Hyper-risk environment requires precise contract design

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Success in business is frequently determined by how effective the enterprise is at identifying and managing risks. Risk, simply put, arises from any factor, event, or occurrence that has the potential to interfere with a desired outcome. Business lawyers help their clients identify, quantify, and price each risk based on the likelihood and consequences that would result from its occurrence. No matter how much Wall Street tries to convince the market, risk cannot be eliminated. There is no such thing as an inherently good or bad risk, there are only mispriced risks.

The dynamics of dealmaking have and continue to change. With each technological breakthrough or geo-political event comes new risks that must be quickly evaluated, priced and allocated among the parties, or offboarded to insurers or other third parties. Allocation of these risks must be appropriately documented to ensure enforcement. It is more essential than ever for the business lawyer to understand his or her client's business model, industry dynamics and transaction objectives to develop a true appreciation of that client's true risk profile.

Clients generally adapt and are comfortable dealing with an array of traditional risks falling into certain buckets that include compliance, reputation, competition, operational, and now, supply chain. Information necessary to evaluate these risks is extracted through due diligence and disclosures in the form of representations and warranties from the counterparties with exceptions being set forth on schedules. Deal terms could be adjusted to respond to the disclosed risks, a process that was cumbersome but generally worked in a world where risks were static and slow changing. Consequently, parties can be lulled into a false sense of complacency wherein the formal contract is never again addressed until the contract was set to expire.

Today's new hyper-risk environment demands more nimble contracts designed for timely administration and action. New risks such as cyber-hacking that shut down production facilities; the imposition of tariffs and trade restrictions and unchecked inflation that unexpectedly spike the cost of critical inputs; travel restrictions that limit access to foreign-based consultants to repair machinery, to name a few, can quickly threaten core operations. Further complicating matters, the interconnectivity within a business's own operations and with its customers and suppliers add an additional level of complexity in spotting, containing and resolving risk factors.

The solution is to first build a dynamic negotiating framework that clearly identifies known risks, that if were to occur, could materially impact a business's model and pricing assumptions.

And, in a worst-case scenario, would that impact likely be transitory or permanent? For each risk, identify which counterparty is in the best position to prevent it from occurring and, thus, should bear all or a portion of the loss or additional cost should the risk materialize. In some instances, the parties may be able to shift the risk to a third party, such as an insurer, with the focus of the negotiations pivoting to how much coverage to acquire and who will pay the corresponding premium.

Whether dealing with traditional risks or new, novel risks, two considerations are frequently overlooked:

- Any issues that went wrong must be fixed immediately. Assigning blame and financial responsibility can wait, but a business's customers and limiting the harm to its name and reputation cannot. Clearly establishing this principle in the agreement is as critical as defining the process the parties will follow in escalating issues. Determining how problems will be resolved is worth the time in negotiations. When it matters, it matters.

- The ability to properly evaluate and price various risks depends on timely access to accurate information. Decide what information is needed and which party has it. If your counterparty has access to the information, your contract should provide you with

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immediate access to it, especially during a crisis situation.

The dynamic and ever-changing nature of risks in commercial contracts requires adopting business protocols that move signed contracts from the back shelf to the front, with a commitment to periodically review, revise and enforce agreements, if necessary. Doing so enhances predictability and increases reliability between the counterparties.

The goal is to ensure that contract provisions align with reality and provide clear economic and financial incentives (and disincentives) to lessen the risk or severity of disruptions. In doing so, negative outcomes when a risk turns pricey can be mitigated by a sound working relationship with your counterparty. In the end, failing to communicate timely with your counterparty when you see signs that change is on the horizon may be the biggest risk factor to your business.

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