The Black Hole Problem in Commercial Boilerplate

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Rote use of a standard form contract term can erode its meaning, a phenomenon made worse when the process of encrustation introduces various formulations of the term. The foregoing process, when it occurs, weakens the communicative properties of boilerplate terms, leading some terms to lose much, if not all, meaning. In theory, if a clause is completely emptied of meaning through this process it can create a contractual black hole. A more frequent and thus potentially more pervasive problem arises when, as the term loses meaning, random variations in language appear and persist, resulting in a grey hole. In both cases, courts will face an interpretive conundrum that we collectively term the “black hole” problem. The question is what interpretive strategy should courts use when parties exploit either the absence of meaning or random variations to advance an interpretation of a boilerplate term that (a) surprises the market that previously had disregarded the term and (b) results in an interpretation that the market disavows. Traditional doctrine holds that even if the court errs, parties have an incentive to revise promptly the standard language to exclude the aberrant interpretation. But what if the assumptions about the costs and motivations to revise this type of boilerplate are wrong? We seek to gain purchase on this question with a study of the pari passu clause, a standard provision in sovereign debt contracts that almost no one seems to understand. This clause gained fame in 2011 because of a series of court decisions in New York arguably misinterpreting a particular variation of the clause. Even though the courts’ interpretation put at risk a multi-trillion dollar debt market, meaningful revisions to the language of the boilerplate term did not begin to appear until late 2014. Market forces, in other words, worked very slowly to remedy a major systemic problem, causing considerable social costs. We ask, therefore, whether courts could do more to avoid the problem at the front end rather than depend on market forces to correct court error at the back end.

INTRODUCTION

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A question that courts face whenever they are asked to interpret a standard provision in a commercial contract is how to determine what the parties understood that provision to mean when they contracted. The interpretive goal in contract cases is to recover and then enforce the parties’ apparent intentions, as they existed at the time of contracting. This goal implies that courts will attempt to interpret even ambiguous terms in a manner consistent with the ex ante intentions of the contracting parties in so far as a court can recover those intentions from the contract or the surrounding context. But standardized terms in boilerplate contracts between sophisticated parties are vulnerable to misinterpretation. At the limit, a boilerplate term that is reused for decades and without reflection merely because it is part of a standard form package of terms, and is thereby emptied of any recoverable meaning, can create a contractual black hole. More commonly, terms that have lost much (but not necessarily all) meaning may still provoke litigation over essentially meaningless variations in the boilerplate language. In this latter case of contractual grey holes, courts may be practically incapable of devising a plausible meaning that was attached to the linguistic variations by the contracting parties at the time the contract was drafted. Thus, regardless of whether a boilerplate term has lost all or only almost all meaning, courts will face an interpretation conundrum that we collectively term the “black hole” problem.

The dilemma that courts sometimes face when interpreting boilerplate is

1 Intention is determined objectively and prospectively: A party is taken to mean what a contract partner could plausibly believe it meant when the parties contracted. Alan Schwartz & Robert E. Scott, Contract Theory and the Limits of Contract Law, 113 YALE L.J. 541, 568-69 (2003). As the arbiter of disputed interpretations, the state determines the meaning of whatever signals of intention the parties agree to. While the state presumably knows what it means by the default rules it implies in every contract, it does not know the intended meaning of those terms that are chosen by the parties.

2 The concept of the “black hole” derives from theoretical physics. Stephen Hawking’s important work on black holes “proved” that no information can escape from a black hole–once it is pulled past the event horizon, it is lost. Stephen Hawking, The Hawking Paradox, DISCOVERY CHANNEL (2006). In the sense we use the concept here, the parties’ original understanding of what a clause meant can, in theory, be lost entirely by the process of repetition and the insertion of random variations: once drawn into a “black hole,” it is lost forever. In the last two years, however, Hawking has decided that he was wrong – he has provided a proof that in fact some information can escape, but it is so degraded as to be virtually useless. See David Castelvecci, Hawking’s Latest Black Hole Paper Splits Physicists, NATURE, Jan 26, 2016, http://www.nature.com/news/hawking-s-latest-black-hole-paper-splits-physicists-1.19236 This, then, is the “grey hole” concept. See note 3 and text accompanying notes 16 to 40, infra.

3 David Dyzenhaus has usefully distinguished the different characteristics of legal black holes and grey holes. DAVID DYZENHAUS, THE CONSTITUTION OF LAW: LEGALITY IN A TIME OF EMERGENCY (2006). In his terms, grey holes are situations where "there are some legal constraints ... but the constraints are so insubstantial that they pretty well permit [an actor] to do as it pleases." Id. at 42. A black hole, in contrast, does not even pretend to constrain. It is "a lawless void." Thus, in the sense we use here, the contractual black hole is the limiting case of a boilerplate term that lacks any meaning whatsoever. A grey hole, in contrast, cannot excuse all possible meanings but the meaning that has survived is incapable of providing a basis for making legal distinctions among the variations in language that have appeared over time. Id. Thus, even for grey holes, where some evidence on the meaning of the contractual term remains, this evidence may be so minimal or contradictory as to leave courts effectively with little guidance on how to apply this meaning in litigation. Since the interpretive issues are the same with both black and grey holes, we use the generic term “black hole” to refer to the range of problems caused by the loss of contextual meaning.
an inherent cost of the reliance on standardized contract terms in commercial contracts. Boilerplate terms are ubiquitous in commercial contracting because they offer the efficiency advantages of standardization. Those advantages include the development of a uniform system of communication that is independent of any particular contractual context. Thus, parties in heterogeneous environments who wish to communicate a shared intent can embody that intent in a fixed and reliable formulation whose meaning does not vary with the nature of the contract or its context. Unfortunately, the very elements of fixed and unchanging meaning that make boilerplate terms attractive are the same elements that can lead to the process of repetition without reflection that contributes to the erosion of that meaning over time.

In addition to the ordinary risks of obsolescence, the repetitious use of boilerplate has two pernicious effects that can undermine the utility of some boilerplate terms. The first effect is “rote usage”: some standardized terms may get used by rote so consistently that they lose a shared meaning; they become a ritualized legal incantation. “Encrustation” is a second cost of too much repetition: the intelligibility of language deteriorates significantly as legal jargon is added to standard formulations, leading to linguistic variations of the same clause. This process further weakens the communicative properties of boilerplate terms, reducing even more their reliability as signals of what the parties really mean. In combination, terms that develop linguistic variations and thereafter are repeated by rote even after the original meaning has been largely lost can become contractual black holes.

