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Stephen J. Choi, Mitu Gulati & Robert E. Scott*

I. Introduction

Contracts are inevitably incomplete. No matter how diligently parties try to anticipate all the possible contingencies that may affect their performance, they will fail simply because the transactions costs of writing complete contracts are too onerous. There are many contingencies that are difficult to discuss ex ante (such as what happens when the relationship breaks up), and others where the probability of an event is too small to justify the parties negotiating over it in the drafting process. Add to the foregoing the fact that parties will have incomplete information regarding each other's character and actions under the contract, and the fact that the contracts are drafted by agents whose actions cannot be monitored fully by their principals, and we have a host of reasons for why gaps and *linguistic uncertainties* are ubiquitous in commercial contracts.

Linguistic uncertainty—terms with indeterminate meaning—present opportunities for strategic behavior well after a contract has been concluded: there is always the risk that, at some point in the relationship, one of the parties will have an incentive to argue that the parties intended the uncertain term or phrase to be interpreted in its favor. From a societal point of view, this problem is diminished in importance so long as the risk of parties exploiting contractual uncertainties is priced into the contract at the outset. Further, sophisticated parties, having observed how an equivocal contractual term was exploited, should be able to revise the contract terms in subsequent transactions by substituting a new provision that eliminates the patent ambiguity. Put differently, the opportunities for contractual arbitrage, where one party to a contract opportunistically exploits a linguistic uncertainty by advancing an

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interpretation not contemplated by the parties in the ex ante drafting process, are eliminated quickly in markets with sophisticated players. At least, that's the theory.

Boilerplate or standard-form contracts, however, are very different from the paradigmatic bespoke commercial contract. They are standard-form; thus, by definition, these instruments fit individual deals less than perfectly than their situation-specific tailored cousins. In other words, the contractual indeterminacy is going to be greater (or at least more numerous) than with a tailored contract because the fit with any individual transactions is necessarily imperfect. Further, because one of the primary virtues of standard-form contracts is the production of network externalities, boilerplate contracts can be slow to change, even when costly ambiguities are identified (Kahan & Klausner 1997; Choi & Gulati 2004). Moreover, the risks posed by linguistic uncertainties may not always be fully priced. To the extent those tasked with drafting the contract (the agents) only care about those matters that are priced, the result is that arbitrage opportunities remain for the clever firm that can identify the opportunities, purchase the underlying contractual rights and then exploit the uncertainties in the contract to capture a larger share of those rights (Choi, Gulati & Scott 2016).

This scenario, where the phenomenon of uncertainties in standard-form contracts attracts the attention of professional contract arbitrageurs, is one that has been playing out vividly over recent years in the context of sovereign debt litigation. The most recent and salient example occurred in March 2016 when Argentina settled with the arbitrageurs for staggering recoveries (up to ten times their original purchase prices, according to some estimates, Levine 2016; Porzecanski 2016). The story of these contract arbitrageurs operating in the sovereign debt markets started, however, more than a decade and a half ago in September 2000, when the Republic of Peru was sued on a clause that no one seemed to understand—the infamous and ubiquitous *pari passu* clause—that had been found in sovereign debt contracts for over a century and a half. Peru ultimately paid a US hedge fund, Elliott Associates, around $55 million on a debt that was purchased for approximately $11 million (Gulati & Klee 2001). One might have thought that such a large recovery, based on an unusual interpretation of a clause that was standard around the world, would not repeat itself as participants in this highly sophisticated market revised or eliminated the clause. As multiple researchers have noted, however, the clause remained as part of the standard package of terms (Varottil 2008, Weidemaier, Gulati & Scott 2013, Nelson 2015). Indeed, the relevant clauses remained basically the same for over a decade.

While the sovereign debt contracts seemed mired in quicksand, the world of contract arbitrageurs was not. The spectacular returns plainly visible as a result of the Peru case attracted other funds eager to copy the Elliott Associates' strategy.[1] As a result of these recoveries, and subsequent ones where sovereigns have settled cases instead of litigating against holdout creditors, contractual arbitrage has become a lucrative business in the sovereign space.[2] When countries are close to defaulting on their debts these days, there are a host of financial firms that begin parsing their contracts, looking for linguistic uncertainties that have not been fully priced and thus can be exploited when the default occurs. Greece faced this in its restructuring in 2012 when it found that a subset of smart creditors had identified the best contracts to hold out on and refused to take the 60% plus Net Present Value haircut that Greece was trying to impose on every bondholder (the smart money got paid in full, whilst the others got brutal haircuts) (Zettelmeyer, Trebesch & Gulati 2013). Ukraine faced a large group of sophisticated creditors in its restructuring in 2015 (Gelpern, Heller & Setser 2016). And Puerto Rico and Venezuela are dealing with a subset of these creditors as of this writing (Mahler & Confessore 2015, Scigliuzzo 2016, Wigglesworth & Moore 2016). And the aforementioned Argentine litigation spilled even more blood in the water only a few months

[1] Elliott, was not the first creditor to utilize a holdout strategy against a sovereign debtor trying to restructure; its fame derived from its effectiveness. For discussions of the pre Elliott holdouts and the evolution of such strategies, see Schumacher, Trebesch & Enderlein (2012); Blackmun & Mukhi (2010).

