

Multi-Tier Dispute Resolution in International Construction Contracts: Conflict Escalation or Resolution?

Ai Li Chu

*Azman Davidson & Co., Kuala Lumpur, Malaysia
chu.aili@azmandavidson.com.my*

Abstract

This last decade has witnessed the proliferation of multi-tier dispute resolution clauses in construction contracts. Multi-tier dispute resolution clauses are now found or entrenched in many international construction contracts, including standard form construction contracts, notably the Fédération Internationale des Ingénieurs-Conseils (FIDIC) suite of contracts. This paper highlights the legal issues and practical problems that arise from multi-tier dispute resolution. The legal issues and practical problems are related to the enforceability of the early tier dispute resolution processes (including negotiation and mediation) and the enforceability of the results of dispute resolution processes. The paper further identifies the main reason for the issues and problems. The paper concludes by answering the question whether the issues and problems that arise from multi-tier dispute resolution outweigh its benefits? This paper is based on a theoretical research approach.

Keywords

Dispute resolution, Construction contracts

1. Introduction

Multi-tier dispute resolution involves separate and distinct escalating tiers or stages of dispute resolution processes. The dispute resolution processes commonly found in multi-tier dispute resolution clauses include negotiation, mediation, expert determination and arbitration. The lower rungs of multi-tier dispute resolution usually are comprised of non-determinative processes such as negotiation and mediation; they pave the way for determinative processes in the higher rungs such as expert determination that usually leads to arbitration. The entire multi-tier dispute resolution process "essentially acts as filtering process", so that only complex disputes or those disputes that require a more efficient procedures, extra cost and greater time, will result in arbitration (Jones, 2009).

Multi-tier dispute resolution is attractive to the international business community because it opens up the choices for dispute resolutions processes, and does not tie its participants down to one process. The participants of multi-tier dispute resolution come from the international business community, many who are disillusioned by the cost and time demands of arbitration and litigation, and yearn for more efficient and cost-effective dispute resolution. They hope that the filtering process of multi-tier dispute resolution will produce the settlement of disputes, at the very least the simpler or urgent ones, at the lower rungs.

Although multi-tier dispute resolution may appear attractive on the outside, hidden within its rungs are serious legal issues that may spring up and trip the dispute resolution processes or their results. The legal issues that arise from multi-tier dispute resolution involve, firstly, the enforceability of the agreement to

use the early tiers, in particular, non-determinative processes such as negotiation and mediation; and secondly, the enforceability of the results of the dispute resolution processes. The main reason why these issues arise is the absence of a legal framework to support the enforcement of the early dispute resolution tiers and the enforcement of the results of the dispute resolution tiers apart from arbitration.

2. Enforceability of Tiers

The legal issues related to enforceability of the dispute resolution tiers rise up to the surface when a party to a contract containing a multi-tier dispute resolution clause sidesteps a tier or does not complete a tier, but proceeds to the next or highest tier (usually arbitration) or commences a court action. In such situations, when one of the parties raises an objection to the defaulting party's breach of the multi-dispute resolution clause, the arbitral tribunal has to address the question whether it can proceed with arbitration or whether the defaulting party should be allowed to proceed with arbitration, and the court has to address the question whether it can or should stay its own proceedings or whether it should compel the defaulting party to complete the unfulfilled or incomplete tier. An examination of case laws reveals that the arbitral tribunals' or courts' responses to the questions mentioned above are generally influenced by the determinative or non-determinative nature of the process for the relevant tier(s), strength of the obligation placed on the parties to complete such tier(s) and whether specific requirements for such tier(s) were provided for by the parties.

