



CHEAT SHEET

- *Identification.* The effective identification of legal risk requires an intimate knowledge of the organisation and its target markets.
- *Evaluation.* Whether or not a risk is acceptable depends on the activities and commercial objectives of the organisation.
- *Improvement.* Monitor and improve the performance of your legal risk management strategy to ensure that it reflects changes in the organisation, in legislation and regulation.
- *Integration.* Legal risk should be managed as a part of an organisation's overall strategy.

The Domino Effect:

The Shift Towards Prevention in Legal Risk Assessment and Management

By Patrick Ambrose

Risk is inherent in any enterprise, whether it is undertaken for profit or not. Managing risks has become an everyday, and increasingly complex, part of life for organisations, as there are many different types of risks that an organisation must manage, each with its own characteristics. For example, the characteristic element of financial risk management is the management of risk of loss inherent in financing methods, which may impair the ability to provide adequate return, while supplier risk management attempts to proactively manage the risk of disruption in the supply chain where the organisation is highly dependent on suppliers to achieve its business objectives.

Legal risk is a particular kind of risk, and its characteristic element is the risk of loss arising from the application of the law. The type of legal risk an entity faces will depend upon the nature of its business and the markets in which it operates. Consequently, the risk of loss caused by technical defects in the manner in which a transaction is carried out is a particular concern for banks and financial institutions who trade, for the most part, in products that are “creatures” of that law rather than tangible goods. In more extreme situations, legal risks can have a systemic or “domino” effect in the market, perhaps because the financial failure of one major institution may trigger failures in other institutions, or where participants in a market become aware of a major legal problem inherent in a specific kind of transaction and, in order to avoid this risk, they avoid entering into such transactions for as long as the legal risk persists.

Lawyers as legal risk managers

Traditionally, the role of the legal function has been to provide technical advice and recommendations on a wide range of legal issues, and it is arguable that this is a form of legal risk management. Typically, however, this has been a somewhat reactive approach and not engaged in as part of a structured risk management process. However, in “The Future of Law: Facing the Challenges of Information Technology,” Richard Susskind predicts a shift in the role of lawyers from problem solving to one of problem prevention:

“While legal problem solving will not be eliminated in tomorrow’s legal paradigm ... the emphasis will shift towards legal risk management supported by proactive facilities, which will be available in the form of legal information services and procedures. ... Where legal problems of today are often symptomatic of delayed legal input, earlier consultation should result in users understanding and identifying their risks and controlling them.”

In practice, financial service providers are already familiar with this shift in emphasis toward legal risk management in the context of operational risk, which is defined with specific reference to legal risk since the second of the Basel Accords (Basel II) set out recommendations for regulations in the banking industry. Increasingly, non-financial service organisations are also encouraging their lawyers to take on a more proactive role, advising on whether particular transactions and commercial strategy are appropriate in view of the spirit, as well as the letter, of the law.

The shift toward problem prevention requires in-house lawyers to develop a broader set of skills beyond an expert knowledge of the law. While in-house lawyers typically present their views to decision-makers within the business and then step back from commercial decision-making, legal risk management requires in-house lawyers to take a more proactive role in the assessment and management of legal risks. The in-house lawyer is uniquely placed within the organisation to constructively challenge decisions on how to treat legal risk where there is a concern that the integrity and reputation of the organisation would be threatened, or where any transactions entered into may not be legally viable. This is particularly important where the business may have succumbed to “group think” on a particular issue, and the legal risk may not have been given proper consideration.

In-house lawyers must also broaden their line of vision beyond an understanding of the organisation and its objectives, and seek a better understanding of the political and environmental

landscape in which the organisation operates. Current affairs and public opinion can be highly influential in developing the law, and failure to take account of the societal changes will invariably lead to a failure to identify a corresponding change in law or regulation. In-house lawyers should also periodically canvass the views of external legal advisors to get a better sense of what is acceptable business practice to gauge the potential response to business practices or new products, and to forecast regulatory responses fuelled by public discontent.

