



# UNIT-10

## Legal & Political Risk Management

### Learning Outcomes

**By the end of this unit the learner will be able to:**

- ✓ Explore different types of legal and political risks encountered by businesses
- ✓ Discuss the essentials of a valid contract
- ✓ Outline benefits of legal risk management

## Unit 10

# Legal & Political Risk Management

## Introduction

For a business, legal risk may be defined as failing to: understand its legal obligations, operate within the law, have evidence to prove that it operates within the law, honour contractual agreements, recognise and effectively manage legal threats or agree on remedies for compensation with a supplier in the event of default.

The sources of risk embraced within the term *legal risk* are considerable and include, but are not limited to:

- Losing legal disputes because of inadequate record keeping;
- Infringing environmental legislation;
- Inaccurate information in terms of misstatements, material omissions, or misleading opinions;
- Breach of copyright;
- Senior management time or business being *lost* through drawn-out legal disputes;
- Prosecution for law infringements;
- Legal disputes with overseas trading partners arising from issues like misunderstandings due to difference between local and overseas law; and
- Damage to corporate reputation from a prosecution or a dispute with a customer, partner or supplier.

## Benefits of Legal Risk Management

Businesses benefit from legal risk management by:

- Encouraging a more detailed review of contracts entered into, both overseas and locally.
- Reducing management and external support time involved in legal disputes.
- Ensuring greater contractual, regulatory, and statutory compliance; and
- Reducing the risk of reputational damage.

## Implementation of Legal Risk Management

Establishing a comprehensive risk management system will depend on a number of issues like:

- Having major contracts reviewed by legal representatives prior to completion;
- Understanding the legal framework within which the specific business operates;
- Retaining legal representation;
- Ensuring that effective legal defence against challenges is available;
- Having accurate annual reports and accounts;

- Complying with copyright, trademark, and patent laws;
- Ensuring that client confidentiality requirements are met;
- Before releasing new products into existing and new markets, current product laws must be reviewed;
- Ensuring systems and processes adhere to employment law; and
- Making sure employees understand the principles they must observe when fulfilling their roles and duties; providing training and monitoring where needed.

### **Business Law**

In order to understand possible sources of legal risk arising from business activities, the basic features of the English legal system must be understood. Take note that English law deals with the law as it applies to Wales and England only. Scotland and Northern Ireland have their own legal systems. This unit is concerned exclusively with English law.

### **Classification of Law**

English law is commonly divided into categories because they are convenient divisions of the law. The categories are not very rigid and may overlap. There are also differences of opinion as to the category into which some areas of the law fall. The principal categories of law are public and private law.

### **Public Law**

Public law deals with the relationship between the state and its citizens. This involves three key areas:

- Constitutional law relates to the British constitution and involves issues like the position of the Crown, central and local government functions, parliamentary composition and procedures, citizenship and the civil liberties of individual citizens;
- Criminal law is about the types of offenses which pose such a severe threat to the good order of society that they are defined as crimes against the whole community. Such anti-social behaviour is deemed an offence against the state by criminal law and offenders are generally prosecuted. The state is responsible for finding, prosecuting, and punishing any offenders; and
- Administrative law involves resolving complaints made by citizens against the decisions of administering authorities like government agencies, which deal with state pensions, child benefits, and income support.

### **Private Law**

Private law deals with the rights and duties of individual people towards each other. The legal process is initiated by the aggrieved citizen, in contrast to criminal law.

### **Civil and criminal Law**

Civil and criminal law can be distinguished very clearly.

## Criminal Law

Criminal cases are called prosecutions and are primarily initiated by the state. Only rarely will they be brought about by private citizens. The accused or the defendant is liable for punishment if the prosecution is successful. There is no direct benefit to the victims of the crimes as they do not receive any fines paid or any benefit from a criminal's labours in prison. However, it is now possible for the criminal courts to make reparation payable directly to the victims under the Powers of Criminal Courts Act 1973.

## Civil Law

Civil actions are different in that the cases are heard in a civil court and they are brought by individuals known as the plaintiffs, who seek compensation for the losses they have suffered through the actions of the defendant. The plaintiffs will be successful if they can prove their case on the balance of probabilities; i.e. the evidence weighs more in favour of the plaintiff than of the defendant. If the plaintiff wins a case, the defendant is said to be liable. If this happens, damages are awarded that are payable to the plaintiff. The damages are normally assessed on the basis of compensating the plaintiff rather than punishing the defendant. A plaintiff does not have to launch a civil action and can stop the process at any time before judgement is made. Many of the laws affecting businesses and businessmen fall under civil law, particularly the property, contract and tort laws.

## Companies

### The Memorandum of Association

The Companies Act 1985 and the Business Names Act 1985 together comprise a system for regulating the business names of companies. A private company, whether limited by shares or guarantee, must use the word *limited* at the end of its name, while a public company must end its name with *public limited company*. Private companies limited by guarantee can apply for exemption and may then remove the word *limited* from their names. The Act awards automatic exemption if the conditions are met.

