

Beware the Champagne Clause: When the Effervescence Fades, It May Just Be Pathological.

Good drafting makes for good contracts and good business relationships. Yet these principles are often forgotten when it comes to drafting dispute resolution clauses. They are often an afterthought and an inopportune one at that, as once the rest of the contract has been agreed, the parties prefer celebration to discussing what might go wrong. For this reason, the champagne clause, sometimes called an eleventh hour or midnight clause, is more often than not unclear, incomplete or contradictory.

While parties are free to waive their right to have their dispute determined by a court based on the fundamental principle of party autonomy, consent is key. Clear consent is vital for arbitration and determinative dispute resolution, in which parties grant jurisdictional powers to individuals, but it is equally applicable to facilitative dispute resolution such as mediation, especially when both modes are included in a multi-tier clause.

The main problem with poorly-drafted or pathological clauses is the lack of clear consent to extra-judicial resolution or Alternative Dispute Resolution (ADR),¹ and the procedure that governs the process. This causes delay and additional costs due to litigation over the interpretation and validity of the clause.

The term pathological clause (or *clause pathologique*) was first coined by Frédéric Eisemann, a former Secretary-General of the ICC Court of Arbitration, in 1974² for arbitration clauses that failed to achieve their object. In 1991, the criteria set forth by Eisemann were considered to still be vital³ and that still holds true today. While the criteria refer to arbitration agreements, they are applicable to all forms of dispute resolution.

According to Eisemann, there are four essential functions of an arbitration clause: it must produce mandatory consequences for the parties, exclude the intervention of the state, empower the arbitrator to settle the dispute and constitute the most efficient and rapid procedure leading to an enforceable award.

Pathological clauses fall into two categories: defective and inoperative. Defective clauses are curable, and depending on the jurisdiction, will generally be upheld. Inoperative clauses, as their name suggests, are unenforceable.

The *raison d'être* of dispute resolution clauses is to manage disputes efficiently, based on the procedure and rules that the parties have agreed upon and not create new disputes.

¹ ADR originally referred to any form of non-judicial dispute resolution, whether determinative or facilitative. It is also called appropriate or even amicable dispute resolution.

² Frédéric Eisemann, *La clause d'arbitrage pathologique*, Commercial Arbitration Essays in Memoriam Eugenio Minoli, UTET, 1974. These were originally called dysfunctional clauses in English, but this was replaced by the English translation of the French term *pathologique*.

³ Benjamin Davis, 'Pathological Clauses: Frédéric Eisemann's Still Vital Criteria' (1991) 7 *Arbitration International* 365.

What Makes For an Effective Dispute Resolution Clause?

Clauses must be clear and carefully-worded. They should be drafted in advance and not left to the last minute. They must be definite to ensure their validity and enforceability. The use of the word 'may' instead of 'shall' will call into doubt the intention of the parties

Most dispute resolution clauses are included in contracts to deal with future disputes. However, parties may also agree to submit a dispute to ADR after it has arisen, when the contract is silent or the parties decide to opt for a different mode of dispute resolution. This is called a submission agreement.

Institutional or *Ad Hoc* Dispute Resolution

As a rule, it is better to use a standard clause and institutional rules⁴ which are 'tried and true' than bespoke drafting. This is applicable drafters with less experience and parties lacking the time necessary to draft the clause properly.

In institutional or administered ADR, it is important to review the institution's rules, practices and cost schedules. These differ from one institution to another and for rules governing domestic or international disputes. Most have model clauses that should be used when choosing that institution. Often parties don't read the rules and are surprised to discover the default provisions that may apply to aspects not specified in the clause.

Institutions update their rules regularly: if you want the rules in force on the date the agreement is signed, it must be specified, or those in force at the time the dispute arises may apply.

Because not all contracts are alike, institutions are being called on to develop more model clauses to fit specific party needs.⁵

In *ad hoc* dispute resolution, the process is not administered by an institution and the parties and the neutral determine the rules. It is wise nonetheless to designate an institution as an appointing authority in the event the parties can't agree on the choice of a neutral, or for arbitration, to choose a set of procedural rules to provide a general framework, such as the UNCITRAL Arbitration Rules⁶.

⁴ ADC provides sample dispute resolution clauses at <https://disputescentre.com.au/wp-content/uploads/2015/02/ADC-Dispute-Resolution-Sample-Clauses-2015.pdf>.

⁵<http://arbitrationblog.kluwerarbitration.com/2013/07/30/the-gang-of-four-rides-again-pathological-clauses/>

⁶ While generally used in international arbitration, the UNCITRAL Rules can also be used for domestic arbitration. In international cases, the Secretary-General of the PCA is the default appointing authority if none is specified.

<http://www.uncitral.org/pdf/english/texts/arbitration/arb-rules-2013/UNCITRAL-Arbitration-Rules-2013-e.pdf>.

