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Challenges of Arbitration in Commercial Disputes Arising from Foreign Investment and the National Sovereignty of States

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ABSTRACT

Given the vital role of foreign investment in the economic development of states, providing legal guarantees to protect investors has become a fundamental necessity. In this context, international arbitration—recognized as the primary mechanism for resolving investment disputes—has, through the expansion of arbitral jurisdiction and the obligation of states to enforce arbitral awards, created serious challenges for the principle of national sovereignty. The purpose of this study is to examine the legal, economic, and political dimensions of the conflict between investment arbitration and national sovereignty and to propose solutions for establishing a balance between these two principles. The research method is descriptive-analytical and includes documentary analysis, a review of recent statistical reports such as UNCTAD 2024 data, and an examination of landmark international arbitration cases as well as Iran's domestic regulations. The findings indicate that limitations on the jurisdiction of domestic courts, the weakening of legislative independence, and financial pressures resulting from arbitral awards have placed states in a difficult position. Nevertheless, comparative analyses show that achieving a balance between investor protection and the preservation of state autonomy is possible. The study concludes by emphasizing the necessity of revising investment treaties and incorporating essential public-policy exceptions in order to ensure both investment security and national sovereignty.

Keywords: *foreign investment, international arbitration, national sovereignty, chilling effect, international economic law.*

Introduction

Foreign investment has, in recent decades, emerged as one of the principal pillars of economic development and has played a decisive role in ensuring sustainable growth in many countries. The inflow of external capital not only compensates for domestic financial shortages but also brings technological innovation, enhances labor productivity, and integrates host economies into global value chains. For this reason, many governments have sought to attract foreign investors by creating secure and transparent legal and economic frameworks. In this context, international arbitration, as the dominant mechanism for resolving investment disputes, has gained a prominent position and strengthened investor confidence.



Nevertheless, the expansion of arbitral jurisdiction and the obligation of states to comply with arbitral awards have raised serious questions about the scope and limits of the fundamental principle of national sovereignty. States, on the one hand, are compelled to accept arbitration clauses to attract foreign investment, while on the other hand, such acceptance may restrict their judicial independence and exclusive authority to regulate public policy. In numerous cases, governmental measures relating to public health, environmental protection, or national security have been characterized by investors as treaty violations, exposing states to significant financial liability.

This situation has given rise to what is known as the *chilling effect*, whereby states refrain from implementing necessary public policies due to fear of potential investor claims. According to international studies such as the 2024 UNCTAD report, investor–state disputes have surpassed 1,400 registered cases, the majority of which have arisen in the past fifteen years. The energy and environmental sectors account for the greatest share of these disputes, and the damages sought in many claims amount to billions of dollars. More than half of all claims have been filed against developing countries, placing considerable financial and political pressure on them. The report indicates that the increasing number of these disputes has intensified the risk of a “chilling effect” in public-policy making and underscores the need to reconsider investment treaties (1).

Furthermore, *Dolzer and Schreuer*, in their book *Principles of International Investment Law*, have shown that the rise in investment disputes can restrict the legislative autonomy of states (2). Domestic studies, such as that of *Koohpayee and colleagues* (2022), which examined the possibility of reviewing arbitral awards, point to the weakening of domestic judicial independence (3). Likewise, *Seifi* (2024) analyzed the position of Article 139 of the Iranian Constitution in international arbitration cases (4).

Despite these studies, the fundamental question remains unanswered: How can a balance be maintained between ensuring investment security and safeguarding national sovereignty? In this regard, one may propose the hypothesis that revising investment treaties and incorporating necessary public-policy exceptions could provide an effective approach to balancing investor protection with the preservation of sovereignty.

The main objective of this study is to analyze the legal, economic, and political dimensions of this tension and to propose solutions for revisiting investment treaties. The theoretical framework of the study is grounded in the conflict between the principle of state sovereignty and the principle of investor protection in international economic law. This framework enables us to interpret the findings not merely as isolated disputes but as indicators of a changing balance of power between states and investors.

The article is organized into four sections: first, the importance of foreign investment and the place of international arbitration; second, the legal and economic dimensions of the conflict; third, its political and social implications; and fourth, an examination of practical case studies and recommendations for reform.

The Importance of Foreign Investment in the Economic Development of States

Foreign investment is considered one of the most significant drivers of economic growth and development in the contemporary world, as the inflow of external capital can compensate for domestic financial shortages and enable the implementation of major infrastructural and industrial projects. Countries facing budget constraints and weaknesses in domestic savings can obtain sustainable financial resources through foreign investment and thereby pave the way for development.

In addition to financial resources, foreign investment brings new technologies and managerial expertise. The entry of multinational corporations into domestic markets improves production standards, product quality, services,

and labor productivity. In many countries, foreign investment serves as a bridge for integration into global value chains and facilitates entry into international markets.

With respect to employment, foreign investment can create new job opportunities and reduce unemployment rates. This is particularly important for developing countries with large young populations seeking employment. Increased employment leads to higher household income and poverty reduction—one of the central objectives of sustainable development.

Foreign investment also increases competition in domestic markets. The presence of foreign investors compels local firms to improve product quality and increase innovation. Ultimately, this healthy competition benefits consumers and national economies. From a financial perspective, foreign capital inflows can improve a country's balance of payments and increase foreign exchange reserves (5). This strengthens economic stability and enhances governmental capacity to implement development policies.

Moreover, foreign investment can contribute to the development of critical infrastructure such as energy, transportation, and communications—foundational elements of sustainable economic growth.

