Western European Journal of Historical Events and Social Science
Volume 3, Issue 5, May 2025
https://westerneuropeanstudies.com/index.php/4
ISSN (E): 2942-1926 Open Access| Peer Reviewed

BALANCING INVESTOR PROTECTION AND SOVEREIGNTY: THE EVOLUTION OF BILATERAL INVESTMENT TREATIES AND INVESTOR-STATE DISPUTE SETTLEMENT IN INTERNATIONAL INVESTMENT LAW

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Abstract
International investment law has evolved into a complex and dynamic field centered around a network of agreements and legal mechanisms aimed at safeguarding foreign direct investment (FDI). At the heart of this regime lie Bilateral Investment Treaties (BITs) and the Investor-State Dispute Settlement (ISDS) system. BITs are international agreements typically concluded between two States to promote and protect investments made by investors from one State in the territory of the other. Meanwhile, ISDS provides a procedural framework that allows foreign investors to bring claims directly against host States for alleged breaches of treaty obligations.
Key words: Bilateral Investment Treaties (BITs), Investor–State Dispute Settlement (ISDS), Foreign Direct Investment (FDI), Fair and Equitable Treatment (FET), expropriation, most-Favoured-Nation (MFN) clause, National Treatment (NT), state sovereignty, sustainable development.

Since the inaugural BIT between West Germany and Pakistan in 1959, the number of such treaties has surged dramatically, with over 2,800 BITs currently in force out of more than 3,000 international investment agreements. This proliferation reflects States' growing recognition of BITs as tools for attracting FDI and signaling commitment to investor rights. However, as the regime expanded, concerns emerged regarding its implications for State sovereignty, particularly with respect to regulatory autonomy and public policy space. This article examines the historical development of BITs, analyzes their core substantive provisions, explores the functioning and criticisms of ISDS, and reviews ongoing reform initiatives aimed at aligning investment protection with sustainable development goals.

The first BIT, concluded in 1959, set the precedent for subsequent treaties that aimed to foster legal certainty for foreign investors. Throughout the 1960s to the 1990s, BITs followed relatively uniform models, often reflecting templates designed by capital-exporting countries.[1] These agreements typically included provisions on fair treatment, protection against expropriation, and access to international arbitration. The establishment of the International Centre for Settlement of Investment Disputes (ICSID) in 1965 under the auspices of the World Bank was a significant institutional development, providing a neutral venue for resolving investment disputes and reinforcing the enforceability of BIT commitments.

[1] Treaty for the Promotion and Protection of Investments between the Federal Republic of Germany and Pakistan (signed 25 November 1959, entered into force 28 April 1962)

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By the late 1990s, the number of BITs exceeded 1,800, and by 2023, the total number of international investment agreements surpassed 3,290.[2] Although BITs remain the primary vehicle for investment protection, newer agreements increasingly appear as chapters in broader trade and economic cooperation treaties. Nonetheless, many older BITs—concluded in an era of limited ISDS experience—remain in force, contributing to calls for modernization and harmonization to reflect contemporary policy priorities.[3]

BITs, despite textual differences, generally contain a consistent set of substantive protections for investors.[4] A central provision is the Fair and Equitable Treatment (FET) standard, which obliges States to respect investors' legitimate expectations and refrain from arbitrary, discriminatory, or bad-faith conduct. While FET has become the most frequently invoked standard in ISDS claims, its open-ended language has led to divergent interpretations by arbitral tribunals, raising concerns about judicial overreach. Recent treaties increasingly seek to clarify FET by referencing customary international law or specifying the elements that constitute a breach.

Another critical obligation concerns protection against expropriation. BITs stipulate that States may not nationalize or expropriate foreign investments unless the measure is lawful, for a public purpose, non-discriminatory, follows due process, and is accompanied by prompt, adequate, and effective compensation. The doctrine of indirect expropriation—whereby regulatory measures significantly impair investment value—has been particularly contentious. To address this, modern BITs frequently distinguish between compensable expropriation and legitimate regulatory measures aimed at public welfare objectives, such as environmental protection or public health.

Non-discrimination clauses, such as Most-Favoured-Nation (MFN) and National Treatment (NT), further protect investors by requiring host States to treat foreign investors no less favorably than domestic or third-country investors. While MFN has been used to extend more favorable procedural rights from other treaties, some recent BITs expressly exclude ISDS procedures from MFN coverage to prevent treaty shopping. National Treatment complements MFN by ensuring equal treatment between foreign and domestic investors under like circumstances.

Additional provisions commonly found in BITs include Full Protection and Security (FPS), requiring States to exercise due diligence in protecting investors from physical harm or interference, and Umbrella Clauses, which elevate breaches of investment-related obligations to treaty violations. Emerging trends in BIT drafting reflect growing attention to sustainable development: modern treaties may include clauses on environmental and labor standards, carve-outs for public interest regulation, and deny protection to investments tainted by corruption or other misconduct.

ISDS represents a landmark innovation in international law by allowing private investors to initiate arbitration proceedings directly against sovereign States. This mechanism depoliticizes disputes by removing them from the realm of inter-State diplomacy and providing a neutral,

[2] UNCTAD, *World Investment Report 2023* (United Nations 2023) (Annex, International Investment Agreements).
[3] UNCTAD, *World Investment Report 2015: Reforming International Investment Governance* (United Nations 2015) ch III (advocating alignment of investment treaties with sustainable development objectives).
[4] Treaty for the Promotion and Protection of Investments between the Federal Republic of Germany and Pakistan (signed 25 November 1959, entered into force 28 April 1962) 457 UNTS 24.

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legal forum—most commonly under ICSID or UNCITRAL arbitration rules. ISDS facilitates enforcement of BIT protections, bolsters investor confidence, and contributes to the perceived stability of the investment climate.

However, the rapid growth of ISDS has also exposed systemic challenges. By 2020, over 1,100 known ISDS cases had been filed, involving at least 124 respondent States.[5] Critics argue that ISDS disproportionately favors investors, lacks transparency, and impinges on States' ability to regulate in the public interest. Tribunals' expansive interpretations of treaty provisions, coupled with the absence of appellate mechanisms, have prompted calls for reform. Concerns about regulatory chill—where governments refrain from adopting public interest measures due to fear of litigation—underscore the urgency of rebalancing the system.

In response to these challenges, efforts to recalibrate the investment protection regime are underway at national, regional, and multilateral levels. States are increasingly revisiting old-generation BITs through renegotiation, termination, or replacement with new-generation treaties that incorporate clearer standards, public interest exceptions, and investor obligations. For example, many recent treaties align FET with customary law, exclude MFN application to ISDS, and include interpretative annexes to guide arbitral tribunals.

Multilateral initiatives, such as the UNCITRAL Working Group III on ISDS reform, aim to address structural concerns, including consistency, independence of arbitrators, and the possibility of establishing a standing investment court. The shift toward sustainable development is also evident, with treaties integrating objectives related to environmental protection, human rights, and responsible investment.

Overall, the evolution of BITs and ISDS reflects an ongoing struggle to balance investor protection with State sovereignty and policy space. While early treaties prioritized investor rights, contemporary reforms seek a more nuanced equilibrium that aligns legal certainty for investors with States' right to pursue public interest objectives. The trajectory of international investment law suggests a move from a rigid, investor-centric model to a more balanced, sustainable, and legitimacy-oriented framework.

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