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Arbitration in Investment Disputes: Balancing Investor Rights and State Sovereignty

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Investment arbitration has evolved as a critical means for resolving disputes between foreign investors and host states. While it fosters foreign direct investment by offering protection to investors, it also raises concerns about state sovereignty, especially in regulating public interest areas like environmental and social welfare policies. This article traces the development of investment arbitration from early diplomatic protections to the modern institutional frameworks of ICSID and UNCITRAL. It highlights the growing tension between investor rights and state regulatory autonomy, with criticisms of ISDS favouring investors and potentially stifling state policies. Recent reforms, including treaty modifications and the incorporation of corporate social responsibility, aim to balance investor protections with state sovereignty, reflecting a shift towards more equitable arbitration systems. The future of ISDS reform will hinge on addressing transparency, fairness, and the need for states to regulate in the public interest without undermining investor confidence.

Keywords: *arbitration, dispute, investor, sovereignty.*

INTRODUCTION

Investment arbitration has emerged as a crucial mechanism for resolving disputes between foreign investors and host states, fostering the growth of foreign direct investment (FDI) while

raising questions about state sovereignty. Rooted in the evolution of international law governing foreign investments, this system, particularly through the Investor-State Dispute Settlement (ISDS) mechanism, allows investors to bypass domestic courts and seek resolution in international forums. While this provides investors with security and protection from discriminatory state actions, it also challenges the autonomy of states to regulate within their borders, especially in matters of public interest, such as environmental and social welfare policies.

The historical development of investment arbitration reflects an evolution from early reliance on diplomatic protection, where investors depended on their home states to pursue claims, to a more direct and neutral method of dispute resolution. The rise of international investment agreements (IIAs) and the establishment of institutions like the International Centre for Settlement of Investment Disputes (ICSID) have solidified investment arbitration as the preferred forum for investor-state disputes.[1] The enforcement of arbitral awards under conventions such as the New York Convention has further enhanced the predictability and reliability of this system, making it integral to the modern investment landscape.

However, the growing reliance on ISDS has also sparked significant debate over its impact on state sovereignty. Critics argue that the system overly favours investors, creating a 'regulatory chill' where states may hesitate to enact necessary public welfare regulations out of fear of costly arbitration claims. Concerns over indirect expropriation and the restriction of state regulatory power have led to calls for reform, with recent years witnessing a shift towards balancing investor protections with the preservation of state sovereignty. Modern IIAs now increasingly emphasise the right of states to regulate public welfare, reflecting a broader trend towards more equitable frameworks.

As global challenges like climate change and sustainable development gain prominence, the evolving nature of investment arbitration continues to reflect these shifts. Recent reforms, including efforts to enhance transparency, clarify treaty language, and incorporate corporate social responsibility (CSR) provisions, demonstrate a move towards a more balanced and

[1] D A Lopina, 'International Centre for Settlement of Investment Disputes: Investment Arbitration for the 1990s' (1988) 4(1) Ohio State Journal on Dispute Resolution

accountable system. These reforms aim to address concerns about transparency, fairness, and the broader implications of investment arbitration on state autonomy, ensuring that the system remains responsive to the needs of both investors and host states in a rapidly changing world.

This article explores the evolution of investment arbitration from its early roots to the present day, highlighting the ongoing tension between investor protection and state sovereignty. It also examines recent trends in ISDS reform and the growing emphasis on balancing investor rights with the regulatory autonomy of states, setting the stage for future developments in this critical area of international law.

EVOLUTION OF INVESTMENT ARBITRATION

The origins of international investment arbitration are deeply rooted in the historical development of laws governing foreign investments and the principles of State responsibility. Initially, foreign investors relied on diplomatic protection from their home States to address violations of property or contractual rights by host States. However, this method was highly unpredictable, as diplomatic protection was discretionary and often ineffective.[2] The shortcomings of State-to-State dispute resolution underscored the need for a more reliable mechanism for protecting foreign investments. Early methods of investment protection involved both customary international law and contracts between investors and States, with these contracts governed by domestic law. The introduction of treaties governing investor-state relationships, subject to international law, set the stage for modern investor-state arbitration, offering a more predictable and enforceable means of resolving disputes.