According to the 2024 UNCTAD World Investment Report, global foreign direct investment reached USD 1.3 trillion, half of which flowed into developing countries. This reveals that attracting foreign capital is essential for these states, yet simultaneously exposes them to costly arbitration disputes. Given its many economic benefits, governments must look beyond merely attracting investment and focus on establishing intelligent legal frameworks to manage potential consequences. Foreign investment should not come at the expense of weakened national policy-making. Therefore, achieving a balance between economic attractiveness and sovereign autonomy is a strategic necessity for developing countries.

The Conflict Between Investment Arbitration and the Principle of National Sovereignty

Foreign investment, as one of the primary tools of economic development, has always required legal guarantees to protect investors. In this context, international arbitration has become the dominant mechanism for resolving investment disputes, and many bilateral and multilateral investment treaties designate arbitration as the principal means of protecting foreign investors.

However, the expansion of arbitral jurisdiction and the obligation of states to comply with arbitral awards have raised serious concerns regarding the limits of national sovereignty. This conflict demonstrates that the investment arbitration regime has, in practice, shifted from being a dispute-resolution mechanism to an instrument capable of constraining governmental authority. Without revising treaty structures, states remain vulnerable to supranational pressures. Therefore, reconsidering international commitments should be aimed at restoring part of the state's sovereign authority.

Legal Dimensions of the Conflict Between Investment Arbitration and National Sovereignty

The core issue is that while states must accept international arbitration to attract foreign investment, such acceptance may restrict judicial independence and the exclusive authority of states to exercise jurisdiction within their territories. In many arbitration cases, governmental measures concerning public health, environmental protection, or national security have been challenged by investors, and arbitral tribunals have sometimes considered these measures to violate contractual or treaty-based obligations (6). This has exposed states to substantial

financial liability and even discouraged them from implementing necessary public-policy measures, resulting in what is known as the *chilling effect*.

Additionally, the relative confidentiality of arbitral proceedings and the absence of transparent accountability mechanisms have fueled concerns about the legitimacy of the system. Critics argue that investment arbitration, rather than balancing the interests of investors and states, has effectively become a tool for constraining sovereignty. Supporters maintain that international arbitration, by offering a neutral and specialized forum, enhances investor confidence and contributes to economic development.

Thus, the tension between investment arbitration and national sovereignty is not merely theoretical but constitutes a practical and growing challenge in contemporary international law (7). This tension is rooted in a clash between two fundamental values: investor protection and economic security on the one hand, and state independence in regulating public policy and exercising judicial authority on the other. The central question is how to strike a balance that preserves investor confidence while allowing states to implement public policies without fear of international condemnation.

The *Philip Morris v. Uruguay* case provides a notable example in which public-health measures were challenged by an investor (8). Similarly, in *Vattenfall v. Germany*, Germany's environmental and nuclear-energy policies became the subject of arbitration (9). These cases illustrate that the conflict between public-interest regulation and treaty-based obligations is a real and pressing concern.

Investment arbitration, as the principal mechanism for resolving disputes between foreign investors and host states, has increasingly come into conflict with the foundational principle of national sovereignty. Accepting the jurisdiction of international arbitral tribunals effectively limits the authority of domestic courts and transfers part of the state's judicial power to supranational bodies. In many cases, legitimate governmental measures relating to public health, environmental protection, or social policy have been treated as treaty violations (6). This has exposed states to significant financial liability and contributed to the *chilling effect* in public-policy making.

It may be argued that the tension between investor protection and state autonomy is one of the central challenges of contemporary international law. Accepting international arbitration without thorough legal safeguards risks undermining domestic legitimacy. Such a situation not only threatens judicial independence but may also erode public trust in the national legal system. Therefore, designing mechanisms for review and oversight of arbitral awards should be prioritized in legal reforms.

Limitations on Judicial Jurisdiction and the Weakening of Domestic Courts

One of the most important issues in the context of foreign investment arbitration is the limitation of judicial jurisdiction and the weakening of domestic courts. When states accept arbitration clauses in bilateral or multilateral investment treaties, they effectively transfer part of their judicial authority to international arbitral tribunals. This transfer of jurisdiction entails sidelining national courts from hearing disputes between foreign investors and the host state, thereby restricting domestic judicial authority in a sensitive area directly connected to the public interest.

In many arbitration cases, foreign investors have bypassed national courts and brought their claims directly before institutions such as the International Centre for Settlement of Investment Disputes (ICSID) or the International Chamber of Commerce (ICC) Court of Arbitration. This not only deprives domestic courts of a role in major economic disputes, but also results in decisions on public and economic policy being made by arbitrators

who are not necessarily accountable to the state's citizens or national institutions (10). For this reason, many legal scholars regard this trend as a form of erosion of judicial sovereignty and national independence.

Moreover, awards issued by international arbitral tribunals are often enforceable, and states are obliged to comply with them even when such awards conflict with domestic law or national public policy. This situation places domestic courts in a passive position, as they generally lack the power to conduct a substantive review of arbitral awards and may only refuse enforcement in limited circumstances such as manifest procedural violations or lack of jurisdiction. As a result, national courts effectively become enforcers of international arbitral awards rather than the final decision-makers.

This restriction of judicial jurisdiction has several consequences. First, public confidence in the domestic judicial system is undermined, as citizens and even economic elites may feel that national courts have no role when foreign investors are involved. Second, the judicial independence of states is exposed to serious threats, because major economic and social decisions can be influenced by foreign arbitral awards. Third, this trend leads to the emergence of a form of "judicial dualism": one system for domestic disputes and another supranational system for foreign investors. Such dualism not only distorts judicial justice but also calls into question the principle of equality before the law (11).

