

LEGAL RISK ASSESSMENT

STAGE I

In our note of July of this year we said that the first stage of our project to promote an understanding of the concept of legal risk and a common approach to its assessment and evaluation would be an investigation of what was understood by the term “legal risk”.

The purpose of this questionnaire is to ask consultees to consider some basic questions on this topic. In addition to answering the questions, we would be grateful for comments on whether other questions should be asked instead or in addition to the ones set out below.

The paper is written in cryptic terms, in order to prompt thought and discussion, rather than to present a detailed argument for approval. The purpose is to find if there is a consensus among lawyers and other interested professionals about the nature of legal risk and how best it can be understood and managed.

The basic questions

A. What is legal risk?

1. What do lawyers understand by the expression “legal risk”?

There are, perhaps, two ways to look at this question: either it can be considered conceptually (i.e. what is involved in the idea of “risk” and how is that concept refined or limited by the addition of the adjective “legal”) or “legal risk” can be defined by discovering all the sets of circumstances but are accepted as falling within it.

Consultees are, of course, free to adopt whichever approach they wish. We suspect, however, that most practitioners will feel that the second of the two

approaches is more likely to help identify the situations where they are required to take action.

To help consideration of this question, we set out in the Appendix a description of a number of different circumstances or events which might be thought to constitute legal risk. We would be grateful for any comments on these categories, as well as any suggestions for additional categories. We are very well aware that most consultees will already have organised their thinking by reference to a different range of categories. *I suggest this is because the paper as a whole should do more to acknowledge that we are asking people not only to think, but also to unpack their old thinking.*

A supplementary question is whether there are differences in the kinds of circumstances which would be recognised as legal risk by lawyers from different backgrounds e.g. between litigation lawyers in private practice and in-house lawyers at banks or in commercial/industrial companies?

2. What do insurers understand by the expression?

I would include a specific reference to the fact that the question to insurers may also be taken to be a question addressed to rating agencies.

In a sense, all insurance against liability to third parties covers “legal risk”. The insurers will only indemnify their customer if the assured is under an obligation enforceable at law to compensate a third party or to make some other payment (e.g. to pay the cost of rectifying environmental damage caused by the assured).

However, there are kinds of insurance which deal specifically with the risk that the assured may be liable to pay damages or other compensation at law as a result of its actions.

Do insurers take the same approach to deciding and evaluating the legal risk involved as would a lawyer in the same position? For example, it is very common for insurance policies of professional indemnity, written in the United Kingdom, to exclude liability incurred in the United States. Although, from the point of view of legal analysis, exactly the same circumstances might give rise to the possibility of legal liability in the United States as in the United Kingdom, insurers apparently see the risk in the United States as very much greater and require an additional premium to assume the risk.

What are the factors which make a difference to the perception of insurers?

3. Is legal risk understood differently by lawyers and by those from other disciplines?

Most risk management techniques centre on the relationship between (i) the possibility that an event will occur and (ii) the practical consequences, should that possibility come to pass. There is, however, an earlier stage of analysis in relation to (i). It is first necessary to decide whether an event is, from a technical point of view, possible at all before there is a need to consider *how* likely is its occurrence.

I think this question is already built into the question posed in the next paragraph.

In assessing the importance of any claimed legal risk, are lawyers more likely to concentrate on the technical possibility that the event might occur than would non-lawyers, with the result that lawyers are likely to ascribe to the risk a higher probability than would non-lawyers?

It might be possible here to draw an analogy with the Y2K problem. With the approach of the millennium, computer experts across the world pointed out the possibility that computers might malfunction at the turn of the year. An enormous amount of money was spent in avoiding the perceived risk. In practice, the disturbance was negligible. It is impossible to say whether this

was because of the concerted action taken to avoid the consequences of the risk, or because the risk was, in reality, negligible. The suspicion among those who are not computer experts, however, is that the expert group may have over-estimated the dangers.

Is there an inherent danger that lawyers will tend to over-estimate the significance of legal risks?

B. Who within an organisation is best placed to evaluate and assess legal risk?

If it is true that lawyers are likely to attach a higher probability factor to legal risks than would non-lawyers, does this mean that their judgment is likely to be over-cautious? Is the most accurate method of evaluation to have the risk evaluation undertaken by someone who is not a lawyer, but who is advised by lawyers?

On the other hand, is legal risk (or, at least, of some kinds of legal risk) so technical by nature that it can be understood only by experienced lawyers?

