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Evolution of Protectionist Approach for Investor-State Settlement of Investment Disputes: A Critical Analysis

Ali Nawaz Khan [1] Dr. Bakht Munir[2] Jawwad Riaz [3]

1. Assistant Professor, University Law College, University of the Punjab, Lahore, Punjab, Pakistan
2. Lecturer, Institute of Languages and Linguistics, University of the Punjab, Lahore, Punjab, Pakistan
3. Assistant Professor, University Law College, University of the Punjab, Lahore, Punjab, Pakistan

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Corresponding Author

alinawaz.law@pu.edu.pk

ABSTRACT

The protection of foreign private investment in the host states remained contesting issue among the stake holders. The development of international law on foreign investment has engendered 'Protectionist Approach' for interests of foreign investors by investor-state disputes settlement (ISDS) mechanisms. International organizations have facilitated for the establishment of specialized transnational adjudicative forums for investor-state disputes of foreign investments, which has been emerged to protect the interests of foreign investors. Qualitative method of research has been applied wherein primary and secondary sources have been consulted. This paper examined historical events in backdrop of contesting stakeholders of investment disputes. Contesting interests of developing and developed world has been led to establish an agreement to protect the interest of foreign investors and how treatification process of ICSID Convention ended up in an imbalance protectionist approach to protect the interests of foreign investors in host states.

Introduction

Investment from outside is mainly in form of foreign direct investment (FDI) and portfolio investment in stocks. Portfolio investments were major form of foreign investment in first half of the twentieth century when countries were interested in issuing bonds to generate money for reconstruction activities in post WWII era (Yannaca-Small & Liberti, 2008). The nature of investment changed after emergence of multinationals corporations and expansion of their subsidiaries in post war era. The expression foreign property was familiar with literature of law in customary international law for property of long resident foreign nationals. The notion of foreign property replaced with more dynamic expression of foreign investment,

which implies certain duration and movement of property from one territory to another. Important features identified for foreign investment includes that substantial commitment involve for some duration with risk for both sides. The profit and return is involved in operation of activities significant for development of host state (Yannaca-Small & Liberti, 2008, p.9).

The preamble of ICSID Convention advocates that private investor can approach to invoke jurisdiction of the Centre for the Settlement of Investment Disputes. Foreign investor includes legal persons incorporated in third country and national of the contracting party of international investment agreement incorporated in the territory of other contracting part (Sauvant & Ortino, 2013, p.59). The criterion for foreign investment and investor thereof has been defined in the ICSID Convention. The question whether foreign investor is public or private entity is left to be decided by states in their treaty or contractual obligations. The ICSID jurisprudence has recognized private, public, and state controlled companies as foreign investors to approach ICSID jurisdiction. The state-owned corporations can invoke ICSID if corporation is not functioning as an agent of the respective government. Corporation cannot be treated as government owned entity unless it is not acting to discharge essential functions of the government and work to advance purposes of the government (Schreuer, 2009, p.161).

This paper discusses the emergence of 'protectionist approach' towards the assets of foreign investors. The contemporary protectionist approach has been evolved in backdrop of contesting stances between capital exporting and capital importing nations. The paper articulates the role of UNO and World Bank to facilitate the member states to resolve their disputes relating to foreign investments. In post WWII era, the UNO took initiatives to acknowledge dire need to protect assets of foreign investors as well as sovereign authority of the states over their natural resources. World Bank has proceeded to reinforce protectionist approach by establishing a specialized forum, ICSID, of institutional arbitration for settlement of investment disputes. The ICSID has introduced a pro-investor protectionist approach in backdrop of growing practice of expropriation by decolonized states. The article has concluded that expropriation incidents without any prompt, adequate and effective remedy and lack of impartial adjudicative bodies of host states have been impetus for the establishment of ICSID forum. ICSID has strengthen the approach in case of an adjudication against host states by making home state irrelevant of the process. Therefore, ICSID recognizes foreign investor as an independent subject of international law even without any reciprocal duty under the Convention.

