of stability - particularly important for mineral companies investing abroad.

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n43. Thomas W. Waelde, Functions of the Contract and Negotiating Process: Congruence and Conflict of Interests, in Christian Kirchner et al., Mining Ventures in Developing Countries (Part I: Interests, Bargaining Process, Legal Concepts) 149, 149-55 (1979).

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The foremost characteristic of investment projects undertaken by these industries is the typically long period of exploration, appraisal, and development. As a rule, mineral projects involve ten years or more of exploration in various phases: geological (geophysical and geochemical) 'surveys; drilling; appraisal or delineation work with further drilling - all with intermittent phases of extended appraisal. Costs incurred, particularly in the latter stages, are very substantial (e.g., ten to thirty million dollars for a major mineral exploration venture; ten to twenty million dollars for each single oil exploration well drilled offshore, with comprehensive oil/gas exploration programs costing $ 100 million and more). Success in exploration is very elusive; in some geological provinces, it may take ten ventures to find a commercial field. n44 Companies employ quite sophisticated financial analysis models based on the quantity and timing of expected future cash flows, n45 but forecasting these cash flows, while looking like a mathematical exercise, is in fact quite speculative since the size and quality of a mineral deposit (oil, gas, or hard minerals) is rarely known in any meaningful way before substantial, highly uncertain, and costly drilling. Companies, as a rule, tend to try to base tax negotiations on a marginal case. If the agreed fiscal regime reflects only the marginal case conditions, a much better than assumed project performance can put the contract's tax mechanism under considerable renegotiation pressure.

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n44. World Mineral Exploration: Trends and Economic Issues 2-11 (John E. Tilton et al. eds., 1988).

n45. See generally Pedro Van Meurs, Financial and Fiscal Arrangements for Petroleum Development, in Petroleum Investment Policies 47 (Nicky Beredjick & Thomas W. Waelde eds., 1988).

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The prices of all mineral commodities are, in addition, unpredictable; all one knows is that they move in unfathomable cycles. n46 Some decision models now use probability functions and incorporate exploration risk and various approaches (scenario ranges or probability distribution functions) to deal with the uncertainty of price risk. n47 Given these massive uncertainties, which do not exist in most other cases of industrial foreign investment, it is understandable that the one thing the natural resources industry abhors is the addition of more factors of great uncertainty (such as the fiscal regime) into their decision process. Fiscal uncertainty could wreak havoc upon these models; at the very least, it means that considerable investment, already at high risk of failure, will be exposed to additional risk.

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n46. See Simon D. Strauss, Trouble in the Third Kingdom: The Minerals Industry in Transition 116 (1986); Van Meurs, supra note 45, at 47.

n47. See generally Franklin J. Stermole, Economic Evaluation and Investment Decision Methods (8th ed. 1993). See also Van Meurs, supra note 45, at 48-53, 67-71; Susan Hodgshon, International Petroleum Licensing, Exploration Activity and Fiscal Terms, in Moving Eastward, supra note 15, at 92; Peter Hadfield, Corporate Strategies for a Changing Environment, in 1 Util. Pol'y 381, 381-87 (1991).

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Uncertainty thus distorts the risk/reward equation which is at the heart of mineral investment. Since it is the expectation of an above-average reward which motivates the mineral investor and compensates for the often massive exploration risk, uncertainty of the reward (driven by the prospect of fiscal intervention into negotiated terms) means that the prior risk is not worth taking. If a government can take away the reward once the risk has been overcome by the company, then it does not make sense to assume the heavy risk (not shared by the government) in the first place. As we know from the dynamics of the government/company interaction, governments are often quite ready to promise a large reward when the risk looms large and unmanageable for a national company. After it has been assumed and successfully mastered by a foreign investor, the reward, in this ex-post perspective, no longer seems justified. This change of host state perspective to the [*228] risk/reward equation becomes particularly acute once a new government takes office, retains new advisers operating with the benefit of hindsight, and contrasts the largesse of its predecessor - eyed with suspicion anyway - with the magnitude of the foreign company's financial success.

Greater uncertainty does not mean investment will not be undertaken. A very promising or fashionable geological resource can attract investors even under conditions of severe political risk (as with Angola, China, Peru in the 1980s, and the CIS at present). Resource companies are moved by the competition to secure mineral acreage and deposits - attractive in terms of geology, technology, and commercial feasibility. Very high attractiveness can overcome perceptions of serious political risk in the case of adventurous companies or companies desperate to maintain their reserve/production ratio. But uncertainty does penalize the average type of mineral investment opportunity. It also adds considerably to the transaction cost n48 of mineral investment since complicated

and costly risk management strategies must be implemented.

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n48. Williamson, supra note 17, at 15-45.

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A mineral investor/project sponsor is likely to experience a negative cash flow on an exploration project for many years. This cash outlay, with a very uncertain payoff, must be funded in some way. Possible sources of funding can include cash flow from existing and productive operations, loans (which have to be repaid whatever the result of exploration), n49 or seed money provided by portfolio investors attracted by the high-risk/high-reward equation. All these mechanisms of funding the high-risk early stages of mineral development are imperiled if the mechanisms to secure the payback in case of successful exploration are undermined by the government's lack of credibility in keeping its commitments.

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n49. It is for this reason that loan financing is comparatively rare in mining or oil and gas exploration. See generally Thomas W. Waelde, Finance for the Minerals Industry, in American Institute of Mining & Metallurgical Engineers (1985).

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E.

Negotiating the Stabilization Clause Under the Shadow of Financiers

Resource projects are usually funded to a considerable extent by external loan financing. n50 This is particularly so at the most costly development stage, where expenditures can run into billions of dollars. n51 Financing institutions (banks, export financing institutions, long-term purchasers of production, international and national development finance institutions, and portfolio investors such as pension funds) do not participate in day-to-day management nor do they wish or have the ability to do so. Their core concern is the ability of the project to repay its debt. Elaborate financing agreements are prepared, often with dozens of lenders participating. The objective is to ensure that the project's revenues, after paying for operating expenditures necessary to maintain the operations, are used with priority to service the debt. The preference of most lenders will be for an offshore trust account set up with a trustee bank which is to receive sales proceeds (in mining, often based on long-term sales contracts). The trustee bank will then service obligations in descending [*229] order of priority (operating expenditures, agreed taxes, interest, amortisation of loans according to maturity and priority) out of this account. An unexpected increase in the fiscal burden (e.g., a significant increase in royalties or a change in the depreciation, amortization and loss carry-forward, and other tax rules, which all can have a decisive impact on the timing and direction of the project's cash flows) will disrupt the carefully

balanced and negotiated financing package and repayment schedule. This package is the basis for the commitment and refinancing of loan funds and the particular terms for project loans.

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n50. See generally id. See also Albrecht Stockmayer, Financing Mining Projects in Developing Countries, in Erich Schanze et al., Mining Ventures in Developing Countries: Analysis of Project Agreements 171 (1981).

n51. The giant Escondida copper mine in Chile, for example, cost close to $ 1 billion to develop. See 1992 Mining Industry Annual Review 42. For cost aspects of the OK Tedi project in Papua New Guinea, see also William S. Pintz, OK Tedi: The Evolution of a Third World Mining Project 33-35 (1987). Expenditures on oil and gas development typically run into the hundreds of millions of U.S. dollars, with some projects, such as the Forties field in the U.K. sector of the North Sea, exceeding $ 1 billion.

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Accordingly, stabilization of the fiscal, foreign exchange, and repatriation terms is an essential requirement for lenders. They will be equally concerned about the project's earning capacity being imperiled by government interference in operations and exportation. While the investor/project sponsor, with the stabilization of fiscal terms, pursues his interests in the overall economics and profitability of the venture for the company, lenders are concerned only with repayment. It is the inability of the project to repay (either because increased taxes reduce the availability of revenues for debt service or because a sudden restriction on foreign exchange transfers makes repayment impossible) 'which is the concern for lenders. This is particularly true for nonrecourse project financing, which is the standard practice for large-scale overseas projects. n52 Lenders usually take a more rigid approach to the predictability of the financial or the financially relevant terms as long as serviceability of their debt remains a concern. On the other hand, if debt service is secure or if debt is already repaid, they will be much less concerned over tax stability. n53

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n52. See generally David Suratgar, International Project Finance and Security of Lenders, in Arrangements, supra note 37; Grover R. Castle, Project Finance: The Alternative That Can Leverage Borrowing Power, 5 Nat. Resources F. 196 (1981); Z. Mikdashi, Oil Funding and International Financial Arrangements, 9 Nat. Resources F. 283 (1985); Norman A. White et al., Financing the International Petroleum Industry (1978); Finance for the Mining Industry (Richard Tinsley et al. eds., 1985); James Otto & David MacDougal, Project Financing and the Mineral Development Agreement, 103 Transactions Inst. Mining & Metallurgy 121, 121-27 (1994).

n53. In the Falcondo renegotiation in the Dominican Republic in 1988, there was no support for the investor's position from lenders (nor from insurers of political risk for lenders) to the extent that loans had already been repaid, or assumed and repaid or repayable by the government. See generally Dunbar, supra note 38.

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To sum up, lenders add their weight both to the negotiation and the enforcement of stable fiscal regimes and against any unilateral abrogation or detrimental interference in fiscal terms, to the extent that their contractually regulated debt service could be impaired. Since large-scale energy and resource projects as a rule require substantial loans, financing imperatives are a very powerful factor in the negotiations between investor and government. The banks may not participate directly, but their influence is very strongly felt. Stability clauses, like other mechanisms of political risk management, are therefore negotiated and included in agreements as much on the insistence of the investor as of the current or prospective project lenders. They complement the guarantees the lenders will often require directly from governments, such as in the form of the World Bank's loan agreements with governments or in the form of government guarantees/indemnity agreements required by Western governmental export finance agencies. n54

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n54. Such government guarantees usually include an undertaking to make payment if one of a number of events related to the project occurs or fails to occur, such as interference with supply, unwarranted price changes, alteration of export taxes/quotas, withdrawals of export licenses, or unwarranted changes in transportation charges. See the presentation by Robert Scallon of Barclays Bank, UK, to the December 8, 1994 conference by the Adam Smith Institute on Oil Refinery Development in the CIS, Vienna (on file with lead author).

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F.

Non-Financial Stability Concerns

While financial concerns constitute the core of the stability issue, there are other concerns which may at times be important enough to investors to be covered by an overall or a specific stabilization guarantee. Most of these nonfiscal issues, though, are relevant to the stabilization aims of the company since disruption to their normal, contractually planned operations will translate fairly rapidly into loss of revenues.

Investors, for example, will be concerned over government interference with their freedom to market production since such restraint will deprive them of sales revenues. Freedom to export at market prices is especially relevant in countries with export quota regimes, acute domestic need for the production at issue, and domestic prices below world market level (e.g., Russia). n55 Similarly, companies will want to have protection from: changes in labor law which might increase employment costs; government intervention in production decisions (reducing production or damaging the asset base of the investment through mandated overproduction); unexpected increases in energy and infrastructure usage costs (e.g., railroad and pipeline charges); changes in accounting rules, leading to an increase in taxes; unexpected obligations to

provide infrastructure; mandated local service and supply contracts, particularly when at preferential rates in nonconvertible currency; and mining/petroleum law changes affecting security of title and tenure. n56

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n55. See Chrysta Freeland & Robert Corzine, Wanted: Capitalists to Share Russia's Riches, Fin. Times, Jan. 6, 1995, at 6 (on the Russian export licensing system).

n56. E.g., after exploration in the OK Tedi mining project in Papua New Guinea, which ran into several millions of dollars, the operating company, Kennecott, failed to obtain rights to the development of the deposits it discovered, hence received no security of tenure. See Pintz, supra note 51, at 32-50. See generally Detlev F. Vagts, Coercion and Foreign Investment Rearrangements, *72 Am. J. Int'l L. 17 (1978);* Christopher T. Curtis, The Legal Security of Economic Development Agreements, *29 Harv. Int'l L.J. 358 (1988);* Ric Lucas, Responsiveness and Security Within Resource Regimes: Regulation v. Contract, in Energy Law "88 at 294 (International Bar Ass'n (London) 1988).

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Perhaps most relevant at the moment is the imposition of new environmental obligations by subsequent regulation or by an administrative/judicial ruling reinterpreting existing law on which the investment decision may to some extent have been based. New environmental obligations - unpredicted and therefore not incorporated into the investment decision - can emerge from the application of existing law to newly emerging "natural" situations n57 and by the introduction, under existing law, of new techniques of environmental assessment and mitigation. Environmental law may therefore change through new interpretation, not untypical for the often very general and open-ended formulations in such 'laws, n58 or by the introduction of completely new or amended environmental legislation. [*231] It can also change if hitherto not-applied environmental law is applied, perhaps in a discriminating manner only against "deep-pocket" foreign investors. Such changes, unforeseen in content, scope, and impact by the company (and probably also by the government) at the time of the investment decision, may be prompted by the emergence of new technologies, by new perspectives on both the damages created by a project and the reasonableness of new ways to deal with them, by continuously emerging international standards, n59 and by the emergence and increasing political influence of national or international environmental organizations. n60 While environmental liability is seen as a major political risk in transition economies, n61 unforeseen environmental opposition and restrictions constitute, at the moment, a major (and, in natural resources/energy projects, the prime) political risk facing developers of new industrial projects in Western countries. With this experience in mind, it is understandable that foreign investors will wish to protect their position at the moment of their most favorable bargaining power - i.e., when dealing with a weak (developing or transition) government anxious to attract investment before and during the negotiations for an attractive investment project.

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n57. For example, the breaking of a tailings dam used as a waste receptacle

for the OK Tedi gold mining project in Papua New Guinea, including the sedimentation of the Fly River, presented the government with a dilemma: either permit continuing pollution of the river or close the mine. See generally Herbert Thompson, Mining and the Environment in Papua New Guinea (1990) (unpublished manuscript, on file with the Department of Economics, Murdoch University, Western Australia); Herbert Thompson, Economic-Ecological Development in Papua New Guinea, paper presented to the Berlin International Round Table on Mining and the Environment (1991).

n58. With regard to such open-ended formulations, environmental protection obligations contained in petroleum and mineral laws and agreements typically require the operator to "take all necessary steps to minimize environmental damage," "to take all appropriate measures in accordance with good petroleum industry practice," "to take all reasonable precautions against pollution," or that "operations should be conducted in a workmanlike manner with reasonable precautions." Cf. Zhiguo Gao, International Petroleum Exploration and Exploitation Agreements: A Comprehensive Environmental Appraisal, in Moving Eastward, supra note 15, at 317, 319-24 (discussing how environmental management is dealt with in the contractual relationships between government and company).

n59. The evolution of international law and standards on mining and the environment has seen the emergence of a number of "guidelines," including those formulated by the International Council on Metal and the Environment (ICME) in 1991, the Mining and Environment "Berlin" Guidelines, 1991, and, more recently, those emerging from the U.N. Conference on Environment & Development (UNCED). See Thomas W. Waelde, Environmental Policies Towards Mining in Developing Countries, 10 J. Energy & Nat. Resources L. 351-53 (1992); Robert W. Hahn & Kenneth R. Richards, The Internationalization of Environmental Regulation, *30 Harv. Int'l L.J. 421-27 (1989)* (discussing the evolution of international environmental standards).

n60. Many national and international environmental organizations often engage in vigorous criticism of international investment projects. See Jeremy Leggett, Environmental Responsibilities in the Oil and Gas Industry: A View from the Environmental Movement, paper presented to the First International Conference on Health, Safety and Environment in Oil & Gas Exploration & Production at the Hague (Nov. 11, 1991).

n61. For example, the Shell draft "Salym" agreement requires a specific agreement between Shell and the government with respect to prior environmental pollution responsibility as a condition precedent for the effectiveness of the overall production sharing agreement. Salym, supra note 12, at 58.

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While changes in a contractually safeguarded tax regime are likely to be regarded with disapproval, it is more difficult for a company in the current climate to rely on legal safeguards negotiated in the past to fend off demands for improved environmental protection, especially if subsequent environmental regulation does nothing but adopt current international practices. Environmental measures imposed on energy and resource projects can have a significant negative impact on the financial viability n62 - and can force the closure - of a particular project or eliminate altogether the profitability of an operation. n63 All these factors of sensitivity for an investor will ultimately translate

into a disruption of the financial equilibrium envisaged at the time of project proposal and negotiation.

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n62. In developing the Flambeau copper mine in Wisconsin, for example, approximately 70% of the $ 20-30 million development cost was earmarked for environmental measures, including a $ 9 million reclamation bond. These measures were necessitated in part by the desire to accommodate local community concerns. See Kenneth Gooding, Copper Mine with a Deep Green Finish, Fin. Times, Apr. 28, 1992, at 17.

n63. See generally Environmental Regulation: Its Impact on Foreign Investment (Dennis Campbell ed., 1992).

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III.

Stabilization Clauses: An Item on the Menu of Political Risk Management

A.

Context and Major Strategies of Political Risk Management

International investors are familiar with the dynamics of company/governmentrelations, often from experience ingrained in the institutional memory of the company. While new [*232] investment opportunities previously closed (such as, currently, petroleum, energy, and mining in the former socialist countries) may at times excite the imagination, energize both ambitious individuals and companies and blind them to the

'possible downside of prospective engagements, a sound professional approach will
try to appreciate the risk, and, once accepted, proceed to manage the risk identified. Stabilization clauses can be appreciated as one of a substantial number of methods to deal with the political risk of foreign investment in proto-states. To properly understand how these clauses function as one of many methods of political risk management, it is useful to briefly review both the concept and the various methods of managing this form of risk.

