CHAPTER 7

Prescriptive Pricing and Stabilisation Clauses in Investment Agreements

Irene Musselli and Victor S. Mariottini de Oliveira

Abstract

'Prescriptive' pricing methods, which employ reference prices and fixed margins for tax purposes, have gained prominence as a pragmatic approach to combatting commodity trade mispricing and tax evasion, especially for countries with limited tax administration capabilities. While these methods hold promise for facilitating enforcement, reducing administrative burdens, and curtailing abusive tax avoidance practices, concerns have arisen about their potential deviation from established international rules and principles. The perceived risk of legal liabilities and investor claims, including 'unfair treatment' under investment treaties, acts as a significant uncertainty factor in the adoption of such methods. Thus, the present chapter addresses the legal aspects of 'prescriptive' pricing methods within the parameters of international investment law, offering a multifaceted perspective on challenges involving the scope of defence arguments that states can mobilise under international investment law to justify such methods and exploring the right and duty of states to regulate corporate conduct and economic activities under human rights law, as well as the practical limitations to this approach in present lawmaking practices.

1 Introduction

'Prescriptive' valuation methods are simplified and targeted means to counter commodity trade mispricing and reclaim diverted profits. To varying extents, they involve the regulatory use of reference prices[1] and fixed margins for tax purposes for the sake of administrative simplicity (Musselli and Bürgi Bonanomi, 2021, 14–17; 2022, 452–54). An instance of this is the requirement to use reference prices when determining the selling price of minerals, or specific

1 Reference prices are price benchmarks compiled and published for reference purposes by commodity exchanges, other recognized market data providers, and government agencies. See below, Section 0.

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limitations on the types of expenses and costs that can be deducted for calculating a mine's net income (see Section 2 for further details). These methods are known as 'prescriptive' because they are based on laws and regulations that set the applicable price ranges, margins, pricing formulas and profit allocation methods (Musselli and Bürgi Bonanomi, 2021, 14). In tax literature, they are often called 'administrative approaches' or 'alternative policy options' for pricing and tax valuation (Readhead and Viola, 2023).

Prescriptive methods go beyond administrative simplification. They can be characterised as anti-abuse rules primarily driven by tax avoidance concerns (Readhead et al., 2023; Readhead and Viola, 2023; Taquiri, Lassourd and Viola, 2023). For example, the so-called 'sixth method' approach (see Section 2) was developed by resource-rich countries in Latin America to address abusive tax avoidance schemes in the commodities sector (Readhead et al., 2023). As discussed in Section 4, the tax avoidance aspect is important since it is the government's response to avoidance or misconduct that forms the basis of several defences under investment law. If well designed, prescriptive methods reduce opportunities for abusive tax avoidance practices that exploit ambiguities in the interpretation of the 'arm's-length' principle (for a discussion, see Musselli and Bürgi Bonanomi, 2020),[2] while providing predictability and certainty for economic actors to plan their transactions (Durst, 2016; Faccio and Picciotto, 2017; Musselli and Bürgi Bonanomi, 2022; Picciotto, 2018; Readhead, 2017; 2018). Prescriptive methods, especially in their most rudimentary forms, offer workable ways for countries with understaffed tax administrations to counter the undervaluation of their commodity exports and the erosion of their tax base.[3] Compared with transactional arm's-length rules,[4] they entail

2 The principle states that related parties should transfer goods and services to each other at the prices that unrelated parties would set (so-called arm's-length prices). As specified in the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines (TPGs), this involves an individualized, fact-intensive analysis of the circumstances of the specific transaction (OECD, 2017).

3 Mispricing in trade transactions occurs when goods or services are 'abnormally priced' with reference to prevailing 'market prices', and when these deviations are not justified in commercial terms (for a discussion of the notion and related concepts, see Musselli and Bürgi Bonanomi, 2020 and 2022). On 'base erosion' in the extractive sectors, see the Intergovernmental Forum on Mining, Minerals, Metals and Sustainable Development (IGF), https://www.igfmining.org (accessed on 7 March 2024).

4 Under the 'arm's-length principle', prices between related parties should approximate the prices that independent parties would have agreed in the same circumstances. The OECD-endorsed methods to assess arm's-length prices require detailed, fact-intensive analysis of the specifics of the transaction. In particular, the analysis should consider the functions performed, assets used, and risks assumed by each transacting party.

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less administrative burden or staff requirements and reduce room for administrative discretion and corruption if properly designed and implemented. Compared with technology-driven innovations and transparency frameworks, they require lower capital costs and lower investment in technology.

Certainly, prescriptive methods on their own involve complex design features and trade-offs: if overly rigid and too simplified, they may lead to distortions and economic inefficiencies; if, instead, open to complex adjustments, they offer scope for manipulation and are difficult to administer, frustrating their very rationale (Musselli and Bürgi Bonanomi, 2022; Picciotto, 2018). It is important to stress, in this respect, that many countries still make complex (and necessary) adjustments for quality differences/processing, which significantly complicate simplified methods.[5] Yet a number of design features can help mitigate or reconcile such trade-offs, for example when some leeway is allowed for the taxpayer in a 'safe harbour' approach (Musselli and Bürgi Bonanomi, 2022, 455–56).[6]

While prescriptive methods may offer a valuable 'heuristic' (Musselli and Bürgi Bonanomi, 2022, 462) for countries with limited tax capacity, their adoption is 'deterred' by the perception that they deviate from established rules and principles and that they may give rise to legal liabilities (Brugger and Engebretsen, 2020). In fact, adoption of the above prescriptive methods implies changes in a state's regulatory or administrative practices. As briefly discussed in Section , regulatory changes that adversely affect the investor's position may trigger claims by foreign investors of 'unfair treatment' under applicable investment treaties. If the applicable law includes rigidly framed 'stabilisation' arrangements, even minor changes in tax practices might lead to assertions of a breach of an investment contract, when not of an investment treaty, depending on any concrete commitment. The threat of arbitration and compensation has a strong deterrent effect on developing countries,

5 For example, 'sixth method' approaches may allow for or require comparability adjustments to the quoted price to account for product quality and contract specifications (for a review, see CIAT, n.d.; Musselli, 2019; UN, 2017b). When commodities are traded in intermediary forms for which no public quotations exist, the quoted price of the final refined commodity is adjusted to 'netback' refining and treatment costs, freight charges and other costs incurred between the market pricing point and the relevant valuation point (Platform for Collaboration on Tax, 2017). In these cases, simplified methods still provide an important administrative benefit by shifting the burden of proof and documentation requirements.

