

# CONTEXT, INTEGRATION AND THE “BIG THREE QUESTIONS” AN APPROACH TO TEACHING TRANSACTIONAL LAW

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## I. INTRODUCTION

I have been mentoring fledgling transactional lawyers in both law school and law firm settings for a long time. Over the years, I have recognized that the most significant challenge to their development and success usually is not their mastery of the substantive laws and regulations applicable to their transactions. Rather, most often their biggest hurdle is their lack of transactional context. Without context for the material being studied or applied, appropriately integrated into the transaction being examined, the student or young lawyer is easily lost in a morass of confusion and left to struggle with any number of issues, including:

- How are the laws and regulations relevant to what the transaction is all about?
- Frankly, what *is* the transaction all about? Why are the parties doing it? What do they really want to achieve?
- And what is the transactional lawyer’s role in bringing it to fruition? Why are we even in the room? What value do we add?

Not only do these questions create a serious case of student “MEGO,”<sup>1</sup> but they also seriously impede the learning process.

To deal with this problem, I have experimented with a number of techniques that I have found helpful in creating transactional context for my students and mentees. In the interests of furthering the transactional law pedagogy, I am pleased to share them in this paper.

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<sup>1</sup> “Mine Eyes Glaze Over” a student condition that I am confident all law professors have encountered!

## II. WHAT IS TRANSACTIONAL CONTEXT AND WHY DOES IT MATTER?

The Online Google Dictionary defines “context” as “[t]he circumstances that form the setting for an event, statement, or idea, and in terms of which it can be fully understood and assessed.”<sup>2</sup> If the event, statement or idea is (or is an element of) a transaction, we can appropriately refer to the context as “transactional context.”

Transactional context provides a lens through which lawyers may analyze the actions and relationships of the transacting parties, identify and test their underlying goals and motivations, and evaluate the likelihood of their success. It lends relevance to the subject matter, fosters understanding and insight into the transactions being undertaken, and helps define the roles of the various players (including the transactional lawyers) in the overall process.

Without transactional context, lawyers cannot effectively assess the assumptions, expectations, and objectives of the parties. Without transactional context, the application of laws and regulations is unclear, and even the most seasoned attorneys find themselves “at sea” in their approach to the transaction. Neophytes, lacking the compass and footing that context provides, flounder about without direction. Inevitably, they seek refuge where they perceive something familiar, and they focus too much on quantitative matters that are not their responsibility (e.g., “deal points”) and not enough on the qualitative aspects of the transaction where they can add real value: for example, identifying and mitigating risks, facilitating the deal, and enhancing the likelihood that their clients can achieve their transactional goals.

In introducing transactional context to law students, I find it helpful first to remind them why clients hire transactional lawyers in the first place. What are our clients’ expectations? What do they want from us? What do they want us to do? To help frame this (to put it in context), let’s remember why they are *not* hiring us:

- (usually) *not* for us to be responsible for agreeing on the “deal points” (although good transactional lawyers can and should help identify the business terms that need to be decided, and they can and should offer suggestions about them based on their own experiences, when relevant);

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<sup>2</sup> *Context*, ONLINE GOOGLE DICTIONARY, <http://googledictionary.freecollocation.com/meaning?word=context> (last visited Aug. 25, 2018).

- (usually) *not* for us to decide whether the transaction is a “good deal” (although good transactional lawyers are not bashful about offering their opinions); and
- certainly *not* just to give us the opportunity (and at their expense, no less) to do something that we think is exciting, challenging, and just plain fun!

Why *are* they hiring us? They are hiring us to use our transactional lawyering skills and available tools to make it more likely that they will achieve their transactional goals, and that transactional outcomes (including dispute resolutions) will be predictable.

So how do we do this? Of course, we do this by applying our substantive legal expertise to the subject matter of the transaction. Depending upon the particular deal, this expertise includes our command of contract law, commercial law, tax law, corporate and other business associations law, securities law, M&A law, intellectual property law, and so forth. If we fail to make the necessary substantive legal contribution to the transaction, none of our other lawyering skills will be sufficient or even relevant. But our substantive expertise is not enough.