2.1 The arbitral tribunals' responses

The legal issues relating to enforceability of multi-tier dispute resolution appear when a party, in breach of the multi-tier dispute resolution clause, commences arbitration proceedings without undertaking or completing the early tiers. The non-fulfillment of early tier(s) is said to affect the jurisdiction of the arbitral tribunal because its jurisdiction is founded upon the arbitration agreement within the multi-tier dispute resolution clause, which requires the fulfillment of pre-arbitral processes before the remaining disputes may be referred to arbitration. The reported decisions of arbitral tribunals, which comprise of the International Chamber of Commerce (ICC) arbitration cases, reveal that there is variance in the arbitral tribunals' responses in such situations, influenced largely by the determinative or non-determinative nature of the early tier process and the wording of the requirement to refer disputes to the early tier process found in the dispute resolution clauses.

Agreements containing the duty to negotiate as a pre-arbitral stage appear to have been treated by arbitral tribunals with some latitude. In ICC case no. 8462 (final award of January 27, 1997), the tribunal reviewed the issue from the point of view of its jurisdiction (Jolles, 2006). The multi-tier dispute resolution clause in this case provided for a first tier of negotiation, and if after 30 days no settlement could be reached, the parties could resort to arbitration. The respondent challenged the arbitral tribunal's jurisdiction on the ground that the claimant had failed to notify the respondent about the precise issues to be arbitrated, for which reason the respondent had no opportunity to find an amicable solution. The tribunal held there were enough indications to conclude the claimant had made efforts to comply with the first tier obligation, it therefore had jurisdiction over the matter. In ICC case no. 9977 (final award of June 22, 2009), the arbitral tribunal had to decide whether the parties met their first-tier obligation to submit disputes "to senior management representatives of the parties who will attempt to reach an amicable settlement" (Jolles, 2006). Meetings were held, but the respondent argued that only the claimant's legal representatives attended the meetings, not members of senior management. The arbitral tribunal found that the respondent failed to raise such objection at the time of negotiations, and dismissed the same.

The arbitral tribunals' responses in ICC cases involving agreements to mediate/conciliate appear to depend on the way the multi-tier dispute resolution clauses are drafted and the words used in the clauses. In ICC case no. 10256 (interim award of August 12, 2000), the tribunal held that the word "may" in a three-tier clause, which provided as a second tier that the parties may refer disputes to an expert for

consideration, was a non-binding term. In other words, the provision was permissive and not mandatory. The tribunal held that either party was free to refer to dispute to arbitration, regardless whether there had been good faith negotiations or reference of disputes to an expert for mediation (Jolles, 2006). In ICC case no. 4230, the clause read, "... all disputes related to the present contract may be settled amicably by three conciliators...". The respondent argued this pre-arbitral requirement was not respected by the claimant. The arbitral tribunal found it had jurisdiction because it interpreted the clause as not being expressly obligatory (Wolrich, 2002).

Arbitral tribunals seem to construe agreements to refer disputes to a determinative process more strictly. In ICC case nos. 6276 and 6277 the arbitral tribunal found it lacked jurisdiction because the claimant failed to satisfy the condition precedent set forth in the dispute resolution clause based on the terms of Clause 67 of the 1989 FIDIC Conditions, and that the submission was premature. The tribunal dismissed the request for arbitration and ordered the claimant to formally demand from the defendant the designation of an Engineer to hear the dispute before the matter could be referred to arbitration (Cremades, 2004). In ICC case no. 6535 the tribunal considered that the claimant did not comply with the first tier requiring submission of disputes to the Engineer because the claimant's letters to the Engineer claiming relief in relation to extension of time and variation of work did not amount to a valid referral of disputes (Cremades, 2004).

2.2 The Courts' responses

The legal issues relating to the enforceability of multi-tier dispute resolution appear where a party, in breach of a multi-tier dispute resolution clause, commences court proceedings, and the other party raises a challenge to this course of action. When this happens, the courts are put in a legal quandary. Do courts have the power to stay their own proceedings for breach of multi-tier dispute resolution clauses? Where does this power to stay come from, since there are no statutory provisions that endow such power on the courts? Should the courts enforce and encourage alternative dispute resolution processes apart from arbitration? Should the courts enforce dispute resolution processes that are uncertain and non-determinative?