It can be said that the limitation of judicial jurisdiction and the weakening of domestic courts in the context of investment arbitration constitute one of the most serious challenges in contemporary international economic law. This situation demonstrates the need to reconsider investment treaties and design mechanisms that, while preserving attractiveness for investors, also guarantee the independence and authority of domestic courts. Only by achieving a balance between these two conflicting values can both investment security and judicial sovereignty be safeguarded. In many countries, such as Argentina and Venezuela, domestic courts have been effectively sidelined, with more than fifty cases registered against these states before ICSID. This shows that the limitation of judicial jurisdiction is a widespread phenomenon, not one confined to Iran. Excluding national courts from the dispute-resolution process leads to judicial dualism and public distrust, and in the long term can weaken the rule of law and increase social dissatisfaction. Therefore, restoring the role of domestic courts in investment disputes is a necessary step for preserving judicial justice.

Constraints on Legislative Independence and Public Policy-Making by States

One of the most significant challenges arising in the context of foreign investment arbitration is the constraint it imposes on the legislative independence and public policy-making authority of states. States naturally possess the right to enact and implement laws and regulations in areas such as public health, environmental protection, national security, and social welfare. This right is part of their national sovereignty and is recognized in international instruments. However, the commitments arising from investment treaties and international arbitration clauses have severely challenged this independence.

In many arbitration cases, governmental regulatory measures taken in pursuit of the public interest have been characterized by foreign investors as violations of treaty obligations (12). For example, restrictive legislation in fields such as tobacco control, energy, or environmental protection has sometimes been interpreted as "indirect expropriation" or as a breach of the fair and equitable treatment standard, exposing states to substantial financial liability. This situation has led to what is known as the "chilling effect": states, fearing investor claims and adverse arbitral awards, refrain from implementing necessary public policies.

This tension between the state's right to regulate and its international obligations has far-reaching consequences. On the one hand, legislative independence and the state's ability to respond to the social and economic needs of its citizens are restricted. On the other hand, the legitimacy of the investment arbitration system itself is called into question. Critics argue that this dynamic elevates the interests of multinational corporations above the public interests of nations. By contrast, supporters of investment arbitration contend that the system is necessary to prevent discriminatory or confiscatory state conduct (13).

The challenge of preserving legislative and public policy-making autonomy in the face of investment arbitration is one of the core issues in contemporary international economic law. Finding a solution that balances investor protection with the state's right to regulate is an unavoidable necessity for the future of the international investment regime. Studies indicate that in 37% of arbitration cases, governmental measures in the fields of environmental protection and public health have been alleged to violate treaty obligations. This statistic shows that the chilling effect is a genuine concern in public policy-making. The chilling effect generated by investment arbitration limits states' ability to respond to social needs and can lead to the prioritization of multinational corporate interests over public welfare. Consequently, incorporating public-policy exceptions into investment treaties is an indispensable requirement for safeguarding national sovereignty.

Economic and Financial Implications of Investment Arbitral Awards for States

The economic and financial implications of investment arbitral awards impose severe pressure on states, constraining public budgets and limiting their capacity to implement development policies. A striking example is the *Yukos v. Russia* case, in which Russia was ordered to pay USD 50 billion in damages (14). These pressures are particularly acute for developing countries and can at times lead to reduced investment in critical infrastructure sectors (15). In addition to damages, the costs of proceedings are estimated on average at between USD 8 and 10 million. Consequently, the mere threat of disputes can lead to an "economic deterrent effect," weakening state autonomy and sustainable development.

High-value arbitral awards, especially those rendered against developing countries, can place intense pressure on government finances. This pressure not only threatens the public budget, but also reduces the state's ability to undertake development and social projects. Therefore, it is essential for states to incorporate caps on damages and financial adjustment mechanisms into their investment treaties.

Heavy Damages and Litigation Costs in Investment Disputes

One of the most significant criticisms of the investment arbitration system concerns the issuance of awards imposing extremely high damages on states. These damages not only strain public finances but also limit the state's ability to implement development and social policies. The *Yukos v. Russia* case remains the largest arbitral award in history, in which Russia was ordered to pay more than USD 50 billion. This case demonstrated that arbitral awards can have far-reaching economic and political consequences for states (16).

According to the 2024 UNCTAD report, the average amount of damages awarded in recent cases is around USD 500 million. In some instances, particularly those related to the energy and natural resources sectors, damages have exceeded several billion dollars (17). This trend poses a serious threat to developing countries with limited financial resources.

In addition to damages, litigation costs impose a substantial financial burden on states. A study conducted by ICSID in 2021 shows that the average cost of arbitration proceedings ranges between USD 8 and 13 million. These costs include international counsel fees, expert fees, the administrative expenses of arbitral institutions, and various ancillary costs. In some cases, litigation costs have even exceeded USD 30 million (18).

For developing countries, these costs are particularly onerous, since, beyond any damages awarded, they must allocate a significant portion of their limited budgets to defending against claims. For example, in the numerous cases brought against Argentina following the 2001 economic crisis, the state not only faced substantial financial liability but also spent millions of dollars on legal costs (19).

Another consequence of these costs is the *economic deterrent effect*. States, fearing high litigation expenses and large damages awards, may refrain from implementing necessary public policies. This phenomenon, which closely resembles the “chilling effect,” can lead to delays or the abandonment of reforms in areas such as environmental protection, public health, or energy (20).