We also do this by bringing our organizational and management skills to bear on the transaction. Transactional lawyers learn to orchestrate complex arrangements so that all the ships enter and leave the harbor at the right time and in the right order without colliding with each other. Even the most straightforward transactions require coordination and attention to process and detail. We prepare, monitor, and update extensive checklists and closing schedules. We worry about third-party deliverables, wire transfer instructions, secretary of state holidays, and whether some director might be climbing Mt. Everest when we need her signature for a unanimous written consent. We anticipate weather events that may disrupt Federal Express pick-ups and deliveries. The list goes on and on.

But most importantly, we add value to our clients’ transactions by evaluating, understanding, and structuring the relationships into which they are embarking. Relationships are the contextual lens through which transactional lawyers apply their legal expertise and their organizational and management skills. In my experience, relationships are also the key to unraveling and deciphering the mystery of context in transactional lawyering.

### III. WHY DO STUDENTS STRUGGLE WITH CONTEXT?

As instructors and mentors of transactional law students and lawyers, we have all heard the excuses:

“I was an [English/history/psych/art/other liberal arts] major, and I do not understand business.”

“I do not know accounting.”

“I am not good at math.”

Whether their sense of intimidation is warranted or not, we must help them overcome the fear and reassure them that they can be successful.

Truth be told, I recall raising these and similar concerns as a law student myself in the early 1970s. But none of these concerns presents the impediment that it might first appear to raise, and none is insurmountable. As an example, I offer my own background with a B.A. in English from a liberal arts college and with absolutely no exposure to accounting or business courses: “If I could learn this, so can you.”

I am not suggesting that a prior background in business, accounting, mathematics, or other technical material is not helpful to a transactional law practice. On the other hand, that is absolutely not a prerequisite for success. An important first step in bringing the students along is overcoming their perception that they cannot do the work because they do not *already* have sufficient background and experience in the subject matter. After all, our goal as educators and mentors is precisely to fill the gaps, to provide them with the knowledge and, more importantly, the tools to build the foundation that they will need. So if a prior background in these areas is not required, what is? And how does the law student master what he or she needs to know? Let’s explore these issues in more detail, one at a time.

First, a transactional lawyer does not need a business degree to be successful. Yes, the lawyer does need to understand what the parties and related business entities do and how they make money and pay their bills. Yes, he or she does need to be able to recognize the purpose of the transaction, the reasons the clients are undertaking it, and what they hope to achieve. However, an attorney exercising a lawyer’s analytical skills, applying some common sense and life experience, asking thoughtful questions, and pursuing appropriate diligence can readily figure all this out. Frankly, I have found that the analytical and problem-solving skills that

come from a liberal arts education are highly advantageous in developing these talents.<sup>3</sup>

What about the relevance of an accounting background? Yes, the business and transactional worlds do have a recognized language, and any lawyers operating in these arenas do need basic financial, accounting, and business vocabulary and literacy. They do require a basic competency in reading and digesting balance sheets and income, cash flow, and other fundamental financial statements. They do need to understand the substance and importance of the information that financial statements reveal. They must be able to discuss these topics intelligently and without embarrassing themselves or broadcasting to clients and opposing parties and counsel their lack of understanding. However, this level of competency does not require mastery of the underlying accounting rules and principles, and it can be achieved in a variety of ways readily available to the diligent law student and young lawyer. I encourage my students to read the *Wall Street Journal* or the financial pages of the *New York Times* on a regular basis, not for any political bias or agenda, but to gain familiarity with transactional language, practice, and procedure, and to develop confidence in their understanding of the same. Numerous “Accounting for Lawyers” resources abound, and they offer solid foundations for the law students and young lawyers willing to put in the time and effort.

