International In-house Counsel Journal
Vol. 8, No. 31, Spring 2015, 1

Negotiating Global Contracts: Balancing Legal Risk and Commerciality

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Financial organisations have a far wider reach in today's business environment as the scale and scope of their customer base expands beyond local and regional borders. Accordingly in-house lawyers, as strategic and trusted advisors to the business, are required to exercise consistent legal and commercial judgement in negotiating global contracts. This paper examines the internal challenges of balancing Legal Risk and Commerciality when negotiating global contracts. The complexity of global contracts requires a unique blend of business and legal expertise.

I. Introduction

As a trusted advisor, the in-house lawyer has the unenviable task of balancing strategic advice with pragmatic methods to maximise business value through appropriate use of legal best practices. In particular, the in-house lawyer is required to be detail oriented and think strategically in a fast paced environment. This is equally challenging in high profile global negotiations where the in-house lawyer has to bring a structured and analytical approach to solving strategic, commercial and operational issues; identify problems and opportunities; structure and execute analysis; as well as provide actionable insights. Undoubtedly, the role of the in-house lawyer has evolved from the role of 'protector of the firm and its assets, providing technical advice and recommendations on a wide range of legal and compliance issues'.[1] Nuanced in its function today is the need for the in-house lawyer to be part of the business framework developing and delivering strategic insights to achieve sustainable growth and profitability in line with overall business goals.

The global financial crisis of 2007/2008 put financial organisations under significant and continuous oversight of regulators globally. Against the backdrop of heightened regulatory control and increased international connectivity, this paper proposes the need for a balanced scrutiny of risk assessment and control as key to an effective and efficient global negotiation. This means that the success of a global contract negotiation is not the sole responsibility of the in-house lawyer but a shared responsibility with key business functions such as Risk, Compliance, Sales, Product and Operations ('Stakeholders').

It is imperative that the outcome of global negotiations is in line with the business strategy, governance structure and risk framework of the financial organisation in

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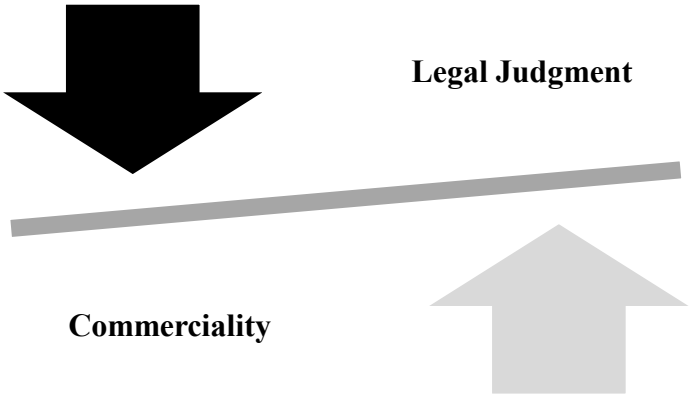
[1]Anderson, K and Black, J **'Legal risks and risks for lawyers'**, Herbert Smith Freehills and London School of Economics Regulatory Reform Forum, June 2013, p.3 http://www.lse.ac.uk/collections/law/projects/lfm/0356o%20LSE%20HSF%20discussion%20paper_d6.pdf

question. A collective and collaborative approach with Stakeholders provides a sustainable key to minimising the current and future liabilities of the financial organisation and potentially gives the financial organisation a competitive advantage over its competitors. Additionally, there are situational variances and exceptions which must be dealt with on a case by case basis. As institutional customers get more sophisticated, they continue to push the envelope in terms of scope and seek higher value benefits from financial organisations. This has resulted in financial organisations establishing a mix of service delivery modules to meet the non-standard requests of customers.

The practical challenges experienced by the in-house lawyer during the course of negotiating global contracts are examined in two parts in this paper (i) ***Legal Risk*** – what is it and how to get the business to own it?; and (ii) ***Commerciality*** – what is acceptable risk and is there a tension between legal judgment and competing commercial interests of Stakeholders? This paper is not focused on the negotiation of contractual terms in global contracts but on the over-arching internal challenge of balancing the assessment of legal risk with commerciality.



II. Legal Risk

'Finally, there is an importance in doing what you can. A risk assessment process may identify some risks that seem to be of such significance or such intractability that they cannot be solved. It is important here to be able to identify what can be done if not to eliminate the risk, to mitigate its consequences or ensure that, if it crystallises, the response is as effective as it can be.'