From the perspective of economic justice, this situation creates a structural imbalance: multinational corporations with vast financial resources can easily pursue claims, whereas states must use public funds to defend themselves. This dynamic not only generates financial pressure but also creates political and social strain on governments.

For these reasons, many scholars and international bodies emphasize the necessity of reforming the investment arbitration system. Proposals include introducing caps on damages, enhancing transparency regarding litigation costs, and establishing support funds for developing countries.

In sum, heavy damages and high litigation costs in investment disputes constitute one of the most serious challenges in contemporary international economic law. This situation threatens states’ financial independence and negatively affects sustainable development and social justice. High-value awards and substantial litigation expenses are among the gravest threats to states’ financial autonomy and policy-making capacity. For developing countries in particular, these burdens are especially severe, as they must devote millions of dollars both to damages and to defending against claims. This dynamic fuels the “chilling effect,” discouraging governments from adopting necessary public policies. Reforming the arbitration system—by setting caps on damages and providing safeguards for weaker states—is therefore an unavoidable necessity for preserving economic justice and sustainable development.

Economic Deterrent Effect and Constraints on States’ Development Policy-Making

One of the important consequences of the investment arbitration system is a phenomenon referred to in the legal and economic literature as the *economic deterrent effect* or *regulatory chill*. This effect arises when states, out of fear of facing investment claims and having to pay substantial damages, refrain from implementing necessary public policies or postpone them. Studies have shown that this phenomenon is particularly pronounced in the fields of environmental protection, public health, and energy. For example, in the *Vattenfall v. Germany* case, the German government, after deciding to phase out nuclear energy, was confronted with a multibillion-dollar claim. This case demonstrated that even large-scale environmental policies can come under pressure from foreign investors.

According to the 2024 UNCTAD report, more than 37% of investment disputes in the past two decades have been linked to measures directly related to states’ public policies in the areas of environmental protection and public health. This statistic shows that the deterrent effect is a real and not merely theoretical concern (17). From an economic perspective, the threat of being sued can lead states to abandon structural reforms or development

policies. Many developing countries, fearing litigation costs and potential damages, have refrained from adopting stringent environmental and social regulations.

The economic deterrent effect is one of the most serious challenges posed by the investment arbitration system. It not only restricts the legislative autonomy of states but can also block the path to sustainable development. Proposed solutions in the legal and economic literature include revising investment treaties, incorporating explicit public-policy exceptions, and creating support mechanisms for developing countries. Overall, the *economic deterrent effect* occurs when states, due to fear of investment claims and heavy damages, refrain from implementing necessary public policies. Cases such as *Vattenfall v. Germany* show that even large-scale environmental policies can come under pressure from foreign investors. The 2024 UNCTAD statistics, indicating that over 37% of disputes are linked to public policies, make this concern concrete and serious. The consequence is a restriction of legislative autonomy and the stalling of developmental reforms in areas such as environmental protection and public health. Only by revising treaties and providing protective exceptions can this negative effect be contained.

Economic and Political Dimensions of the Conflict

The conflict between investment arbitration and national sovereignty has extensive economic implications, as arbitral awards can condemn states to pay substantial damages and thereby place intense pressure on public budgets. This situation can at times reduce governments' capacity to implement development projects and social services. Politically, such a conflict restricts the independence of governmental decision-making and calls into question the legitimacy of the domestic legal order (21). Moreover, reliance on international arbitral forums can weaken public confidence in national sovereignty. Overall, this conflict simultaneously constitutes a threat to both economic stability and the political authority of states.

According to the 2024 UNCTAD report, the average damages awarded in arbitration cases exceed USD 500 million. Such amounts can place severe strain on public finances. Politically, repeated condemnations of states in international arbitration have reduced public confidence in domestic legal systems and increased diplomatic pressures. An examination of landmark cases such as *Philip Morris* and *Vattenfall* shows that even developed states are vulnerable to investment arbitration. These experiences reveal that the sovereignty conflict is a global issue and require international cooperation to reform arbitral structures. Therefore, making use of the experience of states that have managed to achieve a balance can help guide reforms in Iran.

Financial and Economic Effects of Arbitral Awards on States

Awards issued by international investment tribunals have extensive financial and economic effects on states. The first and most obvious effect is the obligation of states to pay substantial damages to foreign investors. In many cases, the awarded amounts reach into the billions of dollars, placing considerable pressure on public budgets. Such costs are often covered from public funds and consequently reduce governments' ability to invest in infrastructure, education, health care, and social welfare.

From an economic perspective, financial liabilities arising from arbitral awards can lead to increased public debt and budget deficits (22). This situation has more destructive effects in developing countries with limited financial resources. In addition, such awards can negatively affect countries' international credit ratings and increase the cost of external borrowing. In some cases, states have been forced to sell national assets or cut social expenditures in order to pay damages, which in turn has fueled public dissatisfaction.

Furthermore, the economic impact of these awards is not limited to the payment of damages; it also affects future policy-making. Out of fear of new financial condemnations, governments may refrain from implementing necessary public policies in areas such as environmental protection, public health, or economic reform (23). Arbitral awards can also have a dual effect on the investment climate. On the one hand, large awards may lead foreign investors to view arbitration as an effective tool for protecting their rights, thereby increasing their incentive to invest. On the other hand, such outcomes may foster domestic distrust toward the legal and economic system and undermine the government's legitimacy in the eyes of citizens.

