



Reforming Investor–State Dispute Settlement (ISDS): A Comparative Legal Analysis of Pakistan, the United States, and China in the Emerging Global Investment Regime

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ABSTRACT

This paper undertakes a comparative legal evaluation of the Investor-State Disputes Settlement (ISDS) legal frameworks of the USA, China and Pakistan. Each jurisdiction represents radically differing political economies and varying degrees of administrative capacity relative to their roles in global investment flow. A "most different systems" comparative-doctrinal method was employed to trace the historical development of each countries' domestic investment legislation, pre-2015 ISA treaty practices and major arbitral decisions (*Methanex v. USA*, *Ansung Housing v. China* and *Tethyan Copper v. Pakistan*). Three distinct reform paths were identified: the "controlled openness" and "legalized transparency" model of the USA; the "pragmatic sovereignty" model of China through selective consent and administrative mediation; and Pakistan's transitional path from extreme vulnerability toward a more balanced model. Lessons learned from the USA and China ISDS models are used to propose a three-layered hybrid ISA model for Pakistan consisting of (i) a mandatory domestic prevention/mediation layer; (ii) a calibrated arbitration layer limited to direct expropriation and nationality-based discrimination with compulsory exhaustion of local remedies for other claims; and (iii) a post-arbitration review layer including multi-lateral/appellate options and retained national court oversight. Finally, the paper argues that lasting legitimacy in ISA will depend upon institutional recalibration that aligns international legalization with each state's administrative capacity and development priorities.



Introduction

The rapid expansion of investor-state dispute settlement (ISDS) legal frameworks since the 1990s has profoundly transformed global economic governance, shifting significant interpretive authority from states to private arbitral tribunals (Schill S. W., 2009). Investor-State Dispute Settlement (ISDS) is a larger legal regime that governs investor-state disputes through treaties that allow for the use of Investor-State Arbitration (ISA). ISDS in Bilateral Investment Treaties provide greater predictability and increased capital flows for investors. However, ISDS has also created a significant legitimacy crisis, especially among capital importing and developing states, whose regulatory autonomy has been compromised by broad treaty standards and expansive arbitral interpretations (Sornarajah, 2015). The USA, China and Pakistan represent the extremes of differing political systems, economic models and institutional capabilities, thereby providing a useful lens to analyze how states adjust the relationship between investor protection and sovereign regulatory space (Poulsen, 2015). The USA has been at the forefront of modern ISDS and initially established such under the North American Free Trade Agreement (NAFTA) in 1994, but soon introduced additional procedures that provide greater transparency and allow for domestic screening prior to ISA proceedings through the Committee on Foreign Investment in the United States, (CFIUS), and the United States Mexico Canada Agreement (USMCA)) (Vandeveld, 2005). China initially presented itself as a cautious host state, with highly restrictive consent to ISA in the 1980s, before gradually adopting a more administratively controlled and selective openness model that subordinates international arbitration to domestic mediation and requires exhaustion of local remedies (Gallagher & Shan, 2009). In contrast, Pakistan in 1990s signed its First Generation BITs and included extensive protections for investors in the treaties; however, without creating institutional protections to counterbalance the risks associated with the open-ended nature of ISDS provisions within the BITs. This created a structural imbalance that resulted in one of the highest recorded losses in Investment-State Arbitration (ISA), amounting to approximately USD 6 billion in the Reko Diq award (Tethyan Copper v. Pakistan, 2019).

In order to address the central research question: "How do the USA, China and Pakistan differ in their approaches to reform of ISA and what comparative lessons can be drawn to assist Pakistan in establishing a balanced, legitimate and development sensitive framework for resolving disputes between foreign investors and the government. Based on the findings of this comparative analysis, the paper provides actionable policy recommendations and outlines a concrete three-layered hybrid ISDS model for Pakistan. These recommendations are intended to demonstrate that reform of ISDS need not involve a rejection of the process of legalization, but rather embedment of the same within robust domestic institutions that can provide for prevention, mediation, and sovereign oversight.

Research Question and Objectives

The central research question guiding this study is:

How do Pakistan, the USA, and China approach ISDS reform differently and what comparative legal insights are relevant for Pakistan in moving towards a balanced, legitimate, and development-sensitive investment-dispute framework?

Subsidiary questions are the following:

- How does each state conceive of sovereignty and consent in the treaty drafting process?
- What procedural or institutional reforms can correct arbitral overreach?
- How can Pakistan modify its own domestic and treaty practices in line with global reformist momentum without endangering its regulatory autonomy?

The goal is both prescriptive and analytical: a hybrid reform model is proposed, which combines procedural transparency and structured consent with mediation, harvesting the advantages of arbitration with the accountability of domestic surveillance.

Methodology

In this study comparative-doctrinal methodology has been adopted that employed a “most-different-systems design”, a traditional design for comparative study (Przeworski 1970). The U.S., China and Pakistan were chosen because they are the most dissimilar among other systems in terms of their respective political system, economic development levels, administrative capacities, and participation in international foreign direct investment flows in the U.S. as a mature capital-exporting democracy, China as a centralized state-capitalist latecomer turned major outward investor, and Pakistan as an economically developing host state with fragile institutions. As such, this study identifies those institutional and treaty design characteristics that contribute to ISDS vulnerability and subsequent reform (Schill and Gülay 2019).

