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Contractual Arbitrage

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CHAPTER

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Abstract

Standard-form contracts are likely to be incomplete because they are not tailored to the needs of particular deals. In an attempt to reduce incompleteness, standard-form contracts often contain clauses with vague or ambiguous terms. Terms with indeterminate meaning present opportunities for strategic behavior well after a contract has been executed. This linguistic uncertainty in standard-form commercial contracts creates an opportunity for “contractual arbitrage”: parties may argue ex post that the uncertainties in expression mean something that the contracting parties did not contemplate ex ante. This chapter argues that the scope for contractual arbitrage is a direct function of the techniques that courts use to resolve ambiguities in boilerplate language. Using the case of *NML Capital v. Argentina*, this chapter shows how traditional contract doctrine can produce a fertile setting for the growth of contractual arbitrage.

Keywords: sovereign debt, contracts, boilerplate, litigation, pari passu

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Introduction

No matter how diligently contracting parties try to anticipate all the possible contingencies that may affect their performance, they will fail simply because the transaction 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, plus 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 uncertainties—terms with indeterminate meaning—present opportunities for strategic behavior well after a contract has been executed: 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 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. By definition, standard-form instruments fit individual deals less perfectly than their situation-specific tailored cousins. In other words, the contractual indeterminacy is going to be greater (or at least there will be more numerous indeterminacies) than with a tailored contract because the fit with any individual transaction 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 and Klausner 1997; Choi and Gulati 2004).[1] Moreover, the risks posed by linguistic uncertainties may not always be fully priced by the market. To the extent the agents tasked with drafting the contract only care about those matters that are priced, the result is that arbitrage opportunities remain for the 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, and Scott 2017).

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—many multiples of their original purchase prices, according to estimates (Guzman 2016; Levine 2016; Porzecanski 2016). The story of these contract arbitrageurs operating in the sovereign debt markets started, however, 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 more than a century and a half.

The story of this litigation has been told in detail, and on multiple occasions, elsewhere (e.g., Buchheit and Pam 2004; Gulati and Scott 2013). We therefore recount here only a simplified version of the key events. The basic clause, whose origins have been traced to at least the early 1800s, provided in essence that "the bonds will rank pari passu with all other unsubordinated bonds of the Republic." The idea of bonds ranking equally (pari passu literally means "in equal step") makes sense in the corporate context: if the entity goes bankrupt, the bondholders who have this equal rank will share proportionally from the proceeds of the liquidation. But sovereigns do not ever liquidate in a bankruptcy-type proceeding. So the question is, what does such a clause mean in the case of a sovereign debtor? As a historical matter, one can tell a story why the clause might have made sense in the 1800s, when gunboat diplomacy was in vogue: back then an imperial power might send its navy to seize the ports of the defaulting nation and divide the customs revenues among foreign creditors based on the terms of their contract rights (Gulati and Scott 2013). But such behavior is no longer acceptable in the global community. Commentators writing in the 1990s had speculated about the value of the pari passu clause in the standard sovereign debt contract, concluding that it had no apparent contemporary meaning and was simply a historical vestige.

In the litigation against Peru, however, the US hedge fund Elliott Associates asserted that it knew precisely what the clause meant. Its claim was that all creditors holding pari passu rights were to be paid on a pro rata basis even outside of a bankruptcy liquidation. One might ask why a hedge fund seeking to obtain a disproportionate share of the payout from a defaulting sovereign would argue that it was equal to everyone else. The strategy chosen by Elliott Associates was to wait until other creditors had agreed to a restructuring offer from Peru for a small fraction of their original claims and then to assert a claim for the full amount of its bonds as a nonconsenting creditor. Elliott claimed that if Peru after the restructuring deal paid 100 percent of the debt owed to the creditors who had exchanged old bonds for new ones (paying, say, 30 cents on the dollar), it was entitled to the same percentage payment on the face value of its original bonds. Moreover, Elliott succeeded in persuading a judge in Brussels to enjoin Euroclear (through which payments to other creditors were being processed) from paying any other creditors in a fashion that violated Elliott's interpretation of the pari passu clause. Peru was then in the midst of a political crisis and did not want to risk going into default on its restructured bonds, so it paid Elliott in full.

The debt that Elliott originally purchased for roughly $11 million ended up paying out in the vicinity of $55 million (Gulati and 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 part of the standard package of terms in the sovereign debt contract (Varottil 2008; Weidemaier, Gulati, and Scott 2013; Nelson 2016). Indeed, the relevant clauses remained basically unchanged for more than a decade longer.