Like any initiative, the success of a legal risk management strategy will depend on how well the organisation responds to it. Therefore, before initiating a legal risk management process, it is essential to obtain senior management support. This can be achieved by highlighting the benefits of the strategy, such as enhanced protection against legal liability and the avoidance of breaches of legal and regulatory obligations, which can give rise to personal liability of board members.

Legal risk assessment

According to the International Organization for Standardization (ISO), the term risk management refers to “coordinated activities to direct and control an organisation with regard to risk” and will generally consist of one or more risk assessments that involves identification, estimation, evaluation and mitigation of risks. But before any risk assessment can begin, in-house counsel must agree on an unambiguous definition of what “legal risk” means to the organisation, and establish the scope of the intended legal risk management activities.



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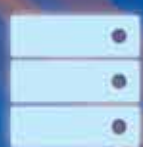


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Swap transactions in the United Kingdom

In the United Kingdom, for a number of years, financial institutions held the view that they could enter into swaps transactions with local authorities on the basis that these were transactions that the authorities had the power to enter into. Hammersmith and Fulham London Borough Council was one such local authority that had entered into interest rate swap transactions to protect itself against adverse money market movements; however, when it began to lose substantial amounts as interest rates rose, the district auditor of the Council sought a declaration from the courts that the contracts were void. The court held that the arrangements formed no proper part of a local authority's statutory functions, and therefore, were ultra vires and not binding on the authority. *Hazell v. Hammersmith and Fulham London Borough Council* was one of many cases concerned with the restitutio in integrum of money paid over by local authorities in swap transactions that were determined to be null and void. As a result of these decisions, a number of financial institutions lost a significant amount of money.

Definition and scope

There is no standard definition of legal risk, but in the broadest sense, it is the risk that an application or interpretation of the law fails to deliver an expected and practical result. Therefore, legal risk can arise in two principle ways: First, legal risk may be specific to an organisation or its objectives (e.g., where the organisation's operational risk controls were inadequate with the result that it acted unlawfully, although the law itself was in no doubt). Alternatively, legal risk can arise from developments in the law generally, or from uncertainty, misunderstanding or a lack of awareness of laws that apply to the organisation or its activities. Clearly, national and supra-national legislators and regulators have an important part to play in mitigating this second category of legal risk. The courts also have a significant role, and while the tendency of the courts is to change the law progressively and incrementally by developing existing principles, in the past, legal risk has crystallised rapidly based upon decisions of the court.

The key starting point in any framework that consistently manages legal risks is having an agreed upon definition of legal risk that is sufficiently understood and consistently applied throughout the organisation. While there is no standard definition of legal risk, each organisation should adopt a definition that reflects its own particular circumstances, such as any specific views of regulatory bodies or public authorities who oversee the activities of the organisation. The organisation should also consider whether other risks should be included within the scope of legal risk, such as regulatory risk of enforcement action resulting in fines, or professional liability risks that arise where lawyers act contrary to their professional obligations. In the context of EU financial institutions, the Basel regime and the corresponding insurance regime, Solvency II,

specifically exclude strategic and reputational risk from the scope of operational risk and, consequently, from its subset, legal risk.

Identification

Legal risks cannot be managed until they have been identified. In general, this involves identifying what, why, where, when and how events impact, or could impact, the attainment of the organisation's objectives or the value of its assets. As legal risks will differ from one organisation to the next, the effective identification of legal risk requires an intimate knowledge of the organisation and its target markets, the legal and political environment in which it operates, and a sound understanding of its commercial objectives. The legal function should ensure that it has a systematic process in place to review all customer, employee and investor complaints and actions, and reports of any regulatory examinations to identify trends that may indicate potential legal risks that need to be monitored. It is also useful to review litigation and regulatory actions against competitors to identify potential areas of legal risk that may apply to the organisation, and to advise business partners of potential exposure.

