Examining the Interaction and Conflict Between Foreign Investment Arbitration and the Principle of State Sovereignty

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Abstract

Foreign investment arbitration, as the most significant mechanism for resolving disputes between states and foreign investors, has played a decisive role in the international investment law system over recent decades. Designed to create a secure and predictable environment for investors, this system imposes obligations that go beyond the classical standards of state responsibility. Conversely, the principle of state sovereignty—rooted in the longstanding tradition of public international law—continues to serve as the principal foundation for domestic regulation, development priorities, and the state's ability to adopt sovereign measures. Consequently, a structural conflict has emerged between the requirements of investment arbitration and the sovereign regulatory powers of states in key areas such as environmental protection, natural resources, public health, and economic policymaking. The primary objective of this study is to explore the nature, dimensions, and mechanisms of interaction and conflict between these two domains. Using a descriptive–analytical method, the author concludes that although the tension between investor protection and state sovereignty is inevitable, recent reform-oriented approaches—including the inclusion of regulatory clauses, enhanced transparency, revision of older bilateral investment treaties, and the movement toward establishing a multilateral investment court—can create an appropriate balance between these spheres. Overall, achieving equilibrium between investment arbitration and the principle of state sovereignty is not only possible but necessary, and the future of the international investment framework is inevitably moving toward strengthening the role of states while preserving the efficiency of arbitration.

Keywords: interaction and conflict; foreign investment arbitration; international investment law; ICSID; investor protection.

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1. Introduction

In recent decades, the rapid expansion of foreign investment and the widespread conclusion of bilateral and multilateral investment treaties have further highlighted the role of international arbitration in resolving disputes between private investors

and states. Investment arbitration, particularly within the framework of the International Centre for Settlement of Investment Disputes, has been designed as a mechanism operating with relative independence from domestic legal systems and aims to create a stable, predictable, and fair environment for foreign investment. However, this rapid expansion of arbitration has generated significant theoretical and practical challenges relating to the fundamental principle of state sovereignty, a principle that emphasizes the freedom of states to regulate domestic affairs, determine public policy, and exercise sovereign authority (Said et al., 2021). The central point of tension arises when state actions—whether general regulatory measures, legislative reforms, nationalization, or judicial decisions—intersect with the rights and legitimate expectations of foreign investors. In such circumstances, international arbitrators must strike a balance between state defenses grounded in sovereign authority and the protection of investors' contractual or treaty-based rights. This point represents the most critical arena of interaction and conflict between foreign investment and state sovereignty.

Moreover, the expansion of contemporary approaches in public international law, including the concept of the "right to regulate," has redefined the boundaries of state responsibility and the permissible scope of state intervention vis-à-vis investors (Işıker, 2020). At the same time, certain arbitral awards, due to broad interpretations of standards such as fair and equitable treatment or indirect expropriation, have prompted criticism for weakening states' authority to adopt public policy measures (Leonhardsen, 2022).

Recent research has also emphasized these challenges. For example, Liu (2024) examines the conflict between state sovereignty and investor protection in international investment arbitration and concludes that with the advance of globalization, international investment has become a primary driver of economic growth. Nevertheless, this has resulted in an increase in disputes between investors and states, especially in investment arbitration, where the central issue concerns the balance between sovereignty and investor protection, not only in terms of economic distribution but also regarding the extent to which states are constrained by international law when formulating policies (Liu, 2024). Since the 1970s, mechanisms such as ICSID and bilateral investment treaties have clarified and strengthened investors' rights.

Similarly, Baltag et al. (2023) emphasize the role of the state's right to regulate and environmental considerations, concluding that investor–state dispute settlement remains a framework in which environmental obligations, human rights, and corporate social responsibility can be integrated within international investment law, enabling both states and investors to benefit from and remain accountable to their respective obligations (Baltag et al., 2023).

Al-Adba (2014), in his doctoral dissertation, examines the limitations of state sovereignty when hosting foreign investment and argues that the value of investor–state arbitration lies in the enforceability of its awards; without enforceability against states, the entire process would lose its practical significance. Accordingly, he suggests that enforcement mechanisms against states should be reinforced through stronger protective structures (Al-Adba, 2014).

Domestic research has also addressed these issues. For instance, Akbari Fatmeh Sarā and Heydar (2022) conclude that foreign investment is one of the most important drivers of development in developing countries, and therefore states make extensive efforts to attract foreign investors. They further argue that bilateral investment treaties in Iran aim to promote foreign direct investment by offering advantages and ensuring the protection and security of investors (Akbari Fatmeh Sarā & Ḥeydar, 2022).

Based on the foregoing and according to the subject of this study, the central question of the present research is: What is the nature and what are the mechanisms of interaction and conflict between foreign investment arbitration and the principle of state sovereignty, and how can a balance be established between effective investor protection and the preservation of states' regulatory authority?

Accordingly, the main hypothesis proposes that although the tension between investor protection and state sovereignty is inevitable, this conflict can be managed through the revision of older treaties, inclusion of regulatory clauses, enhancement of transparency, and movement toward creating a multilateral investment court (Croisant, 2025). Within this context, the primary objective of this paper is to provide a comprehensive analysis of the points of interaction and conflict between these two domains, examine arbitral practice, analyze existing legal theories, and propose mechanisms for establishing a balance between investor protection and regulatory sovereignty.