As the need for more effective protection of foreign investments became clear, two mechanisms evolved: contractual protection and treaty protection. Contracts between investors and States were governed by the domestic laws of the host country, while treaties between States were regulated by international law. Despite their differences, both mechanisms provided for investor-state arbitration, which allowed investors to directly pursue legal claims against States without relying on diplomatic protection. This convergence of contractual and treaty-based

[2] Chester Brown and Kate Miles, *Evolution in Investment Treaty Law and Arbitration* (Cambridge University Press 1988)

arbitration solidified international investment arbitration as the preferred method of resolving investor-state disputes, offering investors a more dependable and neutral forum. The enforcement of arbitral awards was further facilitated by international conventions like Article 54 of the ICSID Convention and Article V of the New York Convention[3], ensuring a more effective redress mechanism for foreign investors.[4]

The evolution of investment arbitration marked a significant departure from earlier methods of resolving disputes, which were often characterised by 'gunboat diplomacy', the use of military force to settle issues, particularly involving debt claims. A key turning point came with the establishment of the Permanent Court of Arbitration (PCA) in 1899, which provided a peaceful means of resolving international disputes. One of the earliest cases under the PCA involved foreign creditors seeking compensation from Venezuela, with the tribunal endorsing the use of force in the absence of other mechanisms. This incident sparked global calls for peaceful dispute resolution, leading to the Drago-Porter Convention of 1907, which prohibited the use of force in settling private debt claims. This shift in international law paved the way for the development of modern investment arbitration, with peaceful dispute resolution becoming the norm.

By the early 20th century, investment arbitration began to take shape, with the first notable instance of 'mixed arbitration' in 1935. The case of Radio Corporation of America (RCA) v China[5] was a milestone, as it involved a dispute over the exclusivity of a radio communications license. What made this case significant was the direct arbitration between RCA and the Chinese government, with the U.S. and China agreeing to resolve the issue without diplomatic intervention. This case exemplified the growing acceptance of arbitration as a legitimate method for resolving disputes between States and private investors. As the field matured, the PCA took on an increasing role in administering such disputes, with additional institutions like the United Nations Commission on International Trade Law (UNCITRAL) and the International Centre for Settlement of Investment Disputes (ICSID) emerging to facilitate global investment arbitration.

[3] New York Convention, art V
[4] ICSID Convention, Regulations and Rules, art 54
[5] *Radio Corporation of America (RCA) v China* [1935]

In recent decades, investment arbitration has become an established and critical field in international law with a strong institutional framework. However, the evolution of international investment agreements (IIAs) has highlighted the need for a balance between protecting foreign investors and safeguarding the regulatory autonomy of host States. Earlier generation IIAs tended to prioritise investor protections, which led to concerns about 'regulatory chill,' where States were hesitant to enact necessary public welfare regulations for fear of triggering investor claims. This concern prompted the development of third-generation IIAs, which emphasise the preservation of States' rights to regulate while still maintaining obligations to protect foreign investors. These agreements reflect a growing recognition of the need to accommodate public policy objectives, particularly in areas like environmental protection and public health.

An emerging trend in recent IIAs is the inclusion of corporate social responsibility (CSR) provisions, marking a shift from the traditional approach that only imposed obligations on States. Modern IIAs increasingly hold foreign investors accountable for adhering to ethical business practices, environmental standards, and social responsibility. This change aligns with global efforts to promote sustainable and inclusive development, with both States and investors sharing responsibilities in achieving these goals.[6] CSR provisions reflect the broader trend toward balancing investor protections with the host State's ability to regulate for the public good, including in areas such as environmental sustainability and social justice. As IIAs evolve, they continue to integrate provisions that protect States' regulatory space while ensuring that investment climates remain favourable for both investors and host countries.