A new name for a company will not be accepted by the Registrar if the same name already exists on the index of names, although similar names may be registered. The Trade Secretary will not register a name if it is, in their opinion, offensive or if its publication would be a criminal offence. The *Bank of England* has to approve any name which includes *bank* in its title. The *Charity Commission* must approve the use of *charity* or *charitable* in a company's name. The Act states that the company's full name must be displayed in an obvious place and in readable form in the following: outside of the registered office, on all business premises, on documentation such as business letters, receipts, invoices, cheques, orders for money or goods, notices, and all official publications.

### Articles of Association

A company may have its own Articles or adopt Table A of the Schedule to the Companies Regulations 1985. Articles must be printed, divided into consecutively numbered paragraphs, and signed by each

subscriber to the memorandum in the presence of at least one witness. When registered, the articles and memorandum are a contract which binds the company and the members as if signed and sealed by each member. The members are bound to the company by the provision of the articles. In the same way, the company is bound to the members in respect of their rights. The articles can be changed or added to by a special or written resolution subject to certain restrictions.

### **The Issue of Shares and Debentures**

The Companies Act dictates that the directors of public and private companies may issue shares without the members 'express authorisation. Generally, the authorisation is given by the members by ordinary resolution at a company's general meeting. The authority may be given for specific allotment of shares or it may be a general power limited for a maximum period of five years.

### **The Official Listing of Securities**

The *Financial and Services Act 2000* assigns express liability to those responsible for listing the particulars for misstatements, material omissions and misleading opinions. The Act only requires *financial condition* information. This is information that investors and their professional advisers would need in order to make an informed evaluation of the company's financial position, its assets, liabilities and prospects. The remedy provided is for individuals who experienced loss to sue for financial compensation. With regard to civil claims, the Act sets out who can be held responsible for all or some of the listing particulars, such as the issuing company and its directors, and anyone who expressly takes responsibility for part or parts of the particulars like an expert who authorised the contents of the particulars or part of them. However, this does not preclude a plaintiff from suing for fraud or misrepresentation under the Misinterpretation Act 1967.

### **Duties of Directors**

The relationship between a company and its directors is that of principal and agent. As such the directors or agents stand in a fiduciary relationship to their principal or company. The directors owe a duty of care at common law not to be negligent in dealing with the company's affairs. Fiduciary duties require that directors use their powers for the proper purpose, i.e. for the benefit of the company. They may not take benefit from the company by taking secret profits.

The Companies Act does not dictate the standard of skill and care which a director must bring to the company. Thus, when remedies are sought, case law is referred to. Where non-executive directors have no business qualifications or experience, they are only required to *do their best*. Non-executive directors who have the relevant qualifications and/or experience in business are expected to exercise reasonable skill and care as may be expected from a person of their professional standing and/or experience.

Executive directors like financial directors are employed for their expertise in company matters as stated in their contracts of service. Generally, there is an implied term in the contract of service that the director will exercise the reasonable skill and care which someone in his position should to have.

## Intellectual Property

Intellectual Property Rights (IPRs) are becoming more important as most advanced industrial economies progressively become *knowledge based*. Companies need to enforce their rights in this area to prevent the value of their intellectual property being destroyed. Intellectual property can be an extremely valuable business asset but becomes a clear risk to any business that does not use the law to protect it.

Intellectual property refers to a product or process that is marketable and profitable because it is unique. This *uniqueness* is protected by *patent law*, which provides protection for inventions of a technological nature. *Copyright* law protects literary, musical, and artistic works, amongst others. The law of *trade mark* and *service marks* protects the use of a particular mark used in trade. Articles that are mass-produced but distinguished from others by a registered design which appears on them are protected by the *registered designs* law. The law also protects a business from competitors who maliciously belittle their products or who pass off their products as those of another business. Protection is also given to businesses with regard to the use of confidential information by employees. The Copyright, Designs and Patents Act 1988 and the Trade Marks Act 1994 are the main laws dealing with these issues.

## Copyright

Copyright is a type of protection provided to authors of original works of authorship. These include:

- original literary works – novels, lyrics for songs, instruction manuals, and computer programs – some types of databases and newspaper articles;
- original artistic, dramatic and musical works – maps, logos, paintings, engravings, photographs, sculptures, songs, collages, works of architecture, technical drawings, diagrams, and stage productions;
- published editions of works;
- sound recordings which may be recordings on any medium; and
- films including videos and broadcasts

The 1988 Act allows the owner of the copyright the exclusive right to reproduce the copyrighted work, to distribute copies of it, to prepare derivative works and to perform or to display the copyrighted work publicly. The copyright protects the form of expression rather than the subject matter of the item. Copyright does not protect ideas, for example, a description of a machine could be copyrighted, but this only prevents others from copying the description. They would still be able to write a description of their own or make use of the machine. The Act does not require the copyright owner to register it or to follow any formalities in respect of it.

