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INTRODUCTION:
THE THREE AND A HALF MINUTE TRANSACTION

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The Hofstra Law Review has organized an "Ideas" symposium around our book manuscript "The Three and a Half Minute Transaction". The idea for this symposium came from a debate that occurred at a faculty workshop at the Hofstra Law School some months ago where we were presenting our book manuscript. The topics of conversation included the following: the future of the current big-law-firm model, what value lawyers add in commercial transactions that use boilerplate contracts, why (and whether) boilerplate contracts are so slow to change, why law firms do not generally have R&D departments, the resolution of the Eurozone sovereign debt crisis and more. The Essays in this symposium are from an exceptional group of scholars and practitioners and we are honored that they use our manuscript as their jumping off point to tackle some of the topics mentioned. What we provide here is a brief introduction to the manuscript itself.

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THE THREE AND A HALF MINUTE TRANSACTION: Boilerplate and the Limits of Contract Design

Mitu Gulati & Robert E. Scott†

INTRODUCTION

Last fall we gave a faculty workshop at the Hofstra Law School on an early version of our book manuscript, "The Three and a Half Minute Transaction." The resulting debate was heated 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 an "ideas 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 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 clearly achieved their goal. And we are pleased that they asked us also to contribute a short introduction to their Ideas 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, was attempting to recover on debt on which the Republic of Peru had defaulted some years prior during the Latin American Debt crisis. Elliott, a so-called "vulture 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). For over a hundred years, creditors had found it nearly impossible to successfully sue a sovereign state for unpaid debt obligations. Elliott Associates was attempting to change the traditional rules of the game. In September 2000 in Brussels they succeeded in doing precisely that.

† Duke Law School and Columbia Law School, respectively.

Given the difficulties associated with trying to sue and recover directly from a sovereign, Elliott was attempting instead to pursue the financial intermediary that Peru was using to pay those creditors who had entered into its officially sanctioned restructuring agreement (holders of "Brady bonds"). 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 mean, literally, "in equal step") -- that has been in cross-border financial contracts for at least a century. One might imagine that a clause of this vintage, one that is found in practically every modern 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 merely as ornamentation. All that changed, however, when the local commercial court in Brussels issued a preliminary injunction based on Elliot's interpretation of the clause as an inter-creditor agreement to share equally in any payments by the sovereign to its unsecured creditors. That interpretation resulted in Elliott recovering somewhere in the vicinity of $55 million on a debt claim that it had purchased for around $11 million. Industry elders were apoplectic at the outrageousness of the decision. But more importantly all the industry players were unanimous in their view that, whatever *pari passu* meant, it was not a term that required creditors who had consented to a restructuring agreement to share their payments 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 a clearly erroneous interpretation, one might have expected the elite practicing bar to have reacted immediately and decisively. Theory tells us that they 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 didn't 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.

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, got 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.

This is also a story about the organic life form known as a standard commercial contract and about 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 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, innovating 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. Financial contracts, in even the most sophisticated sectors, are often very slow to change ("Sticky", in the parlance of the trade). But why? Both the academic literature and the lore of practicing lawyers have posited theories. But scholars have had little success in pinning down an 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 completely 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 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 the 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 the answers to our questions and to publish the results in a short article.

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 dataset. 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. In our original research plan, we proposed to interview 25-30 lawyers in New York and to examine 50-75 sovereign debt contracts over the period 2000-2005.

Our early optimism about finding an answer turned out to be misplaced. No coherent answers could be gleaned from either the first set of contracts or the interviews. Instead of a straight-forward 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 Essay, more than six years after we began, we have examined over 1,500 sovereign debt contracts, covering the period 1820-2010 and conducted more than 200 interviews. As we kept unpacking the story, it became more fascinating 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 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.

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 trade off 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. 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. 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. 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 "ideas symposium" come from a range of perspectives. And those perspectives have helped push the ideas in our manuscript well beyond our starting point. It goes without saying that we are deeply grateful to both them and the editors of the Hofstra Law Review.

The essays in this symposium divide into two sets. The first set of essays 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 essays 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 that, even as we write this, is facing one of its worse crises ever in the Eurozone.

The Institutional Perspective

Stewart Macaulay and Preston Torbert, a legendary scholar and an eminent practitioner, while coming at our manuscript from different directions, end up asking very similar questions. This is perhaps not surprising, since Macaulay and Preston 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*. The "three and a half minute" model of contract production, under current fee structures, is surely not sustainable, both of them seem to suggest, independently. 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 significantly 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.

Larry Ribstein, while also interested in the future of the law firm model, asks the question of why firms innovate so little. In theory, after all, law firms should want to do more (more work means higher billings, and that is what law firms want).

If lawyers are choosing not 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 financing model that U.S. law firms are forced to use, which is one where equity ownership by outsiders is not permitted. This type of model deters long-term R&D development, Ribstein suggests.

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 crafting solutions for an individual client simply does not apply in 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 taken from organizational economics, Richman suggests.

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

The Sovereign Debt Perspective

Mark Wright, one of the best-known economists writing about sovereign debt today, 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, according to Wright, 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. But this does not seem to be happening at all.

Rodrigo Olivares-Caminal and Robert Cohen, an eminent scholar and practitioner, respectively, take up positions as opposite ends of the spectrum in terms of the meaning of the *pari passu* clause in sovereign debt instruments. Olivares-Caminal, formerly the UNCTAD 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 an article by one of the most eminent voices in the sovereign debt world, Philip Wood. Wood doesn't rehash the arguments over what *pari passu* means in the sovereign context. Instead, 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, of course, 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 at the Hofstra Law Review for having worked tirelessly in identifying and persuading the participants in this volume to contribute their thoughts and in putting these diverse perspectives all together.