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.[2] 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.[3] 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 sovereign is seeking to restructure its debt (Schumacher, Trebesch, and Enderlein 2015, 2018). Greece faced this in its restructuring in 2012 when it found that a subset of creditors had identified the best contracts to hold out on and refused to take anything but full value, thus avoiding the brutal haircut (60 percent plus net present value) that Greece was trying to impose on every bondholder (Zettelmeyer, Trebesch, and Gulati 2013). Ukraine faced a large group of sophisticated creditors in its restructuring in 2015 (Gelpern, Heller, and Setser 2016). And Puerto Rico and Venezuela had to deal with a subset of these creditors in December 2016 (Mahler and Confessore 2015; Scigliuzzo 2016; Wigglesworth and Moore 2016). Finally, the aforementioned Argentine litigation spilled even more blood in the water in 2016 when it ended up paying the most aggressive of the holdout creditors between 300 and 800 percent of the principal amount of their claims (Levine 2016; Cruces and Samples 2016).[4]

The experience of the past two decades in the sovereign debt markets should teach at least one lesson: the assumption that sophisticated markets will move quickly to eliminate linguistic uncertainties in standard-form contracts is wrong—at least in the sovereign debt world (although we suspect this assumption is also wrong in other contexts involving standard-form contracts). In related work, we show empirically that powerful international institutions such as the International Monetary Fund, the United States Treasury, and the Paris Club have nonetheless faced extraordinary difficulty coordinating the market in order to induce revisions to the language and terms of boilerplate clauses in the standard sovereign debt contract (Choi, Gulati, and Scott 2017; Gulati and Scott 2013).

The foregoing poses a simple global governance question. If the typical answer that "the market will promptly respond to aberrant interpretations and repair linguistic uncertainties in contracts" does not hold in contexts where standard-form contracts dominate, what else can be done to address the problems caused by the growth in the number and influence of contract arbitrageurs? We propose looking to courts to revise their doctrinal 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 with 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 does not hold 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 simply because they are part of a standard package of terms familiar to the market.[5] In such a case, we argue, courts can ameliorate the problem of contract arbitrage by adopting new techniques for interpreting standard form boilerplate.

When Contract Terms Become Rote and Encrusted

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 insofar as a court can recover those intentions from the contract or the surrounding context.[6] But in the case of linguistic uncertainty, some standardized terms in boilerplate contracts between sophisticated parties may have lost any recoverable meaning. In other words, boilerplate contracts may sometimes contain terms that are akin to a contractual black hole (Choi, Gulati, and Scott 2017). 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 and Scott 1985). Parties often will face difficulties in drafting new terms from scratch that precisely capture their mutual intent. How courts may interpret a new term may vary in different contracting environments, leading to ex ante uncertainty for parties attempting to draft a new term. Boilerplate terms offer a solution, allowing parties in heterogenous environments who wish to communicate a shared intent to 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.

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 empty 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 (Goetz and Scott 1985). "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 used 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."[7] 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 repeated rotely in standard boilerplate? Senior lawyers in the sovereign debt market have described the process 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, and so on 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 ensure 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 used by rote for many years (and therefore is part of the market standard, to which only marginal modifications can be made) are unlikely to have much if any 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 not fully understanding the terms' function can result in the insertion of additional legal language 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 an understood meaning and are frequently used. Later attorneys who see a variation of a boilerplate term with understood meaning and usage will be less likely to follow the variation if it has changed this meaning and usage. Where a term has lost meaning and become a black hole, however, these error-correcting mechanisms will not function, leading to increasing uncertainty about 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 and 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 has become part of the checklist of terms that are always present in all such contracts (Gulati and Scott 2013; Choi, Gulati, and Scott 2017).[8]

Whenever boilerplate terms lose their meaning, through either 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 undermines the original bargain between the commercial parties to the contract. And if the clause has become widely used, the costs to the market of that erroneous interpretation can be very high, as the recent experience with sovereign debt 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 (1) the important role that standardization plays in replicating boilerplate terms in literally tens of thousands of commercial contracts and (2) the nontrivial 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 so that the common meaning is preserved. After all, conventional wisdom holds that commercial parties want to reduce uncertainty insofar 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 for 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 to convert the encrusted boilerplate easily 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. As noted earlier, it is a standard boilerplate formulation common to sovereign debt contracts for close to two hundred 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; it 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.[9] In each of these cases, the courts endorsed a ratable payments interpretation of pari passu that required holdout creditors to be paid in full as a condition to the sovereigns paying consenting creditors under a restructuring agreement. Even though this interpretation rewarded holdout creditors and 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. By late 2016, one segment of the sovereign market (the most elite segment, made up of the pure sovereigns) had repudiated the Brussels 2000 interpretation wholesale, but change in the other segments (quasi-sovereigns) was barely showing signs of beginning. In a sister article, we ask why this action took fifteen 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 the market consequences were of the delay (Choi, Gulati, and Scott 2017). Taking the answers our research generated, we tackle here the question of 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 (our research suggests that they were) and if the costs of inducing change in response to judicial error are similarly high (again, this is what the research shows), 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. As we discuss in more detail below, 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.[10]

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 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 where the meaning has been lost. To hold otherwise is to risk imposing decades-long costs on the affected market.

