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PERSPECTIVES

ESCALATION CLAUSES – SOME TIPS FOR COMMERCIAL PARTIES

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Escalation clauses (also known as 'tiered' or 'multi-tiered' dispute resolution clauses) provide for disputes between contracting parties to be resolved in stages. They provide for alternative dispute resolution (ADR) options, such as negotiation, mediation and expert determination, to take place before the relevant dispute is referred to arbitration or the courts. In this article we outline the potential benefits and downsides of incorporating such clauses into commercial contracts. After discussing recent court decisions as to the impact of non-compliance with an escalation clause, we conclude with some practical drafting tips.

Why include an escalation clause?

Escalation clauses are a common feature of commercial contracts, particularly in the context of infrastructure projects or other long-term contracts, where the resolution of disputes via negotiation or mediation is viewed as being more efficient and less disruptive to parties' ongoing relationship than arbitration or litigation.

The primary value of an escalation clause lies in the fact that it puts ADR options 'on the agenda'. Although ADR is widely recognised as offering a mechanism for dealing with disagreements at an early stage before parties become entrenched in their respective positions, unless already provided

for in the contract, the possibility of ADR may not occur to the parties. Or, as is more common, commercial parties may consider that the suggestion of ADR at an early stage will be perceived by the other as a sign of weakness.

The incorporation of an ADR mechanism clause in a contract circumvents this problem by ensuring that ADR is front of mind for the parties and by justifying the question of ADR being raised and discussed without any suggestion of weakness or lack of confidence by either side. If it is not felt suitable, parties can always agree to waive the ADR steps concerned.

Jurisdiction v. admissibility?

However, particularly when drafted as preconditions to arbitration, escalation clauses can lead to considerable disruption and inefficiency in the resolution of disputes. Most notably, arguments regarding alleged non-compliance can lead to satellite litigation and delays to the arbitration process.

Not only do different jurisdictions adopt differing approaches as to whether requirements for pre-arbitration ADR are enforceable, but there has been debate as to whether non-compliance operates to deprive an arbitral tribunal of jurisdiction to determine a claim or instead goes to the admissibility of that claim.

The distinction is an important one. If non-compliance goes only to admissibility, tribunals will have a broad range of powers available to them in determining how to proceed when non-compliance with an escalation clause has been alleged, without the risk of having their decision being used as a basis for setting aside the final award.

As a matter of admissibility, breach of an escalation clause will not affect the jurisdiction of a tribunal and the tribunal does not necessarily need to terminate the arbitration upon a finding of non-compliance. A tribunal may decide to instead order a stay or adjournment of the proceedings and impose cost sanctions for the breach – or indeed, allow the arbitration proceedings to continue if it considers compliance with the escalation mechanism to be futile.

Recent decisions

The broad global trend (including in decisions of courts in the UK, Singapore and the US) is to treat non-compliance with an escalation clause, or pre-arbitration conditions more generally, as a question of admissibility.

"Where parties do decide to incorporate an escalation clause, the golden rule – as with any dispute resolution clause – is clarity in drafting."

Several recent decisions of Hong Kong courts have adopted the same approach, most notably the decision of the Hong Kong Court of Appeal in *C v D* (2022). *C v D* concerned a clause which provided that in the event of a dispute: "the Parties shall attempt in good faith promptly to resolve such dispute by negotiation. Either Party may, by written notice to the other, have such dispute referred to the Chief Executive Officers of the Parties for resolution… If any dispute cannot be resolved amicably within sixty (60) business days of the date of the Party's request in writing for such negotiation, or any other time period as may be agreed, then such dispute shall be referred by either Party for settlement exclusively and finally by arbitration in Hong Kong."

When a dispute subsequently arose, D wrote to C's board of directors stating that it was "willing to refer the dispute to the parties' respective senior management teams" for negotiation. C's lawyers responded requesting that further correspondence be directed either through C's lawyers or its chief executive. D did not respond but, after 60 business days had passed since the date of its letter, commenced arbitration against C. C argued that the tribunal lacked jurisdiction to hear the dispute because D had not complied with the escalation clause. The tribunal held that the provisions of the escalation clause had been complied with and there was no issue as to its jurisdiction to hear the case and issued an award in D's favour.

The Court of Appeal affirmed the Court of First Instance's decision that questions of non-compliance with escalation clauses are questions of admissibility rather than jurisdiction. In doing so, the Court of Appeal drew on academic writings as well as case law from not only Hong Kong but also the UK, Singapore, New South Wales and the US, noting that "there is a substantial body of judicial and academic jurisprudence which supports the view that 'non-compliance with procedural pre-arbitration conditions such as a requirement to engage in prior negotiations goes to the admissibility of the claim rather than the tribunal's jurisdiction'". The court emphasised the fact that C's objection was not that the substantive claim advanced by D could never be referred to arbitration at all, but that the arbitration was premature, in that certain pre-arbitration steps should have first been taken. As C's objection was targeted "at the claim" instead of "at the tribunal", its objection went only to the admissibility of the claim rather than the jurisdiction of the tribunal.

Practical drafting tips

Such cases illustrate the potential adverse consequences that may arise when including escalation clauses in contracts, even where non-compliance is treated as a matter of admissibility. Careful consideration needs to be given to the practicality of compliance and the risks of increased costs and delays associated with potential allegations of non-compliance in deciding whether or not such provisions ought to be incorporated. Parties might reasonably decide that these risks outweigh the benefits of including an escalation clause, particularly given that it remains open to propose ADR at any stage of a dispute.

Where parties do decide to incorporate an escalation clause, the golden rule – as with any dispute resolution clause – is clarity in drafting. This is particularly true of escalation clauses which can be detailed and complex. There are, however, a number of key principles that can assist in drafting.

It is important to specify a clear process and to be clear exactly when that process is triggered. Parties should incorporate a timeframe (beginning and end) for the steps involved and should also ensure that the decision makers are easily identifiable but

not overly specific (for example, naming specific individuals is not recommended).

We suggest that parties also make it clear in the contract whether or not the process is or is not intended to be a precondition to arbitration or litigation. Finally, parties should also consider including a carve out so that if engaging in the process is likely to cause prejudice (because, for example, a limitation period is about to expire), proceedings can be commenced. CD

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