## Ownership and Duration

The owner of the copyright is the author of the work. However, there are situations where copyright of work performed by an employee on behalf of the employer actually resides with the employer. Therefore, copyright is an issue featured in the contract between a management consultant and employer.

## **Infringement**

Copyright infringement occurs when someone has copied another individual's work and an action can be brought for an injunction and/or damages, or for a share of the profits made from the wrongful use of copyrighted work. No statutory defences to copyright infringement exist, although there are common law defences. Under the Copyright, Designs and Patents Act 1988, authors are given certain moral rights which are independent of copyright which provides protection alongside a copyright. This is useful for an author who sells the copyright to someone else.

The right of paternity includes the right to be identified as the author and should be claimed by the author. The right of integrity gives the author the right to object to changes to their work by additions, alterations, adaptations, or deletions, which is commonly known as mutilation or distortion of the work. A different angle is seen where the right of attribution gives a person such as an author, the right to prevent a work which they have not produced, from being attributed to them. An author is entitled to an injunction and damages when their moral rights have been infringed

## **Designs**

A design right is like a patent but addresses the look, colouring, shape, texture, and/or materials used for a product. Therefore, a design refers only to the features, shapes or patterns of an article by an industrial process which is judged solely by looking at the article e.g. the shape of a Coca Cola bottle. It is now possible to register the Coca Cola bottle as a trade mark under the Trade Marks Act 1994.

## **Registration**

Designs should be registered at the Patent Office (Designs Registry) under the Registered Designs Act 1949 (as amended by the 1988 Act). Registration initially affords the owner of the design protection for five years. By paying further fees every five years, this protection can be extended for four additional periods of five years, thus, for a total of 25 years in all.

## **Infringement**

The registered design owner's rights for infringement are to obtain an injunction, sue the person responsible for damages, demand delivery of the infringing copies, and/or request an account of profits made from the wrongful use of the design.

## **Employment Law**

Companies have to comply with employment law when employing staff and failing to do so can lead to prosecution. The usual principles of contract law apply which means that there must be an offer and an acceptance in a contract of employment, which is in effect the agreement. The intent to create legal relations, payment terms and proper consent by both the parties must be in the contract. In other words no mistake, misinterpretation, duress, or undue influence is present nor is the contract illegal. A contract can be made orally and does not have to be written, although specific minimum written particulars must be given to the employee according to the Employment Rights Act 1996.

These particulars must be provided to all employees within two months of starting work, unless there is a written contract containing all the relevant terms between the employee and employer. Apart from this, an employer must prepare and revise, when necessary, a statement of his policy regarding the health and safety of his employees and preparations for carrying out the policy to meet requirements of the Health and Safety at Work Act 1974. An employer also has other duties in respect of dismissal procedures, payment, holiday and sick pay, time for antenatal care, maternity leave under certain conditions, and many other obligations. Companies are at risk if the employment law is not understood and obeyed and it is now very all-encompassing and far more complex because of the European Union.

## Contracts

This section will address the legal framework controlling the supply of services and goods.

### Essentials of a Valid Contract

The essential ingredients of a valid contract are:

- **Capacity:** The parties must be legally able to enter into a contract;
- **Legality:** The agreement should not be illegal or conflicting to public policy;
- **Intention:** The agreement must have intended to have legal consequences;
- **Agreement:** An agreement is when one party accepts an offer from another party;
- **Consideration:** The involved parties must show that their agreement is part of a bargain; each side must promise to give or do something for the other;
- **Formalities:** At times there are specific formalities which must be observed; and
- **Genuineness of consent:** The agreement must have been freely entered into.

Only a contract which meets all these requirements is said to be valid. If one of the parties fails to meet their part of the agreement, they can be sued for breach of contract. If an essential element is missing, the contract can be made unenforceable, void, or voidable.

### Types of Contracts

There are two broad categories of contracts, simple and specialty contracts. Simple contracts are not deeds or informal contracts and may be in any form, oral, in writing or be implied from an individual's conduct. On the other hand, specialty contracts dictate that the signature of the person making the deed must be witnessed and attested. It must be obvious on the face of the document that it is intended to be a deed.

### Criminal Liability in Business

Extensive criminal controls are applied to supplier activities. Criminal law impacts the supplier of goods and services in the following ways:

- Descriptions of goods and services, which are wrong;

- Misleading price indications about goods and services;
- Safety of consumer goods; and
- Safety and quality of food

### **“Misdescriptions” of Goods and Services**

The Trade Descriptions Act 1968 (TDA) prohibits the use of false trade descriptions in the course of a trade or business.

The main offences defined by the TDA are:

- Applying a false trade description to any goods, or supplying goods to which a false trade description is applied.
- Knowingly or irresponsibly making a false statement in respect of the provision of services, accommodation or facilities.