Political risk can be understood as the occurrence of events in the political sphere (governmental actions, politically motivated insecurity in the country, and international conflict) which impede the normal operations of a business venture and detrimentally impact the commercial viability of the venture. n64 While we can leave aside the question of how to identify and assess political risk, n65 we need to appreciate the role of contracting with the government or a state instrumentality (state contract) n66 and, within the contractual framework, the role of the stabilization guarantee as one element of the various techniques available to manage political risk. n67 A company, after identification of considerable political risk, usually has two choices. Either it can leave the opportunity to more adventurous and less risk-averse investors, or it can decide to exploit the opportunity while attempting to manage the risk

so identified. Risk management will often come at a substantial cost which presumably is recovered via a higher than usual return from the project.

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n64. See W.G. Prast & Howard L. Lax, Political Risk as a Variable in TNC Decision-Making, 6 Nat. Resources F. 183, 185 (1982); see also Managing International Political Risk: Strategies and Techniques 40, 98 (Fariborz Ghadar et al. eds., 1983) [hereinafter Strategies]; Keith W. Blinn, Political Risk Management in Overseas Private Investment in Natural Resources Development Projects: Approaches to the Reduction of Political Risk from the Perspective of the Transnational Corporation Contemplating Investment (1988) (unpublished LL.M. thesis, Centre for Petroleum/Mineral Law & Policy, University of Dundee); Herbert Dusabe, Political Risk and Petroleum Investment in Developing Countries (1993) (unpublished LL.M. thesis, Centre for Petroleum/Mineral Law & Policy, University of Dundee).

n65. For a thorough discussion of the identification and assessment of political risk, see Malcolm Garratt, Assessment of Political Risk, paper presented at Summer Course on International Oil & Gas Investment, Centre for Petroleum/Mineral Law & Policy, University of Dundee (1991); William W. Teeple, Integrating Political Risk Considerations into the Capital Budgeting Process, in Strategies, supra note 64, at 153.

n66. See generally Jean-Flavien Lalive, Contracts Between a State or State Agency and a Foreign Company, *13 Int'l & Comp. L.Q. 503 (1962);* Frederick A. Mann, State Contracts and International Arbitration, *42 Brit. Y.B. Int'l L. 1 (1967);* Georges R. Delaume, State Contracts and Transnational Arbitration, *75 Am. J. Int'l L. 784 (1981).*

n67. See generally Theodore H. Moran, Transnational Strategies of Protection and Defenses by Multinational Corporations: Spreading the Risk and Raising the Cost for Nationalization in Natural Resources, 27 Int'l Organ. 273 (1973); Theodore H. Moran, Legal and Financial Approaches to the Management of International Political Risk: An Overview, in Strategies, supra note 64, at '54; Christian H. Walser, Multilateral Institutions and Political Risk: Deterrence, Co-Financing and Compensation, in Strategies, supra note 64, at 71; Julian G.Y. Radcliffe, The Principles of Managing Political Risks and the Use of Insurance, in Strategies, supra note 64, at 98; John C. Kinna, Investing in Developing Countries: Minimisation of Political Risk, 1 J. Energy & Nat. Resources L. 89 (1983); Hasan S. Zakariya, Political Risks of Transnational Petroleum Investment: The Mitigating Role of National and International Insurance Programs, 11 Nat. Resources F. 165 (1987).

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Subsequent changes to the negotiated and established fiscal regime, which may result in a detrimental effect on the company's income and cash flow, as well as unexpected restrictions on repatriation of foreign exchange earnings, are perhaps the main cases of [*233] political risk. These occur far more frequently than outright nationalization. n68 The political risk of unilateral change in the established fiscal regime by government intervention is well-known and documented. Political risk events are often painfully inscribed in the institutional memory of companies and the personal memory of senior executives.

It is for this reason that considerable attention is devoted by the companies to minimizing and managing that risk.

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n68. For a case involving the imposition of new fiscal levies on bauxite production in Jamaica, see Norma Webb-Brown, Developments in the Bauxite-Alumina Industry in Jamaica, in Arrangements, supra note 37, at 216.

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Risk management will include:

(1) Spreading the risk: This calls for formation of joint ventures for risky projects, involving as many parties as possible in the venture and the fiscal regime (banks, international financial institutions, purchasers and suppliers, national export financing agencies). Spreading the risk reduces the investor's share in the specific risk; it also creates a united front against an interventionist host state with greater bargaining power than an individual investor and, by deterrence, reduces the likelihood of the risk occurring. n69 International companies also manage political risk by diversifying their portfolio of projects or participation in projects among a variety of countries, with a cap on exposure in high-risk countries. n70(2) Insuring the risk: This requires national, private, and multilateral political risk insurance, usually covering the change of a contractually agreed fiscal regime and foreign exchange guarantees. n71(3) Defense against the risk: This strategy necessitates the use of economic, financial, and political persuasion and leverage to discourage governments from abrogating investment agreements. n72 [*234] (4) Structuring and managing: Such actions would include association with the state, low-visibility for the project or its foreign elements (domestic equity, unobtrusive operations, and an inconspicuous style of management), creating perceived "fairness" and domestic benefit associated with project, creating a flexible investment regime for the project, in order to adapt to changing pressures and expectations. n73(5) Contractual mechanisms of risk management: This approach may employ choice of contract with the government as preferred legal format, and design of specific contractual mechanisms (e.g., 'international arbitration, choice of law, offshore accounts, and methods of allocating the political risk to a government partner, in particular the stabilization guarantee analyses in this Article).

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n69. The Falcondo experience also indicates that the Dominican government was ready to take on an individual Canadian company, but not a united front of United States and Canadian government agencies and financing institutions. See generally Dunbar, supra note 41.

n70. See Lax, supra note 64, at 193-95.

n71. See Ibrahim Shihata, MIGA and the Standard Applicable to Foreign Investments, 1 ICSID Rev.-F.I.L.J. 327, 333-34 (1986); Leigh Hollywood, The Role of MIGA, in World Bank Technical Paper: Mitigating Risk for Private Investors in

Energy Development 5 (1992); see also Jorg-Dietrich W<um u>rmstich, Coverage of Political Risk by National Insurance Agencies: The German Investment Scheme, in Promotion of Direct Investment in Developing Countries 123 (1986); Robert Svensk, The Role of Private Sector Insurance, in Strategies, supra note 64, at 114; Douglas A. Paul, New Developments in Private Political Risk Insurance and Trade Finance, *21 Int'l Law. 709, 712 (1987).*

n72. See Kinna, supra note 67, at 95-99. The existence of a bilateral investment protection treaty between the investor's home state and the host country could be of particular relevance in this context. Studies indicate that between January 1990 and June 1992 alone, 146 such treaties were signed (mostly between developed industrialized nations and developing countries). See Margrete Stevens & Ruvan de Alwis, References on Bilateral Investment Treaties, 7 ICSID Rev.-F.I.L.J. 229, 237-41 (1992); see also Kenneth J. Vandevelde, The Bilateral Investment Treaty Programme of the United States, *21 Cornell Int'l L.J. 201, 217 (1988)* (discussing the use of bilateral treaties as instruments for investment protection); Jurgen Voss, The Protection and Promotion of Foreign Investment in Developing Countries: Interests, Interdependencies and Intricacies, *30 Int'l & Comp. L.Q. 686, 686-88 (1981).*

n73. Cf. Waelde, supra note 37, at 163.

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B.

Contract with Government as a Method of Political Risk Management

One of the major risk management strategies lies in the hands of the negotiators and contract drafters - the use of the form of contract and specific contractual provisions, among them the stabilization guarantee. The choice of a contract with the state, or a state instrumentality or enterprise (as opposed to the creation of a legal relationship subject to the general legal framework of a country, combined with administrative permits and licenses), n74 is an important component of political risk management. This strategy is informed by the intention to commit the government (and future governments) to the specific and individualized investment and fiscal regime hammered out during the 'negotiations. The desire to entrench the originally negotiated investment and fiscal conditions results in an agreement formalized and reinforced as much as possible with legislative character or approval and signed by the highest authority in the country or by as many authorities as possible. n75 An investment agreement (also referred to as a "state contract" or economic development agreement) is therefore the preferred legal instrument of setting and firmly anchoring the rules of the game for large-scale and high-risk projects. It is, however, not because of the contract per se, but by reason of the presence of specific provisions in the agreement, that defenses can be raised against any subsequent government intervention. Such specific provisions will often include arbitration clauses, applicable law provisions, and stabilization provisions.

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n74. This form of relationship actually prevails for most foreign investment around the world, particularly in developed countries.

n75. This practice is currently in use in many transition economies. See generally Doran Doeh, Legal and Tax Issues of Eastern European Oil and Gas Investment, in Moving Eastward, supra note 15, at 283.

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It is believed - rightly or wrongly - that by choice of the form of an investment contract with a government, n76 the investment regime is more protected from unilateral intervention by the state than by subjection to general applicable law. The consensual and negotiated procedure, qualification as, and perception of a contract strongly indicate that it can only be changed in the same way it has been reached - that is, consensually and by negotiation. Negotiating contracts with the state means pulling the state down from its sovereign pedestal, replete with powers of command, to a level of equality among business partners. This is why investors worried over significant political risk will want to negotiate [*235] a specific agreement rather than play by the rules of the game applicable to everybody else. Similarly, the considerations relevant in analyzing the relationship between foreign investors and quasi-states apply here as well. The lack of confidence in the host state's system of law and order leads to an attempt to substitute a specific, negotiated regime.

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n76. Qualification of licenses, leases, and other concepts used for denoting the grant of rights by a state to a company as contractual are also believed to offer more protection to the investment regime than a state's unilateral administrative acts.

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These expectations are, however, not easily fulfilled. First, the contracting powers of government are often very limited, even if these limits are not always fully appreciated by foreign investors and government negotiators excited by the prospect of massive investment. Common law countries quite generally seem to adhere to principles which do not allow the parties to fetter by contract the executive powers of government or the legislative power of the 'legislature, n77 except when contracts are concluded within statutory authority or otherwise sanctioned by the legislature. In civil law countries, government agencies must be explicitly empowered with regard to the content, scope, and sometimes procedure of agreements. Often (particularly in Latin America), there are constraints and rules for government contracting in the constitution, investment and sectoral laws, n78 in general public contract regulations, and in the laws and regulations applicable to particular government agencies (e.g., central banks and other monetary authorities). n79 Contracts concluded by government agencies without sufficient authority, and thus most likely in breach of material procedural rules, n80 are ultra vires and therefore void. While one can argue for the validity of agreements where the government agency's defective authority was covered by the central government's apparent acquiescence, it is hard to argue for the effectiveness of a contract concluded without sufficient authority or in noncompliance of material procedural rules, where such defect was known or could have been identified by the other contracting party [*236] applying due diligence. n81 Agreements with governments, particularly on issues

over which the government or its instrumentality has no power of commitment, are hence inherently unsafe. The sensitivity of this issue and the delicate question of legislative sovereignty raised in such agreements would, in addition, place a heavy due diligence burden on companies to ascertain the legal powers of their government partner, irrespective of the claim of the government partner to such powers. n82 Even if an agreement with authorized scope and content is concluded under applicable law and mandated procedures, most legal systems will recognize unilateral public power prerogatives of the government in terms of rescission and amendment, often under the concept of administrative law contract (contrat administratif). n83

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n77. E.g., the principle that the legislative capacity of parliament cannot be bound, nor can the executive/public powers of the government be fettered by a contract with a private individual or corporation - a principle which is firmly established in English common law. See *Redericktiebolaget Amphitrite v. The King, 2 K.B. 500, 503 (1921)* ("It is not competent for the Government to fetter its future executive action, which must necessarily be by the needs of the community when the question arises. It cannot by contract hamper its freedom of action in matters which concern the welfare of the State.").

It is not entirely clear what is meant by this pronouncement, particularly when it is applied to oil production licenses. Governments and parliaments do commit future governments and parliaments - first, to international treaties, and second, to commercial contracts with private individuals (e.g. government purchasing). What is probably meant is that under domestic law, no future legislation can be prohibited (which in effect renders the stabilization clause under these circumstances ultra vires), but that contracts can be concluded which would be proprietary and protected against breach by the principle of compensation. See The Legal Character of Petroleum Licenses: A Comparative Study 213, 213-22 (Terence C. Daintith ed., 1981) (discussing the general implications of this principle of oil and gas operations in common law jurisdictions); Daintith & Gault, supra note 24 (regarding taxation changes in the U.K. petroleum regime). See generally Bentham, supra note 22, at 52; Crommelin, supra note 24 (discussing the position in Australia); David Frecker, Coping with Political Risk, 1992 AMPLA Proc. 507, 519; Lucas, supra note 56 (discussing the position in Canada). Similar problems regarding the constitutionality or legality of intervening fiscal measures in the mineral/petroleum industry have

'likewise arisen in Jamaica. Consider Revere Jamaica Alumina Ltd.'s dispute with the government of Jamaica, discussed in Webb-Brown, supra note 68. For the non-common law perspective in Norway, see Mestad, supra note 24, at 141-45.

n78. See generally Antonio Mendes, Natural Resources in the Americas: New Opportunities for Trade and Investment - Brazil, paper presented to the International Bar Association, Dallas (1993); Santiago de Vizzio, Foreign Participation in the Extraction of Hydrocarbons in Bolivia, paper presented to the International Bar Association, Dallas (1993); Hector Mairal, Issues Arising from the Legal and Constitutional Validity of the Debt Under the Debtor's Own Law, in Judicial Enforcement of International Debt Obligations 119, 119 (David Bradlow & Daniel Sassoon eds., 1987) [hereinafter Judicial Enforcement]; Thomas W. Waelde, Sanctity of Debt and Insolvent Countries, in Judicial Enforcement, supra, at 147; see also Georges R. Delaume, The FSIA and Public Debt Litigation,

88 Am. J. Int'l L. 257, 273-75 (1994).

n79. Mairal, supra note 78, at 147-71.

n80. A recently reported case by the Moscow Court of Arbitration held the award of a contract to a Western oil company invalid because tender procedures - mandatory under the 1992 Subsoil Law - were not followed. On the settlement of this case, see F.T. East European Energy Report 38/15 (1994).

n81. See generally Waelde, supra note 2.

n82. The principle of "restrictive interpretation," as developed by the International Court of Justice for treaties, suggests that limitations on sovereignty should be interpreted restrictively. The principle should add an extra note of caution to the powers of government agencies against "contracting away" what seems to be a part of legislative sovereignty. Ian Brownlie, Principles of Public International Law 631 (4th ed. 1990).

n83. The emphasis which has traditionally been placed on the developmental aspects of most natural resource agreements has led some eminent civil law commentators to adopt the view that such agreements under the civil law system can best be categorized as administrative contracts. See Andre de Laubadere, II Traite Elementine de Droit Administratif 1156 (1982); Andre de Laubadere et al., II Contrats Administratifs 332 (1983); Jean Rivero, Droit Administratif 110 (9th ed. 1980); see also Colin C. Turpin, Public Contracts, in 7 International Encyclopedia of Comparative Law 4 para. 35 (Arthur Von Mehren et al. eds., 1984); Geiger, supra note 2, at 74. However, a comparative analysis of the administrative law systems of Western countries indicates that even if the state may for reasons of public weal be entitled to abrogate its contractual commitments, the legal security sought by the foreign investor is not completely lost, as administrative law systems will usually contain provisions enabling the payment of compensation to the private party to cover its loss. Ignaz Seidl-Hohenveldern, International Economic Law 151 (1989).

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We can therefore conclude that while the government contract format, which is preferred by foreign investors, does provide - particularly in combination with access to international arbitration - some comfort, it often (perhaps in most cases) cannot insulate the investment conditions completely from the intervention of subsequent governments. At most, if there are no doubts on its 'validity ab initio, such agreements help to build a case for compensation for either breach of contract or for taking of proprietary rights acquired out of contract and equivalent to full-fledged nationalization of property. n84 The inherent legal weakness of the government contract approach explains why foreign investors have been searching for additional, more effective ways to remedy the legal hollowness of such agreements. The stabilization clause is one direct response: n85 It seeks to give to the agreement more force than it seems to generate by itself. The stabilization clause is therefore, in most cases, a direct response to direct contracting with the state, an attempt to bind the state to a greater extent than a normal contract would seem to do. The response [*237] of any legal system to a contract is that the parties must comply with the terms of their agreement. The stabilization clause tries to add emphasis, intensity, and strength. The parties must really, with no excuses accepted,

observe the contract. It constitutes an attempt to bypass the frailty of agreements hollowed out by the heavy impact of state sovereignty.

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n84. See Kenneth K. Carlston, Concession Contracts and Nationalization, *52 Am. J. Int'l L. 260, 260-61 (1958);* L.F.E. Goldie, International Responsibility and the Expropriation of Property, *12 Int'l Law. 63, 76-80 (1978);* Higgins, supra note 1, at 235; see also Alcoa Minerals of Jam., Inc. v. Jamaica, 4 Y.B. Com. Arb. 206, 206-08 (1979). Investment insurance schemes - MIGA, OPIC, etc. - have generally followed this approach and in most cases consider the likelihood of a material breach of fundamental obligations contained in a state contract as insurable. See, e.g., Articles IV-V of OPIC Form 234 KGT9-87A (scope of OPIC insurance coverage). For an exhaustive treatment of the subject, in particular focusing on the distinction between legitimate "regulation" of foreign investment and a "taking" requiring compensation, see Kolo, supra note 17, at 126-279.

n85. Others are guarantees required from the central government with respect to the validity of the agreement, its binding powers upon all central and sub-central authorities (administrative, judicial, legislative), obligation of the central government (party to the contract) to assume the risk of countermanding action by such other authorities in the form of compensation/damages, allocation of the risk of divergent interpretation, and application to the central government/contract party. See Salym, supra note 12, at 58 (describing the Shell strategy); The "Pyramids" Case, 8 ICSID Rev.-F.I.L.J. 231, 264 (1993) (with comments by Jan Paulsson and Georges R. Delaume, illustrating such strategies of implicating the central government authorities).

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C.

