# CONTRACT AS STATUTE

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## INTRODUCTION

The traditional model of contract interpretation focuses on the "meeting of the minds." Parties agree on how to structure their respective obligations and rights and then specify their agreement in a written document. Gaps and ambiguities are inevitable. But where contract language exists for the point in contention and a dispute arises as to the meaning of this language, courts attempt to divine what the parties intended. Among the justifications for deferring to the intent of the parties is the assumption that parties know what is best for themselves.[1] Deference also arguably furthers autonomy values.

Not all contracts and contract terms are individually negotiated. Standard-form or boilerplate contracts are common in the commercial world. Standard-form contracts have received considerable attention from commentators.[2] The focus has been on the problem of power and informational asymmetries among the contracting parties. One party dictates the terms—for example, a big consumer-goods producer may draft a standard-form contract that forms a mandatory part of all consumer purchases.

Boilerplate contracts, however, are found in many markets where the relationship between the parties is not characterized by power imbalances. Instead, we find sophisticated parties on both sides and a multitude of parties with their slight variations on the same set of boilerplate terms. Large portions of the markets for bonds and derivatives are dominated by boilerplate of this type. Our goal is to suggest that the interpretation of boilerplate contracts among sophisticated parties is a topic in need of attention.[3] We contend that general principles of contract interpretation should not apply to this important subset of commercial contracts and make the case that these contracts are better viewed as akin to statutes.

A handful of courts have taken modified interpretive approaches, recognizing the special nature of boilerplate contracts in markets consisting of sophisticated parties. These courts have recognized that uniformity in the interpretation of this language is important because it enables the underlying financial instruments to be priced and traded. Such courts have adhered strictly to the textual language of the contract,[4] displayed a reluctance to

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1. *See* Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 618 (2003) (arguing that the principle of deferring to party intent applies strongly in the case of sophisticated commercial transactors).

2. *See, e.g.*, Clayton P. Gillette, *Rolling Contracts as an Agency Problem*, 2004 WIS. L. REV. 679; Friedrich Kessler, *Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629, 631 (1943); K.N. Llewellyn, 52 HARV. L. REV. 700 (1939) (book review); W. David Slawson, *Standard Form Contracts and Democratic Control of Lawmaking Power*, 84 HARV. L. REV. 529, 530 (1971).

3. Little economic analysis exists on contract interpretation. *See* Richard A. Posner, *The Law and Economics of Contract Interpretation*, 83 TEX. L. REV. 1581, 1581 (2005). Alan Schwartz and Robert Scott undertake an examination of how courts should interpret the contracts of sophisticated commercial parties. Schwartz & Scott, *supra* note 1.

4. *See* Broad v. Rockwell Int'l Corp., 642 F.2d 929, 947 (5th Cir. 1981) (en banc). The Fifth Circuit found the disputed contract language unambiguous even though (a) a prior panel had found the language ambiguous and, (b) there was evidence of significant differences of opinion among expert lawyers (and not just the litigators) as to the meaning of the language. *Id.* at 932–40, 955. The

imply good faith duties,[5] and applied judge-made analysis of the economic interests of the parties where the contractual language is undeniably ambiguous.[6] Courts have also applied deference to prior court interpretations of the same language (assuming that if the market had had a problem with the prior court interpretation, the market would have corrected the language).[7]

Courts are right in recognizing the need for uniformity in markets that use boilerplate. We part company with them in terms of strategies that will promote uniformity, such as the preference for textualism and the willingness to defer to prior court interpretations. Over time, slight mutations in the precise language that different actors have in their contracts often emerge[8]—mutations which may not have any particular meaning for the contracting parties and that a court taking a textualist approach may attach too great weight. Different boilerplate terms may get cobbled together in the same contract, leading to potential inconsistencies when interpreted through a purely textualist approach. The chance for court error in interpreting boilerplate is therefore high.

Rather than have courts attempt the error-prone process of determining what would be in the parties' best interests, we argue that courts should take a more statutory approach to interpreting boilerplate terms. Specifically, courts should look to the intent of the original drafters of the terms, much like courts look to legislative intent in interpreting statutes. In discerning this intent, the court may need to look to the overall history of a term, the process by which the term became a standard (or one of the standards) in the industry, and its context within the greater commercial environment.

Like the textualists, we argue that courts should not make an inquiry into the actual intent of a specific set of contracting parties (or try to divine the hypothetical bargain that the parties might have wanted to strike). Boilerplate terms, absent guidance from the initial drafters of the terms or other market standard setters, inevitably will become less clear over time. As parties include boilerplate terms drafted years if not decades earlier as a matter of course, looking to the specific intent of any one set of current contracting

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court explained that finding the language ambiguous would result in an investigation into party intentions that would be detrimental for at least two reasons: (a) it would produce variation in the understanding of a term that the market wanted a standardized understanding of, and (b) the boilerplate nature of these clauses meant that the parties probably hadn't negotiated them which, in turn, meant that investigating party intentions would be pointless. *Id.* at 947 n.20; *see also* Leverso v. SouthTrust Bank of Ala., 18 F.3d 1527, 1534 (11th Cir. 1994); U.S. Trust Co. of N.Y. v. Alpert, 10 F. Supp. 2d 290, 305 (S.D.N.Y. 1998); Katz v. Oak Indus. Inc., 508 A.2d 873, 880–82 (Del. Ch. 1986).

5. CIBC Bank & Trust Co. (Cayman) v. Banco Cent. do Brasil, 886 F. Supp. 1105, 1115 n.8 (S.D.N.Y. 1995); Metro. Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1521 (S.D.N.Y. 1989); *Katz*, 508 A.2d at 880–82.

6. *E.g.*, Sharon Steel Corp. v. Chase Manhattan Bank, N.A., 691 F.2d 1039, 1048–51 (2d Cir. 1982).

7. *See* Morgan Stanley & Co. v. Archer Daniels Midland Co., 570 F. Supp. 1529, 1541–42 (S.D.N.Y. 1983).

8. *E.g.* Stephen Choi & Mitu Gulati, *An Empirical Study of Securities Disclosure Practices*, 80 TULANE L. REV. (forthcoming 2006) (describing the slight mutations that occur in the modification and *pari passu* clauses for Colombia, China, and Italy over the 1985–2005 period) (draft on file with authors).

(and litigating) parties becomes meaningless. The lack of meaning would not be a problem if such terms were merely benign appendices to a contract. However, as in the case of the *pari passu* clause for sovereign bond agreements we discuss in this Article, boilerplate terms may take on unexpected meanings that radically alter the distribution of rights and duties among contracting parties.

Deference to the intentions of the specific parties before a court is especially inappropriate where there are third party effects.[9] In the contexts on which we focus, an interpretation of the contract language in one case will impact the contracts for a multitude of other parties who all have essentially the same boilerplate language in their contracts. Deferring to the intentions of the parties to the dispute may produce problems where these parties do not represent the interests of the others in the market who have no say in the current litigation. We therefore argue that courts should not attempt to supplement the explicit language of a contract with evidence from the parties' course of dealings or performance as suggested under the Uniform Commercial Code.[10]

Referring to historical meaning and the intent of the original drafters is a form of contextual analysis. Rather than looking at the context of the specific set of contracting parties before the court, though, our approach has courts looking at the context of the original drafters of the term in the case of boilerplate, taking a "statutory" approach to the interpretation of boilerplate terms. Looking to the historical context of a term, we argue, provides the highest probability of divining an interpretation that best maximizes the interests of contracting parties (and thus, approximates what the parties would have wanted to adopt ex ante had they focused on the particular issue at hand). Individually, contracting parties may choose (rationally) not to contract for every contingency and clarify the meaning of every term. For many contractual contingencies, any single set of contracting parties may find it too costly both to identify the exact nature of the contingency and to specify how the contract should deal with the contingency. Where the contingency is commonly faced throughout an industry, the single set of parties ignores the positive external benefit to others from expending resources in drafting and clarifying an applicable contract term. A centralized source for terms, such as an industry association or attorney firm (designated a "standard setter") that originally drafted the terms, in contrast, will have internalized the benefit to the group of adopters of the terms to the extent the standard setter profited from more adoptions when first promulgating the terms. Where the interests of contracting parties today are not too different from those at the time of the initial adoption, looking to the historical record

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9. *See, e.g.*, Henry E. Smith, *The Language of Property: Form, Context, and Audience*, 55 STAN. L. REV. 1105, 1114–15, 1182–88 (2003).

10. *See* David V. Snyder, *Language and Formalities in Commercial Contracts: A Defense of Custom and Conduct*, 54 SMU L. REV. 617, 620–22 (2001) (describing the U.C.C.'s interpretive hierarchy).

will result in interpretations that better approximate the goals of the industry or trade compared with any single set of contracting parties.

Minimizing error costs in court interpretations is particularly important in the case of boilerplate terms. The market faces large failures in the ability of dispersed participants to modify boilerplate terms effectively over time to take into account changing business conditions and error-prone court interpretations. Dispersed parties may not coordinate to change a term after a court error in interpretation. Faced with the possibility that others may not change a term, a specific set of parties may not wish to deviate from the standard. Deviating, for example, may signal to the market that the parties are particularly litigious and, in the case of fast-paced transactions, delay a deal from going forward.

Compared with courts, the original drafters of boilerplate terms—that is, the original standard setters—enjoy an expertise advantage and internalize the benefit to the range of market participants that will adopt the boilerplate.[11] Also, deferring to historical context and the intent of the original drafters will induce market-based standard setters to coordinate in creating new, clearer terms as well as authoritative definitions and modifications to the existing pool of boilerplate terms. Doing so allows the standard setters developing the new terms to achieve "original drafter" status, thereby obtaining court deference to the standard setters' interpretation for those parties that adopt the new terms.

The Article proceeds as follows. In Part I, we discuss two examples of boilerplate terms drawn from the sovereign bond and privately negotiated derivatives markets. In Part II, we explore reasons why markets may have trouble responding to litigation or other interpretive shocks. We set forth in Part III our thesis that judges should interpret commercial boilerplate contracts using an analytical framework closer to statutory analysis than conventional contract analysis.

## I. TWO CASE STUDIES

Contracts are negotiated in a variety of contexts and involve parties with varying degrees of skill and experience. We focus on the subset of contracts dealing with boilerplate terms in a sophisticated, commercial context. We provide two case studies of commercial boilerplate terms to start our discussion.

### A. *The Case of the* Pari Passu *Clause*

Perhaps the most litigated and most controversial term in the history of sovereign debt is the *pari passu* clause. This term is found in practically every single sovereign debt contract, whether it is a syndicated loan agreement or a

11. *See* Randy E. Barnett, *The Sound of Silence: Default Rules and Contractual Consent*, 78 VA. L. REV. 821, 908 n.231 (1992) ("[W]hile judges may be good surrogates for the rationally ignorant consumer, they are often deficient interpreters of more specialized usages of trade.").

bond indenture.[12] Indeed, in U.S.- and English-law-governed documents, the clause is considered so important that it is one of the handful of terms that typically gets repeated at the front of the prospectus in the summary of essential terms.[13] A typical formulation of the clause goes as follows:

"The obligations of the debtor under this instrument hereunder do rank and will rank *pari passu* in priority of payment with all other External Indebtedness of the debtor."[14]

What does that mean? In the corporate context, there is a meaning on which commentators agree.[15] Those whose debts rank *pari passu* will get paid on an equal priority in the event of an insolvency distribution. The *pari passu* clause serves to contract around the default rule in some jurisdictions that otherwise gives priority to debts that are incurred earlier in time.[16] What does the clause mean when the debtor cannot go bankrupt, as in the case of sovereign lenders? The leading commentators on sovereign contracts acknowledged that there exists ambiguity as to the meaning of this clause.[17] The presence of ambiguity, in turn, provided an opportunity for rent seeking.[18]

In 2000, in *Elliott Associates v. Peru*,[19] Elliott, a vulture fund, argued that the *pari passu* clause meant that a sovereign could not make preferential payments to any of its creditors whose debt ranked *pari passu* with the debt that they held. Peru had concluded a restructuring with a number of its

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12. This Section of the Article summarizes the research we have been doing for a separate article-length treatment of the *pari passu* clause in sovereign debt instruments. That article combines both qualitative and quantitative research on both the evolution of the clause and the various litigations. In all, we looked at more than 250 sovereign debt contracts for over thirty countries (with in-depth time-series treatments of the evolutions of the clauses for twenty countries). Every single contract we examined, whether from a private or public deal, had a *pari passu* clause in it. *See* Stephen J. Choi & G. Mitu Gulati, When Sophisticated Parties Fail To Cure Ambiguities Caused by a Litigation Shock: The Puzzle of the *Pari Passu* Case (Dec. 22, 2005) (unpublished tables and interview notes on file with authors).

13. We found this to be true in over ninety-five percent of the sovereign debt contracts in the database that we used for this project. When we talk about "contracts," we are talking about the contract language that is reproduced in the prospectuses. We are assuming, therefore, that the prospectuses are accurate when they tell us that they are reproducing the relevant contractual terms. Choi & Gulati, *supra* note 12.

14. *See* LEE C. BUCHHEIT, HOW TO NEGOTIATE EUROCURRENCY LOAN AGREEMENTS 83, 85 (2d ed. 2000) (setting forth variations of *pari passu* language).

15. *See* Lee C. Buchheit & Jeremiah S. Pam, *The* Pari Passu *Clause in Sovereign Debt Instruments*, 53 EMORY L.J. 869, 872–76 (2004) (discussing commentary on the meaning of the clause in the corporate context); G. Mitu Gulati & Kenneth N. Klee, *Sovereign Piracy*, 56 BUS. LAW. 635, 637 (2001).

16. *See* FINANCIAL MARKETS LAW COMMITTEE, ISSUE 79—*Pari Passu* CLAUSES (2005) [hereinafter FMLC REPORT], *available at* http://www.fmlc.org/papers/fmlc79mar_2005.pdf.

17. *See* Gulati & Klee, *supra* note 15, at 643–64 (citing discussions by Buchheit, Wood, and Lowenfeld).

18. *See* Lisa Bernstein, *The Questionable Empirical Basis of Article 2's Incorporation Strategy: A Preliminary Study*, 66 U. CHI. L. REV. 710, 740–42 (1999).