While risk management may be carried out informally, a more formalised process is advisable, particularly where the organisation operates across diversified international or highly regulated markets. The cognitive complexity of legal risk management is particularly evident in the determination of future legal risks, such as non-compliance with legal or regulatory standards, proposed legislation or a decision of the courts that significantly modifies the current understanding of the organisation's position. However, given the pace of legal and regulatory change, dedicating sufficient time to identifying and making provision for future legal risks is just as important as managing known risks. Therefore, on an annual basis, both in-house lawyers and

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Defined by the International Bar Association

The International Bar Association (IBA) suggests a definition of “legal risk” as a risk of loss to an institution that is primarily caused by:

- a. a defective transaction;
- b. a claim (including a defence to a claim or counterclaim) being made or some other event occurring that results in a liability for the institution or other loss (e.g., as a result of the termination of the contract);
- c. failing to take appropriate measures to protect assets (e.g., intellectual property) owned by the institution; or
- d. a change in law.

The notes that accompany the IBA definition suggest that, with regard to item (b) above, organisations should distinguish between claims that reflect a risk that has been anticipated, but nevertheless deliberately taken, and claims that come as a genuine “surprise.” Since the former arises as a result of wilful or reckless behaviour (including fraud), it should not be regarded as legal risk. It is also suggested that the risk of loss caused by contractual commitments to pay money entered into voluntarily (e.g., indemnities or guarantees) should not be regarded as legal risk.

primary external law firms should be canvassed for their views on emerging legal risks facing the company, as well as the steps the organisation should take to address these. In-house counsel should also consider maintaining relationships with government authorities, either directly or through trade associations, to maintain an up-to-date understanding of developing regulatory and enforcement trends.

Once identified, all known and potential legal risks should be documented in a legal risk register, with a separate legal risk register for each corporate entity or business unit that the legal department supports on a country-by-country basis. The purpose of the legal risk register is to provide stakeholders, such as management, the board and (to the extent possible) investors, with information about the risk exposure of the organisation, but it can also be used to inform insurance



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providers of the risks faced by the organisation, thus ensuring that insurance requirements are properly identified, scoped and negotiated. Indeed, the existence of a comprehensive legal risk management program and a regularly updated legal risk register can be a strong argument for a decrease in insurance premiums. Depending on the jurisdiction, in-house counsel may consider it prudent for the risk discussion materials to be documented at the direction of external counsel if there is any doubt that legal privilege may not be claimed over any such material produced by in-house counsel.

Estimation

Once legal risks have been identified, they must be estimated based upon criteria that form part of the common risk language used throughout the organisation. Typically, few individuals have a comprehensive understanding of all relevant aspects impacting an organisation, and consequently, legal risk analysis is often carried out by the legal function in conjunction with the business. The quality of legal risk estimation, therefore, depends to a large extent on the availability of suitably experienced personnel who have in-depth knowledge of the subject matter. However, while it will not always be possible to estimate legal risk with certainty, a recommendation based upon all available information is

often better than waiting until there is certainty, as by then, it may be too late to mitigate the risk.

There are essentially two approaches to legal risk estimation, both of which are based upon an estimation of the likelihood of the risk impacting the organisation and the severity of the consequences. Under the first approach, in-house lawyers will make recommendations based upon a combination of likelihood and consequence as to whether the seriousness of the legal risk is high, medium or low. The advantage of this approach is that it is easy to understand. The second approach is a variation on the high/medium/low estimation method and follows the same approach in measuring likelihood and impact, but financial thresholds, such as the amount of a claim, the cost of remedy or the impact on one year's profits, are used to aid the understanding and ranking of legal risks. This can present a challenge for lawyers who typically estimate legal risks qualitatively by highlighting a hypothetical outcome, but it can be very useful for the business to see a quantitative figure associated with the legal risks when evaluating whether it would be acceptable. Due to their inherent inaccuracy, quantitative estimates should only be one of several factors used to estimate legal risks. Legal risk mapping is also a

useful tool for presenting estimates of legal risk for evaluation.

