

Legal Risk Management – Some Reflections

Jan Trzaskowski

The concept 'Legal Risk Management' is not clearly defined. The purpose of this article is to present some reflections concerning this concept and how it relates to other more established concepts such as corporate governance and compliance, and how legal research can benefit from legal risk management. The focus is on commercial business, but legal risk management may also be carried out by other entities. This paper contains only some initial thoughts to be pursued in further research.¹

1. Legal Risk Management

1.1. Risk Management

Risk management may be understood as the process of measuring or assessing risk and then developing strategies to manage the risk.² The assessment of a risk entails the identification hereof and the choice to carry out risk management. Identified risks may be assessed as to their potential severity of loss and to the probability of occurrence.

Risk management concerns the protection of particular assets, which may be that of a business. In order to justify the introduction and usage of legal risk

¹⁾ This article is elaborated in connection to a presentation at a seminar on the management of legal risks, which is to be held at Oslo University on 10 November 2005. See also Trzaskowski, Jan, *Legal Risk Management in Electronic Commerce – Managing the Risk of Cross-Border Law Enforcement*, Ex Tuto Publishing, October 2005, www.legalriskmanagement.net.

²⁾ http://en.wikipedia.org/wiki/Risk_management.

management, the concept should not only be different from established concepts, but it should also link to the management of legal risks. The concept may be compared to concepts concerning corporate governance and compliance which, like risk management, is of a proactive nature.³

1.2. Legal Risks

Risk may be understood as the potential harm that may arise from a present process or from a future event. In professional risk assessments, risk combines the probability of a negative event occurring with how harmful that event would be.⁴ A legal risk may be defined as a potential detriment caused in connection to a legal relation⁵ and which may be imposed by enforcement through the judiciary. The risk may for example entail that a pecuniary or custodial sanction is imposed, an injunction is issued or that a legal or natural person is deprived from certain privileges such as claiming performance or invoking remedies in a contractual relation.⁶

It seems reasonable to make a distinction between legal relations, which are based upon a contract, and those that are not. In contractual relations, the parties may benefit from the freedom to contract in order to negotiate a well-balanced contract. Outside of contractual relations, norms are settled by law as interpreted by the judiciary and without the same flexibility as within contracts. The discussion below focuses on legal risks outside of contractual relations.

One of the parameters to consider in connection to legal risk management is law enforcement. From a business perspective, the interest in law enforcement is to what extent the law can be enforced on the business and what the business can do to mitigate or eliminate the risk of that enforcement.

³⁾ See for example Iversen, Jon, *Legal Risk Management*, Forlaget Thomson, 2005, where legal risk management is used as another word for corporate governance and compliance. See also www.proactivelaw.org.

⁴⁾ <http://en.wikipedia.org/wiki/Risk>

⁵⁾ A legal relation can be defined as a relation, which entails rights and or obligations that can be enforced through the Judiciary. An important legal relation exists between the state and its nationals, which is fundamental for the legal existence of both natural and legal persons. The relation with the state as such enables Persons to establish legal relations with other Persons under the rules of the legal system.

⁶⁾ The legal sanctions are, however, not necessarily the only sanction to take into account. Most Persons are vulnerable towards especially unfavourable commenting, which is enforced through markets.

1.3. Managing Legal Risks

The treatment of risks may involve transfer, avoidance, reduction (mitigation) and acceptance of the risk. Outside of contractual relations, avoidance through compliance is the path to pursue in order not to infringe the law. Transfer of legal risk through insurance is usually not an option, as it is likely to conflict with public order.⁷ It may be argued that acceptance and reduction (mitigation) suffers from the same problem as transfer since it unavoidably entails an acceptance of infringing the law.⁸

If avoidance is the answer in legal risk management, another question arises; is it at all possible to comply with the law? Legal compliance may be a costly affair. A business must employ or contract with legal counsel to ensure that every step is taken in accordance with legal requirements. For that reason corporate governance and compliance programs may be of great value. It should be emphasised that such requirements also apply to small and medium sized businesses, which may have a chilling effect on entrepreneurship.

Another question concerns the available means of avoidance. A business can choose to refrain from marketing and sales, which on the other hand would take away some of the defining characters of a business. The business must thus find a source of wisdom that can provide correct answers to legal questions. This requires knowledge of the law and of the particular circumstances. Courts are dealing with particular cases in the light of the law. A court decision is correct – provided it is not overruled by a higher ranking judgement. Unfortunately courts are usually not giving advice to businesses – they usually deal with actual conflicts.

To get legal advice, the business may use in-house counsel or other legal advisers. To some extent it is also possible to obtain assistance from public authorities. These sources of wisdom may, however, not be able to foresee how the court eventually will perceive a particular case. Based on sources of law, the counsel may reach a well-argued answer to legal issues. Everybody experienced with legal advice knows that, except for clear-cut cases, uncertainty is a factor – which is usually reflected in reservations accompanying legal notes. Corporate governance and compliance programs do not provide a solution to this imperfectness.