6 Under such an approach, companies that transact at regulated prices are exempt from tax scrutiny, while those that depart from reference prices are required to justify their pricing methodology to the tax administration.

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acting as a 'regulatory chill' that influences the course of policy development (Tienhaara, 2010).

Regulatory chill continues to persist notwithstanding the possible defences that host governments may have against arbitral claims arising from the adoption of predictive methods. Several defences find political support in the 2020 OECD Guiding Principles on Durable Extractive Industry Contracts,[7] which, for example, exclude bona fide anti-avoidance measures from fiscal stabilisation provisions (OECD, 2020). From a political and legal point of view, this introduces the notion of revenue certainty for governments—the opposite of tax certainty. Additionally, there is little evidence of investors initiating legal action against prescriptive pricing approaches, and a lack of conclusive case law regarding stabilisation clauses and changes in fiscal and price terms (see Section 4). These factors alone should be sufficient to mitigate regulatory chill.

Against this background, this chapter addresses 'prescriptive' pricing methods within the parameters set by international investment law. It completes the legal analysis carried out elsewhere in respect of international tax and trade law (Musselli and Bürgi Bonanomi, 2022). As we did in that contribution, here we challenge the popular objection to prescriptive pricing methods as being in breach of international economic law. Instead, we emphasise the complexity of any legal assessment of prescriptive methods under international investment law, bringing to the fore a wide range of 'defence arguments' from investment law and beyond. In so doing, the chapter seeks to enrich the legal debate on price renegotiation and stabilisation regimes under international investment law. It moves beyond the wording of discrete stabilisation provisions, opening to broader jurisprudential arguments that embed considerations of equity and fairness into the fabric of international investment law.

The analysis is organised as follows: Section 2 provides a brief overview of various 'prescriptive' approaches to taxation, drawing on previous works by the authors (Musselli and Bürgi Bonanomi, 2021; 2022). Section 3 briefly considers major challenges to their implementation under international investment law, while highlighting the lack of conclusive case law. Section 4 delves into the wide range of defence arguments that states adopting prescriptive methods can mobilise under international investment law, as well as the challenges they may encounter. Section 5 broadens the scope of defence by exploring the right and duty of states to regulate corporate conduct and economic activities under human rights law, and what this means for legal reasoning. Section 6 concludes

7 Although the Guiding Principles are not an authoritative statement of relevant domestic and international law, they aim at facilitating a common understanding between the parties to a contract regarding their contractual relationship.

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by examining practical limitations to the approach and the need for a new approach to lawmaking.

An important caveat is in order before proceeding further. The following analysis is general and partly speculative. It does not specifically assess the regulatory space a defined state has to pursue prescriptive methods under the applicable law. This would need to be assessed on a case-by-case basis considering any concrete contractual or legislative arrangement in force and the specific terms of the applicable investment treaty (Musselli and Bürgi Bonanomi, 2018, 459–60). Instead, the chapter makes more general remarks on possible legal constraints and defence arguments under international law, pointing to relevant aspects to be considered when assessing the validity of prescriptive methods under investment law.

2 An Overview of Prescriptive Approaches to Countering Commodity Trade Mispricing

This section provides a brief overview of a wide spectrum of 'prescriptive' approaches to taxation, outlining what they consist of without going deep into specifics. Attention is drawn to a spectrum of policy options that have been used or considered to curb mispricing practices in the commodity sector and related tax abuses. The various options are grouped under three headings, not without a certain overlap: the use of reference prices to determine the tax value of commodity export sales, prescriptive approaches to the valuation of deductible taxpayer costs, and simplified profit allocation methods. They are hereafter considered in turn. The analysis draws on previous works by the authors (Musselli and Bürgi Bonanomi, 2021; 2022).

2.1 *Mandated Use of Reference Prices for Valuing Commodity Export Sales*

Several countries concerned about systemic trade mispricing legislate the use of reference prices (with or without adjustments) to determine the tax value of commodity sales, particularly in the context of related-party sales. This is the so-called *sixth method* under transfer pricing law (for an overview of state practice, see CIAT (Inter-American Center of Tax Administrations), n.d.; Grondona, 2018; UN, 2017b, 217–19). Reference prices are price benchmarks compiled and published for reference purposes by commodity exchanges, other recognised market data providers, and government agencies (OECD, 2017 para. 2.18, 'quoted prices'). Examples include prices discovered on the London Metal Exchange (LME) for base and ferrous metals, and prices listed on the

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London International Futures and Forwards Exchange (LIFFE) for forward cocoa sales. In the context of transfer pricing laws, the sixth method requires looking at such reference prices when determining the fair market value of commodity sales. The requirement concerns taxpayers, when filing their tax returns, and/or tax administrations, when auditing the taxpayer's position. The more straightforward the requirement is (use of reference prices without adjustment, or with standardised/minimum adjustments), the more it departs from business practice and transactional 'arm's-length' rules (as codified in the OECD Transfer Pricing Guidelines, OECD, 2017).[8]

Other prescriptive methods use reference prices to legislatively set the tax value of commodity sales (Musselli and Bürgi Bonanomi, 2022, 453). This occurs under *administered pricing* regimes, where the government, rather than the taxpayer, determines the value of the transaction for tax purposes (for examples, see Durst, 2016; Readhead, 2018). In other words, the relevant authority sets and uses calculated prices—rather than actual transaction prices—to determine the income-based taxes and royalties considered due. Differently from the sixth method, it is tax administrations, rather than the taxpayer, that set the value for tax purposes; the burden of requesting and proving adjustments to regulated prices lies with the taxpayer.