Evaluation

When a legal risk has been identified and estimated, it must then be evaluated. The output from the estimation of the legal risk can either be evaluated without the application of existing controls (i.e., the worst-case scenario) or taking existing controls into account. The objective is to establish priorities that represent an acceptable level of legal risk based upon the organisation's risk appetite and other criteria, such as the balance of risks and benefits, which will, in turn, enable the in-house legal function to determine an appropriate action to mitigate the risk.

The key element in the evaluation of legal risk is whether or not the risk is acceptable, and this will depend on the activities and commercial objectives of the organisation. Consequently, the final decision on how the legal risk is evaluated should be made by senior business management or a risk oversight committee that has the requisite knowledge and experience to ensure the integrity and credibility of the decision. If the legal risk is deemed to be minor, or the cost of avoiding it is beyond the organisation's capacity to pay, the organisation may need to consider accepting the risk and its consequences if it is core to the organisation's existence. If, however, it is determined that a legal risk is unacceptable, the in-house legal function will have a crucial role in determining how to avoid or mitigate the risk.

Mitigation

The final phase of the legal risk assessment process focuses on how legal risks can be mitigated in accordance with the risk priorities that have been established. The mitigation of legal risk should be appropriate to the level of risk identified, and generally, any cost of doing so should be commensurate with the potential consequences. Based

Legal risk register checklist

Typically, a legal risk register sets out the following:

- legal risk categories,
- specific legal risks related to each category,
- what might make such a legal risk become reality,
- consequences of the legal risk occurring,
- who in the organisation has responsibility for handling the legal risk,
- likelihood of the legal risk occurring,
- likely severity should the legal risk occur,
- efforts undertaken to mitigate the legal risk,
- legal risk that remains after mitigation efforts have been undertaken, and
- further necessary actions, who is responsible and when completion is expected.

The legal department should monitor and improve the performance of its legal risk management strategy to ensure that it reflects changes in the organisation, in legislation and regulation, and other changes in the outside world that it has no control over.

upon this analysis, in-house counsel should make recommendations to decision-makers in the business on how to manage the identified risks and to ensure that the organisation is taking advantage of any protection or rights afforded by the law.

In particular, in-house counsel will be able to advise the business if there are practical measures that can be taken to legitimately avoid or reduce the likelihood of the event occurring or the financial consequences likely to be imposed (e.g., limitation or exclusion of liability clauses). If it is not possible to remove or substantially reduce the risk, in-house counsel should consider whether it is possible to shift the burden of the risk to another party by means of contractual waiver or indemnity; however, it is important to bear in mind that waivers and indemnities will generally extend only to foreseeable risks, and will not protect the organisation against negligence or failure to act when it could — or should — have done so. Where “letters of comfort” are proposed, in-house counsel should advise the business that such letters generally seek to create moral, but not legal, obligations, with no material impact on mitigating legal risks, and may even result in expensive legal fees being incurred if attempts are made to prove that the letter was a tacit guarantee or professional advice that was intended to be relied upon.