19. 194 F.3d 363 (2d Cir. 1999). For a discussion of the case, see William W. Bratton, Pari Passu *and a Distressed Sovereign's Rational Choices*, 53 EMORY L.J. 823, 823–25 (2004). *See also* Gulati & Klee, *supra* note 15, at 635–38 (summarizing the facts behind the *Elliott Associates* case).

bondholders and was about to disburse a large payment to its European holders of Brady bonds via Euroclear. A Brussels court ruled, ex parte, in Elliott's favor, granting an injunction against Euroclear. Peru's government, with Alberto Fujimori in his final days in power, was in a precarious state, and did not want to be seen as defaulting on its Brady bonds. The end result was that Elliott got paid in full—upwards of $55 million on bonds that cost it approximately $11 million.[20]

The ruling suddenly gave holdouts the teeth to disrupt sovereign debt restructurings. That sent the sovereign bond world into a tizzy, generating an immense volume of speeches, articles, and policy recommendations.[21] Despite a lack of clarity as to what the *pari passu* clause meant in the sovereign context, the sovereigns and their advisers were quite adamant that the clause did not prohibit non-pro-rata payments to creditors under conditions of default.[22] Sovereigns had always thought that they were entitled to pay their favored creditors on a priority basis, especially when in financial crisis.[23] The de facto priority that the official-sector lenders (the IMF, the ADB, the World Bank, etc.) enjoyed when lending to sovereigns in distress provided evidence for the sovereigns' view.[24] On the other side, the holdout creditors and their lawyers were equally firm. The plain language of the clause allowed for only one sensible meaning, they said, which was that the sovereign had to pay all its creditors on a pro rata basis.[25]

Once Elliott won against Peru, others tried to replicate the *pari passu* strategy whenever there was a restructuring (and even if the strategy was not used, the sovereign had to take into consideration the risk that the strategy would be used). In the immediate four-year period after the *Elliott* decision, holdout investors filed suit against sovereigns (the Congo, Nicaragua, and Argentina) in courts located in Belgium, England, and the United States.[26] In some of the cases, the holdouts won and managed to extract significant

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20. The facts in this paragraph are taken from Bratton, *supra* note 19, at 823–25, and Gulati & Klee, *supra* note 15, at 635–36.

21. *See* BARRY EICHENGREEN, FINANCIAL CRISES AND WHAT TO DO ABOUT THEM 75–76 (2002); NOURIEL ROUBINI & BRAD SETSER, BAILOUTS OR BAIL-INS?: RESPONDING TO FINANCIAL CRISES IN EMERGING ECONOMIES (2004); HAL SCOTT, INTERNATIONAL FINANCE (12th ed. 2005); Patrick Bolton & David A. Skeel, Jr., *Redesigning the International Lender of Last Resort*, 6 CHI. J. INT'L L. 177, 186–87 (2005); Sean Hagan, *Designing a Legal Framework to Restructure Sovereign Debt*, 36 GEO. J. INT'L L. 299 (2005).

22. Felix Salmon, *Pari Passu Clause Is a Threat to Markets*, EUROMONEY, May 2004, at 148.

23. *Id.*

24. The various litigations are described in Buchheit & Pam, *supra* note 15, at 900–16, and Phillip R. Wood, Pari Passu *Clauses—What Do They Mean?*, 2003 BUTTERWORTHS J. INT'L BANKING & FIN. L. 371. *See also* SCOTT, *supra* note 21, at 307–11 (providing an overview of the *pari passu* controversy).

25. The holdout-creditor view is most forcefully articulated in the affidavit of Professor Andreas Lowenfeld that is described in Gulati & Klee, *supra* note 15, at 636–37. *See also* Salmon, *supra* note 22 (quoting Professor Hal Scott).

26. The Peru, Congo, and Nicaragua litigations are described in Buchheit & Pam, *supra* note 15, at 877–82, 887–80. For a brief discussion of the Argentine *pari passu* litigation, see Anna Gelpern, *What Bond Markets Can Learn from Argentina*, INT'L FIN. L. REV., Apr. 2005, at 19, 22, *available at* http://www.iie.com/publications/papers/gelpern0405.pdf.

settlements.[27] More important, the sovereign lawyers have not been able to get any of the courts in these jurisdictions to adopt their interpretation of the *pari passu* clause.[28]

Whatever the merits of the Brussels court's interpretations, one would expect that all contracts *after* the *Elliott* case would pay special attention to the *pari passu* clause and clarify its exact meaning. Economic theory tells us that absent significant negotiation costs, parties will prefer contracts that are clear rather than contracts that present a high likelihood of uncertainty and litigation costs. The questions of (a) the degree to which sovereigns and their creditors modified their contract language in the wake of the *Elliott* case, and (b) the reasons for why individual sovereigns did or did not alter their contractual language, formed the basis for a parallel line of research we have pursued examining a dataset of sovereign bond deals from the early 1990s to the early 2000s.[29] Below, we summarize the findings.

### 1. *Patterns in the Data*

For the thirty-plus countries for which we examined *pari passu* clauses in both the pre- and post-*Elliott*-periods, we found wide variation in the precise wording of the clause. Specifically, we found upwards of a dozen different versions of the clause.[30] In light of the *Elliott* ruling, and the strict textualist approach utilized there, the variations across countries turn out to be important. Clauses saying something like "the debt will rank equally with all other External Indebtedness" are less vulnerable to an *Elliott*-type attack than language saying "the debt will rank equally with all other External Indebtedness and will be payable as such."[31]

There was no systematic pattern discernible in the data such as more creditworthy countries picking a certain clause and less creditworthy ones picking a different clause. The lack of a pattern is consistent with the view that the differences are more idiosyncratic than due to any purposeful intent to change the *pari passu* clause to favor (or disfavor) holdouts. A court attempting to read meaning into such differences runs a risk of misinterpreting the clause.

As a follow-up to our quantitative examination of *pari passu* clauses in sovereign bond covenants, we conducted over fifty in-depth interviews with

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27. *See* Anna Gelpern, *Building a Better Seating Chart for Sovereign Restructurings,* 53 EMORY L.J. 1115, 1133 n.59 (2004) (describing the settlement in the Red Mountain case); *see also* Hagan, *supra* note 21, at 315 nn.48–50.

28. *See* Buchheit & Pam, *supra* note 15 (discussing the pre-Argentine cases); *see also* Gelpern, *supra* note 26 (discussing the Argentine litigation over *pari passu*); Salmon, *supra* note 22 (making the point that the interpretive issue remains unresolved even after years of litigation).

29. *See* Choi & Gulati, *supra* note 12.

30. *See id.*

31. The importance, in light of the *Elliott* case, of these small differences in language is discussed at length in the recently released report of elite English lawyers on the matter. *See* FMLC REPORT, *supra* note 16, at 19 (describing the differences in *pari passu* language for Estonia, Croatia, and the Philippines).

market participants.[32] Among our interviewees were prominent attorneys at the law firms most involved with sovereign debt deals, either as issuer's or underwriter's counsel. Market participants uniformly confirmed what the quantitative data suggested: the different versions of the clause do not represent any conscious attempt to vary the *pari passu* clause.

### 2. *Responsiveness to Shocks*

For the twenty countries for whom data was available for over at least ten issuances during the 1985–2005 period, we found no response to the *Elliott Associates v. Peru* litigation in terms of changes in the language of contracts subsequent to the *Elliott* decision. Nor was there any response to any of the later *pari passu* litigations that followed. While variations existed between different countries, no variation existed across bond deals for the same sovereign. We attempted to discern why not through our interviews.

The standard initial response was that it was clear to all that the *Elliott* decision was an aberration. Most lawyers explained that they were confident that no *New York* court would accept the interpretation that Elliott Associates was pushing. We pushed these lawyers on their argument by pointing out the fact that while the "aberrant" *Elliott* reading of the clause had found sympathy with multiple courts, including some federal courts in the U.S., the so called "sensible" reading had not found favor anywhere as yet.[33]

The lawyers who found our first set of quibbles legitimate typically came up with a second explanation, telling us that any change in the language of the new contracts would run the risk that a court would read the modification of the language to mean that while the new contracts meant something new, the holdouts were correct in their interpretation of the old contracts.[34]

But why was it not just as likely, we asked, if not more likely, that a court would interpret a change in the contract language in response to the interpretive shock as a sign of the market's disapproval for the interpretive shock? At this point, we received the most meaningful responses. The lawyers explained that it was impossible for standard-form clauses that were

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32. Thirty-five of these interviews were with lawyers who either are or were active players in the sovereign debt market and included not only lawyers at private law firms, but also lawyers in the official sector and at investment banks and hedge funds. We may have missed talking to a few of the key players in the market, but we conservatively estimate that we spoke to over fifty percent of the population of players who understand the *pari passu* debate. For details, see Choi & Gulati, *supra* note 12.

33. Indeed, even when the matter finally came before a New York judge and the "sensible" reading was supported by amicus briefs filed by the Federal Reserve, the Clearinghouse, and the New York Fed, the judge still chose to duck the issue. *See* Salmon, *supra* note 22. The court decision and the briefs are available on the Emerging Markets Traders Association website. *See* EMTA.org, New Developments, *at* http://emta.org/ndevelop/ (last visited October 22, 2005).

34. The story resembles the tort tale regarding subsequent repairs, where repairs do not get done because of the fear that the very fact of the repairs will be read as a sign that the earlier state of matters was faulty. In response to the disincentive to engage in subsequent repairs, evidentiary rules typically exclude subsequent repairs from being introduced as evidence of the tortfeasor's negligence. *See, e.g.*, FED. R. EVID. 407.

present in every single sovereign debt instrument across the globe to change every time there was an aberrant court decision. The issue was coordination. As a practical matter, the individual lawyer proposing that his client alter a term in response to some interpretive shock faces the possibility that no one else will change their terms. And the market is unlikely to accept a non-standard term. Further, if the court sees that some parties change their terms and others do not, parties will find it difficult to argue to the court that the market is unambiguous in having an understanding different from that which caused the interpretive shock. In sum, it may be in the individual client's interest to stick with the old term.

### 3. *The Form that the Market's Response Eventually Took*

The market eventually did provide a coordinated response to the 2000 *Elliott* decision as part of an overall litigation strategy but, importantly, not in drafting a new set of contract terms clarifying the *pari passu* clause. In the first few *pari passu* cases filed subsequently to the *Elliott* decision, there was no coordinated response by the sovereign debt community. But by 2003, when the *pari passu* matter showed up in a New York court in the case involving the Argentine restructuring, the sovereign debt community organized itself to produce amicus briefs filed by the U.S. Treasury, the New York Federal Reserve, and the Clearinghouse, all opposing the holdout position.[35] Note that it is unusual for these institutions to take the step of filing an amicus brief in a private contract disputes—the U.S. Treasury, as best we know, had filed briefs on only two prior occasions in the sovereign context.[36]

As of September 2005, we are aware of no serious attempt to coordinate a clarification of the *pari passu* clause in the contracts themselves. Instead, the choice was made to coordinate over *litigation strategy*. The law firm that had been litigating almost all the *pari passu* cases from the sovereign side, Cleary Gottlieb, was also the law firm with the largest volume of business in terms of advising new issuances.[37] So, if any firm understood the kind of problems that *pari passu* clause was causing and could engineer a coordinated shift in the clause's language, it was Cleary. Yet, even Cleary's clients were not issuing new bonds with clearer language on the *pari passu* matter.

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35. *See supra* note 33.

36. For discussions of the *Allied Bank* case in 1985 and the *Banco Do Brasil* case in 1995, see Christopher C. Wheeler & Amir Attaran, *Declawing the Vulture Funds: Rehabilitation of a Comity Defense in Sovereign Debt Litigation*, 39 STAN. J. INT'L L. 253, 268–73 (2003). Our cynical public choice perspective on the matter is that considerable political and financial muscle must have been exerted by key private sector interests in pushing these institutions to step in.

37. *See* Thom Weidlich, *Cleary Gottlieb's Iraq Work Secures Place as Top Debt Adviser*, BLOOMBERG NEWS (N.Y.), Dec. 7, 2005, *available at* LEXIS, ALLBBN; *see also* Stephen J. Choi & G. Mitu Gulati, *Innovation in Boilerplate Contracts: An Empirical Examination of Sovereign Bonds*, 53 EMORY L.J. 929, 975 (2004) (observing that Cleary has the lion's share of the sovereign issuer market).

### 4. *Lessons from the* Pari Passu *Case*

We take several lessons from the experience with the *pari passu* clause. First, a single court attempting to interpret the meaning of a commercial boilerplate term used in a single contract can generate long-lasting and disruptive consequences for the rest of the market using the same boilerplate term. As we discuss, the standard approach to contract interpretation magnifies the costs to contracting parties from courts attempting to deal with boilerplate.

Second, even in a market populated with sophisticated players and large intermediary organizations, coordination in response to a court ruling may take some time, three years in the case of the *pari passu* clause. Importantly, the *pari passu* market did enjoy large intermediaries that internalized the interests of significant subsets of the markets. Both attorney firms and underwriters stand in a position to encourage collective action. Evidence exists that Cleary Gottlieb was instrumental in the move toward collective-action clauses in the early twenty-first century.[38] Yet despite the presence of such intermediaries, coordination occurred only after delay.

Third, the coordinated market response may take many forms. In the case of the *pari passu* clause, when a coordinated response came, it was in the form of a litigation response and not in drafting a clearer set of terms. The language of the *pari passu* clause in the new contracts being issued remained the same across a wide number of contracts. As we will argue later, the presence of a prior court decision and ongoing litigation surrounding the *pari passu* clause pushed market participants to respond through litigation rather than a change in the language of the *pari passu* boilerplate term directly. A shift in how courts approach interpreting boilerplate terms may reduce the incentive of market groups to respond through litigation and increase the incentive to focus instead on clarifying the meaning of boilerplate terms.

## B. *International Swap and Derivatives Associations*

The derivatives markets for swaps use boilerplate contracts. With swaps, rather than draft a swap contract from scratch, parties turn to both form agreements and standardized definitions provided by the International Swap and Derivatives Association ("ISDA").[39] Standardized contracts also facilitate trades in public markets—otherwise parties would spend large amounts of time assessing the various non-standard terms in each traded swap contract. ISDA represents more than 625 member institutions from forty-seven countries, including Goldman Sachs, Morgan Stanley, Deutsche Bank, and other financial institutions as primary members, and Cravath, Swaine &

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38. *See* Choi & Gulati, *supra* note 37, at 375.

39. Kahan and Klausner cite ISDA and the Corporate Law Section of the Delaware state bar as instances of standard-setting organizations in the area of bond contracts. *See* Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (Or "The Economics of Boilerplate")*, 83 VA. L. REV. 713, 761–64 (1997).