Andrew Whittaker,
(Butterworths Journal of International Banking and Financial Law), 2003[2]

What is legal risk? Legal risk is context specific as it can be interpreted differently depending on the type of business attributable to that financial organisation. For instance some risks may be too remote and unlikely to arise as a potential issue within the risk framework of a business. This is a matter of judgment for the Stakeholders of the financial organisation.

Following the global financial crisis of 2007/2008, regulators placed significant importance on the legal risk framework of financial organisations. As there is no standard definition of legal risk, opinions vary on what it means. The Basle Committee on Banking Supervision generally known as BASEL II classifies legal risk as part of

[2] Whittaker, A **'Lawyers as Risk Managers'**, Butterworths Journal of International Banking and Financial Law – January 2003, p.7 file:///C:/Users/am2168/Downloads/BankingLaw_LawyersAs.pdf

operational risk which it defines as 'the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events (including legal risk) which differ from the expected losses'.[3] The Operational Risk Exchange Organization (ORX) defines legal risk 'as the risk of loss resulting from exposure to (i) noncompliance with regulatory and/or statutory responsibilities; and/or (ii) adverse interpretation of and/or unenforceability of contractual provisions'.[4] The International Bar Association (IBA) defines legal risk as being a risk of loss to an institution that is primarily caused by[5]:

1. a defective transaction;
2. 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 (for example as a result of the termination of the contract)
3. failing to take appropriate measures to protect assets (for example intellectual property) owned by the institution;
4. a change in law.

Both the ORX and IBA definitions can be broadly interpreted to include (i) exceeding authority contained in the contract; (ii) exposure to new laws; and (iii) changes in interpretations of existing law(s). Basel II goes further to clarify that legal risk 'includes, but … [is] not limited to, exposure to fines, penalties or punitive damages resulting from supervisory actions, as well as private settlements'.[6]

In the context of negotiating global contracts, legal risks need to be identified, assessed, monitored and controlled. This is consistent with the standardised approach put forward by Basel II with respect to the management of operational risk. In practice, legal risks would most likely arise where a claim is made against the financial institution or transactional documentation is defective. In relation to these categories of legal risks, the challenge for the in-house lawyer exists where the organisation (i) lacks a dependable and proven process for assessing the significance of potential legal risks associated with its standard documentation which has been tested; and (ii) fails to maintain a consistent legal analysis of the impact of the legal risk to the organisation.

Furthermore, in relation to potential claims against the financial organisation, Roger McCormick (2004) opines that a comprehensive analysis and examination of the different jurisdictions in which the organisation does business would help in reducing such risks. In particular, he asserts that the examination in those jurisdictions cover, 'potential liabilities, the nature of the potential legal exposures in those jurisdictions (whether for breach of contract, tort, statutory or regulatory liability or otherwise), the litigation "culture" of the jurisdiction and potential financial exposure, including the extent to which an adverse judgment might result in excessive or penal damages'.[7] The absence of such assessment can be challenging for the in-house lawyer and Stakeholders during the

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[3] Basel Committee on Banking Supervision **'Sound Practices for the Management and Supervision of Operational Risk'** February 2003 p.2. This definition was adopted from the industry as part of the Committee's work in developing a minimum regulatory capital charge for operational risk. http://www.bis.org/publ/bcbs96.pdf

[4] Terblanche, J.R **'Legal risk and Compliance for banks operating in a common law legal system'**, the Journal of Operational Risk (p.67–p.79) Volume 7/Number 2, Summer 2012 http://m.risk.net/digital_assets/5500/jop_terblanche_web.pdf

[5] International Bar Association ***'The Management of Legal Risk by Financial Institutions'*** Draft Discussion Paper, Working Party on Legal Risk, 2003, p.13

[6] Basel Committee on Banking Supervision, '***Core* Principles *for effective Banking Supervision***'. Bank for International Settlements, October 2006, p.130

[7] McCormick, R **'The Management of Legal Risk by Financial Institutions'**, discussion paper 2004, p. 2 http://www.federalreserve.gov/SECRS/2005/August/20050818/OP-1189/OP-1189_2_1.pdf

course of a global negotiation. Consequently, the assessment of such risks by reference to the specific products and services being contracted to the customer is crucial to effectively negotiate terms that materially protect the financial organisation in question.

