Commercial contracts and risk management

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- **The potential for litigation as a result of poorly negotiated contracts**
- **Managers who understand the basic principles of contracts reduce a company's risk profile**
- **The relationship between managers and lawyers and ensuring that both commercial and legal issues are managed in contracts**

Many executives in corporations sign contracts every day of the week, sometimes without fully understanding the consequences of the obligations they have committed their company to accept.

Just because one has been signing contracts for years it does not automatically mean that one has necessarily understood the nature and significance of the documents being signed.

Business people and managers deal with commercial contracts each and every day. More often than not, some do so without a basic awareness of the potential impact of much of the fine print contained within those documents.

Traditionally, much emphasis in business is placed on the process of face-to-face negotiations. However, a company's fate in any contract negotiation is ultimately determined by the *translation* of the negotiated bargain into the final contract document.

Since it is the final contract document that embodies and records these negotiations, the tables can often be turned on a 'win' achieved at the bargaining table by a combination of skilful and astute drafting on one side and a lack of attention and understanding on the other.

The outcome of litigation can often be decided by the fine print boilerplate in a contract. While many executives are intimately familiar with the *commercial* terms of an agreement, few ever feel competent to delve into and challenge the fine print.

Quite often, in business, budgetary constraints or tight deadlines (or a combination of both) prevent lawyers becoming involved at the front end of contract negotiations. In the few instances that lawyers are involved, their role is usually restricted to drafting *after* the conclusion of negotiations, or in the litigation that might eventually arise.

Whether lawyers are involved or not, every executive needs to have a fundamental knowledge of contracts.

The ever-present threat

Many executives might be tempted to think they have never yet had a problem, in total ignorance of the potential gravity of the situation in which they place themselves and their companies. It is a reminder of the tale of the person who jumped off the top floor of a tall building, who was heard to say on the way down 'nothing bad has happened to me yet…'.

Because of this lack of understanding of contract fundamentals, it can be said that some managers, quite literally, are betting the companies they work for, each time they sign a contract.

It is the duty of every chief executive to ensure that their managers have an understanding of the basic principles of commercial contracts. The end result is a reduction in the company's risk profile, which limits the potential for adverse publicity and the drain on management resources that contract disputes and litigation can often present.

Ignoring it won't make it go away

One of the greatest fears of directors is that of employees exposing the company to the risk of potentially ruinous litigation. It is a fear with a genuine foundation.

It is estimated that the cost of litigation in the USA alone is in excess of US$100 billion.

There are over 32 000 lawyers today in Australia (incidentally, Great Britain has over 101 000 and the USA has almost one million lawyers, with many more in the pipeline). Continuing demand for lawyers will result primarily from growth in the population and the general level of business activities.

As litigation lawyers become more competitive, with higher stakes involved, increasingly aggressive tactics are practised with greater regularity. Every company must, therefore, take the necessary preventative steps to keep as far away as possible from the litigation minefield. Any company exposed to litigation suffers the fears and uncertainties that are inherent in it. In addition, there is the additional negative of potential adverse publicity and loss of reputation, all of which must be considered in any corporate planning scenarios.

However, one of the most significant hidden costs of litigation is undoubtedly the unrecoverable expense incurred in lost management time; managers forced to spend inordinate amounts of time with lawyers, attempting in vain to recall 'who said what to whom' many years earlier. The opportunity cost of managers dedicating large slabs of time to litigation are difficult to measure precisely, however it is safe to say that it can be substantial. Such costs are frequently unaccounted for by corporations.

All of these consequences are the natural enemies of any business person. Adverse publicity surrounding a case can undermine the marketplace's perception of the company and, in an extreme case, can often have an adverse effect on a company's share price.

It's not all black and white

When dealing with the law, often there is no single right answer. Executives need to develop the ability to deal with the ambiguities of contract drafting and the law. Some commercial contracts can be quite complex and intimidating documents. Not all of them are written in plain English.

Therefore, a certain level of familiarity and a working knowledge of the language of commercial contracts is an essential prerequisite for managers.

Executives armed with such knowledge of contract fundamentals are better able to spot issues before they become problems. In the event of the worst occurring, that knowledge can be applied to working with the company's lawyers more efficiently and enabling executives to manage lawyers more effectively. The bottom line is a tangible saving in cost and time.

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Any lawyer-client relationship can always be improved when an executive instructing a lawyer has a modicum of knowledge of the subject.

Risk management or risk avoidance?

Many executives might argue that avoiding risk is business is impossible. This, of course, is quite correct.

However, what is vital is that any business risk be properly *understood* and *managed*. To avoid risk entirely, one should perhaps stay at home and hide under the bed (however, such a course may present its own dangers). This is why the process is called risk management and not risk avoidance: seek to understand the risks, manage them and do all that is feasibly possible to minimise those risks and their potential impact.