Emergence of Protectionist Approach in Investment Disputes

The phenomenon of foreign investment protection surfaced more prominently when European traders established their trading relationships with the local communities of Asia, Africa, and Latin America (Subedi, 2008, p.7). The early European history has witnessed controversies relating to protection of alien

property. *Sornarajah* has pointed out two opposite point of view by states for protection of foreign investments in the host states. Firstly, foreign traders and investor are to be treated equal to the nationals of the host state. Those alien traders and investors deserve same protection of their property, which had been available to the citizen of the host states. On the other hand, major trader and colonial nations assumed support from the argument of supportive writing of *Vattel,* second rather opposite stance that property of foreign trader and investors is to be treated with some higher external standards of treatment. These opposite point of view have engendered controversies during colonial era in seventeenth century (Sornarajah, 2010, p.19).

In 17th & 18th century, major trading powers of the world decided to maintain restrain rule to protect property of their nationals from interference of the host state in peacetime. In case of confiscation of the aliens' property, compensation was required to pay to the nationals of other contracting state. The Friendship, Commerce and Navigation (FCN) Treaties among trading nations incorporated provisions for protection of economic interests of their nationals (Poulsen, 2011). Customary international law recognized that injury to the assets of foreign citizen is considered as an injury to investor state and the host state could be held responsible for such injury. Thus, the home state has legitimate interest in protecting its citizens and their assets. The home state principle supported by early scholars such as *Grotius* and *Vattel* that a foreign investor is already subject to the laws of their home country, so the laws of host state are not applicable on them (Brownlie, 2008, p.519). This opinion implies that the host state could not expropriate the assets of the foreign investors. The disagreement sometime had resulted in full scale arms conflicts between states.

In 19th century, protection of alien property under customary international law invoked incidents of diplomatic intervention by the home state to provide relief to their investors. This diplomacy ranged from diplomatic efforts and sometime aggravated to gunboat diplomatic intervention by use of arm forces. The USA and France resorted to Gunboat Diplomacy against Venezuela and Mexico in 1860s. The capital exporting nations exercised option of Gunboat Diplomacy for enforcement of 'Responsibility of States' under customary international law. This diplomatic intervention and Gunboat Diplomacy had been exercised as recognized principle of international customary law. International obligations for home state principle to protect aliens' property was justified in number of incidents (Okpe, 2014, p.227, 228).

The last decades of nineteenth century are considered to be an era of the beginning of decolonization. The decolonized nations emerged with the rhetoric of sovereignty and complete independence. These newly established states rejected home state principle and shifted their reliance on sovereignty and sovereign equality. This implies that the host state has supreme authority to legislate and even expropriate assets of foreign investor even by ignoring international minimum standard treatment (Borchard, 2017). In 1868, an Argentinean jurist, *Carlos Calvo,* led

a campaign to oppose the home state principle for expropriation. He supported the assertion that foreign investor should be treated in same manner as his own nationals. And in case of dispute between foreign investor and host state, 'Local Remedy' is to be exhausted before invoking international adjudication (Newcombe & Paradell, 2009). Many newly established developing countries, particularly Latin American incorporated this doctrine in their constitutions. After Russian of 1917 and Mexican revolution of 1920, 'Calvo Doctrine' provided to protect economic and political self-determination by applying domestic law by the national judges (Afilalo, 2004, p.290).

The expropriation experiences in Mexico engendered as a rigorous diplomatic campaign for 'Claim Commissions' set up between the USA and Mexico to resolve disputes of American foreign investors' victim of Calvo doctrine. During diplomatic efforts, American Secretary of State, *Cordell Hull,* articulated his position by asserting that taking of property without prompt, adequate, and just compensation is not expropriation but 'confiscations', which is against the norms of international justice (Lowenfeld, 2008, p.475).The doctrine is known as *Hull Formula*. In the period of decolonization, newly independent states accepted settlements of investment disputes according to *Hull doctrine*.