Identification and Assessment of Legal Risk

The complexity of financial products and services available today along with new technologies as well as potential and/or conflicting regulatory risk heightens the importance of assessing legal risk in global contract negotiations. Stakeholders need to develop an understanding of what legal risks pertain to their respective businesses in order to make informed decisions when considering non-standard requests from customers in global negotiations. Often the challenge for the in-house lawyer is translating and/or quantifying these legal risks into real examples which demonstrate the issue in a way that the business would understand. This demonstrates value and enriches the engagement of the business. However, the responsibility for identifying and quantifying legal risks should not rest entirely on the in-house lawyer. Stakeholders must contribute to the consideration of the risks as these business units will understand the complexity of the products/services in greater depth than the in-house lawyer and together can flesh out the risk, if any, associated with that product/service. Common to most financial organisations are the five primary legal risk categories illustrated below:

Figure 1 Primary Legal Risk Categories - Source: Berwin Leighton Paisner[8]

Legislative Risk
The risk that the business fails to implement legislative or regulatory requirements (this often includes regulatory risk).
Contractual Risk
The risks that your current – and future – contracts expose you to such as: 1. use of non-standard terms & conditions; 2. technical fault: for example, lack of appropriate documentation; 3. inadequate/unclear authorisation; 4. failure to enforce or to comply with terms.
Non-contractual rights Risk
The risk that the business fails to assert its non-contractual rights. Often called 'intellectual property risk'.
Non - contractual Obligations
The risk that the business fails to keep to the spirit, as well as the letter, of the law.
Dispute Risk
The risk that the business makes operational or strategic errors when it manages disputes.

Once identified, legal risks should be assessed and then categorised with the appropriate level of risk impact associated with that line of business to enable effective decision making. In the context of global negotiations this will provide internal guidance on the level of risk the financial organisation is prepared to accept; and highlights the proper escalation and approvals necessary for an effective turnaround of the issues at stake.

[8] Whalley, M 'Five Primary Legal Risk Categories' 11 April 2013 http://www.blplaw.com/expert-legal-insights/articles/legal-risk-definitions/

Using Mynhardt's methodology for managing compliance risk (2008) the diagram below is a useful illustration of identifying risk, assessing relevant impact (high risk, medium risk, low risk) and likelihood/probability of occurrence (high, medium and low):

Figure 2 Identification/ Assessment of Risk – Source: Mynhardt Methodology[9],

A comparative methodology tool is the Legal Indicator Survey of the European Bank for Reconstruction and Development which is designed to measure and assess evolving commercial and financial legal systems in the region particularly in relation to transactions involving the provision of security.[10] The survey identifies 'various countries that have "legal infrastructure" problems of varying magnitudes' and in relation to identifying and assessing legal risk, the survey highlights 'a number of concepts that financial institutions would generally regard as relevant to the effectiveness of law in almost any context'.[11]

Another challenge for the in-house lawyer is identifying and assessing all relevant legal risks arising from a global negotiation as these may vary across multiple jurisdictions and can be a logistical challenge to overcome. Without the legal expertise for the respective jurisdiction, a robust examination will require instructing external counsel to provide a formal legal opinion which means managing costs, potentially extending the negotiation timeline with the customer and translating the legal opinion into digestible terms for the business. Instructing external counsel invariably involves 'the provision of appropriate instructions, the discussion of the issues involved, the analysis and research on both

[9] Mynhardt, R. H. '**Regulatory compliance: a framework for South African banks'** Doctoral Thesis, North-West University, South Africa ,2008, p.175-180. See also Terblanche, J.R **'Legal risk and Compliance for banks operating in a common law legal system'**, the Journal of Operational Risk, p.74-76, Volume 7/Number 2, Summer 2012

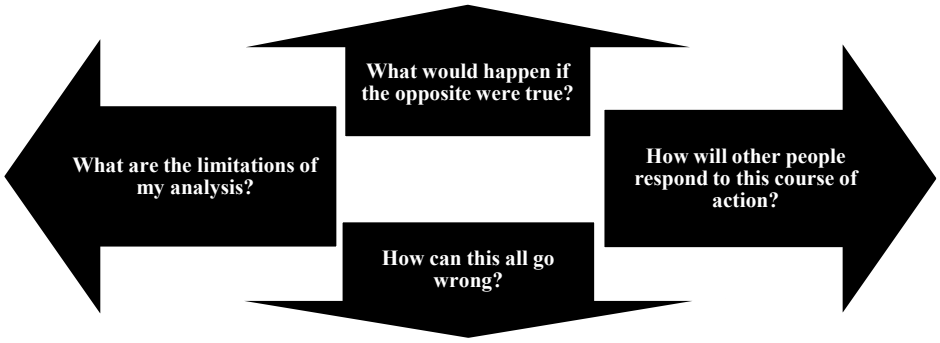
[10] See Ramasastry A **'What local lawyers think: A retrospective on the EBRD's Legal Indicator Surveys'**, Professor of Law, University of Washington – Law in Transition Autumn 2002, p14 http://www.ebrd.com/downloads/research/law/lit022.pdf