The examination of interaction and conflict between foreign investment arbitration and the principle of state sovereignty demonstrates that although these two fields pursue distinct objectives, they inevitably intersect in numerous areas. Investment arbitration is designed to ensure security and predictability for investors, whereas the principle of state sovereignty emphasizes freedom in regulation and the exercise of sovereign authority (Tang & Guo, 2025). The findings of prior research and the present analysis indicate that although the conflict between investor protection and state discretion is unavoidable, it can be managed through treaty reforms, regulatory clauses, greater transparency, and efforts to establish a multilateral investment court (Henckels, 2025). Overall, achieving a balance between the efficiency of investment arbitration and the preservation of state sovereignty is not only possible but necessary. The future of the international investment regime will inevitably move toward strengthening the role of states while maintaining the effectiveness of arbitration. This trajectory can ensure investor security while allowing states to implement public policies without fear of violating international obligations.

2. Theoretical and Conceptual Foundations

The theoretical foundations of this research rest on two main pillars: first, foreign investment arbitration as a dispute-resolution mechanism between investors and states; second, the principle of state sovereignty as a cornerstone of public international law. Foreign investment today is regarded as a major driver of development in many developing countries, and states therefore seek to maximize foreign investment inflows (Akbari Fatmeh Sarā & Ḥeydar, 2022). The relationship between investment arbitration and state sovereignty is characterized by constant interaction and tension: on one hand, foreign investment requires a secure and predictable environment, which international arbitration provides; on the other hand, states must preserve their freedom to regulate and implement public policies. Consequently, the theoretical foundations highlight the need to balance investor protection with the preservation of state authority (Ranjan, 2017).

2.1. Concept and Nature of Foreign Investment Arbitration

Foreign investment arbitration is a mechanism that allows investors to bring claims directly against the host state before international tribunals, without resorting to domestic courts. Such arbitration is typically based on bilateral investment treaties (BITs), free trade agreements (FTAs), or multilateral instruments such as the Energy Charter Treaty. Its principal features include neutrality, enforceability, and flexibility (Bhattacharjee, 2024). Investment arbitration, particularly within the ICSID framework, has gained significant importance and is recognized as the primary tool for protecting foreign investors. Nevertheless, critiques have emerged regarding its potential to restrict state policy space and limit public interest regulation (Paine, 2018).

2.2. The Concept of State Sovereignty

State sovereignty is one of the most fundamental principles of public international law and refers to the exclusive authority of states over their internal and external affairs without external interference. While historically understood in absolute terms, the modern globalized context has given rise to a more flexible interpretation. Sovereignty encompasses the authority to legislate, regulate public policy, manage natural resources, and determine development priorities (Said et al., 2021). At the same time, international obligations and peremptory norms (jus cogens) may impose limits on state sovereignty. Thus, contemporary sovereignty is a combination of independence and responsibility toward the international community (Tang & Guo, 2025).

2.3. The Relationship Between Foreign Investment and State Sovereignty

The relationship between foreign investment and state sovereignty is inherently dualistic and tension-filled. States must provide legal and economic guarantees to attract foreign investment, yet such guarantees may restrict their regulatory autonomy. Tensions often arise in matters involving nationalization, environmental policy, public health, and economic reforms (Liu, 2024). Studies indicate that investment treaties and arbitral practices have frequently strengthened investor rights while

reducing state flexibility. New approaches, such as including regulatory clauses and developing a multilateral investment court, aim to restore balance in this relationship (Kalra, 2023).

3. The Legal Framework of Investment Arbitration and Its Challenges to State Sovereignty

This framework rests on three main pillars: the ICSID system, the UNCITRAL Rules, and bilateral investment treaties. Each of these mechanisms enables investors to bring claims against states at the international level. At the same time, these systems have created serious challenges for the principle of state sovereignty, as they expose states to extensive and sometimes unforeseen responsibilities.

3.1. The ICSID System

The 1965 Washington Convention marked the beginning of the establishment of the International Centre for Settlement of Investment Disputes (ICSID). The Convention was drafted with the aim of creating an independent institution for resolving disputes between member states and foreign investors and rapidly became the most important forum for investment arbitration at the international level (Kirtland & Connolly, 2018).

The Convention's foundations are built on the principle of consent of the parties, meaning that no dispute may be submitted to ICSID arbitration without the consent of both the host state and the investor. The jurisdiction of the tribunal is limited to disputes arising directly out of an investment, and the definition of "investment" has gradually been shaped through arbitral practice.

The enforcement of ICSID awards has a unique feature: under Article 54 of the Convention, member states are obliged to recognize and enforce ICSID awards as if they were final judgments of their own courts, without the possibility of substantive review by national courts. This guarantees the complete independence of ICSID from domestic judicial systems and enhances investor confidence (Schill, 2022).

However, this very independence has attracted criticism, as states effectively lose the ability to control or supervise the arbitral process and may be confronted with awards that place significant constraints on their public policies (Dautaj & Chevalier, 2022). Recent studies have shown that enforcement of awards has, in some instances, encountered difficulties linked to state immunity from execution, which has provoked serious debate about the proper balance between investor protection and the preservation of state sovereignty (Reinisch, 2024).

3.2. UNCITRAL Arbitration and Complementary Rules

The UNCITRAL Arbitration Rules were first adopted in 1976 and later revised in 2010 and 2013. They were designed as a flexible framework for both commercial and investment arbitration and have gained particular prominence in investor–state disputes (UNCITRAL). One of the key features of these rules is their suitability for ad hoc arbitration, meaning that parties can conduct arbitration under the UNCITRAL Rules without relying on a permanent institution. The independence and impartiality of arbitrators are of central importance in this system, and arbitrators must be selected in a manner that secures the confidence of both parties.

The 2013 reforms introduced transparency provisions into these rules, so that investor–state arbitrations, which had previously been conducted largely in secrecy, are now more frequently accompanied by the publication of documents and, in some instances, public hearings (United, 2014). This development has contributed to enhancing the legitimacy of arbitration, although criticisms remain concerning high costs and procedural complexity. Overall, the UNCITRAL Rules are viewed as complementary to the ICSID system, offering investors and states a more flexible and, in many respects, more transparent mechanism for dispute resolution (Bhattacharjee, 2024).