Turning to the math, here again, it is important to dispel the mythology. To be perfectly clear, the transactional lawyer does not need calculus or other advanced math. High school algebra? That is absolutely essential, and I tell my students repeatedly, “If you are sketchy on high school algebra, better brush up.”

Transactional parties and their lawyers regularly use ratios and other formulas for financial analysis, covenants, conditions precedent, and other transactional triggers, and lawyers drafting and negotiating the related documents and agreements must understand them. What items go into the numerator and the denominator, and why? What is the relevance

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<sup>3</sup> Indeed, I suspect we have all encountered the student whose pre-law background in quantitative disciplines has actually proven to be an impediment to his or her development as a transactional lawyer, where the answer to the question is often “what do you want the answer to be?” or “it depends,” an ambiguity that the technically-oriented student—accustomed to there always being a definitive answer—may find uncomfortable, or worse.

of the relationship reflected by the ratio? In addition, the transactional lawyer needs to be able to “work the ratio.” While deciding what ratios or formulas to include in a deal is usually considered a “business decision,” something for the client and not the lawyer to determine, the transactional lawyer who fails to test the ratios and formulas and confirm that they operate as intended does so at his or her peril!<sup>4</sup>

**IV. DECIPHERING TRANSACTIONAL CONTEXT: RELATIONSHIPS—THE “THREE BIG QUESTIONS.”**

Having addressed these threshold matters that law students and young lawyers often find so intimidating, the next step is to tackle the question of context directly. To decipher the context of a transaction, the transactional lawyer must focus on four major topics:

- What is the transaction really about?
- What are the client’s transactional goals?
- What impediments are or might be in the way of achieving those goals?
- How can the risks be mitigated?

Each of these questions can be bewildering in its own right, and students often are flummoxed by them. To get started, I encourage my students to focus again and again on the relationships that are being established. Students usually find the relationships easier to grasp than the financial, quantitative, and other “business issues” relevant to the transaction, and therefore the relationships present an easier entryway into the contextual challenge.

To parse the relationships, I offer the following “Big Three Questions:”

1. *Who is doing what to whom?*

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<sup>4</sup> The translation of formulas and ratios into “agreement language” can be especially tricky and introduces significant opportunity for error, and it falls to the lawyers drafting and reviewing the deal documents to verify that the formulas and ratios have been expressed accurately and yield intended results. In my practice, I routinely sat with my clients and worked the formulas with actual data drawn from their financial statements. Very often this would reveal problems with the formulas that became immediately apparent. I found it commonplace for clients undertaking this review with me to exclaim: “Wait! When I agreed to maintain a leverage ratio [i.e., debt/earnings before interest, taxes, depreciation and amortization (“EBITDA”)] of less than 5.0, I assumed that I got to include W, X, Y and Z in the denominator. The formula as drafted does not include Z, so it does not work. Either include Z, or adjust the quotient.”

2. *Why* is the doer doing the doing?
3. From the perspective of your client, *do you care?*

The transactional lawyer must ask these questions about every aspect of the deal, about every document in the deal, about every section in every document, about every sentence in every section, and about every clause in every sentence: “Who is doing what to whom, why, and do I care?”

Let’s examine these questions in more detail. Who is doing what to whom? Push the students to figure out what *exactly* is going on. What are the mechanics? What are the obligations? What are the remedies? Do they make sense? Do they work? Are they consistent? Details matter.

Why is the doer doing the doing? What *exactly* are each party’s motivations? What does each party expect to accomplish or gain? Where and what are the “hidden agendas?” As any experienced transactional lawyer knows, these are not always obvious. How does “the doing” achieve the goals? Examine these questions both broadly and narrowly. Focus on both the forest and the trees.

Finally, from my client’s perspective, do I care? Ask this question point by point, issue by issue, topic by topic. The transactional lawyer must recognize what matters and what does not and that the priority of any issue depends on perspective. He or she must develop and understand the point of view of each party with respect to each requirement, undertaking, condition, consequence, and event contemplated by the proposed transaction. There is no “equal dignity” rule for all issues, and the transactional lawyer who understands the priorities for each party can more effectively identify and embrace opportunities for negotiation, compromise, and “relationship building” as the deal progresses.

