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Insurance

Don’t trip on a poorly drafted step clause

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(November 3, 2022, 11:12 AM EDT) -- Dispute resolution provisions are a common feature of commercial contracts. Parties often frame these as a series of escalating steps/tiers leading towards arbitration (step clauses). It is unfortunately common for such step clauses to be ambiguous, or lacking in procedural detail, leading to unwanted surprises for parties when it comes time to rely on the provisions. This article outlines some risks posed by ambiguous step clauses.

Is each step mandatory?

A common pattern for step clauses is an escalation from negotiation, to mediation, to arbitration. The contract may further break these stages down, for example, by requiring multiple rounds of negotiation (e.g. first between those involved in day-to-day operations, and second by upper-level managers). However, the value of specifying multiple stages in your step clause can be undercut if the contract does not make each stage mandatory.

When requested to enforce a particular step, courts will closely determine whether the language of the clause is mandatory or permissive and whether consequences flow from a party’s failure to comply with its requirements. If the step clause fails to state what would happen if a stage is missed or happens out of order, and/or fails to provide consequences for non-compliance, the step may not be considered mandatory. This potential outcome underscores the importance of careful drafting, particularly where the intention is that parties be bound to a certain set of stages.

However, there may be instances where parties do not want to be bound to a strict set of stages but would prefer to use stages as a suggested roadmap with the ultimate goal of resolving disputes through arbitration. Where this is the parties’ intention, ambiguity in the step clause may be preferable. However, the parties could consider mandating at least one stage before proceeding to arbitration, such as mediation, and including other stages as optional ones available on consent of the parties.

In *Toronto Truck Centre Ltd. v. Volvo Trucks Canada Inc./Camions Volvo Canada Inc.*, Justice John Macdonald examined a two-stage dispute resolution clause in a contract between the applicant truck dealer and respondent manufacturer (paras. 22-28). This was in the context of the dealer’s motion for an order compelling the manufacturer to submit to binding mediation. The first stage of the dispute resolution clause required the manufacturer to undertake a non-binding review of a dispute at the dealer’s written request. The second stage required the manufacturer to participate in binding mediation in resolution of any such dispute, again at the dealer’s request.

In granting the dealer’s motion, Justice Macdonald did not require the parties to first engage in a non-binding review. This was because the language triggering that first stage of the dispute resolution clause was permissive. The delivery of a written request for a non-binding review was thus

not a condition precedent to the dealer’s ability to simply proceed to binding mediation.

The key takeaway is that if a party wants to be able to insist on any stage of a step clause occurring, then that step must be drafted as a condition precedent to moving to the next stage of the dispute resolution process.

Is the mechanism for each step clear?

The principal reason to include a dispute resolution procedure in a contract is to provide certainty on the resolution process in the event of a dispute between the parties. That is why it is critical that each stage specified within a step clause has the mechanics clearly laid out. A failure to do so will require a determination of those mechanics in the midst of a dispute, which is unhelpful, and it also reintroduces uncertainty.

Parties should be sure to set time limits in the step clause for initiating/completing each stage of the dispute resolution process. Without a clear end date to commence an arbitration, for example, the limitation period for doing so may not begin to run. As a result, disputes a party thought had long fizzled out may come back to life, long after the presumed expiry of the limitation period.

The Court of Appeal for Ontario’s recent decision in *Maisonneuve v. Clark* underscores the importance of such time limits. In Ontario, the enforcement of an arbitration agreement is presumptively subject to the basic statutory two-year limitation period (*Limitations Act*, 2002, SO 2002, c24, Sched B, s 4), but *Maisonneuve* clarified that that limitation period is not necessarily triggered on the date the agreement to arbitrate is signed (2021 ONSC 1960; 2022 ONCA 113). Instead, the commencement of the limitation period in such circumstances is fact specific, and may properly be delayed where the parties had contemplated attempts at informal resolution as a prerequisite to arbitration (para. 1).

In *Maisonneuve*, the parties had reached a settlement of a business dispute, save one issue that was to be negotiated between them, and if not resolved, then arbitrated (para. 4). The settlement and release was signed in September 2016, but it contained no end date for the negotiation period, and no deadline to arbitrate. In June 2019, the plaintiff sent in a request for arbitration, which the defendant claimed was out of time.

The court had to determine when the plaintiff knew, or reasonably ought to have known, that arbitration would be an appropriate means to resolve the dispute. The defendant asserted that arbitration was “appropriate” as soon as the release was signed in September 2016 (para. 45). The plaintiff argued that since the agreement contemplated negotiation, arbitration only became “appropriate” once “the parties first attempted to resolve their dispute informally” (para. 44). The application judge agreed with the plaintiff. The limitation period began in January 2018 when it became clear that Clark did not wish to negotiate the issue (para. 68). The Court of Appeal found that the application judge’s decision was entitled to deference (para. 12).

The *Maisonneuve* decision has continued a line of reasoning developed in *PQ Licensing S.A. v. LPQ Central Canada Inc*. and *L-3 Communication SPAR Aerospace Limited v. CAE Inc.* If an arbitration agreement first requires that the parties attempt to resolve the dispute informally, arbitration may not be “appropriate” until such attempts at negotiation are exhausted (para. 49; para. 14).

To address this risk, and to provide certainty about the commencement of limitation periods, it is recommended to include deadlines for each stage of a dispute in a well-drafted step clause.

Conclusion

1. Parties want certainty about whether a dispute resolution provision or step clause is enforceable. This can be achieved by careful drafting to ensure that such clauses are interpreted in accordance with the parties’ expectations.

2. Making each step mandatory may not be the goal. When drafting a step clause, parties should consider whether it is desirable to make each step mandatory. In some situations, it may benefit a party to be able to bypass negotiation and mediation, and to proceed to arbitration immediately.

3. The mechanism for moving from one step to the next should be clearly articulated. Failing to

identify when a step ends and the next begins may raise unintended limitation period issues.

A cautionary note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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