What is the problem with black holes whose meaning is eroded by rote usage and encrustation? Whenever boilerplate terms lose their meaning, there is a heightened risk that courts may be persuaded to adopt an interpretation of the term(s) at issue that is antithetical to the efficient functioning of the market that

\[\text{4 Standardized terms provide a uniform, and therefore intelligible, system of communication. See e.g., Lon Fuller, Consideration and Form, 41 Colum. L. Rev. 799, 801-03 (describing the “channeling function of legal formality). This standardizing function is analogous to governmental provision of regulated standards of weights, measures and generic product names, and it offers contracting parties similar communicative advantages. Charles J. Goetz & Robert E. Scott, The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms, 73 Cal. L. Rev. 261, 286-88 (1985).}
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\[\text{5 See Broad v. Rockwell Int’l Corp., 642 F. 2d 943 (5th Cir. 1980) (“A large degree of uniformity in the language of debenture indentures is essential to the effective functioning of the financial markets: uniformity of the indentures that govern competing debenture issues is what makes it possible meaningfully to compare one debenture issue with another …”); Sharon Steel Corp. v. Chase Manhattan Bank, NA, 691 F.2d 1039, 1048-51 (2d Cir. 1982) (same); see also Howard Steel, Elnaz Zarrini & Arkady A. Goldinstein, NML v. Argentina: A Lesson in Indenture Interpretation, 8 Insolvency and Restructuring Int’l 31, 32 (2014).}
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\[\text{6 See text accompanying notes 16 to 28 infra (describing black holes and the rote usage phenomenon).}
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\[\text{7 The eminent British lawyer, Philip Wood, has described the process of encrustation as akin to that of barnacles accumulating on a ship’s hull. Philip Wood, Life After Lehman: Changes in Market Practice (Allen & Overy Publications, 2009), at p.9).}
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\[\text{8 See text accompanying notes 16 to 28 infra and Goetz & Scott, supra note 4 at 289.}
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THE BLACK HOLE PROBLEM

relies on the standard contract to regulate the rights and duties of the participating parties. The market may have disregarded the term before a court gives the black hole a contemporary interpretation. But the market will likely have a view of the court’s interpretation of the boilerplate term once the opinion is issued. Then, even if the market cannot readily determine the term’s meaning, the market may nonetheless have an understanding of what the term does not mean, often because of the high cost to market participants of the aberrant court interpretation. As we will show, there are high costs to the participants in standardized market transactions who rely on the widely used boilerplate term when a court is persuaded to adopt an interpretation at odds with the market’s views. Where the original meaning of the term is lost and therefore the evidentiary record on the term’s meaning is absent, the chance of a court issuing an aberrant interpretation is heightened as compared with a boilerplate term with well-known meaning.

These conditions appear to describe the peculiar case of the pari passu clause, a standard boilerplate formulation common to sovereign debt contracts for nearly 200 years whose contemporary meaning was hopelessly unclear. The first disputed interpretation of one variation of the clause occurred in Brussels, in September 2000, in a case against the Republic of Peru. The interpretation of that same variation was affirmed by a federal court in New York in a case against the Republic of Argentina in December 2011, and affirmed again on appeal in that same case in October 2012 and August 2013. In each of these cases, the courts endorsed an interpretation of a particular variation of pari passu that required holdout creditors to be paid in full as a condition to the sovereigns paying consenting creditors under a restructuring agreement. Even though this interpretation effectively undermined efforts by sovereigns to restructure their bonds, meaningful revisions to the language of the boilerplate term did not even begin to appear until late 2014.

To be sure, the extent of rote usage and encrustation in commonly used boilerplate remains an open question because the issue has never been seriously examined by legal or economic scholars. But preliminary evidence from other

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14 In, in addition to the pari passu term, there are other terms in sovereign bonds themselves, such as the negative pledge clause, that may well have become black holes. One can find such potential black holes elsewhere as well, such as the pledges of tax revenues that underlie many
markets where standard form contracts are ubiquitous suggests that the *pari passu* saga is representative of a larger phenomenon, and it argues for a shift in contract doctrine away from the futile and ultimately costly effort to discover a shared meaning that no longer exists. In this Article we explain how courts might better deal with contractual black holes in boilerplate contracts. Our principal purpose, however, is to begin the scholarly focus on the effects of this phenomenon by using the *pari passu* saga as a prototypical exemplar: we use both qualitative and quantitative data to support the claim that courts’ search for shared intent in the case of black holes in standardized contracting can result in substantial social costs.

The article proceeds as follows. In Part I we focus on identifying the causes and effects of black holes in standard form commercial boilerplate. We show how both agency and coordination costs peculiar to the uncertainty that results from black holes can undermine the standard assumption that commercial parties will promptly revise an unanticipated interpretation that generates market inefficiencies. Part II frames our inquiry: does the celebrated dispute over the meaning of the *pari passu* clause offer evidence that the current means of revising black holes imposes large and uncompensated social costs? In Part III, we evaluate a hand produced dataset on *pari passu* clauses assembled from over 1500 sovereign and quasi-sovereign issuances in the period from June 1, 2011 to May 30, 2016, together with interviews with the key participants in the market. Part IV discusses the implications for theories of contract interpretation of our finding that, at least in certain markets, sophisticated commercial actors face extraordinary municipal bonds in the U.S. For a discussion of both these potential black holes, see infra Part V. Standard insurance contracts appear to be another area with the potential for terms that have lost meaning. See Christopher C. French, *The Illusion of Insurance Contracts*, 89 TEMPLE L. REV. __ (forthcoming 2016), who describes conditions ripe for the generation of black holes:

> Many of the terms and conditions contained in standard form ISO [Insurance Service Office, Inc.] policies were drafted many years ago and are reused each time ISO issues new versions of the policy form. For example, the policy language in the 1943 New York fire insurance policy is still used today in some homeowners insurance policies. Because much of the policy language used in standard form policies was drafted long ago, the drafters are often dead or unknown. Documentation regarding the intent of the drafters also rarely exists. Consequently, it often is impossible to discern the original intent of the drafters of standard form policy language.

15 A number of forthcoming papers discuss the conditions under which black holes are more or less likely to occur, see e.g., Robert Anderson & Jeffrey Manns, Boiling Down Boilerplate Provisions in Merger and Acquisition Agreements (mimeo 2016); Michelle Boardman, Black Holes and Dark Matter in Insurance Policies (mimeo 2016); John Coates IV, Why Have M&A Contracts Grown? Evidence from Twenty Years of Deals (mimeo 2016); Matthew Jennejohn, Mapping the Network Typology of Complex Contracts: Evidence from Merger Agreements (mimeo 2016); Anna Gelpern, The Importance of Being Standard (mimeo 2016). See also discussion in Part V infra.

16 The underlying canon of contract interpretation directs courts to give every term and clause in a contract a meaning, under the assumption that parties have drafted terms in a contract to convey their collective purposes. The Second Circuit in *NML v. Argentina*, put it this way: “A contract should not be interpreted in such a way as would leave one of its provisions substantially without force or effect.” *NML v. Republic of Argentina*, 699 F.3d 246, 258 (2d Cir. 2012) (citing *Singh v. Atahkian*, 818 N.Y.S.2d 524, 526 (N.Y. App. Div. 2d Dep’t 2006)).

17 See Part IV, infra.
difficulties in repairing black hole boilerplate following what the market perceives as an aberrant judicial interpretation of the term’s contemporary meaning. These difficulties present a collective action problem whose solution appears daunting owing to the combination of substantial coordination and agency costs that can impair the efficiency of standardized commercial contracting in large scale markets.

I. WHEN STANDARDIZED CONTRACT TERMS BECOME ROTE AND ENCRUSTED

We earlier introduced the concept of black holes in terms of two related but independent factors that contribute to the unintelligibility of standardized language. The first, rote usage, results when, despite many years of repetitive usage, no serious legal challenges or other means of validation affirm the meaning of a routinely invoked term. The absence of disputes over the meaning of a widely used but poorly understood term (or of a collective process of updating the meaning of such standard terms) deprives courts or other authoritative bodies of the capacity to provide parties with a tested, relatively safe interpretation of the boilerplate term at issue that minimizes the risks of unintended effects. Rote usage may also develop as a species of contractual overkill, as in forms that designate already enforceable agreements as “signed and sealed.” In effect, these rote terms become platitudes. Nonetheless, the linguistic formulation continues to be retained and repeated because parties see no reason to eliminate a term they view as costless and thus incur a risk, however small, of jeopardizing the market’s understanding of their agreement. “Encrustation” is a second cost of too much

18 The legal recognition of certain words and phrases preserves a reliable meaning to boilerplate terms. Since the legal system retains ultimate power over interpretation and enforcement, parties cannot be certain what effect will be given to any formulation until it is tested. Definitional recognition does not change the optional character of these terms, but it does confer upon them the status of “invocations,” terms that once deliberately included in a contract have a legally circumscribed meaning that will be heavily, perhaps even irrebuttably, presumed. Goetz & Scott, supra note 4 at 266, 278, and 282.