The common law courts have traditionally refused to enforce non-determinative dispute resolution processes such as negotiation, mediation and conciliation. There was, for a long time, resistance by the courts against enforcing clauses providing for non-determinative processes.

Agreements to negotiate were and still are deemed by the UK courts to be "too uncertain to have any binding force", as held by Lord Denning M.R. in *Courtney and Fairbairn Ltd v Tolaini Bros (Hotels) Ltd* [1975] 1 W.L.R. 297. In Australia, the courts initially distinguished agreements to negotiate from agreements to mediate/conciliate, which were held to be enforceable in *Hooper Bailie Associated Ltd v Natcon Group Pty Ltd* (1992) 28 N.S.W.L.R. 24, because they were more certain. The Australian courts appear to have substantially loosened any strict requirement for certainty when the N. S.W. Supreme Court in *United Group Rail Services Ltd v Rail Corp New South Wales* [2008] NSWSC 1364 held that a provision for disputes to be subject to negotiation "in good faith" was binding and enforceable. The courts in Singapore seem to be stepping cautiously when the High Court regarded a clause requiring reference of disputes to executive representatives "for settlement through friendly consultations" as likely to be unenforceable for being vague and subjective, in *Insignia Technology Co Ltd v Alstom Technology Ltd* [2008] SGHC 134. There are no reported cases on the enforceability of agreements to negotiate in Malaysia, but it is likely that the courts will step cautiously in relation to such agreements.

Agreements for mediation or conciliation were for a long time also regarded as non-binding by the UK courts. The House of Lords decision in *Channel Tunnel v Balfour Beatty Construction Ltd* [1993] A.C. 334 marked the beginning of a turning point in the UK courts' enforcement of multi-tier dispute resolution, but that case involved determinative processes. After the *Channel Tunnel* case, the courts still

resisted enforcing the early tiers of multi-tier dispute resolution clauses. The High Court judge in *Halifax Financial Services Ltd v Intuitive Systems Ltd* [1999] 1 All E.R. (Comm) 303 declined to enforce a multi-tier dispute resolution clause that provided for specific steps and time limits for specific tiers of negotiation, “structured negotiation” (mediation) and arbitration. His lordship held that a distinction had to be drawn between determinative procedures and non-determinative procedures, and said the courts did not compel parties to engage in co-operative processes because of the practical and legal impossibility of monitoring and enforcing the process. It was not until *Cable & Wireless Plc v IBM UK Ltd* [2002] 2 All E.R. (D) 277 that the UK courts openly recognized the public policy of promoting mediation and granted a stay of litigation to enable mediation to take place. In contrast, the Australian courts have been more willing to hold agreements to conciliate/mediate to be enforceable since *Hooper Bailie Associated Ltd v Natcon Group Pty Ltd* (1992) 28 N.S.W.L.R. 24. However, the courts would generally require agreements to mediate or conciliate to contain definite procedural aspects and firm wording before the courts enforced them.

The above research reveals the Courts’ reluctance to enforce the early tier processes, especially negotiation and mediation, in the absence of a statutory basis. The absence of any international instruments obliging courts to enforce mediation agreements results in the issues of the enforceability of agreements to mediate on a case to case basis (Bobette, 2001).

Agreements to settle disputes by way of determinative processes such as expert determination or adjudication were held to be enforceable by the courts, with less hesitation. In *Channel Tunnel v Balfour Beatty Construction Ltd* [1993] A.C. 334, the House of Lords held that the courts had inherent jurisdiction to grant a stay of a court action brought before it in breach of a two-tier dispute resolution clause involving a panel of experts and arbitration, and such power to grant a stay of court proceedings existed independently of any statutory power to stay pending arbitration. Lord Mustill held that the inherent jurisdiction of the courts to stay its proceedings brought in breach of an agreement to settle disputes through other dispute resolution processes was analogous to its power to stay proceedings where the action is brought in breach of agreement to submit disputes to the adjudication of a foreign court. The courts had this inherent jurisdiction even where there was no arbitration clause, as held by the court in *Cott UK Ltd v FE Barber Ltd*. [1997] 3 All E.R. 540. However, the decision in the case of *Cott v FE Barber* indicates that the courts expected and required the dispute resolution process to contain some basic requirements relating to certainty and procedure before they exercised their inherent jurisdiction to stay their own proceedings.