Finally, other prescriptive approaches do not simply set values for tax assessment purposes, but directly intervene regarding prices and price-related terms in contracts (for an overview, see Musselli and Bürgi Bonanomi, 2022, 453–54). An interesting development in this respect are the EGalim laws in France,[9] which require that farmers propose prices on the basis of production costs and that inter-branch organisations develop benchmarks of production costs and market indicators (Delpech, 2021; Ministère de l'agriculture et de la souveraineté alimentaire, n.d.; Vogel and Vogel, 2018). Also of potential relevance are

8 While the use of reference prices as such does not represent a departure from the OECD Transfer Pricing Guidelines, limited/standardised adjustment to reference prices does. Indeed, the OECD Transfer Pricing Guidelines allow the use of reference prices as a starting point for identifying arm's-length commodity prices but subject to adjustments on a case-by case basis to reflect the specifics of the case (the so-called comparable uncontrolled price (CUP) method). This reflects industry practice, whereby reference prices are routinely used by companies to price commodity transactions, but subject to context-specific adjustments that reflect location, supply and demand conditions, time and manner of delivery, quality standards for deliverable products, and other factors. Simplified, prescriptive methods favour instead standardised adjustments or no adjustment at all. In this respect, they depart from industry practice and the OECD methodology.

9 The so-called law EGalim 1 (Loi n° 2018–938 du 30 oct. 2018, JO 1er nov.) and EGalim 2 (Loi n° 2021–1357, 18 oct. 2021, JO 19 oct.).

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those laws or regulations, whether sector-specific or general, that render certain price-related terms in contracts ineffective.[10] Such rules on unfair trading practice do not regulate prices directly, but they may affect the way prices are negotiated and set.

2.2 *Regulated Valuation of Deductible Taxpayer Costs*

While the aforementioned techniques aim to prevent the undervaluation of commodity exports, there are other methods that incorporate prescriptive elements to determine deductible taxpayer costs (Durst, 2016). The main emphasis here is on the input aspect of the commodity trade equation, which includes the cost of services, supplies, and equipment acquired from affiliated entities. Additionally, intra-group funding is also considered (Durst, 2016). As Durst has pointed out, certain prescriptive methods implement 'bright-line' limitations on deductible expenses for taxpayers, with the goal of maintaining the taxable base in 'source countries' (Durst, 2016, 11–14). In certain situations, such as intra-group transactions, the law may prohibit markups on costs for tax purposes.[11] A less severe approach is to establish legally defined profit margins and markups for tax assessment purposes.[12] Some schemes and model laws further disallow tax deductions for the use of intangible properties, including technological know-how.[13] Going one step further, several countries have implemented bright-line interest limitation rules that restrict the amount of deductible interest to a certain percentage of a company's earnings.[14] Another

10 Many EU Member States, for example, have implemented national rules on unfair trading practices in separate legislation, within their competition laws, or in their civil code (Cafaggi and Iamiceli, 2019; Falkowski et al., 2017). At the EU level, Directive 2019/633 prohibits specific types of unfair trading practices (see, e.g., Daskalova, 2019; 2020). Typically, the legislation contains a grey list of terms that may be regarded as unfair, and a blacklist of terms that are automatically ineffective.

11 For example, Article 7 (3) of the *United Nations Model Double Taxation Convention between Developed and Developing Countries* (UN, 2017a) disallows deductions for amounts 'paid' by a permanent establishment to its head office, beyond reimbursement of actual expenses incurred by the head office for the permanent establishment.

12 On a transactional basis, for example, Brazil's transfer pricing legislation sets forth fixed profit margins and markups for related-party imports and exports (Calich and Rolim, 2012; Ilarraz, 2014; Rocha, 2017; Valadão, 2016; Valadão and Lopes, 2013).

13 For example, Article 7 (3) of the *United Nations Model Double Taxation Convention between Developed and Developing Countries* (UN, 2017a) disallows deductions for royalty payments in calculating the taxable profit of the permanent establishment of a multinational enterprise (MNE).

14 OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS) Action 4 recommends limiting an entity's net deductions for interest to a ratio of between 10 and 30 per cent of a company's earnings before interest, taxes, depreciation and amortisation

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solution to make up for the decrease in taxable income caused by making too many payments to foreign affiliates is to impose withholding taxes on outbound payments (Meyer-Nandi, 2018). As summarised elsewhere (Musselli and Bürgi Bonanomi, 2021), all such rules set bright-line restrictions designed to preserve the taxable income of subsidiaries within multinational groups.

2.3 *Regulated Allocation of Profits*

Earlier we discussed schemes that primarily deal with transactions. However, there are also prescriptive methods that concentrate on distributing profits among the different parts of a multinational enterprise (MNE) instead of assessing transactions. For example, proposals have been made for local subsidiaries to be assigned a profit margin in proportion to that of the MNE as a whole (shared net margin method) (Rao, 2018). More complex fractional apportionment methods may be used to allocate a percentage of the MNE's global income to the local subsidiary or establishment, taking into account factors that reflect its substantial activities in the jurisdiction, such as employee count, asset size, and sales in the jurisdiction (for an overview, see Picciotto, 2018). Other prescriptive approaches recommend setting minimum operating margins for various types of businesses, which can serve as a safe harbour in certain situations (Rao, 2018). If taxpayers report their taxable incomes within the safe harbour level, they will be protected from transfer pricing scrutiny. A related method involves setting a minimum tax (Durst, 2012, 647; Picciotto, 2018). This tax is based on a gross base, such as turnover, which is less susceptible to manipulation than net income. These approaches can all be implemented unilaterally by host countries as anti-abuse mechanisms in the context of diffuse trade mispricing. They essentially constitute anti-abuse measures, or safeguards against prominent forms of corporate abuse.

3 Possible Challenges under Investment Law

The adoption of the above prescriptive methods implies changes to a state's regulatory or administrative practices. These changes will affect investors, impinging on their expectations that the existing regulatory framework will remain in place. Thus, any state that decides to reform its legislative

(OECD, 2015). It has been noted that these interest limitation rules may affect the tax position of investors. This includes asset managers, asset holding companies, and downstream investment structures. As a result, the cost of investment funding may increase (Colreavy, 2021).

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environment in pursuit of the prescriptive methods discussed above may face challenges under international investment law.