[11] McCormick, R **'The Management of Legal Risk by Financial Institutions'**, op.cit, p. 9

questions of fact and law and, possibly, the provision of written legal advice'[12]. Roger McCormick (2004) advises caution when instructing and relying on external legal opinions:

> *'They are commonly directed towards very specific sets of circumstances (and documents). They also tend to be based on precisely crafted assumptions and qualifications, many of which are of a highly technical nature. If reliance is to be placed on the opinions, the assumptions need to be examined and, where appropriate, checked out. (If the assumption is incorrect, the legal opinion may be valueless; similarly, unusual qualifications may mean that the institution does in fact have a significant risk exposure notwithstanding the opinion). Care needs to be taken also that the opinion is addressed to the institution that is relying on it or there is a clear statement in it that the institution may rely upon it.'*[13]

In the context of global contract negotiations, ultimately the risk assessment and review undertaken must be robust and thorough which means challenging external counsel opinion in order to reduce the risk of relying on inaccurate advice and constructively challenging Stakeholders so as to ensure no potential risks pertaining to the products/services underpinning the global negotiations are dismissed without due consideration. Andrew Whittaker (2003) opines that a constructive challenge requires the in-house lawyer to think outside the box, in particular he refers to it as 'lateral thinking' and gives the following as examples[14]:



There are clearly implications from risk management when addressing potential risks in global contract negotiations. As discussed earlier, the traditional role of in-house lawyers has evolved from simply providing advice as this function is now intrinsic to the risk management framework of financial organisations. Accordingly risk assessment in global contract negotiations must also identify uncrystallised risks (i.e. invisible risks) such as 'legal risk derived from legal uncertainty or from a court interpretation of the law which is contrary to the accepted understanding of the market or non-compliance of legal or regulatory standards'[15]. Thinking laterally would enable the in-house lawyer and Stakeholders to consider and make an informed decision on both visible and invisible risks.

[12] Ibid
[13] Ibid
[14] Whittaker, A **'Lawyers as Risk Managers'**, op.cit, p.7
[15] Anderson K and Black, J **'Legal risks and risks for lawyers',** op.cit, p.2

Monitoring and Control of Legal Risk

Once identified and assessed, legal risks should be monitored and controlled. This involves 'an examination of business activities to assist management and the board of directors in understanding whether business is being conducted in accordance with the law applicable to that bank'[16] and 'regular reporting of material information to those who can assess its significance and ultimately to senior management'[17] While legal input will be a valued contribution to the monitoring process, it is not advisable that the responsibility for monitoring these risks rest solely with the in-house lawyer. Anderson and Black (2013) opine that 'responsibility should be assigned for assessing and managing aggregated issues across a firm'.[18] Furthermore control of these risks entails effectively allocating responsibility and tasking specific business units to manage the 'mitigation of the risks identified and reported and appropriate feedback loops should be in place'.[19]

The implication of appropriate mechanisms to monitor and control legal risks within the financial organisation has an inevitable impact on global contract negotiations. The outcome can either be negative or positive depending on the robustness and solidity of the mechanisms for monitoring and control put in place. For instance, what risks should be reported and to whom? What process for escalating non-standard/bespoke issues is in place and is it effective? What best practice is adopted for the periodic review and updating of product/service documentation?[20] Documentation review should be regularly carried out to ensure it is consistent with market practice and legal developments (e.g. new case law or legislation) and with consideration of the products and services for which it is used.

III. Commerciality

'Being a constructive, proactive lawyer is about understanding the objectives of the organisation, working to find ways to achieve them, explaining what the issues are, reacting promptly and so on. It is not about saying 'yes' when the true answer is 'no'.'

Andrew Whittaker,
(Butterworths Journal of International Banking and Financial Law), 2003[21]

What is commerciality? It is often used interchangeably with commercial awareness. For the purpose of this paper, commerciality is demonstrated by an in-house lawyer when he or she does the following:

1. provides commercially practicable solutions to solving commercial and operational issues;
2. understands how the business works/operates;
3. comprehends what is important to the business and its customer base;
4. perceives the impact of the economic environment and financial markets on the business;
5. applies commercial understanding to issues and not a narrow application of the law; and
6. succinctly translates business challenges