In the case laws mentioned above, the device adopted by the courts to enforce multi-dispute resolution clauses was to grant a stay of their own proceedings to enable parties to exhaust the early dispute resolution tiers. The courts generally did not regard it appropriate to make injunctive orders to compel the parties to take part in early tier dispute resolution processes. In the case of *Ericsson AB v EADS Defence and Security Systems Ltd* [2009] EWHC 2598 (TCC), the defendant sought an order preventing the plaintiff from taking further steps in adjudication, which was one of the dispute resolution processes mentioned in the dispute resolution clause. The court did not appear to have specifically addressed the issue whether it had the power to grant the type of order applied for by EADS, and merely assumed it had the power. The court decided not to make such an order because it construed the clause as allowing the parties to refer disputes to mediation or adjudication or both.

The courts’ responses to arguments pointing to breach of multi-dispute resolution clauses are not limited to what have been highlighted above. The courts in the US have, in cases where a party sidestepped the entire multi-tier dispute resolution process that culminated in arbitration by filing a court action, refused to stay the court action pending arbitration (File, 2007). In *HIM Portland LLC v De Vito Builders Inc* 317F 3d 41, 42 (1st Cir 2003) the dispute resolution clause provided that arbitration “shall ... be subject to mediation as a condition precedent to arbitration”. Neither party attempted to mediate the dispute. When the court action was filed, one of the parties applied to compel arbitration. The court refused to do so on

the grounds that since neither party attempted to mediate the dispute, neither party could be compelled to submit to arbitration. In *Kemiron Atlantic Inc v Aguakem Int'l Inc* 290 F 3d 1287, 1289 (11th Cir 2002), the dispute resolution clause merely stated “(i) in the event the dispute cannot be settled through mediation, the parties shall submit the matter to arbitration ...”, and did not impose mediation as a condition precedent for arbitration. The court nevertheless read into the clause and created a condition precedent, and refused to stay the court action pending arbitration. The court held that the arbitration provision had not been activated and that the suit should not be stayed. These cases illustrate the risk for parties, who at the time of signing the contract intended for disputes to be finally settled through arbitration, may instead find the courts compelling them to litigate where they neglected to comply with the early tiers of their multi-dispute resolution clause.

2.3 The Malaysian courts’ response?

In Malaysia, there are no reported cases, as at the date of this paper, involving the courts’ recognition and exercise of inherent jurisdiction to stay court proceedings on the basis of the existence of a multi-tier dispute resolution clause. In a recent case, *Mersing Construction & Engineering Sdn Bhd v Kejuruteraan Bintai Kindenko Sdn Bhd* [2010] 1 LNS 793, the procedure for the settlement of disputes stated as follows, “The procedure for Settlement of Dispute is DAB (Dispute Adjudication Board) in accordance with Clause 20 of the FIDIC General Conditions Edition 1999”. The court held that the provision did not state that the whole of Clause 20 of the FIDIC General Conditions 1999 shall apply; it only stated that the procedure for DAB shall be in accordance with FIDIC. As such, the court held there was no arbitration agreement, and dismissed the application for a stay of proceedings under Section 10 of the Arbitration Act 2005. The court did not go further to consider if it had inherent jurisdiction to stay its proceedings and allow the parties to refer their disputes to the DAB. In two earlier cases, *Ranhill Bersekutu Sdn Bhd v Konsortium Lapangan Terjaya Sdn Bhd* [2001] 2 CLJ 380 and *Busuk Jamilah bte Salim & ors v Siti Rahfizah binti Mihaldin & Anor* (17.12.2009) (unreported), the courts did not regard the multi-tier dispute resolution clauses found in the contracts in those cases as having prevented the courts from exercising their powers under the Arbitration Act to stay proceedings.

