ESCALATION CLAUSES: HOW TO AVOID THE PITFALLS

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Escalation clauses (also known as multi-tiered arbitration clauses) are an increasingly common feature across a multitude of commercial agreements. These well-intentioned clauses often require parties to a contract with a dispute to attempt other methods of resolving their dispute as a condition precedent before resorting to arbitration, such as negotiations, mediations or adjudication. After all, arbitrations are often seen as (and can indeed be) both costly and time-consuming.

However, these clauses have also been a source of problems for parties to a dispute, not only because of issues of enforceability of the clause itself but also because either or both of the parties had neglected to comply with the requirements or conditions set out in the escalation clause before proceeding to arbitration with their dispute. This may lead to challenges to the reference to the arbitral tribunal or even the arbitral award.

It may be tricky to draft an effective escalation clause that mandates a party to first engage in negotiation or mediation as a condition precedent before referring a dispute to arbitration because requirements for a party to engage in negotiation or mediation have traditionally been seen as "agreements to agree" and are thus unenforceable.

This was the case in Tang v Grant Thornton International Ltd, whereby the requirement for the parties to attempt to resolve their dispute by submitting a request for conciliation "of an informal nature" as a condition precedent prior to referring the dispute to arbitration was held to be too "equivocal in terms of the process required and too nebulous in terms of the content of the parties' respective obligations to be given

legal effect as an enforceable condition precedent to arbitration". The test was whether the condition precedent/obligation imposed was sufficiently clear and certain to be given legal effect. Note that the effect of the ruling was that the arbitral tribunal in question did have jurisdiction to hear the dispute despite failure by the defendant to comply with the condition precedent.

However, in Emirates Trading Agency LLC v Prime Mineral Exports Pte Ltd, a condition precedent requiring the parties to "first seek to resolve the dispute...by friendly discussion" was upheld as enforceable because it was neither incomplete nor uncertain. It was in the public interest for such conditions precedent to be enforceable as commercial men expect the courts to enforce obligations they have freely undertaken, and the object of such agreements is to avoid expensive and time-consuming arbitration. The condition precedent was held to have been fulfilled in that particular case and the challenge to the jurisdiction of the arbitral tribunal failed.

It appears that the Hong Kong courts have not expressed a general view on the enforceability of similar conditions precedent in escalation clauses. However, they may have few opportunities to do so because whether such conditions precedent have been complied with are not an issue of jurisdiction (an award of which may be set aside under Art. 34 of the UNCITRAL Model Law/s.81 of the Arbitration Ordinance [Cap. 609]) but rather an issue of admissibility of the dispute to arbitration (which cannot be challenged under that same article). This posåition has been confirmed in the recent Hong Kong Court of Appeal decision C v D affirming the jurisdiction/admissibility distinction under Sierra Leone v SL Mining.

The escalation clause between the parties in C v D required them to attempt in good faith to resolve their dispute by negotiation by written notice prior to referring the dispute to arbitration. However, the respondent to the arbitral claim challenged the jurisdiction of the arbitral tribunal due to the alleged absence of a written request for negotiation by the claimant before a notice of arbitration was issued. The arbitral tribunal made a partial award on jurisdiction in favour of the claimant. The respondent applied to the court to set aside the partial award. The Court of Appeal agreed with the court below and found that issue of whether the claimant had complied with the condition precedent was a question of admissibility of the claim to arbitration and not a question of jurisdiction, and thus not subject to review by the courts. This means arbitral tribunals are likely to have a final say on whether conditions precedent in escalation clauses have been complied with.

Parties should also be careful about inadvertently waiving by their right to challenge compliance with such conditions precedent by their own acts. This was one of the findings in Sierra Leone v SL Mining where the respondent in the arbitration insisted on service of the request for arbitration and was found to have waived compliance with the condition precedent under s.73 of the Arbitration Act 1996 and/or Art. 40 of the ICC Rules.

What can we learn from all of these cases? The enforceability of conditions precedent in escalation clauses depends on the certainty and clarity of those clauses, but it is in the public interest for such conditions precedent to be enforced. Also, the issue of whether such conditions precedent have been met is an issue of admissibility and not jurisdiction. As such, challenges to whether such conditions precedent have been met should be raised and dealt with by the arbitral tribunal and cannot be subject to recourse to the Hong Kong courts. Parties should endeavour to comply with these conditions precedent to avoid unnecessary delay or postponement to having their dispute arbitrated if they cannot be resolved by negotiation, conciliation or

mediation. They should also be careful to raise challenges to jurisdiction and admissibility before they have submitted to the arbitral tribunal's jurisdiction or otherwise waived their right to raise such challenges (under the relevant arbitral rules or as a matter of fact).