BALANCING INVESTOR PROTECTIONS AND STATE SOVEREIGNTY

Balancing investor protections and state sovereignty in investment arbitration is an ongoing challenge as the global investment landscape continues to evolve. Investment arbitration, particularly through mechanisms like investor-state dispute settlement (ISDS), allows foreign investors to bypass domestic courts and seek resolution in international forums. While ISDS plays a crucial role in fostering foreign direct investment by providing protections to investors,

[6] Dr. Yulia Levashova, 'The Accountability and Corporate Social Responsibility of Multinational Corporations for Transgressions in Host States through International Investment Law' (2018) 18(2) Utrecht Law Review 40-55 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3204456> accessed 12 August 2024

it also raises concerns about the potential limitations it imposes on state sovereignty. As more states face arbitration claims related to policies enacted in the public interest, such as environmental or labour regulations, the need for frameworks that safeguard both investor rights and sovereign autonomy has become increasingly evident.

The reliance on ISDS mechanisms has sparked debates over the balance of power between investors and states. While investors benefit from protections against biased domestic courts and unfair treatment, states may feel constrained in their regulatory authority.[7] For instance, when states implement policies for environmental protection or public health, they may face ISDS claims alleging indirect expropriation. This tension between investor protections and a state's right to regulate has led to growing criticism and calls for reform, with many advocating for a system that better balances the rights of investors with the ability of states to govern in the public interest.

In response to these concerns, several strategies have been proposed to reform the ISDS framework. One of the key suggestions is the requirement for investors to exhaust local legal remedies before resorting to international arbitration.[8] This approach encourages greater reliance on domestic legal systems while still providing a pathway to international arbitration if local remedies fail. Another reform focuses on clarifying the language within investment treaties, particularly definitions related to expropriation and fair treatment, which are often sources of dispute. Clear treaty language can reduce ambiguity and reestablish a more equitable balance between investor rights and state sovereignty.

Recent reforms have also sought to enhance state autonomy and ensure greater transparency in arbitration processes. For example, newer treaties are increasingly incorporating provisions that clearly define the scope of state regulations, emphasising the right of states to regulate in areas critical to public welfare. These provisions help protect regulatory space for states, ensuring that

[7] Davy Karkason, 'Sovereignty Impacts of Investor-State Dispute Settlement' (*Transnational Matters*, 23 December 2023) <https://www.transnationalmatters.com/understanding-the-sovereignty-impacts-of-investor-state-dispute-settlement/> accessed 12 August 2024

[8] Lisa Sachs, 'ISDS Reform at UNCITRAL: Two Guiding Principles' (*Columbia Center on Sustainable Development*, 26 October 2019) <https://ccsi.columbia.edu/news/isds-reform-uncitral-two-guiding-principles> accessed 12 August 2024

public policy decisions are not unduly influenced by the threat of arbitration. The incorporation of these safeguards into treaties reflects a growing acknowledgement that states need to retain the discretion to make policy decisions in the public interest without fear of disproportionate retaliation from investors.

The future of investment arbitration will likely involve ongoing discussions about how to balance investor protections and state sovereignty in a way that addresses the concerns of both investors and host states.[9] As new challenges arise and the global landscape shifts, the need for fair and transparent arbitration systems will remain critical. Reforms aimed at fostering dialogue, cooperation, and equitable treatment will be essential to navigating this complex landscape, ensuring that both investor confidence and state regulatory autonomy are upheld in a balanced manner.

THE TENSION BETWEEN INVESTOR RIGHTS AND STATE SOVEREIGNTY

The Investor-State Dispute Settlement (ISDS) system has increased the debate over the boundaries of state sovereignty, as governments must balance their independent policymaking with the obligations established by international trade and investment treaties. ISDS allows foreign investors to challenge state decisions in international tribunals, often placing governments in a dilemma.[10] They must choose between accommodating investor demands or facing high compensation claims for breaching investment protections. These disputes can significantly impact national budgets, divert public resources, and limit a state's autonomy as its decisions are scrutinised under international investment law.

