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Managing the Legal Risk of a Business Client

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Abstract:

Purpose: *The purpose of the article is to analyze legal risk management in the context of business customer service. The definition of legal risk, its external and internal factors and its potential consequences for businesses are discussed.*
Design/Methodology/Approach: *Two approaches to risk management - traditional (siloed) and integrated (ERM) - are presented, indicating their application depending on the size and specifics of the organization. The role of the lawyer as a business partner in risk minimization and the importance of a systemic approach to legal risk management are highlighted.*
Findings: *The results of the analysis indicate that the effectiveness of legal risk management depends on the model adopted and its adaptation to the needs of the enterprise.*
Practical Implications: *The article will serve business and legal industry representatives.*
Originality/Value: *This article presents a self-prepared methodology for managing legal risk in business, based on my own experience. The analysis conducted creates a broad view of the client service perspective. It is focused on demonstrating the role of lawyers in ensuring legal security for businesses.*

Keywords: *Legal risk, legal services, risk minimization, risk management systems.*

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1. Introduction

Legal risk is a significant challenge in corporate operations, affecting both day-to-day operations and long-term business goals. In an era of dynamic regulatory changes and increasing complexity of business transactions, legal risk management is becoming a key component of organizational strategies. The article attempts to define legal risk, identify the factors affecting it, and analyze the approaches used to manage it, with a focus on traditional and integrated management systems.

On this basis, it also outlines the role of the lawyer as a partner in business, supporting entrepreneurs in minimizing legal risks and building competitive advantages. The purpose of this paper is to outline effective tools and strategies in the area of legal risk management in the context of serving business clients.

2. The Concept of Legal Risk

The definition of risk, according to the PWN dictionary, is "*the possibility that something will fail"* and also *"an undertaking whose outcome is uncertain*"[2] . In general, then, risk refers to some threat that may contribute to losses as a result of some process. Importantly, risk itself refers to its final stage. Thus, to bear a risk (provided it is conscious) is to accept all negative consequences when taking it. This can apply to a very wide range of activities and refer to many human processes, including management.

For the purposes of this article, this risk should be narrowed down to a specific group, which is legal risk. It does not have its legal definition in Polish or European law. The meaning of this expression should be sought in the literature, as well as in industry studies. In particular, concerning the banking sector, which bears all sorts of uncommon risks, including precisely this one in legal terms.

As the Financial Supervision Commission points out in its document titled. "BION in banks - map of risk classes and their definitions," legal risk is *"the risk related to changes in law and regulations, compliance with them, and enforceability of contracts and related liability"*[3] . It seems that this definition is very concise and sufficient, although not fully complete. Analyzing the literature from this angle, one cannot pass by the definition of legal risk in the view of P. Zapadka[4], R. McCormick[5] or M. Iwancz - Drozdowska[6].

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[2]*PWN Dictionary, https://sjp.pwn.pl/sjp/ryzyko;2518509.html.*
[3]*KNF document:*
https://www.knf.gov.pl/knf/pl/komponenty/img/banki_mapa_ryzyk_25314.pdf .
[4]*P. Zapadka, Managing legal risk, Gazeta Bankowa.*
[5]*R. McCormick, Legal Risk in the Financial Markets, Oxford University Press, Oxford, 2006, p. 105, 107, 113.*
[6]*M. Iwanicz-Drozdowska, Bank risk management, Poltext, Warsaw 2012, p. 75, 78.*

The authors of these publications indicate their reasoning for this formulation, but P. Zapadka does it most accurately. He states that: *"legal risk can be defined as the probability of incurring material and intangible losses, arising, among other things: as a result of erroneous or late drafting or enactment of legal regulations; instability of legal regulations; changes in jurisprudence; erroneous formation of legal relations or unfavorable decisions of courts or public administration bodies resolving disputes arising against the background of legal relations of a given organization with other entities*"[7].