[2] Hedge funds such as Elliott Associates have also been active in the corporate bond contract space, utilizing similar strategies. *See* Rock & Kahan (2009).

ago when it ended up paying the most aggressive of holdout creditors between 300 and 800% of the principal amount of their claims (Levine 2016).[3]

The experience of the past decade and a half in the sovereign debt markets should teach us at least one lesson: the assumption that sophisticated markets will move quickly to eliminate gaps and uncertainties in standard-form contracts is wrong—at least in the sovereign debt world (although we suspect this phenomenon is generalizable). In a related paper, we show empirically that contractual change has been immensely hard to induce in the sovereign debt markets, even where powerful international institutions such as the International Monetary Fund, the United States Treasury and the Paris Club have attempted to coordinate and encourage change (Choi, Gulati & Scott 2016, Scott & Gulati 2013).

The foregoing poses a simple global governance question. If the standard answer that "the market will quickly and easily fix linguistic uncertainties in contracts" does not hold, what else can be done to address the problems caused by the growth of the contract arbitrageur? The answer we propose is to look to the courts to revise their approach to the interpretation of standard-form contracts. This recommendation is a deviation from the typical assumption that sophisticated parties are better able to address problems in their boilerplate contracts than are generalist courts. After all, the parties should know what they were trying to communicate in their contracts better than a generalist court viewing the dispute in hindsight long after the deal was done. But this assumption no longer holds if the contracting parties themselves have little or no understanding of the ex ante meaning of key provisions in their contracts; provisions they continue to use because they are part of a general market standard package. In such a case, we argue, courts can ameliorate the problem of contract arbitrage by adopting new techniques for interpreting standard form boilerplate.

II. **When Contract Terms Become Rote and Encrusted**

[3] For a discussion of the increase the potency of the remedies being obtained by holdout creditors, as represented by the enforcement mechanism authorized by the New York judges against Argentina, see Weidemaier & Gelpern, (2014).

The basic question that courts face whenever they are asked to interpret a standard provision in a commercial contract is how to determine what the parties understood that provision to mean when they contracted. The interpretive goal in contract cases is to recover and then enforce the parties' apparent intentions, as they existed at the time of contract. This goal implies that courts will attempt to interpret even ambiguous terms in a manner consistent with the ex ante intentions of the contracting parties in so far as a court can recover those intentions from the contract or the surrounding context.[4] But in the case of linguistic uncertainty, some standardized terms in boilerplate contracts between sophisticated parties have lost *any* recoverable meaning. Here courts may be practically incapable of recovering a plausible meaning that was attached to the terms by the contracting parties at the time the contract was drafted.

The dilemma that courts face when interpreting boilerplate is an inherent cost of the reliance on standardized contract terms in commercial contracts. Boilerplate terms are ubiquitous in commercial contracting because they offer the efficiency advantages of standardization. Those advantages include the development of a uniform system of communication that is independent of any particular contractual context (Goetz & Scott 1985). Thus, parties in heterogeneous environments who wish to communicate a shared intent can embody that intent in a fixed and reliable formulation whose meaning does not vary with the nature of the contract or its context. Unfortunately, the very elements of fixed and unchanging meaning that make boilerplate terms attractive are the same elements that can contribute to the erosion of that meaning over time. In addition to the ordinary risks of obsolescence, the repetitious use of boilerplate has two pernicious effects that render the life span of some boilerplate terms needlessly short.

[4] Intention is determined objectively and prospectively: A party is taken to mean what a contract partner could plausibly believe it meant when the parties contracted. *See* Schwartz & Scott (2003).

The first effect is "rote usage": over time some standardized terms get used by rote so consistently that they lose their original meaning. In effect, they become platitudes. Nonetheless, the terms may continue to be employed because parties see no reason to eliminate a term they view as costless and thus incur a risk, however small, of jeopardizing the understood meaning of their agreement (Id.). "Encrustation" is a second cost of too much repetition: the intelligibility of language deteriorates significantly as legal jargon is overlaid on standard linguistic formulations. Rote usage and encrustation are related phenomena although they may be found independently in some boilerplate terms. When combined in a particular clause or phrase, a term becomes linguistically uncertain: no particular meaning can be uncovered that is more probable than any other meaning. It is important to distinguish linguistic uncertainty from the more familiar interpretive challenges courts face when interpreting terms that are ambiguous. A term is ambiguous when it is "capable of more than one sensible and reasonable interpretation."[5] Terms that are linguistically uncertain in the sense we use here are not ambiguous but rather are hopelessly vague: the term in question can apply to an infinitely wide spectrum of referents..