19 An example of a collective effort to update standard terms is the International Chamber of Commerce publication of INCOTERMS, the international rules for the interpretation of trade terms. See International Commerce Comm’n, Incoterms (2010). Each of the eleven INCOTERMS sets forth a number of substantive rules, including, most importantly, the point at which risk of loss passes from the seller to the buyer. A contemporary example of updating comes from the International Swap Dealers Association (ISDA), whose rules, standard-forms and definitions are continually revised by a standing committee. See Anna Gelpern, Public Promises and Organizational Agendas, 51 ARIZ. L. REV. 57, 63-67 (2009); Stephen J. Choi & Mitu Gulati, Contract as Statute 104 MICH. L. REV. 1128, 1139-42 (2006).

20 For discussion of the deterioration of the sealed instrument from a prime facie signal of legal enforcement to a wholly meaningless rote incantation, see Robert E. Scott & Jody S. Kraus, Contract Law and Theory 141-143 (5th ed. 2013).

21 Ordinary social relations are similarly replete with phrases that have lost their literal meaning through rote usage. The person who asks “How are you?” usually does not mean to inquire about your health. Similarly, “Have a nice day,” an unusual expression of friendliness a few years ago has now lost most of its meaning and become almost a ritual salutation from personnel in many retail establishments.

22 Goetz & Scott, supra note 4 at 288.
repetition: the intelligibility of language deteriorates significantly as legal jargon and other linguistic variations are overlaid on standard formulations. Rote usage and encrustation are related phenomena although they may be found independently in some boilerplate terms. When combined in a particular clause or phrase, a term becomes linguistically uncertain: no particular meaning can be uncovered that is more probable than any other meaning.

It is important to distinguish the linguistic uncertainty that creates black holes from the more familiar interpretive challenges courts face when interpreting terms that are ambiguous. A term is ambiguous when it is “capable of more than one sensible and reasonable interpretation.” Terms that are linguistically uncertain in the sense we use here are not ambiguous but rather are acontextual: the term in question can apply to an infinitely wide spectrum of referents because there is no basis in the relevant context to determine what, if any, shared meaning exists.

What, then, is the mechanism that produces an encrustation that is then repeated by rote in standard boilerplate? Those running the deals in standard markets describe the process in the following terms: Lawyers hired to do a deal for clients—such as a bond offering—are instructed to use market standard forms so far as possible. But the deals have to be tailored to the client’s needs as appropriate. Names, dates, locations for payment, currencies, etc., have to be changed from whatever prior deal document is being used as a template. The assumption of the clients is that the lawyers possess the expertise to make the necessary marginal modifications to the standard forms to insure that they both fit the client’s preferences and do not depart significantly from what the market would consider the “standard package.” But lawyers working with standard form language that has been repeated for many years by rote (and therefore is part of the market standard to which only marginal modifications would be acceptable) are unlikely to have much, if any, understanding of the purpose(s) served by these terms. The combination, then, of having to make marginal modifications to the contract terms to suit the needs of the transaction, coupled with ignorance of the terms’ function, can result in the insertion of legal language that attempts to add some clarity to the terms. These insertions may occur with greater frequency when the attorneys involved have less experience with the particular boilerplate term.

Encrustation thus results from adapting standard language whose contemporary meaning is unclear to the drafter. To be sure, emendations may occur in other contexts as well. But there are greater error-correction mechanisms for those boilerplate terms that do have well understood meanings and frequent usage. Subsequent drafters that see a variation in an understood usage will be less motivated to repeat the variation if the earlier amendments have changed this

meaning and usage in undesirable ways. Where a term has lost a shared meaning, however, and is repeated by rote simply because the term is part of a standard package of expected terms, these error-correcting mechanisms will not apply. This then leads to increasing uncertainty in the meaning of the variations in the wording of the boilerplate term.

Indeed, there are occasions where the very popularity of a clause as part of the standard package of terms in a given indenture can increase even as the term becomes more encrusted (and less understood). This phenomenon is propelled by information cascades: in an information cascade, followers might imitate the variation regardless of what they think of the merits of the choice as long as they believe there is some chance the earlier movers (or even only the first mover) might have had better information about the term’s intended meaning. Thus, one person’s tinkering can become contagious even when nobody else knows what the revision is supposed to mean.

Ironically, because of rote usage, some clauses are enshrined as an essential part of the standard “check list,” expected by market participants to be found in all contracts of a particular type or in a specific market. These check lists function as templates that reduce the learning costs for potential contracting parties: a list of essential elements for every standard deal facilitates comparisons among contract documents. Paradoxically, however, habitual reliance on standard templates also exacerbates the black hole problem. Once a term becomes an essential part of a package of terms that signals a standard set of contractual rights and obligations, rote usage will increase, thereby accelerating loss of meaning. Rather than consider the underlying substance of terms that are part of a standard checklist, contracting parties may simply reproduce such terms reflexively. As a result, whatever original (and shared) meaning such terms might have had may become lost over time. In this evidentiary vacuum, the chances of a court making an aberrant interpretation are greatly increased as compared with a boilerplate term with well-known meaning. The market may have largely overlooked the function of a clause prior to litigation over its meaning. However, the market will thereafter develop views on how the court’s interpretation affects the parties’ contractual distribution of rights and obligations. And because a black hole had no meaning or function prior to the interpretation (or, at best, minimal or contradictory meaning), the court’s interpretation will likely upset this distribution in unexpected and negative ways.

25 Gulati & Scott, supra note 9 at Chapter 9 (describing this phenomenon in the context of the pari passu clause).
26 Lisa R. Anderson & Charles A. Holt, Information Cascades in the Laboratory, 87 AM. ECON. REV. 847 (1997). We are grateful to Bert Huang for alerting us to this point.
27 See Gelpern & Gulati, supra note 24; Gulati & Scott, supra note 9 at 75-76 (quoting senior lawyers). Market participants report the importance of satisfying expectations of what should be on the “check list” in other contexts relating to sovereign bond issuances as well; even if the item on the list is itself meaningless. See Elisabeth de Fontenay, Josefin Meyer & Mitu Gulati, The Sovereign Debt-Listing Puzzle (2016 draft).
28 Id.
The standard assumption among both commercial lawyers and legal academics is that the social costs of rote usage and encrustation are small: the costs of judicial error will be limited to an isolated case of an aberrant interpretation. This belief is supported by the reasonable assumption that sophisticated commercial parties can (and are motivated to) readily correct a court’s interpretive mistakes. Indeed, given (a) the important role that standardization plays in replicating boilerplate terms in literally tens of thousands of commercial contracts, and (b) the non-trivial possibility that a court may err in interpreting those terms that are infected with rote usage and/or encrustation, commercial parties have strong incentives to revise their standardized contract terms promptly to ensure that a common meaning is preserved. Thus, the theory predicts that “harmful heuristics, like harmful mutations, will die out.” After all, commercial parties want to reduce uncertainty in so far as possible, and leaving inefficient interpretations of encrusted boilerplate unrevised produces unacceptable levels of uncertainty and reduces the gains from contracting.

