

# *Legal Conflicts between State Sovereignty and Investor Protection in International Investment Arbitration*

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**Abstract:** With the advancement of globalization, the conflict between state sovereignty and investor protection has become increasingly prominent in international investment law. This article analyzes the origins of this conflict and its manifestation in international investment arbitration, particularly in areas such as expropriation, environmental policies, and public health. By examining classic cases, it reveals how international investment treaties protect investor rights while impacting the flexibility of state policies. Finally, the article explores the necessity of reforming international investment arbitration mechanisms and proposes a more balanced legal framework to reconcile state sovereignty and investor protection.

## **1. Introduction**

As globalization progresses, international investment has become a key driver of economic growth. However, this has led to increasing conflicts between investors and states, particularly in the realm of international investment arbitration. These conflicts, centered on the balance between state sovereignty and investor protection, not only concern economic distribution but also the degree to which states are constrained by international law when crafting policies.

Since the 1970s, mechanisms like the International Centre for Settlement of Investment Disputes and Bilateral Investment Treaties have clarified and strengthened investor rights. However, when investors challenge state policies through arbitration, they often invoke clauses related to fair treatment, legitimate expectations, and non-discrimination. States, on the other hand, must balance these demands with domestic needs, such as social stability and public health, which can sometimes trigger disputes over whether such policies amount to "unfair treatment."

The tension between state sovereignty and investor protection has become a prominent issue in academic debates. Critics argue that existing international investment frameworks fail to adequately balance the two, placing undue pressure on states, particularly when implementing public policies. This article explores how this conflict plays out in international investment arbitration, examines relevant cases, and suggests potential reforms to achieve a more balanced legal framework.

## **2. The Basic Framework of International Investment Arbitration**

### **2.1 The Role and Development of International Investment Agreements (IIAs) and Bilateral Investment Treaties**

International Investment Agreements (IIAs) and Bilateral Investment Treaties (BITs) developed rapidly in the second half of the 20th century and became key tools for global investment protection and dispute resolution. These agreements provide a series of legal safeguards for foreign investors, ensuring that their investments in host countries are not subject to discrimination and that they receive fair treatment. BITs, in particular, have played a crucial role in this process. Since the signing of the first BIT in the early 1960s, they have become the cornerstone of the international investment legal system. With the increase of global cross-border investments, BITs have become more important in the resolution of international investment disputes and have gradually developed into a central mechanism for ensuring rights protection in the multinational legal environment<sup>[1]</sup>.

However, as BITs have been widely signed, their content has gradually revealed potential legal conflicts, especially when investors challenge host country policies through arbitration. For example, the Investor-State Dispute Settlement (ISDS) mechanism in the North American Free Trade Agreement (NAFTA) has sparked widespread discussion on the conflict between state sovereignty and investor protection. By analyzing the texts of BITs like NAFTA, we can observe that although investors have been granted stronger protection, this protection often limits the space available for host countries to formulate policies. Similarly, the Comprehensive and Progressive Agreement for Trans-Pacific Partnership also includes investor protection clauses, which not only offer high levels of protection for investors but also subject host countries to legal challenges from foreign investors in areas involving public policies, such as environmental protection and public health.

### **2.2 The Structure of International Investment Arbitration**

International investment arbitration mainly resolves disputes between foreign investors and host states. Key bodies include ICSID, an affiliate of the World Bank, and UNCITRAL. ICSID handles disputes with a strict legal framework, while UNCITRAL offers more flexibility, especially for agreements without a dedicated dispute mechanism.

Arbitration panels typically consist of three members: one chosen by the investor, one by the host state, and a neutral third arbitrator. Although designed for fairness, this structure has been criticized for favoring investors.

For instance, in the *Enron v. Argentina* case, the arbitration panel ruled that Argentina's emergency measures violated fair treatment clauses, restricting the country's ability to implement emergency policies during its 2001 economic crisis.

### **2.3 The Principles of Investor Protection**

In international investment arbitration, the protection of investors is a crucial principle. Fair treatment, non-discriminatory treatment, and legitimate expectations are the three most fundamental and important aspects<sup>[2]</sup>. These principles are usually embodied in the provisions of international investment agreements and BITs, aiming to ensure that foreign investors are treated equally to domestic investors and are not subject to undue discrimination by the host country.

The principle of fair treatment requires the host country to provide foreign investors with fair and non-discriminatory treatment. This principle extends beyond physical protection to include legal and administrative safeguards, ensuring that investors enjoy transparent and just treatment in legal

proceedings. However, the implementation of this principle often encounters difficulties, especially when host countries implement policies or measures that affect foreign investors' interests. For example, the *Philip Morris v. Australia* case involved Australia's anti-smoking policies. Philip Morris argued that Australia's tobacco packaging laws deprived the value of its investment, violating its legitimate expectations and fair treatment under the investment agreement.