### **False trade Description of Goods**

- In the course of trade or business: An offence can only be committed by someone in the course of a business or trade;
- Strict liability: Prosecution needs to establish two important requirements. Firstly, that a prohibited act has been committed (actus reus) and secondly that the act was intentional and thus the person was of guilty mind (mens rea). However, some offences do not require mens rea for a prosecution;
- False trade description: A trade description is an indication, direct or indirect, and by whatever means given as defined by the Act. This includes issues like quantity, size, composition, gauge and method of manufacture;
- Applying a false trade description: Descriptions include labels, packaging, oral statements and advertisements. The Act governs the way in which a description may be applied to any goods;
- Supplying and offering to supply goods to which a false trade description is applied: The Act states that a person exposing goods for supply or having goods in possession for supply shall be deemed to offer to supply them, which means that the displaying goods in a shop window or on a supermarket shelf is a contractual offer to sell; and
- Disclaimers: Case law stipulates that for a disclaimer to be effective it must be as bold, precise and compelling as the trade description itself and must effectively be brought to the attention of any person to whom the goods may be supplied.

### **False trade Description of Services**

The TDA states that it is an offence for any person in the course of any trade or business to make a statement which he knows to be false or to recklessly make a statement which is false with regard to the following issues: the nature of any services; the provision of any services, accommodation or facilities; the location or amenities of any accommodation provided; the time at which, the manner in which, or

persons by whom such services etc. are provided and the examination, approval or evaluation by any person of any such services.

The following points are important about false trade description of services:

- **Statements:** The Act deems statements about existing facts as significant, but not statements which are promises about the future;
- **Requirement of mensrea:** This subject is covered by two sections of the Act. First, the prosecution must prove that the defendant made the statement knowing it was false. Second, the prosecution must prove that the defendant made the statement recklessly;
- **Services, accommodation, and facilities:** The Act does not define these terms explicitly; therefore, interpretation can only be achieved through studying case law. Services may refer to a doctor, facilities might refer to a car park and accommodation might refer to bed and breakfast; and
- **In the course of any trade or business:** According to the Act, the offence cannot be committed by a private individual.

### Misleading Price Indications

The Consumer Protection Act 1987 (as opposed to the Trade Descriptions Act 1968) dictates the terms of false and misleading statements regarding prices. Section 20(1) of the Act dictates that an individual is guilty of an offence; if they give an indication by any means whatsoever to any consumer which is misleading as to the price at which any goods, services, accommodation or facilities are available in the course of any business of his.

When dealing with the offence of misleading price indicators, the following aspects should be noted:

- **Consumers:** The Act defines consumers as individuals who might use the goods, services, accommodation, or facilities other than for business purposes;
- **In the course of any business of his:** An offence can only be committed by a person acting in the course of a business of his. Thus this wording limits the scope of the offence to the business owners. Employees acting in the course of their employment cannot be prosecuted for misleading price indications;
- **Price:** The Act defines price as the total payable amount, as well as, any method of determining the total amount to be paid;
- **Misleading:** A list of situations in which the prices or the methods for determining the price will be considered misleading as provided for in the Act;
- **Services or facilities:** The Act itemises the following in the definition: the supply of electricity, off-street car parking and holiday caravan parks, credit, banking or insurance services and the purchase or sale of foreign currency. Services and facilities excluded are facilities for a residential caravan park and services provided by an employee to their employer by an authorised person or appointed representative under the Financial Services Act; and

- **Accommodation:** Part III of the CPA applies to short-term accommodation, such as new freehold homes for sale, homes on lease for more than 21 years, hotels and holiday flats and the fees charged by estate agents. Homes being rented out are not covered.

### Product Safety

The General Product Safety Regulations 1994 and Part II of the Consumer Protection Act 1987 provides the legal framework for dealing with issues regarding unsafe products. The General Product Safety Regulations 1994 implements the provisions of the EC Directive on General Product Safety. They impose regulations in respect of the safety of products intended for consumers or likely to be used by consumers where such products are placed on the market by producers or supplied by distributors. The following aspects should be taken into account:

- **Scope of the Regulations:** The Regulations relate to products intended or likely to be used for consumer use, which have been supplied in the course of a commercial activity. A commercial activity is defined as any business or trade transaction. A consumer is an individual who is not acting in the course of a commercial activity. Regulations apply to new, used or reconditioned products. Products used for commercial activities, even if for or by a consumer, are not the subject to these Regulations. Regulations are not applicable for the following kinds of products: products supplied for repair or reconditioning before use; second-hand products deemed to be antiques; products that are covered by specific provisions of EC law which deals with an aspect of safety and products that are subject to specific provisions of EC law covering all aspects of their safety;
- **Producer:** The regulations define a producer as a manufacturer established in the EC. Where the manufacturer is not established in the EC, his representative or the importer of the product; or other professionals in the supply chain who are identified but only to the extent that their activities might affect the safety of the product;
- **Duty of distributors:** A distributor must assist producers in complying with the specified safety requirements. More specifically, if dangerous products are supplied, then a distributor will have committed an offence;
- **Enforcement of penalties:** The Regulations are enforced by Great Britain's Weights and Measures authorities. Where food is concerned, food authorities are responsible for enforcement;
- **General safety requirement:** The Regulations dictate that a producer may not place an unsafe product in the market. Failure to comply with the general safety requirement is an offence;
- **Safe product:** A safe product is defined in the Regulations. A product will be safe if there is no risk or the risk has been reduced to a minimum during normal or reasonably foreseeable conditions of use (including duration). Any risk must be compatible with the product's use, considered acceptable and consistent with a high level of health and safety protection;
- **Information requirements:** Regulations expect a producer to provide information for consumers to help them to take precautions and assess inherent risks. This is only expected where the risks are not immediately apparent without adequate warnings;

