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Mitu Gulati

Robert E. Scott

Columbia Law School, rscott@law.columbia.edu

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FOREWORD

THE THREE AND A HALF MINUTE TRANSACTION: BOILERPLATE AND THE LIMITS OF CONTRACT DESIGN

*Mitu Gulati**
*Robert E. Scott***

I. INTRODUCTION

Last fall we gave a faculty workshop at the Hofstra University School of Law on an early version of our book manuscript, *The Three and a Half Minute Transaction*. The resulting debate was lively and the discussion ranged over a wide variety of topics. The end result, much to our delight, was that the editors of the *Hofstra Law Review* suggested a symposium where they would invite a group of eminent scholars and practitioners to react to the manuscript. The hope was that those reactions would generate a further debate akin to the one we had at the workshop. Given the exceptional group of scholars and experts in the field that the editors of the *Hofstra Law Review* have assembled, they have achieved that goal. And we are pleased that they asked us also to contribute a short introduction to their symposium that would provide readers with some background on the book manuscript.

The story in the book begins with what, by all rights, should have been a minor legal skirmish. It took place roughly a decade ago, in September 2000, in an obscure commercial court in Brussels. A U.S. hedge fund, Elliott Associates, L.P. (“Elliott”), was attempting to recover on debt on which the Republic of Peru had defaulted some years before during the Latin American debt crisis.¹ Elliott, a so-called “vulture

* Professor, Duke Law School.

** McCormack Professor of Law, Columbia Law School.

1. Elliott Assocs., L.P., General Docket No. 2000/QR/92, ¶ 5 (Court of Appeal of Brussels, 8th Chamber, Sept. 26, 2000) (unofficial translation on file with the Hofstra Law Review); MITU

fund,” specialized in buying unpaid debt obligations on the secondary markets at a deep discount and then seeking to recover in full by using innovative litigation techniques devised by a crack team of lawyers (backed by private investigators and investment specialists).² For over a hundred years, creditors had found it nearly impossible to successfully sue a sovereign state for unpaid debt obligations. Elliott was attempting to change the traditional rules of the game. In September 2000, they succeeded in doing precisely that.³

Given the difficulties associated with trying to sue and recover directly from a sovereign, Elliott attempted instead to pursue the financial intermediary that Peru was using to pay those creditors who had entered into its officially sanctioned restructuring agreement.⁴ If asked about Elliott’s chances of success at the time, most sophisticated observers would likely have put them at close to zero. But a combination of unusual events, including a court that was unfamiliar with sovereign litigation and sovereign debt contracts, a brewing corruption scandal involving the Peruvian president, and Elliott finding a contract provision whose meaning no one else seemed to know, combined to result in a victory for Elliott. In the end, this *ex parte* ruling became one of the most momentous decisions in global finance. Our book is about the impact of that case, and, in particular, what did and did not happen in the decade following.

At the center of the case was the interpretation of a three-line clause—the *pari passu* clause (which means, literally, “in equal step”)—that has been in cross-border financial contracts for at least a century.⁵ One might imagine that a clause of this vintage—one that is found in practically every cross-border sovereign bond issuance—would be among the most well understood of the boilerplate terms that are part of the modern sovereign debt contract. Yet, this was a provision that almost no one understood. In essence, *pari passu* was a boilerplate contract provision that most parties treated as ornamentation.⁶ All that changed, however, when the local commercial court in Brussels issued a preliminary injunction based on Elliott’s interpretation of the clause as an inter-creditor agreement to share equally in any payments by the

GULATI & ROBERT E. SCOTT, THE THREE AND A HALF MINUTE TRANSACTION: BOILERPLATE AND THE LIMITS OF CONTRACT DESIGN (forthcoming 2012) (manuscript at 20) (on file with the Hofstra Law Review).

2. See *Vulture Funds Prey on Poorest Countries*, INDEPEN. CATHOLIC NEWS, <http://www.indcatholicnews.com/news.php?viewStory=10139> (last visited Mar. 1, 2012).

3. *Elliott Assocs.*, ¶ 8; GULATI & SCOTT, *supra* note 1 (manuscript at 20).

4. GULATI & SCOTT, *supra* note 1 (manuscript at 20 & n.12).

5. See *id.* (manuscript at 20-24) (internal quotation marks omitted).

6. *Id.* (manuscript at 21).

sovereign to its unsecured creditors. That interpretation resulted in Elliott recovering somewhere in the vicinity of \$58 million on a debt claim that it had purchased for around \$11 million.⁷ Industry experts and insiders were apoplectic at what they saw as an outrageous decision. More importantly, the dominant view of the lawyers who were experts in sovereign debt transactions was that, whatever it meant, *pari passu* was not a term that required creditors who had consented to a restructuring agreement to share their payments ratably with non-consenting creditors. Such an interpretation would essentially permit any hold out creditor to disrupt restructuring agreements in the future.