3.3. The Role of Bilateral Investment Treaties

Bilateral investment treaties (BITs) emerged in the 1960s as the primary instruments for protecting foreign investors, and today thousands of such treaties have been concluded between states. Typically, BITs contain provisions defining investment, setting out the obligations of the host state, establishing dispute-settlement mechanisms, and regulating transfers of capital (Jacob, 2014).

The most important obligations of states under BITs include: fair and equitable treatment, which requires states to provide a stable and non-discriminatory environment for investors; full protection and security, which entails ensuring the physical and legal security of the investment; safeguards against expropriation, under which direct or indirect expropriation is permissible only upon payment of full compensation; and national treatment and most-favoured-nation treatment, which place foreign investors in a position at least as favourable as that of domestic investors and investors from third states (Batifort & Heath, 2018).

In practice, these obligations have significantly constrained state regulatory powers, as almost any regulatory action may be alleged to breach one of these standards. Recent research has shown that expansive interpretations of such obligations have led to an increase in claims against states and have underscored the need to revisit and modernize older generations of BITs (Paradell Trius, 2015).

3.4. Legal Challenges to State Sovereignty

In recent decades, investment arbitration has become one of the most important mechanisms for resolving disputes between foreign investors and states. Despite its advantages in creating a secure and predictable environment for investment, this system presents serious challenges to the principle of state sovereignty.

The first challenge concerns the limitation of regulatory powers. States need to adopt regulations and public policies to achieve developmental, social, and environmental objectives, yet many of these measures are treated in international arbitration as violations of treaty obligations (Baltag et al., 2023). This tension is particularly visible in areas such as environmental protection and public health. For example, in disputes involving the tobacco or energy industries, states have faced substantial claims as a result of imposing stringent regulatory measures.

The second challenge involves extensive and unforeseen liabilities. Standards such as fair and equitable treatment and indirect expropriation have been interpreted in ways that significantly expand the scope of state responsibility beyond what was originally envisaged at the time of treaty conclusion. As a result, states may be held liable and ordered to pay substantial compensation even for ordinary regulatory actions. Numerous studies have argued that this situation has produced a form of "regulatory chill," whereby states refrain from enacting new legislation or reforming public policies out of fear of facing international claims (Ranjan, 2017).

Another challenge relates to economic and political impacts. Investment arbitration proceedings often impose very high costs on public budgets. Some states have been compelled to pay billions of dollars in compensation, placing considerable strain on public finances and undermining public confidence in the legal and political system (Işıker, 2020). Furthermore, mechanisms such as investor–state dispute settlement (ISDS) effectively grant foreign investors powers that exceed those of domestic citizens, as investors may bring claims directly against states at the international level, whereas domestic citizens lack such access. This discrepancy produces an imbalance between foreign and domestic investors and raises serious questions about the fairness and legitimacy of the international investment regime (Van Harten, 2023).

Another challenge is the conflict with public policies and national priorities. To achieve objectives such as environmental protection, the promotion of public health, or the management of natural resources, states require a substantial degree of regulatory freedom. Yet numerous arbitral awards have treated state measures in these fields as violations of treaty obligations and have resulted in adverse rulings against states. This has been particularly problematic for developing countries that depend on protective and reform-oriented policies (Al-Adba, 2014).

A further concern is the erosion of the perceived legitimacy of the international investment law regime. Critics argue that investment arbitration is overly oriented toward protecting foreign investors and undermines the role of states as regulators in

the public interest. These criticisms have prompted many states to reconsider older treaties and, in some cases, to withdraw from certain arbitration mechanisms (Karkason, 2023).

These challenges demonstrate that the conflict between investor protection and state sovereignty is, to a large extent, unavoidable. Nonetheless, measures such as incorporating explicit regulatory clauses in new treaties, enhancing transparency in arbitral proceedings, revisiting substantive standards of protection, and moving toward the establishment of a multilateral investment court can help mitigate these tensions (Croisant, 2025; Tang & Guo, 2025). The future of the international investment regime will inevitably move toward strengthening the role of states while preserving the functional effectiveness of arbitration (Kalra, 2023).

4. The Interaction Between Investment Arbitration and the Principle of State Sovereignty

The interaction between investment arbitration and the principle of state sovereignty is one of the central debates in international investment law. On one hand, investment arbitration is designed as a mechanism to ensure security and predictability for foreign investment; on the other, the principle of state sovereignty underscores the freedom of states to regulate and implement public policies. This interaction can be examined along four main axes: the legitimacy of investment arbitration, the possibility of flexible interpretation of obligations, the tools available to preserve sovereignty within the arbitral system, and examples of positive interaction in arbitral practice (Langford et al., 2017; Liu, 2024).

4.1. Legitimacy of Investment Arbitration

The legitimacy of investment arbitration is founded on states' consent to arbitration and their participation in the conclusion of investment treaties. By signing bilateral or multilateral investment treaties, states accept arbitral jurisdiction and allow foreign investors to bring their claims at the international level. This consent constitutes the principal basis of arbitral legitimacy, since without it no arbitration would be enforceable (Paradell Trius, 2015). However, the legitimacy of arbitration has always been contested, particularly when states feel that they have transferred part of their sovereign authority to an international body. Recent research indicates that legitimacy is strengthened when states play an active role in the treaty-making process and incorporate provisions that preserve their right to regulate. Moreover, the legitimacy of arbitration is challenged when states adopt emergency measures to protect the public interest, which underscores the need to revisit and modernize older treaties.

