

## **IBA WORKING PARTY ON LEGAL RISK**

### **SUGGESTED DEFINITION OF LEGAL RISK**

*(NB: This definition needs to be read with the accompanying notes, which affect how it should be interpreted).*

Legal risk is the risk of loss to an institution which is primarily caused by:-

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

The reference to a defective transaction in (a) above includes:-

- (i) entering into a transaction which does not allocate rights and obligations and associated risks in the manner intended;
- (ii) entering into a transaction which is or may be determined to be void or unenforceable in whole or with respect to a material part (for whatever reason);
- (iii) entering into a transaction on the basis of representations or investigations which are shown to be misleading or false or which fail to disclose material facts or circumstances;
- (iv) misunderstanding the effect of one or more transactions (for example, believing that a right of set-off exists when it does not or that certain rights will be available on the insolvency of a party when they will not);
- (v) entering into a contract which does not, or may not, have an effective or fair dispute resolution procedure (or procedures for enforcement of judgements/arbitral decisions) applicable to it;
- (vi) entering into a contract inadvertently;

- (vii) security arrangements that are, or may be, defective (for whatever reason).

All references above to a transaction shall include a trust, any kind of transfer or creation of interests in assets of any kind, any kind of insurance, any kind of debt or equity instrument and any kind of negotiable instrument.

All references to entering into a transaction include taking an assignment of a contract or entering into a transaction in reliance upon a contract which is itself a defective transaction.

## NOTES:

1. The consultation paper of 1 July 2003 issued by the EU Commission Services contains a “Working Document” setting out proposed risk-based capital requirements for financial institutions. Article 106 of that document states:-  
**“Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, including legal risk.”**

It is arguable therefore that a legal risk which has been deliberately and prudently taken would not fall within the concept of legal risk described in Article 106 (since it would not result from inadequate or failed internal processes, people or systems) unless it can in some sense be attributed to an “external event”.

2. The document referred to in note 1 above does not offer any definition of “legal risk”.
3. The attached definition should not be regarded as prescriptive. Each institution may wish to adapt the definition for its own particular purposes and, especially, to reflect any allocation of responsibility within that institution (for example, to the legal department) which may not be consistent with the definition as it stands. Any specific views of regulators, as they become known, will also, obviously, need to be taken into account.
4. With regard to paragraph (b) of the definition, institutions may wish to make a distinction between claims which reflect a risk that has been anticipated (but nevertheless deliberately taken) and claims which come as a genuine “surprise”. It is not thought necessary to make any distinction between contractual, tortious or other claims in this context (but see 5 below). However, the prevailing view (and, it is submitted, best practice) is that risks which arise from wilful or reckless behaviour (including fraud) - although they are operational risks - should not properly be regarded as legal risks.
5. It is suggested that the risk of loss caused by contractual commitments to pay money (e.g. indemnities or guarantees) entered into voluntarily should not be regarded as legal risk. The risk of loss caused by a breach of contract is a more difficult question. It is suggested that each institution is likely to have its own procedures for ensuring that clear contractual commitments (e.g. to pay a sum due on a due date) are properly complied with, and may take the view that failure to follow those procedures is primarily a non-legal operational risk. However, it is arguable that extremely complex contractual arrangements might give rise to a more technical risk of breach simply on the grounds that the requirements of the contract have not been fully appreciated. Institutions may, in appropriate cases, regard such situations as an example of legal risk.
6. Situations may arise in the context of paragraphs (a), (b) or (c) which have strong political overtones and may more properly be regarded as examples of political risk or at least a combination of legal risk and political risk. Whether or not any

such situation is to be treated as legal risk will largely reflect the allocation of responsibility within any given institution and may also reflect how that institution perceives political risk in any particular country. It is suggested, for example, that outright confiscation of assets by a governmental authority is, generally, pure political risk and not legal risk. On the other hand, some institutions might regard political interference with the judicial process as a form of legal risk. (See also paragraph (v) of the definition). How responsibility is allocated will no doubt reflect the institution's own judgement as to which departments or officers are best placed to provide advice on such risk situations.

7. "Change in law" has been added as paragraph (d) in order to cover situations where such a change (whether as a result of statute or case law) does not also lead on to a loss under paragraph (a) or (b). It should be noted that, in certain contexts, a change in law may be more properly regarded as a political risk event rather than true legal risk (see 6 above).

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