Cooperative Risk Management Between Investor and Government

The assignment of an unfavorable political risk rating is generally much resented by governments. Equally, political risk management (a process in which they do not participate and which, in appearance and result, is offensive to them) is largely perceived by frustrated governments as an activity directed against them. If their collaboration is required - as it is for public (national and international) risk insurance or for bilateral investment treaties - it is 'usually given reluctantly, under pressure, and with the promise of major investment forthcoming. n86 This is a widespread and important perception, since it permeates the general reluctance of host states to be involved in risk management.

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n86. See Paul Peters et al., Responsibility of States in Respect of the Exercise of Permanent Sovereignty over Natural Resources, 36 Nether. Int'l L.J. 285, 300 (1989). See generally Permanent Sovereignty, supra note 5. International companies, on the other hand, tend to be more cooperative when it comes to the rating by the risk rating agencies.

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The current political risk approach (which views host states essentially as dangerous objects in need of containment or as recalcitrant adversaries to be pressured into accepting a minimum of collaboration with risk management arrangements) minimizes the much greater potential of collaboration between both sides in coming to terms with a present risk that is mostly beyond the control of either party. Accordingly, we advocate a cooperative view of political risk management. Cooperative risk management is premised on the idea that both parties stand to gain from effective measures to contain the risk; cooperation by both parties, sharing a common interest, is likely to generate more benefits and lower cost than the unilateral approach practiced currently.

It is recognized that international companies stand to gain from political risk management, but so do host states. First, a high and negative political risk perception leads to the exclusion of investment flows controlled by risk-averse companies and, consequently, to a lesser choice of (and less competition between) prospective foreign investors. Second, the costs of risk management (directly applicable insurance premiums or costs arising out of non-insurance management methods equivalent to insurance premiums) are added to the capital and operating expenditures of the project. Since a company will need to predict and earn a minimum risk-adjusted rate of return before taxation, the higher the political risk cost, the lower the potential for tax revenues. Consequently, it is in the interest of both parties to search for the most cost-effective means to lower the risk rating and manage the existing risk.

In choosing among the various methods of risk management, governments will sometimes value - for intangible political reasons - some methods differently from a company. Loss of face in arbitration, n87 explicit and visible waivers of sovereignty, and [*238] other data which can be interpreted as bullying of the government by a foreign company usually have a high political price for the government. A sound negotiating and risk management strategy must find solutions of equivalent effectiveness,but without the political cost which the government - and often ultimately the investor - has to bear. This conclusion can have considerable significance for the design, application, and interpretation of cost-effective methods of risk management such as stabilization guarantees.

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n87. Governments which, after internal controversy, chose not to participate in investment arbitration, such as the Libyan government in the 1970s, settled with the companies informally after the award. Similarly, the BELCO case - 'nationalization/termination of a petroleum concession in Peru in 1985, resulting
in a $ 140 million political risk insurance settlement in favor of BELCO - was settled by negotiation between the insurer, AIG, and a new Peruvian government in 1992-93. Equally illustrative is the commotion caused by the Peruvian government's acceptance of an arbitration clause in the financing agreement for the Norperuano oil pipeline in 1974, which caused, to our knowledge, the Chairman of the Lima Bar Association to be jailed by the then-military government. Similarly, we know of the case of a West African minister who was dismissed after a contract arbitration found against the government.

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IV.

Criteria for Application and Interpretation of Stabilization Clauses

Stabilization clauses are dealt with in national judicial and mostly international arbitral litigation as well as in scholarly writings. In the sections which follow, we will retrace the main concepts and arguments used to determine the specific effect of these particular provisions. In view of the fact that strands of arguments from international law (state responsibility, law of treaties), national law, conflict of laws (both international and national conflict of laws), and possibly an international lex mercatoria come together and can be applied, stabilization clauses are arguably one of the most complex issues in international economic law.

Out of this discussion, we will develop criteria which may be relied upon to apply and interpret specific stabilization provisions in individual agreements. The essence of our argument is that it is wrong to develop a generally applicable, standardized judgment on these terms; rather, the solution must be found in the classic approach of lawyers in dealing with these stipulations in their specific and individual contractual and legal context. Given the variety of legal systems, cultures, and arbitral approaches to the matter, our analysis does not purport to set forth a binding canon of interpretive rules, but rather a set of criteria to be taken into account when dealing with a particular situation. Subsequent sections of this Article outline contractual practice and provide examples of how the different types of stabilization clauses could be construed, using the criteria developed in this section.

A.

Stabilization Clauses Under National Law

We examine first the legal value and implication of stabilization clauses under municipal law, since their domestic status is likely to have a bearing on their legal value under the other legal perspectives. Also, municipal law is very likely to be applicable in many cases, certainly under most national conflict of law rules, but also under conflict of law rules of other national laws, international law, and possibly transnational lex mercatoria. First, it is often expressly chosen as the only law or as one of the laws applicable. n88 Second, if no ambiguous or specifically contradictory choice is made, significant indicators can point towards national law (such as location of main performances, project site, incorporation, seat of direct project management, 'constitutional claim for national jurisdiction, negotiation and formation of contract in the country, and under the country's procedural and organizational rules for public contracting).

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n88. Cf. A.F.M. Maniruzzaman, Conflict of Laws Issues in International Arbitration, 9 Arb. Int'l 371, 382-84 (1993). See generally Sornarajah, supra note 4, at 103; Georges R. Delaume, Transnational Contracts: Applicable Law &

Settlement of Disputes (re-issue 1992); Julian D.H. Lew, Applicable Law in International Commercial Arbitration 348 (1978).

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If a contract per se cannot fetter the hands of government or the legislature, then such an effect cannot be achieved by including a stabilization clause in the agreement. [*239] Contractual drafting techniques cannot modify and expand the powers existing under constitutional and other law for government and legislature to make commitments not to exercise their sovereign and legislative rights. n89 No argument can be advanced by a foreign investor that he had a legitimate expectation in the validity of such clauses negotiated in the face of a questionable legal validity to the extent that he can easily (applying due legal diligence) ascertain their invalidity under national law. Clauses negotiated under the shadow of ultra vires and constitutional invalidity cannot generate valid rights simply by appearance or legitimate reliance on the state agency's contracting powers.

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n89. As far as we see, this is uncontested. The authorities cited on the ability of the legislature to override government contracts (including mineral concessions/licenses) apply equally to contracts with or without a stabilization guarantee.

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Would this conclusion be different if the law with respect to investment agreements in a country was not so clear, but depended on interpretation of both the constitution and the particular nature of the agreement and the stabilization provision? If, for example, national law authorizes investment agreements with stabilization provisions, then the question of legal validity of the provision - at least under municipal law - can hardly be raised, at least ex ante. However, even then the game is not up yet; the notion of sovereignty under municipal law means that the legislator can take what he has given. In other words, nothing would prevent the national legislature from retroactively canceling and revoking rights awarded, possibly subject to constitutional and other legal consequences (e.g., the duty to pay compensation under national law).

There are some significant conclusions to be drawn from such analysis:

(1) Stabilization clauses may often be invalid under national law. If they are valid, their continuing effect is in the hands of the national legislature.(2) While it is difficult to argue for any effect to be given to stabilization clauses invalid ex ante under municipal law, it is different if such

'guarantees were legally granted and then subsequently invalidated with retroactive effect. This situation raises - under most national laws, and certainly under international law - the question of protection of proprietary rights against nationalization.(3) There is one effect that a stabilization clause arguably can generate on the level of municipal law, and that is as a guide to interpretation. A traditional and explicit stabilization guarantee does indicate by its wording and meaning that change cannot be effected by unilateral

action of the other party - it requires "sovereign action." In other words, the stabilization guarantee can be understood as requiring that the will, the discussion, and the formality of unilateral abrogation and change needs to be exercised through the legislature. n90 By thus enhancing the required formal and political quality of the intervention into contractual rights, a significant threshold of protection is estab [*240] lished. This view merits considerable attention in the specific context of appraisal of stabilization guarantees under national law. Nevertheless, national law (constitutional,administrative,contract,sectoral)may have other, countervailing principles which oppose the stabilization guarantee on the level of the consensual, equal-footing contractual relationship. Such opposing principles could be found in national law authorizing government contracts or in general legal principles dealing with issues such as change of circumstance and frustration. n91

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n90. The discussion by Daintith & Gault, supra note 24, at 29, and the country reports from Australia and Norway included therein raise (Daintith) or hint (country reports) that this requirement is not effective for stabilization guarantees, but for oil and gas development licenses which are viewed in the study as contracts with the government. See also Peter D. Cameron, Property Rights and Sovereign Rights: The Case of North Sea Oil 117 (1983).

n91. In Germany: gesch<um a>ftsgrundlage; in the United States: "commercial impracticability"; and in France: imprevision. See generally Ole Lando, Renegotiation and Revision of International Contracts: An Issue in the North/South Dialogue, 23 Germ. Y.B. Int'l L. 37 (1980); Geiger, supra note 2, at 92-93; Paul Blacklock, Adaptation of Contract: A Relational Approach 32-36 (1986) (unpublished diploma dissertation, Centre for Petroleum/Mineral Law & Policy, University of Dundee).

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There is still one question open under both national and international law. Does the effect which we have identified for stabilization clauses valid under national law - and possibly international law - apply only to such stipulations made in agreements with the foreign investor, or does it also apply to a stabilization promise made in national investment legislation? Quite a number of investment laws state that the contractual rights or taxation applicable at the time of making the investment will not be altered. n92 One could argue that investors - even when not successful in having an explicit stabilization clause inserted in their investment agreement - accepta general offer of investment/tax stability made in legislation per se. n93 However, in view of the sensitivity of this issue and the principle of interpreting waivers of sovereignty restrictively, we contend that a stabilization promise made only in 'legislation is not sufficient to assume an explicit, formal, and binding stabilization agreement. Investors concerned over stabilization should negotiate for an explicit stabilization guarantee, and a reference in a national law should make it easier to achieve such a negotiating goal. Nevertheless, the fact that general legislation extant at the time of an investment guaranteed contractual and tax stability could well be a factor in ascertaining when

compensation is due and in determining the quantum of compensation if the state subsequently revokes or ignores those same legislative promises of stability. n94

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n92. See, e.g., Decreto-Ley No. 600, tit. V, art. 33 (1976) (Chile); see also the draft Kazakh/Russian oil & gas and production-sharing laws, supra note 32, at 75. A similar article is contained in the 1993 Argentine mineral promotion law which promises the maintenance for 30 years of the tax burden as it is at the moment of the submission of the project. See Ley 24.196, tit. 1, art. 8, L.A. 1993-B (Arg.).

n93. In a number of arbitral awards, the tribunals found that national investment laws could contain the elements required for an arbitration agreement. See The "Pyramids" Case, 8 ICSID-Rev.-F.I.L.J. at 231.

n94. One can argue, based on art. 10 (1) of the Energy Charter Treaty of 1994, that a country adhering to the treaty has an international law obligation to "observe any obligations it has entered into with an investor" and that this obligation includes obligations of investment stabilization created by such a promise contained in a national law. European Energy Charter Treaty, Dec. 17, 1994, art. 10, *34 I.L.M. 381, 389.* However, the reference in the last sentence of art. 10 (1) seems to require "entering" into an obligation and thus requires the contractual element of mutual bargaining and consent/meeting of the minds which is absent in the inclusion of a stabilization promise in national law. We would therefore consider the inclusion of a stabilization promise in national law as an invitation to dance, but not yet as the dance itself (as an invitatio at offerendum, but not the offer itself). On the other hand, the protection against confiscatory taxation in Articles 13 and 21(V) of the Energy Charter Treaty may be closer to the situation where a contractual tax stabilization guarantee is overridden by subsequent legislation, since one can argue that the stabilization guarantee constitutes a separate proprietary right which is affected by its subsequent legislation-induced cancellation. The question, however, is if the protection against confiscatory taxation in articles 21 and 13 does not rather envisage a situation where the taxation is used to eliminate altogether the economic core of a project, equivalent to outright confiscation, rather than situations where tax is increased, contrary to stabilization guarantees, but not to such a level as to make the project altogether and completely unviable. See id. arts. 13, 21; Thomas W. Waelde, The Investment Regime of the Energy Charter Treaty, 297 World Trade 5, 54 (1995).

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B.

'Stabilization Clauses Under International Law

1.

Applicability of International Law

International law provides external legal protection in the event of ensuing conflict between the foreign investor and the host state. International law, however, is not per se applicable to state/investor relations. n95 To benefit from such protection, the overseas investor will therefore often seek to internationalize the agreement. n96 This goal can be achieved primarily, and perhaps exclusively, through the medium of a choice-of-law provision which places the relationship under the aegis of international law as the governing law of the agreement. n97 Internationalization (also referred to as transnationalization, delocalization, or denationalization), combined with the choice of international arbitration in a neutral forum as the principal mechanism of dispute resolution, is primarily intended to ensure a form of binding dispute settlement which is not under the control of the state party. n98 In the event that international law becomes applicable as the governing law, it must be asked what interpretation and effect it gives to the stabilization provision in the [*242] investment agreement. The answer to this question requires an evaluation of the stabilization clause under international law.

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n95. See generally Payment of Various Serbian Loans Issued in France, 1929 P.C.I.J. (ser. A) No. 14 (July 12). See also John Crawford & Wesley Johnson, Arbitrating with Foreign States and Their Instrumentalities, 5 Int'l Fin. L. Rev. 11, 12 (1986); Prosper Weil, Principes Generaux de Droit et Contrats d'Etat, in Le Droit de Relations Economiques Internationales - Etudes Offertes a Berthold Goldman 387 (Philippe Fouchard et al. eds., 1982).

n96. For a very expansive method of selecting international law on the basis of "indicators" in the contractual relationship, see Texaco Overseas Petroleum Co./California Asiatic Oil Co. v. Libya, *17 I.L.M. 1, 8 (1977)* (In the arbitration tribunal's view, "the application of principles of Libyan law does not have the effect of ruling out the application of principles of international law, but quite the contrary: it simply requires us to combine the two in verifying the conformity of the first to the second."). The idea that a contract between a state and an investor can be subjected to international law without explicit submission by a choice of law clause simply by extrapolating an "implicit submission" based on indicators in the contract does not do justice to the negotiating context of transnational investment agreements. In such a situation, the company has most likely attempted to include international law in the agreement, either as the sole choice of law or as the choice of law in addition to controlling national law. It is, however, not the task of the arbitrator to grant to the company that which it did not negotiate for in the quid pro quo of bargaining. See Kenneth J. Vandevelde, Treaty Interpretation from a Negotiator's Perspective, 21 Vand. J. Transnat'l L. 281, 307 (1988).

n97. See Delaume, supra note 88, at 37-50. Though doubts have been expressed over the national legislator's power to subsequently abrogate a choice of law clause, some would argue to the contrary, reasoning that by choosing "international law," the contract "incorporates" international law rules into 'an agreement which remains by nature and formation subject to national law. See Roland Brown, Choice of Law Provisions in Concession and Related Contracts, *39 Mod. L. Rev. 625, 638 (1976)*. This view would seem to run counter to the fairly well-established rule that arbitration clauses - comparable to the stabilization

clause in their investment protection intention - are separate from the main agreement and cannot be unilaterally revoked by a state once it has submitted to arbitration. See Markham Ball, Structuring the Arbitration in Advance - The Arbitration Clause in an International Development Agreement, in Contemporary Problems in International Arbitration 297, 309-11 (Julian Lew ed., 1986). See also Maurice Bourquin, Arbitration and Economic Development Agreements, in Selected Readings on Protection by Law of Private Foreign Investments 99, 110 (Southwestern Legal Found. ed., 1964). It should be said that states have, without much success, claimed the right to withdraw unilaterally from previously agreed to arbitration. See, e.g., John T. Schmidt, Arbitration under the Auspices of the International Center for Settlement of Investment Disputes (ICSID): Implications of the Award on Jurisdiction in Alcoa Minerals of Jamaica, Inc. v. Jamaica, *17 Harv. Int'l L.J. 90, 92-93 (1976)* (discussing the Jamaican bauxite disputes). See generally Robert B. von Mehren & P. Nicholas Kourides, International Arbitration Between States and Foreign Private Parties: The Libyan Oil Nationalization Cases, *75 Am. J. Int'l L. 476 (1981)* (discussing the Libyan oil nationalization disputes of the 1970s).

n98. See Georges R. Delaume, Des Stipulations de Droit Applicable dans les Accords de Pret et de Developpement Economique et de leur Role, 4 Revue Belge de Droit Internationale 336, 337 (1968).

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But before going into the discussion of international law, one should perhaps bear in mind the conclusions reached earlier. A contractual guarantee given by the government without proper authority at the time of the formation of contract can be ultra vires. If so, it cannot be the object of protection under international law. n99 This conclusion is valid at least in so far as a due diligence effort by the investor would have indicated serious doubts about the government's ability to grant such a guarantee effectively under national law.

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n99. Schweighofer, supra note 1, at 150, seems to consider whether the "state" can be held responsible for a stabilization promise by approving or otherwise giving authority to the negotiators. In our view, based on the notion of ultra vires and common rules of agency, a contracting party cannot rely on such approval if (after due diligence analysis of national law) it appears likely to contravene applicable national and, in particular, constitutional law. The situation is different if a competent state organ - e.g., a legislature - approves, and its approval can be considered to override otherwise applicable law. See generally Waelde, supra note 78 (discussing loan agreements).

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2.

Main Concepts: Sanctity of Contract Versus State Sovereignty

Where unilateral intervention by the government does ensue in the breach of a 'contract containing the additional safeguard of a valid stabilization guarantee,
then it falls primarily to international law, if applicable as the governing

law, to allocate responsibility and, in the process, to give effect to the contractual rights of the investor if they are judged to have been violated. This process is by no means an easy exercise, due mainly to the uncertainty and confusion which currently prevails as to the precise status of relevant international norms. International law, in particular the law of treaties, being state-to-state law is at most applicable by analogy, with due account of the significant differences between state contracts with private investors and intergovernmental agreements. International law principles which could apply in these circumstances are those relating to state responsibility for injury to foreign nationals - i.e., the protection of aliens' contractual and property rights and international treaty law (by judicious analogy).