The possibility of flexible interpretation of obligations is also one of the most important tools for creating a balance between investor protection and the preservation of state sovereignty. The "margin of appreciation" doctrine, which migrated from human rights law into the field of investment arbitration, allows states greater room for maneuver in designing and implementing public policies within the treaty framework. In addition, the minimum standard of treatment has been accepted as an international benchmark aimed at preventing overly broad and unpredictable interpretations (Paine & Sheargold, 2023). These approaches ensure that state obligations are interpreted in a manner that both safeguards investors' rights and allows states to pursue their public policy objectives.

Tools for preserving sovereignty within the arbitral system are likewise of great importance. Regulatory carve-outs allow states to exclude specific measures in public domains such as environmental protection or public health from the scope of treaty obligations. National security exceptions enable states, in situations of emergency or security threats, to take necessary measures without incurring international responsibility. Provisions expressly permitting environmental and health regulation have been incorporated into new treaties, enabling states to implement protective policies in these areas. Stabilization clauses in investment contracts can also allow states to introduce legal changes under specified conditions. Taken together, these tools help states, while accepting arbitration, to preserve their sovereignty and avoid excessive constraints.

Examples of positive interaction between investment arbitration and state sovereignty can also be found in arbitral practice (Grigera, 2024). In some awards, the right of states to regulate has been expressly recognized; for instance, in cases involving environmental or public health policies, tribunals have accepted that states may adopt regulations to protect the public interest even where such measures negatively affect foreign investors. In other instances, excessive protection of investors has been curtailed, particularly where claims have been based on unrealistic expectations or expansive interpretations of substantive

standards. These examples demonstrate that a balance between investor protection and state sovereignty is attainable and that arbitral practice is evolving toward greater recognition of the state's right to regulate. Overall, the interaction between investment arbitration and the principle of state sovereignty shows that while conflict between these two domains is inevitable, an enduring equilibrium can be achieved through appropriate legal and interpretive tools. The future of the international investment regime will inevitably move toward strengthening the role of states while maintaining the functional effectiveness of arbitration.

4.2. Possibility of Flexible Interpretation of Obligations

The possibility of flexible interpretation of obligations in investment arbitration is one of the most important tools for achieving balance between investor protection and the preservation of state sovereignty. In recent decades, broad interpretations of standards such as fair and equitable treatment and indirect expropriation have been widely criticized, as they have led to unexpected liabilities for states and have restricted their regulatory freedom. In response to these criticisms, new theories and doctrines have emerged that aim to redefine the scope of state obligations and grant states greater space to pursue public policies.

One such doctrine is the "margin of appreciation," initially developed in human rights law and the case law of the European Court of Human Rights and subsequently transplanted into the field of investment arbitration. This doctrine allows states, within the framework of investment treaties, greater discretion in adopting decisions related to the public interest. In other words, arbitrators are expected to accept a degree of "tolerance" or "flexibility" when assessing state measures and to intervene only when state conduct is clearly unreasonable or discriminatory. This approach is particularly important in sensitive areas such as environmental protection, public health, and national security, where states must be able to implement protective policies without constant fear of international responsibility (Leonhardsen, 2022).

Alongside this doctrine, the minimum standard of treatment also plays a crucial role in limiting the scope of states' obligations. Rooted in customary international law, this standard guarantees a basic level of protection for investors while preventing every state measure from being characterized as a treaty breach. Under this standard, only conduct that is manifestly unfair, discriminatory, or contrary to fundamental principles of international law constitutes a violation. Accordingly, states may continue to implement legitimate regulatory measures even if such measures adversely affect the economic interests of investors (Paine, 2018).

The possibility of flexible interpretation of obligations thus shows that the international investment regime is moving toward greater acceptance of the state's right to regulate. This trend not only helps preserve the legitimacy of arbitration but also contributes to establishing a durable balance between investor protection and state sovereignty.

4.3. Tools for Preserving Sovereignty in the Arbitral System

One of the most significant challenges in the system of investment arbitration is the restriction of states' powers to implement public policies. To address this challenge, a range of legal tools have been developed in investment treaties and international contracts with the aim of safeguarding state sovereignty against the pressures arising from investor claims.

– **Regulatory carve-outs.** These provisions allow states to exclude specific measures in public domains such as environmental protection, public health, or social policy from the scope of treaty obligations. For example, some modern investment treaties include clauses enabling states to implement environmental policies without fear of breaching investment protections (Bhardwaj, 2025). Such provisions have become especially important in the context of climate change, where states must be able to adopt stringent regulations to reduce carbon emissions.

– **National security exceptions.** These exceptions confer upon states the authority to take necessary measures in situations of emergency or security threats without incurring international responsibility. However, reliance on such exceptions has been controversial, as some investors argue that states may abuse them (Henckels, 2025). Arbitral practice shows that tribunals usually approach these exceptions with caution and accept them only where there is a genuine and substantiated security threat.

– **Environmental and health regulation clauses.** New treaties often contain explicit provisions allowing states to adopt protective policies in the fields of environmental protection and public health. These clauses are designed in particular to

prevent "regulatory chill," a situation in which states refrain from enacting new legislation out of fear of international claims (Paine & Sheargold, 2023). Including such provisions in investment treaties has contributed to enhancing the legitimacy of arbitration and to its broader acceptance by public opinion.

– **Stabilization clauses.** These clauses are typically included in investment agreements between states and foreign companies and are intended to provide legal stability for investors. However, some forms of stabilization clauses allow states to introduce legal changes under specified conditions, thereby protecting both investor rights and the state's ability to pursue public policies (Nadakavukaren & et al., 2023). In effect, stabilization clauses function as a balancing mechanism between investor protection and state sovereignty.