But what if the assumption is incorrect that markets evolve rapidly to repair inefficient interpretations of encrusted boilerplate? It is, after all, an assumption based on little in the way of empirical or theoretical work on what one might call the production process of contracts. What if there are circumstances where sophisticated commercial parties systematically fail to react to inefficient judicial interpretations and are unable easily to convert the encrusted boilerplate into a new and intelligible formulation? To be sure, there are many sources of inertia that can delay revisions to standardized contracts, but what if boilerplate that has devolved into a black hole motivates inaction that lasts well beyond the ordinary time for market adjustments?

Why might inertia costs be higher in the case of contractual black holes? Theory supports the argument that encrustation robs these terms of a shared meaning. Over time, these encrustations introduce essentially random variations in the language of the boilerplate term: these variations are stripped of any context

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29 Among the classic discussions of the Darwinian process that will eliminate harmful mutations, see Clifford W. Smith & Jerald B. Warner, On Financial Contracting, 7 J. FIN. ECON. 117, 123 (1979) (discussing the loan covenant context); Merton H. Miller, Debt and Taxes, in MERTON H. MILLER & BRUCE D. GRUNDY, SELECTED WORKS OF MERTON H. MILLER: Volume 1, Chapter 5 at 103 (discussing the capital structure choice context).

30 See Smith & Warner, supra note 29 at 123; Miller, supra note 29 at 103.


32 For a discussion of the inertia costs that apply generally to standardized contracting, see Marcel Kahan & Michael Klausner, Standardization and Innovation in Corporate Contracting (or “The Economics of Boilerplate”), 83 VA. L. REV. 713, 728, 750 (1997).
and thus they offer no means of distinguishing legal rights and duties among the different formulations. Because these random variations are harmless for long periods of time, they persist—at least until an adverse legal interpretation poses a systemic threat to the market. As the pressure then mounts to repair the damage caused by the black hole, parties confront a significant increase in the level of uncertainty across all the dimensions of inertia to change. Individual parties are reluctant to change because they cannot offer a plausible alternative to the aberrant interpretation. In addition, they are unsure how courts will respond to the changes they do make: until the revised term is tested in litigation, there is uncertainty over how courts will interpret what had been an essentially “empty” term. Individual parties also may be reluctant to draft new contractual language in the evidentiary vacuum of a black hole out of fear that the new clause may be used to show that the unrevised clauses in contracts that are still outstanding mean something different from the new clause. Thus, change to the contract language that closes off holdouts in a newly issued bond might put unrevised clauses in prior bonds of that sovereign at greater risk of enabling holdouts. These “legacy” costs increase as does market uncertainty: Changing a term thus poses the further risk that the standard indenture will be viewed as idiosyncratic, thereby increasing learning costs.

The reluctance to act in an evidentiary vacuum is greater when a contracting party moves unilaterally while other parties continue to use the existing boilerplate clause even after a disfavored court interpretation. The uncertainty over the meaning of a black hole term coupled with the continued use of the term by others in the market heightens the risk that subsequent courts will view a unilateral revision of the clause as confirmation of the first court’s interpretation. In contrast, if the market as a whole moves promptly to change the contract language, it sends a clear signal rejecting the court’s interpretation of the black hole clause and affirming the market’s preference for an alternative interpretation. The black hole hypothesis thus predicts that change will not occur in a significant

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33 We use the term “random variation” in a specific sense: the initial change in the language of the boilerplate term was likely an intentional emendation by the agent charged with the duty of adapting the contract to particular client needs. But the lack of error correction mechanisms that exist in the case of variation of well-understood terms means that the durability of the linguistic variation is essentially random.

34 The specific metaphor here is the concept of punctuated evolution as popularized by Stephen Jay Gould. The idea is that evolution does not select against characteristics that are harmless. The evolutionary process is triggered only by an event that makes the characteristic undesirable. STEPHEN JAY GOULD, THE STRUCTURE OF EVOLUTIONARY THEORY 775 (2002). In the context of our paper, the pari passu clause isn’t ripe for revision until holdout creditors persuade the federal district court in New York to adopt an interpretation that blocks an agreement to restructure Argentina’s debt.

35 Learning costs include the costs that parties must expend in learning the meaning of the clause. The prediction from the learning cost literature is that the older and more widely used a term becomes, the better is the common understanding of what it means. Kahan & Klausner, supra note 32 at 719-25, 731-33. See also Goetz & Scott, supra note 4 at 286-88 (explaining how standard terms provide benefits in terms of reducing errors of ambiguity, inconsistency, and incompleteness); TINA L. STARK, NEGOTIATING AND DRAFTING CONTRACT BOILERPLATE (2003) § 1.02 (observing that provisions that have been used repeatedly develop a “hallowed status”; they have now been “blessed”).
way until market participants, confronting a black hole term that the market historically has disregarded, are able to solve a very vexing collective action problem and coalesce around a new industry standard. Once the collective forms, the inertia costs for individual actors are significantly diminished. But as we discuss below, the very uncertainty that deters unilateral efforts to revise black hole boilerplate also increases the coordination costs that make collective action, including the efforts of public institutions to assist the market in clarifying the term’s meaning, difficult to achieve.\textsuperscript{36}

As noted above, the foregoing conditions appear to describe the peculiar case of the \textit{pari passu} clause, a standard boilerplate formulation common to sovereign debt contracts for several hundred years that means, literally, “in equal step.” But what does it mean for sovereign debt to be in equal step? Contracting parties and market players were profoundly uncertain where the clause originated and what, if anything, it said about the relationship of creditors to the sovereign debtor and to each other.\textsuperscript{37} Nevertheless, starting with a suit against Peru in Brussels in 2000 and followed by claims against Argentina in New York in 2011, courts adopted an interpretation of a particular variation of the \textit{pari passu} clause (an interpretation subsequently affirmed by the Second Circuit Court of Appeals in 2012 and 2013) that radically altered the ability of parties to sovereign debt contracts to agree to restructure troubled sovereign debt.\textsuperscript{38} In each of these cases, the courts endorsed a “ratable payments” interpretation of \textit{pari passu} that required holdout creditors to be paid in full as a condition to the sovereigns paying consenting creditors under a restructuring agreement.

The market reaction to these developments was intense: there was near universal agreement that, whatever \textit{pari passu} meant (if anything), it did not mean what the courts had said that it meant.\textsuperscript{39} But even though this interpretation effectively undermined efforts by sovereigns to restructure their bonds, meaningful revision in the language of the boilerplate term did not begin to appear until late 2014. The almost universal view of market participants was that the courts’ interpretation created a significant inefficiency in the standard sovereign bond contract by limiting parties’ ability to use restructuring agreements to maximize expected returns.\textsuperscript{40} Yet, by the end of 2016 only one segment of the sovereign

\textsuperscript{36} For discussion, see Gulati & Scott, supra note 9 at 40-41 (suggesting moral hazard incentives that motivate free riding by private parties on the assumption that the official sector will bear even greater costs if the terms are not revised), and Lee C. Buchheit & Mitu Gulati, \textit{Sovereign Bonds and the Collective Will}, 51 Emory L. J. 1317 (2002) (same). See text accompanying notes 166 to 202, infra.

\textsuperscript{37} Gulati & Scott, supra note 9, Chapter 1.


\textsuperscript{40} E.g., Martin Wolf, \textit{Argentina’s Debt Dispute Must Not be Repeated}, FIN. TIMES, Sept. 19,
market (the most elite subset involving direct issuances by the sovereigns themselves) has repudiated the Brussels and New York courts interpretation. Revisions to pari passu in the other segments of the sovereign bond market (including sub-sovereigns—such as provinces or federal states—and other sovereign-related issuers) is barely underway. The questions we ask are: why did this action take 15 years, what kinds of efforts were required to induce the changes that the market preferred, and what were the social welfare consequences of the delay?