As well as providing a framework for the resolution of international investment, international law principles have also been the subject of heated controversy in the international law debate. Much of the confusion seems to arise from the conceptual eclecticism spawned by the multiplicity of diverse views and opposing ideas in academic writings on the subject. To a certain extent, the contentious context of this debate amply reflects the conflict between property rights and sovereign rights in international law. Underlying the debate are concepts such as the sanctity of contract (pacta sunt servanda), the doctrine of rebus sic stantibus, permanent sovereignty over natural wealth and resources, and the economic rights and duties of states. n100 Attempts to develop a consensus - through the proposed U.N. Code of Conduct on Transnational Corporations - appear to have met with little success. n101

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n100. E.g., Permanent Sovereignty over Natural Resources, G.A. Res. 1803, U.N. GAOR, 17th Sess., Supp. No. 17, I, U.N. Doc. A/5217 (1962) [hereinafter Permanent Sovereignty over Natural Resources]; Charter of Economic Rights and Duties of States, G.A. Res. 3281, U.N. GAOR, 29th Sess., Supp. No. 31, at 50, U.N. Doc. A/9631 (1974). These concepts have given rise to the notion that host states generally have rights to regulate and retain control over the exploitation of their natural resources. In the past, such rights have generally been subsumed under the wider claims to economic and political sovereignty under the banner of a new international economic order. See Jerzy Makarczyk, Principles of a New International Economic Order 235 (1988).

n101. The Code negotiations (initiative taken in 1975-76, with negotiations lasting from 1976-92) reached the stage of a unitary draft with some alternative formulations. See generally International Control of Investment: the Dusseldolf Conference on Multinational Corporations (Don Wallace et al. eds., 1974). The Code initiative appears to have lapsed sometime in 1992, and attempts are now being made to fill the gap. E.g., Legal Framework for the Treatment of Foreign Investment (World Bank 1992) (non-binding), reprinted in Waelde, supra note 78, annex; Energy Charter Treaty, Dec. 17, 1994, art. 10, *34 I.L.M. 381, 389* (completed and signed, but not ratified).

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The conflict between property rights and sovereign rights in international law appears to have arisen largely from the fact that these sometimes

'conflicting values together form part of the same international legal order. In our view, this conflict is most vividly exemplified by the doctrinal debate concerning the validity of the stabilization clause under international law. We shall now turn our attention to this debate.

3.

Doctrinal Writings

A careful analysis of relevant scholarly writings reveals that the question of the precise status and effect of the stabilization clause under international law is by no means clearly settled. n102 Doctrinal opinion has remained sharply divided over the issue of the international legal effect or validity of such provisions. One group of writers has expressed the view that the principal implication of the choice of international law as the governing law of the contract is to render applicable to the agreement certain international norms, most notably, the doctrine of the sanctity of contract (pacta sunt servanda). The application of such norms would thus render any breach by the state of its contractual obligations under the agreement an act unlawful under international law, n103 which applies equally to the contract per se and to the stabilization guarantee contained therein.

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n102. See Paasivirta, supra note 1, at 337; David, supra note 1, at 98. See generally Ignaz Seidl-Hohenveldern, The Social Function of Property and Property Protection in Present-Day International Law, in Essays on the Development of the New International Economic Order 77 (Frits Karlshoven et al. eds., 1980); Brigitte Stern, Trois Arbitrages, Un Meme Probleme, Trois Solutions: Les Nationalizations Petrolieres Libyennes Devant l'Arbitrage International, Revue de L'Arbitrage 3 (1980).

n103. Carlston, supra note 84, at 260; Leo T. Kissam & Edmond K. Leach, Sovereign Expropriation of Property and Abrogation of State Contracts, *28 Fordham L. Rev. 177, 188 (1959);* Weil, supra note 95, at 302-04; Greenwood, supra note 2, at 61; see also Kuwait v. American Indep. Oil Co. (Aminoil), *21 I.L.M. 976, 1051 (1982)*(Fitzmaurice, G., dissenting); Texaco Overseas Petroleum Co./California Asiatic Oil Co. v. Libyan Arab Republic, *17 I.L.M. 1, 11-12 (1977).*

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Also unsettled is the question of whether the addition of a stabilization clause to the agreement - the "meta-contract" - makes a difference. Could states, if international law were applicable, revoke agreements without such a promise, but not those with the addition of a stabilization provision? n104 If it is thought (and this seems to be the opinion of most contract defenders) that states cannot revoke an agreement that does not contain a stabilization guarantee, what then is the purpose and effect of a stabilization clause? Is it just a drafting technique to make the contract "doubly safe," without any legal effect of its own (a somewhat questionable interpretation, since stabilization clauses tend to emerge from quite intensive negotiations)? Or would the

stabilization clause add to the degree of protection - i.e., protection 'accrue, protection au second degre? n105

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n104. Although not clearly stated, one gets the impression that most defenders of pacta sunt servanda and international law responsibility would consider an investment agreement per se already subject to pacta sunt servanda. This leaves the question of what the addition of a stabilization clause means for them.

n105. See Kolo, supra note 17, at 128; Lalive, supra note 4, at 60.

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We can enumerate several possible effects a stabilization clause might have. A stabilization clause could lower the threshold below which state-issued regulations are not yet considered an unlawful interference in the agreement, thus making it more difficult than under the agreement per se for the state to modify the regulatory environment of the project. Perhaps the addition of this provision would prevent or reduce the operation of the doctrine [*244] of rebus sic stantibus - counterpart to the pacta sunt servanda principle. It could, on the other hand, provide an argument for the state's obligation for full restitution or otherwise increase the amount of compensation due for breach of the agreement. n106

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n106. Similar arguments in favor of restitution or higher amounts of compensation appear to underpin the not too lucid reasonings in several arbitral awards, including Aminoil, *21 I.L.M. at 1051;* Liberian E. Timber Corp. (LETCO) v. Republic of Liberia, *26 I.L.M. 647 (1987);* Libyan American Oil Co. (LIAMCO) v. Libyan Arab Republic, *20 I.L.M. 1 (1981);* AGIP Co. v. Popular Republic of the Congo, *21 I.L.M. 726 (1982);* see also Schweighofer, supra note 1, at 153-54.

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It follows from this hypothesis, at a minimum, that the unilateral amendment by the state of the contractual and fiscal regime guaranteed by stabilization provisions would immediately and directly engage the responsibility of the state under international law. Such an act would be considered illicit by its very nature, without the further need for the state to be in breach of the customary international law conditions relating to public purpose, non-discrimination, and the payment of adequate compensation. According to those who subscribe to this school of thought, the doctrine of pacta sunt servanda would be equally valid in these circumstances, notwithstanding the largely quasi-international character of contractual arrangements made between states and private companies. n107 This means in practical terms that arbitral tribunals should give full effect to the stabilization clause contained in an agreement and, at a minimum, order full compensation to companies injured by such breach of contract.

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n107. See, e.g., Hans Wehberg, Pacta Sunt Servanda, *53 Am. J. Int'l L. 775,*

786 (1959); Cohen-Jonathan, supra note 4, at 452; see also Weil, supra note 1, at 324 (stating that the application of pacta sunt servanda in these 'circumstances does not amount to a derogation from the sovereign powers of the state, the capacity of the latter to bind itself by virtue of the stabilization clause being in fact a manifestation rather than a negation of sovereignty).

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An opposing group of commentators has, however, expressed doubts as to the validity of the stabilization clause under international law. Where its intended purpose is to freeze the applicable law as of the date of contracting, these writers see in such a provision an attempt to fetter the public powers of the state - a view analogous to the common law approach under national law. If so, it is argued, such an attempt would constitute a derogation from the principle of sovereignty. n108 According to this second school of thought, economic sovereignty, or permanent sovereignty over natural resources, constitutes jus cogens n109 which a state cannot waive (similar to the constitutional law reservation on this question in many national laws). While states could exercise their sovereignty in making agreements with foreign companies, sovereignty would also constitute, on a continuous basis, a lawful ground for the termination of these agreements - without compensation. n110

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n108. Angelo P. Sereni, International Economic Institutions and the Municipal Law of States, 96 R.C.A.D.I. 210, 210 (1959-I); Sornarajah, supra note 4, at 2-51, 97. This argument often goes hand-in-hand with that of the right of the state to nationalize property under customary international law, a right which is seen to be part of the legal powers inherent in the notion of statehood. Permanent Sovereignty over Natural Resources, supra note 100; see also Seidl-Hohenveldern, supra note 102, at 77; Garcia-Amador, supra note 4, at 20.

n109. Oscar M. Garibaldi, The Legal Status of General Assembly Resolutions: Some Conceptual Observations, 73 A.S.I.L. Proc. 324, 325 (1979); M. Sornarajah, The Myth of International Contract Law, 15 J. World Trade L. 187, 206-09 (1981); T.O. Elias, New Horizons in International Law 200 (2d ed. 1992). See generally Jorge Casta<tild n>eda, The Legal Effect of United Nations Resolutions (1969); Lauri Hannikainen, Peremptory Norms (Jus Cogens) in International Law: Historical Development, Criteria, Present Status (1988); F.A. Mann, Further Studies in International Law 84 (1990).

n110. Paasivirta, supra note 1, at 338; Schweighofer, supra note 1, at 155-56 (with reference to the Aminoil Arbitration, but advocating a very restrictive application of the criteria for rebus sic stantibus).

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A third group of writers, while recognizing some international effect as attaching to stabilization commitments, still doubts the capacity of such provisions to offer absolute [*245] protection to the foreign investor. The view of these writers is that stabilization guarantee clauses, in as much as they constitute a component part of the legitimate expectations of the investor, offer only limited protection under international law. The freezing function which stabilization clauses are intended to perform constitute only part of a

larger picture; the economic, social, and political components of the relationship will of necessity evolve and develop over time, affecting the contractual balance. n111 Other factors, including the principle of rebus sic 'stantibus, can balance stabilization clauses. The ultimate effect of such provisions therefore needs to be ascertained on an ad hoc basis by interpretation in view of all pertinent circumstances. Hence, it is argued, those whose duty it is to interpret and to apply international law will not be "insensitive to the changes taking place in the real world outside of the disputed documents." n112

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n111. Higgins, supra note 1, at 233-35; see also Paasivirta, supra note 1, at 338.

n112. Higgins, supra note 1, at 233-35.

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The doctrinal debate on this issue has without question given rise to a divergence of views and scholarly opinion. No single dominant view seems to have emerged so far. The natural tendency has thus been to look towards international arbitral and jurisprudential practice for guidance.

4.

Arbitral Practice

A critical review of international arbitral practice would seem to indicate the presence of equally divergent views. In AGIP Co. v. Popular Republic of the Congo, n113 for example, the tribunal ruled that the presence of a stabilization clause in the agreement between the two parties did not affect, in principle, the state's sovereign and regulatory powers. The state retained both powers in relation to those with whom it had not entered into such an undertaking. Hence, the clause was held to be valid and enforceable under international law, having been judged not to amount to a derogation from the principle of sovereignty. In Texaco Overseas Oil Petroleum Co./California Asiatic Oil Co. v. Libyan Arab Republic, an important and controversial oil industry arbitration which, in part, involved the issue of the stabilization clause, n114 the sole arbitrator stated:

There is no doubt that in the exercise of its sovereignty a State has the power to make international commitments....There is no value to dwell at any great length on the existence and value of the principle under which a State may within the framework of its sovereignty, undertake international commitments with respect to a private party. This rule results from the discretionary competence of the State in this area....The result is that a State cannot invoke its sovereignty to disregard commitments freely undertaken through the exercise of this same sovereignty, and cannot through measures belonging to its internal order make null and void the rights of the contracting party which has performed its various obligations under the contract. n115

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n113. *21 I.L.M. 726, 735-36 (1982).*

n114. *17 I.L.M. 1 (1977).* The question of breach of the agreement itself was the central issue in this case, and it is doubtful that if the absence of a stabilization clause in the agreement would have made any difference to the tribunal's finding of international responsibility.

n115. *Id. at 22.* See also RCA v. China, *30 Am. J. Int'l L. 535, 540 (1936)* (in which the tribunal stated that the Chinese government could "certainly sign away part of its liberty of action," and that "it can also do so as well in an implicit manner, if a reasonable construction of its undertakings under the agreement leads up to that conclusion.").

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In another oil industry arbitration, Aramco v. Saudi Arabia, the tribunal came to a similar conclusion with regard to the binding force of the stabilization clause under international law. The decision concluded:

By reason of its very sovereignty within its territorial domain, the State possesses the legal powers to grant rights [by] which it forbids itself to withdraw before the end of the concession, with the reservation of the Clauses of the Concession Agreement relating to its revocation. Nothing can prevent a State, in the exercise of its sovereignty, from binding itself irrevocably by the provisions of a concession and from granting to the concessionaire irretractable rights. Such rights have the character of acquired rights. n116

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n116. Saudi Arabia v. Arabian Am. Oil Co. (Aramco), *27 I.L.R. 117, 168 (1963);* see also Mobil Oil Iran Inc. v. Islamic Republic of Iran, 16 Iran-U.S. Cl. Trib. Rep. 3, 64-65 (1987) (according to the tribunal, "contemporary international precedents have concluded that such contractual [stabilization] provisions preclude a sovereign during the stated period from exercising the rights it otherwise possesses under international law to take an alien's property for a public purpose, and without discrimination and for a just compensation"); see also Phillips Petroleum Co. Iran v. Islamic Republic of Iran, 21 Iran-U.S. Cl. Trib. Rep. 79, 88 (1989).

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These judicial pronouncements would seem at first sight to give recognition and validity to the stabilization clause under international law. The reality, however, is far less certain. While the majority of arbitral awards would seem to attach some significance and value to the stabilization clause, the conclusions reached by tribunals on this very question in a significant number of other arbitration cases appear to cast doubts on the extent of the protection

which such clauses can offer the foreign investor.

In the Libyan nationalization cases, for example, the arbitrators in two out of the three awards seemed to have reached the conclusion that stabilization clauses cannot prevent a unilateral change of terms and conditions by the

'government. n117 The ruling in the Kuwait v. Aminoil n118 arbitration could likewise be seen to have depreciated further the "international legal value" of the stabilization clause as a protective device over the long term. In that case the tribunal found that the sovereign rights of the state could be "contracted away," but only for a relatively limited period of time. n119 It also concluded that "what that would require would be a particularly serious undertaking which would have to be expressly stipulated for." n120 In all these arbitral awards, compensation was payable for revocation/breach of the investment agreement, with the specific issue of the stabilization clause largely obscured in the ratio decidendi. Even so, these cases clearly illustrate a lack of consistency in international jurisprudence, which in turn is indicative of the uncertainty which currently prevails over the precise status of the stabilization clause under international law. n121

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n117. See generally BP Exploration Co. (Libya) v. Libyan Arab Republic, *53 I.L.R. 297 (1979)* (Arbitrator Lagergren). But see Libyan Am. Oil Co. (LIAMCO) v. Libyan Arab Republic, *20 I.L.M. 1 (1981)* (Arbitrator Mahmassani); Texaco Overseas, *17 I.L.M. at 18* (Arbitrator Dupuy).

n118. American Indep. Oil Co. (Aminoil) v. Libyan Arab Republic, *21 I.L.M. 976, 1023 (1982).*

n119. See *id. at 1043* (Fitzmaurice, G., dissenting); see also Mann, supra note 109, at 257.

n120. Aminoil, *117 I.L.M. at 1023.* A similar conclusion was reached in Liberian E. Timber Corp. (LETCO) v. Republic of Liberia, *26 I.L.M. 647 (1987).*

n121. See Delaume, supra note 88, at 15-16; Crawford & Johnson, supra note 95, at 11-12; Amoco Int'l Fin. Corp. v. Islamic Republic of Iran, 15 Iran-U.S. Cl. Trib. Rep. 189 (1987).

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V.

Impact of Energy Charter Treaty of 1994

The (European) Energy Charter Treaty of December 17, 1994, covering foreign investment between member states in the field of energy, is the first significant multilateral [*247] foreign investment convention. n122 While the Treaty is replete with open-ended obligations which may keep international lawyers busy with interpretive argument for a long time, the most relevant of these provisions is found in Article 10(1):

Each contracting Party shall observe any obligations it has entered into with an investor or an investment of an investor of any other Contracting Party. n123

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n122. See generally The Energy Charter Treaty (Thomas W. Waelde ed., 1996). At the time of writing, the Charter Treaty was signed, but not ratified by enough member states to come into force.

n123. Energy Charter Treaty, Dec. 12, 1994, art. 10, *34 I.L.M. 381, 389.*

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This provision, when read in conjunction with Articles 18 and 26(3), n124 reaffirms the duty to respect investment agreements freely entered into between a state and a foreign investor n125 and the validity of stabilization guarantees under international law. However, it can equally be read - relying on the special reference to sovereignty over energy resources - as requiring a balance between sanctity of contract on one hand and the public prerogative over contractual commitments often associated with the principle of permanent sovereignty over natural resources on the other. In consequence, the Energy Charter Treaty preserves the current ambiguity in the interpretation of applicable or international law while perhaps embodying a certain preference for the duty of states to observe stabilization obligations entered into except if overriding principles of state sovereignty exist.

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n124. Member States who chose not to opt out of Article 26(3) give unconditional consent to submit disputes to international arbitration. Article 18 refers to sovereignty over natural resources.

n125. Permanent Sovereignty over Natural Resources, supra note 100.

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VI.

