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A. Tojiboev
Tashkent state university of law, Tashkent, 100047, Uzbekistan, a.tojiboev@tsul.uz

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THE ROLE OF STABILIZATION CLAUSE IN INVESTMENT CONTRACT

A. TOJIBOEV

Tashkent state University of law, Tashkent, 100047, Uzbekistan

Annotation: this article discusses the content of stabilization clauses, their types and application in investment contracts. Furthermore, in the article it is emphasized that regardless of the reasonableness of a stabilization clause, there are still theoretical and practical debates on its actual need and efficiency. Considering these facts, an author tried to give his view on efficiency of stabilization clause and its possible application in investment contracts.

Keywords: investment contract, stabilization clause, investor, government, foreign investment, law applicable, the sovereignty of the state.

Immediately after Uzbekistan gained independence the economy was in desperate condition and the government had little time to focus on investment policy. Later, the government realized that investment policy required periodic reforms. Uzbekistan needed to develop its economy as well as a social life. The attraction of foreign investment and the establishment of joint ventures was one of the key points to reach economic growth and to implement a new market experience in the country.
Is it undoubtedly obvious that foreign investment progress began some decades ago and it has especially been reaching its peak for 2 years in Uzbekistan. The government of Uzbekistan declares that attracting foreign direct investment is core priority and there were more than 50 legislative documents issued to accelerate and coordinate investment processes. The legislation provides a wide range of guarantees to investors, including: protection against discrimination, protection from harm caused by retroactive implementation of legislation, protection from interference by the state in the economic activity of foreign investors, and protection from any changes in legislation that worsens foreign investment conditions.[1]

Furthermore, if we observe the last activities on progressing this sphere, we can conclude the all the attempts have reflected to the result. All the results are proven with the statistic indicates. In accordance with all the statistic dates around whole the country, the up progress on involving foreign enterprises to our economical branches depicts there were considerable growth over 10 years than there had been by that time. Especially, the new strategy, declared in 2017, was the new stage on this breach. To involve more foreign investors to our economy, ShavkatMirziyayev, the President of the Republic of Uzbekistan declared the more preferences to tax and custom on this field. The third direction of “The strategy of action on five priority directions of development of the Republic of Uzbekistan in 2017–2021” is dedicated to “Development and liberalization of the economy”, it is envisaged to ensure the stability of the national currency and prices, the gradual introduction of modern market mechanisms for currency regulation, the expansion of the revenue base of local budgets, the expansion of foreign economic relations, the introduction of modern technologies for the production of export-oriented products and materials, development of transport and logistics infrastructure, increase of investment attractiveness for development of entrepreneurship and foreign investors, improvement of tax administration, introduction of modern principles and mechanisms for regulating banking activities, development of multidisciplinary farms, and accelerated development of the tourism industry. In other word, we can without any hesitation say that there will not be any considerable progress in our country’s economy without foreign investment.

Uzbekistan began to introduce policies on foreign investment between 1994 and 1998. The Law on Foreign Investment and Guarantees of Foreign Investors Activities, 1994, represented the basis of a foreign investment policy. This law was amended and reformed in 1998. Since this time, numerous legislative acts were passed to strengthen the regulation on foreign investment activities. In addition, Uzbekistan became a party to several international agreements including the Most Favored Nation Treatment (MFN), the Bilateral Investment Treaties (BIT), and signed the Treaties for Avoidance of Double Taxation.

Today, foreign investors in Uzbekistan enjoy favorable treatment, equal to local investors, as well as specific benefits. For example, The Law on Guarantees and Measure of the Protection of the rights of Foreign Investors (1998) states that, in addition to other guarantees, if a situation occurs in which a subsequent legislative act worsens the condition for the foreign investor, then the previous legislation is applied as far back as ten years. Furthermore, the foreign investor has the right to benefit from new provisions in a changed law that would be advantageous to them. Moreover, Uzbekistan provides tax benefits for direct investment that follows the required minimum amount of investment shown in law. [2]

Foreign direct investment provides a national economy with several advantages including capital inflow; extra employment, new technologies and promotion of the national market and inter country relationships.[3] In order to attract foreign investment, a host country needs to ensure legal confidence so that investors will do business in the country. A stabilization clause has the function to govern the scope of application of the law established after an investment contract has been concluded.[4] This article considers stabilization clauses as a device in which host countries can establish consistent and coherent legal regulations that provide investors with a sense of security for their investments.