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[16] Terblanche, J.R **'Legal risk and Compliance for banks operating in a common law legal system'**, op.cit, p.76
[17] McCormick, R **'The Management of Legal Risk by Financial Institutions'**, op.cit, p. 5
[18] Anderson K and Black, J **'Legal risks and risks for lawyers',** op.cit, p.3
[19] Ibid
[20] Ibid and see McCormick, R **'The Management of Legal Risk by Financial Institutions'**, op.cit, p. 8-9
[21] Whittaker, A **'Lawyers as Risk Managers'**, op.cit, p.6

Commerciality is a key asset valued by senior management in financial organisations. It demonstrates the in-house lawyer is a partner in identifying issues and opportunities; knowledgeable enough to succinctly articulate strategies; collaborates with the business in providing actionable insights; and ensures compliance with group policies, applicable laws and regulations. With all these expected attributes of the in-house lawyer, it can be a challenge balancing legal judgment with competing commercial interests of Stakeholders.

Therefore, caution must be exercised with easily 'getting comfortable' and rationalising decisions based on what everyone thinks simply because it is what the business wants. Langevoort (2011) posits:

> *'My hypothesis about in-house counsel is that an above average tolerance for legal risk and a flexible cognitive style in evaluating such risk are survival traits in settings where corporate strategy and its surrounding culture are strongly attuned to competitive success'.*[22]

Anderson and Black strongly advise that:

> *'... ensure that "getting comfortable" (i.e., concluding that what the business wants does not generate unacceptable legal risk) does not mean that the legal risk manager succumbs to collective rationalisation or group think – or that lawyers become so close to the business that they are no longer able to stand back and assess the issues independently and with professional detachment.'*[23]

As trusted advisors, it is particularly important that the in-house lawyer is sufficiently independent to give good quality and constructive advice which is not negatively influenced by the competing interests of Stakeholders. This is particularly important in the context of global contract negotiations where there must be an internal alignment of the organisation's position on issues before presenting a collective view to the customer. The implication of losing objectivity and independence will inevitably make the in-house lawyer a potential risk to the organisation as the quality of the advice will lose credibility. Andrew Whittaker takes it further when he asserts that the balance of legal judgment and commerciality is achievable:

> *'We would lose our credibility and would cease to have the role in risk mitigation that the organisation needs. Sharing the objectives of the organisation, contributing as best we can to achieving them and still remaining independent and detached is not impossible, but it is vital. It is not achieved by the formality of the relationship. It can be part of a much more fluid process of internal debate, challenge and counter challenge. We each need to recognise that our initial view is not always right and sticking to it where it is not is not a sign of strength.'*[24]

In the context of global contract negotiations, the following constitute good best practice approach to balancing legal risks with commerciality: think outside the box; focus points of the negotiation should be on 'must-haves' as opposed to 'nice to haves' – this will help to streamline and improve the customer's negotiation experience; deliver first class advice and recommendations to the business on the assessment of legal risk, including saying **'No'** when a customer and/or Stakeholders are pushing for **'Yes'**; escalate in a timely manner to the key decision makers who can give the final steer on sticky points; and engage Stakeholders who can help manage the customer relationship so that controversial issues can be taken off the table.

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[22] Langevoort, Donald C., **Getting (Too) Comfortable: In-House Lawyers, Enterprise Risk and the Financial Crisis** (November 22, 2011) p.11. Georgetown Law and Economics Research Paper No. 11-27; Georgetown Public Law Research Paper No. 11-135. http://scholarship.law.georgetown.edu/cgi/viewcontent.cgi?article=1156&context=fwps_papers

[23] Anderson K and Black, J **'Legal risks and risks for lawyers',** op.cit, p.6

[24] Ibid

IV. Conclusion

The first common thread in this paper is that internal challenges of identifying, assessing, monitoring and controlling legal risks inevitably pose practical difficulties when negotiating global contracts. In particular, financial organisations must develop a clear understanding of legal risk as it applies to each of their individual business globally and to the organisation as a whole. The importance of the evolving role of in-house lawyers as legal risk managers in financial organisations today includes sharing the responsibility of identifying, assessing, monitoring and controlling legal risks with Stakeholders.

Secondly, as the legal function continues to be embedded in the business, in-house lawyers must develop the skills to balance their commercial exposure with sound legal judgment as they are required to contribute to discussions and decisions on commercial risk. Such skills can only be gained with experience and draws from it the advantage of working in partnership with Stakeholders. However, such partnership must not cost the in-house lawyer his or her objectivity or impair their legal judgment.

Finally, if it does not make sense, challenge it. Undoubtedly, in-house lawyers must protect and maintain the integrity and credibility of the in-house legal function in order to avoid undermining the assurance of independent and objective legal advice.

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