Moore, Dewey Ballantine, and other service providers as associate members.[40] ISDA membership also includes various end-users of derivative instruments, such as Ford Motor Credit Company and General Electric Capital Corporation, as subscriber members.[41]

Swap contracts can last up to fifteen years. While parties typically negotiate over economic-related terms (such as the interest rate terms, the length of the agreement, the fixed versus variable nature of the interest), often non-economic provisions are not discussed. These include clauses dealing with events constituting default, representation and warranties, governing law and jurisdiction, and other covenants. Parties leave these non-economic terms to the ISDA standardized contract known as the ISDA Master Agreement. The Master Agreement contains a series of boilerplate clauses for the non-economic provisions. ISDA describes its Master Agreement as follows: "[M]arket participants developed the ISDA Master Agreement . . . which would contain the 'non-economic' terms . . . leaving counterparties free to negotiate only the 'economic' terms—that is, rate or price, notional amount, maturity, collateral, and so on."[42] ISDA also publishes a "User's Guide" to the Master Agreement detailing the purpose and use of the ISDA Master Agreement provisions as well as how the provisions differ from prior iterations of the Master Agreement.

Parties supplement the Master Agreement with the negotiated economic provisions. Typically, parties document the economic terms in a "Confirmation" statement. Parties may include all the definitions for relevant terms within the Confirmation itself (a "Long-Form Confirmation"). Alternatively, parties may incorporate a separate set of standard definitions by reference in the Confirmation (a "Short-Form Confirmation").

ISDA promulgates various sets of "Definitions" containing a glossary of standardized terms to which contracting parties may refer in the Confirmation of economic terms. For example, in the 1999 ISDA Definitions, ISDA specifies a set of floating rate indices and currency definitions. Parties negotiating an interest rate swap may simply refer to one of the ISDA indices rather than define the indices from scratch in setting up a swap involving a variable interest rate. ISDA frequently supplements the 1999 Definitions, providing, among other things, definitions for new floating rate indices.

Several lessons emerge from the market for swap and derivative contracts. First, boilerplate terms provide benefits to market participants, reducing the number of "deal" points on which negotiating parties must contract, thereby reducing contracting costs and speeding up transactions. In the

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40. *See* International Swaps and Derivatives Association Primary Membership List, http://www.isda.org/membership/list_of_primary.html (last visited Sept. 3, 2005) (providing a list of Primary-level members).

41. *See* International Swaps and Derivatives Association Subscriber Members, http://www.isda.org/membership/list_of_subscribers.html (last visited Sept. 3, 2005) (providing a list of Subscriber-level members).

42. Int'l Swaps & Derivatives Ass'n, Product Descriptions and Frequently Asked Questions: No. 28 Why Is Derivatives Documentation (Such as the ISDA Master Agreement) Important?, http://www.isda.org/educat/faqs.html#28 (last visited Oct. 27, 2005).

case of swaps and other derivatives, standardization makes possible after-market trading in these financial instruments.

Second, industry associations that represent the interests of all the major participants in a sophisticated, commercial market, such as ISDA, can form. Where contracting parties are sophisticated, an industry association must include a variety of market participants to have effectiveness. If ISDA represented only the interests of financial institutions in the United States when providing standard-form contracts, few institutions outside the United States would accept such contracts when dealing with the U.S. institutions.

Third, certain markets are capable of generating boilerplate contract terms and providing detailed documentation of these terms. ISDA serves this function for the swap and derivatives contracts market. ISDA provides User's Guides and updates its contracts and definitional provisions to meet the needs of the marketplace. In the case of the ISDA Master Agreement, ISDA dictates the standardized form of how swap and derivative contracts will take place. Individual parties may choose to modify this standard, but the incentives are against modification. Doing so is costly, generates legal uncertainty, and results in instruments that are less tradable on the secondary market (where traders expect the ISDA Master Agreement to govern).

Fourth, the lack of any mandate that parties use the ISDA Master Agreement and definitions has not hindered the use of such terms in the marketplace. Parties use the terms and accompanying ISDA User's Guides because of the value they derive from standardization. Moreover, parties are clear when they use the IDSA Master Agreement or definitions. Parties will explicitly incorporate the ISDA 2000 Definitions in Short-Form Confirmations containing the economic provisions of their agreement, for example. Courts attempting to interpret the meaning of a swap agreement, as a result, have clear guidance when they are dealing with an ISDA Master Agreement or definitions.

Lastly, why don't we see more entities like ISDA in other markets?[43] There are a number of possible reasons:

Not all markets consist solely of sophisticated participants. Even where sophisticated participants predominate, commonalities may not exist across the range of participants in what parties desire to see in a contract. The buyers and suppliers of a particular raw input in an industry may have varying preferences on the types of terms they wish to see in their contract. Where variations exist, little gain may exist from drafting standardized terms.

Status quo is important. Where an industry already has standard-setting entities, such as law firms with their own in-house boilerplate provisions, the gain to establishing a centralized standard-setting entity such as ISDA is reduced. In the sovereign bond market, for example, where there are but a handful of lawyers with expertise about the meanings of boilerplate terms and, as a result, have a lion's share of the business, these lawyers may have

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43. This is not to say that entities like ISDA do not exist in other markets. Nonprofits, for example, play a role in developing boilerplate terms. *See* Kevin E. Davis, *The Role of Nonprofits in the Production of Boilerplate*, 104 MICH. L. REV. 1075 (2006).

an incentive to resist moves toward a central standard setter.[44] The emergence of bodies like ISDA, with their standard forms and their User's Guides and Definitions of Terms eliminates much of the advantage that these elite law firms might have otherwise had as a result of their in-house knowledge. Conversely, resistance to centralized standard-setting organizations may come from the smaller players in the market who fear that the standard setter will get captured by the elites and the result will be private lawmaking that systematically favors the elites.

The deference courts give to the intent and guidance of a standard setter is important. Where courts ignore the standard setter, instead focusing on the specific intent of the contracting parties themselves, the standard setter provides little benefit beyond simply drafting the language of the boilerplate term. On the other hand, where courts give more deference to guidance provided by a standard setter on the meaning of boilerplate, as we propose later in the Article, a greater benefit exists to the industry from establishing a centralized standard-setting organization such as ISDA.

In concluding, it helps to look at what happened recently when an ambiguity did arise in the ISDA documentation. The cases we discuss involve swap contracts written on sovereign debt (in other words, involving many of the same lawyers from the *pari passu* debate).

### C. *The* Eternity *Cases and the Meaning of "Restructuring"*

For institutions that invest in sovereign debt, but are concerned about the risk of default, the market provides swaps that hedge against default risk. The relevant market here is a large one that has been growing quickly—it grew from between $100 and $200 billion in 1996 to $4.8 trillion in 2004 and $6.5 trillion in 2005.[45] The *Eternity* cases arose out of a series of swaps that were written on Argentine debt.[46] The events that would trigger the swap contracts were defined under the title "Restructuring." Included in the definition of "Restructuring," in addition to the traditional types of defaults, was something called an "Obligation Exchange."[47] Argentina formally defaulted on its debt in December 2001. But prior to that, Argentina had attempted a series of exchanges that it referred to as "voluntary exchanges" where it swapped around $50 billion of its shorter term obligations for longer term

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44. This is not to say that there won't be rent-acquisition opportunities for these same elite lawyers to take control of the standard-setting process. *See* Schwartz & Scott, *supra* note 1, at 598 (concluding that rent-seeking by interest groups can occur in expert advisory processes such as those set up by the ALI).

45. *See* James Warnot & Justin Williamson, *ISDA Definitions Unclear, Says U.S. Court*, INT'L FIN. L. REV. Sept. 2004, at 27, 27. For full citations to the *Eternity* cases, see *infra* note 54.

46. The material in this subsection that tackles the *Eternity* cases is solely the responsibility of coauthor Choi and does not represent the views of coauthor Gulati (who, although he did not take on the project, was contacted by J.P. Morgan about being an expert on the matter).

47. *See* Salmon, *supra* note 48, at 33.

lower rates and better secured debt.[48] At issue in the *Eternity* cases was whether a "voluntary exchange" qualified as an "Obligation Exchange" and thus triggered the default provision in the swap contracts.

The Argentine swap contracts explicitly adopt the ISDA definitions. Under the ISDA Master Agreement, Obligation Exchanges are defined as "mandatory" exchanges imposed on the Argentine bondholders where any one of a set of things occurred (including reductions in the principal amount of the debt or the interest rate).[49] This definition makes some sense in the corporate context where the debtor and its creditors who are seeking to avoid the costs of entering a formal Chapter 11 proceeding often use prepackaged bankruptcies ("prepacks").[50] Once court approval for a prepack is obtained, the terms of the prepack become mandatory on all the creditors, including minority creditors who did not voluntarily accept the terms. But there is no Chapter 11 bankruptcy equivalent for sovereigns and, therefore, no prepacks either. The same kind of "mandatory" exchange cannot take place—at least for sovereign bonds governed under New York law—where *unanimous* consent of the bondholders is typically required for any reductions in principal or interest amounts.[51]

The ISDA definitions were designed with corporate debtors in mind.[52] Importing the ISDA definition relating to an "Obligation Exchange" into the sovereign context resulted in ambiguity.[53] Contractual terms that lack a clear meaning are an invitation for some clever lawyer to say "I know what that clause means. It means that you owe me $X million dollars." That is precisely what happened in the case of the *pari passu* clause. In the *Eternity* cases, some of those who had purchased swaps on Argentine debt that expired prior to Argentina's formal default in December 2001, but after the "voluntary" exchanges that took place in November, asserted that "mandatory" included those exchanges achieved through economic coercion and that Argentina's so-called "voluntary" exchanges were actually coercive and therefore mandatory.[54]

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48. *See id.; see also* Felix Salmon, *Sovereign Market Awaits Court Verdicts*, EUROMONEY, May 2002, at 32, 32.

49. *See id.*

50. *See id.*

51. The requirement of unanimous consent was the norm for sovereign bonds governed by N.Y. law at the time the swaps at issue in the *Eternity* cases were entered into. That norm has since changed, with typical N.Y. law sovereign bonds now requiring supermajority consent. *See* Press Release, U.S. Dep't of the Treas., Statement of Under Secretary John B. Taylor Regarding the Decisions by Countries to Issue Bonds with Collective Action Clauses (Feb. 3, 2004), *available at* www.treas.gov/press/releases/js1144.htm.

52. *See* Salmon, *supra* note 48, at 32–33; *see also* B. GERARD DAGES ET AL., FED. RESERVE BANK OF N.Y., AN OVERVIEW OF THE EMERGING MARKET CREDIT DERIVATIVES MARKET (2005), *available at* http://www.bis.org/publ/cgfs22fedny4.pdf.

53. *See* Salmon, *supra* note 48.

54. *See* Eternity Global Master Fund Ltd. v. Morgan Guar. Trust Co. of N.Y., 375 F.3d 168, 182 (2d Cir. 2004); Eternity Global Master Fund Ltd. v. Morgan Guar. Trust Co. of N.Y., No. 02 Civ.1312(LMM)(GWG), 2003 WL 21305355 (S.D.N.Y. June 5, 2003); Eternity Global Master Fund Ltd. v. Morgan Guar. Trust Co. of N.Y., No. 02 Civ.1312(LMM), 2002 WL 31426310 (S.D.N.Y.

Our interest is not in the outcomes of these cases or in the validity of the arguments. It is in how ISDA reacted to the ambiguity and how the courts used the ISDA materials as sources of authority. On the matter of the ISDA reaction, even before the Second Circuit tackled the case in 2004 (the first district court opinion came down in late 2002 and the second one in mid-2003), ISDA moved to delete "Obligation Exchanges" from the definition of a "Restructuring" in its revised 2003 Definitions.[55] In addition a committee was formed to tackle the question of what should be done to deal with the special problems of derivatives drawn on sovereign debt contracts.[56] An expert group of elite sovereign debt lawyers was formed soon after the *Eternity* litigation came about and that committee produced a report with recommendations to ISDA. ISDA then acted within a matter of months.

The contrast with the *pari passu* case is striking, since at least some of the same expert sovereign debt lawyers involved in that *pari passu* litigation participated in the ISDA revision process. The same lawyers who took years to respond to litigation or other interpretive shocks in the absence of a centralized standard setter, responded extremely quickly when there existed an effective standard-setting body such as ISDA to work through. With ISDA, the response was immediate. The presence of ISDA ensured a mechanism for coordination and prompt response—a point that finds support in other examples of prompt ISDA responses to documentation problems.[57] In the *pari passu* case, although there was discussion about the need to form an expert committee and produce a report, there was no committee formed and the uncertainty remains unresolved five years later;[58] moreover, sovereign debt contracts as of this writing still all contain the same unclear *pari passu* language. Significantly, the *pari passu* and *Eternity* contract ambiguities were not isolated cases. They were arguably the two biggest contractual ambiguities that the sovereign debt market has had to deal with in fifty years.

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Oct. 29, 2002). In addition to the *Eternity* litigations, there were three other cases involving the same set of circumstances. *See* Warnot & Williamson, *supra* note 45, at 28–29 (reporting on these cases); Salmon, *supra* note 48.

55. *See* Salmon, *supra* note 48; *see also* DAGES ET AL., *supra* note 52 (discussing revisions in the 2003 Definitions that were made to counter the problems that the Argentine default and the resulting swap disputes revealed).

56. *See* Salmon, *supra* note 48.

57. The ISDA 1999 Definition of a Restructuring itself was a response to the ambiguities that the 1998 Russian default revealed—such as whether the Russian domestic debt "reinvestment" program constituted a restructuring, whether it was material, how deliverable obligations should be valued, and which obligations were covered. *See* DAGES ET AL., *supra* note 52.

58. *See* Letter from Charles H. Dallara, Managing Dir., Inst. of Int'l Fin., to Gordon Brown, Chairman, Int'l Monetary & Fin. Comm., (Apr. 9, 2002), *available at* http://www.iif.com/data/public/icdc0402.pdf (discussing the need to set up an expert committee to tackle the ambiguity and uncertainty caused by the *Elliott Associates v. Peru* litigation). In England, thanks to the coordinating efforts of the Bank of England, an expert committee finally came out with a report earlier this year (2005). *See* FMLC REPORT, *supra* note 16. In the United States, however, the coordination of such an effort has proved difficult. On the unresolved state of the *pari passu* debate, *see* Salmon, *supra* note 22.

