Kluwer Arbitration Blog

Escalation Clauses: No Longer a Tripping Hazard for Arbitrations with Seat in Germany?

Rupert Bellinghausen (Linklaters) and Julia Grothaus · Thursday, December 1st, 2016

Escalation clauses (or multi-tiered dispute resolution clauses) need careful drafting so that the wording is both enforceable and commercially useful – and does not produce unexpected surprises. With regard to clauses that provide for 'final' dispute resolution by means of arbitration, in particular, there is uncertainty as to the consequences of the parties' failure to follow the steps set out in the escalation clause. Will it prevent the arbitral tribunal from accepting jurisdiction, or is it a condition precedent for rendering a decision on the merits? Can an arbitral award be set aside for failure to comply with the escalation clause? In two recent decisions of 14 January 2016 and 9 August 2016, the German Federal Court of Justice (*Bundesgerichtshof*) clarified that, in arbitral proceedings seated in Germany, an arbitral tribunal is entitled to assume jurisdiction irrespective of whether the parties complied with the escalation clause.

The cases before the Bundesgerichtshof: facts and background

Both cases were brought before the Bundesgerichtshof by means of a complaint on points of law (*Rechtsbeschwerde*) concerning interim arbitral awards on jurisdiction pursuant to Sec. 1040 (3) sentence 1 of the German Code of Civil Procedure (*ZPO*) after both arbitral tribunals had accepted jurisdiction even though one of the parties argued lack of compliance with the dispute resolution settlement procedure stipulated in the respective escalation clauses.

In the 14 January 2016 ruling, a Finnish shipyard company and a Guernsey company entered into a shipbuilding contract in 2006 that provided for arbitration according to the rules of the German Maritime Arbitrators Association (GMAA) with seat in Hamburg. In addition, the parties stipulated that *"technical disputes […] shall be at the written request of either Party be referred to a mutually acceptable technical expert who shall act as such (and not as an arbitrator) and whose opinion on the matter shall be final and binding upon the parties."* After the construction of the vessel, a dispute arose concerning defects of the vessel such that the Guernsey company initiated arbitration proceedings. After the arbitral tribunal had accepted jurisdiction, the Finnish shipyard company challenged this interim award before the Higher Regional Court of Hamburg (*OLG Hamburg*, case no. 6 Sch 3/15). By a decision of 27 May 2015, the court rejected the challenge. According to the court, the clause amounted to an escalation clause since the two means of dispute resolution were not mutually exclusive, as the expert's competence was limited to technical questions so that he could not render a decision on the parties' claims. The OLG Hamburg further held that it was irrelevant for the question of jurisdiction of the arbitral tribunal whether or not the parties had followed the expert determination procedure set out in the contract. Even if such clause

were to be interpreted as an agreement on the temporary non-enforceability of the claims by means of arbitration, this would not mean that the arbitral tribunal must decline jurisdiction, but that it is rather required to dismiss the claim as 'currently unfounded' (*zur Zeit unbegründet*). Upon a complaint on points of law, the *Bundesgerichtshof* confirmed this ruling with its decision of 14 January 2016, while explicitly leaving open whether to dismiss the claim as either 'currently inadmissible' (*zur Zeit unbegründet*) or 'currently unfounded' (case no. I ZB 50/15, available in German here).

With its ruling of 9 August 2016, the *Bundesgerichtshof* confirmed and substantiated this view in a complaint on points of law concerning an ICC arbitration proceeding seated in Frankfurt between insolvency administrators of two insolvent companies of the same group that had entered into a "Sales Processing and Servicing Agreement" (case no. I ZB 1/15, available in German here, discussed with a different focus by Patricia Nacimiento, Thomas Weimann, Mathias Wittinghofer and Tilmann Hertel in a Kluwer post on 21 November 2016). In this case, the arbitral tribunal had assumed jurisdiction even though the respondent held the view that the parties had not tried to resolve the dispute amicably as required by the Sales Processing and Servicing Agreement. The *Bundesgerichtshof* rejected the complaint on points of law and confirmed and substantiated its ruling of 14 January 2016, stating that the question of whether or not the parties had complied with a preceding dispute resolution settlement procedure is not a question of jurisdiction, but of the admissibility of the claim.

Welcome clarification of consequences of lack of compliance with escalation clauses

In consequence, arbitral tribunals with seat in Germany may accept jurisdiction even if the parties have failed to comply with previous steps set out in an escalation clause. The *Bundesgerichtshof* thus clearly rejects the view that escalation clauses temporarily exclude the possibility of recourse to legal action in favour of other mechanisms of alternative dispute resolution. From a German point of view, the decisions of 14 January 2016 and 9 August 2016 are not ground-breaking, since they are in line with the *Bundesgerichtshof*'s case law pertaining to escalation clauses, providing for litigation as a 'final' means of dispute resolution.