The methodology consists of three closely interrelated stages:

1. The study traced the domestic FDI legal development in each country from the early 1990s through the present day, with an emphasis on the key framework laws that established the foundation for investor–state relations prior to the major arbitral defeats (i.e. U.S. FINSA 2007 and CFIUS regulations 2008–2014; China’s Law on Wholly Foreign-Owned Enterprises (2000 amendment) and its successive Foreign Investment Catalogues 2002–2015; Pakistan’s Foreign Private Investment (promotion and Protection) act 1976, Board of Investment Ordinance 2001).
2. The study also discussed the Bilateral Investment Treaties (BIT), practices and model BITs responsible for generating the disputes under review.
3. The study conducted a detailed review of one landmark respondent-state loss per jurisdiction rendered between 2000 and 2020 in each of three countries.

Through comparison of the institutional shortcomings and broad treaty provisions that were revealed by the award decisions with the content of each country’s post-award new generation treaties and domestic reforms, the study suggests recommendations for Pakistan.

Legal Regime on Investors States Disputes Settlement in the United States

Historical Context of Investor-State Dispute Settlement in the United States

Both historically, and today, the United States is the intellectual creator and largest critic of the current form of investor-state dispute settlement. The U.S. incorporated investor-state arbitration provisions within its post-World War II Friendship Commerce and Navigation (FCN) Treaties (Mundi, 1948.). However, the modern investor-state arbitration framework was developed by Chapter 11 of the North America Free Trade Agreement (NAFTA) in 1994, providing for the ability of private investors to obtain a binding decision against one of the three NAFTA countries, namely the U.S., Canada or Mexico (Vandeveld, 2017). In the late 1990's and early 2000's there were several lawsuits filed against the U.S. primarily regarding environmental and health concerns creating an extreme amount of backlash at the national level even though the U.S. did not lose a single completed lawsuit (Franck, 2005). Following this period of significant exposure, the U.S. rapidly adjusted: The U.S. Model BIT of 2004, and 2012 added increased transparency during the arbitral process, amicus participation and procedures for dismissing unfounded claims. The US-Mexico-Canada Agreement (USMCA) of 2020 nearly completely eliminated ISDS between the U.S. and Canada, and significantly limited ISDS between the U.S. and Mexico (Gagné and Morin, 2018). Thus, the U.S. transitioned from being an enthusiastic promoter of ISDS in the 1990's to

what is now referred to as a "controlled openness" where the U.S. has the ability to utilize their robust domestic administrative capacity and ex-ante screening (namely through CFIUS under the Foreign Investment and National Security Act of 2007) to greatly reduce the exposure to international arbitration (Alvarez, 2020).

Foreign Investment and National Security Act of 2007 (FINSA) and CFIUS Regulations (2008–2014), USA

The Legal regime on foreign investment in the United States has long history, this study focused National Security Act of 2007 and CFIUS Regulations in the United State. In 2007 U.S. Congress passed the Foreign Investment and National Security Act of 2007 (FINSA, Pub. L. No. 110-49), to enhance the authority of the U.S. Government to review foreign investments for national security risks, by providing a structured process for the Committee on Foreign Investment in the United States (CFIUS) to follow (Congress, 2007).

In response to increasing foreign purchases of key U.S. assets, FINSA provided for increased transparency in reviewing foreign investments, required filing of mandatory notifications for certain types of investments, and facilitated cooperation among agencies involved in such reviews, but did not provide for direct investor-state dispute settlement (ISDS) or arbitration of investment disputes between investors and host states. Rather, FINSA focused on preventing post-investment disputes through ex-ante reviews of proposed investments, thus reducing the likelihood of ISDS claims under the frameworks of NAFTA/USMCA (Lai 2021).

With respect to disputes and arbitration, FINSA does not contain specific provisions for ISDS or international arbitration. Its focus is upon the use of domestic judicial review to challenge the decisions made by CFIUS. Pursuant to Section 3 of FINSA (codified at 50 U.S.C. App. § 2170), CFIUS must conduct a review of "covered transactions" (transactions that grant foreign control over a business in the U.S. that involves critical infrastructure) for a period of thirty days. CFIUS may extend the review period for up to forty-five additional days to investigate the transaction. During the review period, parties to the transaction may also agree voluntarily to mitigate the terms of the transaction (for example, by agreeing to divest a portion of their interest in the U.S. business under Section 721(f)) (CFIUS, 2022).

If the President blocks a transaction pursuant to Section 721(d), the affected party may appeal the decision in a U.S. Federal Court under the Administrative Procedure Act (APA, 5 U.S.C. § 706) for arbitrary and capricious action (U.S. Congress, 1946), but will be given significant deference by the court to the national security determinations made by the executive branch (*Ralls Corp. v. Committee on Foreign Investments, et al.*, No. 13-5315 (D.C. Cir. 2014)). CFIUS regulations (31 C.F.R. Parts 800–801) that were promulgated in 2008 and remain in effect until 2014 further reinforce the approach described above in sections 800.220 (mitigation measures) and 800.401 (voluntary notices) by providing for informal consultation with CFIUS, but not for the creation of an arbitral forum (Lederman 2020). Disputes arising out of the failure of parties to comply with conditions imposed by CFIUS will be resolved either through administrative procedures or litigation in a U.S. Federal Court under the APA, but will not involve ISDS. This structure reinforces U.S. sovereignty through domestic processes and avoids exposure to international arbitration (illustrated by the very low number of ISDS claims filed against the U.S. (for example, zero losses in *Methanex v. United States*, UNCITRAL 2005)) while also satisfying the requirement of BIT exhaustion.¹

¹ *Methanex Corporation v United States of America* (UNCITRAL, Final Award, 3 August 2005).