While perhaps a bit pedantic and repetitive, I have found that the Big Three Questions give the students a methodology that they all can use to identify and comprehend transactional context, regardless of their sophistication and prior background in business and transactional matters. The Big Three Questions give the liberal arts students more confidence that they can analyze and comprehend the deal on par with their more business-oriented peers. Conversely, the Big Three Questions help the students who are more comfortable in a quantitative realm recognize and deal with the nuances and ambiguities inherent in the relationships underlying the transactions, which they often find troubling and disconcerting.

## V. TECHNIQUES AND METHODOLOGIES.

While focusing on relationships offers a useful pathway to understanding transactional context, the Big Three Questions beg the question of methodology. Just how do transactional lawyers go about answering the Big Three Questions? What techniques can we impart to law students and fledgling transactional lawyers to help them?

First, simplify the transaction before attempting to work it. What is the essence of the deal? No matter how complicated a transaction seems, expressing “who is doing what to whom” in simple, straightforward terms goes a long way to demystifying the deal. In my experience, if you cannot explain simply what is going on, you probably do not understand what is going on. And if you do not understand what is going on, you certainly cannot identify all the issues and nuances that should be considered or advise the client competently with respect to them.

How to simplify? Start by drawing diagrams. I do this with every transaction, no matter how straightforward it appears to be, and invariably the diagram allows me to visualize relationships and identify issues that were not apparent from a textual description. Supplement the diagrams with outlines. Together, the diagrams and outlines help break the transaction down into its component parts and make it easier for the students and young lawyers to apply the Big Three Questions and determine what they need to accomplish to progress the transaction.

Diagrams are useful not only in understanding *what* is going on in a deal, but *why*. Without illustrations, legal concepts such as structural subordination, fraudulent conveyance, and even more straightforward principles of “due authorization” and “rights in collateral” in a multi-tiered organizational structure are very difficult to grasp and are guaranteed to create mass MEGO. But with diagrams that allow students to visualize the relationships of the parties, the legal issues and solutions become immediately apparent. I have attached as Exhibit A an illustration of structural subordination that my students have found helpful. Similar diagrams can easily be prepared to illustrate virtually any other legal principle, as well.

Second, always identify as many relevant questions as possible before attempting to answer them. While this seems obvious to seasoned practitioners, the inexperienced students and young lawyers often start answering the first questions that occur to them, without developing a broader perspective (i.e., context) for the overall situation. Inevitably, this leads them down rabbit trails from which they cannot escape and results in their likely missing many significant issues that need to be addressed.



Encourage your students to list all the questions the parties need to decide, and why. As an example, consider the hypothetical organization of Courtney’s Creamery attached as Exhibit B. How do the parties’ different backgrounds, talents, objectives, perspectives, resources, histories, personalities, and prejudices influence the list of questions? Think comprehensively, dig deeply, and recognize that questions often beget more questions.

Third, use hypothetical arrangements with which the students can identify. Almost any arrangement can be useful and instructive. Think creatively, but keep it simple. For example, Courtney’s Creamery seems more manageable and less intimidating to students than might be a larger business with more parties in an unfamiliar industry and more zeros in the financial statements. Another of my favorite assignments is to ask small groups of students (usually three or four) to consider organizing a law practice together following their graduation. Once the students become confident with the methodologies in the simpler and more identifiable arrangements, they can be more comfortable and more successful in applying them in transactions of increasing complexity and sophistication.