- **Defence of due diligence:** An individual can show that he took all reasonable steps and exercised all due diligence to avoid committing the offence in order to defend himself when accused of an offence under the Regulations; and
- **By-pass provision:** The Regulations provide a by-pass provision to be able to prosecute a person if in the course of a commercial activity, his act or default causes another to commit an offence.

### Computer Misuse

Although companies are protected against computer misuse through legislation like the Computer Misuse Act 1990 which came into force on 29 August 1990, this is only a deterrent. Trying to get a prosecution is like closing the stable door after the horse has bolted since the damage to customer loyalty, reputation, relations with business partners or income is already done, and prosecution provides little comfort. Computer misuse has become a global problem with activities such as hacking or virus infections being initiated beyond British shores and thus outside the reach of their laws.

### Unauthorised Access to Computer Material

Knowingly causing a computer to perform functions with the intent to secure unauthorised access to programs or data held in a computer is an offence. This basic offence criminalises activities of both, internal company employees who knowingly use a computer outside the limits of their authority (e.g. an irate employee wanting to harm their employer or an employee obtain information which would be useful when joining a new employer) and external *hackers*, who gain access to computers using the public telecommunication system. The offence is summarily prosecutable and punishable by a maximum of six months' imprisonment or a fine of £5000. This is a really trivial fine when considering the level of harm that a company can experience.

### Unauthorised Access with Intent to Commit or Facilitate Commission of Further Offences

To commit an unauthorised access offence with the intent to carry out or facilitate the commission of any serious offence is an offence that is prosecutable by magistrates or the Crown Court. These serious crimes could include blackmail and theft and carry the maximum sentence of five years or more. This offence could cover a situation in which a *hacker* obtains unauthorised access to a computer system, intending to hijack funds during an electronic funds transfer. If convicted, the maximum penalty for this offence is an unlimited fine or five years' imprisonment.

### Unauthorised Modification of Computer Material

Internationally causing unauthorised modification of the contents of any computer with the intent to impair a computer's operation, or to prevent or obstruct access to any programme or data held in a computer, or impair the operation of such a programme or the reliability of data is an offence. This offence covers interference with computer programs and data by means of deleting or altering material or by introducing computer viruses. The magistrates and Crown Court can try this offence which is punishable by an unlimited fine and a maximum of five years' imprisonment.

## Legal Risk Management

In the current business climate legal risk management affects just about every company, specifically highly regulated public businesses like healthcare organisations and banks.

A robust risk management plan and structure enables the company to:

- Make better business decisions;
- Reduce lawsuits;
- Improve safety;
- Achieve best practices;
- Improve asset management; and
- Meet regulatory compliance standards, which, in turn, attracts better insurance premiums, protects the company reputation and improves overall profitability

The expense of creating a risk management plan is always less than the potential costs of a company not managing its risks. Banks are particularly under pressure to use risk management as a popular management tool. Compliance risk management is easily demonstrated in the banking sector, which is under pressure to be transparent for all stakeholders (see further case studies below).

For example, in relation to securities, the board should:

- Identify conflicts of interest relating to their client inter-relationships, holdings or potential holdings;
- Define clearly a company's corporate hierarchy to enable better understanding of their entire global exposure and securities structure; and
- Define the interrelationship between securities, their issuers, related subsidiaries and affiliates.

### Analysis of Risks: Key Questions

A risk management system should have clearly defined risks which are aligned to the business objectives so they can be reviewed with other business information like financial performance, and used to impact decision making.

When risk commentators analyse risks, they ask several key questions:

- What factors influence the possibility of the risk arising?
- What information is there about historic incidences of the risk?
- What pointers or warning factors can be identified which will indicate that the risk is more likely to arise?
- What information is useful to anticipate the incidence or impact of the risk e.g. publicly available financial information about suppliers or contractors?
- When the risk occurs: how long after the event does the risk become less likely?
- What value is lost if the risk does arise?

- What are the costs of alleviating the risk if it occurs?
- How will we know when the risk has occurred and who would have this knowledge?
- How much awareness of risk is reflected in current decision making?
- Who has the most experience of evaluating how much the risk will impact the organisation or has the most experience in handling the risk once it has arisen, internally and externally?

The management of risks should be integrated across the business in order to be really successful. In other words, the evaluation and management of individual risks arising in one part of the business should become part of the programme for addressing risks across the whole organisation. This is because the impact of different risks can be multiplied if they happen simultaneously. For example, the impact of the IT systems failing may be compounded if it coincides with the launch of a new product or service. An effective risk management strategy should identify and manage all the inter-relationships.

