Jankus
LEGAL

Suite 4, 191 Melbourne Street
NORTH ADELAIDE SA 5006

phone: 1300 729 113
website: www.jankuslegal.com.au

THE LAW SOCIETY OF SOUTH AUSTRALIA
GOLD
ALLIANCE FIRM

Using Contracts to Manage Business Risk

Contracts help allocate risk; and it is up to the parties to the contract to negotiate who will bear what risk. From a business point of view, a contract should address at least the following types of risk:

- Market risk
- Financial risk
- Operational Risk
- Regulatory Risk

There is no way that business can eliminate all risk, but an acceptance of some risk is be required. How much risk the business will tolerate is a question for the company's Board of directors or the owners.

1. **Market Risk**

Market risk is associated with the price movements in the market. Movements in price can occur when a new product is introduced, raw material costs change, production methods change, exchange rates vary etc.

A good contract will anticipate such price changes and prevent the parties from being locked in to an unprofitable deal resulting from price changes. Clauses that allow prices to change over time (e.g.' CPI increases); "rise and fall" provisions; and price reviews to market are examples of market risk management.

For example:-

- you do not want a long term commitment to buy products at a particular price if a change in consumer preferences means that you cannot sell your product at a profit;
- in construction contracts where it may be some time before materials are to be purchased and a price guarantee for materials cannot be secured, or where price swings are common a rise and fall clause will allow you recover cost increases as you incur them;
- Landlords will structure rent reviews so that at given intervals, perhaps every three years, the rent will be reviewed "to market" so that the landlord is not locked in to renting at a price below market.

As always, it is a function of the parties to the contract being able to identify the risk to them and negotiating an outcome that is fair on both parties.

If the parties contemplate that a given event will make the entire contract unprofitable for one party, then a clause may be required allowing that party to bring the contract to an end if the defined event occurs.

2. **Financial risk**

Financial risk refers to the risk associated with financing, including interest rate changes and loan defaults. It is also the risk to be considered when your business borrows or lends money or provides goods or services on credit terms.

Careful consideration of the terms of any loan contract or security document is required. Early repayment, default provisions, the release of security and personal guarantees are just as important to consider as the interest rate, term and principal sum being advanced.

Where credit is being given by a business, consideration should also be given to any guarantees of performance or payment. Questions to consider include is a guarantee necessary? Is the person or organisation giving it a person with assets behind them? What security has been offered?

3. **Regulatory risk**
Regulatory risk refers to the risk that changes in legislation will affect your business and its operations. Often, these are completely beyond the business' control.

This paper contains general advice only and may not be suitable for your particular circumstances. Before using it you should obtain personal professional advice.

Some regulatory changes might make it impossible for the business to continue to meet its contractual obligations (as, for example, those activities are now illegal) and the contract will be at an end.

Alternatively, new legislation may impose an additional burden on one of the parties (for example OH&S, new taxes etc.). In those cases the contract issues are what steps are necessary for compliance and whether additional compliance costs can be passed on.

Sometimes existing laws must be complied with before the main obligations under the contract can be performed. In those cases a condition precedent will be required.

In the construction arena, a condition precedent to obtain council approval may not be contentious; however, the question of who has to do the work and who has to pay might be. There will also be the issue of what will occur if the approval is not obtained.

4. **Operational risk**
Operational risk is often managed using policies and procedures which can minimise day to day operational failures that will cause a loss to the business.

For example, contracts can require contractors to be informed of and comply with a business's OH&S policies to prevent operations from being bought to a standstill if an accident occurs. Enforcement of this compliance obligation is essential and the contractor agreement might contain an indemnity to compensate the business should the contractor fail to follow such policies.

Service guarantees are another type of operational risk to be managed. A common example of a service guarantee is the ability to obtain an extension of time in a construction contract.

If service guarantees are in your contract, it is important that the impact of events outside your control is addressed and that compliance is excused or modified if those events occur. If the performance delay occurs because of something beyond your reasonable control, is the force majeure clause going to be of assistance?

Of course, compliance or operational checklists are an inexpensive and invaluable internal resource to manage operational risk.

As Murphy's Law says – *If something can go wrong, it will* but by recognising this and knowing the potential impact of the risks that the business has agreed to take, that risk can be mitigated or even eliminated.

In the end you probably cannot have a contract that works in your favour in all areas – which is why the risk allocation concept comes about. But, as a business person, it is your role to determine which risks the business can and will bear and which it cannot.

This publication is regularly updated.
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enquiries@jankuslegal.com.au

Suite 4, 191 Melbourne Street, North Adelaide SA 5006
Phone 1300 729 113