Familiar hypotheticals are also helpful in illustrating for students how apparently similar scenarios can raise significantly different issues. For example, contrast the following two arrangements:

- Three office colleagues, Bob, Charles and Sally, are jointly buying a 40’ cruising sailboat. They are all in their late 20s. Bob is married, and Charles and Sally are both single (no one is involved romantically with any of the other two). Sally is a very experienced sailor, Bob has moderate sailing experience, and Charles is a novice.
- Three siblings, William, Alan and Diane, are jointly inheriting a vacation beach house on Cape Cod from their now-deceased parents. Alan lives in eastern Massachusetts, Diane in Virginia and William in California. All the siblings are in their 60s, and they each now have their own grown children and young grandchildren scattered around the country. Their parents acquired the beach house in the late 1950s, and the siblings (who were raised in a Boston suburb) each spent their childhood and adolescent summers there.

On its face, each scenario involves three people acquiring a leisure-time asset, and certainly some issues will be common to both. But push

your students to identify the very different questions that they present. This is one of our principal roles as transactional lawyers—not to answer the questions ourselves, but to identify them and present them in clear and digestible form to our clients, and to assist them in reaching resolution. As the students gain experience in deciphering transactional context in familiar settings, they can more easily and more confidently apply these skills in increasingly sophisticated transactions.

Fourth, encourage the students to identify the major transactional objectives and risks. These are not always readily apparent, and often not what students and young lawyers recognize. Lacking experience, they easily gravitate toward obvious deal points at the expense of more fundamental concerns. Consider, for example, a purchase and sale transaction. Both buyer and seller will of course be concerned with price, but students often miss that for the seller, “certainty of close” is frequently far more important, and that for the buyer, due diligence and strategic considerations underlying the transaction may be the overriding issues, fraught with more risk.

Loan transactions offer a similar example. Pricing and repayment schedules are obviously important for both the borrower and the lender. However, funding conditions and operational flexibility during the loan term are usually the paramount issues for the borrower’s counsel, and structuring the transaction to maximize liquidity of the investment during the loan term (i.e., syndication and assignment opportunities and considerations) may well override (or at least influence) pricing and other loan terms for the lender’s counsel. Identifying and addressing the major objectives and risks is where the transactional lawyer’s contributions will be most valuable.

Fifth, seek to present complex material in ways that de-mystify the complexity. Financial covenants offer a case in point. When teaching financial covenants, stress the relationships being measured by the covenants, rather than the math. Why are “these items” in the numerator and “those items” in the denominator? How do they relate? What is being measured or evaluated by the covenant? Why is the relationship between EBITDA and debt relevant? What does cash flow have to do with fixed charges or interest expense? What is the logic underlying each covenant? By examining the covenants in these terms (“who’s doing what to whom and why?”), the students are better able to recognize not only their purpose, but whether they work as intended. As they gain confidence in the “what” and “why,” the math seems to follow more easily.

This approach to de-mystifying apparent complexity also works with the negative covenants. Instead of presenting them as a variety of

independent, discrete and arguably arbitrary restrictions imposed by one side and resisted by the other, address them instead from the standpoint of managing the relationship being established between the opposite parties. How does each party’s perspective play into the risk identification and risk mitigation narrative that the transactional lawyer is choreographing?

Students quickly grasp that the party imposing the restriction typically wants to maintain the status quo, while the party subject to the restriction wants more flexibility. But students often fail to consider why, and whether the “why” matters. The party imposing the restriction usually argues that allowing the subject party more flexibility will increase the imposing party’s risk (because flexibility invites uncertainty and change from the circumstances that the imposing party has evaluated and underwritten). On the other hand, the subject party typically responds that it is the restrictions, and not the greater flexibility, that will actually increase the imposing party’s risk (by limiting the ability of the subject party to address new opportunities and challenges that will inevitably arise during the course of the relationship). Using the relationships and the Big Three Questions, ask what each covenant seeks to accomplish? Why is it relevant? How long does it apply? How do the various covenants interrelate? What qualifications and exceptions would be appropriate? What compromises and middle grounds respond to the reasonable concerns of each party without sacrificing its reasonable protections and expectations? How easily will the parties be able to modify the covenants down the road? The answers to each of these questions influences the seasoned attorney’s approach to the covenants and to the overall transaction. As the students gain experience in this analytical methodology, focusing on relationships examined through the lens of the Big Three Questions, the transactional context becomes more accessible to them and they become more creative and more perceptive in their proposed solutions.