The 2012 Model BIT: Architecture of Procedural Legitimacy

The 2012 U.S. Model BIT includes three primary design features, transparency, accountability, and procedural balance which promote American legitimacy regarding (Shedd, Murrill, & Smith, 2012).

- Transparency (Art 29) : All pleadings, hearings, and awards are public, with exceptions only for secret business information. This provision establishes the “sunlight principle” proposed by the OECD (2008) and later replicated in the UNCITRAL Transparency Rules (2014).
- Third-Party Participation: Tribunals may accept amicus curiae briefs from non-disputing parties. Investment disputes often involve public interests having to do with environmental protection, labor rights, etc. (Methanex 2005).
- Frivolous-Claim Filters (Art 28): Tribunals may summarily reject claims which are manifestly without merit. This counteracts strategic or political litigation.
- Consolidation of Proceedings (Art 27): Similar claims may be consolidated so that proceedings can be coherent and efficient, a response to submissions made simultaneously before various NAFTA panels, e.g., *Canfor v USA* (2005).
- Appellate Contemplation (Art 28 n.): The treaty expressly contemplates a future appellate mechanism which will have standing to rule on matters of law in order to improve consistency. This is an antecedent of the current UNCITRAL Working Group III discussions.

Jurisprudential Practice: Case Study I: Methanex Corp v. United States (UNCITRAL Award 2005)

The Methanex Corp vs. United States decision was a Canadian manufacturer of methanol who filed a complaint against California's 1999 phase out of the gasoline additive MTBE (methyl tertiary butyl ether), arguing that the phase out constituted an indirect expropriation and a breach of the fair and equitable treatment clause contained in Articles 1110 and 1105 of NAFTA (*Methanex Corporation v. United States of America*, UNCITRAL, Final Award, August 3, 2005)². Following one of the most open arbitration processes in history (the first NAFTA case accepting amicus briefs) the tribunal voted unanimously to dismiss all of the claims brought by Methanex, establishing what would be known as the "police powers" doctrine in modern investment law. The police powers doctrine holds that when a government enacts a non-discriminatory regulation in good faith for a public policy objective (such as protecting groundwater from MTBE contamination), such regulation will not constitute an expropriation (regardless of the extent of its economic impact on the investor) if it is enacted pursuant to due process (*Methanex v. United States*, 2005, Part IV.D.7, paras. 7-15; Brower, 2009; Schill, 2010). Additionally, the tribunal ruled that the minimum standard of treatment under customary international law requires conduct that is "grossly unfair, arbitrary, or discriminatory," which the California measure did not violate (*Methanex v. United States*, 2005, Part IV.C, paras. 1-32; Vandeveld, 2017).

Although the U.S. prevailed in this dispute, this case demonstrated an early vulnerability of the NAFTA system, the lack of previous consultation with the investors whose interests were adversely impacted created controversy and additional costs associated with litigation (Franck, 2005). Nevertheless, the arbitration decision clearly demonstrated the ability of the U.S. to protect legitimate public welfare regulations, while avoiding compensation, due to the strength of its administrative procedures, the scientific basis of the regulation and the transparency of the

² *Methanex v United States*, UNCITRAL Award (2005).

proceedings, thus demonstrating the potential for governments to retain their regulatory authority even in the context of a highly favorable investment treaty (Alvarez, 2020).

Legal Regime on Investor States Disputes in China

Historical Background of Investor-State Disputes in China

The development of investor state arbitration for China is traced over three distinct generations as it has moved from being a capital importing country to being a significant outward investor.

i) First Generation (1982-1991):

This first generation was characterized by BITs that were very restrictive. For example, the BIT with Sweden (signed in 1982) and the BIT with Germany (signed in 1983) restricted arbitration to compensation for expropriated assets and reserved the determination of whether an appropriation had occurred exclusively to the discretion of the host State (Gallagher and Shan, 2009).

ii) Second Generation (1992-2007):

The Second Generation followed China's 1992 Southern Tour and China's preparation to join the WTO. The BITs in the Second Generation (for example, the BIT with the Netherlands signed in 2001 and the BIT with Germany signed in 2003) provided for broader consent than previous BITs, including "disputes involving the amount of compensation for expropriation" or, in some cases, "any dispute concerning investment." However, these BITs also often required the parties to exhaust local administrative remedies for at least three to six months prior to initiating international arbitration (Shan, 2012).

iii) Third Generation (Beginning Approximately in 2008):

The Third Generation of BITs began to emerge in approximately 2008 when China became a large capital exporting country. The BITs signed with Canada (2012), Tanzania (2013) and the China-Australia Free Trade Agreement (2015) are examples of BITs providing broad consent for ICSID or UNCITRAL arbitration for virtually all substantive standards, including fair and equitable treatment (Berger, 2015). At the same time, China's preference for domestic mediation and hierarchical control of foreign investments was reflected in the Foreign Investment Law of 2020 and the administrative complaint process established by MOFCOM, which reinforced China's position that international arbitration should remain a remedy of last resort. As such, although China is party to over 130 BITs, it has been a rare occurrence for China to be subject to ISDS litigation and China has yet to experience a single adverse final award on the merits (Wang, 2021).