Depending on jurisdictional requirements and any concrete commitments,[15] a state's regulatory adjustment of the existing tax regime or contractual price terms may trigger claims by foreign investors of 'unfair treatment' under applicable investment treaties. The customary minimum standard of 'fair and equitable treatment' has been interpreted to include legitimate expectations regarding a predictable business environment.[16] The standard may be interpreted to cover legislative changes that might adversely affect the investor's position.[17]

This leads us to the more specific issue of 'stabilisation clauses' that protect foreign investors against change-in-law risks. Stabilisation clauses are commitments whereby the state undertakes not to use its administrative or legislative powers in a way that adversely affects investors. Such clauses come in a variety of forms. They can be contractual clauses in investment contracts, legislative stability provisions in domestic law, or clauses enshrined in investment

15 The regulatory space a country has to implement prescriptive methods legally can only be assessed in context, in the light of any relevant treaty and contractual and regulatory arrangements (Musselli and Bürgi Bonanomi, 2022, 459–60). Yet some general remarks can be made regarding contractual and treaty clauses that may limit states' right to renegotiate price terms in investment contracts or amend their tax regimes to implement prescriptive approaches.

16 See, e.g., *Eco Oro Minerals Corp. v Republic of Colombia*, ICSID Case No. ARB/16/41, Decision on Jurisdiction, Liability and Directions on Quantum (9 September 2021), paras. 705–710, 717. On legitimate expectations under the fair and equitable treatment standard, see, e.g., *Thunderbird v Mexico,* Award (26 January 2006); *Gold Reserve v Venezuela*, ICSID Case No. ARB(AF)/09/1, Award (22 September 2014); *Díaz Gaspar v Costa Rica*, ICSID Case No. ARB/19/13, Award (29 June 2022). Furthermore, some arbitral tribunals have equated the stability requirement under the fair and equitable treatment standard with the same requirement existing under the international minimum standard of treatment; see, e.g., *CMS v Argentine Republic*, ICSID Case No. ARB/01/8, Award (12 May 2005) and *Occidental v Ecuador (I)*, LCIA Case No. UN3467, Award (1 July 2004).

17 See, e.g., *LG&E Energy Corp., LG&E Capital Corp. and LG&E International Inc. v Argentine Republic*, ICSID Case No. ARB/02/1, Award (25 July 2007). It has often been held that only drastic, sweeping, or unreasonable modifications to a regulatory framework relied on by an investor may rise to the level of fair and equitable treatment violation; see, e.g., *Eiser v Spain*, ICSID Case No. ARB/13/36, Award (4 May 2017) and *Silver Ridge v Italy*, ICSID Case No. ARB/15/37, Award (26 February 2019). Yet investment tribunals have expressed sometimes conflicting views on the matter. For example, some tribunals have held that the state's reasons for its reform are irrelevant to the question of liability; others have taken the view that the state has the right to make reasonable adjustments to its regulatory environment, even those affecting investors (for a review, see Hailes, 2022, 168–90; Henckels, 2015, 4).

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treaties. They may be general, covering the whole legal framework, or specific, covering, for example, the tax regime or specific taxes. They may exempt the investment from regulatory changes ('freezing' clauses *stricto sensu*), compensate for any financial losses related to changes in laws ('general equilibrium' clauses) or provide for the renegotiation of contract terms (Gjuzi, 2018, 11–87; Loncle and Philibert-Pollez, 2009, 274–79). Whatever their form, scope and impact, stabilisation clauses have in practice 'a chilling effect on governments who wish to enact new legislation for fear of being sued in international arbitration' (Smaller et al., 2014, 6).

A related constraint arises from the 'repackaging' of contractual and commercial claims into treaty claims under so-called umbrella clauses in investment agreements. Broadly worded, an umbrella clause provides that each state party to the investment treaty shall observe any other obligation it has assumed regarding the investor or the investment in its territory.[18] Such clauses may render the host state internationally liable under the investment treaty for breach of obligations stemming from investment contracts and/or domestic law.[19]

The threat of arbitration and compensation has a strong deterrent effect on developing countries, acting as a 'regulatory chill' that hinders policy development (Tienhaara, 2010). This 'chilling effect' is amplified by the fact that arbitral awards are often binding, final, and immune from review, even if the tribunal made legal errors in determining liability (for a discussion, see Henckels, 2015, 2–7). Low-income countries are especially vulnerable to these

18 See, e.g., Article 9(2) of the Germany—Ghana BIT (1995) ('(2) Each Contracting Party shall observe any other obligation it has assumed with regard to investments in its territory by nationals or companies of the other Contracting Party'). Similar language can be found in Article X of the Switzerland–Philippines BIT (1997), Article 2(2) of the Australia-Hong Kong BIT (1993) and Article 8(2) of the Germany–Jordan BIT (2007).

19 Although frequently found in BITs, the effect of umbrella clauses is still being debated. While most arbitral tribunals have understood that such clauses require states to maintain and enforce their commitments to investors, it is not clear whether such clauses cover only breaches of contracts or also undertakings related to the exercise of sovereign powers; see, e.g., *Supervision v Costa Rica*, ICSID Case No. ARB/12/4, Award (18 January 2017); *Strabag v Lybia*, ICSID Case No. ARB(AF)/15/1, Award (29 June 2020). While some investment tribunals have held that umbrella clauses 'internationalise' contracts and unilateral undertakings of the host state (e.g. *Noble Ventures, Inc. v Romania*, ICSID Case No. ARB/01/11, Award (12 October 2005), umbrella clauses are more widely regarded as having a jurisdictional function, allowing contractual claims to be analysed by the competent investment tribunal against applicable domestic law, as the case may be (e.g. *Consutel Group v Algeria*, PCA Case No. 2017–33, Final Award (3 February 2020). For this reason, recent treaty-making has witnessed a trend of the express exclusion of umbrella clause disputes from the scope of the consent to arbitrate, as in Article 11(3) of the Colombia–Switzerland BIT (2006).

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threats as they may not have the resources to match the legal power of large corporations and could end up having to pay high amounts in compensation.

This in spite of the fact that relevant case law on the matters raised above—namely, the scope of fair and equitable treatment standards, stabilisation clauses, and the elevation of claims from domestic to international law—is far from conclusive. As regards stabilisation clauses, for example, while in some arbitration awards such clauses are strictly upheld by the adjudicator, other cases recognise specific defences from domestic and international law as applicable in investment and commercial arbitration[20] (for a review, see Viñuales, 2020). Some investment cases point to a nuanced scenario whereby fiscal incentives, including stabilisation commitments, 'may be adjusted within the bounds of reasonableness and proportionality' (Hailes, 2022, 168). As we will point out in the concluding section of this chapter, legal interpretations of the issue are 'fluid and contested', shaped by a 'social process of interpretation' in what has been termed 'the inherent indeterminacy of the law' (Miola and Picciotto, 2022, 155–56).

