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Revisiting the use of multi-tiered dispute resolution clauses in commercial contracts

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1. Introduction

Multi-tiered dispute resolution clauses (also known as "escalation" clauses) are commonly found in commercial contracts. These clauses typically require the parties to resolve any disputes through less formal alternative dispute resolution process (such as negotiation and/or mediation), followed by formal court litigation or arbitration proceedings if no settlement is reached. These clauses, if properly drafted, are favourable to commercial parties because they can provide an opportunity for the parties to resolve their dispute in a less adversarial setting (outside of court or arbitration), continue the parties' ongoing relationships, and to save time and money. However, the authors have recently experienced an unfortunate situation that an escalation clause created more hurdles for the parties to commence legal action, resulting in more costs and delay.

In this article, I will discuss (a) the pros and cons of inserting multi-tiered dispute resolution clauses in commercial contracts; (b) the requirement of minimum participation in mediation under Hong Kong law; (c) the recent landmark judgment from the Hong Kong Court of Appeal, *C v D* [2022] HKCA 729; and (d) some practical tips to commercial parties in drafting and incorporating mediation clauses.

2. Pros and cons of multi-tiered dispute resolution clauses

Some commonly perceived benefits and drawbacks of using hybrid dispute resolution mechanisms are as follows:

Pros	Cons
• Parties can enjoy a higher degree of procedural flexibility by adopting ADR, e.g. parties may agree to matters such as the date, venue and mode of meetings/hearings, procedural timelines, evidence and logistics, etc. • Parties may nominate mediators and/or arbitrators of their preference depending on the nature of the particular dispute. • Parties who do not wish to litigate	• The flip side of procedural flexibility is that when a clause is ambiguous, it may result in rooms for arguments: it may delay the commencement of arbitral proceedings even when both parties are unwilling to settle the dispute through mediation, which, in worst case scenarios, may cause the arbitral proceedings fall outside a prescribed limitation period (guerrilla tactics).

Pros	Cons
in open court proceedings could also benefit from the confidential nature of most ADR processes. • If the dispute can be settled before arbitration or litigation, it saves time and costs. • The non-adversarial negotiation and mediation before arbitration or litigation may allow parties to focus on their interests and commercial objectives, which may be beneficial for maintaining and preserving business relationships ("saving face"). • Even if ADR does not result in settlement, it allows the parties to narrow the issues in dispute, test their arguments and keep their communication channels open. The parties also have more time to prepare their case / defence.	• Concerns on the enforceability of the clause (sometimes regarded as pathological clauses): When the wording is of the clause is unclear or vague as regards the prerequisite steps and the mandatory nature, HK and UK courts tend to regard the clause as unenforceable. • "Changing hats" in med-arb proceedings may not be permitted in some jurisdictions, because it may pose concerns regarding procedural fairness and confidentiality. • Incurring more time and costs if the parties eventually fail to settle in the course of ADR processes and ultimately have to commence arbitration or litigation. • In some jurisdictions, it may be difficult for the parties to find the suitable candidate to act as mediator and arbitrator.

3. The requirement of minimum participation in mediation

Mediation is a voluntary process where the parties agree to appoint a neutral third party (i.e. the mediator) to help them facilitate negotiation and resolve the dispute out of court.

Recently, I had been appointed as a sole mediator by the parties in a contractual dispute, pursuant to an escalation clause that required the parties to first attempt mediation for "*a minimum of 5 hours for 2 consecutive days*" before arbitration. This was a tricky mediation as each side started with extreme and contrary positions, where one side wanted to continue the performance of contract, the other side insisted to terminate the contract. It was very difficult to achieve an amicable resolution, which could only be resolved through a binding decision. Despite the unexpected development, I tried to re-orient the parties to discuss and explore the proposed terms of termination and settlement. Unfortunately, it appeared that the parties had attempted mediation as they were contractually bound by the pre-arbitration requirement under their escalation clause.