## **VI. CONTEXTUAL APPLICATION: RISK IDENTIFICATION, ALLOCATION AND MITIGATION.**

Ultimately, the transactional attorney seeks to identify, allocate, and mitigate the risks presented to its client and, using the transactional attorney’s toolkit, make it more likely rather than less likely that the client can achieve its transactional goals and objectives. Through context and

by focusing on the relationships, the lawyer can better understand the transaction and more effectively orchestrate it.

Context enables the transactional attorney to drive the deal process and the documentation, rather than being driven (or even overrun) by the deal dynamics. Through context, the attorney can identify the risks that each party faces and consider how they evolve as the deal progresses through its various stages (from the earliest conversations, through preliminary expressions of interest, term sheets, commitment letters and formal agreements, to diligence and other pre-closing activities, and finally to closing and post-closing time frames). He or she can then use structure and documentation to address what the context reveals:

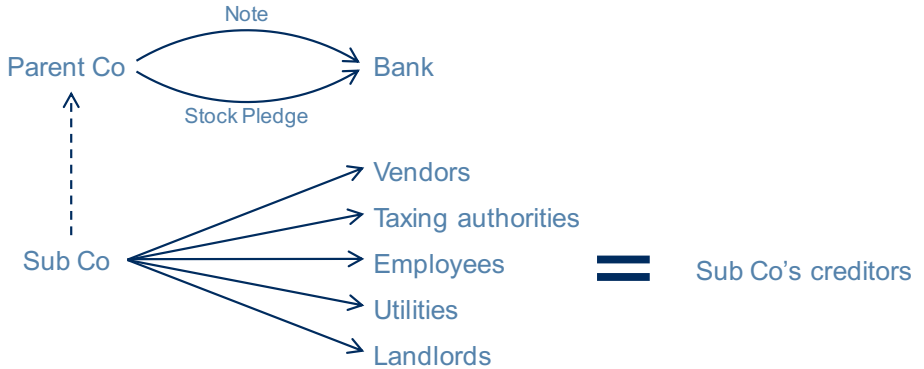
- Due diligence: Is the deal that the parties think it is? How can they figure this out before becoming bound or incurring significant costs prematurely?
- Conditions and termination: What are the options if problems surface pre-closing?
- Performance obligations: Pre-closing and post-closing?
- Remedies: Consequences of non-performance, either before or after closing?

Hypothetical transactions, simulations, role-playing, and problem-solving exercises are invaluable in helping students create and understand context and in building transactional skills and confidence. As the transactional course progresses, I continue to develop and evolve the hypotheticals and exercises to cover additional circumstances, contingencies, and complexity, stressing at each step of the way the relationships and the objectives of each party. Once again, I use the Big Three Questions to maintain the focus.

Experienced practitioners know that there is seldom a single perfect deal structure or arrangement. For students, achieving this realization is very reassuring. It frees them from the paralysis they often encounter in approaching transactional learning and practice, and it permits them the freedom to explore the landscape of risks and possible solutions. Mastering transactional context and integrating context into the transactional attorney's skill set opens the door to successful transactional lawyering.