4 Defence Arguments under International Investment Law

As briefly discussed above, there is lack of conclusive case law on the matter of the legality under international investment law of well-designed prescriptive methods implemented in the public interest despite stabilisation arrangements. However, when it comes to legal reasoning, developing countries that unilaterally adopt bona fide prescriptive measures to address tax abuse would have strong legal defence arguments in favour of such measures. Drawing on Viñuales's comprehensive analysis of 'defence arguments' under investment law (Viñuales, 2020), we introduce three broad sets of 'defences' that can be mobilised to justify a shift from transaction-based valuation systems to alternative, prescriptive valuation methods. Arguments in the first of these three sets are based on considerations of wrongdoing by the investor; those in the second are generally available excuses that can be invoked as circumstances precluding wrongfulness; the third set is based on the assessment of overarching public interests. Such defences may arise from international law, domestic

20 See, e.g., *Watkins v Spain*, ICSID Case No. ARB/15/44, Award (21 January 2020); *Oxus Gold v Uzbekistan et al.,* Award (17 December 2015); *Masdar Solar v Spain*, ICSID Case No. ARB/14/1, Award (16 May 2018); *Total v Argentine Republic*, ICSID Case No. ARB/04/1, Decision on Liability (27 December 2010); *Burlington Resources, Inc. v Ecuador*, ICSID Case No. ARB/08/5, Decision on Liability (14 December 2012).

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law, or both, and intervene at different stages (jurisdiction/admissibility, liability, quantum/compensation) (Viñuales, 2020, 13–18).[21]

4.1 *Allegations of Wrongdoing by the Investor*

The first set of arguments is based on allegations of wrongdoing by the investor who is seeking protection under a treaty. They rely on a variety of legal concepts—from 'illegality of the investment' to 'contributory fault'—that have been invoked to exclude jurisdiction/make the claim inadmissible or reduce the compensation due. As discussed below, the factual configurations involved differ, as do their implications.

At one extreme are allegations of corruption surrounding the investment whose protection is sought. Let us consider, for example, the award of a mineral concession whose financial terms result from political capture and interference, conflicts of interest, bribery, etc. In our hypothetical case, the government subsequently modifies or abrogates the concession, or adjusts its price/financial terms by adopting prescriptive valuation methods. The investor claims compensation for the loss of economic benefit. If corruption is proven, a defence would be that the investment is illegal and does not deserve protection since the benefits of an investment treaty are reserved for lawful investments.[22] For example, as reviewed by Viñuales (2020), in *Metal-Tech v. Uzbekistan* the tribunal concluded that it lacked jurisdiction over the treaty claims since the investor had violated Uzbekistan law on corruption in connection with its investment in Uzbekistan and hence the investment was not covered by the applicable treaty. Article 1(1) of the applicable Israel–Uzbekistan BIT (a legality clause) defined investments as only those implemented in compliance with local law.[23] The illegality defence can be grounded in the applicable treaty (e.g. a legality clause, as in the above case), or stem from the 'implicit understanding that illegal investments do not deserve protection' (Viñuales, 2020, 20). If proven, the illegality of the investment may exclude jurisdiction (the investment treaty does not apply) or make the claim inadmissible.

21 For a more comprehensive review of 'defence arguments' under investment law, the reader is referred to Viñuales's comprehensive review of 23 categories of defence arguments in investment arbitration, some of which may be relevant in our case (Viñuales, 2020).

22 Since the prohibition of corruption is an important public provision established in the public interest in virtually all domestic legal systems, a corrupt deal could be easily seen as a form of aggravated illegality that excludes jurisdiction or make a protection claim inadmissible.

23 Accordingly, the adjudicator concluded that the dispute did not fall within the scope of the treaty. *Metal-Tech Ltd. v Republic of Uzbekistan*, ICSID Case No. ARB/10/3. The claim concerned a joint venture for the extraction and commercialisation of molybdenum.

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Practical difficulties may arise in connection with the burden and standard of proof, particularly in a context where company directors and managers remain intentionally unaware of the details ('wilful blindness' or 'conscious avoidance'). Case law has endorsed a high standard of proof,[24] suggesting that red flag indicators raising suspicions regarding corrupt activities would, in principle, not be enough (for a more detailed assessment, see Viñuales, 2020, 46–49). This makes the detection and sanctioning of corruption difficult. The problem is compounded when the investment is made through a third party who engages in corruption. In this case the critical factor is the level of institutional control and oversight deployed by the investor in relation to the process. Failure to exercise due diligence, or fraud in the form of 'wilful blindness', may still matter when assessing the admissibility of a compensation claim (for a discussion, see Viñuales, 2020, 49–51).

Let us now move on to consider subsequent financial misconduct by foreign investors, for example when companies engage in abusive transfer practices and other tax avoidance techniques. The question is, if the host state implements prescriptive taxation methods as anti-avoidance measures in response to an investor's abusive tax avoidance, can the investor use a stabilisation clause to seek compensation? More generally, does an investor who engages in unlawful tax avoidance deserve the protection of the investment treaty? As held by the tribunal in *Lao Holdings v. Laos*, serious financial misconduct by investors in the host country, in breach of their good faith obligations, is not without treaty consequences: it bears implications in relation to the guarantee of fair and equitable treatment, as well as to investors' entitlement to compensation.[25]

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24 The precise standard of proof required by tribunals has seen some variation in case law. For instance, in *Karkey v Pakistan*, the tribunal was satisfied with 'clear and convincing evidence' of corruption, meaning unequivocal or unambiguous prima facie evidence; while in *Metal-Tech v Uzbekistan* the tribunal circumvented a clear assertion of the required standard of proof and rather pointed towards a balance of probability, considering whether corruption had been established 'with reasonable certainty'. In any event, practice suggests that global circumstances take precedence over any formal standards of proof in the consideration of corruption claims (Viñuales, 2020, 47–49).

