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PERSPECTIVES

RETHINKING DISPUTE RESOLUTION CLAUSES

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In commercial negotiations, business teams and lawyers understandably spend much of their time and energy securing as favourable rights as possible for the companies they represent. Sometimes lost in the frantic to and fro of these negotiations, however, is focus on the mechanism by which those rights will ultimately be enforced, namely, the dispute resolution or 'DR' clause.

DR clauses are often dismissed as boilerplate with little (if any) care taken to assess whether the proposed DR mechanism (usually carried over from the last deal) is suitable or not. The result is that disputes lawyers spend inordinate amounts of time arguing about the very clause that was intended to resolve arguments between the parties.

Sometimes these arguments arise out of obvious errors like overlapping arbitration and jurisdiction clauses, failing to account for multiparty or multi-contract scenarios, or bespoke drafting that conflicts with otherwise applicable procedural rules. But perhaps the most time consuming and costly disputes arise not out of obvious errors like these but out of DR choices which are very commonly included in commercial agreements, and on their face reasonable, but which when applied in practice give rise to unintended consequences.

This article addresses two such choices: tiered DR clauses and split or hybrid clauses. As well as identifying the potential pitfalls of these clauses, this article suggests ways that parties might reconsider their drafting of them.

Rethinking tiered DR clauses

Tiered DR clauses, also known as escalation clauses, are clauses which give parties multiple, escalating opportunities for resolving their dispute. When a dispute arises, they often require the parties to engage in one or more rounds of less adversarial and non-binding methods of dispute resolution such as negotiations and mediation. If the dispute fails to be resolved by these steps, the dispute is then escalated to more formal, adversarial and binding forms of dispute resolution, like arbitration or litigation.

The intention behind tiered DR clauses is to encourage parties to consider early and amicable settlement of their dispute, with a view to avoiding the time and cost associated with formal proceedings. Having a tiered DR clause in a contract avoids perceptions that one party is weak or lacks confidence in their case when they propose settlement negotiations. It is also seen as being useful in disputes where parties would like to preserve a long-term business relationship.

In our experience, these benefits are overstated and often not counterbalanced with the potential downsides of tiered DR clauses.

It is often the case that the parties are not ready to settle their dispute at such an early stage. This might be because of entrenched positions or because parties simply do not yet know enough about the strength of each other's cases. In this scenario, tiered DR provisions cause nothing but delay and, worse still, can be used as a tool by recalcitrant parties to frustrate the DR process.

The most common example is for a party to challenge the subsequent commencement of arbitration on the basis that negotiations were a mandatory precondition to arbitration and that the negotiations were not carried out strictly in accordance with the clause (with that party often alleging some technical breach of the process such as a party failing to provide sufficient details of a dispute or failing to negotiate in 'good faith').

Particularly when limitation periods are at play, this kind of argument can sometimes take years and millions of dollars to resolve – time and money spent arguing about the operation of the DR clause rather than on resolving the actual dispute itself.

In light of these risks, one must carefully consider whether to include tiered DR clauses at all. If they are to be included, care should be taken to mitigate these risks including, for example, by express language as to whether the process is a precondition

to the commencement of formal proceedings or if such proceedings can commence in parallel. Alternatively, one might consider procedures like arb-med-arb, which place the amicable resolution process (mediation) after the commencement of arbitration and after the parties have clarified their positions through initial statements of case.

Rethinking split or hybrid DR clauses

The basic premise of split or hybrid DR clauses, also known as 'forum splitting', is that different types of disputes in a contract are sent to different decision makers.

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The most common manifestation of this is when parties provide for 'technical' disputes to be resolved by expert determination and all other disputes to be resolved by arbitration. This is common, for example, in sale of goods contracts when disputes over things like the quality of goods are resolved by a technical expert or in M&A agreements when disputes over things like purchase price adjustments or earn-out mechanisms are resolved by an accountant.

Expert determination is seen by some as being more efficient and cost effective than arbitration and litigation, as well as increasing the likelihood of a correct decision where a dispute turns on highly technical issues. Expert determination is also generally viewed as a less hostile measure than commencing arbitration or litigation. This is particularly important in long-term contracts, where maintaining amicable commercial relationships is crucial.

On its face, therefore, these clauses represent a sensible, commercial approach to dispute resolution, ensuring different types of disputes are sent to the most appropriate decision maker. However, as with tiered DR clauses, there are potentially significant risks with these clauses that are often overlooked.

First, disputes are rarely contained to only one issue or clause of an agreement and it is very difficult to define with precision which parts of the dispute fall within which mechanism. A dispute over the quality of goods, for example, is also likely to engage other clauses in the contract, such as

the payment or termination clauses. There might also be questions as to the proper interpretation of the quality requirements. It will often be open to argument whether all or only some of these issues should be resolved by expert determination.

For this reason, such clauses often provoke time consuming and costly jurisdictional battles as to where a particular dispute should be heard before the underlying dispute is even considered and can result in some issues being determined by one decision maker and other related issues being determined by a different decision maker, resulting in inefficiency and potentially, inconsistent decisions.

Furthermore, the purported time and cost savings of split clauses can be a false economy as decisions under them are often appealable (especially in cases of 'manifest error'). Additionally, even where the parties agree that an expert's decision is final and binding, that is a mere contractual promise to abide by the decision (it is not directly enforceable like an arbitral award). If one side breaks that contractual promise, a party must commence arbitration or litigation proceedings to enforce it in any event.

The problems associated with the split clauses identified above usually arise when one of the parties adopts a recalcitrant stance and a 'good faith' approach to resolving disputes collapses. A common solution to these problems, therefore, is to make litigation or arbitration the default dispute resolution mechanism for all disputes but providing parties with the option to go to expert determination if the parties so agree in writing at the time the dispute arises.

Requiring both parties' consent to proceed to expert determination allows cooperative parties to assess whether expert determination is appropriate for the dispute in question and if so, to take advantage of the speed and cost savings of expert determination. If the relationship breaks down and the parties cannot agree, however, the dispute can nevertheless be referred to the mandatory arbitration or litigation procedure provided in the dispute resolution clause without the need for costly jurisdictional battles. CD

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