**EXHIBIT A****Structural Subordination**

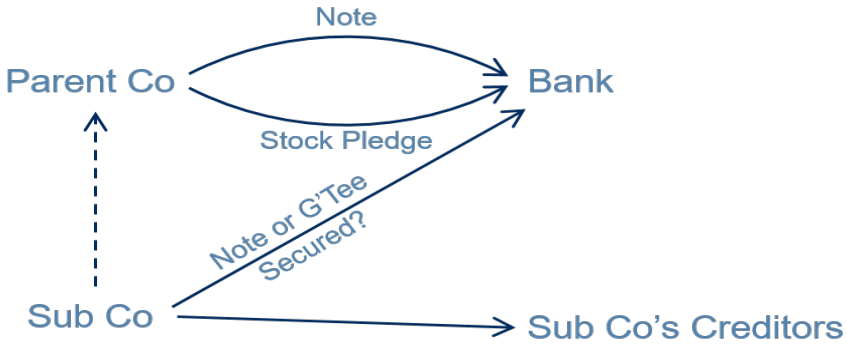
Assume loan from Bank to Parent Co. All “enterprise wide” revenues and assets are to stand behind loan repayment. Parent Co issues note and pledge of Sub Co stock to Bank.



The problem: “Creditors’ Rights 101: debt gets paid before equity.”

- Parent Co’s claims to Sub Co’s revenues and assets are “junior” (i.e., “subordinate”) to Sub Co’s creditors’ claims.
- Vis-à-vis Sub Co’s revenues and assets, Parent Co and Parent Co’s creditors (including Bank) are “structurally subordinated” (i.e., because of the structure) to Sub Co’s creditors.
- Stock pledge doesn’t solve the problem. If Bank forecloses, then Bank becomes equity holder of Sub Co (but not creditor) and is still structurally subordinated.

The solution:



Create a direct obligation from Sub Co to Bank (direct loan or “upstream guarantee”). This puts Bank on par with other Sub Co creditors. If obligation to Bank is secured, then Bank’s claim is senior to unsecured Sub Co creditors to extent of value of the collateral.

If “upstream guarantee,” consider fraudulent conveyance risk.

Exhibit B

Courtney’s Creamery

Courtney has been operating her Creamery for a couple of years as a sole proprietorship, dishing out ice cream to customers in Portland, ME. Like many entrepreneurs, she initially operated the business from the trunk of her car, but last summer she rented a fixed booth adjacent to the harbor pier where the cruise ships visiting Portland dock (lots of traffic—a great location). This was a good move, and she has extended her lease of the booth for the next several summers.

The business has been growing nicely, allowing Courtney to hire a couple of local teenagers to help at the stand while still generating modest positive net income. Courtney thinks that if she made some improvements to the booth, upgraded some of the equipment and expanded her hours of operation, she could do even better, but she cannot afford to front the expansion and upgrade costs herself. Moreover, with her husband working long hours and gunning for partnership as a transactional attorney at a large law firm, and with two toddlers underfoot

(ages 5 and 3), Courtney does not think she can devote any more time to the business than she already is doing. Accordingly, she is looking for a “partner” who can share both the financial and operational responsibilities of the business.

Courtney’s older sister Mary is a single mom who lives in Boston (a two-hour drive from Portland) with her teenage son. A recent victim of corporate downsizing, Mary is looking for something to do (and, frankly, she really needs the income). The sisters were discussing their respective circumstances the other day, and Mary suggested to Courtney that she (Mary) would be the ideal “partner” for Courtney in the venture. Since the Creamery is primarily a summertime venture, Mary figures that she and her son could spend the summer in Portland working in the Creamery and “bunking in” at Courtney’s house.

Mary is prepared to invest approximately \$10,000 as equity into the business, which is just about what Courtney thinks the improvements and equipment upgrades will cost. Courtney’s financial adviser has concluded that before taking Mary’s proposed investment into account, the business has a value of approximately \$30,000. Accordingly, Mary thinks that her \$10,000 cash infusion would justify her getting at least a 25% ownership interest in the business (i.e.,  $\$10,000/(\$30,000 + \$10,000) = 0.25$ ). Mary’s interest would of course dilute Courtney’s ownership interest accordingly, down to 75%.

The sisters have come to you for the legal help they need in deciding on the appropriate organizational form for the business (i.e., partnership, limited liability company, corporation, something else?) and in organizing and then operating and managing the enterprise. What questions and issues need to be addressed? (Do not worry about answering the questions yet; rather, let’s start by just identifying what they are.)