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Stein's Law

It's Complicated, But Is It Right?

Smart lawyers can always get it right. No matter how complex we make a business relationship, and no matter how many players get involved, if we think hard enough, we can cover every eventuality and always get to the right answer. Our documents get longer and longer, but that's just because we are so smart, so sophisticated and know so much.

That seems to be the general view of the commercial real estate financing world. Particularly in the run-up to the recent financial crisis, commercial real estate financing structures and documentation became steadily more complicated, with ever more special provisions for special cases, negotiated outcomes that had to be reflected throughout a document set, contingent provisions for hypothetical eventualities and a list of players that grew ever longer.


Joshua Stein

We all know what happened next, particularly in the world of inter-creditor relationships—junior and senior participations and relationships between mortgage lenders and mezzanine lenders.

Our exquisitely complex, layered and well-thought-through documents didn't always turn out the way we expected. Under the harsh light of litigation, the very long and complex sentences over which so many lawyers had toiled for so many hours turned out to produce surprises.

Even when a document dwelled at great length on every possible eventuality, sometimes the one eventuality that ultimately occurred was the one that the document didn't dwell on at all, or addressed in a very shorthand and incomplete way, or addressed inconsistently in two or three different ways that tripped over one another.

The marketplace saw these dynamics play out in the Stuyvesant Town debacle and other "tranche warfare" situations in which mezzanine lenders turned out to have more or less leverage than many players anticipated. Language that seemed to address one eventuality turned out to mean something else in some other context—and that meaning wasn't necessarily what was intuitively expected—because it turns out that judges didn't necessarily know what the parties were really thinking.

In the world of nonrecourse carve-out guaranties, the meanings sometimes asserted in litigation were fundamentally inconsistent with the very nature and essence of the transaction that the parties actually contemplated.

In ordinary borrower-lender loan documents, the "standard" language in a promissory note dealing with default interest turned out not to require the borrower to pay default interest at all in the single clearest possible circumstance in which a default could arise—failure to pay the loan on maturity. That's because the note required the borrower to pay default interest upon acceleration. If the borrower failed to repay on maturity, that didn't amount to an acceleration; hence, no default interest. No one noticed the anomaly. Yet the language in question probably still appears in thousands of commercial mortgage loan notes, including new ones. The language in question sounds fierce, and "standard," and ever so complex, serious and legalistic, but no one ever bothered to figure out exactly what it means. Now we know. And it doesn't mean what we thought it meant.

In my recent work as an expert witness, I have seen dozens of surprises like these, in everything from loan documents to ground leases to joint venture waterfalls. Very often, complex language that was expected to produce a particular result turned out to produce some other result that seemed bizarre and entirely inappropriate, based on how the facts and the history played out. The parties to the transaction couldn't have possibly meant what the document seemed to say, but layers of complexity masked the anomaly until the facts just happened to play out in the worst possible way, and someone managed to find the anomaly and seize on it.

In some cases, the courts interpret and apply the documents precisely as written, even if the result seems absurd, at least to anyone familiar with how these deals are "supposed to work." In other cases, the courts don't have patience for bizarre results triggered by intricate parsing and interpretation of interacting snippets of incomprehensible prose. The net result: surprises on all sides.

Based on these and many other similar experiences, perhaps the industry should rethink the trend toward making our deal structures and legal documents ever more complex and sophisticated. Perhaps we should recognize that we aren't as omniscient as we may think. Complexity in and of itself creates risk. This would suggest that we should try to keep documents short, simple and comprehensible, and try to trim back some of the encrustation of tedious detail that gets in the way of understanding what the documents actually say.

Of course, it may be too late for that. The industry may expect certain documents to look, sound and feel a certain way, even if that way masks comprehension and increases the likelihood of surprises. And documents only get longer, never shorter, as lawyers identify new issues and new concerns.

Even against that backdrop, it probably makes sense to ask "dumb questions" about a document, and to test particular possibilities to confirm that the document will produce the right result if they ever arise. If one is smart enough to imagine and think through every future possibility, then perhaps one is smart enough to get the document entirely right. Recent experience suggests, however, that this is not as easy as it may sound.

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