At the core of the ISDS controversy lies the tension between upholding democratic policymaking and protecting foreign investments. ISDS claims can lead to a phenomenon known as 'regulatory chill,' where governments may avoid enacting strong regulations due to concerns

[9] Davy Karkason, 'The Future of ISDS: The Reform Initiatives' (*Transitional Matters*, 06 December 2023) <https://www.transnationalmatters.com/decoding-the-future-of-isds-the-reform-initiatives/> accessed 12 August 2024

[10] Karkason (n 7)

over potential investor backlash.[11] While the ISDS mechanism aims to safeguard investors from arbitrary or discriminatory state actions, fostering confidence in cross-border investments, it can also inhibit a state's ability to enact policies in the public interest. Governments may be hesitant to implement regulations on environmental protection, public health, or social welfare due to fears of triggering investor claims. This situation raises the need for a delicate balance, one where foreign investments are protected without compromising the sovereign right of states to govern in the best interests of their people.

State sovereignty, which is a fundamental principle of international law rooted in the Treaty of Westphalia, grants states ultimate authority over their territories. It allows them to regulate individuals, property, and events within their jurisdiction. However, sovereignty is not absolute. States are bound by both internal and external obligations, the latter often taking the form of international treaties and agreements. The principle of '*pacta sunt servanda*' requires states to uphold these agreements once they have committed to them, inherently limiting their sovereignty by accepting international obligations.

The distinction between the state's right to regulate and the power to expropriate is crucial in the context of international investment law. Lawful expropriation, typically requiring compensation, occurs when a state seizes foreign property by legal standards set forth in investment treaties. Failure to meet these standards can result in unlawful expropriation, leading to state responsibility for restitution or reparation. However, regulatory actions taken in good faith for public welfare, such as protecting the environment or public health, are generally not considered expropriation. This allows states to exercise their regulatory powers without triggering compensation obligations, providing the necessary flexibility to pursue public interest policies while safeguarding against investor claims.

[11] Vera Weghmann and David Hall, 'The unsustainable political economy of investor–state dispute settlement mechanisms' (2021) 87(3) International Review of Administrative Sciences <https://doi.org/10.1177/00208523211007898> accessed 12 August 2024

RECENT TRENDS IN ISDS REFORM

The year 2022 marked a transformative period for Investor-State Dispute Settlement (ISDS) reforms, with significant progress achieved through key institutions like ICSID, UNCITRAL, and the Energy Charter Treaty (ECT). These reforms were designed to modernise the legal frameworks governing investment arbitration, addressing contemporary challenges related to transparency, third-party funding (TPF), and the balance between investor protection and state sovereignty.[12] As international arbitration evolves to reflect shifting political, economic, and environmental concerns, these changes aim to create a more transparent and equitable system of dispute resolution.

One of the most notable advancements was the adoption of the new ICSID rules in March 2022. The revised rules introduced groundbreaking measures to enhance transparency, including provisions for publishing arbitral awards unless parties objected. For the first time, ICSID also mandated the disclosure of third-party funding arrangements, a move intended to increase accountability in arbitration proceedings.[13] However, some critics argue that requiring the disclosure of TPF could place funded parties at a disadvantage, potentially revealing strategic information to their opponents. Despite this concern, the amendments are widely seen as a step toward greater fairness and clarity in ISDS processes.

In parallel, the Energy Charter Treaty (ECT) underwent significant modernisation to align its provisions with global sustainability goals. The reforms, finalised in 2022, were designed to support states' right to regulate in areas such as environmental protection while narrowing the definitions of 'investor' and 'investment'. This aimed to ensure that only entities engaged in

[12] Caroline Kittelmann and Sarah Lemoine, 'An Overview of the First Draft of the Multilateral Instrument on ISDS Reform' (*Kluwer Arbitration Blog*, 06 September 2024) <https://arbitrationblog.kluwerarbitration.com/2024/09/06/an-overview-of-the-first-draft-of-the-multilateral-instrument-on-isds-reform/> accessed 12 August 2024

[13] Alberto Favro, 'New ICSID Arbitration Rules: A Further Step in The Regulation of Third-Party Funding'(*Kluwer Arbitration Blog*, 03 June 2022) <https://arbitrationblog.kluwerarbitration.com/2022/06/03/new-icsid-arbitration-rules-a-further-step-in-the-regulation-of-third-party-funding/#:~:text=On%20March%2021%2C%202022%2C%20the%20Member%20States%20of%20the%20International%20Centre%20for%20Settleme> accessed 12 August 2024

substantial business activities would benefit from the treaty's protections.[14] Despite these advancements, critics argue that the revised ECT still falls short in addressing the need for enhanced international cooperation on issues like technology transfer and financial support for developing nations, particularly in the context of transitioning to a net-zero economy.