Taken together, these tools indicate that the international investment regime is gradually moving toward greater recognition of the state's right to regulate. The use of regulatory carve-outs, national security exceptions, environmental and health clauses, and stabilization mechanisms can reduce tensions between investor protection and state sovereignty and strengthen the overall legitimacy of the arbitral system.

Examples of Positive Interaction

- *Tecmed v. Mexico, 2003* [Tecnicas Medioambientales Tecmed S.A. v. United Mexican States, ICSID Case No. ARB(AF)/00/2, 2003]: This case arose from the revocation of a license for a landfill facility. The investor claimed that this measure violated the fair and equitable treatment standard and amounted to indirect expropriation. In its award, the tribunal, while recognizing the importance of the investor's "legitimate expectations," emphasized that such expectations must be balanced against the state's public policy objectives (Baltag et al., 2023). The tribunal held that Mexico's environmental measures pursued legitimate public interests and could not be treated simply as a breach of treaty obligations. This case demonstrated that investor protection should not come at the expense of disregarding states' environmental policies (Grigera, 2024).
- *Methanex v. United States, 1976–2005* [Methanex Corporation v. United States of America, UNCITRAL, 1976–2005]: The Canadian company Methanex brought a claim against the United States after the prohibition of the use of the chemical MTBE in fuel. The investor argued that this measure constituted indirect expropriation. The UNCITRAL tribunal held that the U.S. measure, adopted for environmental protection, was legitimate and did not amount to a breach of treaty obligations (Paine & Sheargold, 2023). This case is particularly important because it showed that environmental measures adopted by states may take precedence over the economic interests of investors and that non-discriminatory regulation adopted in good faith to protect the environment does not automatically trigger compensation (Tang & Guo, 2025).
- *Philip Morris v. Uruguay, ICSID, 2016* [Philip Morris Brands Sàrl, Philip Morris Products S.A. and Abal Hermanos S.A. v. Oriental Republic of Uruguay, ICSID Case No. ARB/10/7]: In this case, Philip Morris challenged Uruguay's strict regulations on tobacco packaging and advertising. The ICSID tribunal, relying on the police powers doctrine, held that Uruguay's measures adopted to protect public health were legitimate and did not constitute a breach of treaty obligations (Baltag et al., 2023). The decision confirmed that public health regulations and public policy measures may prevail over investors' interests and that bona fide public health measures do not amount to indirect expropriation or a violation of the fair and equitable treatment standard (Grigera, 2024). This case has been recognized as a landmark in affirming states' right to regulate in the field of public health.
- *Urbaser v. Argentina, 2016* [Urbaser S.A. and Consorcio de Aguas Bilbao Biskaia, Bilbao Biskaia Ur Partzuergoa v. Argentine Republic, ICSID Case No. ARB/07/26]: In this dispute, the Spanish company Urbaser brought a claim against Argentina over measures taken in the water and sewage sector. While examining the investor's claims, the tribunal referred for the first time to "corporate human rights responsibilities" and emphasized that states are entitled to adopt regulatory measures to ensure public access to water (Baltag et al., 2023). The award showed that human rights considerations can play a role in investment arbitration and that investors' treaty rights must be balanced against their social responsibilities and the state's duty to protect fundamental rights (Tang & Guo, 2025). This case is regarded as an example of recognition of states' right to regulate in the sphere of public services.

5. Conflicts and Tensions Between Investment Arbitration and the Principle of State Sovereignty

Investment arbitration is designed as a mechanism to protect foreign investors, but in practice it frequently comes into conflict with the principle of state sovereignty. These conflicts arise at three main levels: the conduct of proceedings, the enforcement of awards, and the exercise of the right to regulate. In addition, well-known arbitral cases demonstrate that such tensions have sometimes escalated into serious crises between investors and states (Liu, 2024).

5.1. Conflict at the Stage of Proceedings

One of the most significant points of conflict between investment arbitration and state sovereignty emerges at the stage of proceedings. Investment arbitration is premised on the independence and impartiality of arbitrators, yet states often fear that, in practice, this independence may be influenced by professional networks, political pressures, or economic interests. Independence implies that arbitrators decide solely on the basis of legal principles and the evidence before them, while many states believe that in numerous cases arbitrators, due to their professional background or links to particular networks, are more inclined to side with investors. As a result, some states perceive arbitrator independence not as a guarantee of impartiality but as a threat to their sovereignty (Van Harten, 2023).

On the other hand, the selection of arbitrators is one of the most sensitive points of contention between investors and states. In systems such as ICSID and UNCITRAL, each party has the right to appoint its own arbitrator. Investors typically choose arbitrators known for a strong protection of investor rights, whereas states prefer candidates who are more receptive to sovereignty and public policy concerns. This clash in preferences can politicize the composition of arbitral tribunals and undermine confidence in the neutrality of the proceedings (Liu, 2024). Recent research has shown that repeated appointments and dense professional networks among arbitrators have contributed to the emergence of a "club of arbitrators," which, according to critics, is closer to investors' interests than to states' concerns (Langford et al., 2017).

Political influences at this stage are equally undeniable. Some states face diplomatic or economic pressure in the process of appointing arbitrators, which calls into question the genuine independence of the proceedings. Conversely, investors may rely on the diplomatic backing of their home states to strengthen their position in arbitration. This situation has led many scholars and international bodies to propose the establishment of a multilateral investment court with permanent judges, in order to reduce political and economic influence in the appointment process (Croisant, 2025; Kalra, 2023). Such a court could enhance the independence of decision-makers and increase state confidence in the dispute-settlement system.