To this should be added the clarification made by the Basel Committee on Banking Supervision, which indicated in the New Capital Accord (Basel II) that *"legal risks include, but are not limited to, fines, criminal sanctions or punitive damages arising from the actions of supervisory authorities, as well as from private agreements*"[8].

In the absence of a legal definition, and with a very broad understanding of the meaning of legal risk, it is necessary to properly narrow down its understanding. This is necessary to accurately and adequately understand the management of such a process and identify ways to minimize it.

Therefore, combining academic and industry studies, for the purposes of this article, it should be considered that legal risk is the potential possibility of incurring financial losses due to changes in laws or supervisory regulations, incompatibility of internal regulations of financial institutions with external standards, difficulties in the execution of contracts, and consequences arising from judicial and administrative proceedings.

Here it is important to emphasize the essence of financial risks, to focus on issues related to the enforceability of contracts and the compliance of internal regulations with the law. In addition, in this context it is also extremely important to point out the risks arising from the settlement of legal disputes and decisions of administrative bodies.

3. Factors Affecting Legal Risks

Entrepreneurs who run their businesses face all kinds of risks on a daily basis, including legal risks. The success and success of the entire business depends on how they manage and make final decisions. Regardless of the industry, however, risk among entrepreneurs undoubtedly exists. It depends on the "risk factor". This means "*process-specific characteristics indicating the possibility of an event, action or*

[7] P. Zapadka, Legal risk in the activities of commercial banks - selected issues, Banking Law, No. 3, 2007a.
[8] Basel Committee on Banking Supervision 1997, p. 24.

inaction that promotes the occurrence of risk"[9]. The literature usually distinguishes two basic categories of risk factors: external and internal. T. Wetzinski and P. Krasinski point out that external factors are sources of risk originating outside the organization, over which the entity has no direct influence.

Examples include political, macroeconomic, market, liquidity, inflation, or interest rate risks. Such factors also include changing customer needs, changes in legislation or external pressures on the organization. Internal factors, on the other hand, are those that are closely related to the operation and structure of the organization.

They can arise from such elements as the level of experience and competence of management, the qualifications and number of employees, the quality of products and services offered, and the type, number and scale of financial operations conducted.[10]

The above risks, both external and internal, translate into specific subcategories of legal risks, which are detailed by P. Zapadka:[11]

- **Loss risk** - refers to the possibility of operational losses or loss of assets that may arise from unforeseen events related to the organization's operations.
- **Litigation risk** - refers to situations in which an entity becomes a party to legal proceedings, which may result in an unfavorable ruling, exposing it to financial losses or other negative consequences.
- **Risk of misinterpretation** - means the possibility of incorrect interpretation of common law, which can lead to wrong decisions and related legal consequences.
- **Legislative risk** - is associated with unfavorable changes in existing laws that may affect the operations of an entity, resulting in the need to adapt to new regulations.
- **Compliance risk** - includes risks arising from inconsistencies between an entity's internal regulations and applicable laws and regulatory guidelines. This risk is particularly significant in the banking sector, but also applies to other industries.
- **Reputational risk** - is associated with the deterioration of an entity's image in the eyes of the public, which can negatively affect its

[9]*Supreme Audit Office, Glossary of Control and Audit Terms in Public Administration, Warsaw 2005, https://www.nik.gov.pl/plik/id,3364.pdf (accessed: November 27, 2024), p. 18.*
[10]*T. Waściński, P. Krasiński, Risk in the activity of the enterprise - elements of systematics and identification, [in:] Zarządzanie ryzyka działalności organizacji, ed. J. Monkiewicz, L. Gąsiorkiewicz, C.H. Beck, Warsaw 2010.*
[11]*P. Zapadka, Legal risk management, Gazeta Bankowa, 2007b, April 16-22.*

relations with stakeholders, market position and financial performance.