What is the mechanism that produces an encrustation that is continually repeated by rote in standard boilerplate? Senior lawyers in the sovereign debt market have described the process to us in the following terms: Lawyers hired to do a deal for clients—such as a bond offering—are told at the front end that they are to use market standard forms as far as possible. But, of course, the deals have to be tailored to the client's needs as appropriate. Names, dates, locations for payment, currencies, etc., have to be changed from whatever prior deal document is being used as a template. The assumption of the clients is that the lawyers possess the expertise to make the necessary marginal modifications to the standard forms to insure that they both fit the client's preferences and do not depart significantly from what the market would consider the "standard package." But the lawyers working with standard form language that has been repeated for many years by rote (and therefore is part of the market standard to which only marginal modifications can be made) are unlikely to have much if any

[5] Ross Bros. Constr. Co. v. State ex rel Transp/ Comm'n Highway Div. 650 P. 2d 1080 (1982).

understanding of the purpose(s) served by these terms. The combination then, of having to make marginal modifications to the contract terms to suit the needs of the transaction, and a lack of understanding of the terms function, can result in the insertions of legal jargon to attempt to add some clarity to the terms. These insertions can occur with greater frequency when the attorneys involved have less experience with the particular boilerplate term. Encrustation can thus result from tinkering with standard language whose contemporary meaning is unclear to the drafter. To be sure, tinkering may occur in other contexts as well. But there are greater error-correction mechanisms for those boilerplate terms that do have understood meaning and frequent usage. Later attorneys that see a variation of a boilerplate term with understood meaning and usage will be less likely to follow the variation if earlier tinkering has changed this meaning and usage. Where a term has lost meaning however, these error-correcting mechanisms will not apply, leading to increasing uncertainty in the meaning of the words in the boilerplate term.

The result of the encrustation process is that the communicative properties of boilerplate terms are weakened, reducing even further their reliability as signals of what the parties really mean (Goetz & Scott 1985). Indeed, we have found instances where the “popularity” of the clause can increase as it is repeated by rote and becomes more encrusted. Widespread use of such a clause occurs, even after it ceases to have substantive content, because it’s rote repetition means that is becomes part of the “check list” of terms that are always present in all such contracts (Gulati & Scott 2013; Choi, Gulati & Scott 2016).

Whenever boilerplate terms lose their meaning, either through rote usage or encrustation, there is a heightened risk that courts may be persuaded to adopt an interpretation of the term(s) at issue that is unexpected and upsets the overall bargain between the commercial parties in the contract.[6] And the costs to the system of that erroneous interpretation, if the clause has become widely used, can be high as the recent experience with sovereign debt

[6] British lawyer, Philip Wood, has described the process of encrustation as akin to that of barnacles accumulating on a ship’s hull (Wood 2009, at 9).

boilerplate has vividly illustrated. To be sure, the standard assumption among both commercial lawyers and legal academics is that the risks of rote usage and encrustation are small: the costs of judicial error will be limited to an isolated case of an aberrant interpretation. This belief is supported by the reasonable assumption that sophisticated commercial parties can (and are motivated to) readily correct a court's interpretive mistakes. Indeed, given (a) the important role that standardization plays in replicating boilerplate terms in literally tens of thousands of commercial contracts, and (b) the non-trivial possibility that a court may err in interpreting those terms that are infected with rote usage and/or encrustation, commercial parties have strong incentives to ensure that their standardized contract terms are continually revised to ensure that the common meaning is preserved. After all, conventional wisdom holds that commercial parties want to reduce uncertainty in so far as possible and, given the scale of the problem, leaving encrusted boilerplate provisions unchanged produces unacceptable levels of uncertainty.

But what if the foregoing assumption of how markets will spontaneously adjust by correcting the errors caused by encrustation is incorrect? It is after all an assumption based on little in the way of empirical or theoretical work on what one might call the production process of boilerplate contracts. What if there are circumstances where sophisticated commercial parties systematically fail to react promptly to what are widely perceived to be judicial errors in interpreting boilerplate terms, or are unable thereafter easily to convert the encrusted boilerplate into a new and intelligible formulation? Worse still, what if the rote usage and encrustation dynamic is increasing over time? Finally, what if there are daunting collective action problems that impair the efforts of public institutions to assist the market in clarifying the meaning of the encrusted boilerplate terms?

The foregoing conditions appear to describe the peculiar case of the *pari passu* clause, a standard boilerplate formulation common to sovereign debt contracts for close to 200 years. In the era of the modern bond markets, the first disputed interpretation of the clause occurred in Brussels, in September 2000, in a case against the Republic of Peru, was affirmed by a different court in a case against the Republic of Argentina in December 2011, and affirmed again on appeal in that same case in October 2012 and August 2013.[7] In each of these cases, the courts endorsed a ratable payments interpretation *of pari passu* that required hold out creditors to be paid in full as a condition to the sovereigns paying consenting creditors under a restructuring agreement. Even though this interpretation effectively undermined efforts by sovereigns to restructure their bonds, meaningful change in the language of the boilerplate term did not begin to appear until late 2014. And, as of this writing in May 2016, while one segment of the sovereign market (the most elite segment, made up of the pure sovereigns) has repudiated the Brussels 2000 interpretation wholesale, change in the other segments (quasi-sovereigns) is barely showing signs of beginning. In a sister article, we ask the questions: why did this action take 15 years (during which thousands of sovereign and quasi-sovereign bonds worth trillions of dollars were issued with the problematic clause), what kinds of efforts had to be made to induce changes, and what were the market consequences of the delay? (Choi, Gulati & Scott 2016). Taking the answers our research generated, the question we tackle here is whether there is a way to solve the problem sooner and better using the courts.