Setting the Scope or What Types of Disputes Should Be Covered

The scope of the clause is another essential element. The way the clause is worded will determine what disputes will be submitted to ADR. There are two denominations used to define scope: narrow and broad.

While it is often difficult to predetermine the type of dispute that may arise, If the parties agree that only strictly contractual disputes should be submitted to mediation, or more commonly, determined by arbitration, then narrow wording should be used, such as 'disputes arising under the contract or hereunder'⁷. However, since courts are wont to construe clauses expansively in favor of arbitration, it is recommended to add the word exclusively or solely to the above wording. In fact, the Full Federal Court recently supported a liberal interpretation of arbitration agreements, held that the phrase 'any dispute under the deed' has a broader meaning, encompassing the validity of the deeds⁸.

Broad clauses are more widespread, as parties will want to avoid multiple forums. Wording such as any dispute arising out of, relating to, or in connection with the contract has a broad meaning. Adding terms such as the parties' relationship and arbitrability will help ensure that all disputes are determined by arbitration. Broad clauses will exclude only claims entirely unrelated to the commercial transaction covered by the contract⁹ and can also encompass tort and statutory claims¹⁰ unless barred by national law. So if this is not the intention of the parties, then the clause must state so clearly.

Since an arbitration award is the equivalent of a judgment, the conditions are more stringent for arbitration agreements as the risks are higher. Nevertheless, specifying the scope is also essential in expert determination clauses. And even though mediation is more flexible, it is still important for parties to know what disputes must be submitted to mediation, especially when it is mandatory or there is a multi-tier clause.

ADR Clauses and Minimum Requirements

There are different clauses for different types of dispute resolution, such as negotiation, mediation, expert determination and arbitration. Multi-tiered or step clauses allow for, or mandate, two or more processes which can be commenced either consecutively or simultaneously depending on the wording. Some examples are negotiation, mediation and arbitration *or* litigation, mediation and arbitration *or* litigation. Expert determination can be also used in in combination with these processes. For litigation in the courts, there will be a jurisdiction or forum selection clause. However, if the contract includes an arbitration agreement or arbitration

⁷ *Paper Products Pty Ltd v Tomlinsons (Rochdale) Ltd* [1993] 43 FCR 439.

⁸ *Hancock Prospecting Pty Ltd v Rinehart* [2017] FCAFC 170.

⁹ *Ancor Packaging (Australia) Pty Ltd v Baulderstone Pty Ltd* [2013] FCA 253.

¹⁰ Including under ACL. *Comandate Marine Corp v Pan Australia Shipping Pty Ltd* (2006) 157 FCR 45.

clause,¹¹ it is imperative not to include litigation as well, as this will vitiate the agreement to arbitrate and render it unenforceable.

Arbitration

The foundation of an arbitration agreement is the parties' intention to arbitrate. Along with the national law, the arbitration agreement forms the basis of the arbitrator's jurisdiction and powers.¹² In addition to scope and the institution and rules, the minimum requirements of a sound arbitration agreement must be met to ensure enforceability and avoid jurisdictional challenges to the award.

First and foremost, an unequivocal requirement is for the agreement to be in writing or embodied in an exchange of writings, including by electronic communication.¹³ Other elements to be included are the number of arbitrators, the seat or place of arbitration, the language of the arbitration and the substantive law or the governing law of the contract.

If institutional rules are chosen, they may affect the parties' choice. For example, under some rules, disputes under a certain threshold will be determined by a sole arbitrator, rather than a panel of three. Careful reading of the rules is as important as careful drafting.

The seat or the place of arbitration is the juridical seat and determines the procedural law governing the arbitration. While choosing a proper seat is vital in international arbitration, it is also important in domestic cases. Fixing the seat in one place does not preclude the hearings from physically taking place elsewhere, so the choice of the seat should not be based on convenience.

The language of the arbitration is often overlooked by drafters. Even in domestic arbitration, the principal or director of a company may not be a native English speaker, documentation may be in a different language. Specifying the language of the arbitration and documentation and which party will bear interpretation and translation costs if any, avoids disputes further down the line.

Some additional considerations, by means of example, are ensuring that the parties to the contract and the arbitration agreement are the proper parties. If a subsidiary enters into the agreement, the parent company might not be bound to arbitrate. Without going into detail, under the procedural law as well as under some rules, there may be options to opt in or opt out of certain provisions and mandatory provisions, which, if ignored or contradicted, might vitiate the entire the clause.

¹¹ Arbitration clauses are often called agreements. Due to the principle of separability, they are agreements in their own right, irrespective of whether the contract itself is valid. Conversely, a mediation agreement is the agreement between the parties and the mediator for the engagement or appointment of the mediator.

¹² In Australia, domestic arbitration is governed by the Commercial Arbitration Acts in each state and international arbitration by the International Arbitration Act 1974 (Cth).

¹³ *Comandate Marine Corp v Pan Australia Shipping Pty Ltd* (2006) 157 FCR 45.

