

# Managing documentation risk

Andrew Balfour of Slaughter and May takes an in-depth look at document risk and asks why this potentially damaging subject receives such little attention.

Document risk is, perhaps, one of the potentially most damaging risks that corporate treasurers have to face. It is, however, a type of risk that receives little attention. This article is intended to go a small way towards rectifying the lack of writing on the subject. It seeks to define the concept of documentation risk, then goes on to consider some of the implications of the risk. Finally, it will seek to address ways in which the risk can be managed.

## What is documentation risk?

Documentation risk can be divided into three categories:

- the risk that a legal document is not valid and binding;
- the risk that a legal document does not say what one or other party believes it should have said; and
- the risk that a legal document does not address adequately, or at all, a situation that arises.

These risks can be present in a transaction documented by a single legal agreement or in more sophisticated transactions where there may be a multitude of agreements. In this case there is the further risk that the agreements do not work together.

The risk of invalidity is perhaps the most extreme example of documentation risk. This possibility was displayed most vividly in the case of swap transactions with local authorities. Following the court decisions in the Hammersmith & Fulham case it became clear that swap transactions entered into with local authorities were *ultra vires* and void. Counterparties to those transactions incurred significant losses.

The risk of invalidity is, thankfully, relatively small in most commercial arrangements. It is, however, always present. A transaction involving two companies may be invalid if one of

other of those companies does not have the necessary capacity to enter into the transaction, if either of them has not gone through the necessary approval procedures in accordance with its memorandum and articles of association or if the final legal document has been signed in an incorrect manner. English law goes some way to protect counterparties from this type of risk. Comfort may be obtained from the provisions in the Companies Act protecting third parties who rely in good faith on companies with which they are dealing. There are also extensive common law rules concerning individuals capable of being relied on as authorised to enter into transactions on behalf of companies.

The risk nevertheless remains. The more unusual a transaction the more important it becomes to ensure that it is properly authorised. It is also particularly important to consider issues of capacity and authority when dealing with non-corporate or foreign entities. As the Hammersmith & Fulham case demonstrated, failure to take necessary precautions can be extremely costly.

The second aspect of documentation risk is the risk that an agreement does not say what the parties intend. This can arise for a variety of reasons:

- the contract is based on standard terms and those terms have not been reviewed;
- the resources available to a contracting party are such that no proper review of an agreement has been carried out;
- the drafting of an agreement is so convoluted and difficult to understand that it has not been evident to the contracting party that the terms do not reflect its intention; and
- as a result of poor communication between a lawyer and client, the client has misunderstood the implications of a term in the contract.

These risks are very real and occur frequently. The most significant risks are not those which arise from standard terms of business (because they usually reflect a common market practice) but in those cases where there is a tailor-made contract. In these cases it is essential that a party to the contracting process should manage that process in an optimum way to reduce risks materialising. This involves ensuring that proper legal advice is obtained at the right time concerning the drafting of the contract. More importantly, however, it is essential that there is proper liaison between the lawyer and the commercial party. This liaison must result in a full understanding of the commercial transaction by the lawyer and an appreciation of the drafting of the contract by the commercial party.

All too often the process is obscured and problems arise, either because the lawyer does not have a grasp of the commercial transaction or because the commercial party believes that he or she can leave the drafting of the contract to the lawyer. This is a recipe for disaster. Lawyers who are left to their own devices in preparing contracts will prepare contracts which may be entirely satisfactory from a legal point of view,



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but may bear no resemblance whatsoever to what the parties intend their transaction to be.

The final type of documentation risk involves agreements that do not cover a situation which arises between the parties. Lawyers often get blamed for producing documents that are too long. The reason for the length is, in many cases, a desire to cover as many 'what ifs' as possible. This may be a useful exercise in allocating risks between the parties, but judgement needs to be exercised as to what it makes sense to include and what can reasonably be left out. Leaving out too much can lead to trouble later if an agreement fails to address a situation arising in practice.

### **Managing documentation risk**

The variety of risks under the heading of documentation risk means that there is no single tool that can address all the potential concerns. There are, however, systems which can be put in place to minimise the risks.

The key part of dealing with documentation risk is that someone in an organisation needs to have responsibility for addressing it. This role can be centralised or diversified. The important thing is that there is a clear understanding that documentation risk is not always someone else's problem.

The role of the person taking responsibility for managing documentation risk is, in relation to a particular transaction, to ensure that:

- a decision is taken about the need, or otherwise, for legal assistance;
- if it is required, suitable legal assistance is obtained at the right time and from an appropriate source; and
- there is a rapport between the legal and commercial side so that the contract reflects the intention of the parties and all issues are properly addressed.

The manager of documentation risk can be greatly assisted if the agreements used for a transaction are drafted in straightforward English and where the basis of a document is a commonly used market standard or template.

Use of straightforward or 'plain' English in drafting contracts is, thankfully, becoming much more common. Documents that can be clearly understood by non-lawyers are much more likely to be reviewed by the commercial

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parties and, when they are reviewed, discrepancies between the documents and the proposed transaction are more likely to be spotted. For too long lawyers have assumed that documents need to be an end in themselves (always a dangerous result) and their clients have assumed that it is safe to leave the drafting to the lawyer, even if that lawyer has no 'feel' for what is meant to be happening in the transaction.

The use of harmonised documentation is also likely to reduce documentation risk. Commercial parties which are familiar with documents that are regularly used in the marketplace are much more likely to understand the way in which those documents work. There is, of course, the added advantage that the use of standardised terms reduces the time taken to review documents and is likely to produce a greater degree of consensus as to what is acceptable and unacceptable in the negotiation process. Negotiations are, in any event, likely to be more productive. There is no need to spend time fine-tuning relatively unimportant clauses if those clauses are in a commonly used document. This focuses attention on the more significant clauses and time can be taken to ensure that these are right.

**The most significant risks are not those which arise from standard terms of business, but in tailor-made contracts**

Care must be taken, however. The use of standardised documents must not lead to the assumption that the terms 'must be right'. If this happens the use of those documents will increase documentation risk. Each transaction and each party to a contract will have its own specific requirements. These need to be reflected in the terms of an agreement whether it is based on a standardised set of terms or it is tailor-made.

The use of standard terms is not new. It is an ongoing process. From a corporate treasurer's point of view the use of the ISDA contracts has, for many years, been a major feature of all derivative transactions. The complexity of these contracts has, perhaps unfairly, been viewed as a disadvantage. They are, nevertheless, very widely used and have meant a common approach has been possible in relation to number of difficult issues.

A more harmonised approach to loan documentation is also about to begin. The Loan Market Association has launched its template for loan agreements in the London market. Some may view this development as a dangerous one. It could mean that borrowers (or banks) who want to follow a particular path in their documentation will find it more difficult than before. The potential benefit overall is, however, considerable. When the template is used banks and borrowers reviewing draft loan agreements will be able to concentrate on those areas where a draft agreement departs from the template. There should be no presumption against departing from the template; the point is that much less time need be spent reviewing and negotiating a document when the review and negotiation can be focused on the most important topics.

Like many other types of risk, documentation risk is likely to become much better understood in the future. Corporate treasurers will be in the forefront of the process because documentation risk is part of their everyday business. With better understanding will come better management and more sophisticated means of dealing with the risks. As with other types of risk, documentation risk should not be seen only as a problem, but more as a challenge which needs to be managed and sensibly addressed. ■

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