4. Legal Services

Legal risk analysis should be carried out to the fullest extent possible, especially at the strategic level of company operations. This means that these risks must be taken into account in the long-term planning of activities and decision-making that have a key impact on the operation of the company. Regular legal consultations are important in this regard, helping to identify and prevent potential risks.

While companies may be inclined to save money on the services of legal advisors, skipping such consultations can lead to much more serious and costly consequences, such as litigation, administrative fines and loss of reputation. Therefore, taking care of legal support at the risk analysis stage should be considered an investment in the company's stability and security, and not just an additional expense.

Legal knowledge and experience can be essential to accurately and reliably analyze an entrepreneur's legal risks. Such a lawyer (or team of lawyers) can support the company primarily in two ways. First, it can be a permanent or *ad hoc* cooperation with a law firm or attorney's office on a lump sum or hourly rate basis. In this case, it is the provision of outsourcing services, most often in the field of legal advice, preparation and review of contracts or litigation.

The second variant of legal services for entrepreneurs is the involvement of a lawyer (most often a legal counsel, due to the possibility of his employment on the basis of an employment relationship) inside the company. This is legal advice under the so-called in-house service. This term, derived from English, refers to a lawyer permanently employed within the structures of a given enterprise. Unlike lawyers working for external law firms, whose services are used only when needed, such an in-house lawyer is part of the organization and supports its legal activities on an ongoing basis.

Without going into the details of the differences between the two models, it should be noted that outsourcing reduces costs and leverages the expertise of outside firms, but limits project control and requires effective communication. The in-house model, on the other hand, provides a better understanding of the organization's needs and greater flexibility, but comes with higher team retention costs and the potential difficulty of attracting experienced staff. The choice should depend on the company's priorities and long-term goals.

5. Legal Risk Management

Effective legal risk management requires a strategic approach that integrates the analysis of potential risks with the day-to-day operation of the business. A key

element in minimizing risk is the development of internal procedures governing how transactions are carried out and controlling their compliance with applicable regulations.

An important aspect is to document all arrangements in writing to avoid disputes arising from the lack of formal evidence of agreement. To increase legal security, verbal agreements should be recorded immediately, and conversations regarding transactions conducted over the phone should be recorded on electronic media. Standardization of model agreements and their regular updating, combined with training for employees, significantly increases the efficiency and consistency of the legal risk management process.

Each transaction also requires detailed legal verification of the parties involved. The company should make sure that counterparties have the proper authorization to enter into contracts and perform certain actions, including providing guarantees or assuming other legal obligations. This approach avoids misunderstandings and potential legal sanctions.

The reduction of legal risk is also facilitated by the implementation of product programs that tailor contract terms to the specific needs of the company, taking into account factors that can affect the financial flows associated with a given transaction. This allows the organization to accurately identify and minimize risks associated with specific projects.

In the context of international contracts, it is crucial to specify precisely which country's law governs a contract and to include an arbitration clause in standard contracts. Settlement of disputes by arbitration courts minimizes the time and cost of proceedings, while ensuring binding and final decisions.

Finally, the company should conduct a systematic analysis of current and potential legal conflicts to prevent their escalation to the level of litigation. This approach makes it possible not only to avoid costly litigation, but also to build a more predictable operating environment.

6. Lawyer as a Partner in Business

Today's legal risk management in customer-business service is to identify and master potential litigation situations as quickly as possible, at the earliest possible stage. Given the current realities of the Polish court system, the worst solution for a company is to move a dispute to the court stage.

Staggered court hearings and trials, time-consuming preparation of expert reports, appeal instances, and above all, the uncertainty of winning - all this is the last resort for business. Today, running a business is all about acting quickly and efficiently. The same is expected of lawyers. Sometimes it is better for an entrepreneur to reach

a settlement or agreement than to get into a court dispute. Although such a compromise may not always fully satisfy him, because, for example, he will not recover the entire amount owed to him, the speed and certainty of the money recovered will compensate for the years of waiting and uncertainty in litigation.