## II. THE PROBLEM WITH BOILERPLATE

In sophisticated markets, conventional wisdom holds that the standardized nature of these contracts means that everyone (that is, "the market") understands them. The terms in these contracts are the ones that the market has determined as optimal, hence their widespread adoption. Interpretation (and pricing) is easy because there is only one set of terms, and everyone understands what these terms mean. Even if courts make mistakes in interpretation, the story goes, the market will contract around those mistakes.[59] We contend that the interpretation of boilerplate terms in these contracts is nowhere near as easy as one might think.

### A. *Traditional Contract Interpretation*

Courts follow certain precisely defined "canons" of contract interpretation. In assessing these canons as applied to boilerplate terms, we assume that the goal of contract interpretation is to minimize the transaction costs facing contracting parties.[60] Judge Posner sets forth two types of costs that make up the overall transaction cost: "drafting-stage costs" and "litigation-stage costs."[61] While drafting-stage costs are always incurred, the litigation-stage costs "must be discounted, that is multiplied, by the probability of a legal dispute."[62]

Under standard canons of contract interpretation, courts first attempt to discern the intent of the parties (the meeting of the minds) from the language of the contract. Second, if actual intent is obscure, courts will turn to the course of dealings and course of performance between the contracting parties in an attempt to indirectly determine intent. Courts will sometimes use course of dealings or course of performance between a set of parties to trump even explicit terms in the contract.[63] Third, courts will look to industry custom and practice. Lastly, courts will examine the Uniform

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59. *See, e.g.*, Posner, *supra* note 3, at 1588 ("[S]ince the judicial gap-filling contract rules are *only* gap fillers, the parties can negate such a rule by expressly rejecting it in their contract. In other words, unlike many other legal rules, gap-filling rules for contract cases are subject to the discipline of the market.").

60. Posner states that the goal of contract interpretation should be to minimize overall contracting transaction costs. *See id.* at 1583. Minimizing transaction costs will, in turn, allow more transactions that increase the joint welfare of the contracting parties to go forward. Positive accounts exist on the efficiency of contract law. *See, e.g.*, Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 91–94 (1989). We note, without jumping into the debate, that no one theory, whether based on autonomy or economic efficiency, has succeeded either in positively describing contract law or setting forth a consistent norm for contract law to follow. *See, e.g.*, Eric A. Posner, *Economic Analysis of Contract Law After Three Decades: Success or Failure?*, 112 YALE L.J. 829, 830 (2003).

61. Posner, *supra* note 3, at 1584.

62. *Id.*

63. *See* Omri Ben-Shahar, *The Tentative Case Against Flexibility in Commercial Law*, 66 U. CHI. L. REV. 781, 787 (1999) ("[P]erhaps surprisingly, if a past practice is in conflict with an explicit contractual provision, the past practice will often be allowed to vary and trump the express terms." (citing U.C.C. § 2-208(3))).

Commercial Code for a specifically applicable term, if any. For example, UCC § 2-304 provides that the price in contract may be payable by money, goods, realty, or otherwise. Importantly, the process of contract interpretation flows from evidence specific to the parties outward to more general and contextual sources of contract meaning.[64]

Several costs exist in applying standard contract interpretation techniques to boilerplate that exceed the typical transaction costs for a non-boilerplate contract, as we discuss below.

### 1. *Textual Analysis*

The first interpretive method that a court is likely to apply is textual analysis, looking at the language of the contract. Formalists would have courts stop at the text itself as the sole source of interpretive authority, applying tie-breaking rules where the text is ambiguous. Further, formalists view all clauses in the contract as dated as of the time that the contract was signed. Such a hard ex post approach will lead contracting parties (and trade associations and other aggregating institutions) to provide standardized terms and standardized understandings to the market, increasing the certainty of contracts and ultimately decreasing dispute and litigation-related costs. The approach also results in greater upfront drafting costs. High upfront costs are justified where the alternative, greater expected litigation costs, would be even higher. For example, where judges are life-time bureaucrats, lack practical business experience, and are likely to generate error-prone interpretations of contract terms, the argument for a formalistic approach to minimize inexpert judge error costs takes on significance.[65]

The nature of boilerplate terms suggests that looking to the text of the contract alone is problematic. The point of using a boilerplate clause is to invoke, along with the language of the clause, all of the historical context and learning that comes with it. Otherwise, the parties could simply customize a clause that captures their particular understandings. Focusing on solely the text may miss particular nuances of language deriving out of this historical context leading to court errors of interpretation and greater uncertainty for contracting parties. Consider the following two examples of potential court error that may arise from applying solely textual analysis in analyzing the meaning of boilerplate clauses.

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64. We are oversimplifying somewhat in the text. As noted earlier, the U.C.C. itself complicated the hierarchy we describe in the text in that it seems to accord importance to evidence from trade usage, course of dealing, and performance even where the terms of the contract itself are perfectly clear and are "integrated." *See* Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice*, 73 CAL. L. REV. 261, 274–76 (1985).

65. *See* Posner, *supra* note 3, at 1583.

### a. *Conflicting Boilerplate Clauses*

The following two clauses appeared in at least a half dozen issuances of sovereign debt by Mexico during the 2003–2005 period.[66] The first clause is the Mexican collective-action clause ("CAC") governing changes in payment related terms. In March of 2003, Mexico was the first of the big sovereign borrowers to move from unanimity action clauses ("UACs") to CACs.[67] Mexico's CAC clause became the model for practically every other sovereign borrower seeking to issue bonds in the New York market.[68] This clause became one of the most discussed and carefully scrutinized contract clauses in the history of the world financial markets.[69] The clause[70] states that 75% or more of the creditors (in aggregate principal amount) on a particular bond instrument can agree to modify the payment terms of the instrument.[71]

When Mexico made its shift to CACs, it had to make all sorts of public disclosures to its investors in its road shows and press conferences to promote the offering and in the text of its prospectus supplements.[72] In the contract itself though, on the page following the page where the new 75%-CAC-modification clause appeared was an "Obligation Absolute" clause.[73] The Obligation Absolute clause provided that "no provision of this Note or of the Fiscal Agency Agreement shall alter or impair the obligation, which is absolute and unconditional, to pay principal of and any premium, if any, and interest on this Note."[74]

These two clauses seem both clear and in contradiction with one another. Traditional contract analysis would take the view that it makes little sense that the parties would include these two contradictory provisions. So,

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66. See the "Terms and Conditions" section in the Sub-Authorization Certificates for issuances dated Mar. 3, 2003, http://www.sec.gov/Archives/edgar/data/101368/000090342303000227/ums18ka_02-28.txt; June 10, 2003, http://www.sec.gov/Archives/edgar/data/101368/000090342303000515/ums18kaex1_06-10.txt; Nov. 19, 2003 (AuthorizationCertificate), http://www.sec.gov/Archives/edgar/ data/101368/000112528203006283/b328193_ex9-e.htm; Jan. 13, 2004, http://www.sec.gov/Archives/ edgar/data/101368/000095012304000308/y93195exv99w1.txt; Apr. 27, 2004, http://www.sec.gov/ Archives/edgar/data/101368/000095012304006039/y97209exv99w1.htm; Aug. 9, 2004, http://www. sec.gov/ Archives/edgar/data/101368/000095012304009881/y00759exv99w1.htm; Nov. 22, 2004, http:// www.sec gov/Archives/edgar/data/101368/000095012304014077/y69121exv99w1.htm; Jan. 7, 2005, http:// www.sec.gov/Archives/edgar/data/101368/000095012305000163/ y04635a2ex v99w1.htm.

67. *See* INT'L MONETARY FUND, COLLECTIVE ACTION CLAUSES: RECENT DEVELOPMENTS AND ISSUES 20 (2003), *available at* http://www.imf.org/external/np/psi/2003/032503.pdf.

68. *See id.*

69. *See* Anna Gelpern, *How Collective Action Is Changing Sovereign Debt*, INT'L FIN. L. REV., May 2003, at 19, 19; *see also* ROUBINI & SETSER, *supra* note 21, ch. 8.

70. United Mexican States, Form 18-K/A, at Ex. 2, cl. 11 (Mar. 3, 2003), *available at* http://www.sec.gov/Archives/edgar/data/101368/000090342303000227/ums18ka_02-28.txt.

71. *See* United Mexican States, Prospectus [Rule 424(b)(3)], at 1 (Dec. 1, 2003), *available at* http://www.sec.gov/Archives/edgar/data/101368/000090342303000995/ums-424b_1202.txt.

72. The prospectus for Mexico, for example, states on the cover page that these particular issuances are governed by CACs and not the traditional UACs. *Id.*

73. United Mexican States, Form 18-K/A, *supra* note 70, at Ex. 2, cl. 14.

74. *Id.*

proceeding on the assumption that rational parties would not include contradictory provisions, the court would try to reconcile the two provisions.[75] And if that were not possible, the provisions would knock each other out. The end result: confusion and a greater likelihood of court error.

To the extent that contracts with boilerplate pull from different clauses from varying historical sources, a "Frankenstein" contract may result. Taking a boilerplate analysis that looks to the histories of the clauses can help interpret these Frankenstein contracts. In the case of Mexico's bond covenants, a historical analysis would reveal that one of the clauses (Obligation Absolute) was older and a relic of when sovereign bond contracts used unanimity language similar to that used in domestic corporate bonds. The same analysis would reveal that the other clause (CAC) is of recent vintage and intended to trump the unanimity language. While attorneys succeeded in removing the most explicit language about unanimity, they neglected to remove additional clauses that also reflected the unanimity sentiment. Once this inadvertence is recognized, the need to place greater weight on the more recent vintage collective-action clause becomes clear.

### b. *Treating Small Differences in Language as Deeply Meaningful*

In our *pari passu* case study, we reported that the *pari passu* language for every sovereign was not the same.[76] Instead, there are small differences in the language; our data revealed at least twelve different versions of this so-called standard clause.[77] We saw, for example, that while the most stan-

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75. Even a brief examination of the case law will reveal that courts are skilled at reconciling seemingly inconsistent provisions, whether they be in statutes or contracts, explicit or implicit. *See* Goetz & Scott, *supra* note 64, at 285 ("[T]here is almost always some contextual argument upon which seemingly inconsistent terms can be rationalized.").

76. *See* Choi & Gulati, *supra* note 12.

77. Among the versions of the *pari passu* clause in our database were the following dozen (references are to the issuer, quantity, type of offering, and date of the offering):

- "The debt securities . . . will rank at least pari passu without any preference among themselves. The payment obligations . . . will at all times rank at least equally with all other payment obligations of Jamaica." Jamaica, $300 million, Registered Offering, dated 5/25/05.
- "[The debt securities] . . . will rank equal in right of payment among themselves and with all of Mexico's existing and future unsecured and unsubordinated public external indebtedness." Mexico, $1 billion, Registered Offering, $1 billion, 1/4/05.
- "The notes will rank pari passu with all other unsecured Indebtedness of the Issuer." Portugal (U.S. law), $ 2billion, Registered Offering, 7/26/05.
- "The obligations under the Bonds . . . will rank at all times at least pari passu in all respects with all other present and future outstanding unsecured indebtedness issued, created, or assumed by Portugal." Portugal (German Law), DM 1.5 billion, Bearer Bonds, 7/2/93.
- "The bonds shall at all times rank pari passu without any preference among themselves." Russia, $2 billion, Private Offering, 6/24/97.
- "[The bonds] will rank equal in right of payment among themselves and with all of Uruguay's existing and future unsecured and unsubordinated foreign debt as defined (under the Negative Pledge) below." Uruguay, $250 million, Registered Offering, 3/20/02.

dard articulation of the clause was that the sovereign's debt would "rank *pari passu* in priority" with all other unsubordinated debt of the sovereign, there are clauses, such as that of Italy, that are more specific and say that the sovereign's debt will "rank *pari passu* in priority and will be payable as such."[78] Applying traditional contract analysis where we assume that the parties intend these small differentials in wording to have significance, we would treat the Italian clause as different from the more standard one. And the commentators who have compared the Italian *pari passu* clause to the others precisely predict this result: that the Italian clause is going to be treated differently.[79]

But take a boilerplate analysis. Let us say that the Italian version of the clause is some historical relic from well before the *Elliott Associates v. Peru* case. Lawyers around the world have slightly different phraseology in their contracts, but they are all trying to do the same thing. And that is to invoke the historical understandings of the clause. They are not trying to set forth a customized version of their own clause that is independent of the historical understandings. Changes may occur to clauses deriving from the same original boilerplate, not out of a deliberate attempt to change the meaning of the term but rather due to stylistic preferences of a particular attorney or

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- "The Debt Securities . . . will rank equally . . . Amounts payable in respect of principal and interest . . . will be charged upon and be payable out of the State Revenue Account of the South African Government . . . equally and ratably with all other amounts so charged and amounts." South Africa, $1 billion, Registered Offering, 5/24/04.
- "[The bonds r]ank at least equally in right of payment with all of the Philippines' other unsecured and unsubordinated External Indebtedness." Philippines, $1.5 billion, Registered Offering, 1/26/05.
- "The bonds . . . shall at all times rank pari passu and without any preference among themselves. The payment obligations of the Republic shall . . . at all times rank at least equally with all its other payment obligations relating to External Public Debt." Venezuela, $1.5 billion, Registered Offering, 4/21/05.
- "The Notes . . . rank and . . . will rank at least pari passu with all other, subject to Condition 3 (Negative Pledge), unsecured Indebtedness of the Republic other than any Indebtedness preferred by Lebanese Law." Lebanon, $400 million, Private Offering, 5/6/01.
- "The payment obligations of Israel under the bonds will at all times rank at least equally with all other payment obligations of Israel relating to unsecured, unsubordinated external indebtedness." Israel, $500 million, Registered Offering, 5/7/05.
- "They will rank equally with all of our present and future unsecured and unsubordinated general borrowing . . . . We will pay amounts due on the debt securities equally and ratably with all general loan obligations of Italy." Italy, $4 billion, Registered Offering, 1/13/05.

Choi & Gulati, *supra* note 12.

78. Based on our interviews, we are fairly certain that the Italian clauses were *not* drafted with the goal of favoring the holdout creditors. Rather, Italy's advisers assumed that they had much the same clauses as did every other sovereign borrower. In the wake of the Elliott case, however, the Emerging Markets Creditors Association did consciously draft a *pari passu* clause that favored the holdouts' interpretation. *See* Michael M. Chamberlin, A Casual Observer's Commentary on the Taylor Proposal and EMCA's Model Covenants for New Sovereign Debt Issues (5/3/02 draft), (Aug. 9, 2002) (draft manuscript), *available at* http://www.emcreditors.com/pdf/n_Chamberlin_on_covs.pdf. As best we know, the EMCA clauses were not adopted by any sovereign.