Preliminary Assessment: Functional Value of the Stabilization Clause

From a practical point of view, therefore, the degree of protection which the stabilization clause can offer to the foreign investor under international law is by no means easily determined. Some modern authors believe that international law in any case prohibits arbitrary or unlawful interference by the state in the functioning of international investment agreements, and that, as such, no stabilization clause is required for this purpose. n126 Others have identified in the clause a financial function - based on the hypothesis that, even if violation of the clause does not affect in kind the question of unilateral intervention, it could, on the other hand, influence the amount of compensation due to the investor. According to J. de Arechaga, n127 for example, an anticipated violation of such a clause would give rise to a special right to compensation. This special right implies that the amount of indemnity in such

instances would be higher than would otherwise be the case. n128 Viewed from this perspective, the existence of a stabilizing provision in the agreement may be said to constitute a pertinent circumstance; it could, for instance, imply a duty to compensate which extends to prospective gains or lost profits (lucrum cessans) due the private party for the remainder of the effective period of the contract. It could also imply that the investor is entitled to compensation for any additional financial burdens imposed by subsequent unilateral measures.

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n126. Higgins, supra note 1, at 243.

n127. Eduardo Jimenez de Arechaga, International Law in the Past Third of a Century, 159 R.C.A.D.I. 307, 307 (1978).

n128. See Geiger, supra note 2, at 99-103; Oscar Schachter, International Law in Theory and Practice, 178 R.C.A.D.I. 113, 113-14 (1982).

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This particular area of international law is undoubtedly fraught with many conceptual and practical difficulties. This is particularly so with regard to fiscal regime stabilization - [*248] taxation being an area which has traditionally been regarded as belonging to sovereign jurisdiction. n129 In our view, the validity and the enforcement of tax stabilization mechanisms under international law is at best uncertain. It would depend not only on their interpretation by the particular tribunal in question, but also on conditions prevailing in the industry as a whole. Even so, the fiscal regime stabilization provision could yet have a practical relevance and usefulness in the company/host government relationship. This is particularly so if it is intended to provide a framework for long term cooperation between the parties for the rational management of changes which may be necessary for the ongoing evolution of the relationship.

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n129. See Higgins, supra note 1, at 246.

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VII.

Choice and Conflict of Law

There has been surprisingly little discussion of the conflict-of-laws aspects of the stabilization clause. n130 Contracting parties usually have the freedom to select the system of law applicable to their relationship (the theory of party autonomy), n131 except for those choices prohibited for reasons of national law (e.g., Calvo clause). n132 Arguably, a stabilization clause can function not only as an additional safeguard of the investment agreement, but also, alone or in combination with the choice-of-law clause, as a method to refer to a particular system of law governing the contract. n133 If there should be no choice-of-law clause, a stabilization clause (depending on its formulation) can be read as choosing the national law as effective at the time of formation of

contract n134 to be the law governing the contract (law applicable), a stipulation which can be considered as an intertemporal choice of law. If, on the other hand, the stabilization clause in the agreement is combined with a choice of solely international law, then the parties presumably want a combination of both, and the task of the arbitrator will be to find common ground between both legal systems, harmonize conflicting solutions, and fill in gaps in one system with relevant principles drawn from the other. The same result should be sought if the stabilization clause and an express combination of national/international law clause come together. A more difficult situation 'would seem to emerge if a stabilization clause and an exclusive choice of national law coexist. In that case, the law applicable would appear to be that preferred by the national legislature. Does the presence of the stabilization clause make a difference? Since the stabilization clause does not come without the reservation of the national law choice, a solution in favor of inferring the applicability of the law only at the time of [*249] formation seems inevitable. Under these circumstances, perhaps the stabilization clause can be given a useful effect by considering it, first, as an interpretive guideline (indicating that future law affecting the agreement should say so explicitly) and, second, as expressing the mutually-agreed upon, legitimate expectations of the investor relevant for defining the nationalization threshold. The clause would thus function as a criterion for both assigning and calculating compensation.

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n130. For illuminating analysis, see F.A. Mann, The Theoretical Approach Towards the Law Governing Contracts Between States and Private Persons, 11 Revue Belge de Droit Internationale 56 (1975). For a thorough discussion on choice and conflict of laws, see generally F.A. Mann, Lex Facit Arbitrum, in Liber Amicorum for Martin Domke (P. Sanders ed., 1967).

n131. See generally Jean-Cristophe Pommier, Principe d'Autonomie et Lois du Contrat en Droit Privee Conventionnel (1992).

n132. See A.F.M. Maniruzzaman, International Arbitrator and Mandatory Public Law Rules in the Context of State Contracts: An Overview, 7 J. Int'l Arb. 53, 53-54 (1990).

n133. Maniruzzaman, supra note 88, at 398; see also Texaco Overseas Petroleum Co./California Asiatic Oil Co. v. Libyan Arab Republic, *17 I.L.M. 1, 15-16 (1977)*; Revere Copper & Brass, Inc. v. Overseas Private Investment Corp., *56 I.L.R. 258, 272-79 (1978)*.

n134. Among those who appear to favor this interpretation is Sornarajah, supra note 4, at 92, who points out that by seeking to insulate the functioning of an investment agreement from the effects and influences of the municipal legal system, the stabilization clause upholds the proposition that the municipal law of the host state - as opposed to international law - is in most cases the proper law of the contract, the object of the clause being thus to shield the agreement from any subsequent changes in the proper law (i.e., municipal law). Delaume, supra note 88, at 44, on the other hand, argues that stabilization provisions are not necessarily inconsistent with the purpose of internationalization, since a contract can probably never be completely internationalized, and certain features of the transaction must therefore remain

subject to local law.

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Such analysis cannot be complete without reference to the conflict-of-law rules prevailing under both national and international law. Does national law, being probably the ultimate foundation for the legal effectiveness of the agreement - and its choices of law to govern the agreement - give effect to the choice of a former version of itself? In international law, a systematic body of choice-of-law rules has not evolved, but is probably implicit in much of the 'discussion on the stabilization guarantees.

A last contribution to the question of how to apply and interpret stabilization guarantees could be found in the notion of the lex mercatoria. n135 References to a body of law which is neither national nor part of public international law have always seemed a solution to the multi-faceted character of transnational investment agreements. n136 Such a body of law, assuming its existence is generally accepted (which it is not), would have to be consulted both as to its conflict-of-laws and its substantive contract law rules. A possible outcome could be that the law applicable should be based on where the "center of gravity" of a transnational investment agreement lies - a solution not too far from the Resolution adopted by the International Law Institute in 1979 (Articles 1 & 5), according to which state contracts are, in the absence of choice-of-law rules, subject to the law with which the contract has most linkages. n137 In the case of transnational investment projects, this is most likely to be the law of the host state. n138

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n135. A body of law that is neither international nor national, but specific to international commercial transactions, including government/company relations, based on principles which are identical among the major legal systems, on customs and usages of the particular industry. See generally Leon Trakman, The Law Merchant (1983); Berthold Goldman, Une Bataille Judicaire Autour de la Lex Mercatoria, Rev. De l'Arbitrage 379 (1983); Stephen Zamora, Is There Customary International Economic Law?, 32 Germ. Y.B. Int'l L. 9, 42 (1989); Irene Strenger, La Notion de Lex Mercatoria en Droit du Commerce International, 227 R.C.A.D.I. 209 (1991). But see generally David, supra note 1, at 301 (reservations); Keith Highet, The Enigma of the Lex Mercatoria, *63 Tul. L. Rev. 616 (1989)*.

n136. As early as 1958, Alfred Verdross attempted to place government/foreign investor agreements into a third category - to wit, quasi-international agreements. See Alfred Verdross, The Status of Foreign Private Interests Stemming from Economic Development Agreements with Arbitration Clauses, 9 Oest. Zeitschrift fuer oeffentlich Recht 449, 449-62 (1958); Alfred Verdross, Protection of Private Property under Quasi-International Agreements, in Varia Juris Gentium: Liber Amicorum presented to J.P. Francois 355 (Neth. Int'l L. Rev. ed., 1959). For more recent writings on the subject, see generally F. Dasser, Internationale Schiedsgerichte und Lex Mercatoria, Rechtvergleichender Beitrag zur Diskussion uber ein Nichstaatliches Handelsrecht (1989); Ole Lando, The Lex Mercatoria in International Commercial Arbitration, *34 Int'l & Comp. L.Q. 747 (1985)*; Bernardo M. Cremades & Steven L. Plehn, The New Lex Mercatoria and the Harmonization of the Laws of International Commercial Transactions, *2*

B.U. Int'l L.J. 317 (1984); Harold Berman & Colin Kaufman, The Law of International Commercial Transactions (Lex Mercatoria), *19 Harv. Int'l L.J. 221 (1978).*

n137. David, supra note 1, at 104; see also Maniruzzaman, supra note 88, at 378.

n138. See Maniruzzaman, supra note 88, at 381-82; see also Sornarajah, supra note 4, at 103.

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While the idea of transnational economic law/lex mercatoria has, in our view, much to offer (in particular, its strong emphasis on comparable practice and usage in a particular industry), it is too controversial to serve, at this moment, as a completely separate legal system to govern investment agreements. Nevertheless, the emphasis in the lex mercatoria debate on current commercial and state/company practices is an issue which should be taken into account when dealing with specific stabilization provisions. These, after all, reflect not [*250] national, but an international practice, reinforced by arbitral awards and theoretical discussion.

A.

Interpretation Criteria for Stabilization Clauses

In our view, the debate about stabilization provisions has so far been conducted in an overly dogmatic way, with positions developed out of a debate on general principles subse-quently being imposed on the particular case at issue. It is suggested that this approach reflects the perhaps predominant involvement of public international lawyers in the debate. On the other hand, a commercial contract approach to the interpretation of stabilization clauses would first tend to find the solution in the document and the specific nature of the contractual relationship, then find out if a system of contract law can be applied to the issue at hand. The parties would subsequently try to interpret and fill identified gaps with references to international usage and practices, and only as a last resort would they look towards the general principles of treaty law so familiar to public international lawyers. In the sections that follow, we shall therefore focus on methods of contract interpretation available to lawyers to understand, appraise, and determine the legal impact from the document and the contractual context per se. As will be shown, external factors - applicable contract law, international business practices, and even the international law debate - can be assigned a proper role as the background against which interpretation takes place.

1.

Application of Standard Methods of Contract Interpretation

The initial approach to interpreting a stabilization clause would be traditional. Literal and grammatical interpretation n139 - being uncontested - will, however, rarely lead to a unanimous result, as the controversies over stabilization clauses illustrate. First, contractual language needs to be understood in the context of the overall document. Often, a stabilization provision will be countermanded by other provisions obliging parties to cooperate in the review of the agreement or to renegotiate in good faith. n140 In addition, the precise scope of a stabilization clause, the consequences of breach, and the relation between subsequent law and the stabilization clause (which is of a legal order inferior to that of subsequent national law) will remain quite unclear. All of this is generally not due to poor draftsmanship, 'but it reflects the essence of contracting. Issues that cannot be settled in an agreement both parties wish definitively to conclude will be veiled with ambiguous language, each party reserving to itself explicitly or implicitly the right to take an [*251] interpretative position opposed to the other side's. The negotiators, in effect, consider the issue of clarity not vital enough to merit further negotiating efforts or to risk the collapse of the negotiations, so they delegate the determination of the issue at heart to the agreed procedure for dispute settlement - hoping, naturally, that the issue will not come up, and certainly not during their own tenure. This feature is central to negotiations, in particular to international public and commercial negotiations; there is no use in decrying such practice as theoretically or professionally flawed. It has to be taken as the foundation and starting point for the interpretation effort.

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n139. Literal interpretation is the traditional and exclusive key method of English common law; it is currently being superceded in United States and continental law by more extensive methods of interpretation. See generally Robert Alexy, A Theory of Legal Argumentation: The Theory of Rational Discourse as Theory of Legal Justification (Rith Adler & D. Neil MacCormick trans., 1989); Interpreting Statutes: A Comparative Study (D. Neil MacCormick & Robert Summers eds., 1991) [hereinafter Interpreting Statutes]. The United States perspective, 3 Arthur Corbin, Corbin on Contracts 532-72 (1960). For a comparison of interpretation methods in international public law, of limited application to our primarily commercial issue, see Rudolf Bernhardt, Interpretation in International Law, in Encyclopedia of International Law 420-21 (Rudolf Bernhardt ed., 1984).

n140. Item IDV of the Heads of Agreement, June 6, 1974, Papua N.G.-Bougainville Copper Co., an example of a renegotiation or review clause, stipulated that "the parties would meet at intervals of seven years to consider in good faith whether the Agreement was operating fairly to each of them and, if not, to use their best endeavors to agree upon changes to the Agreement as may be requisite in that regard" (on file with lead author). A similar purpose in promoting renegotiation underlies the essential function of "most-favored-nation/company" clauses contained in international investment agreements.

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The next level of interpretation would be purposive n141 - where the purpose

of the parties serves to assist construction of contractual language. Such purpose would preferably be indicated in or inferred from the agreement, in the context of the negotiations, n142 or readable into the agreement by an informed and objective expert in the practices of the particular industry in question. n143 Anglo-Saxon/common law drafting practice, imbued with the notion of mainly literal interpretation, tends to reduce the scope for purposive interpretation by use of very detailed and complex contractual language. n144 Nevertheless, since even the ideal document, drafted in extreme detail and with comprehensive precaution, needs to pass through the other party's negotiated acceptance, the logic of intentional ambiguity is likely to assert itself and overcome the perfectionist efforts of legal draftsmen. As a result, any professional lawyer called to appraise the legal impact of the stabilization clause - in-house lawyer, counsel, judge, or arbitrator - will not avoid recourse to purposive interpretation, a solution to which civil lawyers, and in particular Asian 'lawyers, will resort to almost automatically. The purpose of an agreement - different, at least at first sight, from statutory interpretation n145 - is, however, based on the will of the parties. If the parties could not agree, but chose intended ambiguity, an exploration of the parties' intention will only reveal at best a fundamental disagreement, and in many cases probably a serious misunderstanding on the government negotiators' part of the proposed scope of the stabilization clause. n146

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n141. D. Neil MacCormick & Robert S. Summers, Interpretation and Justification, in Interpreting Statutes supra note 139, at 511, 514, 518-21; Kim Lewison, The Interpretation of Contracts 2-4 (1989); Karl Larenz, Methodenlehre der Rechtswissenschaft, 208-09 (1969); see generally G.G. Fitzmaurice, The Law and Procedure of the International Court of Justice: Treaty Interpretation and Certain Other Points, *28 Brit. Y.B. Int'l L. 1 (1951);* Vienna Convention of the Law of Treaties, May 23, 1969, art. 32, 1155 U.N.T.S. 331.

n142. E.g., from press releases, references in published reports, company reports, memoranda exchanged during negotiations, correspondence, internal briefs, and memoranda.

n143. See also Convention on Contracts For the International Sale of Goods, U.N. Doc. A/CONF.97/18 (1980), reprinted in S. Treaty Doc. No. 98-9, 98th Cong., 1st Sess.; *19 I.L.M. 671 (1980).*

n144. For the differences in drafting techniques of Anglo-Saxon common law and civil law or Asian drafters, see generally Blanco, supra note 18; Michael H. Whincup, Contract Law and Practice: The English System and Continental Comparisons (1990); Donald Harris & Denis Tallon, Le Contrat Aujourd'hui: Comparisons Franco-Anglaises (1987).

n145. The distinction between contract and statutory interpretation is that in statutory interpretation, only one presumed will, that of the legislator, needs to be ascertained, whereas in bilateral contract negotiations, there are two wills and intentions to deal with. The difference is of lesser significance in practice since there is usually not one "legislator," but, as with bilateral negotiations, a process composed of many individual wills and intentions which coalesce into one binding document.

n146. See generally Vandervelde, supra note 96.

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The normal route chosen by a legal interpreter is to rely on one's own professional judgment of what the intention of the parties should have been and to pretend that what is in fact his personal subjective judgment is actually the parties' intent. This method may lead to perfectly reasonable results if the subjective judgment is based on an understanding of the specific circumstances surrounding the contractual relationship and its needs; it may, however, also lead to unacceptable results when the legal interpreter (either the judge or [*252] arbitrator) in substituting his own judgment, in fact becomes one party's negotiator - and awards to that party by interpretation what it could not obtain in the quid pro quo of a freely negotiated bargain. It is hard to reject the impression that some writers or arbitrators who argue for 'internationalization of state contracts without an express choice-of-law clause in fact award to the private party what this party had tried but failed to obtain in the direct bargaining with the other (state) party. n147

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n147. See Texaco Overseas Petroleum Co./California Asiatic Oil Co. v. Libyan Arab Republic, *17 I.L.M. 1, 3 (1977)* (attempt by sole arbitrator Rene-Jean Dupuy to effectively construct a choice of law clause stipulating international law as applicable, when such a choice of law clause did not exist).

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All that we can deduce from this part of our analysis is that the initial focus should be on the agreement and the contractual context itself; the arbitrator/legal interpreter should ascertain what positions are likely to underlie the specific formulations in an agreement. The arbitrator should refrain from partisan (re)construction of the agreement - from awarding to one party a concession the other party quite clearly did not agree to make. The one rule we can now postulate is that partisan interpretation of an ambiguous bargaining result is plainly wrong; bargaining victories must be had at the negotiating table, and not in the arbitrator's mind. If, on a contentious issue, the parties did not achieve an agreement by bargaining, the arbitrator must not read into the ambiguity what one party may have wanted but failed to achieve. In many cases, the result will be that intentional contractual ambiguity in effect implies the delegation of contract-making powers - by way of interpretation - to the judge/arbitrator. Judicial/arbitral filling of mostly intentional gaps now becomes necessary.