The Malaysian courts have, in recent years, been promoting mediation. As such, the foundation of public policy in favour of mediation is in place, as it was in the UK when the courts’ shift in mindset began. There is a real likelihood that the courts will be open to exercising their inherent jurisdiction to stay proceedings in order to encourage mediation.

3. Enforceability of Results

Apart from the legal issues relating to the enforceability of early dispute resolution tiers, there are serious legal issues relating to the enforceability of the results of dispute resolution processes, both non-determinative and determinative.

3.1 Results of Non-Determinative Processes

Agreements reached in negotiation or mediation of international commercial disputes are generally considered unenforceable; they may be enforced indirectly in municipal courts either as contracts that create new legal rights and obligations, or as subject of consent orders/decrees (Wolski, 2001). A mediated settlement is not recognized as an arbitration award by the New York Convention for the purposes of settlement. The fulfillment of the terms of a negotiated or mediated settlement depends largely on the voluntary performance by parties, in the absence of a legal framework for enforcement of such agreements.

In practical terms, this means that if one of the parties refuses to honour a settlement reached in mediation or negotiation, the other party who negotiated or mediated in order to avoid the complicated and

expensive process of arbitration may find itself drawn into more complicated and no less expensive processes of the courts to seek an order in terms of settlement reached by the parties and to enforce the said order. That party may then be faced with the very legal issues relating to the enforcement of court orders that it intended to avoid in the first place when it agreed to refer disputes to the arbitration process that is supported by an established legal framework of international conventions and statutory laws that recognize and enforce arbitration awards.

3.2 Results of Determinative Processes

There is a marked absence of a legal framework for the enforcement of decisions obtained as a result of determinative dispute resolution processes apart from arbitration. One of the most common international standard forms of construction contracts is the FIDIC suite of contracts that contain pre-arbitral determinative dispute resolution processes such as references of disputes to the Engineer (under Clause 67 of the 1987 FIDIC General Conditions of Contract) or a Dispute Adjudication Board (under Clause 20 of the 1999 FIDIC General Conditions of Contract). Although Clause 20.4 of the 1999 FIDIC General Conditions appears to place clear obligations on parties to be bound by decisions of the Dispute Adjudication Board (DAB), in practice, compliance with the DAB's decisions depends largely on voluntary performance by the parties, in the absence of a legal framework for the enforcement of such decisions. The experience of a party in an ongoing arbitration in the case study below may illuminate the difficulties faced by parties wishing to enforce a DAB decision.

3.2.1 Case study

The parties entered into a contract containing the 1999 FIDIC General Conditions for the construction of an engineering project. The modified dispute resolution clause required reference of disputes to a DAB, and unless settled amicably, the reference of any dispute in respect of the DAB's decision to arbitration under the rules of the Kuala Lumpur Regional Centre for Arbitration.

The disputes that arose were first referred to a DAB. The DAB made decisions on all of the disputes submitted to it. Parties issued notices of dissatisfaction in respect to the DAB decision. It is clear from the DAB decisions that a certain sum was payable by the employer to the contractor. This sum was not paid by the employer after a demand was made for payment of the sum. The contractor filed a court action to apply for a declaration that the employer had breached the contract by failing to pay the sum owed as a result of the DAB decision, and an order for damages in the said sum. The court, on application by the employer, stayed the court action pursuant to its powers under the relevant Arbitration Act. As a consequence, the contractor decided to pursue the question of enforceability of the DAB decision pending arbitration in the arbitration proceedings that were already commenced.

