Be Careful What You Ask For: Multi-Tiered Dispute Resolution Clauses

New York Law Journal (August 7, 2017) -- Generally speaking, a "multi-tiered" dispute resolution clause is a contractual provision requiring that parties to a dispute engage in certain preliminary settlement-focused efforts as a prerequisite to bringing a claim in arbitration or filing a court proceeding. Such provisions typically require that the parties meet and make some level of effort during a defined term to settle the dispute (often identifying the persons who must be involved) before either party can file a claim against the other under the relevant contract. Multiple preliminary steps are sometimes mandated, such as informal negotiations followed by formal mediation, prior to filing. Examples of Examples of these clauses are included in "Compilation of Sample Mediation Clauses," issued in 2016 by the New York City Bar Association's Alternative Dispute Resolution Committee.

Such clauses are most frequently found in commercial contracts, but they also are present in many forms used in non-commercial relationships like employment contracts or HR policies, and they can cover tort claims as well as more standard commercial dealings. It is widely noted that they are used predominantly in construction contracts, and while the construction industry routinely incorporates them, they are now fairly prevalent in all types of contracts and in a variety of industries.

These clauses are generally enforceable under New York law, but counsel may encounter some twists if the clause is not carefully drafted or if the arbitrator or court is not properly educated on the legal effect of the language employed. Indeed, the drafting may influence (actually *should* influence) whether a dispute over compliance is heard by a court or an arbitrator (at least in instances where the dispute would ultimately be arbitrated).

Pros and Cons

Before we review how these clauses work, let's address a preliminary question that current writing on the subject seems to ignore: Why bother at all with such a clause? If parties to a dispute are inclined to discuss settlement, typically they will, especially given escalating litigation and arbitration costs, so why force parties who are not inclined or ready to settle at the beginning of a dispute to go through the process? Including the clause may have sounded fine during contract negotiation and drafting (if it was ever raised at all), but the parties have a much better sense of whether such efforts are worthwhile after an actual dispute arises.

There are pros and cons to including requirements encouraging settlement efforts in a dispute resolution clause. On one hand, when parties attempt to settle

a dispute, it is possible they will succeed, which is true even if the parties were initially reluctant and forced by the contract to do so. The obvious benefits are the costs and time saved if the dispute is resolved at this early stage. These clauses typically require specific personnel to be involved in the negotiations, and the participants should be carefully chosen during the drafting stage. Senior personnel who were not involved in the activities that led to the dispute may have cooler heads or may be driven by different considerations, potentially advancing settlement chances. Most clauses also specify a time period during which negotiations must stay open, providing a cooling-down period that may enhance the possibility of settlement. Another potential benefit (depending upon your viewpoint) is that the clause prevents one party from racing to file to secure claimant or plaintiff status, which likewise prevents or delays the surprise of being served when your client is the adverse party, who may not yet even be fully aware of the dispute. Even in unsuccessful negotiations, gaining a better understanding of the nature of the dispute and how your counterparty approaches it can be beneficial.

On the other hand, some cases present significant disadvantages to incorporating these requirements. If the claims or parties are not ripe for settlement, such clauses can result in unnecessary delay, expense and inconvenience. Even when settlement is unlikely, the mandated proceedings can be rather protracted, depending upon the clause at issue, which is of particular concern when claims may be close to time barred. Also, some counsel may intentionally abuse the process, using it to obtain tactical delay, drive up costs for the adversary or as an opportunity for pre-filing discovery. And there are dangers for the unwary, particularly if the clause requires arbitration, where noncompliance may result in forfeiting the ability to compel arbitration of the dispute at all.

All of this certainly warrants caution in deciding whether to include such requirements in a contract, and if so, in drafting the provision properly.

Enforceability

Once you decide to include a multi-tiered dispute clause in an agreement, increase its enforceability by including definite and objective standards against which compliance can be judged. If the clause is too vague about what is required, it can be challenged as an unenforceable “agreement to agree.” To enhance success in enforcement, the clause should be explicit about who must be involved in the discussions, how to initiate the process, any required in-person meeting(s), how long the process must continue and whether any information must be exchanged prior to or during the process. Although not a requirement, courts have favorably observed the specific use of the phrase “condition precedent” in determining enforceability.

Establishing that the preliminary step(s) are a condition precedent to being able to bring suit or file for arbitration is important because it dictates whether compliance is judged by a court or an

arbitrator. As one court observed, "[t]he 'threshold determination of whether a condition precedent to arbitration exists and whether it has been complied with, is for the court to determine.' By contrast, '[q]uestions concerning compliance with a contractual step-by-step grievance process have been recognized as matters of procedural arbitrability to be resolved by the arbitrators, particularly in the absence of a very narrow arbitration clause or a provision expressly making compliance with the time limitations a condition precedent to arbitration.'" *Matter of Incorporated Vil. of Floral Park v. Floral Park Police Benevolent Assn.* The New York Court of Appeals made the following pronouncement:

It is recognized that both conditions precedent to access to the arbitral forum (falling within the judicial ambit) and procedural regulations or conditions in the arbitration proceedings (falling to the arbitrator) may be verbally referred to indiscriminately as "conditions precedent" to arbitration. Such loose description, however, obscures analysis and clarity. Whether the particular requirement falls within the jurisdiction of the courts or of the arbitrators depends on its substance and the function it is properly perceived as playing—whether it is in essence a prerequisite to entry into the arbitration process or a procedural prescription for the management of that process. Under the first heading will come provisions which in point of time are intended to be preliminary to the institution of any arbitration proceeding and in a precise sense are unrelated to it, e.g., a requirement that before any demand for arbitration can be made the dispute between the parties be referred to the architect or to the partnership—"conditions precedent" in the literal meaning of that term. Under the second heading will come provisions relating to the conduct of the arbitration proceeding itself, i.e., requirements or conditions in arbitration, e.g., that the demand be made within a specified time, or be served in a specified manner or on specified persons. Beyond that it is to be remembered that inasmuch as the entire arbitration process is a creature of contract, the parties by explicit provision of their agreement have the ability to place any particular requirement in one category or the other, to make it a condition precedent to arbitration or to make it a condition in arbitration. *(County of Rockland v. Primiano Construction Co.)*

A party found not to have complied with the requirements of a condition precedent may lose its ability to compel arbitration under an otherwise valid arbitration clause. See *Darrah v. Friendly Ice Cream.* Moreover, where the condition precedent is contained in a dispute clause that does not require arbitration, failure to comply with the clause may lead to dismissal of the action. See *MCC Develop v. Perla.* Of course, if a party fails to raise the adverse party's noncompliance for an extended time and actively participates in the proceedings, courts have found waiver using the ordinary waiver analysis.

In the end, trying to settle a dispute early is certainly worthwhile and should be encouraged where appropriate, but you should thoughtfully consider

whether to contractually require the process as a condition precedent to bringing a claim rather than making the decision after a dispute arises. If a party can and must be forced to negotiate, what are the chances of success? Given the potential pitfalls and disadvantages, it is prudent to carefully weigh during contract drafting whether including such requirements makes sense and is worth the risks. As always, a frank discussion with your client is the most practical course.

Richard De Palma is partner and vice chair of the business litigation practice group at Thompson Hine in New York.