In addition to fair treatment, the principle of non-discriminatory treatment is also embodied in many international investment agreements. This principle requires the host country not to discriminate against foreign investors in areas such as law, taxation, and finance, ensuring that they receive the same treatment as domestic investors. However, despite the intent to protect investors' rights, this principle can sometimes make it difficult for host countries to implement policies with public interest, such as those related to environmental protection or public health. Countries that implement restrictive policies to strengthen environmental or public health management may face legal challenges from investors who argue that these measures violate the non-discriminatory treatment principle<sup>[3]</sup>.

These investor protection clauses are theoretically designed to safeguard foreign investments, but in practice, they may constrain the public policies of host countries. In several international arbitration cases, the conflict between investor protection and state sovereignty has become increasingly evident, particularly when states adopt emergency economic measures or formulate new policies. This conflict highlights the need for international investment law to strike a balance between protecting investors' rights and allowing states the freedom to implement their policies.

### **3. Legal Conflicts between State Sovereignty and Investor Protection**

#### **3.1 Legal Analysis of State Sovereignty**

State sovereignty is the supreme authority a nation holds within its territory, allowing it to independently formulate and implement policies. Historically, sovereignty was seen as absolute, meaning a state had full control over its domestic affairs without external interference. However, globalization has complicated this view, as cross-border investments and international trade require states to balance sovereignty with international commitments.

The theory of absolute sovereignty emphasizes a state's unrestricted control over its territory. Yet, globalization limits its applicability, as states must consider international agreements and market demands when crafting policies. On the other hand, limited sovereignty suggests that state authority is constrained by international law. This approach, now dominant in international investment law, allows states to maintain policy autonomy while also fulfilling their international obligations.

In the globalized world, state sovereignty is evolving, with international economic rules and investment law playing an increasingly critical role. The legal framework around sovereignty now directly impacts both state autonomy and investor protection.

#### **3.2 Legal Basis and Theoretical Analysis of Investor Protection**

International investment law, through treaties like BITs and IIAs, protects foreign investors. This protection is grounded in two main theories: free-market economic theory and universal justice theory.

Free-market economic theory advocates for a global system where investors' rights are fully protected, and state policies do not disrupt the free flow of capital. It emphasizes uniform legal protections, including fair treatment, non-discrimination, and legitimate expectations.

Universal justice theory, however, seeks to balance investor rights with the social and environmental needs of the host country. It argues that international law should ensure that host

countries can regulate public policies while protecting investors. This theory underpins the need to balance investor protection with state sovereignty, especially when national policies change.

In practice, investor protection clauses, such as fair treatment and non-discrimination, often clash with host countries' policy autonomy. When public policies, like those on health or the environment, change, investors may seek compensation through arbitration, challenging the host country's sovereign rights to regulate.

### 3.3 Analysis of Specific Conflict Scenarios

Legal conflicts between investor protection and state sovereignty often arise in cases involving expropriation, compensation, environmental policies, and public health.

A key example is *Enron v. Argentina*, where Argentina implemented emergency measures during an economic crisis, restructuring the energy sector and affecting foreign investors. Enron argued that Argentina violated fair treatment clauses in the investment agreement, while Argentina defended its actions as sovereign measures necessary for economic stability. This case highlights tensions between expropriation, compensation, and state sovereignty during crises.

Another notable case is *Philip Morris v. Australia*, where Australia's strict tobacco packaging regulations, aimed at public health, impacted Philip Morris's investment. The company sought compensation, highlighting conflicts between environmental and public health policies and investor interests.

The COVID-19 pandemic further complicated the issue, as countries imposed public health measures that disrupted foreign investments. Whether investors could challenge these policies based on international investment agreements became a significant legal question, emphasizing the challenge of balancing public health and investor protection.

These cases illustrate the complex legal dynamics between state sovereignty and investor rights, with global public policies adding additional layers of complexity to international investment law.

## 4. Resolution Paths for the Legal Conflict between State Sovereignty and Investor Protection

### 4.1 Mechanisms for Resolving Conflicts in International Law

International investment law provides a framework for resolving conflicts between state sovereignty and investor protection. These frameworks are primarily implemented through International Investment Agreements (IIAs) and Bilateral Investment Treaties (BITs), where disputes between investors and host states are typically resolved via arbitration mechanisms. While arbitration procedures offer protection for investors, they also expose the potential risks to state sovereignty, as they allow external entities to challenge national policies.