UNCITRAL's Working Group III also made substantial strides in ISDS reform during 2022, particularly with the development of a Multilateral Instrument on Investment Reform (MIIR). The MIIR seeks to create a unified legal framework for resolving investor-state disputes, though debates continue over its retroactive application and the extent to which states should be allowed to deviate from its provisions in future treaties. Additionally, progress was made on the joint ICSID-UNCITRAL Code of Conduct for Adjudicators, which aims to address concerns about 'double hatting,' where arbitrators take on multiple roles in different disputes. While the Code has received broad support, disagreements remain over how to enforce its provisions effectively.

Amid these institutional reforms, the future of ISDS continues to be a topic of intense debate. For decades, ISDS has been seen as a cornerstone of international investment law, protecting foreign direct investment (FDI) and providing a mechanism for resolving disputes between investors and states.[15] However, concerns about transparency, inconsistent rulings, and the perceived imbalance in favour of investors have led to growing dissatisfaction with the system. As such, various reform efforts aim to recalibrate the ISDS framework, ensuring it meets the needs of both investors and states in a rapidly evolving global economy.

The ongoing reform initiatives reflect the broader challenges faced by the ISDS system. Critics argue that the assumption underlying ISDS that domestic courts in developing countries cannot fairly adjudicate foreign investment disputes may no longer be valid[16]. Furthermore, studies have questioned whether adopting ISDS frameworks leads to increased foreign direct investment in developing countries. These critiques have led to more radical reform proposals,

[14] Toby Fisher, 'The Modernised Energy Charter Treaty: The New Text' (*Kluwer Arbitration Blog*, 15 October 2022) <https://arbitrationblog.kluwerarbitration.com/2022/10/15/the-modernised-energy-charter-treaty-the-new-text/ > accessed 12 August 2024
[15] Karkason (n 9)
[16] *Ibid*

including the establishment of regional investment courts and the renegotiation or termination of existing international investment agreements. While some countries have already taken steps to withdraw from ISDS frameworks, the future of global investment arbitration remains uncertain, with many looking to these reforms to strike a new balance in the system.

CONCLUSION

The evolution of international investment arbitration has been a complex journey, shaped by the need to provide foreign investors with reliable mechanisms for dispute resolution while protecting state sovereignty. Starting from the use of diplomatic protection and state-to-state negotiations, the development of treaties and contractual agreements marked the foundation of modern investment arbitration. The establishment of institutions like ICSID and UNCITRAL further cemented this approach, offering investors neutral forums to address grievances and arbitral awards enforceable under international conventions. As this system matured, it became clear that investment arbitration was not just a tool for protecting investors but also a means of fostering global economic cooperation.

However, the increasing reliance on Investor-State Dispute Settlement (ISDS) mechanisms has sparked significant debate regarding the balance between investor rights and state regulatory autonomy. Concerns over regulatory chill, where states hesitate to enact necessary public welfare laws for fear of investor claims, have led to calls for reform. Recent trends reflect a shift towards including clearer language in investment agreements, reinforcing states' rights to regulate in areas like environmental protection and public health without undermining investor confidence. These changes underscore the ongoing challenge of finding an equitable balance between fostering foreign direct investment and maintaining state sovereignty.

As ISDS reform efforts continue, the future of investment arbitration is likely to be shaped by the evolving dynamics between investors and host states. The introduction of transparency measures, corporate social responsibility provisions, and greater clarity in treaties all aim to modernise the system and address longstanding concerns. Ultimately, the success of these reforms will depend on their ability to create a fair, transparent, and balanced arbitration

framework that protects both investor interests and the sovereign right of states to govern in the public interest.