79. *See* Buchheit & Pam, *supra* note 15.

even transcription errors. If the reason for a particular piece of language is to invoke historical understandings, as opposed to setting out a customized statement of intent, then it is not at all clear that the small differences in language, such as that between Italy and the other sovereigns, should be given much weight at all. Italy's lawyers likely were trying to invoke the same history that the lawyers for Belize and Argentina and Peru were invoking, each with their slightly different clauses.

One might ask how a court is to distinguish between a historical invocation and a special customized clause. The answer has to do with the nature of boilerplate. If Italy was trying to adopt a customized understanding for these parties, then we would see that specified in the prospectus and flagged prominently. But, instead, if we see that this same clause has been there ever since the first Italian contract was negotiated and is phrased in a particular way largely because Italy's lawyers did not foresee the *Elliott Associates v. Peru* case, then we should treat it similarly with other boilerplate clauses deriving out of the same historical tradition. With boilerplate, small differences in language should not be treated as having great meaning. The market does not price these differences as meaningful, the lawyers do not understand them as such (mostly, they do not even notice them), and the only people with an incentive to push these differences are the litigators representing typical holdout investors seeking to maximize their short-term, ex post position.

### c. *What About the Penalty Default Approach in the Foregoing Two Cases?*

Court mistakes due to a formalist approach may act like a penalty default, forcing contracting parties to write better-specified contracts with fewer ambiguous terms.[80] Penalty defaults in the context of boilerplate terms, however, are unlikely to reduce overall transaction costs. First, because the actual contracting parties did not draft the boilerplate provision (and likely do not even understand the meaning of the boilerplate terms), imposing a penalty interpretation approach may not result in many of the parties changing their contracting behavior. To go back to the *pari passu* case study, what the court did in *Elliott Associates v. Peru*, in taking a strict textualist view, was to impose a penalty on the market for its failure to provide clarity. We have seen from not only the cost to Peru, but the cost in subsequent litigations (not to say anything of the uncertainties created), that the penalty was substantial. Yet, the market was unable to respond by providing greater clarity in its contracts. Instead, the *pari passu* study suggests that parties will sometimes endure the cost of greater court errors, reducing the overall surplus from contracting behavior.

Second, a penalty default approach may lead some parties to pay closer attention to which boilerplate terms they select. Parties will be uncertain

80. On penalty defaults in contract law, see Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 YALE L.J. 729, 757 (1992).

whether relying on a particular boilerplate will in fact avoid the penalty. The specter of the penalty, in the form of court errors, will lead parties to expend costly resources in assessing the boilerplate term, eliminating most of the cost savings from using boilerplate in the first place. For those parties that choose to eschew a boilerplate term and draft their own term, higher costs are incurred. Parties desire boilerplate terms as private-market contractual gap-fillers for terms over which the parties do not wish to negotiate. It is therefore dubious whether it is socially desirable to get the actual contracting parties to focus more on the boilerplate terms at the time of contracting.

For boilerplate terms, even courts that fear they lack expertise to handle ambiguous boilerplate terms may turn, under our approach, to the intent of the original drafters, a source of expertise that will minimize the court error in dealing with boilerplate terms. Once parties start introducing non-boilerplate provisions, courts will lack a centralized authority to which to turn, leading to more frequent court errors.[81]

### 2. *Contextual Analysis*

The usual alternative to textual formalist analysis is contextual analysis.[82] The context that one looks to in contract interpretation is that surrounding the parties in dispute (course of dealing) and, beyond that, industry custom and trade usage. Here, neither is likely to give one much help due to (a) idiosyncratic contracting parties who do not represent the interests

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81. Why should sophisticated, commercial parties care about court errors? Alan Schwartz and Robert Scott argue that business parties will not care about variance in court interpretation. *See* Schwartz & Scott, *supra* note 1, at 576–77. Higher variance in interpretation leads to more errors. Such errors, assuming courts get the interpretations correct on average, means that a party will sometimes benefit and sometimes lose based on any one error. But on average, according to Schwartz and Scott, these errors will even out. Business parties that are risk-neutral will, thus, not care about the errors. In the case of boilerplate terms, we disagree with the Schwartz and Scott view on court errors. Litigation over forgotten meanings is likely to be one-sided because it is only parties with short-term interests who will push aggressively for meanings that are inconsistent with the long-term interests of the majority of players. Often there is some initial starting point of understanding for what the boilerplate terms mean (or at least what the terms do not mean). Consider again the *pari passu* clause. Many believed that the *pari passu* clause did not prevent a sovereign from giving preferential payments to a particular creditor, or perhaps more accurately, never gave any thought to the *pari passu* clause at all prior to the *Elliot* litigation. Preferential payments to the IMF and other international organizations were common when a sovereign was in distress and bond prices reflected this practice ex ante. One can therefore see the large cost to sovereigns if the clause is interpreted instead to forbid preferential payouts (to the IMF for example). The sovereigns will not be able to obtain new financing and the country's welfare will fall as a result (or, in the alternative, the sovereign will have to pay off the holdout creditors with a hefty premium). On the other hand, it is unclear what the cost to the holdout creditors is if the clause is interpreted not to forbid preferential payouts since the price they paid already took this into account. Court errors that deviate from the understandings of the majority of participants in the market, therefore, may create dramatic and asymmetric shifts in wealth among contracting parties. The magnitude of court errors may also be quite large. Consider the interpretive battles over the meaning of the *pari passu* clause in the sovereign bond context. As the Argentine litigation illustrated vividly, literally billions of dollars turned on how the clause was interpreted. Collective-action problems among participants exacerbate these error costs. Where errors of interpretation take place infrequently but with large magnitude, even sophisticated commercial parties may not take a risk-neutral attitude to such errors.

82. *See id.* at 572 (describing the contextual approach to contract interpretation).

of the group of contracting parties in the industry that may rely on a particular boilerplate term, and (b) the paradox of efficiency for boilerplate terms that may undermine the ability of courts to rely on industry custom.

### a. *Idiosyncratic Contracting Parties*

In the boilerplate context, a focus on the needs of the specific parties before the court may adversely impact the welfare of other contracting parties. An interpretation that increases value for the specific parties may reduce overall value for the majority of other parties using the same term.[83]

Even where the specific parties before the court are not systematically different from others, the resources of the specific parties are unlikely to match the resources of the group of all contracting parties. Once a dispute arrives at court, there will exist at least two opposing opinions on how the court should interpret a particular boilerplate term. How well a particular position is viewed by the court will depend in part on resources and abilities of the particular party pushing the position before the court. Other interested parties can submit amicus briefs to the court, but their influence will likely be less than that of a litigant before the court.

Providing clarity to boilerplate terms, made incomplete with the vagaries of time, through litigation as opposed to a more collaborative process incorporating interests across all contracting parties can lead to skewed interpretations. Litigation is inherently adversarial. Only two out of many possible positions get full vetting before the court. Parties in litigation have few dimensions along which they may trade to broker compromises.

Parties in litigation may also place too much weight on their particular ex post situation compared with the overall future benefit of the pool of all contracting parties. For example, an employee, once in litigation, may argue against broadly interpreting a boilerplate term prohibiting the employee from engaging in related work activities after leaving the employer. Employees generally, however, may favor such a term at the time they enter into such contracts to the extent they result in higher wages. One saw something to this effect happen in the *Elliott Associates v. Peru* case, where Peru settled with Elliott based on an ex parte decision interpreting the *pari passu* clause. It was in the political interests of Peru's government to not be seen as defaulting

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83. Stewart Macaulay kindly pointed out to us that our cost calculus might have to change in circumstances where the deal in question was one that evolved as a function of the relationship. For example, take a construction project where evolving circumstances idiosyncratic to the particular project—such as unduly soft soil calling for stronger foundations—might alter the relationship. There, looking to the "real deal", as captured by the pattern of conduct of the parties and industry custom, might be important even where parties were using standard boilerplate contracts. In the examples from the sovereign bond and derivatives industries that we use though, there is very little room for interaction among the contracting parties after the original deal. The "real deal" is the original "paper deal". The only problem is that sometimes parties do not know what the "paper deal" is. What we do know though is that parties intend to enter into the standard deal, under the standard contract, that everyone else is entering into. On the distinction between "real" and "paper" deals, see Stewart Macaulay, *The Real and the Paper Deal: Empirical Pictures of Relationships, Complexity, and the Urge for Transparent Simple Rules*, *in* IMPLICIT DIMENSIONS OF CONTRACT 3, 51–102 (David Campbell et al. eds., 2003).

on its Brady bonds (the Fujimori government was on its last legs). But the cost of leaving the Brussels interpretation unchallenged produced a significant amount of uncertainty for the rest of the market.

Focusing on the intent of the specific contracting parties also invites strategic behavior. A party unhappy with how a contract turns out may argue to a court that the contract in fact means something different according to the "private" course of dealings and understandings between the contracting parties. Where few objective indicia exist on this "private" meaning, courts will have difficulty in distinguishing between situations where the parties agreed ex ante to vary the contract with situations where one party ex post simply makes such a claim to nullify an unfavorable contract.[84]

### b. *Industry Custom*

When standardized terms are first drafted, the original drafting parties will know what the terms mean, what contingencies the terms are supposed to address, and how different terms relate to one another (for example, in case of conflict, which term trumps). Although the scholarship on the processes that lead to the emergence of standardized terms is limited, we know that even the most sophisticated markets generally take time before they can coordinate and agree to adopt a new standard term. In other words, at the point of adoption, there is likely to be maximal knowledge and understanding in the market about what the term was intended to mean.[85] Just as importantly, the original adopting parties will also have a sense of what contingencies their terms do not address.

As the standardized terms spread through numerous contracts, later contracting parties will often simply adopt the terms with the implicit assumption that the terms (often coming as a package with other standardized terms) are "efficient." Why else would others use the terms? With the passage of time, the assumption that the terms are efficient—while perhaps justified at the time of the first use of the terms and the initial dispersion of the terms throughout the marketplace—becomes more problematic. Market participants, nonetheless, may cling to the assumption about efficiency for extended periods of time. It bears emphasizing that a key assumption is that this is a world where disputes over the meanings of provisions are rare.

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84. *See* Schwartz & Scott, *supra* note 1, at 585–86. Schwartz and Scott therefore advocate a textualist approach to contract interpretation to prevent such "private" understandings from receiving any interpretive weight unless explicitly included in the contract language at the time the contract is entered into. *See id.* Our proposal, in contrast, gives no weight to the private understandings of the specific contracting parties and thus is less vulnerable to strategic behavior on the part of any one set of contracting parties.

85. *See* Choi & Gulati, *supra* note 37, at 937; *cf.* Richard A. Epstein, *Confusion About Custom: Disentangling Informal Custom from Standard Contractual Provisions*, 66 U. CHI. L. REV. 821, 824 (1999) (noting, in his comment on Lisa Bernstein's article, *supra* note 18, the many years it took the various trade associations to convert their industry customs into unified codes that then often became standard contracts).

The assumption of efficiency may lead contracting parties to expend few resources in discussing or investigating such boilerplate terms.[86] Instead, attorneys will uncritically include the terms in all their contracts. Paradoxically, the assumption that the terms are efficient produces an equilibrium where no one knows what the terms mean (and what contingencies are addressed and not addressed by the terms), thereby calling into question whether such terms in fact are efficient for the contracting parties.

By contrast, Goetz and Scott, in their 1985 article, portray market understandings of these terms as improving over time.[87] Over time, the terms get used, resulting in the removal of errors, ambiguities, and incompleteness.[88] For such terms, the implication of this high level of understanding at which the market eventually arrives is that the history of the term should be irrelevant in contract interpretation.[89] Our Article, however, is about the standard-form terms that do not get frequently "used" in the sense of there being frequent and public disputes where divergent views are aired and common understandings are cemented. There is an initial point in time when these terms are generally agreed upon and inserted into standard-form contracts. But then decades can go by without the terms being used, during which market understandings can vanish. Where current market understandings are absent, the history of the term becomes important in its interpretation. The majority of terms in standard sovereign and corporate bond contracts are, for example, reused without much notice or attention.

With clauses whose understandings have been forgotten, neither context about the parties themselves nor current industry custom is likely to be useful. The context that needs to be unearthed is a different beast—it is historical context. Moreover, even if courts are able to determine a current industry custom, it is unclear how much weight to place on this custom. At the time a term is drafted, all affected parties will pay relatively more attention to the meaning of the term. In contrast, after the passage of time, not all affected parties will pay as much attention to the term. Industry participants will simply ignore most boilerplate terms. Any custom that exists, therefore, is unlikely to represent the full array of interests in the industry.[90]

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86. The classic articulation of the efficiency paradox comes from Grossman and Stiglitz, who were demonstrating the circularity of the efficient capital markets hypothesis. Their insight was that the very assumption of efficiency meant that no one would have an incentive to look for arbitrage opportunities (because embedded in the efficiency assumption is a no-arbitrage assumption). But the market can only arrive at efficiency if market players look for arbitrages and eliminate them. *See* Sanford J. Grossman & Joseph E. Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 AM. ECON. REV. 393, 404 (1980).

87. *See* Goetz & Scott, *supra* note 64, at 287; *see also* Michelle E. Boardman, Contra Preferentum*: The Allure of Ambiguous Boilerplate*, 104 MICH. L. REV. 1105, 1112 (asserting that the understanding of terms improves over time).

88. *See* Goetz & Scott, *supra* note 64, at 287.

89. Epstein, making the same assumption about perfect market understandings of standard-form terms, writes that "[t]hese provisions should be construed as written, wholly without reference to the fractured history of their origins." Epstein, *supra* note 85, at 831.

90. Likewise, if courts are able to uncover a course of dealings or performance between a specific set of contracting parties, applying this to interpret a boilerplate term is problematic. Be-

The problem with appealing to contemporaneous industry custom to assist in the interpretation of longstanding boilerplate terms is different from the problems identified by Lisa Bernstein with relying on industry custom in the U.C.C. context.[91] Bernstein reports that in several commercial industries, including the hay, textile, and silk industries, trade associations often failed to come to a consensus in developing trade rules. While local customs existed, there were often conflicts in understandings, and trade associations frequently failed to put forward nationwide usages and meanings.[92] And when they did succeed, the process often took multiple decades.[93] In a sense, the context we are interested in is the half of the process that Bernstein does not analyze. That is, what happens *after* industry custom gets reduced to a standard-form provision and when it becomes a default rule.[94] The issue that motivates us is that the robust understanding of the standard-form provision that may have taken the market years to develop can then get forgotten.

