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Knowhow briefs
Escalation Clauses

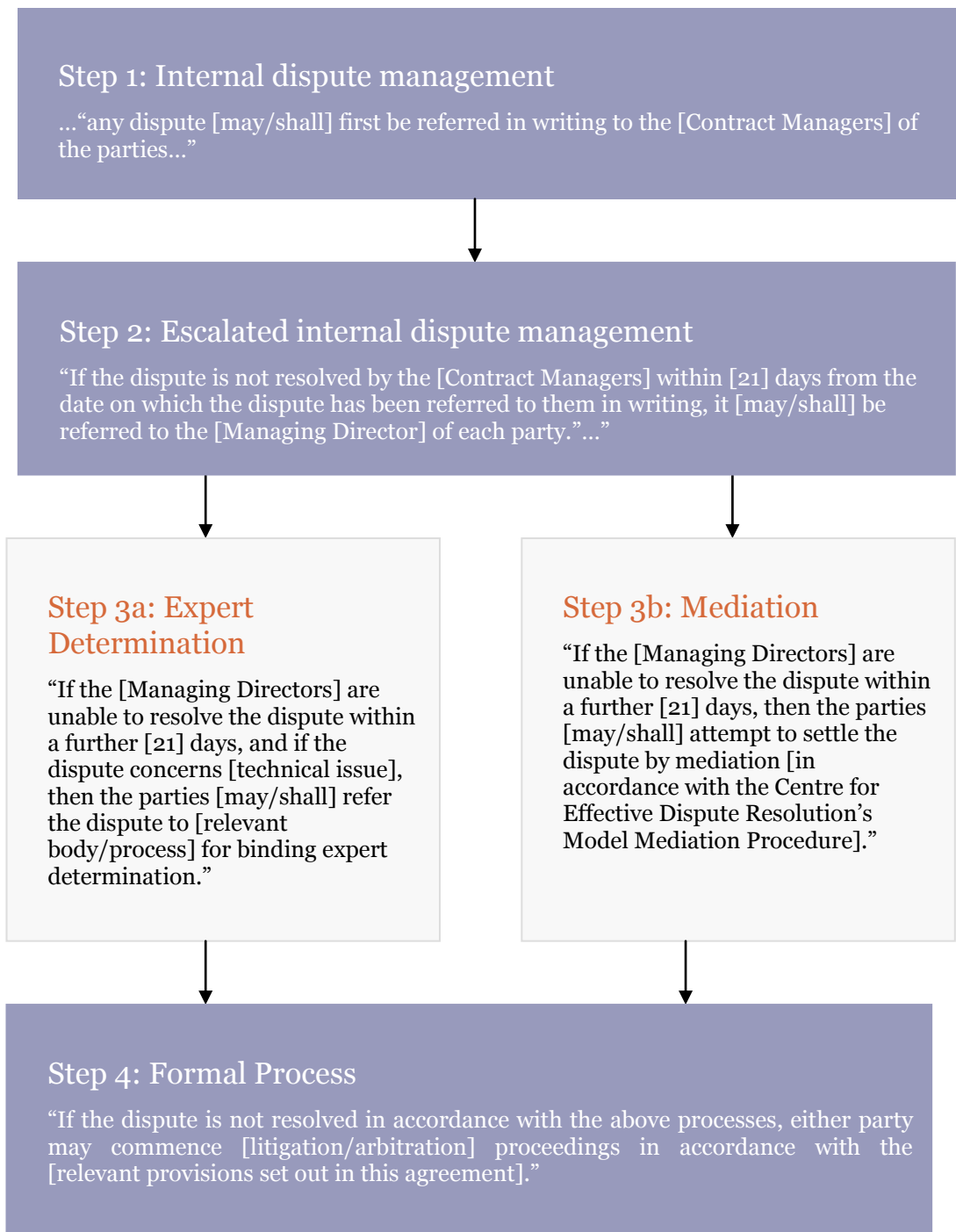
Executive summary:

- A dispute resolution clause that records the parties' agreement that any dispute between them shall be resolved on a staged basis.
- Can provide parties with a commercial and cost effective dispute resolution mechanism.
- Can put ADR 'on the table' without either party having to give up a perceived strategic advantage.
- Need to ensure that the escalation clause is drafted to reflect the specific circumstances at hand - you do not want to be compelled to engage in inappropriate early stages of an escalation process.
- Can be enforced by the court (by staying proceedings for compliance, or costs consequences), and may be enforceable in arbitration (this is very fact and arbitration specific).

What are 'tiered' or 'stepped' escalation clauses?

1. A tiered or stepped escalation clause is a dispute resolution clause that records the parties' agreement that any dispute between them shall be resolved on a staged basis. Each step, or tier, is designed to handle the dispute if it has not been resolved by the previous step and each step "escalates" the dispute management to a level above the previous step. An escalation clause typically requires each stage of the process to be engaged before the parties can move on to the next.
2. If drafted carefully, such clauses provide parties with a commercial and cost effective dispute resolution mechanism. If drafted poorly, however, these clauses can lead to uncertainty - which itself can give rise to a dispute - and, at worst, can leave the parties without a mechanism for proper recourse to the courts or arbitration.
3. Typically, escalation clauses involve as an initial step some form of internal/management resolution followed by a stage (or stages) of alternative dispute resolution ("ADR") (such as mediation) and conclude - as a last resort - with formal dispute resolution, either by litigation or arbitration. They can also include a provision for resolution by expert determination, which is particularly suited to technical disputes.

Flow diagram of sample dispute escalation process



4. There has been some uncertainty in the past about whether or not such clauses are enforceable, and whether the parties can avoid a stage or escalate the dispute without having complied with various stages. These issues are addressed below.