Overall, conflict at the stage of proceedings shows that arbitrator independence and state control represent two opposing poles that must be carefully balanced (Langford et al., 2017). If arbitrator independence is strengthened without safeguards, states may feel that their sovereignty is being eroded; if state control over the process increases, investors may lose trust in arbitration. The solution lies in reforming appointment mechanisms, increasing transparency in proceedings, and establishing permanent bodies with genuinely independent adjudicators (Menkes, 2021).

5.2. Conflict in the Enforcement of Awards

The enforcement of investment arbitration awards is one of the most sensitive stages in the dispute-settlement system and the one that most directly collides with state sovereignty. The first challenge concerns conflict with domestic public order. Many states consider that certain arbitral awards may contradict fundamental legal principles or core public policies. For example, where an award orders the payment of very large compensation that disrupts the public budget or significantly affects macroeconomic policies, states may view enforcement as contrary to public order. In such situations, domestic courts sometimes refuse to enforce awards or restrict their implementation, demonstrating that even within international systems, domestic public order remains a defensive shield for states (Schill, 2022).

The second challenge relates to state immunity from execution. Under customary international law, states enjoy immunity from coercive measures against their public assets, unless they have expressly waived it. This immunity is especially important in relation to diplomatic property, military assets, or critical economic resources. In many cases, investors, after obtaining a favorable award, face serious difficulties in execution because state assets located abroad are protected by immunity. As a

result, some awards remain practically unenforceable despite their formal binding nature, and the tension between the obligation to comply with awards and the preservation of state immunity becomes one of the most serious issues in investment arbitration (Dautaj & Chevalier, 2022).

Recent research indicates that some states have attempted, through specific clauses in investment treaties, to limit the scope of immunity from execution in order to facilitate award enforcement (Reinisch, 2024). However, many states still insist on maintaining broad immunity and consider it an integral component of national sovereignty. This has sparked extensive debate on the need to reform enforcement mechanisms at the international level. Proposals such as the creation of international guarantee funds or a multilateral investment court have been advanced to ensure investor rights while preserving state sovereignty (Tang & Guo, 2025).

5.3. Conflict in the Right to Regulate

The state's right to regulate is one of the most fundamental expressions of national sovereignty, yet it generates the most intense conflicts with international obligations in the context of investment arbitration. To protect the public interest, states must adopt regulations in fields such as environmental protection, taxation, natural resources, and public health, but foreign investors often treat these measures as breaches of treaty obligations and bring substantial claims against states (Liu, 2024).

In the environmental field, states adopt stringent measures to combat climate change and safeguard natural resources. The Methanex case, in which the ban on MTBE in fuel was recognized as a legitimate environmental measure, is a notable example of a tribunal upholding environmental regulation (Paine & Sheargold, 2023). Nevertheless, in many cases investors argue that such measures amount to indirect expropriation or violations of fair and equitable treatment. This demonstrates that tensions between investor protection and environmental policy remain acute (Baltag et al., 2023).

In the tax sphere, state measures to increase public revenue or reform tax systems have frequently given rise to disputes. Investors claim that heavy taxation or sudden changes in tax laws violate their legitimate expectations. Arbitral decisions have sometimes upheld new taxes as legitimate state measures, but in other instances have treated them as treaty breaches, thereby placing significant constraints on states' fiscal autonomy (Baltag et al., 2023).

Conflicts are even more intense in the area of natural resources. Natural resources are vital national assets, and states often impose strict regulations on their exploitation. The Occidental v. Ecuador case, in which Ecuador's termination of an oil contract led to a massive damages award, vividly illustrates the potential for severe conflict between investors and host states in the management of natural resources (Tang & Guo, 2025).

In the domain of public health, regulations on medicines, food, and tobacco have repeatedly prompted investor claims. The Philip Morris v. Uruguay case is a prominent example, where Uruguay introduced stringent tobacco packaging rules and the investor alleged a breach of treaty obligations. The tribunal, however, found Uruguay's measures to be legitimate and confirmed the state's right to regulate in the field of public health (Baltag et al., 2023; Grigera, 2024). This decision has been widely regarded as a turning point in recognizing states' authority to protect public health without automatically incurring liability.

Taken together, conflicts over the right to regulate show that states must exercise their powers to protect the public interest, yet the investment arbitration system often constrains these efforts. The solution to this tension lies in revising investment treaties, inserting clear regulatory carve-outs, and more broadly recognizing states' right to pursue public policy objectives within the international investment regime (Henckels, 2025; Tang & Guo, 2025).

6. Reform Approaches in the Investment Arbitration System to Strengthen State Sovereignty

Recent reforms in the ICSID system, aimed at increasing transparency and reducing costs, have enabled states to present more robust defenses based on public policy considerations (Zhang, 2023). The proposal to establish a Multilateral Investment Court with permanent judges is intended to provide greater independence than ad hoc tribunals and to enhance states' trust in the system (Croisant, 2025; Kalra, 2023). The adoption of the 2014 Mauritius Convention on Transparency has also contributed to making arbitrations more transparent and to ensuring that documents and hearings are accessible to the public (United, 2014). Many states have additionally embarked on revising their older investment treaties to incorporate regulatory

carve-outs and security exceptions (Faccio, 2023; Unctad, 2023). The idea of introducing an appellate mechanism for arbitral awards has been proposed with a view to reducing errors and increasing the legitimacy of the system (Menkes, 2021; Unctad, 2024). Taken together, these reforms reflect a broader movement toward rebalancing investor protection with the preservation of state sovereignty (Tang & Guo, 2025).