Selling the idea to managers

Often, the difficulty encountered in selling the benefits of any risk-prevention activity is that a company cannot recoup such investment on its bottom line at the end of the following month. On the other hand, when a company finds itself caught out by an unduly onerous contractual obligation, that should never have been accepted in the first place, money becomes no object in then attempting to deal with the problem. When faced with such situations, organisations tend to *overspend* to solve those problems.

The easiest way to sell the benefit to management is by demonstrating the effectiveness of incurring the much lower front-end cost, in order to avoid the big spend when the worst occurs. This tends to be an easier task at the apex of an organisation.

The idea of training managers in the fundamentals of contracts is not to try and turn them into lawyers, it is simply equipping them with the necessary tools to be able to make calculated commercial decisions, which have an ultimate beneficial effect on a company's risk profile.

Some managers make a conscious decision to win new business at any price. This behaviour is often pronounced when a company is tendering for new business. In that situation, a manager might be tempted to ignore the potential downside by thinking that 'everyone else is agreeing to this'.

Entering into contracts with immediate revenue benefits can ultimately prove to be a counterproductive strategy, if such contracts do not undergo proper and prudent scrutiny for areas of potential risk. This is particularly the

case where such contracts may contain onerous indemnities or consequential loss provisions, which can have a disastrous effect long after the document is signed.

The difference between legal issues and commercial issues

Issues in contracts requiring evaluation can either be legal or commercial in nature. This is an important distinction.

This distinction divides issues that need to be dealt with by lawyers and those that are commercial terms requiring decisions to be made by managers. Managers should not seek to absolve themselves from all decision-making responsibility or the consequences thereof by having lawyers sign off on everything; even on issues that are not strictly legal in nature.

A deal can be placed in jeopardy (or even be lost) when commercial people abdicate total responsibility to their lawyers or, worse still, where an overzealous lawyer decides they know what is right for the company and takes decisions on commercial matters for the client.

If a manager ever gave an over-zealous lawyer a *carte blanche* brief to exercise total control over a transaction, there is every possibility that the deal could fall apart and the commercial relationship between the contract parties be adversely affected. One example of this occurs where an overprotective lawyer (inflexibly) demands the inclusion of the most onerous warranties into a contract.

Of course, to achieve a harmonious balance, much depends upon the ability of:

- the lawyer to know which decisions are properly commercial ones for the client to ultimately make and
- the manager to properly brief the lawyer and realise where an overzealous lawyer might be overstepping the boundaries.

Taking matters one step further, everything is ultimately a commercial decision, although not always for a line manager to decide. When issues arise requiring decisions of corporate policy, they must then be referred to the organisation's apex for the final decision to be made.

Make your lawyer your friend

Some managers tend to regard lawyers (perhaps unfairly) in the same manner as Mario Puzo's character Don Corleone, in the *Godfather*, who wryly observed, 'A lawyer with a briefcase can steal more than a thousand men with guns'.

Some managers may take the view that lawyers have a desire to complicate matters by insisting on negotiating every minute point to the death. Happily, this is not the philosophy of a vast majority of commercial lawyers.

In the event that the disasters warned of or predicted by a lawyer do not eventuate, this should be music to the ears of a manager. It is indeed confirmation that the lawyer and manager have both performed their respective tasks correctly.

What must be appreciated is that the seemingly endless discussions spent hammering out what may, at the time, have seemed minute points often contribute significantly to clarifying the understanding and intentions of the parties. Reaching this level of understanding between parties can often save major headaches in the long term.

Conclusion

Miscalculations in contracts can have a lasting impact, often enduring for many years during the life of a contract.

For this reason, directors need to ensure that their managers develop a fundamental knowledge of and familiarity with commercial contracts. As a prudent risk management measure, this helps to ensure that a continual balance is achieved between winning new business and not inadvertently committing an organisation to unduly onerous contract provisions or (unwittingly) accepting an unusually high level of risk.

Most importantly, such preventative initiatives need to be *compatible* with the individual organisation's policies regarding its tolerance and comfort levels for the amount of risk it is willing to regularly and consistently accept.

As an example of organisations developing policies compatible with their risk tolerance, consider that it is indeed rare to find an investment bank that will provide an indemnity to a client for any act or omission. Indeed, many will confirm that they do not, as a matter of policy, ever give indemnities.

There are usually sound reasons behind an investment bank having such a policy (usually along the lines that they are dealing with or relying upon client-generated information as the basis of their work).

What it does demonstrate is how an organisation attuned to risk management considers its recurrent risks and formulates appropriate policies for its managers to follow. The directors of many investment banks probably feel quite comfortable knowing that its managers would not ever be in a position to unwittingly provide a client with an indemnity, without explicit sign-off from the highest level.

Frank Adoranti has written a new and innovative series of books, called Commercial Contracts for Managers, *designed to educate managers on the fundamentals of commercial contracts. They are available from www.cled.biz.*