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That Escalated Quickly: Hong Kong Court Orders Stay When Plaintiffs Skip Escalation Steps of Dispute Resolution Agreement

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In *William Lim and Another v. Hung Ka Hai Clement and Others* [2016] HKCFI 1439; HCA 1282/2016 (24 August 2016), the Hong Kong Court of First Instance ordered a stay of court proceedings and referred an ongoing dispute to arbitration pursuant to s 20 (1) of the Arbitration Ordinance (Cap 609). The Court found that it had no jurisdiction when an action brought before it is the subject of an arbitration agreement.

Disputes arose between the parties after the Defendants, members of the Governing Board of a large professional services firm, decided to impose a financial penalty on two firm members (the Plaintiffs). The Plaintiffs had sent emails to other partners of the practice expressing concerns on the Board's decisions and further raised issues with the Board's governance. By their dispatch of various emails to other partners, the Plaintiffs allegedly acted in breach of their confidential obligations by communicating highly sensitive information concerning the firm.

The Plaintiffs sought an order from the court that the Board's sanctions were void, had no effect and should be set aside because the Plaintiffs were not given the opportunity to know and answer the charges made against them, and that members of the Board had exercised their power for improper purposes. The Defendants applied to stay the proceedings to arbitration, pursuant to the arbitration clause contained in the Shareholders' Agreement.

The Shareholders' Agreement contained the following escalation clause for dispute resolution:

> "if at any time any dispute shall arise […], such dispute shall first be referred, to the Chairman who shall attempt to resolve such disputes to the satisfaction of the parties in dispute. If the matter is not so resolved within twenty one (21) clear Business Days of being referred to the Chairman, the Chairman shall refer such matter to the Governing Board. If such dispute shall not be resolved within twenty one (21) clear Business Days of being referred to the Governing Board, any party to the dispute may refer the matter for final resolution to arbitration…"

The Plaintiffs' main argument for maintaining court proceedings was that the dispute between the

parties had already been referred to the Chairman and the Governing Board for resolution, and the mechanism for dispute resolution was therefore exhausted. The Court first reiterated that an applicant for stay has only to demonstrate that there is a prima facie case that the parties are bound by an arbitration clause. Unless the point is clear, the Court should not attempt to resolve the issue but should stay the matter in favour of arbitration (*PCCW Global Ltd v. Interactive Communications Services Ltd* [2007] 1 HKLRD 309). The Court has no discretion under s 20 (1) of the Arbitration Ordinance (Cap 609), if the action brought before it is one which is the subject of an arbitration agreement – unless the agreement is null and void, inoperative or incapable of being performed.

The Court found no merit in the Plaintiffs' argument that the dispute resolution mechanism set in the Shareholder Agreement was exhausted. If the Chairman and/or the Board had already resolved the dispute, as contended by the Plaintiffs, by imposing the monetary sanctions, such resolution was clearly "not to the satisfaction of the parties in dispute". Since the Plaintiffs did not admit the sanctions, there was clearly a dispute between the parties, and such dispute fell within the ambit of the arbitration clause in the Shareholders' Agreement. All the other matters raised by the Plaintiffs, as to whether or not they were entitled to circulate the emails amongst the partners, are to be considered and decided by the arbitral tribunal, not by the Court.

As is well known, escalation clauses for dispute resolution require parties to engage in a series of steps before resorting to litigation or arbitration. Escalation clauses can easily become "pitfalls" of poor drafting. A poorly drafted escalation clause will lead to uncertainty. It may allow one party to delay reference to arbitration (particularly where no time limit is specified for completing the preliminary steps) or leave the parties without a mechanism for proper recourse to the courts or arbitration. However, when properly drafted, the court will stay proceedings if they are initiated before all steps of the escalation process have been fully exhausted (*Cable & Wireless v IBM U*K [2002] 2 ALL ER Comm 1041). The Plaintiffs' resistance to the stay was therefore misconceived. In the Court's view, there was no claiming that the dispute resolution procedure had been exhausted when there were clearly residual disputes, which had not been resolved by the Chairman or the Board to the satisfaction of the parties. Prior to the court proceedings, the Defendant's solicitors had issued letters stating that the disputes should be referred to arbitration. These were all ignored by the Plaintiffs, without any justifications.

The astute reader may also have noticed a finer point, that is, the use of the term "may" instead of "shall" in the arbitration clause. This was not raised by the Plaintiffs or addressed by the Court. However, even if the Plaintiffs had attempted to attack the validity of the arbitration clause on that point (i.e. by arguing that the use of the term "may" has the effect of making arbitration optional instead of mandatory), it would have equally failed since in Hong Kong and other pro-arbitration jurisdictions, the word "may" effectively becomes "shall" where an agreement to arbitrate is otherwise sufficiently certain (*China State Construction Engineering Corporation Guangdong Branch v Madiford Ltd* [1992] 1 HKC 325, see also the recent Privy Council decision in *Anzen Limited v Hermes One Limited* [2016] UKPC 1).

In the broader context, even in the course of one reference to arbitration, more than one dispute may arise, and unless all these disputes are resolved and decided by the tribunal, the arbitration cannot be said to have been terminated. Further, one or more disputes may arise under the arbitration agreement between the same parties. The fact that one dispute has been referred to arbitration does not mean that the arbitration agreement has been "exhausted", and cannot be further implemented.

William Lim and Another v. Hung Ka Hai Clement and Others illustrates how parties too often fail to understand the full significance of dispute resolution clauses. By agreeing to arbitration, parties fully oust the jurisdiction of the court to settle their disputes. Failing to grasp this concept is especially costly in Hong Kong where a party who unsuccessfully challenges an arbitration agreement before the court will pay costs on an indemnity basis, unless special circumstances can be shown (*Chimbusco International Petroleum (Singapore) Pte Ltd v Fully Best Trading Ltd* HCA 2416/2014).

Costs were ordered on the indemnity basis. However, it is unclear from the judgment whether this was on the basis of the Plaintiffs' conduct or an extension of the court's general practice of awarding indemnity costs in any failed arbitration-related application.

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