Just as Bernstein identifies disagreement over the meaning of custom in the pre-standard-form-provision period, we find in our *pari passu* case (and predict more generally) that disagreement over the meaning of that standard-form contract can arise subsequently because the meaning that everyone thinks they understand can then get lost in the sands of time. The difference, for purposes of contract interpretation, between our situation and that which Bernstein's paper addresses is the following: Unlike where trade associations failed to establish nationwide customary meanings in an industry, the lack of any current industry customary meaning for boilerplate terms due to the passage of time leaves courts with an important alternative source of interpretive authority. As we argue later, courts may look to the historical context of the term—that is, the point at which disagreements over custom were settled and a standard-form provision arose—to determine the original meaning of the drafters.[95]

Bernstein also notes that many gaps in custom also relate to remote contingencies that trade associations and industry participants find too costly to

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cause a boilerplate term is designed to cover an entire industry or trade, the specific course of dealings or performance among any idiosyncratic set of parties is unlikely to maximize the interests of the industry or trade.

91. *See* Bernstein, *supra* note 18.

92. *See id.* at 717–46. Bernstein further emphasizes that the mid-to-late-nineteenth-century and the early-twentieth-century industries which she examined were particularly conducive to the development of national trade customs. *See id.* at 715.

93. For example, the National Hay Association took eleven years or more to decide on the definition of a contract carload. The National Grain and Feed Association took more than twenty years to promulgate its Feed Trade Rules. And the textile trade took approximately eighteen years to produce its Worth Street Rules. *See id.* at 719–20, 723 n.44, 725–29, 732; *see also* Epstein, *supra* note 85, at 824 (citing Bernstein's evidence on this point).

94. Richard Epstein's comment on Bernstein's article makes the distinction between the pre-standard-form period, where understandings of custom are in flux, and the post-standard-form period that Bernstein's article does not address. Epstein, *supra* note 85, at 824. Epstein though, seems to assume that once custom morphs into a standard form, the understandings of what the standard-form term means will remain. *Id.*

95. Once courts emphasize historical meaning, the original standard setters will have an incentive to record and preserve the meaning behind boilerplate terms.

address.[96] Boilerplate terms, in contrast, do not present necessarily remote contingencies. Ambiguity may arise even in major contingencies, such as the interaction of the *pari passu* clause with the sovereigns' ability to make preferential payments to the IMF and other world organizations, simply due to the passage of time and the corresponding loss of meaning with time. For widely prevalent boilerplate terms, finding a consistent and industry-wide method of resolving interpretation issues, such as referring to the historical context of terms, greatly affects the welfare of all contracting parties in the industry.

### B. *Guessing at Welfare Maximization*

If neither the textual nor the contextual approach yields answers, then a third option is for the court to attempt a welfare-maximizing estimate for what the parties must have wanted from the clause. This is what Judge Winter attempted in the *Sharon Steel* case, where he recognized that he was dealing with boilerplate terms and the related need to defer to market understandings with these types of terms.[97] Since there was no market understanding readily available to him though, Winter simply estimated what the two sides might have been looking for in negotiating this clause.

As with textual analysis, the court that attempts to divine a welfare-maximizing solution is misunderstanding the nature of boilerplate. The value of the clause to the parties is in the historical context that it brings with it. The parties may not know what that historical learning is, but they use the clause because they want the benefit of history. In performing the value-maximizing guess, the court is throwing away the historical context and guessing at a solution, leading to a high possibility of error.

### C. *Dealing with Court Errors*

Ill-advised attempts on the part of courts to interpret boilerplate terms with standard contract interpretation techniques may result in a market response. The market can respond in two ways. First, it can reprice the contracts for the new meaning that courts have provided. Second, it can revise the language in existing contracts to communicate to the courts that the understanding that the parties have is different from the one that the courts articulated. In theory, these market responses can ameliorate the costs of court interpretation attempts. But there are reasons to expect that amelioration will be minimal in practice.

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96. *See* Bernstein, *supra* note 18, at 747.

97. *See* Sharon Steel Corp. v. Chase Manhattan Bank, N.A., 691 F.2d 1039, 1048 (2d Cir. 1982).

### D. *Pricing Response*

In theory, if parties understand a standard provision to mean X, but a court reinterprets it to mean Y, the market price of all contracts will simply adjust to take into account the new meaning.[98] Even if this pricing adjustment does take place, there remains the problem that the parties wanted their contract to mean X, not Y. So, with *pari passu* for example, neither the debtor nor the majority of creditors likely wanted a contract provision that would make it harder for the country to obtain emergency financing from the IMF. In other words, the new interpretation was value-reducing for both sides. Even with the possibility of a price response, uncertainty costs remain. The fact that some local court in Brussels asserts an interpretation does not make it universally accepted. This uncertainty can be priced, but once again, it is a cost that the parties would prefer to avoid. In sum, a pricing response by the market still leaves the parties with significant costs.

### E. *Language-Clarification Response*

If courts misinterpret some customized clause between parties, parties can supposedly correct it because they know what they want their clause to say. When the market responds through the creation of new terms more in line with the market's understanding, all subsequent contracts will avoid the negative effects of an ill-advised court interpretation. An immediate market response may also help signal to other courts that the prior court's decision was contrary to the market's understanding of that boilerplate term.[99] Such a response may cut off further litigation or at least ensure that future interpretations are closer to the market understandings.

If the market functioned well in responding to court interpretations of boilerplate terms, the social cost of remaining with the present contract interpretation doctrine would be low. But with boilerplate clauses, dispersed market participants may lack the ability to coordinate, at least initially, to clarify the language in subsequently adopted terms. Market participants may also hesitate to correct terms out of a fear that a scattered, non-unified attempt at clarification may increase the likelihood of further unfavorable court rulings.

Scholars have observed that boilerplate contract terms display features of network externalities.[100] The more terms of a specific type that are used,

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98. *See, e.g.*, Boardman, *supra* note 87, at 1118.

99. One may wonder how a court is to determine when a market has in fact made a decided shift in contract terms. Courts see only the subset of contracts that end up in litigation, a subset that may not be representative of the group of all contract terms in use. Posner provides that "[a]cademics can conduct the necessary inquiry into the negation rate." Posner, *supra* note 3, at 1589. Running an academic study, however, can take years and academics often lack access to the full range of contracts used in an industry or trade.

100. *See* Robert B. Ahdieh, *Between Mandate and Market: Contract Transition in the Shadow of the International Order*, 53 EMORY L.J. 691, 710 (2004); Kahan & Klausner, *supra* note 39, at 729–35; Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 774–75 (1995).

the greater is the likelihood that the term will receive court scrutiny and, as a result, greater legal clarity in meaning. Attorneys are also more likely to draft other terms complementary in operation with more common terms. Other reasons for "sticky" contract terms exist. Contracting parties must balance several goals in entering into a contract. Parties will desire terms that maximize their return from the contract. Parties in certain contexts may also care about the speed with which a deal is completed and the speed of transactions will be higher, other things equal, if every transaction occurs under the same uniform code that no single party can alter unilaterally.[101] In the sovereign bond context, for example, speed matters in the placing of a new bond issue. Sovereigns typically will issue new bond deals when interest rates are favorable and will not wish to delay out of a fear that the interest rates may shift unfavorably.

Additionally, once the market comes to an equilibrium of quick deals, any deal that results in a delay will result in investors searching for other deals. Delay may result from information asymmetries. When a sovereign proposes new, non-standard terms, delay may result as investors puzzle over the new term (or simply jump ship to another deal). One side negotiating a contract may not be sure of the motives of the other side or the penchant of the other side to act litigious or difficult about the performance or interpretation of contract terms into the future. Calling attention to a particular boilerplate term may signal to the other side that one is perhaps acting opportunistically or is potentially difficult to deal with. Rather then send such a signal, parties may choose to leave a boilerplate term as-is, even if the term is not optimal for the parties' situation. Keeping the contract terms identical is important in the area of sovereign bond deals for this reason. Any change will result in investors stopping a bond offering in its tracks to investigate the reason for the change—anathema for issuers and underwriters eager for quick placement of the offering debt securities.[102]

Another market failure that may result in a lack of response to contractual shocks is the dispersed nature of contracting parties in many industries. Many sovereigns typically will seek to issue bonds through no more than a single offering in any given year. Coordination among dispersed contracting parties may be difficult. As discussed in the *pari passu* example, an individual party negotiating a contract only internalizes the benefit from the specific contract. The party will ignore the benefit to other contracting parties in various contexts from improving on a boilerplate term. The same lack of coordination may result in a non-uniform response to a court ruling interpreting any given boilerplate term. Rather than put forward a non-uniform response (with unpredictable response on the part of future courts), parties may simply choose not to change a boilerplate term. When coordination does eventually take place, it may take place so long after the initial court

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101. *See* Epstein, *supra* note 85, at 827.

102. For discussions of this negative signaling effect as a cause of contract stickiness, see Omri Ben-Shahar & John Pottow, *On the Stickiness of Default Rules*, 33 FLA. ST. U. L. REV. (forthcoming 2006).

interpretive shock to the term that even a coordinated shift in the contract term may fail to convince the court that the market originally had a different understanding. As with the *pari passu* example, sophisticated parties may therefore coordinate instead around litigation strategy, submitting amicus briefs and publishing commentary to affect the public discourse, among other tactics.

The market does not always respond to a court interpretive error with inaction. In at least one instance, involving an important corporate bond term, the market did respond to an erroneous court interpretation. Bill Bratton documents such a coordinated move to correct the language in bond contracts in the wake of the classic Fifth Circuit case of *Broad v. Rockwell International Corp*.[103] The response, while faster than in the *pari passu* or CAC cases, nonetheless took several years.[104] Even with the possibility of a market response, our point is that the present contract interpretation regime works to retard such a response. An alternative regime that focused first on the historical understandings of a term and accepted evidence from the range of market participants on this understanding would not create the same level of deterrence on market participants seeking to clarify terms in subsequent contracts.

## III. A Theory of Boilerplate Interpretation

The fact that contracts, even those between sophisticated parties, are not always complete, failing to take into account every contingency and leaving ambiguities in language, has been long recognized. Parties may rationally choose not to expend scarce resources in clarifying every possible term when the possibility of a problem arising from the terms is low (and thus the discounted cost with having to deal with any conflict in meaning of a term is lower than the upfront cost of clarification at the time of contract drafting).

Standard interpretation doctrine allows courts to play a gap-filling role and assess what the parties would have contracted had they considered the situation. Courts also look to the course of dealings and performance as evidence of the intent of the specific set of contracting parties. Allowing courts to fill contract gaps ex post allows parties to focus on the more important provisions of their contracts ex ante, secure in the belief that even if a low probability contingency does occur and they end up in a contractual dispute, an impartial decisionmaker, the court, will ascertain a solution that provides value to all the contracting parties. Where upfront contracting costs are high and parties trust that courts will generally get things "right" in their gap-filling in the low probability event that a term will lead to litigation, parties may rationally choose to leave terms ambiguous or unspecified (minimizing

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103. 642 F.2d 929, 961–62 (5th Cir. 1981) (en banc), *cert. denied*, 454 U.S. 965 (1981); *see* William W. Bratton, Jr., *The Economics and Jurisprudence of Convertible Bonds*, 1984 Wis. L. Rev. 667, 687 n.75, 695 n.111.

104. Our evidence on this point is anecdotal.

the combined upfront negotiation and drafting costs and discounted dispute-related costs associated with the contingency).[105]

Where contracts are incomplete due to the high costs of drafting complete contracts, there is reason to be cautious when asking courts to resolve ambiguities and engage in gap-filling for boilerplate terms used in sophisticated markets. The lack of any intent on the part of contracting parties with respect to the boilerplate terms combined with the possibility that the specific parties before a court may not be representative of the industry heighten the risk of court error. Once a court error occurs, collective-action problems, combined with a fear of how courts will interpret a disjointed, non-uniform market response to a court interpretation of a boilerplate term, may lead market participants to delay modifying the term, seeking instead to mount a litigation strategy. Taking a formalist approach is unlikely to improve on matters. Even when courts refuse to look beyond the text and take a hard line on ambiguous terms, specific contracting parties are unlikely to want to negotiate over the boilerplate term (this is why they chose to use a boilerplate term in the first place!) and even if they do so, may incur large duplicative costs across the industry.[106]

Our observation that boilerplate terms are not the product of any actual meeting of the minds but instead are placed into contracts because such terms are used in most contracts (and thus are standardized) and seem to work (the paradox of efficiency) leads us to the contention that courts are approaching contract interpretation in exactly the backward fashion. These terms are not representations of the specific intent of the parties to the transaction. They are more like incantations, where the parties, by invoking the boilerplate language, avail themselves of the historical reasons for the survival of these terms in generations of contracts.[107]

Unlike the focus of much of contract law scholarship on discerning the precise understanding of a particular set of contracting parties, courts should embrace the possibility that a general understanding for boilerplate terms is desirable. Interpretation should be akin to statutory interpretation—courts focus first on unearthing the original intent of the drafters and the historical context in which the terms were initially drafted. Taking a statutory approach to boilerplate enables courts to turn to an alternative, more expert source of interpretive authority, leading to a greater likelihood that the welfare of contracting parties will be maximized. Under such an interpretive

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105. *See* Posner, *supra* note 3, at 1583.

106. Posner describes boilerplate terms as a private alternative to courts as "gap-fillers" for areas in a contract that the contracting parties find too remote a contingency or unimportant to expend valuable resources in negotiation. *See* Posner, *supra* note 3, at 1585.

107. In their 1985 article, Goetz and Scott also recognize that there will be certain terms whose value is in that they are invocations (or "talismanic") that carry predefined legal meanings that are not readily discernable from looking at the terms themselves (these can be terms like "F.O.B", "C.I.F", and "as is"). Goetz & Scott, *supra* note 64, at 282–83, 300–01. The difference between our approach and that of Scott and Goetz, though, seems to be that they don't see the meanings of these terms getting forgotten over time. They recognize that there are certain express terms that the parties choose that are invocations. But, in the world Scott and Goetz describe, the market understands what these invocations are meant to connote. *See id*. at 282–83.

approach, industry standard-setting entities are more likely to organize and clarify existing boilerplate terms as well as draft new boilerplate terms for unaddressed contingencies. A statutory approach to contract interpretation also minimizes the influence of any one set of contract parties who happen to litigate over the meaning of a boilerplate term, and places greater weight on the industry-wide understanding. Treating boilerplate terms as statutes for purposes of interpretation also will lead to fewer court errors and a greater ability on the part of the market to correct for any errors that do occur.[108]

If courts follow a statutory approach to interpreting boilerplate terms, to whom should courts look as the "legislative" body? Ideally, an industry association would exist that incorporated the viewpoints of all the relevant players in the industry in every pronouncement and decision the industry association made on the meaning of boilerplate terms. Under this ideal, a court may simply defer completely to the interpretations of the industry-wide association. Such an all-aggregating industry association, however, is unlikely to exist, at least with respect to every pronouncement and decision, whether formal or informal, coming from the association. While the formal promulgation of new terms are likely to represent the views of all member groups, ordinary press releases and other communications from the group not coming out of a formal deliberative process may not.

