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Disaster Prevention In Deals

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The transaction started out with a straightforward idea—some set of relationships, rights, and obligations—a loan, a lease, a partnership, an acquisition, or some other commercial real estate transaction. Everyone thought it was a great idea at the time, or at least the right thing to do, or at least better than the next best alternative.

Then time passed. Agendas diverged. "Great relationships" became less great. Eventually, the transaction descended into a dispute. And when the transaction participants and their new counsel actually dredged the documents out of the drawer, they didn't match up to what everyone remembered and expected. In fact, they were full of surprises.

Viewed under the crisp magnifying glass of a dispute or potential litigation, the documents supported one interpretation, but there were also other interpretations. The documents had gaps where they "should have" covered issues that seemed "obvious" and "fundamental."

Lawyers wrote long memos analyzing how a court would or should or could interpret the documents. It wasn't easy. The documents were murky, sometimes even incomprehensible. They addressed the same issue in eight different ways in eight different places, sometimes with incredibly nuanced possible interactions. Yet the documents all sounded very legal and very authoritative throughout.

If the parties didn't actually settle their differences, i.e., resolve the uncertainty in their deal by writing checks adjusted for the magnitude of the uncertainty, and they actually went to court, then it was anyone's guess how it might turn out.

A judge might apply the documents in accordance with their literal terms, even though that couldn't possibly reflect what anyone really meant or expected, but judges haven't necessarily closed similar transactions. Or the judge might parse through the language from an entirely different perspective and reach an interpretation that seemed unimaginable. Or the judge might look at the "big picture," and figure out who was misbehaving and trying to take advantage of the situation and claim an unexpected windfall. At the end of the day, almost no one was happy with how it turned out. And the costs of getting there were extraordinary.

These events play out with an unfortunate frequency in real estate and other transactions, creating ample work for courts and for lawyers who litigate, and for people like me, who are sometimes called upon as expert witnesses to explain "what the parties must have meant" and the commercial context for documents that aren't as clear as perhaps they should have been.

What can transactional lawyers (also like me) and their clients do when they close their deals to try to avoid creating all that work for the courts, litigators, and expert witnesses? How can one prevent all these problems at the outset?

One might start by doing less – creating less paper, less complexity, and keeping relationships simple where possible. The more words and the more pages a document has, the more room they create for some imperfection to creep in. That's especially true if, as part of the complexity, the documents address the same issue, or related issues, in multiple contexts and locations randomly strewn throughout the document. What are the chances all of those various provisions will all match up and play well with one another? Surely not always 100%.

Simplicity and a logical structure not only make a document easier to understand and negotiate and live with over time; they also decrease the likelihood of mistakes and problems.

Modern deal documents often devote vast amounts of verbiage to minor and unlikely hypothetical possibilities. That's where a lot of the complexity arises. Those nuances may be important, but they are not as important as the fundamental main issues staring everyone in the face.

Clients and their attorneys would do well to not lose sight of those fundamental main issues – dumb things like the interest rate in the promissory note; the space that the tenant will actually occupy; the dollars in a rent schedule; or including a "consent" in a document that is supposed to evidence someone's consent to something. In documents that I've reviewed for expert testimony and other assignments, I've seen problems and fights arise over deficiencies in all those issues and others just like them.

Usually, as a pretty good mistake prevention technique, one can start by following the money. That means actually recalculating and reconfirming the numbers in the documents. And where words seek to define future numbers, don't assume those words work they should, even if they sound like they work.

In one document I reviewed, for example, the "waterfall" in a joint venture agreement was extraordinarily complex. It was written with exquisite care and precision. It was very authoritative. It was full of cross-references and adjustments to reflect allocations of cash that took place at other levels of the waterfall or elsewhere in the document.

The waterfall was, however, fundamentally wrong. It gave someone a significant share of the joint venture's income at a stage when that just didn't make any sense. But mere mortals had failed to identify the problem during negotiations and drafting, thanks to the opacity of the wording. Someone should have run some more test cases, just carefully applying the words of the document to different possible outcomes of the investment. Better yet, someone should have figured out a way to totally blow up, simplify, and rewrite the waterfall so that mere mortals could follow exactly what it did.

Simplicity is great, if it's achievable. It often isn't. At least we assume and believe that. In those cases, another key to preventing surprises lies in controlling the negotiation and closing process.

Today, we all know lawyers can get documents turned and deals closed faster than ever, so the result is deals move faster than ever. That doesn't always work well when combined with complexity. It works particularly badly when a deal keeps changing as it hurtles down the track. And if the documents are written like most "sophisticated" documents, with eight different provisions in eight different places addressing many issues, each change in the deal requires recrafting provisions and their interactions from top to bottom of the document and perhaps some others. It is a recipe for imperfection. One imperfection is all it takes for a document to become the basis for a dispute.

In an ideal world, the business negotiations would end when the legal work starts. But any legal issue can, if not resolved, become a business issue. Fundamental terms change as the transaction proceeds. And the closing process, particularly due diligence, often discloses concerns that require more negotiations. The process continues until closing.

As one way to move along a transaction while preventing mistakes, the parties to the transaction ought to try to identify any issues or disagreements as early as possible, then resolve them and move on. The longer an open issue festers, the longer it creates uncertainty and the risk of last-minute changes in documents; and last-minute changes are particularly likely to introduce mistakes. Merely keeping track of, and devoting time, to issues that remain gapingly open often gets in the way of, and can even sidetrack, the further work needed to get the deal done.

Sometimes a transaction participant thinks it's a good negotiating technique to keep issues open to trade them for other issues or to maintain tension. Maybe that's true sometimes. If so, one should still balance that benefit against the benefits of closure and reducing the risk of imperfections in the documents. If possible, one should try to get the "open issues" game played out earlier rather than wait until the last minute.

When a long-term transaction, such as a lease or a joint venture, unfolds after the closing, certain types of provisions in the documents seem particularly likely to cause problems, at least in my own experience. Those provisions often involve future pricing or payment formulas of any kind; possible future changes in the deal based on future circumstances, good or bad; and standards for performance. In each case, the documents need to put into words something that may cause great pain or pleasure to one party or another depending on future circumstances.

Often, provisions like these are essential and cannot be avoided. In such cases, one can maybe minimize trouble by keeping these provisions as direct and straightforward as possible, so that anyone who reads them can understand them without enlisting a team of experts. But it's also a good idea to enlist that team of experts to play out actual cases and see what happens. If it's an appraisal adjustment, for example, will the appraisers be able to understand and apply it? Ask them. But also ask the nonappraisers if they can comprehend the words. If they can't, try rewriting them again.

Another common cause of trouble relates to what I call the "reality connection"—making sure that whoever's negotiating and writing the documents knows what they need to know about the actual real estate underlying the transaction. One can't assume perfect knowledge and perfect communications. Everyone needs to ask the right questions and deliver the right information. If something important about the property slips between the cracks, that might create a future gap and dispute. Clients shouldn't assume the lawyers automatically know everything, and the lawyers shouldn't assume that either.

Collectively, the suggestions in this column can go a long way to preventing problems: keep it simple; read it carefully; insist on understanding it; don't miss the simple but important issues; have a reasonable schedule; communicate within the team; understand the real estate; and don't let open issues fester.

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