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PAVING THE ROAD TO ARBITRATION WITH GOOD INTENTIONS: ESCALATION CLAUSES IN COMMERCIAL CONTRACTS

As a means for resolving international commercial disputes, arbitration has many advantages and one big disadvantage: cost. 68% of respondents to the 2015 Queen Mary International Arbitration Survey reported that the worst feature of international arbitration was the cost of the process. As a result, most businesses would prefer to settle disputes amicably, whenever possible, before resorting to arbitration.

An increasing number of businesses incorporate escalation clauses (or "multi-tiered dispute resolution clauses") in their contracts as a means of encouraging early settlement. Escalation clauses require (or encourage) parties to attempt one or more alternative forms of dispute resolution before resorting to arbitration. Typically, parties are required to participate in negotiations, mediation, or conciliation for a certain period before commencing arbitration. In other instances, parties are required to participate in a more formal, adjudicative procedure before arbitration (such as expert determination or dispute board proceedings).

Escalation clauses are particularly popular in long-term contracts, where it is important for parties to maintain a working, commercial relationship. It is easier for parties to preserve their relationship during a consensual process like negotiation, than during a more confrontational process like arbitration.

However, as explained below, escalation clauses are of uncertain legal effect, with divergent approaches being taking by different jurisdictions and even by different courts within the same jurisdiction. This legal uncertainty has given rise to numerous disputes resulting in unnecessary costs and delay. Businesses should therefore consider whether it is worth adopting escalation clauses at all – and in any event, should take care to draft such clauses so that their meaning and effect is as clear as possible.

LEGAL DIFFICULTIES REGARDING ESCALATION CLAUSES

Escalation clauses have given rise to numerous disputes such as:

- whether the pre-arbitral process prescribed by the clause is mandatory or non-mandatory;
- whether an arbitral tribunal can excuse non-compliance with an escalation clause or whether non-compliance prevents an arbitral tribunal from assuming jurisdiction over a dispute;
- whether an obligation to negotiate is enforceable;
- whether an escalation clause is too uncertain to be enforced;
- whether the steps taken by one party satisfy the requirements of the clause;
- whether a party may seek emergency arbitral relief or interim relief from a court without first complying with the clause;
- whether a party can proceed directly to arbitration when the pre-arbitral step would be futile (e.g., when negotiations would be very unlikely to succeed);

- whether a pre-arbitral step can be fulfilled after the commencement of arbitration (e.g., when negotiations or mediation take place at a later stage); and

- whether the requirement to comply with a pre-arbitral step is an impermissible restriction on access to justice.

The chances of these disputes arising can be reduced by careful drafting, but they cannot be eliminated. Ultimately, the meaning and effect of any escalation clause will depend on the wording of the provision in question and the treatment of such clauses under the applicable law.

In arbitration, parties often spend time and money arguing about the effect of escalation clauses before the merits of the underlying dispute are even considered. This runs contrary to the motivations for incorporating these clauses in commercial contracts – that is, the desire to resolve disputes quickly and cheaply, and to preserve commercial relationships.

However, the risk does not end there. An arbitral tribunal's decision on the effect of an escalation clause can be reviewed by national courts in annulment and enforcement proceedings. If a national court decides that non-compliance with an escalation clause deprived the arbitral tribunal of jurisdiction over a dispute, it can annul or refuse to recognize an arbitral award.

An entire arbitration can be wasted – and a party forced to start arbitration again – because of a dispute regarding an escalation clause. Such cases are thankfully rare, with most courts reaching pragmatic decisions about compliance with pre-arbitral processes, but these disputes have the potential to add years and significant expense to the enforcement process.

DO YOU NEED AN ESCALATION CLAUSE?

In light of these legal difficulties, the first question for any business should be whether it is desirable to incorporate an escalation clause in its contracts at all.

These clauses can perform a useful function by forcing parties to meet or talk before disputes become too heated or parties become too entrenched in their positions. They can stop resolvable commercial disagreements (or misunderstandings) spilling over into multi-million dollar arbitrations. This author has witnessed the benefits of such clauses.

But businesses do not rush into arbitration in any event. Most disputes begin with telephone calls, meetings, and exchanges of letters where the parties explore each other's positions and the chances of an amicable resolution. And most disputes are actually resolved in this way, whether or not the parties are bound by an escalation clause. It is unclear whether adopting an escalation clause increases the chances of early settlement.

Furthermore, it is difficult to decide the best method of resolving a dispute in advance. In some cases, it is useful to attempt mediation before arbitration; in others, negotiation is more appropriate and cost-effective; and sometimes, parties can only arrive at a negotiating position once a dispute is more advanced. Businesses have more flexibility to adopt case-specific forms of dispute resolution if they do not incorporate escalation clauses into their contracts.

DRAFTING ESCALATION CLAUSES

If a business does decide to include an escalation clause in its contract (or is negotiating with a counter-party that is strongly in favour of including such a clause), it is important to draft the clause in a way that reduces the risk of serious disputes arising at a later stage. (Business should, in any event, always seek legal advice on the treatment of escalation clauses under the applicable law of their agreement.)

When drafting escalation clauses, it is of primary importance to consider the consequences of non-compliance with the clause – in particular, whether non-compliance is a procedural matter that can be excused by the arbitral tribunal or a jurisdictional matter that prevents the tribunal from assuming jurisdiction over the dispute.
This author submits that in almost every instance it is better to specify in the contract that non-compliance shall not deprive the tribunal of jurisdiction over the dispute. Instead, parties should specify that non-compliance shall be taken into account by the tribunal when it makes its decision on costs (i.e., its decision on whether one party can recover its legal costs from the other party), but that non-compliance will not deprive the tribunal of jurisdiction.

Drafting clauses in this way has a number of advantages:

- Parties can be effectively sanctioned for non-compliance by being ordered to pay part of the other side's legal costs or by being prevented from recovering part of their legal costs from the other side;

- The arbitral tribunal has the discretion to excuse non-compliance if a party has good reason for non-compliance (e.g., cases of extreme urgency);

- The tribunal can proceed directly to consider the underlying merits of the dispute, since non-compliance will only be considered at the end of the arbitration; and

- Most importantly, national courts are much less likely to annul or refuse recognition of an award on the grounds of non-compliance, when the escalation clause states expressly that it does not have jurisdictional effect.

It is good business to settle disputes early, without great expense, while maintaining commercial relationships. It is understandable that escalation clauses, which are intended to achieve just that, should be increasingly popular.

But, when amicable settlement is unachievable, escalation clauses should not be allowed to imperil the efficiency, integrity, and finality of the arbitral process. When drafting escalation

clauses, the best way to reduce that risk is to provide expressly that the escalation clause is non-jurisdictional, but that non-compliance shall be taken into account when the tribunal makes its decision on costs.