5-1. ICSID Reforms

The ICSID reform process, which began in 2016, culminated in the adoption of new rules in July 2022 and their entry into force in 2023, and is widely viewed as a turning point in the investment arbitration system (Zhang, 2023). These reforms were designed to address longstanding criticisms concerning a lack of transparency, high costs, protracted proceedings, and the limited ability of states to defend public policy measures.

One of the most important changes was the enhancement of transparency. The new ICSID Rules require, as a general principle, the publication of awards and key documents, and they provide for hearings to be held in public whenever possible. This has allowed states to present their regulatory actions as legitimate before domestic and international public opinion and to counter accusations of "secrecy" or "discrimination against investors." At the same time, investors now operate within a more transparent regime, which can increase their confidence in the system (United, 2014).

The reforms also focused on efficiency and cost reduction. States had frequently complained that arbitration costs and lengthy proceedings placed significant strain on public budgets. Through the use of digital technologies, electronic filing and case management, and stricter time limits, the new rules aim to reduce costs and accelerate proceedings (Zhang, 2023). These changes are directly related to the principle of state sovereignty, because states are no longer compelled to devote substantial financial and human resources to defending themselves in protracted disputes.

From the perspective of the state's right to regulate, the ICSID reforms are particularly significant. The new framework facilitates more explicit and structured presentation of defenses based on public policy—such as environmental protection, public health, or national security—allowing states to articulate the regulatory rationale underlying their measures (Faccio, 2023).

The reforms have also expanded the possibilities for participation by third parties (amicus curiae), enabling civil society organizations and international bodies to submit views relevant to the public interest (United, 2014). This development has helped shift investment arbitration away from being perceived as a mechanism serving only investors, and has highlighted the role of states in safeguarding the public interest.

Nonetheless, the ICSID reforms still face serious challenges. First, the independence of arbitrators and the composition of tribunals remain contentious, as many states believe that arbitrators' professional networks continue to favor investors (Langford et al., 2017). Second, the enforcement of awards continues to clash with state immunity from execution, and the reforms have not fully resolved this structural issue (Reinisch, 2024). Third, although the new rules allow states to rely more explicitly on public policy defenses, traditional standards such as fair and equitable treatment and indirect expropriation may still constrain regulatory autonomy (Tang & Guo, 2025).

Overall, the ICSID reforms represent an effort to strike a balance between investor protection and the preservation of state sovereignty. They have alleviated some of states' concerns, but significant structural challenges persist. The future of the investment arbitration system will depend on how far these reforms succeed in building trust between states and investors (Tang & Guo, 2025; Zhang, 2023).

6.1. Establishment of a Multilateral Investment Court

The idea of creating a Multilateral Investment Court (MIC) was first advanced by the European Union and then taken up within the framework of discussions at UNCITRAL. The main objective of this initiative is to replace the current system of investment arbitration with a permanent institution that can offer greater independence, transparency, and accountability than existing mechanisms (Croisant, 2025; Hallak, 2020).

In the current system, arbitrators are appointed on an ad hoc basis, which has raised concerns among states about impartiality and the influence of political or economic interests in the decision-making process (Van Harten, 2023). The MIC is envisaged

as a court with permanent judges who would be selected according to transparent criteria and financed by the member states, thereby reinforcing both independence and institutional legitimacy (Croisant, 2025). This institutional design is expected to give states a greater sense of control over the process while preserving judicial independence.

Another key feature of the MIC is the creation of an appellate mechanism. Under the current system, arbitral awards are usually final and not subject to appeal on the merits, except in limited circumstances such as serious procedural violations. This has left states facing substantial awards with virtually no possibility of substantive review. The MIC's appellate body would provide a framework for correcting errors and improving the overall quality and consistency of decisions (Unctad, 2024).

From the standpoint of interaction with the principle of state sovereignty, the MIC has the potential to reduce tensions. First, permanent judges and transparent institutional procedures can enhance state confidence in the fairness of proceedings. Second, the possibility of appeal enables states to feel that their rights are more fully respected. Third, the MIC can incorporate explicit provisions regarding the state's right to regulate, thereby creating a more balanced relationship between investor protection and the safeguarding of public interests (Kalra, 2023).

At the same time, questions remain regarding the MIC's global jurisdiction and its acceptance by non-European states. Ultimately, the success of the MIC depends on broad participation by states and on its inclusion in future investment treaties (Croisant, 2025; Tang & Guo, 2025). In sum, the MIC constitutes a major structural reform proposal in the investment arbitration system that could mitigate conflicts between investor protection and state sovereignty and significantly enhance the legitimacy of the international investment regime.

6.2. Greater Transparency (Mauritius Convention 2014)

One of the main criticisms of the investment arbitration system has been the confidential nature of proceedings and the lack of public access to documents and hearings. Such secrecy has placed states under domestic and international pressure, as crucial decisions regarding public policy have often been taken without public oversight (Van Harten, 2023).

To address this concern, the United Nations Commission on International Trade Law adopted the Mauritius Convention on Transparency in 2014. The convention is specifically designed to increase transparency in treaty-based investor–state arbitrations and provides states with a tool to reinforce the legitimacy of their actions before their citizens and the international community (UNCITRAL; United, 2014).

Under the Mauritius transparency framework, core arbitral documents—such as party submissions, procedural orders, and final awards—are to be made public, and hearings are, as far as possible, to be open to the public. This has transformed investment arbitration from a confidential process into a more accountable one, subject to broader scrutiny (United, 2014).

The convention also allows third parties, such as non-governmental organizations and international bodies, to submit observations. This helps states to support their defenses in areas such as environmental protection, human rights, or public health with broader expert input (Bhattacharjee, 2024).