Yet, the clarification is valuable in an international context since it provides certainty in an area that is handled strikingly differently by national courts and arbitral tribunals depending on the jurisdiction and the exact wording of the escalation clause. If the escalation clause is considered to be enforceable at all, a significant number of authorities suggest that compliance with the preceding dispute resolution settlement procedure is, in one form or another, **a matter of jurisdiction**, in particular a condition precedent to arbitration, while others treat the question as a **matter of admissibility or a substantive obligation** (jurisdictional qualification: e.g. Swiss Supreme Court, decision of 7 July 2014, case no. 4A-124/2014; English High Court, *Emirates Trading Agency LLC v Prime Mineral Exports Private Limited*, [2014] EWHC 2104 (Comm)); Cour de Cassation, 2e Ch. civ., decision of 6 July 2000 (*Société Polyclinique des Fleurs v. Peyrin*); High Court of Singapore, *International Research Corp PLC v Lufthansa Systems Asia Pacific Pte Ltd*, [2012] SGHC 226 (lack of jurisdiction was assumed on appeal at [2013] SGCA 55); ICSID Case No. ARB/11/28, *Tulip Real Estate Investment and Development Netherlands B.V. v. Republic of Turkey* (award on bifurcated jurisdictional issues); qualification as a matter of admissibility or as a substantive obligation: e.g. Swiss Federal Supreme Court, decision of 16 May 2011, *X. GmbH (précédemment V. GmbH) v. Y. Sàrl*, Ière Cour de droit civil, 4A_46/2011, 29 ASA Bull. 6443, 651 et seq. (2011); *Link-Trading joint stock company v. Department for Customs Control of Republic of Moldova*, UNCITRAL, award on jurisdiction dated 16 February 2001). At the same time, there

are different answers among national courts and arbitral tribunals to the question of whether non-compliance precludes the proper initiation of arbitration proceedings or whether the requirements can be satisfied subsequently, and regarding the allocation of competence over disputes regarding escalation clauses.

The *Bundesgerichtshof*'s approach can thus only be welcomed, since it provides for certainty for arbitrations with seat in Germany. Arbitral tribunals can assume jurisdiction even though the parties may not have complied with an escalation clause or are in dispute about it, and are thus competent to decide on those disputes and to grant injunctive relief, while parties will no longer be inclined to initiate time-consuming and costly challenge proceedings concerning interim awards on jurisdiction in this respect. At the same time, compliance with the escalation clause is ensured since the arbitral tribunal is not entitled to decide on the merits if the parties have not acted in accordance with the particular dispute resolution settlement procedure. Furthermore, the decisions of 14 January 2016 and 9 August 2016 should have reduced the prospects of successfully applying for a setting aside of the final award by qualifying compliance with the escalation clause as a matter of the admissibility of the claim instead of a matter of jurisdiction. The jurisprudence is thus in line with the arbitration-friendly approach taken by the German courts.

Stay of the arbitration proceedings as expedient alternative to dismissing the claim as premature

However, it would have been helpful had the *Bundesgerichtshof* pointed out that there is an alternative to dismissing the claim as 'currently inadmissible': As in German litigation, it must be possible for an arbitral tribunal to direct the parties to comply with the dispute resolution settlement process stipulated in the escalation clause by staying the proceedings and setting a deadline for the parties to comply with the relevant process, and to resume the proceedings once the parties have followed the preceding step.

Such approach is preferable from an arbitration user's point of view, since a preceding dispute resolution settlement process, in particular negotiations, will usually not lead to a happy ending if there is already a dispute between the parties that has been brought to arbitration. Dismissal will only cause recommencement of the arbitration and the appointment of a new arbitral tribunal, which will result in a waste of precious time (that could have been used to resolve the conflict) and additional costs (arbitrators' and institutional fees and costs of the parties for two sets of arbitration proceedings).

Although the *Bundesgerichtshof* did not expressly refer to this alternative, one can expect that a stay of the arbitration proceedings will be the preferred solution in practice. In addition, the parties' respective behaviour, including any initial refusal to follow the dispute resolution process stipulated in the escalation clause, may be reflected in the cost decision of the arbitral tribunal.

Implications for setting aside and enforcement proceedings

Irrespective of the aforesaid, contracting parties are strongly urged to draft their escalation clause clearly and to strictly follow the established procedure when enforcing their claims, even if this takes (much) longer than desired, to achieve certainty in the long run. Although the *Bundesgerichtshof* reduced the prospects of successfully applying for a setting aside of the final award, there remains a risk so that a party's (alleged) failure to comply with an escalation clause or the tribunal's failure to deal with this situation properly will be put on the table in setting aside and

enforcement proceedings, especially if such proceedings are taking place in a country where compliance with escalation clauses is considered to be a matter of jurisdiction rather than admissibility and non-compliance precludes the proper initiation of the arbitration.

** Gordon Kardos assisted in preparing this blog post.*

To make sure you do not miss out on regular updates from the Kluwer Arbitration Blog, please subscribe here. To submit a proposal for a blog post, please consult our Editorial Guidelines.

This entry was posted on Thursday, December 1st, 2016 at 5:02 am and is filed under Arbitration, Domestic Courts, Escalation clauses, Germany
You can follow any responses to this entry through the Comments (RSS) feed. You can leave a response, or trackback from your own site.