For this task of gap-filling, the right approach in our view is for the arbitrator/judge to identify relevant circumstances in both the contractual document and the specific relationship, pertinent legal concepts, and arguments from the debate about stabilization clauses, n148 and to distill a rule of reason for applying the contract and pertinent law out of the practices of the industry/government interaction at issue, as well as the economic, financial, technical, political, and legal logic of the specific project. n149 This approach will ensure that the arbitrator/judge does not get caught in sterile dogmatic controversies and become labelled as partisan to one camp or other. It will also provide flexibility to do justice to the particular case and situation

and the ability to construct fairness and equity not out of dogmatic debate, but out of the specific relationship.

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n148. We rely here on the notion of "topical legal reasoning" developed by Giambattista Vico in the 16th century. See generally Theodor Viehweg, Topik und Jurisprudenz (1969).

n149. On the "logic" (technical, economic, financial) of a particular industry as informing the legal practices and concepts see Thomas W. Waelde & Alan Page, Editorial, 11 J. Energy & Nat. Resources L. 1, 5 (1993).

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The interpreter/arbitrator must therefore place himself into the bargaining context. n150 Understanding the background, the issues, and the logic of negotiations, he has to find a solution which informed, reasonable, and equitable negotiators might have well found had they the combination of time and pressure needed to find a position on this particular issue. Another perspective is that of an informed, impartial adviser who is asked by both parties to make a recommendation on how to settle an issue, fill a gap, or formulate more specifically the content, scope, and contours of the issue which they themselves are unable to define in detail. The interpreter/judge, in carrying out this task, has to give principal attention to the negotiating context and issues and to find a primarily internal solution before applying an external law. External law (e.g., the international law debate on stabilization [*253] promises) does have relevance, but rather on clarifying possible implications of alternative solutions and helping to show where a solution would lead to intractable problems than in imposing a one and only solution that is permissible under the interpreter/arbitrator's legal reasoning.

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n150. The method proposed incorporates the contextual/communicative approach advocated in Myres McDougal, et al., The Interpretation of International Agreements and World Public Order (2d ed. 1994), but we cannot ignore the particular, generally accepted, formal quality of the contract's text itself which, in the parties' shared acknowledgement and expectation, takes a higher, exceptional, and most conspicuous role in identifying the starting ground for defining the agreement.

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2.

Pertinent Legal Arguments to Support Interpretation

Legal criteria which are applicable to interpretation of state contracts can be developed out of comparative law. Where legal doctrines in most major legal systems (and today this should not be merely a common law/civil law perspective, but should also include Islamic law n151 and the non-law approaches to commercial contracts in Asian societies) n152 come to a common result, then clearly such unanimity should guide both interpretation and the application of

whichever legal system is applicable to the contract. For example, most legal systems tend to uphold a negotiated and contractually formulated allocation of the risk of subsequent regulatory action to the one party best able to manage it - i.e., a clause which does not commit the government, but allocates the risk of government action among private parties. n153 On the other hand, while most legal systems have principles for commercial impracticability or fundamental change of circumstance, there are significant differences with respect to the threshold of fundamental changes and unenvisaged burdens that must be reached before rights to terminate or adapt an agreement are triggered. n154 In international commercial agreements which are freely negotiated between informed parties, such intervention from general contract law will require a very high threshold since parties can be expected to negotiate their own specific system of allocating and managing such risks. n155

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n151. See generally Walied El-Malik, Sharia Law and Mineral Investment (1993); Susan Rayner, The Theory of Contracts in Islamic Law (1991).

n152. Takeyoshi Kawashima, Dispute Resolution in Contemporary Japan, in Law in Japan 41, 51-52 (Arthur von Mehren ed., 1963); Roberto Unger, Law in Modern Society 134 (1976); Lawrence M. Friedman et al., The Impact of Large Scale Business Enterprise Upon Contract, in 7 International Encyclopedia of Comparative Law 3-10 (1973).

n153. Modern stabilization practice tends to move from per se state commitments to agreements of a much more commercial nature between foreign investors and national companies that are state-owned, partly state-owned or completely privately owned.

n154. See Lando, supra note 135, at 751. See generally William A. Stoever, Renegotiations in International Business Transactions: The Process of Dispute-Resolution Between Multinational Investors and Host Societies (1981).

n155. See generally Russell Weintraub, A Survey of Contract Practice and Policy, *1992 Wis. L. Rev. 1 (1992).*

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International treaty law based on the Vienna Convention is, naturally, beloved by public international lawyers. However, as has been pointed out frequently, it is meant to apply to inter-state agreements where enforcement is often unavailable and the political and sovereign nature of both parties are of great influence. Treaty law certainly does not have the finely tuned systems of most developed contract law to deal with issues such as commercial impracticability, damages, force majeure, or contributory negligence handled by specialized commercial arbitration tribunals. Nevertheless, the more a state contract and the stabilization clause it contains are impregnated by the state character of the agreement, the higher the sovereign content and sovereign intensity of an agreement (with significant implications for typically sovereign-state focused obligations, such as committing a state directly to freeze or not to apply its legislation). Hence, international treaty law may be of some relevance. For example, it seems to be an established principle of

treaty law that [*254] waivers or limitations on sovereign powers should be interpreted restrictively n156 and that subordination of a state to a law other than its own be considered with prudence. n157 These standards of international treaty law can be considered pertinent to the extent that we are faced with a "state contract" in the original sense of the word (e.g., an agreement between the state as such and a foreign company, where the state's legislative prerogative is at stake, subject to contractual commitments or assigned in some way to the private company - the case of a stabilization clause in the traditional 1950s concession agreement). The waiver of sovereignty implicit in the traditional freezing clause should hence be treated in the same careful way as the waiver of sovereign immunity generally found in loan agreements involving sovereign governments.

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n156. Brownlie, supra note 82, at 622; Delaume, supra note 88, at 273-75 (Interpretations by New York courts of waivers of sovereign immunity indicate that the courts are particularly careful in requiring that the waiver of 'sovereignty in loan agreements must be unambiguous and explicit.).

n157. Saudia Arabia v. Arabian Am. Oil Co. (Aramco), *27 I.L.R. 117, 152-172 (1963).*

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Contractual commitments by the host state vis-a-vis a foreign investor should, to the extent possible, be construed with the intention of achieving consistency between the state's obligations under contract law and international law - in particular treaty commitments - be they bilateral n158 or multilateral. n159 The state's treaty obligation - e.g., to "observe any obligations it has entered into with an investor" n160 - may not directly apply to a particular state/investment contract. Nevertheless, if both parties have negotiated a stabilization clause before the known background of such a treaty obligation, then one should assume that the treaty's obligation to respect contractual commitment reinforces the contractual mirror-image. While the state investor contract has absolute precedence in the regulation of the relationship between state and investor, interpretation should try to avoid conflict between the contract level and the treaty level. n161

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n158. Glenn Gallins, Bilateral Investment Protection Treaties, 2 J. Energy & Nat. Resources L. 77, 92-94 (1984). See generally M. Sornarajah, State Responsibility and Bilateral Investment Treaties, 20 J. World Trade L. 79 (1986).

n159. See generally Waelde, supra note 94.

n160. Energy Charter Treaty, supra note 123, art. 10 (1).

n161. In the European Energy Charter Treaty, this issue is more complicated. Art. 10 (1) in conjunction with the right of private energy investors created by the Treaty to sue governments before arbitral tribunals effectively creates a "meta-meta" stabilization obligation directly between the state and the private

investor as third-party beneficiary out of the Treaty. A contractual stabilization clause obliges an investor to observe the contract per se, but the Energy Charter Treaty obligation reinforces this meta-obligation again on the treaty level. Id.

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In addition, the developing-world view of jus cogens of permanent sovereignty over natural resources as invalidating stabilization clauses may perhaps not be considered as an "absolute" cause for invalidity, but as a reason to take a very circumspect approach in constructing, interpreting, and applying stabilization guarantees. To the extent that concession agreements in this sense have largely disappeared and have been replaced with contracts with state companies of an increasingly commercial character, n162 it would seem far-fetched and quite inappropriate to even consider application of international treaty law. Selling cars to a state or its instrumentality is rarely considered to be the subject of international treaty law, and the situation should not be much different when the contractual arrangement covers the provision of services and a financing mechanism for a state-owned company 'holding mineral rights. The debate in international fora (such as the U.N. General Assembly) may not produce binding international law, but rather topoi - concepts of [*255] relevance - for interpretation. n163 There may be counterbalancing concepts found in bilateral investment and international treaties emphasizing the security of foreign investment (e.g., the Energy Charter Treaty), but these have a more limited scope than, in particular, U.N. General Assembly Resolutions. Both types of legal instruments help to shed light on the meaning and intended scope attached by parties to the terms used in state/investment contracts.

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n162. See Thomas W. Waelde, International Petroleum Investment: Regulation and Contracts, Energy L.J. (forthcoming 1996); Gao, supra note 39, at 228; Thomas W. Waelde, Investment Policies in the International Petroleum Industry - Responses to the Current Crisis, in Petroleum Investment Policies 7, 13-14 (Thomas W. Waelde & Nicky Berendjick eds., 1988).

n163. See A.A. Fatouros, International Law and the Internationalized Contract, *74 Am. J. Int'l L. 134, 138 (1980);* Bruno Simma, Methodik und Bedeutung der Arbeit der VN f<um u>r die Fortentwicklung des V<um o>lkerrechts, in Die Vereinten Nationen im Wandel 79, 93-94 (W. Kewenig ed., 1975).

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The parties' behavior before and after the conclusion of the agreement can often give significant clues as to how a contract should be constructed. For example, the parties' interaction during the life of a long-term agreement often deviates quite significantly from the rules of the agreement itself. Parties may, by explicit or implicit consent and often without complying with the agreement's pre-established adaptation and ratification procedures, behave very differently from the contractual "programme." There may be board or committee decisions (minuted perhaps), government declarations (formally accepted or not), ongoing negotiations (reaching some sort of formal agreement on all or on parts of the agreement or not). In the case of most long-term agreements, some sort of

continuously negotiated and implicitly accepted (if only by compliance) renegotiation has, as a rule, taken place. n164 This tacit adaptation should certainly guide the arbitrator/interpreter who should not try to roll back the parties to the original contract and give them a lesson in how a formal contract adaptation should have been carried out, but instead, should proceed cautiously and with respect for the parties' evolving relationship.

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n164. The Aminoil arbitration, Kuwait v. American Indep. Oil Co., *21 I.L.M. 976 (1982)*, illustrates the decade-long discussions between the government and company which seem to have led to some tacit acceptance of renegotiated aspects of the agreement. We know of other similar agreements where actual party behavior deviated significantly over the decades of the contract's life from the rules of the mostly disregarded original agreement, without a formal renegotiation or documentation of such agreements ever taking place. The lead author has experience of a case (Refidomsa/Shell agreement in the Dominican Republic) where significant payment obligations were de facto changed subsequent to presidential radio announcements and in response to the parties' interaction without any formal renegotiation or documentary evidence of renegotiation '(such as minutes of meetings or exchanges of letters). A lawyer's response would
be to interpret into this factual change of behavior an implicit renegotiation of the written agreement.

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Another important principle of interpretation applicable both to state treaties and commercial contracts is that the interpretative solution should be both workable and effective. n165 Interpreting an agreement in a way that is theoretically satisfying, but unworkable, would seem to be a case of professional negligence on behalf of the interpreter. For example, interpreting a stabilization clause in a way that would commit a government not to adopt its legislation for a period of decades (with the sanction of restitution) appears utterly unworkable in any political context. On the other hand, it seems realistic to require a government to fully compensate an investor who, having carried out massive and high-risk investments based on his trust in a government's promise of regulatory stability, is then confronted with a dramatic change of essential economic parameters before recovery of investment. Denying the power to make environmental changes in tune with international industrial practices and evolving international agency guidelines seems to place an unrealistic burden on a government; disputing the government's right to use environmental legislation for discriminatory harassment of a particular investor appears, on the other hand, acceptable.

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n165. Brownlie, supra note 82, at 631; see also Arnold D. McNair, Law of Treaties 383-92 (1961).

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Through the standards of effectiveness and workability, the logic of an investment agreement needs to become the context of the interpretative effort.

By logic of an investment we mean the technical, commercial, and financial imperatives, or the generally [*256] accepted business practices which, in general, form and shape the legal instruments used. n166 For example, international resource investment (oil, gas, mining) implies a high exploration risk, a long lead time, and - to mitigate these and other political risks - a predictable fiscal regime during the initial recovery phase. Massive changes in the fiscal regime contrary to a stabilization promise ignores the imperatives under which the industry operates. A stabilization promise can therefore be construed as prohibiting such changes much more clearly than the adaptation of a fiscal regime decades after the project began, in accordance with evolving practices elsewhere.

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n166. Waelde, supra note 149, at 3.

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Prevailing practices in industry-government interactions in comparable situations offer another significant criterion for interpretation. Without delving into the lex mercatoria debate and the legal foundation of state contracts, we believe that there is wisdom in using comparable practices and 'reasonable current expectations in interpreting a stabilization clause. Whatever
a theoretically pure approach would say, one cannot deny that large-scale projects carried out under a special regime between a foreign investor and a government - particularly of a developing or transition economy - are not the standard material of either national or international law. Instead, the better comparator for such agreements is current international practice. While agreements of this type are generally not standardized and each tends to involve a specific quid pro quo, there have been global developments. Innovations in investment contracting are rapidly reported, discussed, and disseminated from country to country. They serve as negotiating drafts and model contracts. It is the reputation of the players in this globalized field (more so than courts and arbitral tribunals) which safeguards compliance and generates self-enforcing agreements. n167 Interpreting stabilization clauses therefore means taking a close look at how other reasonable governments interact with foreign companies in this particular field. To take an example from the safety field, it would seem unreasonable for a company to argue that a stabilization clause should be relied upon to prevent a government from following the examples of developed countries and the consensual guidelines of international agencies in bringing its safety and offshore pollution legislation up to date.

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n167. L.G. Telser, Theory of Self-Enforcing Agreements, 53 J. of Bus. 27, 28 (1980); Hans-J<um o>rg Schmidt-Trenz & Dieter Schmidtchen, Private International Trade in the Shadow of the Territoriality of Law, 58 S. Econ. J. 329, 330 (1991).

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National law should, as well, be scrutinized for its impact on the legal value of a stabilization clause, whatever its role under the choice of law

applicable to the agreement. Stabilization clauses which reflect, and which are expressly authorized by, national law would seem to have a much stronger legal value than, for example, stabilization promises made in manifest contravention of national (and particularly constitutional) law. n168 One can hardly argue that credibility should be given to a stabilization promise which violates a well known national law principle (for example, that no parliament can bind its successor). Borderline cases (where contravention of national law could not reasonably be apparent to the foreign investor or where national law is silent but arguably not opposed to stabilization [*257] commitments on the part of the government), need to be settled in a borderline way - by giving effect, though limited in terms of duration, scope, and sanction, to stabilization promises.

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n168. Jurisprudence and discussions of the waiver of sovereign immunity in loan agreements entered into by governments or governmental instrumentalities such as a Central Bank are very instructive. The prevailing opinion seems to be that constitutional and other legal limitations on such waivers of sovereignty - such as consent and procedural requirements - need to be taken into account. A waiver of sovereign immunity is therefore invalid if it lacks required consent or contravenes material procedural requirements. See Mairal, supra note 78, at 154; George Kahale III, State Loan Transactions, *37 Bus. Law. 1549, 1564-65 (1982);* Georges R. Delaume, supra note 78, at 271-75 (discussion of cases).

'There is the possibility of overcoming the lack of required consent or procedural non-compliance through the concept of "apparent authority." Nevertheless, we believe that in such a sensitive case as stabilization clauses, the scope of "apparent authority" is severely circumscribed by the due diligence principle.

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In the bargaining context, one needs to take into account the relative capabilities and information available to each party. It is hard to see why a third party should intervene in a freely negotiated risk allocation scheme between a multinational oil company and a well-establishedmajor state oil company where the state company assumes - for good reasons and as part of a carefully negotiated and crafted quid pro quo package - the financial risk of detrimental changes in the host state's tax regime. On the other hand, the risk of exploitation of the potential lack of understanding, know-how, and bargaining resources of a newly-independent transition economy would seem to require a much more careful scrutiny of comprehensive guarantees contained in a stabilization clause which a knowledgeable state would normally not accept or which appears to be a politically unfeasible promise.

Here, principles of consumer and economic development law come into play. n169 The developing world position on the jus cogens character of permanent sovereignty over natural resources (very much a defense against multinational companies with stronger bargaining power) n170 may be based on an excessive and untenable notion of absolute sovereignty n171 and, in fact, be counterproductive to the goal of building up strong government bargaining power since it circumscribes and weakens a government's contracting power. The underlying philosophy of the concept - protection of proto-states in an infancy stage of

participation in the world economic system - may, however, serve to emphasize the argument that a restrictive interpretation of stabilization clauses is warranted in the context of proto-states.

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n169. See generally Philippe Kahn, Contrat d'Etat et Nationalization: Les Apports de la Sentence Arbitrale du 24 mars 1982, 109 J. Droit Int'l 844 (1982); Seidl-Hohenveldern, supra note 7, at 169; N. V. Cabolent v. Nat'l Iranian Oil Co., *5 I.L.M. 477 (1965);* Kl<um o>ckner Industrie et al. v. Cameroon (Award of 21 October 1983), in Jan Paulsson, Third World Participation in International Arbitration 71 (1985); Jan Paulsson, The ICSID Kl<um o>ckner v. Cameroon Award: The Duties of Partners in North-South Economic Development Agreements, 1 J. Int'l Arb. 145 (1945); Thomas W. Waelde, The Evolution of International Economic Development Law, 23 German Y.B. Int'l L. 59 (1980); Lawyers in the Third World (C. Dias et al. eds., 1981).

n170. See generally Rolf Knieper, The Concept of National Sovereignty and Development (1992).

n171. See generally Seidl-Hohenveldern, supra note 7. See also Thomas W. Waelde, Requiem for a New International Economic Order: The Rise and Fall of Paradigms in International Economic Law, paper presented to the Qatar International Law Conference on the U.N. Decade of International Law, Doha, Qatar (March 1994).

