6 Management of Counterparty Risk

6.1 Introduction

Counterparty risk is normally understood as the risk that the other party fails to fulfil its contractual obligations. Managing the firm’s exposure to counterparty risk means managing the principal-agency relationship with the firm as principal and its contract party as agent.

**Forms of counterparty risk.** It is possible to distinguish three basic forms of counterparty risk on the basis of how they are mitigated. According to the definitions used here, the basic forms of counterparty risk are counterparty corporate risk, counterparty commercial risk, and counterparty credit risk. Different forms of counterparty risk will typically be mitigated in different ways.

*General counterparty risk.* General counterparty risk means the risk that the other party to the contract for any reason fails to fulfil its contract obligations. This can also be caused by legal reasons.

*Counterparty corporate risk.* Counterparty corporate risk is caused by the fact that the other party is a legal entity. For example, questions of the existence of the counterparty, its capacity to enter into the contract, and the power of its representatives to bind it belong to counterparty corporate risk.

*Counterparty commercial risk.* Counterparty commercial risk is the risk that the other party fails to fulfil its obligations for commercial or operational reasons. Questions of the commercial ability or willingness of the counterparty to fulfil its contractual obligations belong to counterparty commercial risk.

*Counterparty credit risk.* The firm is exposed to credit risk if the firm has advanced value in exchange for a promise to pay at a later date. Counterparty credit risk is the risk that the debtor will, for whatever reasons, not fulfil its payment obligations when due. Counterparty credit risk is a combination of counterparty corporate risk, counterparty commercial risk, and other risks that may influence the fulfilment of payment obligations. It will be discussed in the context of payment claims (Chapter 10; for debt contracts, see Volume III).

*Effect of legal aspects.* Legal aspects influence counterparty risk in two ways. Some counterparty risks can be regarded as transaction-specific legal risks (counterparty corporate risk). Other counterparty risks are affected by contributory legal risks (counterparty commercial risk, counterparty credit risk).
6.2 Counterparty Corporate Risk

6.2.1 Introduction

Counterparty corporate risk is caused by five core problems: (a) Does the other party exist as a legal entity? (b) Does it have legal capacity to enter into the agreement and perform its obligations under the agreement? (c) Do the people who act on the other party’s behalf have legal power to bind it? (d) Has the other party taken all necessary (internal) corporate action for it to be bound by the agreement? (e) What company is the right contract party or responsible for the performance of the contract party’s obligations where the other party in reality consists of many companies that form a company group or otherwise form one business undertaking? The firm should know these things about its counterparty, but the firm should ask itself the same questions.

These questions arise from the basic legal characteristics of the business corporation and are therefore governed by corporate laws. In order to provide legal security and reduce information costs both for third parties and for corporate agents (i.e. people who act on behalf of or in the name of a legal entity), corporate laws typically limit freedom of choice. In particular, there can be overriding rules of attribution of the exchange of information and acts to a legal entity (Volume I).

6.2.2 Community Law and Member States’ Laws

Introduction

Community law and Member States’ laws influence counterparty corporate risk in many ways. Community law and Member States’ laws have addressed questions such as the existence, recognition, capacity, and representation of companies as well as the law governing these issues.

The Right Contract Party

The quality of the firm’s contract party is a question of counterparty commercial risk (section 6.3). The identity of contract parties is a question of counterparty corporate risk. The identity of contract parties can be unclear in two ways. The

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2 See also ibid, p 16.
3 See, for example, ibid, p 21. “… the constitution of a company may impose limits on the contractual power of a company’s board that even its own directors fail to notice and, in any event, the action necessary to override certain limits can be far from clear.”