The situation described above shows that legal risk management now comes down more to a conciliatory advisor than an attorney fighting battles in court. Lawyers, must act as a partner that supports the company at every stage of its operations. Especially in those industries where transactions are sometimes complex and risky. With such activities, relationships based on trust and cooperation are key. A lawyer should be a partner that the client can rely on, especially in difficult cases.

7. Legal Risk Management Systems

Based on general risk management theories, two main approaches can be distinguished: traditional (siloed) and Enterprise Risk Management (ERM) integrated risk management.[12] In the context of legal risk, the traditional approach is to separately manage different aspects of risk, such as regulatory compliance, contract enforceability or potential litigation.

Each of these areas is analyzed independently, which can lead to overlooking the links between different risks. In practice, such a way of handling legal services for an entrepreneur is revealed on the basis of external cooperation with an attorney or legal counsel as part of his law firm's activities.

In contrast, the ERM concept postulates comprehensive management of all legal risks, taking into account their interdependencies and impact on the company's strategy. When applying this method, the lawyer or legal team is an integral part of the company's internal structure. Only in this way can he comprehensively implement integrated procedures and monitoring systems that allow him to quickly identify risks, analyze their impact and take coordinated preventive action. This approach also promotes better use of legal resources and minimization of negative consequences resulting from non-compliance with the law or unfavorable legislative changes.

The ERM concept is particularly important in legal risk management, as it enables effective coordination of activities between different company departments, while ensuring consistency in the implementation of compliance strategies and protection against unforeseen legal consequences.

[12] *U. Malinowska, Characteristics of key concepts of enterprise risk management, [in:] S. Kasiewicz (ed.), Integrated enterprise risk management in Poland, Wolters Kluwer, Warsaw 2011, pp. 63-79.*

It is believed in the literature that the ERM concept is seen as more effective and yielding better results compared to the traditional risk management approach.[13] However, it seems that the success of such a system depends on the size of the company. The larger it is, the better systems for minimizing legal risks can perform. It is hard to expect a micro or small enterprise to have the same risks as a huge corporation.

To confirm the above, cite the example of the regulation of the whistleblower protection system, which from September 2024 imposes new obligations on businesses. As a rule, companies employing (cooperating) with at least 50 people are required to implement internal notification procedures.

This proves that the introduction of such a system to minimize legal risks is justified in those larger companies with dozens of employees. Then it is required to define clear and transparent procedures in case of violations in the company, followed by an in-depth and systemic analysis of the irregularity in question. The legislator in this case probably considered that smaller companies can minimize such risks based on a traditional management system, based on an *ad hoc* response to a case.

When comparing the two methods on the ground of business client legal services, it is impossible to say which is better. However, it seems that traditional, siloed risk management will work better for smaller entrepreneurs, while integrated management will work better for large entrepreneurs and corporations.

8. Conclusion

Legal risk management is integral to the effective operation of businesses, especially in the face of increasingly demanding regulations and the growing uncertainty of the market environment. Legal risk analysis requires a strategic approach, including both the identification of potential risks and the implementation of appropriate preventive procedures.

The article points out that a traditional approach to legal risk management may be sufficient for smaller companies, while integrated management (ERM) offers greater effectiveness in larger organizations where risks are more complex. A key role in this process is played by the lawyer as a business partner, supporting the company in taking informed and effective preventive measures.

The conclusions of the analysis indicate that the choice of an appropriate legal risk management system should be tailored to the specifics of the enterprise, its size and the nature of its business.

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[13] *R. Sasin, Evolution of the ERM concept, [in:] S. Kasiewicz (ed.) Integrated Enterprise Risk Management in Poland, Wolters Kluwer, Warsaw 2011, pp. 98-113; J. Lam, Enterprise Risk Management. From Incentives to Controls, John Wiley & Sons, New Jersey 2014.*

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