The pari passu saga vividly illustrates the substantial social costs caused by aberrant interpretations of contractual black holes. These costs include a) the long term consequences of failed efforts to restructure bonds owing to the large number of inefficient contracts containing a now-disfavored pari passu clause, and b) the high cost of public efforts to overcome collective action problems and induce change in response to the judicial error. Given these costs, it is misguided for contract doctrine to adhere stubbornly to the standard interpretive command to courts to “find” what the parties to the litigation “meant” by the black hole term. Instead, as we suggest below, social welfare considerations support interpreting black hole boilerplate terms “infected” by rote usage or encrustation in ways that reduce ex ante the ex post costs of an inefficient court interpretation.41

II. A PROTOTYPICAL EXAMPLE: THE PARI PASSU CLAUSE IN SOVEREIGN BOND CONTRACTS

A. The Inquiry: Does the Market Repair Black Holes?

Our normative claim that in some cases courts should abandon a search for party intent when interpreting certain boilerplate terms is often difficult to support empirically. Consider the case where a single court in one jurisdiction interprets a boilerplate term and, despite public outcry, the market continues to use the same unchanged term for years after the interpretation. Notwithstanding the public reaction, it will be challenging to discern whether, in fact, the market views the court as erring in its interpretation. If it is indeed the case that market actors do not react quickly to judicial error, all that an outsider observer sees is that the boilerplate terms in the contract have not changed. While the absence of revision to the boilerplate may mean that the market is constrained in some way that impedes

2016. In a companion paper, we test the claim by several scholars that the courts’ interpretation enhanced the efficiency of bond contracts and overcame a moral hazard problem by permitting debtors to precommit not to restructure their debts. See Choi, et al., Evolution or Intelligent Design, supra note 13. Our data offers support for the inefficiency hypothesis and finds little or no support for the claim that the courts’ interpretation enhanced the incentive gains from rational variations in sovereign bond contracts.

a prompt response to inefficient interpretations, the absence of revision is also consistent with the possibility that the courts’ interpretation reduced hitherto unacknowledged inefficiencies in the standard form. In that case, the absence of a market wide revision to the term in question would be a confirmation of the welfare benefits of the novel interpretation.\textsuperscript{42}

What evidence would be sufficient to support the claim that the market is peculiarly disabled from promptly revising (or deleting) a contractual black hole following an erroneous interpretation? Ideally, we would hope to see multiple courts across different jurisdictions interpreting an encrusted boilerplate term in a particular way (removing the argument that the market does not bother to respond to a single aberrant court decision), followed by numerous contracts written with the same unrevised term. To be sure, there are many sources of inertia that delay revisions to standardized contracts,\textsuperscript{43} but inaction that lasts well beyond the ordinary time for market adjustments justifies the inference that either a) contractual black holes are associated with extraordinary inertia costs\textsuperscript{44} or b) the market is endorsing the prevalent court interpretation.

But how can we then distinguish between these two plausible reasons for the lack of a market response? Suppose after an extended delay we do observe an eventual and wholesale revision in the language of the boilerplate that explicitly rejects the courts’ interpretation of the meaning of the black hole term. With multiple instances of judicial interpretation, particularly if the courts are taken as authoritative, researchers can more credibly dismiss the explanation that the interpretation from an aberrant court does not reflect the prevailing judicial view.

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\textsuperscript{42} This argument has been advanced in the case of the \textit{pari passu} controversy by Marcel Kahan \& Shmuel Leshem \textit{Moral Hazard and Sovereign Debt: The Role of Contractual Ambiguity and Asymmetric Information} (2016 draft, on file with authors), and by Mark L. J. Wright, \textit{The Pari Passu Clause in Sovereign Bond Contracts: Evolution or Intelligent Design?} 40 HOFSTRA L. REV. 103 (2011). In another article, we test the “Intelligent Design” hypothesis and find little or no support for the claim that the failure to respond to the courts’ interpretation was a rational attempt to reduce moral hazard costs by precluding a subsequent restructuring. See Choi, et al., \textit{Evolution or Intelligent Design}, supra note 13.

\textsuperscript{43} See, e.g., GULATI \& SCOTT, supra note 9 at Chapter 3.

\textsuperscript{44} If in fact inertia costs peculiar to black holes do contribute to the extraordinary delay, then an inefficient interpretation of such a clause will impose additional social costs on the market as parties continue to write contracts that fail to maximize the joint gains from contracting. In the case of the \textit{pari passu} clause in sovereign bonds, the extraordinary inertia costs cited by market players as explanations for inaction can be grouped in four distinct categories: (1) Legacy Debt Costs: A change to the contract language that closes off holdouts in cases involving a newly issued bond might put the unrevised clauses in prior bonds of that sovereigns at greater risk of enabling holdouts (if the court draws a negative inference about the meaning of the old clauses from the fact that there was a substantial change in the new issues.). (2) Market Reaction Uncertainty: There will be uncertainty as to how investors will react to a new formulation of a commonly used clause, especially where the clause lacks a well-understood meaning in the market. (3) Idiosyncrasy Costs: Investors have a preference for the “standard” package of terms, whatever they are. Changing a term poses the risk that the bond will be viewed as idiosyncratic, thus increasing learning costs. 4) Legal Uncertainty: How courts will interpret the new term remains an uncertainty until the term is tested in litigation: the uncertainty is greater if the lack of a settled market understanding means that courts must interpret the clause in an an evidentiary vacuum. For discussion, see id. at Chapters 6 \& 7.
And when the eventual changes to the clause expressly reject the prevailing judicial interpretation, researchers can dismiss the explanation that the market had acknowledged the efficiency of the newly-minted boilerplate. The foregoing conditions are, unsurprisingly perhaps, hard to find. However, the decade long litigation between NML Capital, the hedge fund of the U.S. billionaire, Paul Singer, and the Republic of Argentina, has provided a natural setting that allows us to do just the test described above.\textsuperscript{45}

\textbf{B. The History of Pari Passu Litigation}

To understand why an examination of the history of the \textit{pari passu} clause offers a valuable natural experiment, let’s go back fifteen years to litigation involving NML’s predecessor, Elliott Associates (another hedge fund run by Mr. Singer). In that instance, Singer’s fund was pursuing the Republic of Peru on debt claims his fund had purchased at a deep discount.\textsuperscript{46} Obtaining a judgment against Peru for nonpayment of the debt was straightforward (there was no dispute that Peru had not paid). Enforcement of the judgment was the difficult step, as it always is with sovereign debtors (this is also why defaulted sovereign debt trades at a deep discount on the secondary market). Elliott Associates had purchased discounted debt and sought to use its legal expertise, along with its unusually deep pockets, to recover in full from recalcitrant debtors so as to make a hedge-fund worthy profit. As part of that endeavor, Elliot was chasing Peruvian assets in a variety of jurisdictions around the world, including Brussels. There, Elliott struck pay-dirt: The commercial court in Brussels ruled, on an \textit{ex parte} motion, that the version of the \textit{pari passu} clause used in the Peruvian debt contracts\textsuperscript{47} meant that Peru could not pay any other creditors without paying Elliott a pro rata share.\textsuperscript{48} Further, the judge ruled that Elliott was entitled to an injunction against Euroclear, the Brussels based financial clearinghouse, which would bar payments to the holders of restructured bonds (who were being paid in full on their restructured amounts) unless Elliott got its full payment (on its unrestructured amount).\textsuperscript{49}

\textsuperscript{45} We take the standard sovereign bond contract that includes the ubiquitous \textit{pari passu} clause to be prototypical, not representative, of boilerplate contracts of its type: Its elements are not those most frequently to be found in an empirical survey of standard form contracts with some encrusted terms. Rather, the standard contract contains the essential features that, in repeating boilerplate terms untested by litigation over long periods, define the category. In this sense, the sovereign bond contract is a prototype or central exemplar of a distinct class of contracts, in the way that robins and swallows are prototypes of birds, while chickens, ostriches and penguins, despite their many similarities to robins and swallows, are not.