In post WWII developments, the newly independent states culminated an assertion of sovereignty by developing states after long suppressed period of colonization. This had motivated sizeable number of states to assert a control and to preserve natural resources for indigenous population of the states. In 1950s, this rhetoric provoked the wave of nationalization and expropriation of assets of their colonial era. There was a wide spread wave of control of investments of foreign controllers mostly in African and South American nations. The massive nationalizations and expropriations occurred in Iran, Libya, Egypt, Chile, Venezuela, and Cuba. These states took measures to recapture their natural resources and industrial potentials under perceived inequality of economic rights of foreign investors and host states (Kaushal, 2009, p.499). These states nationalized and expropriated by exercising their sovereignty. The *Hull Rule* was objected for its application on account of obligatory payment of adequate and effective compensation for expropriation of foreign property. The capital exporting nations pointed evidences of practice and writings to articulate international law in favour of *Hull Rule* for "prompt, adequate and effective compensation" as opposed to "appropriate compensation" for taking over foreign property by the host state in accordance to the local laws (Kaushal, 2009, p.648). The UNO took initiatives to demand for the protection of foreign investment assets among members' states with object to avoid any future conflict. The UN Economic and Employee Commission had conducted a study for development of an "investment code" in 1947 (Parra, 2017, p.11).

The world community under the auspices of the UNO started its efforts for formalization and regulation of international investment law. In 1962, UNGA passed

the Resolution, 1803 to recognize permanent sovereignty over the natural resources. The resolution passed to establish a balance of assertion between developed and developing hosts with consensus with the western states. This resolution protected permanent sovereignty of states over their natural resources with the need to protect the interest of foreign investors by providing compulsory compensation in case of any nationalization or expropriation (Kaushal, 2009, p.500). The UNGA Resolution of 1803 was passed on the lobbying of the developing nations in pursuance of their efforts to preserve its sovereignty over their natural resources (Subedi, 2012, p.500). In 1962, the UN Resolution of 1803 has recognized that states have permanent sovereignty over their national resources. Foreign investment must not be subjected to condition which conflict with the interests of the states. Foreign investment agreements are to be freely entered upon by or between the sovereign states. These agreements aimed to respect sovereignty of states and their natural resources (UNGA Resolution 1803 of 1963). The resolution was an effort to ensure protection of sovereign rights, while encouraging international cooperation in field of foreign investment. After the UNO initiatives taken for the promotion and protection of foreign investment, some other world economic organizations such as World Bank started its efforts for providing acceptable solution for ISDS.

On the other hand, the efforts of capital exporting nations remained ineffective to implement the *Hull Rule* due to growing opposition by capital importing nations. These decolonized LDCs resorted to less stringent the Rule of 'appropriate compensation' rather the principle of Prompt, adequate, and effective compensation for expropriations (Guzman, 1997, p.646, 647). The Rule of "appropriate compensation" remained dominant against the *Hull Rule* until the emergence of specialized transnational forums to resolve investment disputes (Guzman, 1997, p.651). The investment disputes had been in deadlock in absence of a specialized mechanism for ISDS between capital exporting nations and the Host states. The historical analysis of investment disputes suggests that foreign investors remain dissatisfied with the domestic settlement of investment disputes for politically influenced court system of national judiciary of host states. The capital exporting nations advocated for transnational institutional disputes settlement mechanism for investment disputes.

ISDS – Institutionalization of Protectionist Approach

Institutionalized approach for protection of foreign investment emerged from the creation of related international instruments. These instruments include international conventions, multilateral regional agreements, Multilateral Investment Treaties (MIT), Bilateral Investment Treaties (BIT), and investor-state investment contracts. The main objectives of these instruments are the promotion and protection of free flow of international investment. The international instruments i.e. International Investment Treaties (IITs) have been cornerstone for the establishment of international legal framework for the assertion of 'protectionist approach' for foreign investment. The existing framework of investment treaties provides

facilitative approach for entry, admission, stay, and expatriate of profits for foreign investors. At the same time, overwhelming majority of investment treaties have been providing for institutional settlement of investment disputes by providing real, prompt, and effective protection to the interests of foreign investors.