In view of what was supposedly an erroneous interpretation, one might have expected the elite practicing bar to react immediately and decisively. Theory tells us that the transactional lawyers responsible for negotiating sovereign debt contracts would have quickly clarified their forms so as to discredit the heretical interpretation of this boilerplate provision before the heresy could spread and gain traction. That did not happen. Ten years later, almost all sovereign debt contracts still have this contract provision, often on the front page of the sales document, and essentially unchanged in form and language from the clause that was the subject of litigation in Brussels.⁸

In our book, we attempt to unpack the puzzle of why these financial contracts were not revised despite the on-going risk of other courts or adjudicative bodies adopting the same destabilizing interpretation. But we also tell a story of forgetfulness. It is a story of how a remarkably unconfiding contractual provision was introduced into international financial contracts over a hundred years ago, was absorbed into the lumpish boilerplate of such contracts, and then came to be replicated, thousands upon thousands of times, even while the knowledge of its origin and purpose insensibly faded from the minds of its remote drafters. If anything, the increase in the popularity of this clause in international financial contracts seems to have been inversely related to market understandings of its meaning. As the clause became more widely used over the past century, shared understanding of its intended meaning actually diminished.⁹

This is also a story about the organic life form known as a standard commercial contract and how such documents pass relatively untouched through the hands of generations of lawyers, much like a seed can pass unharmed through the intestinal tract of a bird. The story can be told

7. *Id.* (manuscript at 24-25).

8. *Id.* (manuscript at 75, 79-80 & 80 tbl.1).

9. *Id.* (manuscript at 86-91).

from the standpoint of basic human psychology—novelty sparks curiosity, repetition stupefies it. Or it can be told from the perspective of a legal profession in which new lawyers are expected to learn the lore of their craft from their elders in a tutorial, master-apprentice system that no longer exists in most major law firms. Or the tale can be brought down to the individual lawyer working on a financial document late at night, and who briefly wonders about the significance of a *pari passu* representation in her agreement, only to pass on, comforted by the thought that someone at the firm must know why it is there; the document is, after all, the firm's standard form for this type of deal.

Finally there is the question: If the *pari passu* clause could have lain dormant, unchallenged for over a century in cross-border financial contracts, how many other boilerplate clauses might similarly have outlived the memory of their origins and purpose, making them prime candidates for creative interpretations by highly motivated litigants?

Conventional wisdom in the world of contract theory is that sophisticated lawyers, especially those who get paid large amounts of money to service clients in the financial sector, are fast moving, innovative, and quick to fix any problems that their clients might encounter. If a court makes an error of interpretation, according to this story, lawyers will soon respond by revising their contracts to make sure that the problem does not occur again. Yet numerous scholars over the years have observed that reality does not match theory.¹⁰ Financial contracts, in even the most sophisticated sectors, are often slow to change (in the parlance of the trade they are “sticky”).¹¹ But why? Both the academic literature and the lore of practicing lawyers have posited a number of theories.¹² But scholars have had little success in developing the data that permit a more definitive answer.

The *pari passu* case from Brussels interested us because it had the potential to unlock a mystery that had long bothered legal scholars in the financial contracts field. Why was it that these sophisticated and highly paid lawyers, working at the most elite firms in the world, failed to alter a contract term that not only posed a litigation risk to their clients, but that no one understood?

The failure to revise a contract term that, owing to an aberrant interpretation, now carried a non-trivial litigation risk was inconsistent both with the theoretical models of how sophisticated contract drafters behaved and with the dynamic model of case law serving as the basis for

10. *See id.* (manuscript at 17-18 & 18 n.6).

11. *See id.* (manuscript at 18).

12. *Id.* (manuscript at ch. III, VI).

contract drafting and innovation. We assumed there had to be a rational explanation for the fact that “the dog didn’t bark.” Our speculation was that we would find some form of “agency problem” driving the phenomenon: lawyers were failing to represent their clients’ interests adequately owing to recognizable conflicts of interest. Perhaps, for example, lawyers were reluctant to admit that they had failed on past deals to exert appropriate efforts on behalf of their clients to remove the litigation risk that ultimately materialized. Whether owing to this or other causes, we believed that we would be able to solve the puzzle quickly. Surely, it would only take a few months to find answers to our questions and to publish the results.