Given the lack of an ideal legislative body, in this Part we set forth our proposal of how courts may implement a contract-as-statute approach to contract interpretation for boilerplate terms in sophisticated contracting situations. We would (A) allow parties to designate a standard-setting entity as the "legislative body" for a particular set of boilerplate provisions in a contract. Even if an ideal legislative body does not exist, courts may rely on sophisticated commercial parties in negotiating a contract to designate an entity that best serves the parties' joint interests.

Where parties do not designate a legislative standard setter, we (B) set forth an alternative set of contract interpretation steps, starting with historical evidence on the meaning of a boilerplate term and moving forward in time toward the market's current understanding of the term. Importantly, we focus the court's inquiry squarely on market-wide perceptions of the terms and not on the intent of any specific set of contracting parties before the court. We make the argument that an inquiry into the historical evidence and the intent of the original drafters comes closest to determining how an ideal legislative body would interpret a boilerplate term.

We then discuss (C) how a contract-as-statute approach to interpretation will affect the incentives of standard-setting entities to form in an industry. We lastly (D) examine how boilerplate terms change the nature of contracts

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108. We do not mean to suggest that contract law should incorporate the entire debate over statutory interpretation. Indeed, we recognize that there is a strain of statutory interpretation that prescribes strict textualism and abhors historical inquiry into legislative intent. Our point instead is to suggest that, at least in the boilerplate context, it is worth having the kinds of debates over textualism versus historical understandings versus contemporary understandings that take place in the statutory context.

from a single document, representing a meeting of the minds of a set of contracting parties, to a compilation of several different sources of authority (consisting of varied boilerplate provisions drawn from different sources).

### A. *The Designated Legislative Body*

What does it mean to view boilerplate terms more like statutes? First, contracting parties should have the ability to designate a standard-setting entity to provide a definitive source of interpretive authority for the contract. Put differently, the presumption that the state (through its courts) stands at the top of the interpretive hierarchy needs to be altered.[109] Even in the absence of an ideal legislative body capable of incorporating the interests of all relevant industry participants for any given decision, sophisticated contracting parties may find close alternatives. ISDA, for example, provides a close approximation in the swaps and derivatives markets. Courts may use the selection on the part of sophisticated parties of ISDA, or some other entity, as their designated legislative entity as evidence of the parties' revealed belief that selecting the designated legislative entity to interpret future contract ambiguities will result in fewer uncertainties and errors than relying on court-based interpretation.

Such a designation would require courts to adopt the interpretation of the designated standard setter, even if provided after the same court has interpreted the term differently in prior litigation, for terms that are part of contracts negotiated in the past. This "legislative" designation would allow the third party to revise constantly the meaning of boilerplate terms not only for contracts negotiated in the future but also all previously negotiated contracts. The boilerplate term parts of contracts no longer would reflect a particular snapshot of time but rather form a network of dynamic terms, changing flexibly with the needs of the market or in reaction to ill-advised court interpretations of boilerplate. When a court gets an interpretation of a term incorrect, the designated legislative source could simply correct the interpretation, affecting not only subsequent but all pre-existing contracts, that we argue courts should take as conclusive.

Where the market has a pool of existing contracts containing boilerplate terms, dealing with uncertainties in the terms (and correcting for court mistakes in interpreting terms) is particularly difficult. Contract doctrine views each contract as a separately negotiated meeting of the minds. Under this view, even if parties subsequently decide to change a term's meaning for subsequent contracts, there is no presumption (indeed there is a presumption against) changing the meaning for prior, already negotiated contracts. Treating each contract as a separate instrument for purposes of contract interpretation is justifiable where each contract in fact does represent a new meeting of the minds. But where specific terms are boilerplate and included because the "market" requires them in a pool of contracts, the meeting-of-

109. *See also* Schwartz & Scott, *supra* note 1, at 568–69 (noting this presumption and also arguing for it to be altered, albeit in a somewhat different context).

the-minds rationale breaks down. Attempting to discern a specific intent can introduce a degree of randomness into how boilerplate terms are interpreted, leading to interpretive shocks such as the case of the *pari passu* clause.

Importantly, present contract law does not appear sympathetic to the possibility of allowing parties to opt into a separate body of terms in a contract agreed to at a particular point in time that may change in the future pursuant to actions taken by a third-party standard-setting body. This lack of sympathy, we suspect, stems from the view that each contract represents a meeting of the minds of the particular set of contracting parties at the time when the contract is signed.[110] Swap contracts that incorporate ISDA terms, for example, incorporate only a snapshot of the ISDA terms current as of the date of the contract itself. If ISDA changes its terms or definitions, these changes only come into effect for *subsequent* contracts. Under this interpretive approach, similar boilerplate contracts in an industry take on a "wine"-like character, with the meaning of different contracts dependent on the "vintage" of the boilerplate terms to which they refer.

Providing a mechanism for market-based bodies to change the meaning of standardized terms not only for subsequent contracts but also for the pool of pre-existing contracts would give several benefits for contracting parties. First, the risk of mistaken court interpretations is lessened. If a court provides an interpretation of a boilerplate term that affects the entire market, private standard-setting bodies may simply change the term for all pre-existing as well as subsequent contracts. Second, an expert industry association would have the ability to fine tune terms, correct prior mistakes in drafting, and respond to changing market conditions. Parties ex ante that realize the risk of misinterpretation is reduced may rely more on such boilerplate provisions and reduce any premiums for the reduced level of risk, lowering overall contracting transactions costs. Our proposal bears similarities to Llewellyn's call for merchant juries to assist courts ex post in interpreting industry-related terms.[111] The U.C.C. ultimately did not adopt Llewellyn's notion of merchant juries.[112] We would go one step further than Llewellyn, allowing parties not only to designate a third party to interpret ambiguous terms in the contract into the future but also to rewrite even clear terms in the contract.

Because several contracts can use the same boilerplate terms and make the same legislative delegation, a standard setter given the "legislative" authority to determine the meaning of terms may change in one stroke the collective market meaning of terms. This allows for quick adjustments to the meaning of a term that applies consistently across an industry. Consistency

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110. *See id.* at 547 ("[C]urrent law . . . holds that interpretation is an issue for courts to decide and should be conducted according to rules that parties cannot vary."). Scott and Schwartz argue that the method of court interpretation should be made a default, allowing parties to opt out of the default. Unlike our proposal, however, they argue that the majoritarian default would be to adopt a strict formalist interpretation approach. *See id.* at 569.

111. *See* Zipporah Batshaw Wiseman, *The Limits of Vision: Karl Llewellyn and the Merchant Rules*, 100 HARV. L. REV. 465, 527–29 (1987).

112. *See id.*

is important both to minimize the amount of conflict that may arise and to facilitate transactions involving the contract in the secondary aftermarket. Where speed is important in completing a contract, such as in the sovereign debt market, consistency allows parties to focus only on the subset of terms (typically pricing terms) where the parties are likely to disagree. In contrast, if one court interprets a particular contract, uncertainty will arise whether a second court will follow the first court's interpretation for another contract with the same boilerplate terms. The arising uncertainty may cause the discount buyers of such contracts to demand compensation for the risk they face that courts may change the meaning of the terms away from what they expect.

How likely is it that parties would opt into a designated legislative standard-setter approach to contractual boilerplate? Parties in certain markets already explicitly opt to use a set of pre-existing definitional terms provided through third parties. Swap contracts today make explicit reference to the ISDA definitions in the Short-Form Confirmation sheets containing the economic terms of an agreement. Parties need only agree to follow the terms of a particular standard setter (without negotiating the specific terms) when they opt into a pool of standardized terms.

How courts interpret boilerplate terms affects the incentives for a standard-setting body to arise in an industry and the activities that such a standard-setting body undertakes. Various reasons exist for a standard-setting entity not to arise in an industry, as discussed above.[113] On the margin, nonetheless, changing court interpretation of boilerplate terms will provide greater incentives for industry-wide standard setters to organize and provide boilerplate provisions. Under the current regime, courts will look to how a standard setter defines a specific term only if such definitions are incorporated into a specific contract. Otherwise, each contract is treated as a separately negotiated instrument even if it contains boilerplate provisions. Even where definitions from a standard-setting body are used in a contract, the current interpretive regime imposes several large costs on such standard setters.

First, courts will not look to what a standard-setting body does subsequent to the formation of a particular contract as a definitive source for the interpretation of that specific contract. While a fast-moving market may require a change in how a particular term is used, the present lack of doctrinal support deters a standard-setting body from doing so for the stock of existing contracts. Second, because each contract is ultimately viewed as a representation of the meeting of minds between a specific set of contracting parties, these parties will have the ability to bring forward their own extrinsic evidence on what they thought a particular boilerplate term meant, trumping even the views of the standard-setting body. Where the specific contracting parties are different (at least ex post at the litigation stage) from the universe of potential users of a boilerplate term, they may thus skew the

113. *See supra* Section I.B.

interpretation of a boilerplate term. At the very least, parties will face greater uncertainty in how courts will interpret the term.

While standard-setting bodies thus may find it worthwhile to generate boilerplate standards and definitions for a particular industry, the benefit they provide (and thus the return they can make from developing boilerplate terms) is truncated by the present contract interpretation regime. Taking a statutory approach to boilerplate interpretation would ameliorate these costs, thereby raising the return for standard-setting groups to generate boilerplate terms in a greater number of industries with sophisticated parties.

Significantly, the delegation of authority to a third party to interpret ambiguous contract terms only changes to whom contracting parties delegate authority. Already the (mandatory) default is that courts interpret the meaning of contracts for parties well after the contract is agreed upon. As shown in the *pari passu* example, this authority on the part of courts can lead to drastic ex post deviations from the ex ante understanding of the contracting parties. Our proposal simply shifts the locus of interpretive authority away from courts and toward standard-setting bodies in the industry to whom the contracting parties agree to delegate interpretive authority at the time of contracting. Shifts in how terms in pre-existing contracts are interpreted may still occur—but now these changes are explicitly taken into account by the contracting parties in designating an expert third party to guide these changes rather than through the decentralized, non-expert rulings of courts.

One possible criticism of our proposal is that industry association groups, while containing greater expertise, may not have the best interests of all contracting parties in mind. It is unclear, however, what motivates courts in interpreting contracts; courts internalize none of the interests in the industry. As well, a market incentive will exist for a designated legislative body to work in the best interests of all in the industry. If a standard setter does not take into account the joint interests of the market participants in the industry, few new contracts would delegate authority to the standard setter. The delegation of authority on the part of sophisticated contracting parties at the time of their contract provides, in our minds, presumptive evidence of the value of the standard setter to all sides of the contract.

One could also imagine conditional delegation of authority, granting legislative powers to a standard-setting entity only so long as the entity contains a specific proportion of members of a particular type (for example, swap industry professional intermediaries in the case of ISDA). Alternatively, parties could conditionally delegate authority to entities only to the extent the entity engages in a specified, formal deliberative process that is inclusive of all interests in the industry in determining what to do with contract ambiguities. Contracting parties may worry that a standard-setting entity to which they give their trust could change over time and no longer represent their best interests. These forms of conditional delegation of authority provide assurance to the contracting parties that the entity will continue, through time, to represent their particular interests. Partial delegation of authority is also possible, giving courts the authority to interpret relatively plain language terms but giving residual authority to interpret

more ambiguous provisions to an industry standard setter. A standard-setting entity may reduce the fears that the entity may, in the future, no longer represent the interests of all members in an industry with a detailed, specified contract. Where matters are clear, courts would interpret such a provision, turning to the standard-setting entity in the future only for contingent issues left unresolved by the plain language of the term.

Another criticism of our proposal is that arbitration already provides parties an ability to bypass court interpretations of boilerplate clauses. In some ways, arbitration is similar to our proposal, allowing a third-party organization the ability to substitute its interpretative authority in place of court-based interpretation. For at least three reasons, however, arbitration is inferior to a system that forces courts to pay legislative-like deference to a third party source of interpretive authority.

First, arbitration is costly. Rather than incur the cost of establishing an arbitration system, a third-party standard setter may wish to have courts interpret future ambiguities subject to deference to the association's interpretations, if any. Court-based resolution of conflicts provides a subsidy to a third-party group seeking to draft and refine boilerplate terms for an industry.[114] So long as the courts pay appropriate deference to the intent of the third-party group, as we advocate where the contracting parties specify the third-party group as a "legislative body," the availability of court-based adjudication allows the third-party group to focus its attention and resources on developing terms that provide the greatest surplus for contracting parties.

Second, parties may not be sure how long a particular third-party group may stay in existence. If boilerplate terms are used in contracts after the third-party group ceases to exist, the possibility of arbitration may disappear with the group. Court-based dispute resolution does not suffer from this same risk. Moreover, even if a third-party organization dissolves, courts may still apply deference to the intent of the organization at the time the boilerplate terms were originally drafted in interpreting ambiguous terms.

Third, arbitration involves a different form of interpretation. Interpretation that occurs through arbitration is relatively informal and decentralized. Individual arbitrators make their own decision with respect to the meaning of specific contract clauses. Parties may not wish third-party organizations to interpret clauses in this fashion. Where parties are uncertain about the motives of a third-party organization (particularly over time), the parties may wish future interpretations to take place only through a broad, industry-wide deliberative process. Such a process is more visible in the industry and, as a result, is more likely to generate criticisms if unbalanced in favor of a particular subset of the industry. Relying on court-based interpretation that pays deference only to industry-wide pronouncements by a designated legislative third-party body provides an incentive for such groups to work through more collective and visible means in clarifying and generating new boilerplate terms.

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114. Of course, from an overall societal viewpoint, this subsidy is not cost free.