After WWII, investment disputes were resolved between the states by ICJ by treating such as dispute between states. The paradigm shifted when 'foreign investors' were allowed to approach international tribunals for redress of their grievances directly without intervention of home states. The transnational tribunals such as ICC, SCC, and LCIA have provided some choices of impartial forum for settlement of commercial disputes of foreign investors. The growing trends of ISDS in supranational tribunals raised its dire need for a specialized forum for settlement of investment disputes.

In post WWII era, some important institutions were established for settlement of investment disputes. These institutions promoted arbitration mechanism for settlement of investment disputes. The process of international arbitration can be classified into two main categories: *ad hoc* dispute resolution and institutional resolution of investment disputes. *Ad hoc* arbitration does not rely on formal administration or supervision. On the other hand, institutional settlement of investment disputes is done under aegis of transnational arbitration institutions. Some leading international forums of institutional arbitration include international court of arbitration of International Chamber of Commerce (ICC), London Court of International Arbitration (LCIA), the arbitration institution of Stockholm Chamber of Commerce (SCC), and other regional arbitration centers that have been set up in Asia, Middle East, Africa, and North America. These institutions are providing forums for the settlement of investment disputes.

International Centre for the Settlement of Investment Disputes (ICSID) has been emerged as the leading arbitration institution as compare to other supranational arbitration forums since 1965. ICSID has been emerged as a preferred forum for the settlement of investor state disputes, settlement between contracting states and the nationals of other contracting states. The Centre was established by a multilateral treaty commonly known as ICSID Convention or Washington Convention. The Centre established under ICSID Convention is one of the five international organizations that make up the World Bank Group. The Centre has been created 'to fill a gap' in mechanism for settling international investment disputes (ICSID Convention of 1965). The gap deems difficult for the governments and foreign investors to find a mutually accepted choice of forum and law for settlement of their investment disputes (Osode, 1997)

The trends of entrusting jurisdiction to ICSID have been on the rise for institutional arbitration since 1990s (UNCTAD, 2014) *Stephan W. Schill* has referred an explanation by *Gary Born* for establishment of the ICSID that international arbitration process has been providing neutral and speedy remedy for violation of

the investment agreements. The expert process of transnational institutional arbitration suffers fewer ills than domestic litigations (Schill, 2015, p. 70).

United States lobbied for incorporation of supranational forum for the ISDS in NAFTA i.e. Chapter 11, which refers ICSID jurisdiction for resolution of investor state disputes. The signing of NAFTA treaty by Mexico considered as abandonment of longstanding adherence to '*Calvo Clause*' by a Latin American nations (Afilalo, 2004, p. 289). The ICSID Convention provides for informal means of settlement of investment disputes between foreign investors and host states, which includes conciliation and arbitration. The administrative and jurisdictional structure of ICSID has been established with aim to promote international economic cooperation with participation of foreign investor. Confidence of foreign investors has been persuaded by extending a reliable structure and jurisdiction for settlement of investment disputes in consequent of their investment (ICSID Convention of 1965).

Establishment of ICSID

In early 1960s, the President of International Bank for Reconstruction and Development (World Bank) took initiative to establish an international adjudicatory body for settlement of foreign investment disputes (Parra, 2017, p.12). The Secretary General of World Bank put up their notes for the establishment of multilateral approach to settle investment disputes. A special Committee was constituted after approval of Executive Directors of World Bank Group with the task to prepare a draft of a Convention for a forum for the investor state dispute settlement (History of ICSID Convention, vol. I). The Special Committee prepared a Report which was discussed in Regional Expert Committees established for making recommendations for the proposed forum. The first draft of the ICSID Convention was approved by Executive Directors after incorporating recommendations of Regional Expert Committees. Final draft was approved by the Executive Directors on March 18, 1965(Parra, 2017, p. 41, Appendix II, III, IV).

The ICSID jurisdiction exclusively deals with the 'legal disputes' arising out of an international investment between foreign investor and host state (ICSID Convention, Art.25). The ICSID jurisdiction tacitly excludes local remedies and diplomatic protection unless otherwise agreed by the parties (ICSID Convention, Art.26, 27). To invoke jurisdiction of ICSID, one of the parties must be a contracting state (or a constituent sub division or agency of a contracting state) and other party must be a national of another contracting state ICSID Convention, Art.25). The distinctive feature of ICSID mechanism is the recognition of foreign investors as the subject of international law with the status not less than a state. Thus, foreign investors can approach international dispute settlement forum without interference and recourse from the home state against the host state as party to foreign investment dispute.