Chinese Law on Wholly Foreign-Owned Enterprises (as Amended in 2000) and Catalogue for the Guidance of Foreign Investment Industries (2002–2015 Editions)

The law governing wholly foreign owned enterprises ("WFOE") in China (the "WFOE Law"), as adopted in 1986 and amended October 31, 2000, is a cornerstone of post-Deng Xiaoping reform efforts in China. The Law was adopted to attract Foreign Direct Investment ("FDI") in China, while still providing the Chinese government with control over foreign investment activities, the WFOE Law allows for 100 percent foreign ownership in both manufacturing and services companies. The 2000 Amendments to the WFOE Law made it easier to obtain approvals prior to the Ministry of Commerce ("MOFCOM") regarding the establishment of WFOEs; lessened bureaucratic obstacles; and prepared China to join the World Trade Organization ("WTO"); while establishing a procedure to resolve any disputes in domestic administrative and/or arbitration processes so as to maintain Chinese sovereignty. The WFOE Law was concurrently implemented

with the Catalogue for the Guidance of Foreign Investment Industries ("Catalogue"), which lists various industries as either encouraged, restricted, or prohibited, as seen in the 2015 edition of the Catalogue, which liberalized 49 categories of industry and restricted 38 categories of industry (Kluwer, 2021). Overall, the WFOE Law and the Catalogue require foreign investors to adhere to sector-specific regulatory standards related to their foreign investment activity in China and do not allow them to pursue post-investment litigation opportunities. Any investor-state dispute resolution ("ISDR") claims under a Bilateral Investment Treaty ("BIT") (e.g., the China-Korea BIT 2007) will have to go through local remedies (Zhang, 2022). Regarding disputes and arbitration, the WFOE Law does not provide for the resolution of disputes through investor-state arbitration ("ISDS"). Rather, it provides for the resolution of disputes through domestic mechanisms that can help prevent disputes from escalating internationally. Specifically, Article 18 of the WFOE Law requires wholly foreign-owned enterprises to comply with the laws of China and therefore disputes between parties are typically resolved through negotiation or arbitration in accordance with the Arbitration Law of the People's Republic of China ("Arbitration Law", 1994). when there is a foreign-related economic dispute Article 2 for foreign-related economic disputes., (National People's Congress, 1986³; Arbitration Law, 1994⁴).

Additionally, pursuant to Article 30 of the WFOE Law, parties to a contract may agree to contractual arbitration in institutions like the China International Economic and Trade Arbitration Commission ("CIETAC") only after attempting to settle their disputes amicably, thereby acting as a prerequisite to the exhaustion of local remedies under the applicable BIT. Moreover, the 2000 Amendments to the WFOE Law (Article 6) require approval from MOFCOM for the establishment of a WFOE, and failure to obtain such approval results in administrative sanctions under State Council regulations rather than arbitration. The Catalogue (e.g., the "Prohibited" list for news media in Section I of the 2002 Catalogue) does not contain any provisions for arbitration; however, it works in conjunction with the WFOE Law by requiring MOFCOM to review any disputes arising from breaches of the Catalogue (as stated in the 2001 Implementing Regulations, Article 42) or CIETAC to resolve any disputes arising from contractual breaches, but prefers mediation to adjudication. Ultimately, the overall framework established by China's law limits ISDS claims, as evidenced by the jurisdictional dismissal in *Ansung Housing v. China* (ICSID ARB/14/25, 2017), due to a lack of compliance with procedural requirements, and demonstrates the state-centric design of China's law, in which arbitration is limited to domestic and conditional forums; as opposed to the more open BIT consent of earlier generations (Feng, X, 2022).

The 2020 Foreign Investment Law (FIL)

Starting January 1, 2020, the FIL repealed the three historical laws governing various kinds of foreign-invested enterprises and together subsumed them in a single law. The FIL provides for national treatment (Art. 4), accords protection for intellectual property (Art. 22), and prohibits forced transfer of technology (Art. 23). Its main distinctive contribution, however, deals with its dispute resolution mechanism. Article 26 provides that investors may "seek resolution through consultation, mediation, arbitration or litigation", but makes no provision for automatic consent to international arbitration. The mechanism is to submit grievances first through the domestic administrative complaint centers created under the MOFCOM Complaint Rules of 2019. These centers are designed to mediate disputes between foreign investors and local governments and reflect Beijing's preference for internal resolution of disputes. Scholars view this as a form of administrative legalization, whereby legal rights are conferred without disfurnishing state oversight

³ National People's Congress. (1986). *Law on Wholly Foreign-Owned Enterprises (WFOE Law)*, adopted April 12, 1986, amended October 31, 2000.

⁴ Arbitration Law of the People's Republic of China. (1994). Article 2: Foreign-related economic disputes. Available at: [https://www.newyorkconvention.org/media/uploads/pdf/5/3/532_1994-arbitration-law.pdf?utm_source=chatgpt.com].