In 2009, the Civil Justice Reform ("**CJR**") came into effect with the aims of improving case management and facilitating dispute settlement. In response to the objectives of the CJR, the Practice Direction on Mediation ("**Practice Direction 31**") was promulgated, which encourages parties to engage in an ADR procedure to facilitate the settlement of disputes. Practice Direction 31 applies to most civil proceedings in the Court of First Instance and the District Court which have been initiated by writ. Solicitors are expected to have advised their clients of the possibility of the Court making an adverse costs order where a party unreasonably fails to engage in mediation (see the Law Society of Hong Kong's Guidance Note on Judiciary's Practice Direction 31 on Mediation).

The parties' solicitors are required to file into court a Mediation Certificate to explain whether the party is willing to attempt mediation with a view to settling the court proceedings, and if not, to provide the reasons for not doing so. Practice Direction 31 provides that in exercising its discretion in relation to legal costs, the Court takes into account all relevant circumstances, including any unreasonable failure by a party to engage in mediation. The Court will not make any adverse costs order against a party on the ground of unreasonable failure to engage in mediation where:

a. The party has engaged in mediation to the minimum level of participation agreed to by the parties or as directed by the court prior to the mediation; or
b. A party has a reasonable explanation for not engaging in mediation, such as: –
   (i) where active *without prejudice* settlement negotiations are progressing between the parties. However, where such negotiations have broken down, the basis for such explanation will have gone and the parties should then consider the appropriateness of mediation; or
   (ii) where the parties are actively engaged in some other form of ADR to settle the dispute.

<u>Minimum level of participation</u>

Legally speaking, what is the "minimum level of participation in mediation"?

This was considered by the Hong Kong Court in *Resource Development Limited v Swanbridge Limited* HCA 1873/2009 and *Hak Tung Alfred Tang v Bloomberg LP and Anor.* HCA 198/2010, where the parties in both cases applied to the Court to decide on a minimum amount of time that each party should commit to the mediation process. The Hong Kong Court held that:

a. With reference to the proposed direction in footnote 4 of Appendix C of Practice Direction 31, the participation can be up to and including at least one substantive mediation session (of a duration determined by the mediator) with the mediator.

b. The purpose of having the minimum level of participation relates to the sincerity of the parties to undertake the mediation, rather than the length of the mediation.
c. The Court should not impose anything that is more than necessary for the parties to participate as mediation is voluntary and any party may decide to terminate it at any stage of the mediation. To make an inflexible direction about the minimum level of participation may germinate other unnecessary disputes between the parties.

Unreasonable failure to engage in mediation

In *Golden Eagle International (Group) Ltd v GR Investment Holdings Ltd* HCA 2032/2007 , the Court ordered the Defendant to pay the Plaintiff's costs on an indemnity basis, due to the Defendant's unreasonable refusal to mediate. The Defendant contended that:

a. The dispute could not be 'easily mediated' as it involved a complicated agreement and factual matrix.
b. The Defendant reasonably believed that it had a strong case.
c. The Defendant had made a settlement offer to the Plaintiff.
d. The cost of mediation would be disproportionately high.

The Court rejected the above arguments and stated that:

a. This case involved a simple, one-off contract dispute which did not raise any point of law, the determination of which would provide guidance for the future, whether for the parties or others in the trade. The case did not involve injunctive or other protective relief.
b. '*Reasonable belief of a strong case*' would be relevant only in clear-cut cases, e.g. where a party would have succeeded in an application for summary judgment. The Defendant's defence could only be regarded as a "borderline" one, and would not fall within this category.
c. The Defendant's settlement offer had been '*way off the mark*'. However, the wide difference between the parties did not indicate that mediation would be a waste of time and effort.
d. There was no factual basis for the submission that the cost of mediation would be disproportionately high. The mediation costs were significantly lower than the claim itself.

The Court held that the burden was on the refusing party to provide a reasonable explanation, rather than on the willing party to show that mediation had a reasonable prospect of success.

4. *C v D* [2022] HKCA 729: a recent landmark decision in escalation clause

An escalation clause provides a series or "waterfall" of ADR procedures in stages, typically being negotiation, followed by mediation, and then arbitration.