Under the circumstances presented by the *pari passu* saga, if the costs of delay are sufficiently high (the above mentioned research suggests that they were), and if the costs of inducing change in response to judicial error are similarly high (again, this is what believe the research to show), the standard interpretive command to courts to "find" what the parties to the litigation "meant" by the boilerplate terms may be misguided. Instead, social welfare considerations support interpreting boilerplate terms "infected" by rote usage or encrustation in ways that reduce the costs of an erroneous interpretation. This argues, in turn, for a shift in contract doctrine away from the entirely futile and ultimately costly effort to discover a meaning that no longer exists.[8]

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[7] The key decisions were Elliott Associates v. Republic of Peru 2000/QR/92 (Ct. App. Brussels, 8th Chamber, Sept. 26, 2000); Order, NML Capital, Ltd. v. Republic of Argentina, ____(S.D.N.Y. Dec. 7, 2011) (No. 08 Civ. 6978), 2011 WL 9522565, at *2; NML Capital, Ltd. v. Republic of Argentina, 699 F.3d 246 (2d Cir. 2012).

[8] The underlying canon of contract interpretation directs courts to give every term and clause in a contract a meaning, under the assumption that parties have drafted terms in contract to convey their collective purposes.

To be sure, the extent of rote usage and encrustation in commonly used boilerplate remains an open question, and distinguishing encrusted terms from those whose meaning can be discerned by a court remains an essential requirement of any change in interpretive approach. But what the case of the *pari passu* clause suggests is that changing boilerplate terms can take years and the process can prove enormously costly; particularly in terms of the bonds worth hundreds of billions of dollars being issued with suboptimal contract terms in the interim period. Those costs support our claim that a search for party intent is both futile and counterproductive when boilerplate with these characteristics is included in industry contracts. Instead, we argue that courts should adopt an interpretative rule that recognizes the reality: when encrusted boilerplate is repeated by rote for many years without legal challenge, and no party has reason to know a different meaning attached to the clause by another party, the clause is legally meaningless and should not be given operational effect. Put differently, the canon of contract interpretation that directs courts to give every provision in a contract a meaning—under the assumption that provisions in contract are there only because the parties want them there for a reason—should be ignored in the set of cases where the provisions in question can be identified as encrusted and whose meaning has been lost. To hold otherwise is to risk imposing decades-long costs on the affected market.

III. Getting the Courts to Change Their Interpretive Strategy

As noted above**,** our sister paper reports on the data we collected on the evolution of the *pari passu* clause through multiple litigations, the most prominent of which were the hedge fund attacks on Peru and Argentina (Choi, Gulati & Scott 2016)**.** At first glance the empirical evidence we collected—both quantitative and qualitative—seems puzzling and even confounding. Contract theory predicts that contract drafters will promptly revise standard

The Second Circuit, NML v. Argentina, put it this way: "A contract should not be interpreted in such a way as would leave one of its provisions substantially without force or effect." NML v. Republic of Argentina, 69 F.3d 246, __ (2d Cir. 2012) (citing Singh v. Atakhanian, 818, N.Y.S.2d 524, 526 (N.Y. App. Div. 2d Dep't 2006)).

contract terms when faced with an interpretation adverse to their client's interests. That relatively few changes were made to the *pari passu* boilerplate for over three years after federal courts in New York indorsed the ratable payments interpretation in the litigation involving Argentina (and roughly fifteen years after the Brussels decision involving Peru) is perplexing. While some issuers inserted disclosures attempting to explain to investors the risk that courts may misinterpret the issuers' existing *pari passu* clauses, only a handful of issuers in the first several years after the Southern District of New York's *pari passu* decision in 2011 actually changed the language of the clause. The foregoing is especially perplexing because the drafting lawyers, and the entire sovereign bond industry, were nearly unanimous in condemning the series of judicial decisions that permitted the contractual arbitrage strategies of the holdout creditors to prevail. Moreover, when clarifying revisions to the *pari passu* clauses eventually began to appear, they seemed to be prompted by two conferences held in New York in late fall of 2014 rather than by the succession of adverse court decisions by the leading commercial courts in the U.S. Adding to the mystery, the clarifying revisions that began appearing in many bond issues in late 2014 were limited to bonds issued directly by a sovereign (pure sovereign bonds). But almost no similar changes have as of this writing yet been made to *pari passu* clauses in bonds issued by quasi-sovereigns (cities, regions, state owned companies with sovereign guarantees) even where those bonds in some cases are guaranteed by the same sovereigns whose own *pari passu* clauses had been "repaired."

Notwithstanding the apparent contradictions, and as we explain in Choi, Gulati & Scott (2016), a story does emerge from the quantitative and qualitative data. We don't suggest that this is the only story that explains the *pari passu* puzzle, but it is the only explanation that fits all the data sources we have collected. After describing below the story that emerges from our quantitative and qualitative data, we then address the question with which we began: what interpretive rule would motivate courts to better determine the common meaning in encrusted boilerplate like the *pari passu* clause?