(Li, 2021). By embedding mediation in the bureaucratic hierarchy, China has retained control of all interpretive authority. Arbitration is permitted only where no domestic resolution obtains, and even then, subject to conditions of jurisdiction. Thus, the FIL is properly stated to exemplify “legal modernity with Chinese characteristics,” through selective absorption of international standards processed through a prism of socialist administrative rationale (Y. Zhang, 2020).

China's Pre-2010 BIT Model: Architecture of Restrictive Consent and Jurisdictional Safeguards

Prior to 2010, China's Bilateral Investment Treaties (BITs) employed a restrictive-consent approach to limit investor access to International Arbitration, and provide considerable flexibility to China in its domestic regulatory environment (Shan, Gallagher & Zhang 2021). While prior to 2010 BITs established basic substantive provisions for National Treatment (NT) and Fair and Equitable Treatment (FET), their ability to be practically enforced was limited due to the jurisdictional framework of the BIT Regime.

In China before 2010, most BITs allowed arbitration of an investor's claim for compensation in case of expropriation only as a means to determine the amount of compensation owed to the investor, and did not allow arbitral tribunals to evaluate the legitimacy or even the existence of the regulatory measures at issue. Furthermore, many of these BITs included an exhaustion of domestic administrative or judicial remedies clause which would require investors to seek relief through such channels for a minimum of six to twelve months; and further included "fork in the road" clauses that prohibited investors from pursuing both domestic and international arbitration claims simultaneously, or sequentially (Xu, Wang & Hsu 2020). The majority of BITs concluded before 2010 did not include umbrella clauses, and used very narrow formulations of FET, which severely limited the potential for investors to make claims against host states for violations of legitimate expectations, or violations of regulatory fairness (Chaisse 2019).

Together, these characteristics created a "jurisdictional minimalist" design to the pre-2010 BIT Regime, which essentially allowed claims to be filtered out prior to being subject to substantive review (Shan, Gallagher & Zhang 2021). A clear example of the effective design of this pre-2010 BIT Regime is shown in *AsiaPhos Limited and Norwest Chemicals Pte Ltd v. People's Republic of China* (ICSID Case No. ADM/21/1, 2023), wherein the tribunal determined it had no jurisdiction over the claimant's dispute because the claimants failed to comply with the six-month domestic remedy provision contained within the 1985 China-Singapore BIT, and therefore never evaluated the merit of China's mining regulations.

Jurisprudential Practice: Case Study II: AsiaPhos Limited and Norwest Chemicals v. People's Republic of China (ICSID Case No. ADM/21/1, Award on Jurisdiction, July 2023)

Two Singaporean investors initiated international arbitration against China based upon the People's Republic of China denying a mining license to a phosphate project in Sichuan Province, after which they filed an international arbitration case with claims of indirect expropriation and violation of the BIT (Bilateral Investment Treaty) between China and Singapore of 1985, specifically alleging a breach of the 'fair and equitable treatment' provision as well as an indirect expropriation by China. The ICSID Arbitral Tribunal has made an award of jurisdiction relating to this matter on 16 February 2023 (ICSID Case No. ADM/21/1).⁵ The Tribunal did not reach the merits of the case, however, as it determined that the claims were entirely without jurisdiction. Article 9(2) of the 1985 BIT, which is a typical second-generation Chinese provision, requires that foreign investors exhaust local administrative remedies for at least six months prior to bringing a

⁵ *AsiaPhos Limited and Norwest Chemicals Pte Ltd v People's Republic of China*, ICSID Case No. ADM/21/1, Award on Jurisdiction, 16 February 2023.

claim to international arbitration and establishes a strict three year statute of limitations for filing an arbitration claim commencing when the investor first knows or should know about the breach of duty (*AsiaPhos v. China*, 2023, paras. 189–214). The Claimants' failure to satisfy either of these requirements rendered their request to bring the dispute to arbitration time barred and therefore juridically defective. This result provides a perfect illustration of the continued efficacy of China's pre-2010 restrictive-consent model: even though the BIT includes substantive obligations such as national treatment and fair and equitable treatment, the combination of mandatory exhaustion of local administrative remedies, short statutes of limitation, and "fork-in-the-road" provisions operate as powerful juridical filters preventing any substantive examination of the legality of China's regulatory decisions (Gallagher & Shan, 2009; Shan & Su, 2017; Du, 2022). Even though the Claimants criticized the lack of transparency with respect to China's licensing procedures, the Tribunal found the procedural defense sufficient and ordered the Claimants to pay all arbitration costs and China's attorney fees (approximately \$1.2 million) (Kong & Du, 2023). As a result, *AsiaPhos* demonstrates that China's pre-2010 treaty drafting model continues to provide near complete immunity from negative merits awards many years after the treaties were entered into (Shan & Gallagher, 2022).

The Mediation Turn and the Belt and Road Framework

A distinguishing feature of the recent jurisprudential drive taken by China has been the principle of "mediation first" (mediation first). The One Belt One Road policy, which the PRC launched in 2013, institutionalized this principle by the establishment of the China International Commercial Court (CICC) and the related BRI Mediation Centers (Supreme, 2018). These organs efficiently blend mediation, arbitration and litigation under judicial control, providing foreign investors with a hybrid form of dispute resolution which combines the rigidity of legal proceedings with the flexibility of deal-based negotiations (Chaisse, 2022). The design of the CICC incorporates the Confucian legal imperative of conciliation of disputes and avoiding the adversarial approach (Zhu 2019). In promoting conciliation, China is exporting the congenitally orientated spin on dispute resolution to its partner states (Khan 2024).