In the same way, the management of risk must be integrated into the processes and policies for managing the business as a whole. It should be used to inform decision making alongside more traditional information, such as financial performance.

The SERM Approach found that the impact of risk management techniques will be undermined if they are not consistent with the approaches and policies applied elsewhere in the organisation. For example, a risk-based methodology for pricing projects with potential long-term liabilities may have little effect if it is contradicted by remuneration policies that reward short-term financial performance on the part of particular individuals or units.

## Political Risk

### Introduction

Political risk is the uncertainty that stems in whole or in part from the exercise of power by governmental actors and the actions of non-governmental groups (Zonis and Wilkin 2001). This definition applies to both domestic and international markets, although it more often applies to overseas markets, mainly in developing countries. Political risk can also develop from national and local government inaction or direct action of both, national and local governments.

Examples of inaction could be failure to issue required permits or government failing to enforce local legal provisions. Examples of direct action include: contract frustration, currency inconvertibility, tariffs, tax laws, seizing assets, or restricting profits leaving or entering the country. The definition also includes sources of political risk, such as political instability, politicised government policy and political violence. Political risk may also arise from increased credit risk if the government changes policies in a manner that makes it difficult for the company to pay creditors.

There are two broad categories of political risk often identified, called *macro political* and *micro political* (Griffiths and Wall 2005).

They may also be called country-specific and firm-specific political risks, as described below:

## Macro-Political Risks

Macro-political risks possibly affect all businesses in a country. Threats may come from intense actions, such as terrorism, civil war, or a coup d'état or military takeover. These risks may result in the government seizing the organisation's assets without compensation. However, the more common macro-political risk specific to a country arises from the possible threat of adverse economic circumstances which leaves a company unsure of the security of a planned future investment if a project has commenced and concern over the ultimate financial performance of the organisation. Economic recession with less overall demand for a broad range of products; higher general levels of inflation or taxation, escalating crime and labour disputes are all examples of incidents which may adversely affect all companies.

## Micro-Political Risks

Micro-political risks only affect specific companies, industries, or types of ventures. These risks may be due to new regulations or taxes imposed on specific types of businesses in the country. However, this picture is changing as Kobrin (1997) points out that the *new* political risk is likely to involve multiple companies and multiple governments where business partners are caught between three, four or five governments with different policy objectives and economic philosophies.

In addition, he describes the emergence of an asymmetry between international business and international politics. He explains that the existence of this asymmetry arises from the emerging mode of business organisations and the nature of politics. While politics is still organised geographically in terms of territory and borders, a business organisation is no longer confined by national boundaries.

In order to survive fierce competition and rapidly developing technology, IBM, Siemens and Toshiba have joined forces to pool knowledge. Because of this, organisation centres, borders and hierarchies are no longer relevant. Without the normal headquarter/subsidiary hierarchy and clarity over the nationality of the business (is it American, German, or Japanese?), what controls can be imposed by which governments? Future political risk will become more complex if this type of alliances become commonplace, e.g. how will taxation be managed?

While this isn't a complete list, it does provide an idea of some of the common sources of risk.

Additionally, each geographical area will have its own unique risk profile.

## Types of macro and Micro Political Risks and their Impact on Businesses

### Macro-Political

- Recession;
- Reduction in market share;
- Loss of sales and future profits;
- Inflation or hyperinflation;
- Higher operating costs;

- Disrupted production;
- Increased costs of production;
- Increased managerial costs;
- Military insurgence, coup d'état, civil wars, or other politically motivated violence;
- Property destruction;
- Lower productivity and interference with production;
- Higher security costs;
- High staff turnover;
- Public campaigns against foreign goods;
- Reputation damage;
- Higher public relation costs to recapture the market;
- Danger of product contamination;
- Bureaucratic incompetence;
- Government changes, which results in new fiscal policies;
- Government policies on credit payments;
- More stringent legislation, new or revised;
- Protracted approval processes;
- Increased taxation;
- Lower after-tax profits;
- Corruption;
- Inability to pay creditors;
- Delays in getting products to market;
- Expropriation, confiscation, and nationalisation of industry or project;
- Economic losses;
- Terrorism or kidnappings;
- Currency devaluations/depreciation;
- Reduced valuation of repatriated earnings;
- Currency revaluation/appreciation;
- Less competitive in overseas markets and in competing against imports in the local market;
- Restriction on repatriation of profits; and
- Breach of contract and contract frustration

#### **Micro-Political**

- Politically motivated violence (e.g. against the petrochemical or pharmaceutical industry);
- Industry-specific taxation;
- Lower after-tax profits;
- Tariffs and quotas;

- Volumes;
- Disruption to production;
- Disruption to research and development;
- Higher security costs; and
- Difficulties retaining staff

### **Benefits of Political Risk Management**

Political risk management provides the following business benefits:

- Ensures that a proactive and methodical approach is taken when evaluating alternative investment opportunities based on analyses of different geographical markets set in different political contexts;
- Provides an additional means to evaluate return on investment;
- Causes more rational decision making when considering alternative choices;
- Produces concrete mitigation actions to reduce investment exposure; and
- Ensures a more holistic approach to risk management.