Legal risk management

Systems and policies

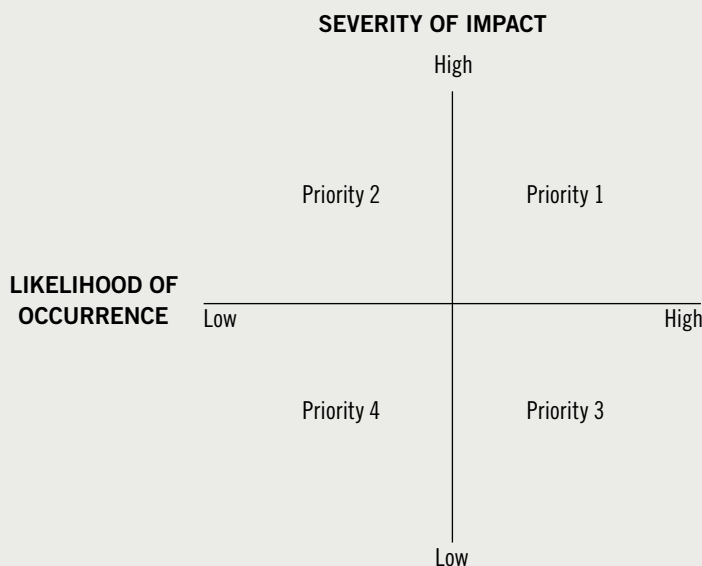
The management of legal risk is an ongoing activity and should be accompanied by effectively communicated systems and policies that strike an appropriate balance between prescription and high-level principles, and foster a culture of legal risk compliance throughout the organisation. In particular, there should be a specific protocol in place that identifies responsibilities, as well as a mechanism for escalating and reporting urgent issues. Every year, the legal function should also develop a legal risk monitoring plan that sets out the areas to be monitored over the year depending on perceived legal and/or regulatory risk, and risks assessed as high priority should receive closer attention. Within the legal department itself, newly hired legal staff should be obliged to participate in a legal risk management orientation program to ensure they are alert to the organisation’s legal risk management practices and procedures, and in larger legal departments, each practice group should have a

designated legal risk coordinator who is responsible for ensuring that the practice group’s legal risk management activities achieve the overall legal risk management objectives. External law firms should be provided with consistent and specific guidance as to the level of legal risk that the organisation is willing to assume, and the law firm’s performance in identifying and managing legal risks on behalf of the company should be reviewed annually. At the end of major projects, external counsel should be asked to submit a list of suggested actions for improving legal risk management.

The legal department may wish to include the results of the risk management plan as part of the internal performance assessment of the legal department itself, as the inclusion of positive financial and reputational outcomes associated with legal risk mitigation activities is an effective way to demonstrate value added to the business by the legal department.

While the organisation’s legal risk management program aims to reduce the risk of loss incurred as a result of

Sample legal risk mapping matrix





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an unforeseen or unexpected application of the law, there will be times when things go wrong, and it is important to have crisis management protocols in place to deal with contingencies. This is, in itself, a form of risk mitigation, as it will prepare the organisation to deal with legal issues as they arise by clearly defining the reporting structures and immediate actions to be taken.

Improving risk management capabilities

Legal risk is not static, and as present risks fade, new risks will emerge. The legal department should monitor and improve the performance of its legal risk management strategy to ensure that it reflects changes in the organisation, in legislation and regulation, and other changes in the outside world that it has no control over. It should also seek to ensure that it is aligned with “lean” management principles and best practices, both within and outside the organisation. This process may also highlight potential efficiencies to be gained by integrating the legal risk management strategy in other information and reporting systems operated by the legal department, or by integrating more closely with other risk management and internal control systems and processes within the organisation.

The reliability of the legal risk management strategy should be frequently tested to ensure that it is adequately identifying and assessing all material legal risks of the organisation.

Standards, policies and best practices should then be updated accordingly. The process should also test the efficiency of the resources required to organise and operate the legal risk management strategy, and its effectiveness in adequate and effective risk mitigation or remediation. The legal risk management strategy should be subject to strong governance and, ideally, will be subject to review at least annually by audit committee and/or the board of directors. The key objectives are to ensure that the legal risk management strategy is closing legal risk gaps, building awareness of the importance of legal risk compliance and embedding a legal risk mitigation culture. In summary, “good procedures, regularly followed” should be the legal risk management mantra.

Integrating with other risk management processes

Legal risk can overlap with other forms of risk and, therefore, should be managed as a part of an organisation’s overall strategy to ensure it is integrated into wider risk management systems. There are significant benefits to doing so. For example, it facilitates closer integration of the legal function with the firm’s governance risk and compliance management capabilities, and can also create greater business unit accountability. In particular, it enables lawyers to identify and tackle an organisation’s overall legal risk, not simply those relating to specific transactions. In-house

lawyers should, however, be mindful of preserving legal privilege to ensure that information that would otherwise be privileged is not circulated beyond into wider risk management systems.