Getting the Courts to Change Their Interpretive Strategy

As noted, 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, and Scott 2017). At first glance, the empirical evidence we collected—both quantitative and qualitative—seems puzzling. Contract theory predicts that contract drafters will promptly revise standard 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 more than 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 United States.[11] 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 by late 2016 almost no similar changes had 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, and Scott 2017), a story emerges from the quantitative and qualitative data. We do not 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 the story that emerges from our quantitative and qualitative data, we will 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 Collective Action Story (With a Heavy Dose of Agency Costs)

Various inertia costs may deter any individual market participant from introducing 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 draws a negative inference about the meaning of the old clauses from the fact that the older language was subsequently revised). Moreover, there will be some uncertainty as to how investors will react to the new clause, especially if the sovereign using the revised clause is a first mover. We know from interviews with investors, government debt managers, and the lawyers who draft these terms that they have preferences for the "standard" package of terms, whatever they are (Gulati and Scott 2013; Gelpern, Gulati, and Zettelmeyer 2017; de Fontenay, Meyer, and Gulati 2018).[12] Changing a term that is part of the market standard poses the risk that the new bond will be viewed as idiosyncratic and face a market price penalty. There is resulting uncertainty over how courts will interpret the new nonstandard 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 collectively, they could overcome many of these inertia costs. If the market endorsed a new standard with a clear statement of the intent that motivated the change (for example, to overturn what the market viewed as the courts' erroneous interpretation of the pari passu clause), then this market-wide action would establish a new standard accepted by investors, reduce the legal uncertainty over 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 in concert is not a simple task, however. 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 lawyers who draft the contracts are the mirror image of the interests of their de facto clients: the debt managers acting as the agents of the sovereigns and the investment banks acting as agents of the investors. And both sets of agents are subject to hyperbolic discounting relative to the sovereigns and investors: they are motivated to reduce the ex ante costs of a bond issue (transaction costs plus price discounts) even where expected ex post costs are thereby increased by an even greater amount (restructuring cost, the cost of holdouts, etc.) due to the discounting of these ex post costs.[13] In contrast, the collective interests of the same set of bond 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 US Treasury, etc.) and the industry trade associations (ICMA, IIF, EMTA) do internalize the collective problem, but they are helpless to act until they are able to assemble a critical mass of key players to coordinate on the best way to reject the disfavored ratable payments interpretation.[14] 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 standard sovereign bond.[15]

This collective action story supports an agency cost hypothesis and explains the apparent inconsistency between the expressions of outrage by the elite bar over the various court interpretations of pari passu 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 case of 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.

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 which form the standard boilerplate, are seen by debt managers and investment banks as immaterial to the initial pricing of the bonds. 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 (which 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 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 and Scott 1985; Kahan and 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, both the collective action problem facing the group of elite lawyers and the hyperbolic discounting on the part of the agent debt managers and investment banks deter concerted efforts at change. This hyperbolic discounting problem exists whenever agent debt managers and investment banks pay more attention to the ex ante or front-end costs of the contract (getting the deal done with minimal negotiation costs) than to the potentially larger ex post or back-end costs of default.

When Elliott 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 interest 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 nonstandard 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 fifteen years until one lawyer at an 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, along with 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 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 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.

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 when 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.

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 to 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, Elliott's legendary contract arbitrageur, prides himself on reading the bond contracts once default looms in order to capture rents as a holdout 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, with smart investors buying bonds selectively based on their reading of the legal terms because even if they do not 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. One response is that investors act as though the risk of a default without the ability to restructure is too remote to affect initial price. Given only a remote probability of default at the time of issuance, it may not be worth the expense for vulture funds to investigate the specific contract terms of the issued bonds at that time.

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 initially there is a 1 percent probability that any particular batch of #1 corn will rot before it reaches the ultimate consumer, resulting in an expected $18 loss if the rotting corn reaches the consumer (including shipping costs and the additional cost of discarding the corn once it is in the hands of the consumer). Assume that a rational consumer understands the possibility of rotten corn and will demand an $18 price reduction from the wholesaler to compensate for the expected losses due to rotten corn. Assume finally that investigation costs to identify any rotten corn before the corn is shipped and sold to the wholesale market are $20. If the potentially rotting corn is identified before shipment, the expected $18 loss can be entirely avoided. Here it is rational for wholesalers not to spend $20 to search for the telltale signs of future rot in order to save $18 in discard costs. Things may be different for a wholesaler if later on new information comes to light that there is a higher probability of rotten #1 corn (perhaps because of wet weather conditions)—suppose a 2% probability resulting in an expected loss of $36 if the rotten corn is shipped. Once the probability of rotten corn increases, expending resources to identify the corn to prevent shipment becomes rational for the wholesaler. In short, so long as the initial investors (similar to the wholesalers at the time the wholesalers initially acquire the #1 corn) face only a low risk of a default, it still may be rational for the initial investors to purchase bonds without discriminating among legal terms that influence the costs of default. This calculus, of course, may change for subsequent investors once a country approaches default.