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Stabilization guarantees should also be appraised in conjunction with counter-balancing principles such as fundamental change of circumstance and commercial impracticability/frustration. These counter-principles to sanctity of contract can be derived from the typically open-ended renegotiation, review, and cooperation clauses in the agreements themselves, but also from the specific national law applicable, comparative law, the international law of treaties, and the widespread practice of de facto adaptation of long-term international commercial contracts. n172 The precise effect of such weakening principles on the committing power of contract differs from one legal system to another and is, even within most legal systems, quite ambiguous and uncertain. n173 Usually, a dramatic and [*258] unpredictable change in the economic environment of long-term contracts - impacting severely on the commercial survival capability of both the contractual project and the contracting parties - serves to activate legal doctrines which in quieter times lie dormant. In interpreting an agreement buttressed by a stabilization clause, one needs first to look into the agreement itself. Often, there will be direct or indirect evidence of the concept that in case of a fundamental change of circumstances underlying the agreement causing an extreme increase in the onerousness of performance for one party, that party shall be entitled to request, and the other party shall be obliged to accommodate, some sort of adaptation. n174 The contractual dispute settlement process itself may provide an explicit or implicit procedure for dealing with fundamental dissatisfaction with the operation of the agreement. The next recourse is the applicable law. National law may include the concept of adaptation and, if the agreement is subject to national law (either by reason of the choice of law clause or through application of the "center of gravity" approach), n175 then such counterbalancing principles should certainly be relied

upon in interpreting the agreement. The legal value of a stabilization clause can thus be diluted by the existence of an applicable rebus sic stantibus principle in national law, though due regard must be given to the contract's usual objective to be the exclusive or at least principal source of law governing the parties' relationship. If we are dealing with a strong state/sovereign component in the relationship, the next recourse could be to Article 62 of the Vienna Convention on the Law of Treaties recognizing the rebus sic stantibus principle. Again, while this principle may not be directly applicable, it does express the need of states, in transactions with a strong sovereign/public service character, to be allowed an easier exit from contractual obligation than in purely commercial contracts between equal, non-state partners.

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n172. See Kolo, supra note 17, at 207.

n173. See generally Henri Lesguillons, Frustration, Force Majeure, Imprevision, 5 Wegfall der Geschaeftsgrundlage 507 (1979); Leon Trakman, The Allocation of the Risks of Unusual Contingencies in International Oil Sales (1979) (unpublished S.J.D. dissertation, Harvard); Karl-Heinz B<um o>ckstiegel, Hardship, Force Majeure and Special Risk Clauses in International Contracts, in Adaptation and Renegotiation of Contracts in International Trade and Finance 156-61 (N. Horn ed., 1985); George Ndi, Change of Circumstance and the Continued Performance of Petroleum and Mineral Contracts 59-195 (1989) (unpublished LL.M. Thesis, University of Dundee).

n174. See Peter, supra note 2, at 304; Waelde, supra note 59, at 353. See also the Falcondo "cooperation" clause, discussed in Dunbar, supra note 38, at 263, for an example of a clause which provides for adaptation.

n175. See Maniruzzaman, supra note 88, at 381.

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Finally, one needs to look at the lex mercatoria, which we understand as the current practices in a particular business. Here, one will tend to encounter two perspectives. One attitude is that transnational commercial contracts, freely négotiated between informed partners, will be considered by most participants in international business as commitments out of which there should be no easy withdrawal. It is up to the parties to develop specific adaptation mechanisms of a contractual nature in negotiations. A party should not be allowed to escape from an unexpectedly onerous commitment if he was unwilling or unable to negotiate a fall-back clause for such a case. n176 Explicit mechanisms of contractual allocation of risk are usually based on a specific quid pro quo. This result of hard bargaining should not be undermined by the hindsight and subjective judgment of an arbitrator. However, it is not certain whether, in terms of a world lex mercatoria, this position is universally accepted. First, even within the United States, there seems to be a tendency to settle on adaptation if a major change of circumstance occurs. n177 In Asia in particular, commercial culture views the agreement more as a framework than as an exhaustive list of unalterable fixed commitments with a social obligation to accommodate adaptation requests in a reasonable manner. n178

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n176. One may add that under traditional Sharia law, there is a strong presumption - perhaps stronger than in most Western legal systems - for leaving the contractually formalized bargain undisturbed, relying on the strong command in the Quran on obedience to contracts. See El-Malik, supra note 151, at 103, 114.

n177. Weintraub, supra note 155, at 16-19.

n178. Blanco, supra note 18, at 11-16. See also Shiela S. Hollis & John W. Berresford, Structuring Legal Relationships in Oil and Gas Exploration and Development in "Frontier' Countries, in Moving Eastward, supra note 15.

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In sum, wherever one looks for applicable legal principles - national, international, or law merchant - only in exceptional circumstances will an absolutely clear response emerge. A fundamental change of circumstance underlying the contract (with an extreme increase in onerousness close to commercial impracticability) will more likely lead to a weakening of the legal impact of a long-term stabilization promise; while minor, more predictable changes with no dramatic consequences should not be capable of displacing the stabilization clause. Moreover, the very presence of a stabilization clause freely negotiated among informed partners should increase the threshold beyond which external events compel a review of the agreement. Nothing, however, in this discussion is absolute. In the end, it is the balancing of numerous 'factors and criteria which should decide the outcome.

3.

Economic Analysis of Stabilization Clauses as an Interpretation Standard

Economic law, particularly in the United States, has been increasingly influenced over the last twenty years by the new law and economics approach. n179 This method examines the economic implications of a particular legal rule, with a bias toward any rule which results in increased economic efficiency. So far, this approach has created surprisingly little echo in international economic law. n180 Our analysis now moves on to the application of some of these law and economics concepts to the particular problems surrounding stabilization clauses.

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n179. See Antony Dnes, Unfair Contractual Practices and Hostages in Franchise Contracts, 148 J. Institutional & Theoretical Econ. 484, 484-504 (1992). See generally Richard A. Posner, Economic Analysis of Law (2d ed. 1977); Ronald Coase, The Problem of Social Cost, *3 J.L. & Econ. 1 (1960).*

n180. But see generally Georg Ress, Ex Ante Safeguards Against Opportunism in International Treaties/Theory and Practice of International Public Law, 150 J.

Institutional & Theoretical Econ. 279 (1994).

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Let us focus first on the strict contractual and internationalist approach supporting full stabilization guarantees. If companies and governments can expect unconditional support for this theory from an arbitral tribunal, companies - in expectation of such awards - will have extensive bargaining power in extracting a maximum price from governments compelled to demand even marginal changes in their law in tune with both international developments and internal pressures. This does not encourage investors to seek a settlement by give-and-take, but instead, encourages inefficient opportunistic behavior. The company could, in effect, use the absolute unalterability of the investment terms and conditions for a long-term project to hold a government hostage n181 against mounting political pressure for adaptation. There would be a high premium for exploiting initial bargaining power advantages as well as ensuing litigation, and governments would be prevented from carrying out timely adjustments, even if pushed to do so by legitimate political pressures - clearly not a very efficient approach. Similarly, imposing all possible risks of the future on one party - in particular, the weaker party with least information and control over such risks and their implications - does not create efficiency in terms of risk management. Instead, the party having better risk management capability should assume such risk. n182

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n181. Id. at 287.

n182. Helmut Koehler, Vertragsrecht und Property Rights-Theorie, 144 Zeitschrift fuer das Handelsrecht 589, 593-95 (1980).

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The opposite solution - considering stabilization clauses invalid as contravening the international jus cogens of permanent sovereignty - would undermine the confidence value of a government's contractual commitment. It would impose considerable political risk-management cost on the investor and the project and thereby reduce the surplus mineral rent available for sharing. It would also raise the threshold of overall viability for investment [*260] projects and penalize mid-range opportunities to the detriment of the country. Finally, lack of credible contracting powers by a government - with the government treated akin to a minor in national law, incompetent for major transactions - would reduce the scope for long-term investment and introduce inefficient "short-termism." Crediting the stabilization commitment with some legal value, on the other hand, would make government/company contracting more efficient since it would give the government a tool to enhance its credibility and reputation as a reliable contract partner and, thus, contribute to the self-ordering n183 that is required for international business transactions to be efficient. Thus, the jus cogens approach proves equally inefficient.

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n183. See Beth V. Yarbrough & Robert M. Yarbrough, International Contracting and Territorial Control: The Boundary Question, 150 J. Institutional &

Theoretical Econ. 239, 243 (1994) (on the requirements for self-ordering in international contracts).

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The most efficient solution would seem to be one where both parties have reasonable confidence in each other, where commitments are kept, and where a mutual settlement process is engaged once the contract is subject to unbearable tensions. n184 How does one reach this situation? Our argument is that a situation where the specific award of the dispute settlement process is not utterly predictable, but dependent on specific circumstances and a balanced approach, would most likely propel the parties to reach a settlement. Given that risk adversity is likely to dominate the bureaucratic organizations of both parties, under the criteria here advocated, both parties would have reason to expect that their maximum demands are not likely to be met by an award, and they both would have reason to be concerned that perhaps only a minimal satisfaction of their demands would be affected. If both parties and their negotiators/executives have reason to fear the loss of face by an unfavorable award, common business, bureaucratic, and political logic dictates that they would rather seek accommodation than entrust their interests to an arbitration tribunal. n185 Hence - and this may come as quite a surprise to dogmatic purists - it is not the simple and clear-cut solution, but rather the unpredictability of a specific result which contributes to economic efficiency. While this line of argument needs to be pursued in greater depth, an initial result of the application of economic analysis of law supports our advocacy of an interpretative approach which focuses on the facts and merits of a particular case.

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n184. See Robert H. Mnookin & Robert B. Wilson, Rational Bargaining and Market Efficiency, *75 Va. L. Rev. 295, 315 (1989)* (on settlement within litigation; it does not, however, deal with the issue we pose here, settlement of government/investor tension over renegotiability).

n185. See generally Weintraub, supra note 155 (on the settlement of disputes by non-litigious means).

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VIII.

Stabilization Clauses: Contractual Practice

In the following section, we survey the evolution from traditional freezing clauses to modern schemes of contractual allocation of sovereign and political risk. This survey is necessary since most, if not all, of the previous discussions of stabilization clauses have been based on the contractual practice of the 1950s which, in turn, provided the arbitration subject matter of the 1970s. There has been a whiff of antiquity in such discussions; with our survey, we shall endeavor to modernize the understanding of the issue.

The traditional form of the stabilization clause - underlying all of the arbitral awards - had as its objective the freezing of the applicable law, the fiscal regime, or other essential investment conditions. The government was contractually prohibited from enacting legislation inconsistent with the agreement. In a more moderate version, such legislation, [*261] if enacted, was declared not applicable to the agreement. n186 This Article is directed toward this type of provision. Its frequency diminished substantially in the 1970s, when the conflict between stabilization clauses and the principle of permanent sovereignty over natural resources was highlighted in major U.N. resolutions n187 and in basically all writings from LDC lawyers and their sympathizers. The stabilization clause practice made an unexpected comeback in the 1980s and 1990s, as developing countries' policies reversed from restriction to encouragement of foreign investment. n188 A country with a previously poor record in dealing with foreign investors was usually persuaded that its readiness to accept stabilization guarantees would reduce the perception of political risk and was, in fact, an instrument of managing, from the host state's side, the political risk. We also know that freezing clauses of all sorts are currently being revived in transition economies n189 where there is an acute perception of extreme legal, institutional, and political uncertainty (a situation which instinctively causes Western legislative advisers and company negotiators to respond via stabilization clauses). n190 The 1970s debate over nationalization, forced renegotiations, and arbitral awards dealing with compensation n191 is likely to resurface over the next decade when the countries in the East question the deals made during the transition period.

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n186. A case in point is Clause 33 of the 1979 Prospecting License Agreement between the Government of Ghana and Texas Pacific (Ghana) Inc. which contains the following provision: "The Agreement shall be governed by and construed in accordance with the laws of Ghana existing at the date of this Agreement and 'no subsequent laws shall affect the contractual rights and obligations of the Prospector hereunder without his consent." Basic Oil Laws and Concession Contracts, South & Central Africa (Supp. 63), at 13.

n187. E.g., Declaration of a New International Economic Order, G.A. Res. 3201, U.N. GAOR, 6th Spec. Sess., 2229th mtg., Supp. No. 1, U.N. Doc. A/9556 (1974); Programme of Action on the Establishment of a New International Economic Order, G.A. Res. 3202, U.N. GAOR, 6th Spec. Sess., 2229th mtg., Supp. No. 1, U.N. Doc. A/9556 (1974); Charter of Economic Rights and Duties of States, G.A. Res. 3281, U.N. GAOR, 29th Sess., Supp. No. 31, U.N. Doc. A/9631 (1974).

n188. See Waelde, supra note 10, at 95; Pollio & Riemenschneider, supra note 10, at 114.

n189. E.g., a contract in a recent transition economy stated: "Contractor is hereby granted total exemption from any change in or introduction of any law after the effective date hereof which affects contractor's fiscal position as set forth in this contract" (on file with lead author).

n190. In 1994 and 1995 there was a very strong revival of stabilization promises in both legislation aimed at attracting foreign investors and in contract negotiations. As an example of this revival, compare the stabilization promises in the draft Russian and Kazakh oil/gas (art. 57) and

production-sharing (art. 17) laws and published negotiating drafts, in Salym, supra note 12, at 58, 74, 77.

n191. See Kolo, supra note 17, at 128; George Ndi, Investment Policy Transformation in the Natural Resources Sector: Legal Implications as Regards the Tension Between International Property Rights and Sovereign Rights 334-36 (1994) (unpublished Ph.D. thesis, Centre for Petroleum/Mineral Law & Policy, University of Dundee).

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This traditional form of stabilization clause - intended to commit the state per se and at the core of its legislative sovereignty - evolved under the impact of both LDC assertiveness and the legal controversy surrounding freezing provisions in state contracts. First, some clauses, rather than unequivocally committing government to refrain from legislation, focused instead on defining the relationship between general law and specific agreements. Consistency clauses emphasized the character of the agreement as a special regime which was to prevail over general legal regimes, even if based on subsequent legislation. n192 Such formulations should be seen rather as interpretative guidelines. While [*262] they are not meant to be an unequivocal restriction on future legislative action (and would not have been accepted by the state's negotiators), they will require subsequent legislation to explicitly override them in order to affect the agreement. Until such explicit repeal - which states may often be reluctant to do - subsequent legislation is inapplicable by the operation of the contractually anchored lex specialis rule.

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n192. E.g., Article 45 of the 1958 Joint Venture Agreement between Sapphire International Petroleum Ltd. and the National Iranian Oil Company, which provides as follows: "The provisions of the Mining Act of 1957 shall not be 'applicable to this Agreement, and any other laws or regulations which may be wholly or partly inconsistent with the provisions of this Agreement shall, to the extent of such inconsistency, be of no effect in respect to the provisions of this Agreement" (on file with lead author). With striking similarity, Article 30 of the so-called Khemco Agreement of July 12, 1966 between Amoco International Finance Corporation and the National Petrochemicals Company of Iran provides in part that "any current laws or regulations which may be wholly or partly inconsistent with the provisions of this Agreement shall, to the extent of such inconsistency, be of no effect in respect of the provisions of this Agreement" (on file with lead author).

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Further refinements made stabilization clauses focus not on any subsequent law, but on legislative interventions into specific core areas of the contractual regime - primarily, the fiscal regime set up by the agreement. n193 Again, depending on the status of the agreement (ratified as law, authorized by law to set up its own fiscal regime, or subject to overriding national tax regulation), such a clause can serve as an interpretative guideline, protecting the contractual tax regime until such time as subsequent tax laws explicitly abrogate the contractual tax terms.

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n193. E.g., the 1985 Gabonese Model Exploration and Production Sharing Contract provides as follows: "Stability of the Agreement: The Government guarantees the stability of the legal, financing, mining, customs, and economic conditions. Rights and obligations cannot be aggravated or the balance of this contract affected during the validity period of the contract." World Petroleum Arrangements 451 (1987). Similarly, the production sharing agreement of November 30, 1982 between the Government of Togo and Getty Oil International (Togo)/Ecomint provides that with the exception of taxes on income, the contractors are guaranteed exemption "from any duty, royalty, tax and retention at source of any kind." Petroleum Legislation (Supp. 1993), supra note 21, at 93. See also the Attock Oil Contract of 4 October 1981 between the Government of Abu Dhabi and the Attock Oil Company which contains a stipulation to the effect that "no other or higher taxes, duties or charges shall be imposed upon the company" (the obvious intention of which is to stabilize the fiscal regime applicable to the agreement). World Petroleum Arrangements, supra, at 38.

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The emergence of state enterprises in the 1970s (mostly as the exclusive holders of mineral rights) transformed the foreign investment agreement. In place of the traditional "state contract" concluded between the foreign company and the government, the foreign company now provides contract services (albeit in function and content more or less equivalent to the traditional concession contract) to the state company. n194 While the system of remuneration set up under most service contracts, in effect, mirrors the tax regime applicable to more traditional concession and other equity-based investment arrangements, the foreign investor is converted, in law and form, into the role of a contractor to the state company. n195 Since the company no longer deals directly with the government, it is more difficult to find a mechanism to keep the government from intervening in the contractual relationship between the state company and the foreign contractor. As a rule, state enterprises would act ultra vires if they 'would commit the state as such not to exercise its general sovereign and legislative powers against contracts concluded by the state company. Theoretically, the state could, through a separate agreement, n196 enter into a contractual [*263] relationship with the foreign company; however, this is now quite rare. Given the often close relationship between governments and state companies, n197 the risk of government intervention into such contractual relationships still exists.