We began by gathering information along two different dimensions. First, we collected data on the contracts themselves—to see whether what we had perceived by casual observation (that the contract provisions had not been revised to fix the offending provision) was actually the case for a large data set.¹³ Second, we asked a sample of the senior New York lawyers who worked on sovereign debt contracts whether we could speak to them about our puzzle.¹⁴ In our original research plan, we proposed to interview twenty-five to thirty lawyers in New York and to examine fifty to seventy-five sovereign debt contracts over the period 2000–2005.¹⁵

Our early optimism about finding an answer turned out to be misplaced. No coherent answers emerged from either the first set of contracts or the interviews.¹⁶ Instead of a straightforward agency problem or other market failure explanation, these hard-nosed Wall Street lawyers told us stories about rituals, talismans, alchemy, the search for the Holy Grail, and Zeus. Frustrated, we assumed that we simply had not talked to enough people or the right people or looked at enough sovereign debt contracts. As we write this piece, more than six years after we began, we have examined over 1500 sovereign debt contracts, covering the period 1820–2010, and conducted more than 200 interviews.¹⁷ As we kept unpacking the story, it became more interesting, even as a straightforward conflict of interest hypothesis proved ever more elusive. No single agency cost explanation emerged from the data; at least not in a fashion that we could assert with confidence. To be sure, we recognized that the lawyers we talked to would be unselfconscious about the array of possible conflicts that might explain the failure to

13. *Id.* (manuscript at 11).

14. *Id.*

15. *Id.*

16. *Id.*

17. *Id.*

amend or eliminate a troublesome clause, and also would be quite ignorant of any theoretical explanations for the faithlessness of agents. Nevertheless, the explanations we were given for why a troublesome clause was allowed to remain in subsequent contracts were both diverse and conflicting. Moreover, we determined from our research that these explanations often rested on myths that were based on quite unsupportable factual premises.¹⁸

Over time, a messy but more consistent hypothesis began to emerge: there are many overlapping sources of agency costs in contemporary big firm law practice—at least law practice of the sort represented by the firms that draft these contracts and thus have had to grapple with the *pari passu* issue. The myths that we were told can be best understood as ways in which the lawyers were able to deflect what would otherwise be obvious failures to correct errors in the formulation of historic boilerplate. “Three and a half minutes” is one explanation that was candidly offered to us by a lawyer who sought to explain the tradeoff between the time it took to “draft a new contract” and the effort costs of redesigning boilerplate that was widely used and had been part of the standard form contract for many years.¹⁹ But “three and a half minutes” is also a metaphor for a business model that relies on herd behavior, fails to provide incentives for innovation, and thus rises and falls on volume-based, cookie-cutter transactions.²⁰

To be sure, we find that in cases where the litigation risk is perceived as acute, firms adapted to the risk by redesigning sovereign debt contracts (often by adding new terms rather than correcting errors in existing terms). But our evidence suggests that where the risk is real but not acute, lawyers rely on the herd and on their myths—the returns to the firm in terms of volume transactions outweigh the present value of the risk to them.²¹ This is despite the fact that a social planner seeking to maximize the joint interests of lawyers and their clients would likely choose a different business model. In short, we conclude that social welfare is less than it would be under a different regime even though the private benefits of volume transactions over careful design may explain the firm behavior that we see.

The contributors to the symposium²² come from a range of perspectives. And those perspectives have helped push the ideas in our

18. *Id.* (manuscript at ch. VIII).

19. *Id.* (manuscript at 12) (internal quotation marks omitted).

20. *Id.*

21. *Id.*

22. The symposium pieces referenced *infra* are published in Vol. 40, No. 1 of the *Hofstra Law Review*.

manuscript well beyond our starting point. It goes without saying that we are grateful to both them and the editors of the *Hofstra Law Review*.

The pieces in this symposium divide into two sets. The first set of pieces takes an institutional perspective. The focus is on the modern law firm and why its contract production model may be malfunctioning. The second group of pieces is from scholars and practitioners more interested in the sovereign debt markets themselves. These pieces, unsurprisingly, focus on the implications of our findings for that market which, even as we write this, is facing one of its worst crises ever in the Eurozone.

II. THE INSTITUTIONAL PERSPECTIVE

The late Larry Ribstein was a constant source of encouragement during the six years of our research for the book. Larry was a prolific and wide-ranging scholar; in recent years he had been particularly interested in the business model of the large law firm, one that he perceived to be unduly hindered by antiquated laws such as the restrictions on law firms being able to raise equity capital. In the piece that he wrote before his untimely passing, he asked the question of why law firms innovate so little. In theory, after all, law firms should always want to do more (more work means higher billings, and that is what law firms want). If lawyers are choosing not to do certain types of work, therefore, there must be some structural feature of the market that is deterring them from doing this work. Among those structural features is the difficulty that lawyers have in capturing the returns from innovations, particularly contract innovations. There are also other structural features of law firms that deter innovation, such as the rules that forbid equity ownership by outsiders. Larry suggested that these restrictions on financing deter long-term research and development.