A. A Collective Action Story (With a Heavy Dose of Agency Costs)

Various inertia costs may deter any individual market participant from inducing a change in a boilerplate term. A change to the contract language that closes off holdouts in cases involving a newly issued bond might put the unchanged clauses in prior bonds of that sovereigns at greater risk of enabling holdouts (if the judge takes a negative inference about the meaning of the old clauses from the fact that there was a change). There will be some uncertainty as to how investors will react to a new clause; especially if the sovereign using the clause is an early mover. Investors may have a preference for the "standard" package of terms, whatever they are. Changing a term poses the risk that the bond will be viewed as non standard. No one knows for sure how courts will interpret the new term, particularly if the problematic interpretation of the old clause gets reversed by a higher court.

If the market participants in the sophisticated sovereign bond market—including the elite lawyers and their clients (the sovereigns and the investors or, more properly, the agents for the sovereigns and the investors)—acted together, they could overcome many of these inertia costs. If the market as a whole put forward a new market standard with a clear interpretation of the intent of this standard (for example, to overturn what the market viewed as the SDNY's erroneous interpretation of the *pari passu* clause), then this act by the market as a whole would establish a new standard accepted by investors, reduce the legal uncertainty on how this new standard would be interpreted, and minimize the risk that courts would view the new standard as creating a negative inference on how to interpret the existing stock of old clauses.

Getting market participants to act together however is not easy. The best explanation of the *pari passu* puzzle, we believe, is a variant of a collective action problem: The individual interests of the key market participants are inconsistent with those parties' collective interests. The private interests of the elite lawyers are the mirror image of their de facto clients, the debt managers, the agents of the sovereigns, and the investment banks, the agents of the investors. And both sets of agents are subject to hyperbolic discounting relative to the sovereigns and investors: the agents are motivated to minimize the ex ante costs of a bond issue (transaction costs plus price discounts) even where expected ex post costs (restructuring cost, the cost of holdouts, etc.) are thereby increased by an even greater amount.[9] In contrast, the collective interests of the same set of elite lawyers are to protect the "industry" and the market for sovereign bonds so that future issuances proceed smoothly and future business can grow. The public sector (the IMF, the U.S. Treasury, etc.,) and the industry trade associations (ICMA, IIF) do internalize the collective problem but they are helpless to act until they are able to assemble the critical mass of key players to coordinate on the best way to reject the ratable payments interpretation. This is because any revision to the clause has to be "settled" among the key players, since those same private interests demand "standard" legal terms that minimize the ex ante costs of placing the bonds in the market. And this demand for standard terms is particularly high if the term in question is one that is on the proverbial checklist; that is, the type of term that one expects to see if one has a sovereign bond.[10]

This collective action story supports an agency cost hypothesis and explains the apparent inconsistency between the expressions of outrage by the elite bar and their concomitant unwillingness to effect any change in the standard boilerplate language. It also explains why there finally was substantial movement to revise the pure sovereign issuances in the late fall of 2014 and why the apparently coordinated decision to revise *pari passu* was not followed in the quasi-sovereign bonds that were issued during the same time frame. In what follows, we support the collective action/agency cost story by describing in more detail the respective individual and collective interests of each of the principal parties.

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[9] Excessive discounting by agents thus leads to bond issuances that are less efficient than they could be. An efficient sovereign bond contract optimizes total contracting costs by trading off the ex ante or front end costs of the contract and the ex post or back end costs of default. *See* Scott & Triantis (2006).

[10] One way to understand the stickiness of terms that make it on to the check list is to see them as category defining terms. Scholars in sociology have long observed the importance attached, even by sophisticated market actors, to whether products fit certain defined categories–e.g., a vehicle is not a car unless it has four wheels, and only if it is a car, will it get rated by car magazines and evaluated by car experts and sold by car dealers and so on. On this, s*ee* Zuckerman (1999).

a. The elite lawyers: The private interest of each of the elite lawyers who dominate the sovereign bond market is to process bond issues at the least ex ante cost and as quickly as possible, notwithstanding expected default costs. This single minded focus on front end contracting costs is simply a reflection of the fact that the "legal terms" for which the lawyers are responsible and that form the standard boilerplate are seen as immaterial in the initial pricing of the bonds. Thus, any change in the risk of default that results from a change in the legal terms of the contract is ignored by both the debt managers (who act as agent for the sovereign) and the investment bank (that serves as agent for the investors). In short, the ex ante legal meaning of *pari passu* is irrelevant: the clause is essentially meaningless encrustation. Nevertheless, the *pari passu* clause remains as part of the bonds' contractual boilerplate because it is part of the "standard form," and standardization is valued because it reduces ex ante contracting costs (Goetz & Scott 1985, Kahan & Klausner 1997). While elite lawyers, if they could coordinate, would value addressing the ambiguity in the *pari passu* clause that may increase costs associated with ex post holdouts and harm the overall market, the collective action problem facing the group of elite lawyers as well as the hyperbolic discounting on the part of the agent debt managers and investment banks deters concerted efforts at change.