25 *Lao Holdings N.V. v Lao People's Democratic Republic*, ICSID Case No. ARB(AF)/12/6, Award (6 August 2019), paras. 7, 105–106. In the case at hand, the tribunal held that there was sufficient evidence of serious financial misconduct by the investor in the establishment and operation of accommodation and gambling facilities in the host state, even though allegations of corruption could not be established. A series of actions attributed to the investor suggested impropriety in the interest of obtaining or retaining business, which made treaty protection claims inadmissible. While the 'clean hands' doctrine was said to have a disputable basis in international law, the tribunal nonetheless held that its rationale remained operative as a matter of equity. For a discussion, see Viñuales (2020, 95–96).

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In such contexts, a variety of concepts grounded in domestic and international law ('unclean hands', 'causation', 'contributory fault') may operate to reduce or suppress the compensation due (quantum) in investment disputes (Viñuales, 2020, 96). They operate in international law as a matter of 'equity'. The underlying rationale is that damages arising from a claimant's misconduct should not be compensated because such misconduct is their cause (Viñuales, 2020, 95). The practical difficulty is establishing a clear causal relationship between the investor's (mis)conduct and the challenged measure. It is equally challenging to identify and provide evidence of illegal tax avoidance practices, especially in situations where legal and administrative resources are limited (Musselli and Bürgi Bonanomi, 2020).

The above arguments essentially intervene at the quantum/compensation stage. Beyond compensation, the doctrine of 'abuse of right' is a legal concept that can impact liability and the admissibility of a claim. Under case law, the 'abuse of right' doctrine has been used to deny protection in situations involving 'abusive restructuring'[26] or 'multiple suits'[27] (Viñuales, 2020, 42–46). Our hypothetical case involves a different set of circumstances. Specifically, it concerns an investor who has engaged in tax abuse and is now seeking compensation due to a tax reform that aims to prevent such abusive practices. The effectiveness of the 'abuse of right' defence forwarded by the state would depend on how the adjudicator defines the requirements of this defence in the dispute context, and their more or less restrictive character.

More generally, in international law the doctrine of abuse of right is an expression of the principle of good faith (Viñuales, 2020, 42). Transposed to the field of investment protection and extended to investors, good faith would require a reasonable exercise of the investors' protection rights, in furtherance of the *legitimate* interest that the rights are intended to protect. In our context, considerations of good faith and investors' due diligence come into play, for example, in determining whether the adoption of prescriptive pricing methods encroaches on the *legitimate* economic expectations of an investor.

4.2 *Generally Available Excuses*

Some 'general excuses' can be invoked under international investment law as circumstances precluding wrongfulness: the treaty is technically breached, but

26 This refers to a situation where an investor, who is not protected by an investment treaty, restructures its investment to fall under the coverage of a treaty in view of a specific foreseeable dispute.

27 A scenario where companies within the same group routinely bring claims against the same measures under various treaties.

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the breach is excused. In domestic law, for example, the defence may build on concepts of 'hardship' or 'unforeseeability', equated with the French '*théorie de l'imprévision*'; in international law, the same rationale underpins the customary *rebus sic stantibus* clause codified in Article 62 of the Vienna Convention on the Law of Treaties (Viñuales, 2020).

Such excuses generally refer to a fundamental change of the circumstances in which an agreement was concluded.[28] For example, booming demand and supply scarcity for some critical minerals in the clean energy transition may lead to a fundamental supply/demand imbalance that may require a renegotiation of pending contracts. The objective would be to re-establish the balance of the contract in a changed scenario.

Yet the availability of this defence depends on various requirements that can be interpreted with varying levels of strictness in the dispute context. To be successful, for example, a plea of 'hardship' must meet stringent requirements—drawing from contract law and practice. As codified in model contract law (Article 6.2.2 (b) and (d), the International Institute for the Unification of Private Law (UNIDROIT) Principles), 'hardship' may not be invoked if, for example, adverse price developments could reasonably have been taken into account by the disadvantaged party at the time the contract was concluded, or when the risk of the events was assumed by the disadvantaged party. This seems to apply to price fluctuations that are a result of market fundamentals and business cycles, which cannot be considered unforeseeable.[29] Eventually, as discussed in the concluding section of this chapter, much depends on the standard of review adopted by the adjudicator when scrutinising the factual and legal aspects of the state's decision.

28 Drawing on (model) private law, there is 'hardship' where 'the occurrence of events fundamentally alters the equilibrium of the contract either because the cost of a party's performance has increased or because the value of the performance a party receives has diminished' (first part of Article 6.2.2 of the UNIDROIT Principles of International Commercial Contracts). In simpler terms, there is hardship when an event fundamentally alters the contract's equilibrium because of increased cost or diminished value of performance received.

29 In some cases, however, unexpected events such as the COVID-19 pandemic can cause a price shock that could not have been predicted at the time a contract was made. In such situations, it may be reasonable to argue that the party that was negatively affected by the price increase could not have reasonably anticipated the event at the time the contract was concluded.

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4.3 *Public Interests*

Finally, a range of defence arguments support the view that a state can permissibly regulate in the public interest without being liable for compensating the investor. This argument is based on legal concepts of 'police powers' and 'international public policy'. The exercise of 'police powers' refers to the exercise of governmental functions.[30] This notion, grounded in general international law, acknowledges a state's 'entitlement, indeed [its] duty to regulate' (Viñuales, 2020, 66), and posits that 'the exercise of regulatory powers is permitted unless prohibited' (Viñuales, 2020, 66). The principle acknowledges that the exercise of police powers may be subject to limitations, including by treaty norms such as investment protection standards. Going one step further, 'international public policy' commonly refers to 'a narrow core of principles of fundamental importance to a wide number of legal orders' presumed to 'override any inconsistent instrument, agreement or claim' (Viñuales, 2020, 35). The notion is generally advocated when tensions arise with higher-ranking values that cannot be superseded transactionally, such as 'public order' and 'human rights'. This brings us to the following section, which explores human rights claims.

5 Counterarguments under Human Rights Law

In Section 4 we discussed the 'defence arguments' a state can mobilise under international investment law. This section will explore a different approach and briefly touch upon the 'counterclaims' that a state can present to assert its right to regulate in the public interest. These claims are based on human rights law and public policy. Although they are similar to the legal grounds for defence that we previously discussed in Section , they serve as a source of rights and legal claims rather than as a defence.