Pakistan: Legal Vulnerability and Emerging Reform

Historical background

The situation in Pakistan regarding ISDS is a similar dilemma to that facing many developing economies which liberalized the flow of investment in the 1990s without commensurate institutional strengthening. Between 1990 and 2010 Pakistan signed over fifty BITs, largely first-generation international conventions drafted by donors which provided blanket consent to arbitration on ICSID or UNCITRAL, (UNCTAD 2020). These conventions tended to contain wide definitions of 'investment', generous Fair and Equitable Treatment clauses and vague expropriation clauses, but not many safeguards such as exhaustion of local remedies or explicit wording indicating a local right to regulate. (Dolzer & Schreuer, 2012) Behind this lie the assumptions that good investor protection generates capital and indicates stable economic policies. In practice, however, such constructions resulted in it assuming asymmetrical obligations: foreign investors acquiring various enforceable rights against Pakistan while it faced an ever increasing risk due to open-ended liability with limited rights of interpretation. The lack of a centralized investment-law unit in the Government compounded these problems. Contracts and negotiations were spread over the wide ministries, departments of the province etc. and also the public sector corporations which led to lack of uniformity, deregulation of problems which weighed heavily in its later defence before the international authorities (Khan 2023).

Foreign Private Investment (Promotion & Protection) Act 1976

Pakistan's Foreign Investment (Protection and Promotion) Act (FIPPA) was enacted in 1976, immediately after nationalization, as an assurance to foreign investors. As the main source of domestic legal support for foreign investments, FIPPA remains in effect today, although it is a very limited act containing only seven operative sections, and has been used by Pakistan as an instrument of its own undoing, causing much of the country's disastrous ISDS record from 2008 to 2020 (Khan, 2020)).

Article VIII of FIPPA provides for complete protection against expropriation, but only for a public purpose and only when "prompt, adequate and effective compensation" is provided that can be freely repatriated. Article VIII does not contain an "in accordance with law" clause, nor does it contain a carve-out for nondiscriminatory, legitimate public policy regulation. Further, FIPPA includes an umbrella clause created by later amendments to Article IX, requiring the Government of Pakistan to "ensure the observance of any undertaking, contract or agreement" with a foreign investor. This umbrella clause has made numerous disputes that might have otherwise been resolved in domestic courts enforceable on an international basis, because it converts routine commercial agreements and informal governmental assurances into internationally enforceable obligations (Khan, 2020)).

When paired with the broad consent clauses of Pakistan's pre-2000 bilateral investment treaties (BITs), the 1976 Act created a perfect storm. Tribunals have frequently interpreted the Act as demonstrating enhanced Pakistani commitments and therefore increased investor entitlements to claims under fair and equitable treatment, expropriation, and umbrella clauses. For example, in *Tethyan Copper v. Pakistan* (ICSID Case No. ARB/12/1, Award 2019), the Tribunal repeatedly referred to the Act to dismiss Pakistan's police powers defense and find the Federal Government liable for Provincial regulatory decisions. Likewise, in *Karkey Karadeniz v. Pakistan* (ICSID Case No. ARB/13/1), and the string of rental power plant arbitration cases, investors successfully relied upon Section 9 of the Act to convert simple contractual breaches into treaty breaches, leading to awards and settlements totaling over \$8 billion in total.

The Act also contained other structural weaknesses that exacerbated the problem: The Act requires no exhaustion of local remedies; It has no transparency requirements; And it has no mechanisms to balance investor rights with public interest or environmental issues. Therefore, measures taken to protect the environment, indigenous peoples' rights, and fiscal responsibility were commonly characterized as expropriatory or as breaches of legitimate expectation.

Therefore, in essence, the Act of 1976, conceived as a temporary demonstration of openness to foreign investment after the Bhutto era nationalizations became a permanent legal trap. By enacting 1950s style absolute protection standards in domestic legislation without any of the balancing mechanisms that developed globally in the late 1990s onwards, Pakistan inadvertently amplified the already generous protections of its first generation BITs (Xuwu, (2022)).

A reform of FIPPA particularly with respect to the umbrella clause and the standard of compensation has therefore become a primary recommendation in both domestic and UNCTAD reform efforts (UNCTAD, 2022).

Board of Investment Ordinance 2001 and Investment Policy 2013, Pakistan

The Board of Investment was created to act as a one-stop shop for facilitating investments into Pakistan. The Board is responsible for registering companies, administering incentives to investors and assisting with resolving disputes between investors and the government of Pakistan. The purpose of the Board of Investment Ordinance was to increase investor confidence in Pakistan's economy at a time when political

instability threatened the attractiveness of doing business in Pakistan⁶. As such, the Ordinance relied on the terms of contracts entered between investors and the Government of Pakistan, and the domestic remedies provided under Pakistan's laws, to protect the rights of investors. However, the reliance of the Ordinance on contracts and domestic remedies has exposed significant gaps in investor protection afforded by Pakistan's older Bilateral Investment Treaties ("BITs") including the BIT between Pakistan and Turkey dated June 27, 1995.⁷