Content and types of Stabilization clauses

A stabilization clause is a provision in investment contracts that serves the purpose of stabilizing the terms of an agreement and to immunize a foreign investor from possible future governmental actions or changes in the law that may be detrimental.[5] The inclusion of a stabilization clause in an investment contract gives legal protection to a foreign investor and creates legal certainty during the life span of the project in the host country. In practice, stabilization clauses are often included in contracts that are related to industrial projects such as infrastructure development or public service projects. These projects
typically require large a amount of investment and could become effectively important to the development of the country.[6]

The theory of investment law identifies several types of stabilization clauses, including full freeze and equilibrium clauses. The full freeze clause aims to ensure that the law applicable to the contract will not change during the active term of the project.[7] This type of stabilization clause was prevalent in arbitration cases throughout the 1970s and 1980s and is still in use today. The second type is the equilibrium clause, which is more commonly in use by developing countries. The main purpose of an equilibrium clause is to protect investors against financial consequences that may arise from the changes in the national law of the host country and create an economic balance between the parties.

There are some critical differences between freezing clauses and equilibrium clauses. The freezing clause contractually prohibits the government from enacting any legislation that would contradict the terms of an investment contract. With the freeze clause, a host country is not allowed to make any changes in legislative regulation that could affect a project. For developing countries, the freezing clause is disadvantageous because the sovereignty to enact new laws becomes restricted by the promises of legal stability to the foreign investors. Despite this problem, some countries continue to rely on this clause as tool to attract foreign investment into their economies.[8]

In contrast, many scholars feel that equilibrium clauses represent a more modern type of stabilization clause, as they leaves room for negation and adjustment to the new legal changes under the contract provisions. With this type of clause, an investor must comply with a new law that has been passed after a contract agreement; however, the state assumes the obligation to compensate or restore the terms of the original agreement. In addition, this clause allows both sides to provide favorable compliance or delay the application of the new law. Foreign investors tend to prefer equilibrium clauses rather than the freezing clause”, because the clause is more likely enforceable, as it does not limit the sovereignty of state to enact the new law or amendments and limit the scope of compensation for the harm. The clearer frame also leads to the accelerated solution of conflicts. Such balance between the parties and the efficiency of application of economic equilibrium clauses increase the interest of potential contracting parties to include the stabilization clause. Thus, economic equilibrium clause aims to seek prevention from particular economic issues that may come out after the new changes established in legislation. This clause does not limit the state to enact a new legislation, but impose on the parties the duty of negotiating in good faith aiming to restore the economic equilibrium of the original agreement.

**The actual necessity of stabilization clauses**

Stabilization clauses in fact cannot protect a contract as whole, although in international investment contracts it can be a device to provide a certain stability of agreement provisions during the life of the investment project. Both parties of a contract are concern to include the stabilization clause, although they have different incentives and interests. In international investment law such contrasting interests and incentives of the parties led to a debate on the real necessity of stabilization clause in investment contracts. The debate can be observed from two different perspectives: the first point states that existence of stabilization clauses are for foreign investors to foresee the legal condition in a potential host.[9] In contrast, the second point emphasizes that stabilization clauses are invalid under international law. Sovereignty over natural resources is a *jus cogens* form where there can be no diminishing of state power. Hence, a stabilization clause would be invalid and a state, making use of principles of public international law, can continue enacting new legislation, and in some arbitration cases to breach an agreement, without compensation.

Consequently it is not clear whether such a device as “stabilization clause” does indeed impose a blanket prohibition on the host state to change its domestic legislation under international law; or whether they only bind the host government to compensate the investor if deviating from the stabilization provisions. Considering this ambiguity treatment of stabilization clauses in international investment law the issue relates to the question of validity of stabilization provisions in investment contracts with developing countries. These countries present us that frequent updates of legislation are unavoidable.[10]

Some scholars critically define the implementation of stabilization clause into state contracts, arguing that such provision is just a way to attract more foreign investment, and the situation and promises may change after the agreement enter into force. Peter D Cameron in his work says that in spite of stabilization
clauses countries defines their sovereignty power confidently, asserting the arguments of public interest. [11] Also, Herbert Smith mentioned that some countries have a strict principle which does not allow a contract with private individual to fetter the executive power of the state.