From the perspective of state sovereignty, the Mauritius Convention plays a significant role. It enables states to explain their regulatory measures within a transparent framework and to show that new regulations are adopted not to undermine investors' rights but to protect the public interest (Tang & Guo, 2025). Transparency thus increases public trust in governments and reduces criticism that they are "surrendering" to foreign investors. At the same time, investors benefit from transparency by gaining a more predictable and legitimate process.

Nevertheless, challenges remain. Some states fear that far-reaching transparency may expose sensitive economic or political information, and open hearings may make proceedings more complex and expensive. Moreover, the convention has not yet achieved universal acceptance, and many states have not become parties to it, limiting its global impact (Unctad, 2023). Overall, however, the 2014 Mauritius Convention is an important step toward strengthening state sovereignty and enhancing the legitimacy of investment arbitration by enabling more effective public-policy defenses within a transparent system (UNCITRAL; United, 2014).

6.3. Revisiting Old Bilateral Investment Treaties

Older generations of BITs, concluded mainly between the 1960s and 1990s, are commonly referred to as "first-generation" treaties. These agreements were largely drafted with the objective of attracting foreign investment and typically contained very broad standards of investor protection, with insufficient attention to the state's right to regulate. Clauses such as fair and equitable treatment and protection against indirect expropriation were formulated in ways that significantly constrained regulatory freedom.

As claims against states increased and public pressure mounted, many countries began to revisit these treaties. Treaty revisions have included the insertion of new provisions such as national security exceptions, environmental and social clauses, and limitations on the scope of the fair and equitable treatment standard (Unctad, 2023). Transparency provisions and mechanisms for third-party participation have also been added to newer agreements.

Some states, such as India, have issued new model BITs that explicitly safeguard the state's right to regulate in the public interest, while the European Union has incorporated broad public policy clauses in its more recent trade and investment agreements (Ranjan, 2017). These revisions reflect a shift from unconditional investor protection toward a more balanced approach that integrates investment protection with national policy space and sovereignty (Tang & Guo, 2025). In this sense, the revision of old BITs is one of the most important reform tools for reducing tensions between investment arbitration and the principle of state sovereignty.

6.4. Appeal Mechanisms

One of the principal criticisms of the investment arbitration system is the final and non-appealable nature of awards. Under the current regime, awards may only be annulled or set aside on limited procedural grounds, such as serious departures from fundamental rules of procedure or corruption, but there is no comprehensive review on the merits. As a result, states facing heavy financial obligations often have no opportunity for substantive reconsideration and may feel that their sovereignty has been undermined.

The proposal to create appeal mechanisms is intended to reduce potential errors, improve the quality of decisions, and enhance states' confidence in the system. Such mechanisms could take the form of a permanent body with specialized judges empowered to review arbitral awards and, where appropriate, to modify or reverse them. The European Union and UNCITRAL have discussed this idea in connection with broader reforms, including the proposed MIC, and have treated it as a core component of a reformed dispute-settlement architecture (Croisant, 2025; Unctad, 2024).

From the viewpoint of state sovereignty, an appellate system is highly significant. States could be assured that their defenses against investor claims will receive full and thorough consideration and that potential errors in first-instance decisions can be corrected. This would increase the legitimacy of the investment dispute-settlement regime and alleviate accusations of bias in favor of investors (Menkes, 2021).

However, appeal mechanisms also raise challenges. Critics argue that such systems may further increase costs and lengthen proceedings. Questions have also been raised about the global jurisdiction of an appellate body and the extent to which it would be accepted by different states (Tang & Guo, 2025). In sum, appeal mechanisms are conceived as a tool for rebalancing investor protection with state sovereignty, but their success will depend on broad state participation and careful institutional design (Menkes, 2021; Unctad, 2024).

7. Conclusion

The examination of the interaction and conflict between foreign investment arbitration and the principle of state sovereignty shows that although these two domains pursue distinct objectives, they inevitably intersect in numerous areas. Investment arbitration is designed to ensure security and predictability for investors, whereas the principle of state sovereignty emphasizes the freedom of states to regulate and exercise sovereign authority. The theoretical and analytical findings of the article indicate that conflict between investor protection and state regulatory powers is unavoidable, since any regulatory measure adopted by a state may be perceived as a breach of treaty obligations, and any arbitral award may impose constraints on public policy.

Nonetheless, the analysis of arbitral practice and recent legal scholarship demonstrates that this conflict can be managed. Doctrines such as the "right to regulate" and the "margin of appreciation" have gradually gained acceptance in arbitral jurisprudence, providing states with greater room to implement public policy measures. Furthermore, institutional reforms—including the revision of the ICSID Rules, the adoption of the Mauritius Convention on Transparency, the updating of older bilateral investment treaties, and proposals for establishing a Multilateral Investment Court—show that the international investment regime is moving toward strengthening the role of states.

The main hypothesis of the study—namely, that it is possible to create a sustainable balance between effective investor protection and the preservation of state regulatory authority—is confirmed. The evidence demonstrates that although conflicts are inevitable, they can be managed through revising outdated treaties, incorporating regulatory carve-outs, enhancing transparency, and creating mechanisms for appellate review.

The innovation of this research lies in its combination of theoretical foundations with an examination of practical arbitral developments, providing a comprehensive view of points of tension and available reform strategies. The future of the international investment system will inevitably move toward reinforcing the role of states while maintaining the functional effectiveness of arbitration. This trajectory can simultaneously guarantee investor security and enable states to implement public policies without fear of violating international obligations. Therefore, achieving a balance between the effectiveness of investment arbitration and the preservation of state sovereignty is not only possible but necessary, and ongoing reforms signal the beginning of this structural transformation in international investment law.

Ethical Considerations

All procedures performed in this study were under the ethical standards.

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Conflict of Interest

The authors report no conflict of interest.

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