When Elliot Associates succeeded in having a court adopt the ratable payments interpretation in Brussels in 2000, the elite bar was outraged but not because any lawyer's individual interests were imperiled. As we know, their clients did not care. The elite lawyers were outraged (in unison with the public sector and other collective groups) because they saw that the ratable payment interpretation imperiled the very health of the industry itself. If bonds in default cannot be restructured then, over time, the pressure from the contract arbitrageurs whenever a sovereign faces default will reduce the demand for issuing debt in this form and the robust market for sovereign bonds will be negatively impacted. This means a future decline in a lucrative legal business. The collective interests of the lawyers who dominate this industry is to maintain a healthy and thriving sovereign bond market where bond issues are produced on an assembly line. And this way of doing business was threatened.

At the same time, these lawyers had no incentive to revise the standard terms for their individual clients. The debt managers for the sovereigns do not care about the legal terms at the time of issuance: they do not regard the legal terms as relevant to the initial pricing of their bonds because they know that the investment banks charged with marketing the bonds only care about having the standard form. Moreover, the clients affirmatively discourage individualized deviations from the boilerplate formulation because non-standard legal terms make the initial issuance more difficult and costly to get to market. Thus, the lawyers repeatedly demanded that the state solve the problem but did nothing themselves other than to offer empty platitudes about why they failed to act.

This saga continued for nearly 15 years until one lawyer at a October 2014 Columbia University conference committed a gaffe by saying: “We don’t know how to respond to this problem because the interests of our clients are not identical and many clients do not ask for (or want) any change in the standard legal terms.” The evidence we have points to the fact that this session, and the subsequent meeting of an elite subset of the same group (with some additions) several weeks later at the New York Fed, was the impetus for coordinating a move to a revised standard (and equally meaningless) *pari passu* clause. The lingering agency problem for the elite bar is that the de jure client is the "true sovereign"—the people or at least the duly constituted government—and not just the debt managers. And it is not at all clear that those interests are advanced by treating all sovereigns as having the same default risk and issuing standardized boilerplate for sovereign bonds despite the apparent variance in the probability of a future restructuring between first world countries and developing nations.

b. The sovereigns. The sovereign’s interests are also skewed by an agency problem. The agents (the debt managers) are only motivated to consider the sovereign’s immediate interests (low transaction costs and a good initial price). Yet, many sovereigns also have a long-term interest in having the capacity to restructure their bonds as economic conditions change and the threat of a default is real. These long-term interests are, however, typically underrepresented in the state's bureaucracy where politicians and state officials often focus on the immediate short-term (corresponding to their tenure in office). This short-term focus of the state's bureaucracy translates into short-term incentives imposed on debt managers. Thus, the debt manager only cares about what the investors claim to care about—the business terms that they believe do influence bond prices—and they want the legal terms to remain unchanged and uncontroversial so as to secure the best initial price at the lowest issuance cost. In short, the sovereign's agents engage in hyperbolic discounting because that is what they are paid to do. Nevertheless, theory predicts that some (many) sovereigns will have issued bonds prior to the revisions to *pari passu* that risk imposing substantial costs on their county's citizens.

c. The investors. But why don't the investors who buy the bonds care about the ability to restructure in the event of default? This is a difficult question, but one hypothesis is that it is too costly to try and match a given sovereign with the optimal clause. Some sovereigns may present a measurable default risk while others may not, and the information to make particularized ex ante calculations is costly to acquire especially in a world of encrusted boilerplate of uncertain meaning. The same holds for the information needed to quantify how changes in *pari passu* will alter the present value of future repayment if default occurs. A rationalist skeptic might ask: Why is the market so imperfect? Behavioral theory may explain part of the answer as being a function of excessive discounting. Another consideration is the fact that this is a liquid market where bonds can easily be resold on the secondary market. In such an environment, the business terms are a good enough proxy for future default risks especially where boilerplate terms have been stripped over time of comprehensible legal consequences.

But the preceding does not answer one remaining question: If Jay Newman, Elliot's legendary contract arbitrageur, prides himself on reading the bond contracts once default looms in order to capture rents as a hold out creditor, then doesn't it follow that he and other vulture fund hotshots will read the bond contracts at the time of issuance as well? This means there should be arbitrage in the primary market where smart investors are buying bonds selectively based on their reading of the legal terms because even if they don't plan to be there when the default hits, they know that Jay Newman and others will pay them a higher price for the bonds with better contract terms in that near-default scenario. To be sure, investors act as though the risk of a default without the ability to restructure is too remote to affect initial price. But will the market adjust if the vulture funds engage in arbitrage ex ante as well as ex post?