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n194. See Zhiguo Gao, International Petroleum Exploration and Exploration Agreements, in Moving Eastward, supra note 15, at 317, 319-24. See also contributions by T.N. Machmud, The Production Sharing Contract in Indonesia, in Moving Eastward, supra note 15, at 113; Sena Anthony, Recent Developments in the Legal Structuring of Petroleum Investments in Nigeria, in Moving Eastward, supra note 15, at 121.

n195. See Robert Fabrikant, Production Sharing Contracts in the Indonesian Petroleum Industry, *16 Harv. Int'l L.J. 303, 311-17 (1975);* Machmud, supra note 194, at 113-14; Maniruzzaman, supra note 88, at 213-15.

n196. In fact, there are attempts by foreign investors to make the government party to the agreement with the state company - similar to the way the World Bank, for example, requires a government guarantee for loans to state companies. Sometimes, as in the past in Colombia, a governmental decision - e.g., a decision to grant certain investment incentives - could, arguably, be viewed as a government/company agreement. Chile, for example, employs the instrument of the "investment contract" to grant incentives, including a tax stabilization guarantee, to investors. See generally Fischer, supra note 22, on 1970s Chilean contracts. In other situations, an exchange of letters between the company and either the Central Bank, the Ministry of Finance, a sector Ministry or other government instrumentality could be construed as creating a direct link between the investor and the government. But apart from government ratification - as opposed to consent - of contracts with state companies, it is usually quite rare and difficult to construct a direct contractor-state relationship if the principal contractual relationship is with the state company. In the "Pyramids" Case, 8 ICSID-Rev.-F.I.L.J. 231, 264 (1993), an attempt was made to portray the state's "approval" of a state enterprise contract as essentially a direct state guarantee for such contracts.

n197. See Richard Bentham, Legal Status of State Petroleum Companies, in Petroleum Investment Policies 257, 258-61 (Nicky Beredjick & Thomas W. Waelde eds., 1988).

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One way to lessen this risk would be to hold the government directly contractually liable for actions taken against a contract with a state company, on the theory of its full control over the state company. This line of argument has, in fact, been played out in earlier cases with state companies arguing force majeure for government-imposed impossibility of performance. n198 This approach, however, must overcome the separate legal personality of the state company, and such lifting of the corporate veil is rarely accepted. Contractual practice, though, has been creative in finding a mechanism to overcome the disassociation of the state as such. In our view, the predominant "modern" 'stabilization clause no longer looks towards the government as such, but makes the state enterprise responsible for unilateral intervention by its own government. While state enterprises do not control their governments and cannot reasonably be made legally responsible for what their governments do, n199 they can assume the mainly financial risk of government intervention into their contractual relationship. n200 Indeed, current practice has moved towards allocating the risk of government action to the state company - on the theory that the state company is better positioned to influence such risk, is closer to the source of the risk, and is likely to have the resources for shouldering such risk.

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n198. See Mann, supra note 66, at 199-216; Karl-Heinz B<um o>ckstiegel, Der Staat als Vertragspartner Ausl<um a>ndischer Unternehmen 55-75 (1971).

n199. In Amoco Int'l Finance Corp. v. Iran, a stabilization commitment in an agreement between the claimants and the National Petrochemicals Company of Iran (a state enterprise) was held not to be binding on the Iranian government, largely because of the way in which the particular provision in question was

phrased. See Amoco Int'l Finance Corp. v. Iran, 15 Iran-U.S. Cl. Trib. Rep. 189 (1987). Article 21 of the so-called Khemco Agreement required the "mutual consent of NPC and Amoco" to any annulment, amendment, or modification of the terms of the agreement, while Article 30 (the "Applicable Law" clause), in recognizing the Laws of Iran as the governing law, also stated that any laws and regulations which were inconsistent with the terms of the agreement were to be of no effect to the extent of such inconsistency. The tribunal, however, ruled that the subsequent cancellation of the agreement by the government through a legislative measure was valid and did not come within the ambit of the stabilization clause. None of the contracting parties had, as such, the legislative authority which would have triggered the "mutual consent" requirement of the clause. See also CCI Egypt & Egoth v. SPP, *23 I.L.M. 752* (Int'l Chamber of Commerce Ct. of Arbitration, 1983).

n200. See Mobil Oil Inc. et al. v. Iran, 16 Iran-U.S. Cl. Trib. Rep. 3 (1987-III).

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Thus, the modern stabilization clause is, in effect, a risk allocation provision. The state company promises to compensate the foreign contractor should his financial burden increase due to subsequent government legislation. n201 Such compensation can take the form of an offset of the financial value of subsequent legislation against payments due by the contractor to the state company or of a corresponding counter-payment by the state company to the contractor. Modern service contracts - especially production-sharing agreements - create a [*264] financial regime where the contractor assumes risk and expenditures and is repaid out of production. n202 Here, the mechanism for remuneration (often part of the annexed accounting rules of the agreement) sometimes provides that the recoverable expenses due the contractor out of production ("cost oil") include all taxes and comparable government levies except for those expressly mentioned in the agreement. n203 In other words, the government may play with its tax levies, but this is of reduced relevance to a contractor who will, according to the agreement, recover whatever additional taxes and levies the government wishes to impose. The cost recovery mechanism

'expressed in production-sharing agreements and accounting rules thus can function effectively as a limited stabilization clause, without all the problems of tainting the government's exercise of sovereign powers of legislation. n204 When viewed from this perspective, the function of the stabilization clause has been effectively converted from an instrument aimed at the government's legislative powers to a risk allocation mechanism in a purely - or mainly - commercial contract with the state company.

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n201. E.g., a recent East European production-sharing agreement said: "It is hereby agreed that if the laws of X were subsequent to the signing of this contract to be changed in such a way as to materially diminish contractor's rights or expand contractor's obligations hereunder, the [partner] shall be bound to readjust the contract so as to restore contractor's rights and obligations as existing on the effective date." This clause was followed by a mechanism providing for contractor's notification, followed by negotiation in good faith on how to "restore contractor's economic rights and benefits," and

concluded by authorization of the contractual arbitrators to determine whether a "material change in conditions has occurred and the modifications, if any, necessary to the contract," with arbitrators' determination being "final and binding and...part of this contract" (on file with lead author).

n202. A 1996 agreement (a production-sharing contract in a transition economy) includes the following stabilization techniques:

First, "in the event that the government...has...after the date of this contract made amendments to the tax laws requiring the contractor to be assessed for and pay income tax at a greater rate than 50% (i.e., the maximum rate under the agreement), then the state company agrees that the contractor shall be entitled to receive an additional amount of the available petroleum to compensate for any economic loss suffered by the contractor as a result of such income tax increases. The parties agree that the intent of such amendment shall be to indemnify the contractor out of available petroleum or by any other means agreed...against such losses."

Later, the state company "assumes and discharges all...taxes except those taxes" provided under the agreement - in effect a tax stabilization clause by shifting the tax payment burden inter partes to the state company.

In addition, while "no term of this contract...shall prevent or limit the government from exercising its inalienable rights...new legislation...shall either be inapplicable to the contractor if they are prejudicial or the parties shall amend this contract so as to compensate for any such prejudice" (on file with author).

n203. A 1992 East European exploration and production agreement includes, in the accounting rules, as "recoverable expenses": "All taxes, duties, dues or imposts of every kind and nature assessed or levied upon or in connection with the operations hereunder, other than those covered by Art....of the Contract" (on file with lead author). In other words, should the government impose additional taxes, the contractor can recover such tax payment before paying tax or sharing the product.

n204. An example is the following cost recovery provision from a production-sharing contract in Kenya:

Cost Recovery, Production Sharing and Income Tax:

(1) Subject to the auditing provisions under Clause 30, the contractor shall recover the Petroleum Costs by taking and separately disposing of an amount equal in value to...per cent (...%) of all Crude Oil produced and saved from the Contract Area and not used in Petroleum operations. Such cost recovery Crude Oil is hereinafter referred to as "Cost Oil'...

(2) The total Oil produced and saved from the Contract Area and not used in Petroleum Operations less the Cost Oil, shall be referred to as the Profit Oil and shall be shared, taken and disposed of separately by the Government and Contractor [on a sliding scale] according [to the] increment of Profit Oil...

(on file with lead author). See also Keith W. Blinn et al., International Petroleum Exploration and Exploitation Agreements: Legal, Economic, and Policy Aspects 69-81 (1986) for examples of similar clauses.

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One should, nevertheless, not forget the limitations of this modern approach. First, the contractor is limited in the pursuance of his claims to the state company and its generally limited liability. One could, for example, envisage a legalist government strategy which involves increasing taxes on the operations until the cash flow and assets of the state company are no longer sufficient to service its obligations towards its foreign contractor/investor - a strategy that would risk being classified as a "creeping expropriation." [*265] Second, the solution (now being increasingly pursued) of using the concept of recoverable expenses and its definition in the accounting rules of a production-sharing agreement moderates the effect of subsequent add-on taxation, but does not eliminate the financial impact completely. n205 Third, a government could rely on the hard core of legislative sovereignty and annul, by legislative fiat, contracts between the state company and its contractors. n206 In that case, and in the absence of an arbitration agreement (compromis) concluded directly with the government, the foreign contractor/investor is reduced to the diplomatic protection of his home state and other customary international law remedies. The only other remedy would entail extending privity of contract by a reverse lifting of the corporate veil and arguing the state company's responsibility for the actions of its controlling owner, the state, or alternatively, on an alter ego theory, holding the state responsible for the political risk assumed by the state enterprise (i.e., using quite ambiguous corporate law doctrines to create joint liability by the state and its enterprise for the state's sovereign action).

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n205. The reason for this is that when additional and subsequent taxes are added to the deduction of recoverable cost, the pre-sharing or pre-tax "profit oil" or "net profit" element is further reduced, thus reducing the 'contractor's share in it. There are further limits to the use of the cost recoverability. If taxes are increased massively or gross revenues are modest, the "cost oil" available for cost recovery may not be sufficient to cover the now added tax component in recoverable cost.

n206. Such action was threatened in 1985 by the Garcia government of Peru against both BELCO and Occidental, which were operating on the basis of contracts with the state company Petroperu, and actually carried out against BELCO - leading to a successful political risk insurance claim against insurer AIG and, recently, to the settlement of the compensation claim of BELCO/AIG against Peru. Nicolas David, in Les Clauses de Stabilite dans les Contrats Petroliers, 113 J. Droit Int'l 79, 105 (1986), recognizes the risk and advocates submission to international law.

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Another line of evolution from the traditional freezing clauses has moved

towards a combination of freezing with adaptation mechanisms. This combination, though at first sight incongruous, illustrates the ingenuity of negotiators squeezed between political risk on one side and national sovereignty on the other. In this form of contractual mechanism, the occurrence of unilateral government intervention in the contractual regime results in an adaptation of the agreement to restore its original equilibrium. n207 As a consequence of the disruptive act, the parties are under obligation to negotiate in good faith to restore the original balance. If this fails, either a specific adaptation procedure or the contract's general dispute settlement mechanism is competent to carry out such restorative adaptation. n208 The renegotiation clause - originally meant to open the agreement to the government's desire for change - has thus been turned on its head and functions like a stabilization clause of yore. Naturally, given the variety and ingenuity of real-life situations, hybrid forms are possible and do exist. Renegotiation clauses meant to adapt the agreement to changed circumstances can coexist, in the same clause or in different places in the agreement, with adaptation [*266] clauses, the primary function of which is to restore an agreement's original terms in response to governmental disruption. n209

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n207. See generally Martin Bartels & James E. Silva, Contractual Adaptation and Conflict Resolution: Based on Venture Contracts for Mining Projects in Developing Countries (1985); David N. Smith & Louis T. Wells, Conflict Avoidance in Concession Agreements, *17 Harv. Int'l L.J. 51 (1976).* An example would be the provision in a recent transition economy production-sharing agreement. See supra note 202.

n208. E.g., from a recent transition economy production-sharing agreement: "If contractor's rights, benefits and interests are adversely affected or contractor's...financial obligations increased, as a result of any change or annulment in or to any applicable laws,...(the state enterprise)... will consult promptly and make necessary revisions and adjustments to the relevant provisions of the contract affecting contractor...as applicable in order to maintain contractor's...rights, benefits and interests hereunder as at the effective date and to ensure that any revenues or income derived or to be derived under this contract shall not in any way be diminished (in comparison to that which was originally contemplated) as a result of such changes or annulment to 'applicable laws...If the parties are unable to agree...upon the adverse impact on contractor's...rights, benefits and interest or upon the necessary changes to be made to this Contract, then either Party may refer the matter for arbitration" (on file with lead author).

n209. A good example of such a hybrid clause is Section 47 of the On-Shore (Voltaian basin) Petroleum Production Agreement of 1974 between the Government of Ghana and Shell Exploration and Production Company (Ghana) Ltd which provides: "It is hereby agreed that if during the term of this agreement there should occur such changes in the financial and economic circumstances relating to the petroleum industry, operating conditions in Ghana and marketing conditions generally as to materially affect the fundamental economic and financial basis of this Agreement, then the provisions of this Agreement may be reviewed or renegotiated with a view to making such adjustments and modifications as may be reasonable having regard to the Operator's capital employed and the risks incurred by him, always provided that no such adjustments

or modifications shall be made within 5 years after the commencement of production of petroleum in commercial quantities from the production area and that they shall have no retroactive effect" (on file with lead author). Nicolas David, supra note 1, at 107, is one of the few writers who has so far recognized and incorporated the close relationship between adaptation and stabilization clauses, no doubt because of his familiarity with current petroleum negotiating practice.

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In summary, contractual practice has moved away from the traditional freezing clause and developed two major successors: (1) a renegotiation clause which intends to restore a disrupted equilibrium (and hence functions much like the original stabilization clause) and (2) an almost universally practiced mechanism whereby the risk of governmental disruption is placed squarely on the shoulders of the state company contracting with the foreign company by explicit allocation or by implication in the contract's cost recovery and cost accounting rules. None of these methods, however, is absolutely foolproof; they cannot exclude the possibility that the state, no longer party to the contract, might annul such contracts by legislative fiat. Should the state pursue this strategy, the discussion should move toward state responsibility for "creeping expropriation" and perhaps toward "lifting of the veil" of separate legal personality between the state and its enterprises.

IX.

Conclusion

This study has attempted to inject a modern approach into a somewhat worn debate in international law: the issue of contractual promises made by a host state not to alter existing terms or not to apply subsequent detrimental regulation to foreign investment projects. First, we have discussed extensively the function of stability for long-term investment projects, particularly in capital-intensive and natural resource and energy projects, with a particular focus on the stability of the financial regime. Second, we have reviewed the international law debate and found that the two main positions seem to be mostly related to political alignment and do not offer a reasonable solution to possible disputes. Third, we have developed an approach based on interpretation of particular terms in the context of an individual contractual relationship. 'We thereby developed a number of key concepts and interpretive standards which should be flexibly applied to a dispute and which allow an effective, realistic, and equitable solution, including concepts incorporated from the economic analysis of law approach. In the main, we recommended consideration of the stabilization promise as an important element of the contractual relationship which should have a significant bearing on the quantum of compensation due for breach of such a promise. Its legal weight should fluctuate depending on a number of identified circum-stances and criteria.

We have also reviewed current practice and found that the traditional freezing clause has been to some extent superseded by modern practice (consisting of contractual mechanisms to allocate the risk of subsequent government intervention in agreements between state companies and foreign contractors with a predominantly commercial - not "sovereign" - character). These "political risk allocation" clauses should be left largely intact and

should only be affected in exceptional instances by operation of general legal [*267] principles such as fundamental change of circumstance or commercial impracticability. Other elements of modern practice combine the stabilization and renegotiation mechanisms in hybrid contractual formulations with, again, the element of sovereignty being reduced in lieu of more commercial forms of transnational business contracting.

There are, not unexpectedly, some questions left for further study. The Article has not focused on the question of compensation which is linked to stabilization clauses. If stabilization promises are meant to have any effect - apart from more or less repeating that contracts are contracts and need mutual consent for modification - then this effect should be enforced through a stabilization premium added to the compensation otherwise due for the state's abrogation of existing contracts. The amount of this stabilization premium should depend on the legal weight of the stabilization promise as ascertained by the interpretive method proposed. Unreasonable attempts to forever fetter a state's regulatory powers (which it may use to adjust legislative terms to international developments) should not be given effect, while a tax stabilization promise made to allow the development of a long-term, high-risk project should be given full effect, at least in the initial and essential phase of investment recovery.

Some years ago, it would have been easy to argue that stabilization clauses were a thing of the past, largely done away with by the permanent sovereignty and new international economic order movements of the 1970s. We would now be more cautious. Stabilization promises are likely to be around as long as investors are fundamentally concerned about political risk and legal instability in host states. While many of the developing countries are well on the way to becoming developed countries (particularly in Asia), and in many cases "state contracts" are replaced, first, by more commercial agreements with state companies and, later, by fully commercial contracts with private national companies (particularly after privatization), political risk and legal instability are still on the minds of international investors. This is particularly so in the transition economies of the former Soviet Union. Even in rapidly developing countries in Asia and Latin America, there is at times an unexpected politicization of international commercial relations. n210 The specter of such politicization will lead prudent counsel to consider - in some form or other - allocating the political risk to the national partner, even if it is unlikely that in such countries the government itself will accept commitments freezing its legislative powers. Further work will focus on the

'use of the stabilization technique to deal with the environmental regulation risk of foreign investment.

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n210. E.g., the politically motivated boycott by Malaysia of U.K. business due to unfavorable reports in the British press alleging improper procurement practices in Malaysia. See Kieran Cooke, Malaysia Steps Up Curbs on Britain, Fin. Times, Mar. 1, 1994, at 6.

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