Arbitrators, Not Courts, Should Resolve Disputes Concerning Escalation Clauses Confirms the Hong Kong Court of Final Appeal

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INTRODUCTION

Arbitration agreements often form part of a tiered dispute resolution clause. These provisions, also known as escalation clauses, may require arbitration to be preceded by efforts to negotiate a mutually satisfactory result or to participate in a conciliation or mediation. If these processes are unsuccessful, the matter may then be escalated to the next dispute resolution mechanism specified in the clause, typically with arbitration as a last resort.

Parties may include escalation clauses in contracts for a variety of reasons. Other forms of dispute resolution may provide a less costly means of resolving a dispute than arbitration. They may also be more effective in preserving a continuing relationship between the parties than the more adversarial arbitration process. By including an escalation clause, it may be more likely that the parties will make use of one of these other dispute resolution mechanisms. If the parties simply agree to arbitrate any disputes arising between them, and a dispute arises, in some circumstances, it may be difficult for either party to resort to one of these procedures because of the concern that doing so may signal weakness in its position.

Escalation clauses must be drafted and followed with care so that parties do not become embroiled in a collateral dispute over whether a party has complied with the requirements of the escalation clause and whether it is entitled to proceed to arbitration. In recent years, the courts of a number of jurisdictions have had to consider the effect of these clauses and, in particular, whether disputes about compliance are solely to be determined by the arbitral tribunal, or whether they go to the tribunal's jurisdiction and are therefore a matter of shared competence between the tribunal and the courts.

RECENT COLLATERAL LITIGATION OVER ESCALATION CLAUSES IN THE HONG KONG COURTS

Recent litigation in Hong Kong in the case of *C v D* raised precisely these issues. The case made its way through all levels of the Hong Kong court system.[1]

The parties (whose names were anonymized in accordance with the robust confidentiality protections afforded to parties to Hong Kong arbitrations) were satellite operators based in Hong Kong and Thailand. They entered into a Hong Kong law-governed agreement concerning the operation of a jointly owned broadcasting satellite. A dispute arose as to whether one of the operators was in breach of the agreement by switching off satellite transponders following the other operator's failure to comply with demands to cease transmission of video signals which had not been approved by the People's Republic of China.

The agreement contained an escalation clause. This provided that if a dispute arose, then (i) the parties were required to attempt in good faith to resolve the dispute by negotiation, (ii) either party could provide written notice to the other to have the dispute referred to the Chief Executive Officers of the parties for resolution, (iii) a meeting between the Chief Executive Officers (or their authorized representatives) would take place within 10 business days, and (iv) if the dispute could not be resolved within 60 business days of the date of the written notice, then the dispute could be referred to arbitration under the UNCITRAL Arbitration Rules to be administered by the Hong Kong International Arbitration Centre ("HKIAC").

After exchanges between the parties, the claimant filed a notice of arbitration at the HKIAC. The respondent objected to this on the basis that the claimant had not first sent a request for negotiation. The respondent argued this meant that the arbitral tribunal did not have jurisdiction to hear the dispute. The arbitral tribunal disagreed and held that a letter sent by the claimant to the respondent constituted an attempt to resolve the dispute by negotiation. The arbitral tribunal issued a partial award, holding that the claimant had complied with all pre-arbitration conditions, and ultimately held that the respondent had breached the agreement and was liable to pay damages.

SET-ASIDE APPLICATION

The respondent sought to have the partial award set aside by the Hong Kong courts. Article 34 of the UNCITRAL Model Law on International Commercial Arbitration (the

[1] *C v D* [2021] HKCFI 1474; *C v D* [2022] HKCA 729; *C v D* [2023] HKCFA 16.

"Model Law"), incorporated into Hong Kong law by section 81 of the Arbitration Ordinance (Cap. 609) (the "Arbitration Ordinance"), permits the setting aside of arbitral awards on limited grounds. These grounds include that the award deals with a dispute not contemplated by or not falling within the terms of the submission to arbitration such that the arbitral tribunal did not have jurisdiction to determine it.

Disputes over compliance with preconditions to arbitration tend to focus on the distinction between jurisdiction and admissibility. The key issue is whether noncompliance with a pre-arbitration condition goes to the admissibility of a claim or to the power of the arbitral tribunal to determine the claim. This is an important distinction, as in set-aside applications under the Model Law a court is empowered to review a tribunal's ruling on a challenge to its jurisdiction but not a ruling on the admissibility of a claim. In short, if compliance with an escalation clause is a matter of jurisdiction, it can be reviewed by the court in a set-aside application; if it is a matter of admissibility, it cannot be reviewed.

In *C v D*, the Court of First Instance, the Court of Appeal and the Court of Final Appeal each determined that compliance with a pre-arbitration condition is a matter concerning the admissibility of claims and not the jurisdiction of the arbitral tribunal to determine them. On this basis, the parties' dispute as to whether pre-arbitration conditions had been fulfilled was viewed as a matter that the parties had intended to submit to arbitration. It followed that the courts were not empowered to review the arbitral tribunal's decision that the claimant had complied with conditions precedent to arbitration.

Under Hong Kong law, it is now clear that an arbitral tribunal's determination on whether an escalation clause has been complied with cannot be reviewed by the courts in an application to set aside an arbitral award. An exception to this is where it is clear from the terms of the arbitration agreement that the parties did not intend for disputes about compliance with pre-arbitration conditions to be determined exclusively by the arbitral tribunal. Such circumstances will rarely arise.

As Hong Kong is a Model Law jurisdiction, this judgment has real international significance in the 120 jurisdictions which have arbitration statutes based on the Model Law. The Court of Final Appeal's judgment is also notable as the full court did not adopt the same reasoning. The majority held that the distinction between jurisdiction and admissibility is a helpful aid to construction of the Arbitration Ordinance when deciding whether, in a particular case, judicial intervention in the arbitral process is permissible. The minority (Mr Justice Gummow NPJ) ultimately agreed with the outcome of the appeal, but considered that the distinction between admissibility and jurisdiction is an unnecessary distraction and that the real question is whether the dispute about compliance with preconditions has been submitted to arbitration. If it has been, then

the arbitral tribunal's decision on this dispute could not form the basis of a set-aside application.

DRAFTING ESCALATION CLAUSES

Escalation clauses should be carefully drafted to reduce the risk of collateral disputes about compliance. Those disputes can be both costly and time-consuming, particularly if they are fought both in the arbitration and before the courts. In the recent Hong Kong litigation, the respondent filed its set-aside application on 21 May 2020, and the Court of Final Appeal issued the final judgment concerning this application over three years later on 30 June 2023.

A carefully worded escalation clause should promote the speedy resolution of disputes over compliance. The escalation clause should make clear that it is open to either party to commence arbitration either at any time or after a short specified time period for negotiation, conciliation or mediation. Including such a provision will mitigate the risk of a protracted dispute, as occurred before the Hong Kong courts, over whether a party failed to meet a condition precedent to arbitration. In addition, the clause should specify that any disputes about compliance with an escalation clause are themselves subject to arbitration so that a delaying party does not attempt to litigate the question in the courts.

Our Debevoise International Arbitration Clause Handbook (available here) contains suggested language which may be used if parties wish to include an escalation clause in their arbitration agreement.

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