Why insert an escalation clause?

1. A properly drafted multi-tiered escalation clause can:
 - provide an opportunity to resolve disputes in a less adversarial setting than formal dispute resolution;
 - enable the parties to manage and preserve an ongoing commercial relationship;
 - provide a cost effective route to dispute resolution.
2. The reality is that many disputes can be resolved at the early stages by use of internal management dispute resolution processes. Escalation clauses which contain early stage tiers to accommodate this can therefore enable the parties to resolve such disputes swiftly (and amicably).
3. Escalation clauses also put ADR firmly on the agenda. While ADR is accepted - generally speaking - as providing a legitimate and effective route to dispute resolution, when parties are in the midst of a dispute there is often a view that offering or proposing ADR may be perceived as a sign of weakness. Including specific ADR provisions in the contract enables the parties to engage in the process without either party having to give up a perceived strategic advantage in order to explore a non-litigious resolution.
4. That said, there is also a risk that escalation clauses can provide leverage to prolong disputes. Certain disputes are clearly incapable of amicable or swift resolution and can only be resolved through a binding decision by a third party (such as the court). In such circumstances, forcing the parties to escalate a dispute through their internal management structures and/or ADR may be inappropriate and a waste of time and costs.
5. It is therefore important to ensure that escalation clauses are drafted to reflect the specific circumstances at hand and that the parties are not compelled to engage in early stages of an escalation clause if that would be inappropriate. It is also worth mentioning that, while large, complex and long-running litigation/arbitration can be costly and ADR (such as mediation) is often perceived as providing a cheaper alternative, this is not necessarily the case. For example, mediation may not lead to a final resolution (as it is an entirely consensual process) and the costs of preparing for and attending a lengthy mediation can be similar to the costs of preparing for and attending a short court hearing. Furthermore, if the mediation does not result in settlement, the cost incurred could be perceived as 'wasted'.

Why parties should follow escalation clauses

1. Where litigation or arbitration is the ultimate (and formal) means for the parties to resolve their dispute, there are various reasons why parties should follow the earlier steps set out in an escalation clause.
2. In relation to litigation, it is settled law in the UK¹ that if an escalation clause is sufficiently clear as to what the parties must do to comply with it, then the courts will be able to hold that such a clause is sufficiently certain to be enforceable. While the case-law has tended to focus on the (un)certainty of such clauses (the courts, generally speaking, do not enforce uncertain obligations), the courts have also made clear that even intrinsic uncertainty may not be sufficient reason not to enforce such a clause. This is because of the public policy incentive to encourage early-stage dispute resolution - as expressed in the Civil Procedure Rules.

¹ *Cable & Wireless v IBM UK* [2002] 2 ALL ER (Comm 1041).

3. Therefore, even contractual references to ADR (e.g. in escalation clauses) which are uncertain to a degree (e.g. they do not include a provision for an identifiable procedure) may not necessarily fail for uncertainty.
4. The likely consequence of an enforceable escalation clause is that an English court would stay proceedings issued before compliance with the processes outlined in the escalation clause while the parties explore/exhaust them. The court could also ask both parties to report to the court on progress and/or why the processes have not worked.
5. Further, in terms of the court's powers in relation to costs, if a party fails to comply with an escalation clause and engages in litigation, there is a risk that, even if successful, a court may consider that party's failure to comply with the escalation clause as a reason for making a costs award that is less favourable to that party than if they had complied with the clause.
6. As for arbitration, the consequences of a party's failure to comply with an escalation clause will largely depend on the wording of the provision (i.e. whether or not it is drafted to be mandatory rather than optional²) and the arbitral tribunal may be asked to determine this question.
7. It is often argued that procedural errors in commencing the arbitration, including failing to comply with mandatory pre-arbitration requirements, constitute a defect which will prevent the arbitral tribunal from having jurisdiction. Although tribunals are generally reluctant to refuse jurisdiction due to a party's failure to comply with the pre-arbitration dispute resolution process³, such an argument has been accepted by tribunals and courts in the past. Further, any finding by a tribunal or a court in relation to jurisdiction and a party's failure to comply with an escalation clause may later lead to a challenge of the award or refusal to enforce the award by the relevant court. To achieve certainty in the long-run, it is therefore advisable to follow the escalation clause.
8. Less extreme approaches for arbitral tribunals include directing parties to comply with the relevant dispute resolution process prior to or during the arbitration and/or making a costs award reflecting the parties' respective behaviour including any refusal to attempt to resolve the dispute amicably before commencing arbitral proceedings.

Practical application

1. We have worked with colleagues in our corporate/commercial departments to advise clients on the benefits/risks of certain clauses and wording. These clauses are often considered to be 'boilerplate' to which little consideration is given. They can be, however, of crucial importance, especially in international contracts (where parties may have different experience/expectations of dispute management) and contracts where maintaining an ongoing relationship is of paramount importance.
2. Part of this work includes reviewing escalation clauses provided by counterparties, to assess their suitability for our clients and – if necessary - how our clients can push back with a more appropriate counterproposal.
3. We often advise clients on the application of an escalation clause when a potential dispute may be in the offing. This enables clients to (i) follow the correct process and (ii) make effective use of the various stages from the outset.

² E.g. "must"/"shall" or "may".

³ Interim Award in ICC Case No. 10256, in Figuera, Multi-Tiered Dispute Resolution Clauses in ICC Arbitration, 14(1) ICC Ct. Bull. 82, 87 (2003); Final Award in ICC Case No. 8445, XXVI Y.B. Comm. Arb. 167 (2001).

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