### B. *Interpretation*

What if parties make no such legislative designation in their contracts (as is the case in all boilerplate terms in use today)? Our second insight is that courts, when faced with the interpretation of boilerplate, should attempt to construct how an industry-wide legislative body would have interpreted the boilerplate term, an approach distinct from constructing what the specific contracting parties would have done. Taking an industry-wide view ensures that courts do not place undue weight on the individual contracting parties before them. An industry-wide view also increases the likelihood that other courts taking a similar approach will come to similar results, leading to greater certainty in the marketplace on the meaning of the boilerplate terms.

How should a court construct what an industry-wide legislative body would have provided for in an ambiguous boilerplate provision? The starting point in an analysis of general market understanding should be the historical understandings of a boilerplate clause, discerning the intent of the original drafters of the term.[115] This understanding includes direct evidence of the intent of the drafters, such as memoranda detailing the purpose. The historical record also includes how boilerplate terms fit into the overall structure of the contract envisioned by the original drafters.

Much like the enacting legislative body for a statute, the original drafting parties provide the best source of information on the original meaning of boilerplate contract terms. The original drafting parties will have spent the most time and resources in negotiating the contract term (and thus represent a true "meeting of the minds").[116] In a market populated with sophisticated parties on all sides, the drafting parties necessarily must balance the interests of all sides for a contract term to gain at least initial widespread acceptance in the industry.[117] The fact that a boilerplate term gains initial acceptance in a market consisting solely of sophisticated parties provides some evidence as to the value of the term for all parties.[118] The drafters will

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115. Such an activity, while difficult, is often feasible even for terms that are over a century in existence. For example, Lee Buchheit, the leading U.S. commentator on the meaning of sovereign debt contract terms, and his colleague, Jeremy Pam, embarked on a largely successful historical excavation of the *pari passu* clause's past. *See* Buchheit & Pam, *supra* note 15, at 891–914.

116. To be clear, the "original drafting parties" referred to in the text are those who first adopt the clause as a *standard provision*. That same clause or some version of it may have been used years prior in idiosyncratic circumstances. But it is not the intentions of those idiosyncratic parties we are interested in. Given that the goal is to discern the intentions underlying standard or boilerplate provisions, one has to go back to the point at which the clause becomes standardized. And that point should be fairly easy to discern, given that there is likely to be some big event (war, large financial crisis, revolution, oil shortage, etc.) that causes everyone to focus on the need to alter the existing standard forms.

117. Once a standardized term becomes entrenched, the very fact that a term is the standard may promote its continued use. And, as we discuss above, *see supra* Section II.A.2.b, parties may eventually forget the meanings of the terms, simply incorporating them into their contracts as an automatic matter.

118. Once a term becomes standardized, parties may adopt the boilerplate term without much analysis.

also enjoy an expertise advantage over any court attempting to interpret a term. Courts looking to the historical record will increase the chance that a court interpretation will better match the needs of the marketplace.

To the extent a historical record exists, a doctrine of deferring to this record also encourages consistency across different courts interpreting the same boilerplate provision. Varying parties in different litigation may have idiosyncratic views of what a particular boilerplate term means. Different courts, likewise, may come out with divergent opinions on what maximizes the welfare of any particular set of contracting parties. The historical record provides a common and fixed evidentiary source of the meaning of the term across different litigation. Referring to this source first will minimize the importance of idiosyncratic factors in separate litigation while stressing the common element of the boilerplate terms.

One difficulty with looking to the historical understanding behind a boilerplate term is the potential lack of connection behind the understanding and the particular context of the contracting parties that have chosen to adopt the boilerplate term (often without much thought on the terms). Why should it matter whether the drafters of a term from several decades in the past intended a *pari passu* term to prohibit non-equal payments to creditors? If the contracting parties had no intention one way or the other about allowing non-equal payments, it is unclear why allowing the historical understanding to prevail will further the intent of the parties. Perversely, the original drafters may not necessarily have the best interests of all contracting parties as their goal, instead adopting terms that systematically favor groups with greater power and influence in the industry. Once a term becomes standard in the industry, such terms may perpetuate themselves despite their one-sided nature.[119] Nonetheless, advantages exist to relying on the historical understanding of boilerplate terms.

First, making a clear historical understanding conclusive creates an incentive for the original drafters to create a record in the first place. Over time, a doctrine of deference to the historical record will lead to a greater amount of information on the initial intent of the drafters of such terms. Standard setters in an industry that provide such a record will increase the certainty and value of their terms, leading to a greater likelihood that their terms will become widespread in a particular industry and to more profit for the standard setters (or value for the entities that establish a non-profit standard setter). The record will also help flush out the motives of drafters. A record that states that the drafters intend specific boilerplate terms to result in outcomes that favor one set of contracting parties will make it more likely that other (sophisticated) sets of contracting parties will refuse to use the terms. Drafters could forego such a record, but at the risk that courts will not interpret the term as they had wished.

Second, the probability that historical understanding may be outdated must be compared with the probability of court error in interpreting a boilerplate contract using standard interpretive techniques. Of course, the

119. *See* Bernstein, *supra* note 18, at 754–56.

farther back in time the historical understanding, the greater the likelihood of the understanding becoming outdated. For boilerplate terms, the cost of a court error differs depending on whether it uses a historical or standard contract interpretation approach. When a court makes an error using standard contract interpretation techniques, the error is likely to chill a market response. Because of the focus on the specific intent of the contracting parties, outside third parties (including industry groups) are unlikely to have much persuasive power over a single court as to the meaning of a term. Coordination over litigation may therefore take place at a later time and with less effort due to the lessened influence of outside, third party views on the interpretation of a particular term.

The standard approach to contract interpretation is also likely to chill a coordinated response to draft new terms that better reflect the market's preferences. As we discuss above, market participants may fear courts will misconstrue an uncoordinated response immediately after a court interpretive shock as supporting the view that the interpretive shock correctly characterized the market's prior understanding of a term. Market participants will hesitate to respond as a result. After the initial delay (sometimes taking years), a coordinated response may become possible as in the *pari passu* example. But by this time, even a coordinated change in the contract terms is unlikely to persuade a court that there existed a different market understanding from a now-prior court interpretation. Indeed, a market-wide shift after such a long delay may signal that the older pre-existing terms were in fact different from the new terms to which the market moves. Of course, courts could interpret a market-wide shift the other way. The key point here is that much uncertainty exists in how courts will react. Rather than run the risk of negatively affecting how courts will interpret a term contained in a large number of already outstanding contracts, market participants will not focus on clarifying the contract term language but instead focus on winning the litigation battle.

In contrast, where courts take a historical approach to interpretation, the market response to a court error in interpretation is likely to differ. The historical approach does not focus initially on how dispersed parties react to a prior court interpretation of a boilerplate term. Instead, the focus is on the historical understanding of the original drafters, giving parties greater leeway to clarify the language of contract terms adopted after the shock without fear that this change will be used to interpret pre-existing terms adversely to the parties' interests. The historical approach, as a result, allows market participants to develop new, clearer terms immediately after an interpretive shock.

We concede a cost to our approach. Markets often find it difficult and costly to put new boilerplate terms in place. Restricting courts to original intent, that is, not giving legal recognition to evolving meaning, forces on parties the cost of being stuck with original meaning until resources can be coordinated to produce a market-wide shift. If, however, the result of our proposal is the emergence of a standard setter that can engineer changes in boilerplate at a low cost, the problem is ameliorated. Plus, if the preservation

of historical understandings makes it easier for coordination around innovations in language to take place, there is an additional ameliorative effect.

### C. *Other Industry-Wide Sources of Authority*

In some situations, the task of determining the historical understanding of a boilerplate term is straightforward. Where an industry association exists that maintains a detailed set of boilerplate terms for use in the industry, the historical understanding is easily observable. Consider the meaning of the terms in the ISDA Master Agreement. Not only is ISDA present to clarify the meaning of its terms, but ISDA also publishes a detailed User's Guide detailing the purpose and operation of its terms. In other situations, determining historical understandings is more difficult. A specific set of attorneys at an individual law firm many decades in the past may have crafted a particular clause. Over time, the term may become incorporated in a greater number of deals, traveling (through cut-and-paste) from contract to contract and law firm to law firm. As the term moves across firms and time, it may be subject to minor changes—word shifts, additional punctuation marks, one person's sense of style replacing another's. As we discuss above, without a written record documenting the spread of a particular boilerplate term, as is absent in the sovereign bond context, the historical understandings will inevitably become lost.

What if the historical record is either absent or ambiguous in meaning? Courts attempting to construct what an industry-wide standard setter would do should next turn to industry views on the meaning of the terms, placing greater weight on groups that aggregate the interests of a greater portion of the industry (and have reputational interests at stake). Courts should look to amicus briefs and other sources from industry groups and others providing evidence on the historical record. Even where an industry-wide group does not exist, but instead a court is faced with disparate views across the industry, our approach will result in a better approximation of what maximizes the welfare of all industry participants compared with simply focusing on the specific contracting parties before a court.

If an industry-wide aggregating body exists, why not presume that the body speaks for all contracting parties in the industry and defer to the group's current understanding of the term without deference to historical understandings? Even where an industry aggregating body such as ISDA exists, turning to historical precedent first provides value. Historical precedence may better comport with what contracting parties at the time thought they were getting in incorporating a boilerplate provision. Stressing historical precedence also places a burden on an aggregating entity to go through the formal process of putting forward new terms to change the historical precedent, creating a "focal" point for those in the industry. While a group such as ISDA may aggregate the interests of most members of an industry, going through the process of promulgating a new set of terms may heighten the awareness of the industry with respect to the process, ensuring greater participation of the range of industry participants in the redrafting process.

More industry participants may take notice if an industry association goes through the process of drafting a new set of model terms than if the association puts out an opinion letter on the interpretation of pre-existing terms. Giving deference to the historical context and the intent of the original drafters also gives industry groups an incentive to draft new terms to resolve ambiguities. With the drafting of a new term, the industry group becomes the "original" drafter and, under our proposal, obtains primary deference from courts. Industry groups will also have an incentive to create a detailed record at the time they draft a new term on the meaning of the term to ensure that courts taking a statutory approach to interpreting boilerplate terms have a rich "legislative" history from which to find guidance.

A criticism of our proposal might be that for many markets with boilerplate, there are no market-wide deliberative bodies that attempt to collectivize the interests of all (or even most) market participants. The presence (or absence) of trade associations and other groups, however, is endogenous. A shift in contract interpretation doctrine giving industry associations more weight in the interpretation of standardized contract terms will result in more industry associations forming.

In many industries, there already exist efforts to centralize the creation and modification of centralized terms. Consider again ISDA. When swap derivative contracts first came onto the financial scene, a large variety of terms and contracts arose in the marketplace. The variety, however, led to uncertainty in the precise meaning of terms. Industry participants worked to centralize the definition of key terms through the creation of ISDA. ISDA today provides a glossary of standardized terms. Contracting parties may then reference the ISDA terms as part of their contracts, incorporating by reference the contemporaneous ISDA definitions into their contract.

Not all industries will have a clear, aggregating industry body such as ISDA. In such industries, courts must determine which industry groups or associations to look to in interpreting contracts. At first glance, this seems a formidable problem. Where one dominant group arises (such as ISDA) that all market participants look to, then a court may simply look to this dominant group. But what if competing groups arise? And what if some groups systematically favor certain market participants (for example, investors over issuers or vice versa)? Where such groups are able to agree on the meaning of boilerplate terms, nonetheless, such an agreement allows courts to find interpretations that increase the value of market participants while removing courts directly from the decisionmaking process on the exact meaning of terms. Looking to historical precedence also mitigates the problem of multiple competing groups. Courts look only second to the opinion of industry groups. Where more than one such group exists, or if the sole group does not represent the interests of all the participants in the industry, then a court may give less weight to the opinions of such competing groups.

### D. *The Disaggregated Contract*

A primary advantage of the historical approach to interpreting boilerplate is the emphasis on looking to the intent of the original drafters of a particular boilerplate clause. The focus on sources outside of the particular contract and contracting parties provides a new way of looking at the contract as a whole. Rather than one cohesive document, negotiated at one singular point in time, a contract containing boilerplate language is a conglomeration of different pieces. Each piece may have a different history and timing.

We saw in the example involving Mexico's shift from UAC to CAC terms that different boilerplate terms in the same contract may be in conflict with one another. A historical boilerplate analysis recognizes that contradictory provisions can exist, especially where one provision is a recent addition and another is a historical hold over. To the extent the two contradict each other, the provision more recent in time would be held to trump because it was clearly intended to replace the other older provision.

We hypothesize that the lawyers for Mexico were so focused on altering the modification provisions from unanimity to 75%, that they failed to notice that there were other portions of the contract that were inconsistent with that move. Unearthing a historical understanding of the Obligations Absolute term would reveal it to be a remnant of the UAC provision; something that the prospectus and other sale documents clearly indicate was meant to be modified and replaced by the 75% term. A strict textual and traditional analysis would neither allow for consideration of when the terms arose as a matter or history or consideration of information in the prospectus (the latter not being considered to be part of the contract). But, to recognize the reality of how these documents evolve and how certain terms can get forgotten but nevertheless retained in the contracts will help courts reach a more accurate understanding of the reality of what the contract is intended to mean.

## CONCLUSION

The standard approach to contract interpretation in the context of commercial boilerplate terms generates perverse results and diminishes the incentives of market participants to generate new terms and clarify the meaning of existing boilerplate terms. If the market corrected for court mistakes quickly, such errors would impose little cost. However, dispersed contracting parties may take time to coordinate in an effort to put forward new contract terms. The presence of ongoing litigation may chill the incentives of parties to draft new terms, shifting the focus of any coordinated efforts onto affecting the litigation itself.

In response to these problems, we propose a new approach to contract interpretation for commercial boilerplate terms. Under our approach, courts would interpret boilerplate terms similarly with statutes. Where parties explicitly opt to select an industry standard setter to act as the authoritative

interpretive source, courts should simply defer to this standard setter. Where parties do not explicitly opt for a standard setter but nonetheless use well-worn boilerplate terms, courts should follow a similar contract-as-statute approach in interpretation. Under such an approach, courts should look to the intent of the original drafters of the boilerplate term and the historical context of the usage of the term.

Taking a statutory approach toward interpreting commercial boilerplate allows courts to rethink the nature of any one contract. Instead of a single document created at one moment in time when contracting parties arrive at a meeting of the minds, a contract with boilerplate terms represents a mixture of different components, each with potentially different timing at which actual agreement (by the initial drafters) on the meaning was determined. Courts may take advantage of this differential timing, resolving conflicts between different boilerplate provisions by giving priority to boilerplate terms drafted more recently in time. Our approach moves toward viewing contracts as interconnected parts of a larger overall commercial network that ties market participants to one another.