Let's try a simple thought experiment: Assume sellers and buyers are selling #1 corn: the standardization criterion is critical to the market because it reduces search costs. Assume as well that 1% of all #1 corn will rot before it reaches the ultimate consumer. Assume finally that consumers absorb ½ of the $18 costs of rotting and wholesalers absorb the other ½ and that investigation costs to identify that 1% before the corn is sold to the wholesale market are $10. Here is it rational for wholesale buyers not to spend $10 to search for the telltale signs of future rot in order to save $9 in discard costs. In short, so long as the initial investors only bear some of the price risk caused by legal arbitrage, it still may be rational for them to sell bonds without discriminating among legal terms that influence the costs of default.

d. The public sector and industry associations. The IMF, the Paris Club, the Institute of International Finance, the International Capital Markets Association (ICMA) and so on have only collective interests. Why was it so hard to coordinate with the elite lawyers and solve the problem much earlier? The best inference from our data is that the collective interests believed that the expected costs of litigation in the Second Circuit and the Supreme Court (where the initial New York decision against Argentina in 2011 was appealed in 2012 and 2013) were lower than the costs of coordination given that the elite members of the bar were individually reluctant to do anything. Thus, so long as the courts could be expected to "get it right" in the end, coordination costs were simply too onerous.

This then leaves the last part of the story. How did the process of change finally get induced in mid to late 2014? Recall that solving the collective action problem not only required a willingness to consider the collective interest over private interests but the parties all had to coordinate around a common formulation in order to substitute a new standard term in place of the defective one. At the Columbia conference in October 2014, many of the elite lawyers were openly critical of the clarification to the standard *pari passu* clause proposed by the IMF and ICMA. Yet once they were invited to a second meeting limited to the most elite among them and asked to participate in solving a common problem of global significance, the attendees quickly and easily reached an agreement and revisions began to appear from that point onward. Is it really true that status and flattery were all that was needed to do the trick? Was the Columbia conference an important first step for the elite bar to recognize that they all shared the same private and collective interests (and that the Emperor had no clothes)? Our data cannot answer these last questions but we do know that the elite lawyers who were in the room at both the Columbia and New York Fed meetings in October 2014 represented the "pure" sovereign issuers doing offerings under New York and English law. And the market for pure sovereign bond issuances is precisely where the standard revision has now become the norm, whereas other lawyers who were not invited to the meeting with the IMF (and are often partners at the same law firms as the elite cohort) represent subsidiary sovereign interests that have yet to coordinate around a revision that rejects the ratable payments gloss.

B. What Should Courts do with Encrusted Boilerplate?

The Second Circuit Court of Appeals in *NML v. Argentina* approached the interpretation question by relying on conventional contract doctrine under New York law. The standard interpretive principle courts are instructed to use in ascertaining the meaning of a contract term to which both parties have manifested assent is to look for the shared intent of the contracting parties. Intent, in turn, is determined both objectively and prospectively: A party is taken to mean what its contract partner could plausibly believe it meant when the parties contracted (Schwartz & Scott 2003). Textualist theories undergird the New York courts' doctrines of contractual interpretation that are designed to uncover the objectively reasonable, ex ante intent of the parties. Textualist jurisdictions, such as New York, use a "hard" parol evidence rule that gives presumptively conclusive effect to merger or integration clauses[11] and, in the same spirit, this approach bars context evidence suggesting that parties intended to impart non-standard meaning to language that, read alone, is unambiguous.[12]

There is a powerful justification for giving boilerplate terms in commercial contracts their plain or standard dictionary meaning: a valuable state function is to create standard vocabularies for the conduct of commercial transactions (Scott 2000). When a phrase has a set, easily discoverable meaning, parties who use it will know what the phrase requires of them and what courts will say the phrase requires. By insulating the standard meaning of terms from deviant interpretations, this strategy preserves a valuable collective good, namely a set of terms with clear, unambiguous meanings that are already understood by the vast majority of commercial parties (Goetz & Scott 1985). It is tempting to argue, as the British lawyers did following the New York courts' interpretations of *pari passu* in *NML v. Argentina*, that such a strict construction might subvert the parties' true intentions (Choi, Gulati & Scott 2016a). However, the ability of commercial actors to select language unencumbered by predefined meaning offers the conventional justification for the rule.

But the preceding exposes a fundamental dilemma that textualist courts confront when applying the plain meaning presumption to linguistically uncertain boilerplate such as the *pari passu* clause: the interpreter must somehow distinguish between meaningful language and

[11] Merger clauses are given virtually conclusive effect in New York. *See* Tempo Shain Corp. v. Bertek, Inc., 120 F.3d 16, 21 (2d Cir. 1997) ("Ordinarily, a merger clause provision indicates that the subject agreement is completely integrated, and parol evidence is precluded from altering or interpreting the agreement."); Norman Bobrow & Co. v. Loft Realty Co., 577 N.Y.S.2d 36, 36 (App. Div. 1991) ("Parol evidence is not admissible to vary the terms of a written contract containing a merger clause.").

