NEW LAW ON ESCALATION CLAUSES IN HONG KONG

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Legal Briefings – By **Simon Chapman QC, Partner and Charlotte Benton, Senior Associate**

KEY JUDGMENT ON ARBITRATION CLAUSES AFFECTING THOUSANDS OF COMMERCIAL CONTRACTS

Many commercial contracts contain "escalation clauses"requiring parties to take certain steps before formal arbitration begins – such as a requirement to "negotiate in good faith" before starting arbitration.

Previously, failure to comply with the escalation mechanism in a contract left the arbitrators' decisions vulnerable to challenge in domestic courts. In a new judgment, the Hong Kong High Court confirmed that this approach is wrong, and that questions around compliance with the escalation mechanism are matters of admissibility for arbitrators to resolve, not matters of jurisdiction subject to review by local courts.

As Hong Kong is a Model Law jurisdiction, this judgment has real international significance. The case will be of relevance in the 118 jurisdictions which have legislation based on the Model Law, and follows a wider international trend. Those in contractual disputes can now have certainty that arbitration agreements will be upheld, even where there are questions around pre-conditions to arbitration. It also provides welcome confirmation of the pro-arbitration stance of the Hong Kong courts, particularly in cases where, as the judge observed: "the parties' commitment to arbitrate is not in doubt".

Herbert Smith Freehills acted for the successful Defendant, with Partner Simon Chapman QC appearing as advocate.

C V D [2021] HKCFI 1474

Background

The contract in issue stipulated that, if a dispute arose between the parties, they should "*attempt in good faith promptly to resolve such dispute by negotiation.*" The contract went on to say that "*Either Party may, by written notice to the other, have such dispute referred to the Chief Executive Officers of the Parties for resolution*" and that, if the parties could not resolve the dispute amicably within 60 business days"*of the date of the Party's request in writing for such negotiation*", they could refer the matter to arbitration.

A dispute arose between the parties which the Defendant raised with the Board of Directors of the Plaintiff "*in a final effort to resolve this issue and avoid further legal proceedings*". The relevant correspondence indicated that it was "*clear... that a relevant dispute now exists for the purpose of [the contract]*", but ultimately the matter was not resolved. The Defendant therefore commenced arbitration, with the Plaintiff challenging the jurisdiction of the tribunal on the basis that the Defendant had not properly complied with the escalation mechanism in the contract, because the dispute had not been referred to the parties' respective Chief Executive Officers.

Issues in dispute

The tribunal in the arbitral proceedings rejected the Plaintiff's complaint, finding that the Defendant had complied with the clause, such that no issue of jurisdiction arose. The Plaintiff then applied to set aside the tribunal's decision under section 81 of the Arbitration Ordinance (Cap 609), which incorporates Article 34 of the Model Law.

Section 81(2)(a)(iii) provides that an arbitral award may be set aside if: "*the award deals with a dispute not contemplated by or falling within the terms of the submission to arbitration*". Section 81(2)(a) (iv) provides that an award can be set aside where: "*the arbitral procedural was not in accordance with the agreement of the parties*".

It was common ground between the parties that the contract contained a mandatory condition precedent to arbitration, and that, at a minimum, this required a request in writing for negotiation. There was a dispute, however, as to the precise requirements of the contract, and whether those requirements had been fulfilled. The Plaintiff's case was that they had not, such that the tribunal lacked jurisdiction. The Defendant argued that the contract had been complied with in full, but in any event this was a question of admissibility, rather than jurisdiction, such that section 81 of the Ordinance was not engaged.

Decision

The court found that the "*generally held view of international tribunals and national courts*" is that non-compliance with a pre-condition to arbitration is a question of admissibility, not jurisdiction.

The court relied on a number of academic authorities which recognise the distinction, as well as previous authorities from the United States Supreme Court and the Singapore Court of Appeal. The court also cited, with approval, the recent English High Court decision in *Republic of Sierra Leone v SL Mining Ltd* [2021] EWHC 286 (Comm). In that case, the contract in question required the parties to negotiate in good faith for three months before commencing arbitration. The Defendant allowed less than three months to elapse, but the court nonetheless declined to set aside the award on the basis that this was ultimately a question of admissibility, not jurisdiction.

In reaching this conclusion, the court distinguished previous authorities from England and Wales and Hong Kong in which it had been found that compliance with escalation clauses did give rise to questions of jurisdiction. The Plaintiff had sought to rely, for example, on *Emirates Trading Agency LLC v Prime Mineral Exports Pte Ltd* [2015] 1 WLR 1145, where the English High Court held that a contractual requirement for friendly discussions in good faith before the arbitration was a matter going to jurisdiction. A similar point was argued in *HZ Capital International Ltd v China Vocational Education Co Ltd* [2019] HKCFI 2705, albeit where the condition precedent was found to have been waived. The court noted, however, that in both of these cases the distinction between admissibility and jurisdiction was never argued, such that neither decision provided any real support for the Plaintiff's case.

Limited exception to the rule

The court recognised that there may be a limited exception to the general rule that pre-conditions to arbitration do not go to the jurisdiction of the tribunal, namely where the parties have explicitly provided that failure to comply with pre-arbitral requirements will exclude the tribunal's jurisdiction. In this case, however, there was no indication that the parties intended compliance with the relevant provisions to be a matter of jurisdiction. Moreover, it seemed "*unlikely to be the parties' intention that despite a full hearing before and a decision by a tribunal of their choice the same issue should be re-opened in litigation in the courts.*"

Constitutional objection rejected

The Plaintiff had also argued that it would be unconstitutional for the court not to intervene in these circumstances, on the basis that this would curtail the Plaintiff's fundamental right of access to the courts under Article 35 of the Basic Law. The judge rejected this argument on the basis that one of the underlying principles of the Ordinance is to restrict the court's interference in arbitration to circumstances expressly provided for under section 3(2) (b) of the Ordinance. The restrictions set out in section 81 were, furthermore, proportionate to the aim of section 3(1) of the Ordinance to "*facilitate the fair and speedy resolution of disputes by arbitration without unnecessary expense*".

Comment

This important decision provides welcome certainty that arbitration agreements will be upheld, even where there are questions regarding compliance with pre-conditions to arbitration, such as mandated cooling off or negotiation periods.

This does not mean that these provisions are not enforceable. As the court made clear: "*The fact that a condition is regarded as going to admissibility rather than jurisdiction does not mean it is unimportant. What it does mean is that the arbitral tribunal has jurisdiction and may deal with the question as it sees fit.*" The tribunal may, for example, choose to stay the proceedings to allow time for compliance with the clause, order some form of cost sanction to account for the breach of contract, or even dismiss the claim outright as inadmissible. As the court observed, this approach has: "*considerable advantages*" because the tribunal chosen by the parties is likely to be well-placed to "*consider and determine what needs to be done having regard to the commercial realities and the practicalities including whether it would be futile to compel the parties to go through the motions*".

Importantly, and having surveyed all of the international authorities on this issue, the judge concluded that this approach was: "*entirely consistent with the policy in Hong Kong law which respects the parties' autonomy in choosing arbitration as the means to resolve their disputes with its incident of speed and finality as well as privacy*". The decision therefore further underlines the pro-arbitration stance of the Hong Kong courts, particularly in cases such as the present where "the parties' commitment to arbitrate is not in doubt". Reflecting the usual practice in Hong Kong, the Defendant was awarded costs on the indemnity basis.

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