Conclusion

Risk is — and always will be — with us, and as long as there are legal obligations, there will always be legal risk. The in-house lawyer’s traditional strengths of expertise, judgment and common sense in problem-solving will continue to be important, but increasingly, organisations will look to their in-house lawyers to perform a legal risk prevention role. As lawyers are not typically trained in risk management methods, meeting this new challenge will mean acquiring new skills. In particular, given that the law is often open to interpretation, and legal decisions are not always predictable, in-house counsel will need to become more comfortable with legal risk assessment based upon uncertain variables. In addition, legal risk management may be quite time consuming and costly, so ensuring top-level support and appropriate resource allocation will be a key challenge to the success of any legal risk management strategy. **ACC**

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ACC Docket

Tips & Insights — Disciplined and Practical Risk Management (Dec. 2011). www.acc.com/docket/t&i_dec11

Tips & Insights — A Little Understanding Goes a Long Way (Dec. 2012). www.acc.com/docket/t&i_dec12

Top Tens

The Top Ten Ways to Mitigate Risk Once a Crisis Occurs (Jan. 2013). www.acc.com/topten/crisis_jan13

Top Ten Risk Allocation Pitfalls To Avoid (March 2014). www.acc.com/topten/risk_mar14

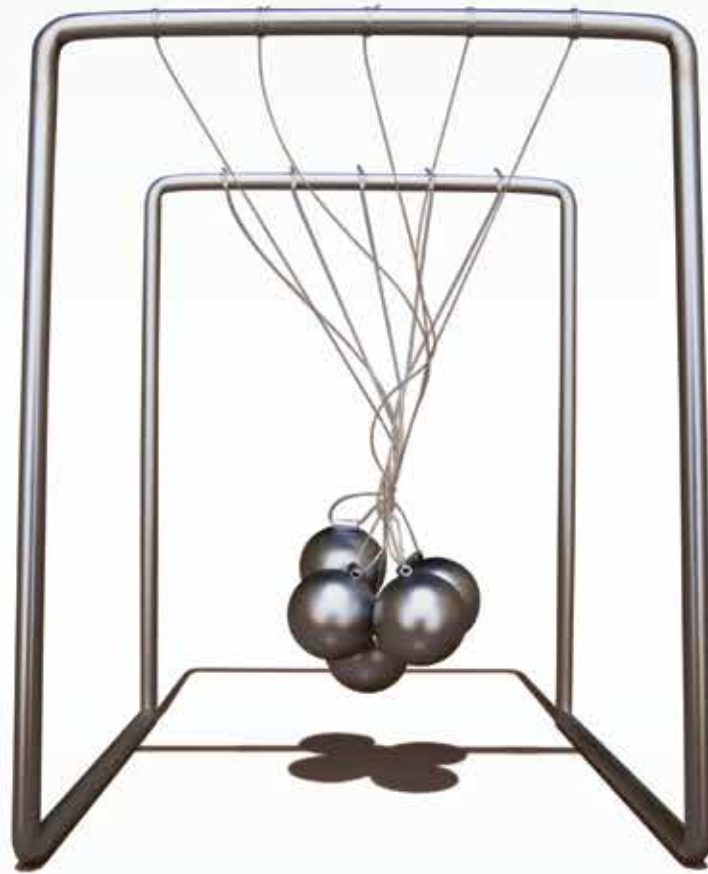
Program Material

Risk Management in the New Age of Scrutiny: Strategies, Tips and Guidance for in House Counsel (Nov. 2011). www.acc.com/risk-mgmt-scrutiny_nov11

Article

Basel III Capital Standards Agreed (Sept. 2010). www.acc.com/article/basel3_sep10

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