C. Do regulators see legal risk in the same way as individual organisations?

I think we should specify that regulators in this context includes all public authorities with a supervisory function

Regulators are concerned not only with the stability and solvency of individual regulated institutions, but also with the stability of the financial system as a whole. A risk that is of little significance to a particular company (e.g. doubts as to the availability of netting and insolvency in a particular jurisdiction) because its exposure to that risk is very low may nonetheless be a major cause of concern of a regulator, which looks at the exposure of the system as a whole.

Are the systemic concerns of a regulator likely to influence its view of the significance of a legal risk so that it requires individual institutions to attribute to it a different importance than they otherwise would?

The Process

We would like first to receive comments on questions A1 and A2. It does not seem sensible to ask whether regulators and others see the topic differently from the way lawyers see it, without first establishing the nature of the lawyers' understanding.

As soon as we have a sufficient number of replies, we will report back on our analysis of them and move on to look at questions A3, B and C. It would greatly help if those who are able to respond could do so by 31 October 2001.

THE APPENDIX

Legal risk situations affecting a commercial institution ("the company") might be grouped under three headings:

Organisational Legal Risk

This is the risk connected with the maintenance of the company's assets and property and with the internal affairs of the company. Examples:

1. The risk the company may fail adequately to protect its intellectual property assets or that the ownership and/or value of these assets might be successfully disputed by third parties. (*can't challenge value*)
2. The risk of liability to shareholders or that shareholders might be able to compel action contrary to the wishes of the management of the company.
3. The risk that management action may fail to take proper account of employment law or of the rights of employees or trade unions.
3. The possibility that the company may fail to see the consequences of an act or omission because of:

- i) failure to take appropriate outside legal advice;
- ii) shortage or inadequacy of in-house legal advice; or
- iii) defects in internal procedures for identifying when legal advice is needed.

Legal Methodology Risk

This is the risk that the methods adopted and steps taken to protect the company's assets against claims by others or to protect against liability to pay damages or compensation to others are inadequate. Examples:

1. In a commercial transaction, the company does not take warranties from its counterparty, but relies instead on its due diligence procedures. The due diligence procedures fail to reveal a defect, leaving the company with no contractual recourse.
2. The use of standard or "generic" legal opinions on the content of legal rules in overseas jurisdictions may fail to reveal an issue relevant to a particular transaction because of the general nature of the opinion given.
3. The risk that the only available method of taking protection can never be completely effective. For example, opinions given about the ownership of and capacity of "tax haven" companies with bearer shares can never, in practice, avoid the possibility of fraud.

Operational Legal Risk

This is the risk that, in the course of the conduct of the company's commercial operations, it will incur obligations or liabilities that were not foreseen, or are greater than were foreseen or that its rights and claims prove to be fewer, or of a lower value, than had been expected. Examples:

1. The possibility that contractual rights will be void or unenforceable because of:
 - i) illegality;
 - ii) a technical defect (e.g. lack of restriction or registration);
 - iii) lack of capacity (of either party).

2. The possibility that a contractual or statutory provision may be interpreted differently by a court than by the company either
 - i) because of misunderstanding by the company; or
 - ii) because of misunderstanding by the court.

This risk is particularly acute where the contractual documentation is complex and the court is not specialist (e.g. if a technical point of insurance or shipping law comes before a bankruptcy court in a country that is not a major commercial jurisdiction).

3. The possibility that a court will take a view on a technical point that is different from the view on which the company has relied, with adverse consequences e.g. a court may categorise a contract as a gambling contract (and, accordingly, unenforceable under local law) contrary to the view taken by the company.
4. The possibility that legal proceedings will have an adverse consequence greater than expected (or a favourable consequence lower than expected) e.g. the company takes an over-optimistic view of the outcome of litigation or regulatory proceedings.

5. The operations of the company produce unforeseen liabilities to third parties e.g. the company becomes liable to compensate third parties or account as a constructive trustee because of the default or fraud by another party to a transaction with the company.
6. The possibility that the company's operations might infringe the legal rights of third parties e.g. breach of copyright or patent infringement.
7. The risk that the company's claim, although sound in law, will not be capable of satisfaction in practice e.g. a counterparty may refuse to honour its obligations and precipitate litigation as a delaying tactic. The company's claim, although sound in law, will not be satisfied because of the insolvency of the debtor.
8. The risk that a claim by the company, although it appears likely to succeed, may fail because of unforeseen events occurring during the litigation process (e.g. the loss of a crucial witness).
9. The risk that the company's rights, although they appear secure in law, may need to be enforced in an overseas jurisdiction with which the company is unfamiliar. Its right to claim may, therefore, be subject to potential difficulties of procedure of which it is unaware.