### **Implementation of Political Risk Management**

Implementing a robust political risk management system will depend on the following issues:

- Acquiring political risk management capabilities;
- Understanding the sources of political risk;
- Obtaining intelligence on the market that the company wishes to penetrate;
- Knowing the historical and social environment of the country in which investment is planned; and
- Understanding the support which is available from British government agencies.

### **Contracts**

Organisations often face many political risks that threaten the profitability of a transaction when they enter into contracts with private overseas entities or foreign governments, for either the purchase or supply of goods or services. Situations that may prevent fulfilling a contract, which occurs before or after shipment or delivery of the contracted goods, and before, during, or after completion of the contracted services. Below are the most frequent types of contract risk events.

Contract frustration prior to the shipment or delivery of goods:

- Legally granted import or export licences being cancelled or laws inhibiting import or export of goods being implemented;
- Where the party is a government entity, it can unilaterally cancel the contract; and
- Outbreak of a new war or civil war preventing the contract from being completed.

Contract frustration after shipment or delivery of goods:

- When contract disputes occur, a government buyer or bank may not honour an arbitration judgement in favour of the exporter in accordance with the arbitration procedure outlined in the transaction contract;
- Despite the private local buyer depositing the agreed amount in equivalent local currency with the foreign exchange authority, the authority fails to transfer the full amount in the contract currency to the exporter; and
- Government entities, who refuse to pay

### **UK Government Fiscal Policy**

The British Government influences the economy to accomplish its four main goals which are:

- full employment;
- favourable balance of payments;
- stable prices; and
- economic growth

The government implements policies to affect total demand in the economy in order to accomplish these goals. Fiscal policy involves changes in taxation and government spending. Taxes can be direct and taken directly from income, e.g. income tax or corporation tax, indirect and placed on goods and services like VAT, or progressive, such as taking a higher proportion of income as income rises. Government spending includes transportation and communication, social security, health, education, defence, public order, safety and housing, and community amenities.

### **Pressure Groups**

Pressure groups are organised groups of people with similar interests who attempt to influence others, usually governments and large corporations. Business development overseas may be exposed to pressure groups. These groups vary in size, ranging from international organisations such as Friends of the Earth, Greenpeace, and Amnesty International, to far smaller local groups concerned only with matters affecting their community that exist just for the lifespan of one specific issue.

The success of a pressure group's effort depends on the level of public, financial and political support they have, and their ability to assemble themselves. Reactions from the more well-known pressure groups can to a degree be foreseen, depending on the planned business investment in terms of whether it is unique or following a well-worn path. However, the groups that form just to oppose or restrict a single situation are harder or impossible to forecast.

### **Terrorism and Blackmail**

Many products are vulnerable to accidental or deliberate product contamination due to malice, or for financial or political gain, particularly products like food and drink, cosmetics, pharmaceuticals, and tobacco. These threats are increasing and attract a lot of media attention when they occur, which, in turn, have a disastrous impact on the product or brand name. Having to recall and replace the damaged

products and the resultant loss of sales and additional advertising costs to regain the public's confidence and to rehabilitate the brand name incurs significant costs for organisations.

Mobile and permanent facilities located in emerging markets are susceptible to terrorist attacks, wars or other forms of politically motivated violence, and result in physical damage to these assets. More frequent outbreaks of military conflict are occurring around the world, not only in less developed countries but also in industrialised nations, like the unrest in former Yugoslavia. Along with this, acts of terrorism which are targeting transport systems or the corporate sector rather than military or diplomatic locations are also on the rise.

### **Managing Political Risk**

A common criticism of political risk analysis is that it usually takes place too late when projects are already under way (Griffiths and Wall, 2005). This is reinforced by Zonis and Wilkin, who cite a common problem of businesses taking a reactive approach to political risk (Zonis and Wilkin 2001). They go on to say that such businesses usually end up with a political risk management strategy that emphasises damage control. However, these strategies are very expensive. Political risks tend to be easier to handle before they evolve into full-blown crises.

Organisations, which rely on damage control strategies, after an event need to employ experienced management consultants, solicitors and ex-diplomats to limit losses and protect shareholder value. However, these expenses may be futile as once political decisions have been made, they are hard to reverse because credibility and public confidence are at stake. In addition, there are no standard techniques, such as control charts that can be used to minimise political risk (Eppen, 2001). A more effective approach is that management time and effort is directed at political risk assessment at the start of projects before investing overseas.

