

Successfully managing legal risks can mean the difference between celebrating business success and being tied up in endless litigation. Yet, of all the risks faced by organizations today, legal risk is among the most difficult to measure, manage and align with an organization's risk tolerance. This article explores how to define and classify legal risk, so that organizations can develop and implement effective legal risk management strategies.

Legal Risk Management

Legal risk is just one component of a complete enterprise risk management (ERM) program. However, the same basic framework for ERM applies to legal risk. That framework includes:

- Identifying the risk
- Assessing the risk in terms of likelihood of occurrence and potential impact, as well as how the risks relate to each other
- Defining the risk appetite or risk tolerance
- Developing a framework for managing the risks, with a view to conforming behavior and decision-making with the stated risk appetite

This article will follow the framework set forth above and explore each component.

Identifying Legal Risk

The informal notion of risk is "the chance that something bad might happen." This definition of risk focuses on the negative side of risk or the probability of a loss given an event. A more appropriate definition, however, focuses on the identification of uncertainties and evaluating their effects, both positive and negative. RIMS defines risk as "an uncertain future outcome that can either improve or worsen your position."¹ Using this definition allows an organization to take the known risks that could improve its position to be exploited, and those that could worsen its position to be managed.

While we have produced a standard, workable definition of risk in general, when speaking about legal risk specifically, it can mean different things. While there is an accepted definition of "risk," there is no standard definition of "legal risk" and it may or may not be helpful to produce a definition. It may be just as helpful to think of legal risk simply as the risk that lawyers can help to identify or mitigate. However, one way to think about risk is by dividing it into the following four types.

- **Litigation risk.** Litigation risk is the risk of suing and being sued. Litigation risk is often the most discussed legal risk. Litigation is often public and always distracting. The range of events that cause litigation is broad.
- **Contract risk.** Contract risk is the risk that a company will fail to keep track of and meet or enforce its contractual obligations or rights, or enter into contracts with terms that are either inadequate, unfair or unenforceable. Contract risk is the most difficult to track among legal risks. In most cases, individual contracts do not, on their own, have the gravity of litigation or other significant liabilities. The difficult-to-track risk here is the uncertainty that arises from the contract portfolio in its entirety.
- **Regulatory risk.** Regulatory risk is the risk of new or modified regulations, changes in regulator focus, growth of an administrative agency or civil, criminal or injunctive fines or penalties imposed by the regulator. Regulatory risk represents the uncertainty of the consequences of an administrative agency's action.
- **Structural risk.** Structural risk is the risk that arises from uncertainty about a particular industry, technology or method of doing business. Structural risk is rare for most organizations. The scope of a structural risk is broad and it usually alters the competitive landscape. It can happen quickly, for example, when a law is passed or a court decision clarifies a particular issue. A structural change can benefit one organization while harming another.

Thinking through each risk type is a good place to start identifying legal risks. It may also be helpful to think about legal risk by category. Some categories to consider include industry-specific risks, company activities, types of law (e.g., employment, intellectual property, real estate) and functional areas (e.g., accounting and finance, human resources, product development).

Analyzing Legal Risks

Once the legal risks have been identified, the next step is to analyze the risk in terms of likelihood of occurrence and potential impact, as well as how the risks relate to each other. There are multiple tools available to companies to help collect and assess risk information, including business risk matrices that plot the likelihood of a risk occurring against its projected impact, categorization tools to ensure that all risks have been considered and financial quantification tools to help prioritize risks by projecting their likely financial impact. However, while these tools can be helpful, much of the assessment process is subjective. The best tool a company can use is common sense.

¹ "Has ERM Reached a Tipping Point?," *Risk Management Magazine*, November 2011. RIMS is a global not-for-profit organization dedicated to advancing risk management for organizational success.

To analyze the risk, it is helpful to look at three components.

- **Assessment of legal risk controls** – Assessment of the effectiveness of controls (e.g., litigation: insurance and training, contracts: exceptions and requirements tracking, regulatory: compliance reviews and ratings and structural: lobbying and trade associations)
- **Likelihood of the legal risk occurring** – Probability estimation of the likelihood of discovery or an adverse or positive decision
- **Consequences** – Impact analysis of damages (i.e., economic loss or gain) and the frequency of occurrence (i.e., single incident or repeat behavior)

Defining Risk Tolerance

The concepts of risk appetite and risk tolerance are often used interchangeably, but in ERM literature they have distinct differences in meaning. This article does not focus on the distinct definitions, but asks the question: how much risk is acceptable for my company in pursuing its goals?

A company's risk tolerance is directly related to the company's overall business goals. If a company has aggressive growth as a strategic goal, it will need a commensurate tolerance for risk. A company with a lower appetite for growth should be matched with more conservative business goals. There are several other factors that impact a company's legal risk tolerance, including size of the company, past experiences, competition, culture and changes in leadership or ownership.

Once a company has a better understanding of its legal risks and the level of risk the company is willing to accept, it is important to document the legal risk tolerance. It should be directly linked to the company's strategy.

Effective risk tolerance documentation will:

- Set out the aggregate level and types of risk that the company is willing to assume to achieve its strategic objectives
- Be expressed in qualitative and quantitative terms

There are many ways to communicate risk tolerance. The most important factor in determining how to communicate risk tolerance is that it should be easy to communicate and, therefore, easy for all stakeholders to understand. Communications regarding risk tolerance often start out broad and become more precise as they cascade into departments and operations across the company. Which type of communication is best for a particular company is a management decision. Often, as companies become more experienced in risk management, their communications regarding risk tolerance will become more precise. There are three main approaches for communicating risk tolerance:

- **Heat map** – Color banding with a heat map that indicates acceptable versus unacceptable risk levels
- **Statement** – A statement of risks that ties to the company's objectives

- **Categories** – Statements of risk that tie to generic risk categories, such as economic, environmental, political, personnel or technology

Operating Within the Risk Tolerance

As important as determining and documenting the risk tolerance, is determining how to act within this framework. Lawyers have a key role to play in the risk management process, in particular because of their direct understanding of the company that comes from working across many functional areas.

The role that in-house and outside counsel play for companies is changing. "[T]oday's legal leaders also must *take an enterprise view of risk* and work with the business to evaluate commercial decisions and advance corporate strategy."² It is no longer enough to present the legal risks. Lawyers are expected to identify the risk, assess the risk and help guide the business through the decision-making process.

Because of this, many lawyers may need to reconsider how they think about risk.

Lawyers have been accused of being overly risk averse as they look to eliminate every risk, no matter how small and no matter how much opportunity awaits on the other side. An unfortunate consequence of having overly risk-averse attorneys is that it actually increases the likelihood that something will go wrong. Risk-averse lawyers may get marginalized as management determines they are not helping to find solutions. When lawyers are not consulted and given the opportunity to guide the business leaders, it can lead to a problem that requires more significant and negative legal intervention. If management sees its lawyer as someone who is working to grow the business and help it take smart risks, management will be more likely to consult its lawyer and more likely to listen on those occasions where the lawyer needs to guide the business away from a risk.

It is the role of lawyers to help identify, analyze, define and communicate legal risk tolerance. However, the best lawyers help to guide and steer reasonable risk-taking within this framework.

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² Russell Reynolds Assoc., "Becoming the Calm Risk Taker: Attributes for Success in Today's New Legal Environment," russellreynolds.com (last visited November 9, 2018).