In sum, the financial and economic effects of arbitral awards on states are multilayered: direct pressure on public budgets, increased debt and deficits, constraints on public policy-making, and wide-ranging social and political consequences. This reality shows that the conflict between investment arbitration and national sovereignty is not merely a theoretical issue but has tangible and profound impacts on the economies and societies of states. Arbitral awards in investment disputes impose heavy financial and economic burdens on states that go far beyond a purely legal disagreement. Billion-dollar damages strain public budgets and consume resources needed for education, health care, and infrastructure development. In developing countries, this often leads to higher debt, budget deficits, and even the sale of national assets, thereby intensifying social discontent. In addition, fear of new condemnations can halt public policy initiatives and restrict legislative autonomy. These consequences demonstrate that the conflict between investment arbitration and national sovereignty is a real challenge with deep economic, social, and political effects.

Political and Social Implications for State Sovereignty and Legitimacy

Investment arbitration and the awards issued by international tribunals have, in addition to financial and economic consequences, profound political and social implications for states. When a government is condemned in international arbitration, this can undermine its political legitimacy domestically, as citizens may feel that the state has failed to defend the national interest. This situation, especially in developing countries with limited financial resources, can lead to public dissatisfaction and reduced trust in governing institutions.

Politically, repeated condemnations in investment arbitration can restrict states' decision-making autonomy (24). Governments may, out of fear of facing new claims, refrain from implementing public policies in areas such as environmental protection, public health, or economic reform. This effectively narrows the space for independent policy-making and reduces the state's ability to respond to societal needs.

Socially, such constraints can fuel a sense of injustice among citizens. When people perceive that the interests of multinational corporations are being prioritized over the public interest, social trust in the political and judicial system declines (25). In the long term, this can weaken social cohesion and increase civil protests.

At the international level, arbitral condemnations can damage states' political credibility and reputation. Governments that are repeatedly condemned in arbitration risk being perceived as unreliable actors in the global investment regime, which weakens their position in international negotiations.

Overall, the political and social consequences of investment arbitration for states are multilayered: diminished domestic legitimacy, limitations on policy-making autonomy, increased social dissatisfaction, and a weakened international standing. This reality shows that the conflict between investment arbitration and national sovereignty is not merely a legal debate but has deep political and social ramifications that can affect the very foundations of state legitimacy. Accordingly, the consequences of investment arbitration are not confined to the financial sphere;

they also challenge the political legitimacy and social cohesion of states. International condemnations may be viewed by citizens as evidence of governmental weakness in defending national interests, thereby reducing public trust in state institutions. Politically, repeated condemnations restrict independent decision-making and deter governments from pursuing major policies in areas such as environmental protection or economic reform. Socially, these constraints amplify feelings of injustice and civil discontent, while internationally they erode states' credibility and bargaining power. Investment arbitration is therefore a multidimensional challenge that can seriously strain the foundations of legitimacy and national sovereignty.

Practical Examples and Case Studies

Investment arbitration cases clearly illustrate how the conflict between investor protection and state sovereignty manifests in practice. The following section discusses some of these cases.

Landmark Cases in International Investment Arbitration

Landmark cases in international investment arbitration have played a pivotal role in shaping practice and interpreting the legal principles governing this field. One of the most famous is *Philip Morris v. Uruguay*, in which a tobacco company brought a claim against Uruguay over legislation restricting cigarette advertising and packaging. The arbitral tribunal ultimately ruled in favor of the state and affirmed its right to regulate public health. This case is a paradigmatic example of the conflict between investor interests and governmental public health policy.

The *Yukos v. Russia* case is also among the most important in the history of investment arbitration. In this dispute, shareholders of the Yukos oil company brought a claim against Russia alleging indirect expropriation of their assets, and the tribunal ordered Russia to pay more than USD 50 billion in damages (26). This award not only had enormous financial implications but also sparked extensive debate on the limits of national sovereignty and the legitimacy of investment arbitration.

The *CMS v. Argentina* case is similarly significant. During Argentina's early-2000s economic crisis, the government modified energy contracts and froze tariffs. Foreign investors argued that these measures violated treaty obligations, and in many instances the tribunals ruled in favor of the investors. This case showed how emergency measures taken by states to manage crises can come into conflict with their international commitments.

The *Tecmed v. Mexico* case has also received considerable attention in the legal literature. In this dispute, the revocation of a landfill permit on environmental grounds was deemed an indirect expropriation, and Mexico was ordered to pay damages. The award triggered wide-ranging debate over the balance between environmental protection and investor protection.

The *Methanex v. United States* case, decided under the NAFTA framework, is likewise of great importance. Here, a Canadian company brought a claim after the United States banned the use of a particular fuel additive, but the arbitral tribunal ruled in favor of the United States and affirmed its right to adopt environmental regulations (27).

These cases show that investment arbitration is not only a mechanism for protecting investors but also a forum for testing the boundaries of national sovereignty and governmental public policy. Examining these examples reveals the complex dimensions of the conflict between private and public interests and highlights the importance of reform and reconsideration of the investment arbitration system. Collectively, they demonstrate how serious and multifaceted the practical conflict between investor protection and national sovereignty can be. Cases such as *Philip Morris v. Uruguay* and *Yukos v. Russia* reveal that arbitration can both affirm states' regulatory rights and impose

multibillion-dollar liabilities on them. Examples such as *CMS v. Argentina* and *Tecmed v. Mexico* show that emergency or environmental measures can directly clash with treaty obligations. These cases make clear that investment arbitration is not merely a technical legal mechanism but a battleground where public and private interests collide. The author concludes that such practical examples underscore, more than ever, the need to revise and reform the investment arbitration system.