5.1 *A Human Rights Framing of the Issue*

If we were to approach the issue from the perspective of human rights law, we would follow this line of reasoning:

– Commodity trade mispricing and tax avoidance have significant human rights impacts: they prevent developing countries, and especially the least developed, from mobilising and spending the public

30 The term 'police', in its original English, coming from the Greek *politeia*, i.e. 'policy' or 'government' (Viñuales, 2020, 60).

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financial resources required for inclusive and equitable social and economic development;

- Under human rights law, the state has the obligation to respect, protect—including from deprivation by third parties—and fulfil human rights;
- In the exercise of this duty to protect and fulfil, the state has the right (and duty) to regulate corporate abuse tightly, including by enacting effective anti-abuse measures.

Thus, in contexts where undervalued commodity exports and profit shifting drain development resources, prescriptive measures to address mispricing and tax avoidance may be explicitly anchored in a state's duty to protect against human rights abuses by third parties, and to progressively realise human rights (CESCR, 2017).

A rigid application of stabilisation clauses implies that states agree to refrain from using their legislative or administrative prerogatives in a manner that adversely affects the investor. Under human rights law, this would directly encroach on the state's obligation to fulfil human rights and to protect them from deprivation by third parties.[31] Regarding contractual and legislative stabilisation clauses in particular, there is an issue of ranking between international law commitments—in the field of human rights–and the contractual/legislative stabilisation mechanism. Importantly, Principle 4 of the Office of the United Nations High Commissioner for Human Rights (OHCHR) 2015 Principles for Responsible Contracts (OHCHR, 2015) focuses on stabilisation

31 See *Sempra v Argentina*, ICSID Case No. ARB/02/16, Award (28 September 2007), paras. 331–332; *Feldman Karpa v Mexico*, ICSID Case No. ARB(AF)/99/1, Award (16 December 2002), para. 103; and *Phoenix Action Ltd. v Czech Republic*, ICSID Case No. ARB/06/5, Award (15 April 2009), para 78. The mobilisation of human rights defences in scenarios where a legitimate expectation of stability might exist is still nascent but may arguably be seen in *Veolia Propreté v Egypt*, ICSID Case No. ARB/12/15, Award (25 May 2018), paras. 19, 181, 215 and 234. Among other issues, the case concerned a change of minimum wage legislation made by the host state in opposition to economic balance commitments made to the investor, which rendered contractual obligations for the latter more onerous. The respondent prevailed. Otherwise, human rights defences have been raised in connection with the rights of indigenous peoples and minorities in *South American Silver v Bolivia*, PCA Case No. 2013–15, Award (22 November 2018), paras. 638–640 and *Houben v Burundi*, ICSID No. ARB/13/7, Award (12 January 2016), para. 177; the right to water in *CMS Gas Transmission Co v Argentina*, ICSID Case No. ARB/01/8, Award (12 May 2005); consumer rights in *Azurix v Argentina*, ICSID Case No. ARB/01/12, Award (14 July 2006), para. 254; and the rights to life, health, education and personal integrity in *EDF and others v Argentina*, ICSID Case No. ARB/03/23, Award (11 June 2012), para. 192.

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clauses: while recognising investors' need for financial stability, the Principles underscore that stabilisation clauses have the potential to restrict states' policy space in areas of human rights. The Principles for Responsible Contracts recommend that if stabilisation clauses are included in contracts, they should be 'carefully drafted so that any protections for investors against future changes in law do not interfere with the state's bona fide efforts to implement laws, regulations or policies, in a non-discriminatory manner, in order to meet its human rights obligations' (OHCHR, 2015, 15).

5.2 *Conflict Resolution and Conflict Avoidance*

Under public international law, how will the adjudicator proceed when stabilisation commitments prevent states from adopting anti-abuse measures in the public interest? There are two possible approaches: one involves regime conflict and conflict resolution techniques, while the other emphasises interpretation and conflict avoidance.

5.2.1 Relationship of Conflict

The first approach recognises that conflicts of law may arise between two bodies of law that impose conflicting requirements on host states: human rights law and investment treaties with stabilisation clauses. This reflects a situation whereby specialised lawmaking systems such as 'human rights law' and 'investment law', each possessing its own principles and institutions, have evolved 'with relative ignorance of legislative and institutional activities in the adjoining fields and of the general principles and practices of international law' (International Law Commission, 2006, para. 8). The result is 'conflicts between rules or rule-systems, deviating institutional practices and, possibly, the loss of an overall perspective on the law' (International Law Commission, 2006, para. 8).

If permitted under the applicable law, the adjudicator will then resort to techniques of conflict resolution in its efforts to deal with tensions between legal rules and principles in public international law. There are well-established legal techniques (*lex specialis*, *lex posterior*, *lex superior*) capable of resolving normative conflicts or overlaps (International Law Commission, 2006). One relevant technique in our context may be the maxim *lex specialis derogat legi generali*. It suggests that 'whenever two or more norms deal with the same subject manner, priority should be given to the norm that is more specific' (International Law Commission, 2006,105). The risk is that the adjudicator comes to the conclusion that human rights law does not contain an obligation that is sufficiently unconditional and precise to challenge the validity of

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detailed investment treaty clauses.[32] The *lex superior* (hierarchy) rule may also play a role. It posits that some rules of international law enjoy a superior position. Article 103 of the United Nations (UN) Charter stipulates that the obligations of UN Member States under the Charter prevail, in the event of a conflict, over their obligations under any other international agreement. The Article has been taken to suggest that the Charter-endorsed promotion and protection of human rights constitutes an international public order to which other treaty regimes must conform. Yet the scope of the supremacy clause of the UN Charter is not settled and its precise meaning and scope of application are contested (Liivoja, 2008).

5.2.2 Relationship of Interpretation

A second approach seeks to avoid or mitigate conflict through 'systemic integration', or 'harmonisation', instead of conflict (International Law Commission, 2006). This involves using legal reasoning to reconcile seemingly conflicting provisions 'as parts of some coherent and meaningful whole' (International Law Commission, 2006, para. 414). The approach moves from the assumption that, in international law, there is a strong presumption against normative conflict (International Law Commission, 2006, para. 37). It restates the applicability of general international law in treaty practice. Going one step further, it leads to a constructive generalisation of the core values of multi-layered legal orders, integrating into the process of legal reasoning 'a sense of coherence and meaningfulness' (International Law Commission, 2006, para. 419).