In *C v D*, the escalation clause stated that before a dispute could be referred to arbitration, 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 [CEOs] of the Parties*". The dispute should only be referred to arbitration if it cannot be resolved amicably by negotiation within 50 business days of the party's written request. While the parties agreed that a written request for negotiation was a pre-condition to arbitration, they disagreed on whether it was necessary to give written notice to their CEOs. The arbitral tribunal held that referral of the dispute to the CEOs was optional and that the pre-condition only required a written request for negotiation.

The Court of First Instance dismissed C's challenge on grounds that the issue of compliance with a pre-condition to arbitration goes to the admissibility of the claim (i.e., whether a claim is defective and should not be raised at all), instead of the tribunal's jurisdiction (i.e., whether a claim should not be arbitrated due to a defect in or omission to consent to arbitration), which was not the basis of C's challenge. Subsequently, C appealed the decision.

The Court of Appeal rejected C's appeal and upheld that the non-compliance with escalation clause is the issue of admissibility of a claim, which means it is appropriate for the arbitral tribunal to hear the case and decide whether the case is procedurally defective because of the non-compliance. The non-compliance of escalation clause is not the issue of jurisdiction, which suggests the arbitral tribunal has the jurisdiction to deal with the case and the court has narrow grounds to interfere in.

This decision is consistent with the approach in other common law jurisdictions, for example, English court decision in *Republic of Sierra Leone v. SL Mining Ltd* [2021] EWHC 286 and *BBA v. BAZ* [2020] 2 SLR 453 ruled by Singapore court.

5. Practical tips to commercial parties in drafting and incorporating mediation clauses

Parties are free to negotiate and agree on the terms of the dispute resolution clause to be inserted to their contract. A dispute resolution clause is an important contractual provision that records the parties' agreement on how their dispute is to be resolved. However, parties should be cautious when drafting multi-tiered dispute resolution clauses.

- Before including any precondition(s) to arbitration (such as negotiation, mediation, adjudication, dispute board etc.), the parties are suggested to consider the necessity, whether they are mandatory, and the time periods to prescribe.
- It is important to use clear and precise language to ensure the validity and enforceability of the multi-tiered dispute resolution clause:
  - For example, use mandatory but not permissive language, e.g. use "shall" rather than "may".
  - Avoid using terms such as "good faith", "friendly negotiations" and "best endeavours".
- When inserting a mandatory mediation clause, it is not advisable to stipulate the exact length of time of negotiation, as it may cause inflexibility. The parties can refer to the example given in Practice Direction 31: "*Agreement between the parties as to the identity of the mediator and the terms of his or her appointment, agreement as to the rules applicable to the mediation (if any) and participation by the parties in the mediation up to and including at least one substantive mediation session (of a duration determined by the mediator) with the mediator*".
- It is recommended to use clear wording in relation to the agreed particulars, in order to ensure the negotiation process is workable by clearly specifying who is to meet, the meeting time, the purpose of meeting and etc. It is not suggested to insert two options in one clause, which brings uncertainty in negotiation process and can render the clauses unenforceable.
- The parties may consider adopting set of specific procedural/ institutional rules, e.g. the HKIAC Mediation Rules and the HKIAC Administered Arbitration Rules.
- It is suggested for the parties to make clear the events determining failure of the pre-arbitration steps and allowing them to be skipped, so as to prevent delay in commencing arbitration or litigation.
- The parties may insert a clause to allow application for urgent/interim relief during the mediation so that relevant assets are not dissipated, and the evidence can be preserved.

6. Conclusion

The inclusion of multi-tiered dispute resolution clauses in commercial contracts is popular with many commercial parties because they hope that such processes can help to avoid the expense of formal proceedings, afford the parties with more procedural flexibility, and preserve confidentiality and business relationships.

Nonetheless, if the parties do not pay sufficient attention to the drafting of such clauses, they can become uncertain and make the dispute resolution process more expensive, resulting in further disputes and delay the commencement of arbitral

proceedings. Therefore, attention must be paid to the drafting of such clauses to ensure its enforceability. More importantly, parties are encouraged to consider carefully if they want to adopt such clauses at all.

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