\textsuperscript{46} This part draws on \textsc{Gulati & Scott}, \textit{supra} note 9 at 12-17.

\textsuperscript{47} For a discussion of the \textit{pari passu} variation used in the Peruvian debt contracts, see text accompanying note 93, \textit{infra}. The Latin translation for \textit{pari passu} is “in equal step.” The clause has been present in sovereign debt instruments since at least the early nineteenth century. See Benjamin Chabot & Mitu Gulati, \textit{Santa Anna and His Black Eagle: The Origins of Pari Passu}, 9 \textit{CAP. Mkts. L. J.} 216 (2014); Pablo Triana, \textit{The First Foreign Sovereign Pari Passu: It’s all Scottish to me} (2015 draft), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2662851

\textsuperscript{48} Elliott Assoc. No. 2000QR92 (Ct. App. Brussels, 8\textsuperscript{th} Chamber, Sept 26, 2000.).

\textsuperscript{49} For discussions of the Brussels case and its aftermath, see, e.g., Manuel Monteaguodo, \textit{Peru’s Experience in Sovereign Debt Management and Litigation}, 73 \textit{L. & CONTEMP. PROB.} 201 (2010); Robert A. Cohen, \textit{Sometimes a Cigar is Just a Cigar: The Simple Story of Pari Passu}, 40 \textit{HOFSTRA L.}
The international financial community reacted with alarm. The luminaries in the field uniformly condemned the decision as inconsistent with long held market understandings of the meaning of *pari passu*: whatever the clause meant (and here no one was certain of the contemporary meaning), the experts asserted that everyone knew that it *did not mean* that all creditors must be paid pro rata despite a restructuring agreement giving preference to consenting creditors. But notwithstanding the dismay expressed in dozens of academic and policy articles, and even after a proposal for a new IMF-led international bankruptcy court for sovereign debtors, for over a decade almost no *pari passu* provisions in sovereign debt contracts were modified to clarify this supposedly universal understanding. The same variation in the traditional language of *pari passu* that had led to the supposedly unsupportable decision in Brussels was used over and over again for a decade in literally hundreds of contracts.

What explains this disjunction? The same law firms whose senior lawyers were declaiming that the Brussels interpretation was clearly wrong were simultaneously continuing to use the same problematic version of the clause in their own documents for their sovereign clients. To understand why this "patent
judicial error" was uncorrected in subsequent contracts, two of us conducted close to a hundred interviews with leading sovereign debt lawyers in New York, London, Paris, and Frankfurt.56 Their answers varied, but the typical response was: 'Why should we change the clause? No court in New York or London would ever make such an error; this was an aberrant decision from an obscure court in Brussels.' Moreover, the debt lawyers argued, this was an ex parte decision:57 if Peru's lawyers had been given an opportunity to argue their position, the case would never have come down that way.58

Ten years later, in December 2011 a federal district court in New York shattered the assumptions of the sovereign debt lawyers who had heaped contempt on the Brussels court. This time, the hedge fund was NML Capital, holding defaulted debt owed by the Republic of Argentina. NML asked a federal judge in New York for an injunction based on a claimed violation of essentially that same version of the pari passu clause.59 And this time the litigation was not ex parte: Cleary Gottlieb, the firm on the sovereign side, had ample opportunity to make its arguments in full. Moreover, the judge had handled major sovereign debt disputes before60 and had access to a decade's worth of academic research studying the impact of the Elliott v. Peru cases.61 Nevertheless, after hearing extensive argument from both sides, the court held that this version of the pari passu clause required a pro rata payment to all creditors, including holdouts, in essentially the same way as had the Brussels court.62

The financial community again expressed profound dismay at the court's

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56 GULATI & SCOTT, supra note 9 at Chapters 6-8.
57 The context was a request for injunctive relief. See id. at Chapter 1.
58 Peru's lawyers in the case were from the firm Cleary Gottlieb Steen & Hamilton, probably the leading sovereign side law firm in the world. For discussion, see GULATI & SCOTT, supra note 9 at Chapter 1; see also Michael Bradley, Irving Salvatierra & Mitu Gulati, Lawyers: Gatekeepers of the Sovereign Debt Market?, 38 INT'L REV. L. & ECON. 150 (2014) (describing the market for lawyers in the sovereign debt context, and the key players there).
59 GULATI & SCOTT, supra note 9 at 170-75. This version of the pari passu clause is reproduced in the text accompanying note 87 infra.
61 Judge Griesa's attempts to manage the aftermath of the Argentine default and the various litigations is discussed in Marcus Miller & Dania Thomas, Sovereign Debt Restructuring: Judge Griesa, the Vultures, and Creditor Rights, 30 WORLD ECON. 1491 (2007).
62 NML Capital v. Republic of Argentina, Case No. 08CV6978; 08 Civ.1707; 081708 (S.D.N.Y. Sept. 28, 2011). As in Brussels, the judge granted an injunction. This order applied to the institutions that might have otherwise helped Argentina pay the non-holdout creditors—they were at risk of being in contempt of court if they aided or abetted the debtor. Republic of Argentina v. NML Capital, Order, Feb. 23, 2012; S.D.N.Y. Case No. 08CV 6978; 08 Civ. 1707; 08 Civ. 1708 (S.D.N.Y. Feb. 23, 2012).
interpretation of the *pari passu* boilerplate language. The almost universal assumption (or at least hope) of the sovereign debt community of lawyers, academics and government officials was that the Second Circuit Court of Appeals—traditionally, the pre-eminent court in the country on business law matters—would overrule the District Court and repudiate the pro rata sharing interpretation of *pari passu*. Numerous amicus briefs were filed (including briefs by the U.S. Department of Justice, the Federal Reserve Bank of New York, Euroclear, the Clearing House Association, and the American Bankers Association), most of which excoriated the trial court’s interpretation of *pari passu*. Yet, in October of 2012 the Second Circuit’s three-judge panel unanimously affirmed the trial judge’s interpretation of Argentina’s *pari passu* clause. Again there were expressions of surprise and alarm by market insiders and more briefs were filed (including briefs by a former deputy-director of the IMF, a Nobel laureate who was expert in sovereign debt, and four separate countries) asking the U.S. Supreme Court to take the case and repair the damage the pro rata interpretation of *pari passu* was inflicting on the market for sovereign bonds. Nevertheless, in June 2014 the Supreme Court declined to hear the case, seeing no substantial reason to disturb the decision of the lower court.

In April 2013, as a result of the failure to get relief in the courts and because the market seemed unable or unwilling to fix the *pari passu* problem on its own, an effort to solve the problem began at the Spring IMF/World Bank Meetings. The primary conveners were the U.S Treasury Department and the

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64 A leading New York law firm, Shearman & Sterling, has usefully consolidated and organized all of the key filings in the *NML v. Argentina* case, see http://argentine.shearman.com/.