The Experience of Iran and Developing Countries in Confronting Arbitration

The experience of Iran and many other developing countries in confronting international investment arbitration reflects the tension between the need to attract foreign capital and concerns over preserving national sovereignty. Owing to constitutional constraints and sensitivities regarding the delegation of judicial authority to foreign bodies, Iran has traditionally adopted a cautious approach toward accepting international arbitration. Nevertheless, in oil and investment contracts, arbitration clauses have been included as a means of building foreign investors' confidence, which in some cases has led to complex disputes.

Other developing countries have had similar experiences. Argentina, after the economic crisis of the 2000s, faced a wave of investor claims and was ordered to pay substantial damages in many cases. This experience showed that emergency measures adopted by governments to manage economic crises can come into conflict with their treaty obligations. Venezuela, likewise, after the nationalization of its oil industry, faced dozens of arbitration cases with far-reaching financial and political consequences. In Iran, although the number of investment arbitration cases has been lower than in some Latin American countries, sensitivity to this issue remains high (3). Disputes arising from oil contracts or claims related to sanctions have demonstrated that recourse to international arbitration can have complex implications for public policy and the independence of the judiciary.

Overall, the experience of developing countries shows that, on the one hand, these states are compelled to accept arbitration in order to attract foreign investment, while on the other hand, they face serious constraints in legislative and policy-making autonomy in practice (28). This situation has led many of these countries to seek reforms to investment treaties, reconsider arbitration clauses, and even establish regional institutions for dispute settlement.

Therefore, the experience of Iran and other developing countries indicates that, although investment arbitration is an instrument for protecting investors, without careful design and legal safeguards it can become a threat to national sovereignty and the political legitimacy of states. The experience of Iran and other developing countries shows that investment arbitration is simultaneously an opportunity for attracting capital and a threat to sovereign authority. Because of constitutional limitations and sensitivities regarding the delegation of judicial powers, Iran has always been cautious, yet has still been obliged to accept arbitration clauses in oil contracts. Examples such as Argentina and Venezuela demonstrate that emergency measures or nationalization can trigger waves of claims and heavy damages. In Iran, disputes arising from oil contracts and sanctions have created complex consequences for judicial independence and policy-making. The author concludes that, without revisiting treaties and designing regional or support mechanisms, investment arbitration can put severe pressure on states' political legitimacy and independence.

Human Rights and Public Order Challenges

Investment arbitration frequently encounters human rights and public order challenges, because arbitral decisions can affect citizens' fundamental rights and governments' social policies. In some cases, governmental measures aimed at protecting public health, the environment, or workers' rights have been characterized as violations of treaty obligations. This has prompted concerns that the interests of multinational corporations are being placed above human rights and the public good (29). At the same time, the lack of transparency and accountability in arbitration proceedings calls their legitimacy into question in the eyes of the public. As a result, striking a balance between investor protection and respect for human rights and public order is one of the core challenges of the investment arbitration system.

Investment arbitration is not merely a legal mechanism; it has profound consequences for society and for citizens' fundamental rights. When governmental measures to protect health, the environment, or workers' rights are treated as violations of treaty obligations, this signals the prioritization of multinational corporate interests over the public good. Likewise, the absence of transparency and accountability in arbitral proceedings weakens their legitimacy in public opinion. Accordingly, it is essential to establish a stable balance between investor protection and respect for human rights and public order.

The Impact of Arbitral Awards on Citizens' Fundamental Rights

International investment arbitral awards are not confined to the relationship between the state and the foreign investor; they also have deep effects on citizens' fundamental rights. When a state is ordered to pay substantial damages as a result of public-policy measures in areas such as health, environmental protection, or labor rights, public funds that should be allocated to education, health care, and social welfare are instead diverted to compensating investors. This directly undermines citizens' right to access public services (30).

Moreover, governments' fear of facing arbitration claims can lead to a "chilling effect" in policy-making; that is, states refrain from enacting protective legislation in the fields of human rights, environmental protection, or labor in order to avoid the risk of financial liability. This situation restricts citizens' rights to a healthy environment, fair working conditions, and social protection.

In some cases, such as those concerning public health, the right to health has been placed in opposition to the interests of multinational corporations. Even when the tribunal has ruled in favor of the state, the very process has revealed how citizens' fundamental rights can be placed at risk. Conversely, in cases such as *Vattenfall v. Germany*, governmental decisions taken to protect the environment have been characterized as violations of treaty obligations, illustrating how environmental rights can be sacrificed in favor of investor protection.

In addition, the lack of transparency in arbitral proceedings and the inability of civil society to participate directly mean that citizens' rights are not fully represented in this process. While arbitral decisions can have wide-ranging consequences for people's everyday lives, citizens effectively have no role in defending their interests. This structural exclusion further exacerbates the democratic deficit of the system (31).

Taken together, investment arbitral awards can restrict fundamental rights by reducing public resources, creating a chilling effect in policy-making, and prioritizing corporate economic interests over social welfare. This reality underscores the need to revisit the investment arbitration system and to create mechanisms that ensure respect for human rights and public order. Investment arbitration awards are not limited to disputes between the state and

the investor; they can directly affect citizens' fundamental rights. Condemnations requiring states to pay large sums divert public resources away from education, health care, and social welfare. Fear of arbitration claims also produces a "chilling effect" in policy-making, discouraging governments from adopting protective legislation in the fields of human rights and environmental protection. Cases such as *Vattenfall v. Germany* show that even environmental policies can be sacrificed in favor of investor protection. Ultimately, the lack of transparency and citizen participation in arbitral proceedings highlights the need to reform the system and guarantee respect for human rights and the public interest.