In the context of international law, principles such as fair and equitable treatment (FET) and legitimate expectations play a central role. These principles ensure that investors are granted a stable and just legal environment in the host state, while acknowledging the state's freedom to implement public policies. However, the tension remains in how these principles intersect with a state's policy autonomy, especially when it comes to policy adjustments related to expropriation or emergency economic measures.

For example, in expropriation cases, the state usually bases its actions on public interest grounds such as social welfare, national security, or environmental protection. However, investors may seek compensation through international investment treaties when expropriation occurs. The legal conflict in these cases lies in finding a balance between respecting state sovereignty and protecting investors' rights. International law's mediation in these disputes largely depends on how arbitral tribunals interpret and apply the balance between public interest and fair compensation.

Effectively resolving the conflict between state sovereignty and investor protection requires cooperation and dialogue between the parties involved in the dispute. The outcome of international investment arbitration often relies not only on the legal text of treaties but also on the tribunal's discretion and its contribution to international law and the global economic order.

## **4.2 The Need for Reform in the International Investment Arbitration System**

The international investment arbitration system is increasingly criticized for issues of transparency, fairness, and the imbalance of interests. Reforming the system is essential to better address the complexities of today's global economy.

A key area for reform is enhancing transparency. Although many cases publish judgments, the arbitration process often lacks full transparency, particularly regarding tribunal procedures and the reasoning behind decisions. Advocates propose public hearings and full disclosure of tribunal decisions to improve fairness.

Additionally, a more balanced mechanism is needed to consider the perspectives of multiple stakeholders, including civil society and environmental groups. Traditionally, disputes involve only investors and host states, but expanding participation in arbitration would ensure more equitable outcomes, especially in cases with significant public policy implications.

The debate over reforming the Investor-State Dispute Settlement (ISDS) mechanism is intensifying. Critics argue that ISDS favors investors and lacks transparency. Proposals include greater oversight on tribunal composition, improved procedural norms, and the introduction of a credible appeals process.

A proposed solution is the establishment of a Multilateral Investment Court, which would replace the current ICSID and ISDS systems with impartial judges and transparent procedures. This court would improve the fairness and legitimacy of international investment law, ensuring a better balance between investor protection and state sovereignty, while supporting sustainable global economic development.

## **4.3 The Role of State Sovereignty and Investor Protection in Future Reforms**

As global challenges such as climate change, pandemics, and social justice continue to evolve, the tension between state sovereignty and investor protection is likely to intensify. Future reforms should seek to address this conflict in a way that allows for both the protection of investors' rights and the recognition of a state's legitimate interests in public policy.

**Flexible Treaty Provisions:** International investment treaties could be amended to incorporate more flexible provisions that allow states to implement public policies without fear of arbitrary legal challenges. For example, introducing clauses that permit states to take emergency measures in times of crisis, such as during economic recessions or health emergencies, could offer states more leeway in safeguarding public welfare without jeopardizing investor protection.

**Public Interest Safeguards:** Future reforms might involve introducing clearer safeguards for public interest, allowing states to take actions in areas such as environmental protection, human rights, and public health without facing extensive financial penalties. Tribunals could take into account whether the state's actions are proportional to the need to protect public goods.

**Stakeholder Involvement:** Incorporating a broader range of stakeholders into the arbitration process would be an important step toward balancing investor protection with broader social interests. This could include the participation of civil society, environmental organizations, and even international bodies, ensuring that the broader societal context is taken into account when decisions are made.

**Alternative Dispute Resolution Mechanisms:** In addition to formal arbitration, introducing

alternative dispute resolution mechanisms such as mediation or conciliation could offer a more flexible and mutually agreeable way to resolve disputes. These mechanisms could provide greater opportunities for negotiation, allowing for solutions that better accommodate both state interests and investor rights.

In conclusion, resolving the legal conflict between state sovereignty and investor protection will require systemic reforms in international investment law. These reforms should focus on transparency, fairness, and multi-stakeholder involvement to create a more balanced and just system. As the global economic landscape continues to evolve, it is critical that international investment law adapts to address emerging challenges while ensuring that the fundamental principles of investor protection and state sovereignty are preserved.

## 5. Conclusion

The conflict between national sovereignty and investor protection has always been a central issue in international investment law. Globalization has exacerbated this conflict, especially as national policy adjustments collide with the protection of investors' rights. Although international investment treaties safeguard investors' rights, balancing a nation's policy freedom with investors' legitimate expectations remains a challenge in practice.

To resolve this conflict, the key lies in enhancing dialogue between investors and host countries, promoting transparency in treaties, and establishing a more equitable arbitration mechanism. In recent years, international investment law has shifted towards more balanced solutions, protecting investors' rights while respecting national policy autonomy. Future research should focus on how to combine international courts and arbitration mechanisms to improve transparency and fairness in dispute resolution.

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