The Public Sector and Industry Associations

The IMF, ICMA, Paris Club, 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 late 2014? Recall that solving the collective action problem not only required a willingness to consider the collective interest over private interests; in addition, 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 University 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 at the New York Federal Reserve 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 questions, but we do know that the elite lawyers who were in the room at both the Columbia and New York Federal Reserve 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.

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 and 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.[16] In the same spirit, this approach bars context evidence suggesting that parties intended to impart nonstandard meaning to language that, read alone, is unambiguous.[17]

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 and 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, and Scott 2017). 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 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 here 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? Is a 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? Is there credible evidence that the particular provision was priced at the original issue stage?

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 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 understood by the counterparty, who in turn did know (or have reason to know) the meaning understood by the first party.[18] 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 found that NML/Elliott 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. In a sister article, we note examples from other fields of contract law (Choi, Gulati, and Scott 2017; see also French 2017; Coyle and Weidemaier 2018). We recognize, though, that we are but at the beginning of what we hope will be a new area of inquiry in contract law. For those who are interested in this topic, we urge them to look at essays by Bernstein (2017) and Baird (2017) that counter our perspective.

To conclude, we note the observations of a British judge from the interwar years (MacKinnon 1926: 13–16) that Jérôme Sgard unearthed in his archival research:

> With commercial contracts the difficulty … is commonly due to two different causes: first, that the traditional form of contract is often old standing, and is ill-adapted to more modern occasions; and, second, is often used in novel circumstances that properly require adaptation or amendment, and these are but ineptly achieved. [In other words,] the surviving use of traditional form may obscure the true interpretation of the parties' bargain.
>
> Even if the difficulty or obscurity of the [traditional forms of commercial contracts] be signally emphasized by some expensive litigation, it is not thereupon abandoned or amended. It remains in use for the provision of further litigation, and to repeat the enrichment of commercial lawyers.

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Notes

1. In some settings where standard form contracts are common, the problem of persistent linguistic uncertainties can in theory be eliminated by a coordinating agency such as an industry association, as described in Sgard’s contribution in this volume. See also Gelpern 2017.

2. 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 more detail, see Schumacher, Trebesch, and Enderlein 2015, 2018.

3. Hedge funds such as Elliott Associates have also been active in the corporate bond contract space, see Rock and Kahan 2009.

4. 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 and Gelpern 2014.

5. For evidence on this phenomenon, see Gelpern, Gulati, and Zettelmeyer 2017.

6. 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 and Scott 2003.

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

8. An example of rote usage in contracts is frequently used language such as the "signed and sealed" term that, as a legal matter, adds no value other than providing legal-sounding jargon.

9. The 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).

10. 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. The Second Circuit 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, 258 (2d Cir. 2012) (citing *Singh v. Atakhanian*, 818, N.Y.S.2d 524, 526 [N.Y. App. Div. 2d Dep't 2006]).

11. Somewhat inadvertently, we were involved in organizing one of these conferences at Columbia Law School in early October 2014. We use the word "inadvertently" because our intention had not been to coordinate industry leaders. Indeed, at that point in October 2014, our assumption had been that coordination attempts by institutions like the IMF, the ICMA, and the US Treasury had failed, and our goal had been to explore the reasons for the failure. The Columbia meeting did seem to make clear to those present that coordination attempts were not proceeding smoothly, and the result was that a subsequent meeting of key players (we were not among those) was called at the offices of the New York Federal Reserve Bank, and it was at this meeting that coordination occurred. Gatherings of the key actors around those dates also occurred at the annual World Bank–IMF meetings late that month and in a Queen Mary University conference in Paris. See Choi, Gulati, and Scott 2017.

12. In economic terms, this suggests that contract terms are far more endogenous than is typically assumed in models of contract setting, where individual purchasers and sellers are assumed to come to the market with their individual needs and preferences (which are independent of what the other wants).

13. 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 front end costs of the contract and the back end costs of default. See Scott and Triantis 2006.

14. IMF: International Monetary Fund; ICMA: International Capital Market Association; IIF: Institute of International Finance; EMTA: Emerging Markets Traders Association.

15. One way to understand the stickiness of terms that make it onto the checklist is to see them as category-defining terms. Scholars in sociology have 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, evaluated by car experts, sold by car dealers, and so on. See Zuckerman 1999.

16. 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").

17. 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 and Scott 2010.

18. 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).