⁷⁾ If a business chooses to have a note drawn up by a lawyer, it could be perceived as a transfer of risk, as the lawyer and his insurance company may be liable in case of certain errors in the note.

⁸⁾ This is not to say that such considerations are not in fact taking place in businesses.

In this light, it could be argued that avoidance of risk through legal advice is merely a means of mitigation rather than avoidance. Such a conclusion would, however, mean that the most common means of risk-avoidance is merely a means of risk mitigation, which may, as discussed above, be in contravention of public order. Or the conclusion could be that risk mitigation is an accepted means of legal risk management. If the latter conclusion is true, it leads to the question of which degree of risk mitigation should be applied.

On a sliding scale, mitigation lies between the extreme ends of acceptance and avoidance. If acceptance is unlawful and avoidance is impossible, the proper solution to legal risk management must be found in risk mitigation. Under these circumstances, it can be argued that legal risk management is about risk mitigation, including risk avoidance to the extent possible.

1.3.1. Cost-Benefit

It could be argued that a business should apply a cost-benefit approach to the management of legal risks. Why should a business deal differently with legal risks than with other commercial risks? The answer is probably found in the obvious statement that it is unlawful to break the law. Even an attempt to break the law is usually unlawful. On the other hand, it may be argued that by attaching sanctions to the law, infringement is assumed. In this context, it is assumed that the legal or natural person has chosen to comply with the law.

It seems that legal risk management as a cost-benefit approach is incompatible with the assumption that the law is to be complied with. This is in particular true for the situation in which a business is well aware of the unlawfulness of a particular transaction, but carries it out because it is the most profitable option. The cost-benefit analysis may be defined as the process of weighing the total expected costs against the total expected benefits of one or more actions in order to choose the most profitable option.⁹ The cost-benefit analysis applied to legal risk management would entail that a business should break the law if it is more profitable than complying with the law.¹⁰

The cost-benefit analysis may be of interest in connection with examining whether the law is properly sanctioned. In general, and from an economical point of view, it could be assumed that the law is properly sanctioned and thus keeping the illusion that nobody can benefit from breaking the law. This

⁹⁾ http://en.wikipedia.org/wiki/Cost_Benefit_Analysis

¹⁰⁾ The cost-benefit analysis entails a number of difficulties in particular related to calculating probability, potential loss and reliability of legal advice. It does, however, not change the fact that the business must find a way to deal with uncertainties and thus risks.

assumption works perfectly when the law is examined in general, i.e. in connection to determining what the law is. In practice, however, businesses do not have unlimited resources. Even when the business has chosen to comply with the law, it may have several choices on how to deal with a particular legal risk. The choice could for example be between using the broadly trained in-house counsel or an external jurist. The later option is usually more expensive, but usually also more reliable. The business should go for the most profitable choice – whatever that is?

1.4. Legal Risk Management and Research

The focus in legal research is usually concentrated on finding the law by analysing sources of law. That is to deal with the law in the same way the judiciary does, but notably without having particular, factual circumstances. Research within legal risk management should focus on identification and/or mitigation of legal risks. In order to do so, the research should take the viewpoint of particular interest (certain assets). It may for example be the viewpoint of a business, a natural person or another entity. One of the benefits of maintaining a particular focus is that the research is easier to implement in real life. An approach can be to provide a standardised scenario, which may be useful to delimit the scope of the research. A delimited scope can make it easier to deal with different areas of law and thus explore law in a broader perspective. One approach could be to provide a test set-up.¹¹

Corporate governance deals with the method by which a corporation is administered, and it deals with the laws and customs affecting that administration.¹² Compliance refers to systems to ensure that personnel are aware of and take steps to comply with relevant laws and regulations.¹³ Compliance or compliance programs may thus be measures to be taken under corporate governance. Both concepts may be perceived as measures under legal risk management.

Legal risk management can be considered from three perspectives or layers. The first layer is the organisation layer, which deals with the practical elaboration and implementation (management) of legal risk management strategies (e.g. compliance programs). The second layer concerns the economical rationale behind decision taking. The third layer is invoked as a base for assessing legal risk and elaborating alternative legal strategies. These

¹¹⁾ See for example Trzaskowski, Jan, Legal Risk Management in Electronic Commerce – Managing the Risk of Cross-Border Law Enforcement, Ex Tuto Publishing, October 2005, www.legalriskmanagement.net.

¹²⁾ http://en.wikipedia.org/wiki/Corporate_governance.

¹³⁾ http://en.wikipedia.org/wiki/Compliance_%28regulation%29.

layers involve organisation theory, economic theory and legal theory. It is difficult for all researchers to involve all aspects and legal risk management thus calls for multidisciplinary cooperation in research.