However, as the practice of the international arbitral tribunal shows, a stabilization clause is still preferable to include into investment agreements; many developing countries still apply the stabilization clause into investment contracts, for example the Duke vs Peru award [12] also an arbitration clause of Ghanaian concession contract case, which deals with the compensation case for breach of the stabilization clause states as follows:

If any contractor’s rights, interest or property provided herein are expropriated, nationalized or otherwise taken by reason of any act of the State or any contractor or local governmental authority of Ghana, then the arbitrators shall apply the principal of full and fair compensation for loss of profits determined on the basis of a going concern.[13]

The actual role of stabilization clauses in investment contracts is to minimize the political and fiscal risk that the parties (especially foreign investor) may face. Often the breach of a stabilization clause is done by the host State, mainly in developing countries, where the frequent updates of the law is inevitable. However in many arbitration cases, such breaches done by a host state are often classified as lawful. The reason for such a decision is that a stabilization clause in a contract cannot be extant to the sovereignty power of the state and limit to policy making power. Consequently, based on given statement and scholar opinions, it is clear that despite being an effective device to keep the balance between actually unequal parties and maintain the original terms of investment agreements, there are still various interpretations of actual necessity and efficiency of stabilization clause.

Interpretation of stabilization clauses in arbitration cases

In the regard of the extent of stabilization clause to limit the State sovereignty power to execute the new legislation arbitral practice is divided into diverse decisions. In LIAMCO (Libyan American Oil Company v Libyan Arab Republic) case arbitration judgement concluded that the stabilization clause actually does not guarantee full protection from establishing a new law by a sovereign State, but the clause does provide for the unilateral annulment or amendment of the contractual terms.[14]

Also, in Texaco (Texaco Overseas Petroleum Company and California Asiatic Oil Company) v Libya case the arbitration court indicated that the state is not related to stabilization clause in exercising its sovereign rights, which could have an impact on the contractual rights of the concessionaire.[15] However, such an implementation of states’ rights, including nationalization, is illegal. In this case tribunal focused on principles of pactasuntervanda, and in fact sovereignty does not preclude a state from being a party to an investment contract. Arbitration stated that when the contract is internationalized, the parties act as equals.

The case of Aminoil (American Independent Oil Company) v Kuwait can be another good example for the interpretation of a stabilization clause in an arbitral tribunal. The case arbitrator held that although the investment contract included a stabilization clause, this clause did not actually cover the agreement to not nationalize. Nationalization means confiscatory termination, but in the case of Kuwait the state actually offers the compensation for a breach of contract terms. Maniruzzammanns says that the Texaco tribunal took the “contractual perspective” approach while the Amnoil tribunal the “expropriation prospective” to come up with their respective decisions on compensation.

Judicial interpretation of stabilization clauses can also be seen in the AGIP [16] award, where the dispute was about the nationalization of an oil distribution sector in Congo. In that case arbitration held the stabilization clause valid under the international law. The arbitration tribunal stated that the stabilization clause did not actually diminish the state’s sovereign powers.

Thus, it can be observed that the same clause contained within an investment contract can be interpreted from different perspectives and arbitral tribunals may have differing conclusions. The classification of the new legislative enactment of the hosting state as an expropriation should consider that the expropriation constitutes a significant influence of the state act on the investment project.

The contrasting opinions stated in this article show that there are questions regarding the following points that need to be answered:

• whether the inclusion of a stabilization clause into an investment contract limits the sovereign power of the state;
• the necessity of a stabilization clause in domestic law;
• which type of stabilization clause is more favorable to apply.

To answer these questions based on scholars’ discussion and statements this article states that:

first, a stabilization clause actually does not limit the sovereignty of the state, but just requires the party to compensate the harm done by a breach;

second, inclusion of a stabilization clause into domestic investment law is important for the state to attract foreign investment and settle the regulation of investment contracts. For foreign investors stabilization clauses give the opportunity to foresee the legal consequences of the country they invest in;

third, considering the fact that a stabilization clause is mainly used by developing countries whose legal and economic condition is not stable, it is preferable to apply the equilibrium clause into investment contracts, as this clause leaves room for adaptation of contract provisions to new changes in law;

fourth, there is no any concrete notion of the essence and stabilization clause in domestic legal acts, namely “On investment activities”, “On guarantees and measures for the protection of rights of foreign investors”, “On foreign investments”. Considering the attractiveness of foreign invest, main rules and samples on stabilization clause have to be defined in high level of normative acts, such as in codes and laws on investment activities.

In sum, these analyses show the importance and efficiency of stabilization clauses, both when included into investment contract and investment law. This leads the article to the concerns in Uzbekistan with regard to this clause.


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