The enforceability of the DAB decision was referred to the arbitral tribunal as a preliminary issue. The contractor relied on Clause 20.4 of the FIDIC General Conditions to argue that the DAB decision was binding on the parties even where notices of dissatisfaction were issued and the disputes were referred to arbitration. The contractor referred to the arbitral tribunal's decision in ICC case no. 10619 ((2008) *ICC 19 International Court of Arbitration Bulletin*, No.2, pp. 52-56) relating to the dispute resolution provision in Clause 67 of the 1987 FIDIC Conditions. In ICC case no. 10619, the arbitral tribunal ordered the employer to honour its obligation to comply with the Engineer's decision on the grounds that the decision was binding even though a notice of dissatisfaction had been given. The arbitral tribunal in the ICC case held that the decision had an immediate binding effect on the parties, and any non-compliance was deemed a breach of contract, and that there was "no reason why in the face of such a breach the arbitral tribunal should refrain from an immediate judgment giving the Engineer's decisions their full force and effect. This is simply the law of contract". The contractor submitted that the decision in ICC case no. 10619 was applicable to a decision of the DAB under Clause 20 of the 1999 FIDIC conditions. This submission is consistent with the wording found in both Clause 67 of the 1987 FIDIC

Conditions and Clause 20.4 of the 1999 FIDIC Conditions. This submission is also consistent with opinion within the international arbitration arena (Seppälä, 2009).

The employer raised an issue as to the arbitral tribunal's jurisdiction to determine the preliminary issue of whether the DAB decision was binding pending arbitration. The employer relied on two grounds: first, the preliminary issue was not specifically included in the notices of arbitration; secondly, the preliminary issue had not been subjected to the contractual multi-tier dispute resolution mechanism. The employer submitted that the parties may only refer disputes in respect of a DAB decision that had not become final and binding to arbitration.

The arbitral tribunal decided that it had no jurisdiction to determine the preliminary issue of whether the DAB decision was binding pending arbitration. The arbitral tribunal's decision was based, *inter alia*, on the ground that the preliminary issue should have been but was not been referred to the DAB in accordance with the multi-tier dispute resolution provided under Clause 20 of the 1999 FIDIC Conditions.

This case study illustrates the potent challenge presented by the legal issues relating to the jurisdiction of the arbitral tribunal where a multi-tier dispute resolution clause is drafted to filter disputes like Clause 20 of the FIDIC Conditions. The experience of the contractor in this case illustrates the real danger that a party, after having complied with the contract provisions for multi-tier dispute resolution and after having obtained a result in his favour, may find, to his dismay, that the courts and the arbitral tribunal refuse to enforce the result of a determinative dispute resolution process. He may find himself being in no better position than before he had gone through the dispute resolution process and obtained the favourable result.

4. Conclusion

The research reveals the multitude of legal issues that are hidden within the tiers of multi-tiered dispute resolution clauses. The legal issues that arise from multi-tier dispute resolution relate to the enforceability of the agreement to use the initial dispute resolution processes, in particular negotiation and mediation, as well as the enforceability of the results of dispute resolution processes apart from arbitration. It is submitted that the main reason for the issues that arise from multi-tier dispute resolution is the absence of statutory support, which in turn results in weak support by the courts in relation to the enforcement of the processes and the results. The absence of statutory support causes the courts to question whether they have the power to stay their proceedings for breach of dispute resolution processes that are not recognized in any statute. The absence of statutory support also causes the courts to hesitate in enforcing the results of dispute resolution processes that are not recognized in any statute.

As a result, multi-tier dispute resolution clauses are said "to bear a particular risk of being pathological, i.e. of being not capable of functioning in practice"; and in this regard, there exists a "risk that, rather than coming closer to a resolution of their dispute, the parties will 'stumble' on the escalation ladder during the course of proceedings" (Berger, 2006). So long as the legal issues and practical problems highlighted in this paper exist, multi-tier dispute resolution will, it is submitted, increase or escalate conflicts, not resolve conflicts. This research reveals the many legal issues hidden within the early tiers of multi-tier dispute resolution. The risk that the parties will uncover and rely on the hidden legal issues is significant. Multi-tier dispute resolution clauses therefore increase the disputes between the parties as well as escalate the disputes to a serious level where the jurisdiction of the arbitral tribunal or the entire arbitration agreement may be challenged.

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