The dispute must relate to the existence or scope of a legal right or obligation. Meaning thereby reparation has to be made for the breach of a legal obligation. The

Centre arbitrates foreign investment disputes by voluntary irrevocable consent of the parties. The dispute can be arbitrated through ICSID when clauses of consent to submit the dispute are mentioned in the agreement between investor and the state. The logical result of the clause is that a state as contracting party cannot frustrate arbitration as agreed by effecting changes in its municipal law (Osode, 1997) The host states have assumed international obligations under ICSID jurisdiction sometime by domestic legislation or investment treaties or investor-state contracts. However, majority of BITs are provided with dispute settlement clauses which confer for ICSID jurisdiction (Parra, 2017, p. 41-43).

Tunisia was the first country to sign the Convention. There were thirty countries which signed the Convention till December 1965. The nine industrial capital exporting states, seventeen African LDCs and only three Asian countries, including Pakistan were the pioneer signatory members of the Convention. Till the end of 1965, there were no Latin American and countries from communist and socialist block, which has signed the Convention. Nigeria was the first country which submits its ratification with the World Bank on 23rd August 1965. The USA ratified the Convention on 10th June 1966. The first 20 countries which ratified include 14 countries from African and Netherland was the 20th country which ratified the Convention to qualify on October 14, 1966 (Parra, 2017, p. 87, vol. II, III, IV).

In first decade of its establishment, ICSID was not attractive mechanism for investment protection. The difference of political and economic approach in the bipolar world can be referred as one of the underlying reasons for such avoidance. But introduction of BITs to recognize the ICSID arbitration made it an attractive mechanism for ISDS. The proliferation of BITs has contributed rising trend to accept arbitration jurisdictions of transnational dispute settlement forum for ISDS. The end of cold war and establishment of unipolar politico-economic regime has facilitated to make it a popular destination for ISDS in last three decades since 1990s.

Evaluation of Protectionist Approach for ISDS

The capital importing nations are reluctant to submit their investment disputes to these institutions of arbitration for foreign investment disputes because they perceive it as biased and untrustworthy. The less developed and developing countries insistence on retaining their sovereignty and to have an effective control over admission and activities of foreign investment by exercising their sovereign rights. These countries exercised this control through *Calvo Clause* in constitutions, by laws for screening mechanism for the inflow and outflow of capital, performance requirements, nationalizations, and state monopolies. These states want these laws to resist encroachment of foreign influence and distribution of gains of their economic development more evenly across socio-economic spectrum within the nation state. These transnational institutional rules of arbitration are placing limitations on legislative capacity of sovereign governments (Schneiderman, 2010).

The capital exporting nations and their investors prefer to submit their claims in case of investment disputes to these institutional tribunals at some neutral place before impartial judges rather than domestic courts (Law Review Association, 107). These tribunals are considered depoliticized (Shihata, 1995) and beyond the dominant influence of host country's authorities (Al-Saeed, 2008). Furthermore, the other reasons for adopting this institutional arbitration approach for the settlement of foreign investment disputes are risk of abuse of the legal procedure and transparency under local procedural laws. The domestic laws and procedure are evaluated as below minimum standard of justice and equity (Subedi, 2008, p.10). The inconsistent governmental policies and commitments, along with instances of expropriations without adequate compensation can be cited as justification for the transnational arbitrations (Al-Saeed, 2008). The trend of supranational institutional arbitration for ISDS has been on the rise since 1979 and increasingly providing a substitution for domestic litigation (Brower & Sharpe, 2003, p. 416). The perceived partiality of host state court system is another factor for shift of paradigm from national to transnational adjudications. The domestic courts show reluctance to fully scrutinize affairs of sovereign state actions for constitutional or legal reasons. The 'act of the state' in its sovereign capacity has been justified to redress the disputes in some international forums by independent adjudicators (Brower & Schill, 2008). p.471).