65 Id.

66 Id.

67 Id.

68 Id.


70 The amici were Anne Krueger and Joseph Stiglitz, respectively. The countries filing briefs in opposition to the lower court’s *pari passu* ruling were Brazil, France, Mexico and the U.S. See http://argentine.shearman.com/.

71 See NML Capital, Ltd. v. Republic of Argentina, 134 S.Ct. 2819 (June 16, 2014). Not only did the Supreme Court decline to reinterpret *pari passu*, but in a related dispute over the scope of discovery allowed NML, the Court ruled in a fashion that facilitated NML’s efforts to pursue its litigation overseas. Karen Halverson Cross, *U.S. Supreme Court Denies Certiorari and Affirms Discovery in Bondholder Litigation Against Argentina*, 18 ASIL (October 15, 2014).

International Monetary Fund, with the support of the French Finance Ministry’s Paris Club, the International Capital Markets Association (ICMA), the Bank of England, and representatives from major ministries of finance and industry groups around the world. This group of experts met again at the Fall IMF/World Bank meetings in October 2013. In December 2013, after extensive discussions with the foregoing committee of experts, ICMA, the leading industry group, issued new proposed versions of the *pari passu* clause in draft form. The International Monetary Fund, that had been actively involved in the ICMA process, followed suit a few months later with an extensive report recommending that sovereign issuers revise their *pari passu* clauses. Finally, in September 2015, after their meeting in Ankara, the G-20 Finance Ministers and Central Bank Governors included an endorsement of these reform efforts on the part of the IMF in their communique.

As we write this in late-2016, we know from the IMF’s latest report on the topic that a large fraction of pure sovereign issuers have now clarified or modified outright their *pari passu* clauses. What the foregoing provides, now that widespread modifications have appeared, is the opportunity to unpack the mechanics of the process by which boilerplate terms are revised. By using a combination of the data on the changing language of *pari passu* and interviews with market participants involved in the revision process, we can begin to answer the question how and when contractual black holes that are (apparently) infected both with rote usage and encrustation are remedied by revisions to contract language. We know that in the ten years between the Brussels decision in September 2000 and the decision in New York in December 2011 almost no sovereign issuer amended its *pari passu* clause to explicitly foreclose the interpretation handed down in *Elliott v. Peru*. But as of the IMF’s report from mid-2015, we also know there has finally been an extensive movement—albeit among only one distinctive subset of sovereign issuers—to reject explicitly the ratable payment interpretation advanced by the Brussels and New York courts. What we examine in the following Part are the dynamics—and associated costs—of the revision process.

Understanding those dynamics is critical to answering the question with

75 *Id.* at 287-97. The final version of the proposed ICMA clauses was issued roughly six months later in June 2014.
77 According to the Report, over 60% of new issues under both English and New York law have amended their *pari passu* clauses in the post-October 2014 period. See Agarwal & De Long, *supra* note 73.
78 See [GULATI & SCOTT](http://www.shearman.com/), *supra* note 9 at Chapter 5.
79 See IMF Report, *infra* note 104; see also Figure 5, *infra*. 
THE BLACK HOLE PROBLEM

which we began: How accurate is the assumption that sophisticated commercial actors will overcome inertia costs and reject a judicial interpretation of a black hole in a standard form boilerplate contract that regulates a major industry? Our empirical study described below suggests, at least in the context of this one market (albeit, a multi-trillion dollar market), that the standard assumption is false. Changing a boilerplate term whose meaning has largely been forgotten and that has developed numerous encrustations can take years and the process can prove enormously costly, particularly in terms of the hundreds of billions of dollars’ worth of bonds issued with suboptimal terms in the interim period. Those costs support the claim we advance in Part IV that a search for party intent is both futile and counterproductive when boilerplate with these characteristics is included in industry contracts.

III. ANALYZING THE POST-LITIGATION DATA

A. Data Sources and the Coding of Variables

To unpack the boilerplate revision process, we assembled a unique, hand-produced dataset of all of the available sovereign and quasi sovereign bonds for the five-year period between June 1, 2011 and May 30, 2016. For data sources, we

81 The overwhelming sentiment (at least as publicly articulated in the press, and what we have heard in interviews for this project) is that the interpretation of pari passu by the courts in Brussels (2000) and New York (2011-2012) reduced the efficiency of the sovereign bond market. Nevertheless, there is the counterargument that observed variations in pari passu are a rational precommitment by debtors with different risk profiles to either foreclose or invite the possibility of a future restructuring attempt. See, e.g., Kahan & Leshem, supra note 42; Wright, supra note 42. In a companion empirical paper, we test the “Intelligent Design” hypothesis and find it wanting. See Choi, Gulati, & Scott, Evolution or Intelligent Design, supra note 13. That evidence is also consistent with the view of this case in the financial press:

So the people who thought the holdouts’ pari passu theory was crazy seem to be right. The world seems to be unambiguously worse off than it would be if the U.S. courts had rejected the theory. Argentina is worse off (it’s in a default crisis), the exchange bondholders are worse off (their interest payments have stopped), and the holdout bondholders are no better off, since it’s not like they’re getting paid anything either.

More generally, it’s crazy because it makes sovereign debt restructuring impossible. If you know your choice is to take 30 cents on the dollar or to take zero, you’ll probably take 30. But if you know that if everyone else takes 30, you can still sue for full repayment, then you have no incentive to negotiate. The courts’ reading of the pari passu clause means that those holdout bonds can never be compromised; every single holder of those bonds can demand full payment. This is a problem that Argentina currently faces: Even if the holdout bondholders who sued Argentina do want to reach a settlement for less than 100 cents on the dollar, they have no way of binding other holdout bondholders.


82 The federal district court decision that is at the heart of our inquiry occurred in December 2011. Given that the briefs in the case were circulating some months before that date and some market actors might have predicted the outcome, we collected data from roughly six months earlier as well (June 1, 2011). Prior to this litigation, the ratable payments argument for NML had appeared unpromising since the judge in charge of the cases had expressed skepticism when it was raised in 2003. Moreover, the U.S. Department of Justice had filed a brief with the court expressing strong
used Thomson One Banker and Perfect Information, the two primary public data sources that make available offering circulars and prospectuses for public debt offerings. For data on prices and maturities, we supplemented the foregoing with information from DCM Analytics. The datasets provide documentation on what the industry designates as “managed deals,” where bankers and lawyers are involved in preparing the contract documentation, setting the initial prices and finding the initial customers. The strongest AAA issuers (the U.S., U.K., Netherlands, Japan, Germany and France) are not included: owing to their strong credit they do not use traditional contracts with pari passu clauses to sell their bonds.\textsuperscript{83}

The foregoing cut of the available sovereign bond data produced a set of over 1600 bonds from 81 different issuers. The bond issuances were governed either under local law or a dozen different governing foreign law regimes. For each of these bonds, we coded two basic bond characteristics.\textsuperscript{84} These were: (1) \textbf{The type of issuer} divided into two sub categories—pure sovereign bonds issued by nations, and quasi sovereign issuances (such as sovereign guarantees, sub-sovereign bonds of cities, states and provinces and supra nationals\textsuperscript{85}) all of whom have a degree of sovereign immunity and, most importantly, are either not subject to a bankruptcy regime or where the applicability of bankruptcy is unclear,\textsuperscript{86} and (2) \textbf{The governing law} variable as either local law—the sovereign’s contracts are governed by its own law—or some foreign law that the sovereign cannot change at its discretion (typically English or New York law).

We turn next to focus on the primary question: whether and how the \textit{pari passu}

\textsuperscript{83} Also outside our dataset are bonds that might be issued in some non-AAA countries to purely domestic investors (usually, captive domestic banks) where bankers, lawyers and contracts are not involved.