Companies can reduce risk in the following ways:

- Develop a risk friendly investment environment by establishing good relationships with the local workforce. Foreign businesses are often seen as have uncaring managers who do not care about their workers. This can have dire consequences. One of the best ways to protect a company's assets is to generate a loyal workforce. Managers can be replaced more easily than the workforce;
- Ensure proper planning and due diligence. Despite there being ways to protect a business against political risks, too many businesses begin working in other countries without having ensured a better-than-average chance of success. Developing solid relations with relevant governing authorities is the preferred approach, but this may not always be possible;
- Only investing in projects or entering into contracts where the host government has adopted policies which encourage private sector involvement, especially where risk mitigation and risk transfer is promoted. Longstanding policies can be trusted more since once introduced, such measures are less likely to be repealed;

- Invest in projects where the host government has made clear and explicit statements to provide support for the type of investment being made, especially if linked to some form of guarantee;
- Procure insurance against political risk. National export credit agencies (ECAs) provide this to their exporters within limits. In the UK this is the Export Credits Guarantee Department;
- There are now more political risk insurance (PRI) providers with greater capabilities than ever before and PRI can be obtained in the private market, from such multinational companies as Marsh & McLennan Companies Inc., the Aon Corporation and Willis. One or more of the private-sector PRI providers can assist a company's needs be it for general coverage against expropriation, currency inconvertibility, or political violence, or policies tailored towards specific circumstances. Organisations must obtain coverage before a problem occurs as it will be difficult to obtain after the fact. The World Bank and their Multilateral Investment Guarantee Agency can offer more extensive cover. PRI has become very important for lenders following the Asian financial crisis and sovereign defaults by Russia, Indonesia, and Pakistan;
- Entering into hedging contracts to protect themselves against fluctuations in interest rates and currency exchange rates. These are financial devices used to reduce losses caused by future price movements;
- Beefing up on-site security to protect against terrorist attacks; and
- Incorporating strong arbitration language into contracts to address labour disputes.

The best protection is for a company to be aware of what is happening in its host country. Although this may sound obvious, it is easy to lose sight of the bigger political picture when absorbed in operational aspects. It is often too late to do anything about an operating environment after it has changed. Always maintain contact with the local embassy and chambers of commerce, since a collective voice is more powerful than that of an individual company, even if it has a strong relationship with governing authorities.

### **Assessing**

Unfortunately, there are no standard techniques available to reduce political risk. Progressive companies tend to use tools such as decision analysis based on decision trees and scenario analysis to help them appraise the risks associated with a given business opportunity. By using available mathematical models and fast computing capability, corporations can reduce the impact of uncertainty and improve the decision-making process.

The type of political risk that investors are exposed to depends on the type of investments in which they are engaged i.e. direct or portfolio category. Generally, portfolio investors are affected by macro-political risks, such as, a sudden increase in interest rates or unanticipated currency devaluation.

On the other hand, direct investors investing in individual businesses tend to be affected more by business-specific risks. They need to focus on political dynamics that affect the overall business environment in a host country. When assessing political stability, the focus should be on the legitimacy

of the state authority, the ability of that authority to impose and enforce decrees, the level of corruption that pervades the system of authority and the degree of political fractionalisation that is present (Wagner 2000). For investors, effective political risk management requires them to differentiate between incidents that pose true risks that are well-defined threats to business performance from political events and media headline grabbing events.

### **Prioritising Political Risk Factors**

Political risks can be prioritised once they have been identified and evaluated in terms of their probability and impact. This ensures that management energy is used in the most efficient way. One method of communicating the varying possible impacts of political risks to a management team or board is through a risk map or a risk register, where the risks have been recorded in descending order. Using visual representations which allow information to be readily and quickly assimilated is preferred by board members as a strategy to reduce time needed to prepare for board meetings.

### **Improving relative Bargaining Power**

Some businesses try to gain a stronger bargaining position in the country within which they are operating to overcome political risk. For example, an organisation may attempt to create a circumstance whereby the government loses more than it gains by taking action against the interests of the business. This is possible when the organisation has technical expertise that will be lost to the country if it chooses to move to another country to avoid new regulations. This bargaining power is increased if the business has integrated as much as possible with the local economy so that it actually becomes part of the host country's infrastructure. The car industry is a good example as it generally uses local labour, suppliers and subcomponent manufacturers. Thus, if it moves, the local economy is hit hard through loss of employment, loss of employee spending and a loss in sales for manufacturers and suppliers.

Risk management techniques that can be used are: cultivating good relations with the host government and other local political groups; developing good employee relations with the local labour force; producing the product locally as much as possible; conducting local research and development; developing joint ventures and hiring local people to manage and run the operation. These techniques will highlight the benefits of the corporation's presence within the country for the government of the host country not to interfere in the business's activities, as the losses for the local communities would be dire.

### **Further Reading:**

- ✓ *Political Risk Management for the Global Supply Chain 1<sup>st</sup> Edition, (2021), By Ralph L. Kliem*
- ✓ *Political Risk: Facing the Threat of Global Insecurity in the Twenty – First Century Kindle Edition, (2018), By Condoleezza Rice, Amy Zegart*
- ✓ *The Art of Legal Risk Management: A Guide to Managing Legal and Corporate Risk Kindle Edition, (2019), By Bryan E. Hopkins*