[12] The New York courts' plain meaning rule addresses the question of what legal meaning should be attributed to the contract terms that the parol evidence rule has identified: when words or phrases appear to be unambiguous, extrinsic evidence of a possible contrary meaning is inadmissible. For discussion, see Schwartz & Scott (2010).

empty boilerplate. This suggests that textualist courts are well advised to interpose a further step before applying the plain meaning presumption when interpreting standardized terms in commercial contracts. The court should first admit evidence on the question of encrustation. The evidence we have described above is illustrative of the proof that the parties alleging encrustation might proffer. Has the clause been repeated by rote over many years, where repetition has robbed the term of any obvious conventional meaning? Has the term been embedded in layers of legal jargon such that its intelligibility is substantially reduced?[13] Is an historic or original meaning of the term accessible in a fashion that makes sense in the contemporary context and are contemporary commercial actors aware of that meaning?[14] Is there credible evidence that the particular provision was priced at the original issue stage?[15]

If a textualist court finds evidence of encrustation in standard boilerplate, the presumption of shared meaning is no longer apt. Rather, the court might approach a resolution of the dispute by shifting to a presumption that the parties have attached different meanings to the term in question. That presumption invokes the common law rule that if parties have

[13] A critic might ask whether what we call "layers of legal jargon" or "encrustation", is being unfairly dismissed as meaningless. After all, these encrustations (like the insertion of the word "payment" into the *pari passu* clause sometime in the 1970s) were knowingly chosen by some junior lawyer so as (probably) to make the clause clearer or more advantageous for his client. If it was consciously chosen by a lawyer, the critic might say, surely it is the opposite of meaningless jargon. Our response is that the key here is whether the underlying core clause has a meaning that both parties understand. If not, then adding some clarifying language to what is gibberish at the core either leaves us with gibberish or produces a new clause that neither party understood they were contracting for (or at the least, only one party's junior lawyer understood).

[14] When we began the *pari passu* project over a decade ago, one of the initial ideas that two of us had about solving the problem of the market unwillingness to fix their clauses was that perhaps all it would take was an unearthing of the original meaning (and form) of the clause. Once someone did that and credibly showed all of the parties involved what the clause had originally meant to say, then they could decide on how to revise it. Choi & Gulat (2006). So, a number of scholars, including us, embarked on a search for the original meaning of the *pari passu* clause (the first versions of the clause, we discovered, were used in the early 1800s) (Scott & Gulati 2013, Chabot & Gulati 2014, Gelpern 2016). To our chagrin, however, it turned out that the contemporary contract drafters didn't care one bit about the clause's original meanings – the context of the 1800s, we were told by some respondents, was simply too different to care about what the original conception was in determining what to do with the clause today.

[15] Based on what we have seen, it probably does not mean much if we do not find a pricing effect. But if we do find an effect, it likely means that the clause was intended to have a specific discernable meaning.

attached different meanings to a term neither party is bound by the meaning of the other *unless* at the time of contracting one party did not know (or have reason to know) the meaning of the counter party, who in turn did know (or have reason to know) the meaning of the first party.[16] Applying this principle to the *NML* case, and assuming neither party knew or had reason to know of the other's different ex ante understanding, the court should find that neither party's interpretation of *pari passu* was legally relevant. Alternatively, if the court were to find that NML/Elliot knew or had reason to know of Argentina's ex ante understanding that *pari passu* did not encompass the ratable interpretation, the court would be directed by the rule to adopt the meaning asserted by Argentina.

* * *

A natural question for a skeptic is to ask whether the *pari passu* clause is idiosyncratic. Perhaps the *pari passu* clause is a unique example of encrustation. Perhaps there are few, if any, other instances of standardized boilerplate that no one understands, but that nevertheless persist. We have not done a systematic examination of all of the contract provisions in standard sovereign bond to examine which of them have become rote and encrusted and which ones are clean—the skill and ability to do that lies with the contract arbitrageurs.

The foregoing caveat aside, even we—as outsiders looking at this industry—can readily observe other contractual black holes, including number of examples found in the basic check list for sovereign bond offerings. The obvious one for us is the Negative Pledge clause that, like the *pari passu* clause, has a vintage that goes back to the early 1800s. The basic idea underlying the negative pledge clause is that the sovereign promises contracting creditors not to pledge its assets to make payments to other creditors (basically, giving the other creditors a preference) unless it also ratably or equally pledges its assets to the contracting creditors. The clause probably made sense in the 1800s when sovereign borrowers regularly pledged assets to

[16] *See* Restatement (Second) Contracts § 201(3). In the case where one party does not know the meaning of the other and the other does know or have reason to know the meaning of the first party, the term is interpreted in accordance with the meaning asserted by the first party. *See* Restatement (Second) § 201(2).

foreign creditors and those foreign creditors periodically sent troops to seize assets (mines, customs houses, railroads and so on) when they were not paid (E.g., Krasner 2001). But gunboat diplomacy is no longer considered civilized and international law does not allow one nation to use military force on behalf of its nationals who wish to seize another sovereign's assets. The end result is that no sovereigns pledge assets these days. But if they did pledge in violation of the clause, and then subsequently defaulted, it is not at all clear how the promise of ratable security would be implemented, what legal body would enforce the promise, or what that would mean for payments to the creditors with and without the clauses. Yet, despite the fact that no sovereigns pledge assets these days and almost no one seems to know how the negative pledge clause would operate vis-à-vis a sovereign that did decide to pledge assets to some and not others in violation of the clause, the clause persists. Indeed, like the *pari passu* clause, it is ubiquitous—it is on the "check list" and therefore an integral part of the standard form, even though no one seems to have any idea why it is there. That, we would say, based on watching the *pari passu* debacle, is fertile ground for a contract arbitrageur.

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