Stewart Macaulay and Preston Torbert, a legendary scholar and an eminent practitioner, respectively, while coming at our manuscript from different directions, end up asking similar questions. This is perhaps not surprising, since Macaulay and Torbert are both interested in the nitty gritty of how contracts are produced at the ground level and what function they serve, according to those who are producing and using them. Both of them suggest, independently, that the “three and a half minute” model of contract production, under current fee structures, is not sustainable. If eminent law firms are doing little more than reproducing contract documents from prior deals, without doing much to correct errors in prior drafts, let alone innovating and improving contracts, then it will not be long before boilerplate contract drafting gets outsourced. One does not, after all, need to pay Wall Street lawyer fees to have some

junior associate cut and paste a document from a prior deal. That process can occur at a lower cost in Bangalore or Manila, with what will probably be a higher rate of error correction. Perhaps the future of the elite U.S. or U.K. law firm is less leverage, higher quality, and greater outsourcing of routine tasks.

Of the four institutional voices, Barak Richman is perhaps the most optimistic about the modern law firm. His criticism is reserved for what he sees as an antiquated model that contract scholars use to understand the production of boilerplate contracts. Contract production in the modern law firm, according to Richman, is akin to the assembly-line production of a car in Detroit. It is mass production, not Savile Row tailoring. The traditional principal-agent model where a lawyer is tailoring solutions for an individual client does not fit the context of boilerplate financial instruments. Precisely because boilerplate contracts are mass produced (hence, “three and a half minutes”), they are necessarily going to fail specific client needs. The model to apply, if one wants to understand modern contract production, should be one built on insights taken from organizational economics, Richman suggests.

III. THE SOVEREIGN DEBT PERSPECTIVE

The last four pieces are by scholars and practitioners grounded in the sovereign debt market itself.

Mark Wright, one of the best-known economists writing about sovereign debt, makes at least two significant points in his piece. First, he suggests that the fact that lawyers have been unwilling to alter the *pari passu* terms may mean that they and their clients prefer the existing formulation. They may not have appreciated the outcome in the Brussels case, where Elliott obtained a disproportionate recovery, but that does nothing to undermine their preference for a rule mandating *pari passu* treatment. Put differently, the actions of the lawyers in retaining the clause are a better indicator of true preferences of market actors than their rhetoric. Second, Wright asks whether, as an independent matter, it really is so outrageous for creditors to ask for a clause that both promises them equal treatment vis-à-vis other unsecured creditors and also allows them a meaningful remedy if those rights are not respected.

Wright is asking exactly the right questions, we think. In terms of the first point, it was the disjunction between what lawyers were saying (that the Brussels interpretation of *pari passu* was outrageous) and what they were doing (failing to alter the *pari passu* clauses in their own contracts to negate the outrageous interpretation) that interested us in the first place. The second point also raises interesting issues. What we see

as a result of the Brussels case is that sovereign contracts can, in fact, be designed in ways that make it possible to sue and enforce against the sovereign. Contract lawyers, one might think, would take the Brussels case and the success of Elliott as an impetus to design better mechanisms to enable enforcement against misbehaving sovereign debtors. After all, *ex ante*, that should produce a lower cost of capital. Indeed, from an *ex ante* perspective, the inability to bring meaningful legal action against defaulting sovereigns is almost certainly the central economic problem in the sovereign debt market. Yet, there seems to be little attempt to design new contract provisions that would meaningfully improve enforcement; not even after the impetus of Elliott's success.

Rodrigo Olivares-Caminal and Robert Cohen, an eminent scholar and practitioner, respectively, take up positions at opposite ends of the spectrum in terms of the meaning of the *pari passu* clause in sovereign debt instruments. Olivares-Caminal, formerly the U.N. Conference on Trade Development expert on sovereign debt, takes the official position of condemning the interpretation given in Brussels. Cohen, one of the primary lawyers for Elliott in the *pari passu* litigation, reiterates the basic point that his clients have made repeatedly: If *pari passu* does not mean *pro rata* payment in the sovereign context, what else can it possibly mean?

Finally, we have a piece by one of the legends of the sovereign debt world, Philip Wood. Wood does not rehash the arguments over what *pari passu* means in the sovereign context. His interest is in the broader notion of *pari passu* promises and how, even in the non-sovereign context, this notion is confusing and often violated. Contracting parties seem to want the symbolism that comes with a promise of *pari passu* treatment, even when they do not wish to have it operate as a strict contractual provision. And that begs the question of why the notion of *pari passu* treatment shows up so often in both contracts and statutes.

We are delighted that these eminent scholars and practitioners have engaged our manuscript with such care and attention. They have surely moved the discussion far beyond what we envisioned originally. Our thanks also to Allana Grinshteyn and her fellow editors of the *Hofstra Law Review* for having worked tirelessly in identifying and persuading the participants in this issue to contribute their thoughts and in putting these diverse perspectives together.