Moving from a 'systemic' approach to international law, the adjudicator may argue that the use of prescriptive methods provides greater certainty and predictability, which are the very objectives of investment protection law. Indeed, well-designed prescriptive methods provide the predictability and certainty required for economic actors to plan their transactions and can be seen as a way to interpret the arm's-length principle in a transparent and predictable manner. By emphasising the importance of stability and predictability in legal systems, the adjudicator would reconcile seemingly conflicting provisions through interpretation. This links with the fact that legal rules are 'normative',

32 In the Kokopelli case (Case C 59/11 *Association Kokopelli v Graines Baumaux*), for example, the Court of Justice of the EU concluded that the International Treaty on Plant Genetic Resources for Food and Agriculture (ITPGRFA) did not include any provisions that, as regards their content, were unconditional and sufficiently precise as to challenge the validity of EU seed marketing legislation. The case opposed human rights and business claims in relation to the EU prohibition to market seeds of non-registered varieties.

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which means that their interpretation is necessarily 'purposive' (Miola and Picciotto, 2022, 156).

This approach also means that adjudicators should find a way to balance both the investor's (legitimate) expectations and the host state's right to regulate in the public interest (Gehne and Brillo, 2014; Gjuzi, 2018). The approach has implications for the 'method' and 'standard of review' employed by the adjudicator.[33] In reviewing the prescriptive measure, the adjudicator should strike the right balance between overseeing a state's compliance with its obligations under the investment treaty and respecting the state's right to regulate in the public interest (Bürgi Bonanomi, 2015; Henckels, 2015). Some suggest that a 'proportionality analysis' approach to review, along with an appropriate level of deference in situations of normative or empirical uncertainty, would help achieve this balance (Henckels, 2015, 193–94). The approach entails a method of review whereby the adjudicator assesses the legitimacy of the objective of the measure, its suitability to achieve its stated objective, its necessity, and possibly the importance of achieving the objective vis-à-vis competing interests, with appropriate deference to the regulating state in situations of normative uncertainty.[34] When evaluated under this method and standard of review, prescriptive methods are considered proportional means to achieve desirable outcomes if they are non-discriminatory and rationally connected to their stated goal, more effective than less restrictive methods in reaching their objective, and designed in a balanced manner (based on market data and industry practices) (for more details, see Musselli and Bürgi Bonanomi, 2022).

33 A method of review is 'a technique used by adjudicators (such as proportionality analysis) to determine the permissibility of interference with a right or interest', whereas the standard of review 'refers to the intensity with which the method of review is applied—whether taking a strict or more deferential approach' (Henckels, 2015, 31). Together, they are the 'critical factor' in the tribunal's determination of whether a government may permissibly regulate in the public interest without being liable for compensation to the investor (Henckels, 2015, 31).

34 As developed in administrative law in continental Europe, the doctrine of proportionality 'requires public restrictions of fundamental rights of citizens to be effective, efficient and adequate in order to be legitimate' (Bürgi Bonanomi, 2015, 151). The first dimension—*effectiveness*—considers the adequacy of a measure to reach a desired objective. The second aspect—*efficiency*—considers whether the regulatory action 'is the mildest among those theoretically fit to achieve the same practical goal', by intervening 'as little as possible' (Bürgi Bonanomi, 2015, 151). The third aspect—*proportionality in the narrowest sense*—calls for overall balancing of interests. It necessitates considering the objective pursued against the interests and values sacrificed in its pursuit. It implies that the policy measure 'is balanced and that the associated trade-offs do not stand in disproportion to the goals that are to be achieved' (Bürgi Bonanomi, 2015, 151).

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6 Concluding Remarks

As discussed in the previous sections, in theory host states can mobilise different legal constructs and principles, and adjudicators can use suitable interpretative and judicial review methods to allow for effective, non-discriminatory and bona fide prescriptive methods. Deductive reasoning and doctrinal analysis—and some arbitral jurisprudence—provide some interpretative leeway under international investment law for prescriptive methods aimed at addressing abusive commercial practices. Case law and the scholarly debate emphasise principles of good faith, investors' due diligence, and proportionality as legal reasoning instruments that soften the interpretative rigidity of investment protection clauses.

In practice, however, whether the lines of defence here discussed will be upheld by an adjudicator in a specific case depends on various factors. These include the inclination of the adjudicator to apply public international law principles to investment disputes instead of solely considering the investment treaty on its own in isolation from the broader body of international law. It also depends on the set of legal norms that the parties agree would apply to the contract, and their choice of the relevant forum to adjudicate disputes.

As discussed, much also depends on the 'standard of review' employed by the adjudicator with reference to 'the degree of scrutiny' of the state's decision by an adjudicator. This is also a matter of legal culture and legal context. A stringent, 'intrusive' standard of review would result in the strict oversight of a state's compliance with its treaty obligations; a more 'deferential' approach would substantially defer to the national authority when assessing the right of the state to regulate in the public interest without being liable to compensate a foreign investor.

Finally, the outcome of an investment dispute regarding the implementation of prescriptive valuation methods would ultimately depend on specific contextual and legal details, such as the specific wording of the relevant treaty and contractual and regulatory arrangements in place. For example, a stabilisation clause that explicitly freezes the financial terms of an investment is less amenable to purposive interpretation than a stabilisation clause that requires compensation for financial losses relating to changes in law.

Ultimately, the lines of defence here discussed may or may not be upheld by the adjudicator, depending on the unique legal and factual aspects of the case, the specific practices of legal interpretation deployed and the varying sociolegal contexts in which they are embedded. This reflects the 'inherent indeterminacy of the law', whereby legal concepts are abstract and general, leaving room for interpretation in specific situations (Miola and Picciotto, 2022, 156). Which

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brings back the importance of prescriptive valuation methods as a way to manage legal uncertainty. Well-designed prescriptive methods provide predictability and certainty, narrowing the broad scope for judicial interpretation of legal principles such as the arm's-length principle. By taking a formulaic, textualist approach to lawmaking, prescriptive methods move away from imprecise and open-textured norms that require determination of the legal outcome based on interpretation. This shift to bright-line rules reduces legal uncertainty and the indeterminacy of legal outcomes, which abusive corporate practices have so prominently exploited so far.

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