The Board of Investment's Investment Policy of 2013, which was issued under section 4 of the Board of Investment Ordinance, updated many of the incentives offered to investors by the Government of Pakistan, abolished the minimum capital requirements imposed upon new businesses and introduced the concept of national treatment and the connection between the domestic investment policy of Pakistan and the protections afforded to investors under Pakistan's BITs.⁸

Regarding investor-state dispute settlement ("ISDS"), the Board of Investment Ordinance relies upon negotiations rather than adjudications and does not contain its own ISDS mechanism. Section 4(a) of the Ordinance gives the Board of Investment authority to encourage and support investment and to provide assistance with the resolution of disputes "by way of discussion" while Section 9(m) of the Ordinance grants the Board authority to negotiate and sign BITs that would allow for arbitration only after all local remedies had been exhausted⁹. In addition, Section 9(g) of the Ordinance allows the Board of Investment to agree to investment agreements that include provisions allowing for arbitration and requires that prior to referring a dispute to arbitration, the parties to the agreement must first attempt to resolve their differences through amicable settlement. Finally, Section 7 of the Ordinance states that foreign arbitral awards will be enforced under the Arbitration Act of 1940.¹⁰

The Board of Investment's Investment Policy of 2013 also establishes this structure. Section 3.2.2 of the Investment Policy provides that an investor may seek international arbitration under the applicable BIT only if the relevant contract permits it and only after the investor has exhausted all local remedies; however, the Investment Policy continues to express a preference for using domestic dispute resolution mechanisms such as BOI led mediation.¹¹ Furthermore, Section 3.1.5 of the Investment Policy provides additional incentives for investors such as tax holidays and connects repatriation protections to the Protection of Economic Reforms Act of 1992.¹²

Pakistan's reactive institutional structure has increased Pakistan's exposure to treaty-based arbitration, evidenced by the \$6 billion award rendered in favor of the claimant in *Tethyan Copper Company Pty Ltd v Islamic Republic of Pakistan* (ICSID Case No ARB/12/1, 2019)¹³ where the tribunal found that Pakistan had engaged in expropriation of the claimant's assets and breached the principle of fair and equitable treatment. Calls for legal reform to address these issues continue and have included the implementation of mandatory pre-arbitral review mechanisms to limit Pakistan's exposure to ISDS claims. (*Tethyan Copper Company Pty Limited v. Islamic Republic of Pakistan*, 2019).

Case Study III: Tethyan Copper Company Pty Ltd. v. Pakistan (Reko Diq): A Review of Arbitration Award of June 21, 2017

The Tethyan Copper Company Pty Ltd (TCC), a partnership of Canadian company Barrick Gold and Chilean company Antofagasta was the applicant in an ICSID arbitration filed against Pakistan pursuant to Article 8 of the 1998 Australia-Pakistan Bilateral Investment Treaty (BIT) regarding a mining lease denial for the Reko Diq copper/gold deposit project in Balochistan Province in 2011. After examining all evidence provided, the Tribunal determined that Pakistan breached its obligations for fair and equitable treatment (Article V) and indirectly expropriated TCC's investment (Article VII) through conduct which frustrated

⁶ *Board of Investment Ordinance 2001* (Ordinance No LXXI of 2001) (Pakistan).

⁷ Agreement between the Republic of Turkey and the Islamic Republic of Pakistan Concerning the Reciprocal Promotion and Protection of Investments (signed 16 March 1995, entered into force 3 September 1997).

⁸ Board of Investment, *Investment Policy 2013* (Government of Pakistan 2013).

⁹ *Board of Investment Ordinance 2001*, ss 4(a), 9(m).

¹⁰ *ibid* ss 4(d), 9(g), and *Arbitration Act 1940* (Pakistan) s 7.

¹¹ Board of Investment, *Investment Policy 2013*, s 3.2.2.

¹² *ibid* s 3.1.5; *Protection of Economic Reforms Act 1992* (Pakistan).

¹³ *Tethyan Copper Company Pty Ltd v Islamic Republic of Pakistan* (Award) ICSID Case No ARB/12/1 (12 July 2019).

TCC's legitimate expectations, considering TCC already had significant pre-existing rights to explore the property and complied fully with applicable laws of Pakistan (Tethyan Copper Company v. Islamic Republic of Pakistan, 2019).¹⁴

Additionally, the Tribunal found that because there were no exceptions for legitimate government action within the broad definition of "investment" (Article I(2)), and due to the fact that the Agreement did not contain an exhaustion of local remedies clause, the Tribunal could consider typical administrative governmental actions as being treaty breaches (Schill, 2019; UNCTAD, 2020). Also, the severe inconsistency between federal and provincial regulations regarding the project, combined with the lack of institutionalized mediation or dispute prevention measures, made an early resolution of the conflict impossible, leading to the escalation of the conflict resulting in a USD 5.976 billion award and interest, approximately 2% of Pakistan's GDP at the time (Khan, 2020).

Ultimately, the Reko Diq case demonstrated the vulnerability caused by the first generation BITs of Pakistan and the 1976 Foreign Private Investment Act, which ultimately led to a 2022 out-of-court settlement to restructure the project with new terms (Balochistan Government, 2022). Therefore, Reko Diq is the clearest example of how institutional weaknesses and unrestricted consent can convert normal regulatory activity into disastrous international liability.