ICSID mechanism differs from the hierarchy of national court system. Consistent body of jurisprudence and public acceptance has established legitimacy for domestic court system (Brower & Sharpe, 2003, p.418). On the other hand, ICSID mechanism is the product of global contractual regime between capital exporting nations and capital importing nations of the world. In international law regime 'legitimacy' is desired element for the applicability and compliance of a regime for the stakeholder states.

The ISDS system is built on the justification of seeking durable and credible commitments to keep the promise on behalf of host states. The international obligations of host states for independent and presumptively neutral mechanism of ISDS have contributed for the adherence to the system for their national interests (Brower & Schill, 2008). p.478). At the same time, acceptance of jurisdiction and rising trend for ICSID arbitration has strengthened legitimacy rhetoric in favour of the mechanism. On contrast, negative response of host states might impact trust of existing mechanism and deter potential foreign investors to precede for their dealings with the state thus, the legitimacy of the system is questioned.

Conclusions

The protection of assets of foreign investor has been a long debated issue in international law. The diametrically opposite approach remain challenging for the protection of foreign investment in host states between capital exporting and importing nations. Those opposite stances generated controversies, which lead to some incidents of arm intervention by the capital exporting nations to protect the

assets of their citizens in the host states. The protection of foreign investors had soaring point for international peace and security of the world. The decolonization of late 19th and early 20th centuries, sparked a wave of nationalism among the newly independent states to protect and exploit their natural resources by exercising their sovereign authority. In number of cases the newly established governments exercised their sovereign authority to nationalize or expropriate the assets of foreign investors. These incidents of expropriations without adequate and effective compensations posed a challenging situation for the flow of foreign investment as well as international peace and security.

The protectionist approach of foreign investment mainly revolved around the rules regarding entry, admission, stay and dispute resolution mechanism. In post WWII era, UNO took initiatives for the establishment of an 'investment code' for the promotion and protection of foreign investments. At the same time, UNO recognized and protected sovereign rights of states over their natural resources, which had been, in most of the cases, subject matter of investment disputes. In post WWII period, numbers of disputes resolution mechanisms were established to preserve peace and security of the world. *Scheuer* has pointed out that the disputes between states can be solved by ICJ or Permanent Court of Arbitration (PCA) and commercial disputes between corporations by domestic courts or transnational arbitrational forums such as ICC, SCC. But the purpose of the ICSID Convention was to establish a transnational independent forum to resolve investment disputes between foreign investor and the host state (Schreuer, 2009, p.160).

The capital exporting nations lobbied for the establishment of a transnational institutional settlement of investment disputes for prompt, adequate, and effective compensation to foreign investors in case of expropriations. The overwhelming majority of capital importing nations pleaded 'appropriate compensation' by domestic adjudications. At the same time, foreign investors showed serious concerns with policy and working of domestic courts to deal with the issues of foreign investment. These concerns relating to domestic adjudication include lack of expertise in issues of international transactional law, international commercial practices, change of government policies, and biased judicial bodies having control of political authorities in Least Developing Countries (LDCs). These long standing controversial stances between capital exporting and importing nations led to the establishment of a supranational forum of institutional arbitration for investment disputes.

These competing stances motivated World Bank to take initiative for the establishment of fifth organ of World Bank Group. ICSID has been established as a specialized forum for the settlement of foreign investment disputes between foreign investors and host states. ICSID Convention has created tribunals for the member states to refer their investment disputes relating to legal issues. The Convention has by recognized foreign investor as subject of international law with the right to claim against a sovereign state by eliminating any role of contracting home state.

Taking into account the developments to protectionist approach for foreign investments, ICSID Convention has reinforced pro-investor approach in line with *Hull doctrine* of superior external standards for the protection discourse of foreign investment. ICSID has contributed to widen the scope of protectionist approach for foreign investment. At the same time, the inherent unpredictable standards of formation of ICSID tribunals and exercise of jurisdictions have potential of backlash from LDCs host states.

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