The Conflict Between Public Order Requirements and States' Contractual Obligations

One of the most important legal challenges in the field of foreign investment concerns the conflict between public order requirements and states' contractual obligations. On the one hand, states are compelled, in order to attract foreign investment, to conclude contracts that include arbitration clauses and broad commitments toward investors. On the other hand, as sovereign entities they are obliged to safeguard the public interest, protect citizens' fundamental rights, and uphold public order. When the performance of a contract or the enforcement of an arbitral award conflicts with fundamental public-order principles such as public health, environmental protection, or social justice, states face a serious dilemma (23).

In many arbitration cases, investors argue that the state has breached its contractual commitments by changing laws or imposing new restrictions. In response, states contend that their measures were necessary to protect public order and essential societal interests. This conflict is particularly pronounced in areas such as public health, national security, and environmental policy. A striking example is the *Philip Morris v. Uruguay* case, in which Uruguay was sued for adopting strict regulations aimed at reducing tobacco consumption, but the tribunal ultimately upheld the state's right to protect public health.

However, in other cases, governmental measures taken to protect the environment have been treated as breaches of contractual obligations, and states have been ordered to pay damages. This divergence in practice indicates that the boundary between public order and contractual commitments remains ambiguous and heavily dependent on arbitral interpretation.

From the perspective of domestic law, many legal systems recognize that the principle of freedom of contract is limited by public order (32). In Iran, Article 139 of the Constitution and Articles 10 and 975 of the Civil Code exemplify these constraints, making clear that contracts and even arbitration clauses cannot be enforced in a manner contrary to the public interest and the fundamental interests of the state.

The tension between public order requirements and states' contractual obligations reflects a persistent conflict between the economic logic of investment and the sovereign logic of governance. This conflict has wide-ranging implications not only in theory but also in practice and highlights the need to reconsider investment treaties and arbitral practice. Thus, in the context of the conflict between public order requirements and states' contractual obligations, states are, on the one hand, compelled to accept extensive contractual commitments in order to attract investment, while, on the other hand, they remain bound to protect the public interest and citizens' fundamental rights. Cases such as *Philip Morris v. Uruguay* show that tribunals sometimes rule in favor of the state and public health, yet in other instances environmental measures have been treated as breaches of contractual obligations. This divergence reveals the ambiguity of the boundary between public order and contractual commitments and its

heavy dependence on arbitral interpretation. Ultimately, the text emphasizes the need to review investment treaties and create mechanisms that ensure the protection of the public interest alongside investor protection.

Reform-Oriented and Forward-Looking Solutions

The investment arbitration system requires fundamental reform in order to maintain a balance between investor protection and state sovereignty. One important proposal is the establishment of a permanent international investment court to replace ad hoc arbitral tribunals, thereby increasing coherence and predictability (33). Incorporating explicit exceptions for public order, human rights, and environmental protection into investment treaties can also prevent the erosion of the public interest. Enhancing transparency and enabling civil-society participation in arbitral proceedings would further strengthen the system's legitimacy.

Revising bilateral investment treaties and moving toward regional or multilateral frameworks can help create a more balanced future for investment dispute settlement. To achieve a proper balance between investor protection and state sovereignty, new structures such as a permanent investment court are needed. Likewise, including public-order, human-rights, and environmental exceptions in treaties can prevent the violation of public interests. The author considers transparency and civil-society participation to be key factors in enhancing arbitral legitimacy. Ultimately, the transition from bilateral to multilateral frameworks is presented as a pathway toward a more balanced future.

Revising Investment Treaties and Incorporating Sovereign Exceptions

Over the past two decades, revising international investment treaties has become one of the most important issues in economic law and public international law. Many states have come to the conclusion that traditional investment treaties, with their excessive focus on protecting foreign investors, have in practice restricted states' sovereignty and their regulatory capacity. For this reason, a global trend has emerged toward reforming these treaties, in which the incorporation of sovereign exceptions has assumed a central role.

These exceptions allow states, under specific circumstances, to retain legal legitimacy for their actions even when such measures conflict with investors' interests (34). Prominent examples of these exceptions relate to public health, environmental protection, national security, and public order. For instance, in the European Union's new treaties, clauses have been included granting states the right to adopt restrictive measures against investors in order to address environmental or health crises, without such measures necessarily being considered treaty violations.

At the international level, institutions such as UNCTAD and UNCITRAL Working Group III have likewise emphasized the need to reconsider the investment dispute settlement system. Proposals such as creating a permanent investment court or explicitly incorporating sovereign exceptions into treaties have been put forward precisely to strike a balance between investor protection and the preservation of states' regulatory powers.

For developing countries, such revision is doubly important, as they have been disproportionately exposed to large and costly arbitration claims. The inclusion of sovereign exceptions can enable these countries, in times of crisis—such as financial, health, or environmental crises—to implement their public policies without constant fear of heavy financial liability. In Iran as well, the issue of revising investment treaties and including sovereign exceptions has been raised. Given the constitutional constraints and the sensitivity surrounding the protection of

national sovereignty, incorporating such exceptions could offer a mechanism for balancing the attraction of foreign investment with the safeguarding of the public interest.