Expert Determination

There are specific requirements for expert determination agreements, as the disputes are primarily of a technical or financial nature and may be decided on the papers without a hearing.

The scope of the matter for determination is a fundamental requirement. Other elements to include are the rules, the appointment process and the procedure. It is also imperative to specify that the expert is not an arbitrator and whether the determination will be binding or not final.

Mediation

Unlike arbitration where a final award is rendered by the equivalent of a private judge, in mediation parties are free to enter into a settlement agreement or not. Nonetheless, for the mediation process to be efficient and the clauses enforceable, especially when part of a multi-tier process, good drafting, as always, is necessary.

Parties are increasingly seeking commercial and not just legal outcomes and holistic resolution of disputes. This is true both nationally and internationally.¹⁴ Some contend that parties can always choose to mediate when the time comes, once a dispute has arisen, they generally won't agree on much at all. It is far better for parties to craft their own dispute resolution procedure, particularly since courts are increasingly mandating mediation.

In commercial contracts, mediation is often one step in the process. The mediation clause may or may not constitute a condition precedent, depending on the way it is drafted. It is critical to ensure that parties do not forgo their right to a binding determination of the dispute if the negotiation or mediation is not successful, and their claim has become time-barred.

To address this, there are several types of clauses that can be used. For example mediation can be optional and conducted without prejudice to any other proceedings. Mediation can also be made mandatory, while allowing for parallel proceedings - most commonly arbitration - to be commenced, in order to ensure any limitation periods are met.

The most stringent wording requires mediation to take place before any party can commence any other proceedings. In this case, a time limit for the mediation or negotiation process or both (which may later be extended by agreement) must be specified in the clause. Standard clause will include such periods, which may vary between institutions.

Other situations requiring special consideration, which are beyond the scope of this article, are multi-party and multi-contract situations. The first, where there is a

¹⁴ The advent of the United Nations Convention on International Settlement Agreements Resulting from Mediation known as the Singapore Convention will no doubt support the rising trend in global mediation.

single contract with more than two parties, the second, where there are a number of related contracts, with the same or different parties.

In both of these cases, careful drafting is a must in order to avoid conflicting or inoperative clauses.¹⁵ In the first, a key issue is specifying the appointment procedure. In the second, the clauses and procedure must be consistent between the contracts.

A Few Examples of Pathological Clauses and How to Avoid Them

As mentioned above, although courts in Australia and many other countries will uphold defective arbitration agreements, the parties' intention to arbitrate must be certain. Thus, if there is no clear agreement to arbitrate as evinced in a step clause with mediation being required "before having recourse to arbitration or litigation" the parties will not be bound to arbitrate.¹⁶ This is an unfortunate example of choosing an institution, yet rewriting the model clause, thereby rendering it inoperative and unenforceable.

However, if a clause contains a reference to an incorrect or inexistent institution or rules, such as "the arbitration guidelines of the Law Institute of Victoria", provided the parties clearly agreed to arbitrate, such a defective clause will be upheld.

Other mistakes to avoid include providing too much specificity with respect to time periods or arbitrator requirements. Fast-track or expedited processes are acceptable; time limits on negotiation and mediation necessary. Yet micro-managing each step of the process in a lengthy clause may result in an unclear procedure, requiring court intervention.

Naming a specific person as the arbitrator or neutral, who could be deceased or refuse the appointment may render the clause pathological. The same holds true of excessive specificity with respect to languages spoken - even in Europe more than three may be difficult, especially when coupled with nationality requirements and professional or technical skills.

Lastly, and this is far from an exhaustive list, if parties attempt to incorporate the right to appeal an award, particularly on questions of fact as opposed to questions of law,¹⁷ a thorough review of the procedural law and any applicable rules is compulsory.¹⁸

¹⁵ It is particularly important for arbitration, to specify that an arbitrator appointed under one contract has jurisdiction to consider and decide related issues under the other contracts.

¹⁶ *GL Energy Limited v Jemena Gas Networks (NSW) Ltd* [2017] NSWSC 765. See also <https://disputescentre.com.au/wp-content/uploads/2017/09/AGL-Case-Note.pdf>.

¹⁷ *Carr v Gallaway Cook Allan* [2014] NZSC 75. NZ Arbitration Act only appeal questions of law. *Hall Street Associates, L.L.C. v. Mattel, Inc.*, 552 U.S. 576. In addition, in domestic arbitrations in Australia.

¹⁸ For appeals on questions of law in domestic arbitration in Australia, the parties must opt-in. See, e.g. s34A of both the Commercial Arbitration Act 2011 (VIC) and the Commercial Arbitration Act 2010 (NSW).

It has been said that arbitration begins with the arbitration agreement and likewise, dispute resolution and efficient management of the procedure begin with the dispute resolution clause.

So yes, parties should drink champagne and celebrate their contract, but only once a carefully and clearly-drafted dispute resolution clause has been included.

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