The Model BIT 2021: Doctrinal Re-engineering

Understanding these vulnerabilities, Pakistan promulgated a revised Model Bilateral Investment Treaty (2021) meant to adapt to new global reform trends as well as its own experience in disputes (Pakistan Investment Policy, 2023). The elements put into place include:

- Structured Consultation and Mediation: Mandatory amicable-settlement procedures pre-existing arbitration.
- Right-to-Regulate Clause: The preamble described talks about the right of each party to regulate in regard to the paramount public welfare of the country, in accordance with the guidance of UNCITRAL Working Group III (2023).
- Narrow FET Standard: FET is understood with reference to customary international law definitions and not open-ended terms of fairness and equity.
- Transparency and Accountability: The pleadings and awards will be public although under appropriate exceptions of confidentiality.
- Sustainable-Development Integration: The references to corporate social responsibility (CSR) as well as environmental governance integrate the treaty-protection to responsible investment.

This rethinking of approach has shifted Pakistan's focus from unqualified openness to that of qualified consent i.e., it engenders a conceptual shift in approach towards balanced governance. The remaining deficiency concerns implementation, as existing BITs continue to be in effect under previous terms stressing the investor.

The Foreign Investment (Promotion and Protection) Act 2022

Promulgated shortly thereafter adopting Model BIT 2021, the Foreign Investment Act 2022 consolidated existing legal guarantees, but largely reproduced existing pre-emptive protections of national treatment and expropriation. It omitted the innovations of the Model BIT in respect of mediation and transparency, thus highlighting the gap between policy-making and legislative enactment (Khan, 2024). Nevertheless, the Act introduced clearer registration procedures and circumscribed guidelines for dispute prevention, which are indicative of rudimentary institutional learning.

¹⁴ Tethyan Copper Company Pty Limited v. Islamic Republic of Pakistan, ICSID Case No. ARB/12/1, Award, July 12, 2019.

Comparative Chart

Case	Key Provisions	Tribunal Reasoning	Outcome	Weak Points of Host Country	Strong Points of Host Country
Methanex Corp v. United States (2005)	NAFTA Chapter 11; public policy exception for environmental regulation	Environmental regulation does not equate to expropriation; no violation of FET standard	Favorable to the United States; claim dismissed	Lack of clear engagement with investors; failure to address investor concerns early	U.S. ability to defend regulatory actions under public health goals; state sovereignty upheld
AsiaPhos Limited and Norwest Chemicals v. People's Republic of China (2023)	China-Singapore BIT; requirement to exhaust local remedies before arbitration	Jurisdiction declined due to failure to exhaust local remedies; procedural win for China	Favorable to China; jurisdiction declined, claimants bear arbitration costs	Lack of transparency in licensing decisions; potential unpredictability for foreign investors	China's strategic use of local remedies requirement to filter claims and protect sovereignty
Tethyan Copper Company Pty Ltd v. Pakistan (Reko Diq, 2019)	Pakistan-Australia BIT; broad investment definition without exceptions for regulatory functions	Violation of BIT through expropriation; awarded USD 5.97 billion to TCC	Favorable to TCC; damages awarded to TCC due to unlawful expropriation	Regulatory inconsistencies between provincial and federal authorities; absence of early mediation	Pakistan's legal framework for protecting sovereignty but weakened by inconsistent actions

Conclusion

The legitimacy crisis in Investor State Arbitration is an institutional issue as opposed to solely a procedural issue. The U.S., China and Pakistan have shown us that the same treaty standards are producing drastically different results based upon the administrative capabilities of the parties, and the structure of consent to be bound by those standards. The U.S. has maintained its ability to regulate domestically due to its dense internal procedures, and through careful calibration of transparency. China has used international arbitration to further the goals of mandatory mediation and local remedy requirements to achieve sovereignty through control as opposed to withdrawal. Due to the unconditional consent, fragmented institutions, and the self-harm provisions contained in the 1976 Investment Act, Pakistan's severe losses have ultimately prompted substantive reforms exemplified by the 2021 Model BIT and growing preventive measures.

Through the use of comparative analysis, the study finds that there is no single model that will fit all, legitimacy is developed through the contextual alignment of international obligations and the relative strength of a country's internal governance structures. Therefore, the way forward for Pakistan will be to develop a practical three-tiered hybrid model consisting of the following:

- a) a mandatory domestic prevention tier, which will utilize mediation through a statutory National Investment Mediation Center and provide early warning systems.
- b) a calibrated arbitration tier, which will restrict ISDS to direct expropriation and nationality-based discrimination while require exhaustion of local remedies for FET and contract claims; and
- c) a post-arbitration review tier providing access to multilateral/regional appellate bodies while maintaining national court jurisdiction to refuse enforcement of any award that exceeds the consent of the parties or violates fundamental public policy.

When combined with precise treaty language, binding transparency regulations, and improved institutional coordination, this hybrid model will greatly reduce the frequency and costs associated with arbitration proceedings, while at the same time preserve investor confidence and provide a sovereign state with regulatory space to make decisions in the best interest of its citizens.

In conclusion, reforming ISDS is not a "zero sum game" between law and sovereignty, it is an opportunity to reconcile them. Through the inclusion of prevention, structured consent, and enhanced administrative capabilities, Pakistan can transition from being among the most vulnerable respondent countries to being a credible, development sensitive, and attractive destination for sustainable foreign investment.

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