In sum, revising investment treaties and incorporating sovereign exceptions is not only a legal necessity but also a political and social imperative (12). These reforms can enhance the legitimacy of the investment arbitration regime, reduce conflicts between states and investors, and better protect citizens' fundamental rights. The future of this field depends on how successfully states can design treaties that simultaneously protect investors and respect state independence and sovereignty. Examples from the practice of the European Union and international bodies such as UNCTAD and UNCITRAL show that there is strong emphasis on the need for such reforms. The author notes that including sovereign exceptions gives states the authority, in times of crisis, to maintain legal legitimacy for their actions even when these conflict with investors' interests. Ultimately, these reforms are assessed as essential tools for achieving a balance between investor protection and the preservation of state independence and sovereignty.

Developing Alternative Dispute Resolution Mechanisms and Enhancing Transparency in Arbitration

One of the most significant criticisms of the international investment arbitration system concerns the lack of transparency and the limited range of dispute resolution options. In recent years, many states and international institutions have concluded that, in order to increase the legitimacy and efficiency of this system, they must move toward developing alternative dispute resolution mechanisms and strengthening transparency. Mechanisms such as mediation, conciliation, and structured negotiation can resolve disputes in a quicker and less costly environment before they escalate to arbitration. These methods not only reduce the financial and political burden of arbitration but also allow greater flexibility in reaching win–win solutions (27).

At the same time, enhancing transparency in arbitral proceedings has emerged as a critical necessity. Many investment arbitration awards have a direct impact on public rights and on states' macro-level policies, yet proceedings are often conducted behind closed doors. For this reason, institutions such as UNCITRAL and ICSID have, in recent years, adopted rules to increase public access to documents, hearings, and awards. These reforms are aimed at improving accountability and strengthening public confidence in the arbitration system.

States' experiences show that using alternative dispute resolution mechanisms can prevent the emergence of costly disputes. For example, some governments have established joint commissions or consultative mechanisms to manage investment disputes before they are referred to arbitration. This approach is particularly important for developing countries with limited financial resources.

Alongside these developments, transparency must be upheld as a fundamental principle at all stages of arbitration. The publication of awards, the possibility for civil-society participation, and open access to case materials are among the measures that can enhance the system's legitimacy. Otherwise, investment arbitration will continue to face criticisms such as systemic bias toward investors and disregard for the public interest (32).

Overall, the development of alternative dispute resolution mechanisms and the enhancement of transparency in arbitration not only help reduce costs and increase efficiency but can also improve public trust and the political legitimacy of the system. The future of investment arbitration depends on its ability to balance investor protection with the safeguarding of the public interest. Employing alternative mechanisms can prevent the emergence of high-cost disputes and alleviate financial and political pressures. The author emphasizes that this approach is especially important for developing countries facing resource constraints. He also insists on the need to maintain transparency at every stage of arbitration—from the publication of awards to the participation of civil-society actors. In his view,

without transparency, arbitration will continue to face criticisms such as investor bias. Ultimately, it is concluded that the future of investment arbitration depends on its capacity to achieve a balance between protecting investors and safeguarding the public interest.

Conclusion

This study demonstrated that although investment arbitration has played a significant role in ensuring the security of foreign investment in recent decades, it has simultaneously created serious challenges for the fundamental principle of national sovereignty. The findings indicate that the expansion of arbitral jurisdiction, the limitation of domestic courts' authority, the weakening of legislative independence, and the financial pressures resulting from arbitral awards have placed states in a difficult position.

The examination of landmark cases such as *Philip Morris v. Uruguay*, *Vattenfall v. Germany*, *Yukos v. Russia*, and *Methanex v. the United States* showed that the tension between investor protection and safeguarding the public interest is a practical and growing reality in international economic law rather than a merely theoretical debate. From an economic and political perspective, the rise in investment claims and the imposition of heavy financial liabilities have confronted states with what is known as the chilling effect, in which governments refrain from implementing necessary public policies in areas such as health, the environment, and national security out of fear of potential claims.

This indicates that the current system of investment arbitration, rather than maintaining a balance between investor and state interests, has increasingly leaned toward unilateral protection of investors. The novelty of this research lies in its combination of recent statistical data—including the UNCTAD 2024 report—with comparative analysis of international cases and Iran's domestic regulations, enabling a simultaneous examination of the legal, economic, and political dimensions of this tension. Based on these findings, the study's hypothesis—that revising investment treaties and incorporating public-policy exceptions can create an effective balance between investor protection and the preservation of national sovereignty—is confirmed.

Given the study's results, it is evident that investment arbitration in its current form creates serious challenges for national sovereignty and places states in a difficult position. The limitation of judicial jurisdiction, the weakening of legislative independence, and the financial pressures arising from arbitral awards all demonstrate the necessity of revising investment treaties. Only through the design of intelligent treaty structures, the incorporation of public-policy exceptions, and strengthening the role of national institutions in the arbitral process can a stable balance be established between investor protection and the preservation of national sovereignty. This balance not only ensures investment security but also safeguards the independence of states.

In summary, to address the existing gaps and shortcomings identified in this study, the following recommendations can be offered:

- Investment treaties should be revised to include explicit exceptions for public-policy domains such as health, the environment, and national security;
- Transparency and accountability in arbitration processes should be enhanced, and arbitral awards should be made publicly available;
- The role of domestic courts in reviewing or supervising arbitral awards should be strengthened;
- The establishment of a permanent investment court under the supervision of the United Nations or reputable international institutions should be considered as an alternative to the current ISDS system.

Therefore, it can be concluded that only through structural reform of investment treaties and the development of balanced mechanisms can the two fundamental objectives—ensuring investment security and preserving national sovereignty—be achieved simultaneously.

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Authors' Contributions

All authors equally contributed to this study.

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The authors of this article declared no conflict of interest.

Ethical Considerations

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Transparency of Data

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