\textsuperscript{84} In a companion paper, where we do an econometric analysis, we code for additional variables such as the yields, bond ratings, amounts, currencies and maturities. \textit{See Choi et al. supra} note 13.

\textsuperscript{85} Supra nationals include entities such as the Asian and African Development banks.

\textsuperscript{86} This latter aspect is particularly important because the supposedly damaging impact of the ratable payments interpretation is most relevant in the context where there is no bankruptcy court to oversee a restructuring and, if necessary, force a resolution. We only coded these bonds if they used \textit{pari passu} clauses in the period prior to December 2011 (since our interest is whether and how the clauses changed in these bonds in response to the case).
passu clauses changed in the wake of the series of NML decisions that the New York courts issued during the 2011-2013 period. Here, we coded changes to the pari passu provisions in terms of two different types of changes that we observed in the data: (a) major changes to the core language of the pari passu clause, and (b) minor changes at the margins, that might, for example, expand (or contract) the scope of the clause’s applicability.

**B. Major Changes to the Core Language of Pari Passu**

The first question we considered was whether the clause changed in the direction of either the pro or anti-ratable payments interpretation. Our hypothesis was that the market would either delete the pari passu clause or revise it in order to reduce the risk of another court adopting the ratable payments interpretation. Our baseline for each bond was the version of the clause that the issuer in question was using before June 2011. From that baseline, we examined whether and what changes were subsequently made to the boilerplate language of the clause itself.

The typical pari passu clause, found in almost every sovereign or quasi sovereign bond contract, states in essence:

*The notes rank and will rank without any preference among themselves and pari passu with all other unsubordinated public external indebtedness of the Republic.*

We refer to this version of clause as the “Rank” clause. Prior to the pari passu litigation, eminent practitioners in the field were openly puzzled why this boilerplate clause was ever used in a sovereign debt instrument. The concept of “Rank” has a clear meaning in a domestic bankruptcy context, where a judge supervises the division of the debtor’s limited assets among creditors of different rank. All of those creditors who are of equal or pari passu rank share equally once the creditors senior to them have been paid. But sovereigns do not and cannot enter a judge-supervised bankruptcy procedure. There is no procedure by which an insolvent sovereign’s assets (primarily, its ability to impose taxes on its citizens) get divided. The clause, these practitioners were saying, was essentially meaningless boilerplate; a holdover from a distant era when its inclusion in these sovereign instruments might have made more sense. From the viewpoint of the contemporary market participants, the pari passu clause in sovereign debt instruments was precisely the kind of contractual black hole that over the years had lost meaning as a result of encrustation and rote usage.

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87 GULATI & SCOTT, supra note 9 at Chapter 4.

88 Indeed, in our prior work we suggest a story for why the clause might have made sense in the era of gunboat diplomacy in the 1800s. With the gunboats, after all, the foreign creditors could take over the debtor’s ports (where the tax revenues came in) and, in effect, liquidate the assets. But almost no one among the parties to the current transactions seemed aware of that earlier interpretation nor, more importantly, seemed to care. GULATI & SCOTT, supra note 9 at Chapters 8-9.
Over the roughly 200 years that the clause has been found in debt instruments (steadily increasing in popularity, even as contemporary understanding diminished), encrustations began to appear leading to several different variations as words and phrases were added and subtracted. For example, in 2010 immediately prior to our sample period, Italy adopted a sui generis pari passu clause in its New York law bonds providing that:

The Securities are the ... unsecured obligations of Italy and will rank equally with all other . . . unsecured and unsubordinated general obligations of Italy for money borrowed.... Amounts payable in respect of principal of (and interest on) the Securities will be charged upon and be payable out of the [Treasury of Italy], equally and ratably with all other amounts so charged and amounts payable in respect of all other general loan obligations of Italy.

We term this version of the clause that provides for explicit ratable payments, the “Pay Equally and Ratably” pari passu clause. The Pay Equally and Ratably clause poses a high risk of holdouts as it appears to promise that all creditors be paid ratably whether or not they have consented to a restructuring.

Sometime in the 1980s, other bonds began to promise investors yet a third version:

The bonds rank and will rank pari passu in right of payment with all other unsecured and unsubordinated External Indebtedness of the debtor.90

We term this version the “Rank Equally in Payment” pari passu clause. This was the version of the clause seized upon by Mr. Singer’s hedge fund, first in Brussels and later in New York. The leading practitioners might not have understood what the clause meant, but Singer’s fund found an eminent New York University law professor who opined that he fully understood the meaning: a sovereign debtor who was in arrears to creditors, Professor Andreas Lowenfeld explained, had to pay the creditors who ranked “pari passu in right of payment” on a pro rata basis.90 And importantly, given that a court’s order to pay is largely meaningless against a sovereign debtor, Lowenfeld explained that the clause was an inter-creditor agreement that entitled a creditor who was not paid his pro rata share to an injunction against other creditors who were paid that share.91 In the context of a debt restructuring, where some creditors had agreed to take a haircut

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91 Id.
on their bonds and others were holding out and not receiving any payment, the
injunction against another creditor was a powerful remedy in the hands of the
holdouts. And that was precisely what the creditors in Brussels in September 2000
and in New York in December 2011 asked for and obtained.

For coding purposes, it is important to recognize that the version of the
*pari passu* clause at issue in both the Argentine and Peruvian litigations was
particularly vulnerable to Lowenfeld’s pro rata or ratable payment interpretation:
the word “payment” was used to modify the promise on the part of the issuer that
the bonds would “rank equally.” The clauses at issue in both litigations went
beyond the standard “rank equally” language to include the promise that “the
bonds rank and will rank *pari passu* in right of payment.”

We therefore rated the vulnerability of the different clauses to holdout risk
on a scale of high risk to zero risk, with high risk being maximal vulnerability
(where the contract language said explicitly that each creditor was entitled to equal
ratable payments), to medium risk (the type of clause that used the word
“payment” to modify “rank”) to low risk (which only articulated the concept of
ranking).92

Finally, we coded a category of bonds found in a subset of clauses
primarily governed by English law as having a near zero risk. In these bonds, the
standard *pari passu* language gets supplemented by words such as “except as
subject to provisions of mandatory law.”93 On its face, this additional language
appears to say that the effect of the basic clause can be negated by the passage of a
local law. In other words, the debtor has the power to render the clause
meaningless as a creditor weapon. Table I summarizes the different types of *pari
passu* clauses found in the data set in 2011 and the risk of holdouts each posed
prior to the Southern District of New York trial court opinion (“SDNY opinion”).94

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92 In our empirical tests of pricing effects for a companion article, we code these on a scale of
10, 5, 1 and 0, which roughly corresponds to the relative risk levels.

93 See Weidemaier et al. *supra* note 89 at Figure 2 (and accompanying text). This provision has
come to light in the context of Ukraine’s recently concluded restructuring exercise. See Joseph
Cotterill, *Ukraine’s Bonds: A Little Local Leverage?* FT ALPHAVILLE, March 26, 2015,

94 For discussions of the evolution of these different clauses and their risk levels, see Buchheit &
Martos, *supra* note 89 at 491-93; Weidemaier et al., *supra* note 89 at Figures 1-3. We had also
envisioned coding some bonds as zero risk, where the *pari passu* clause had been deleted altogether
but no such observations appear in the data.
Table I: Types of Pari Passu Clause

<table>
<thead>
<tr>
<th>Pari Passu Clause</th>
<th>Risk Level</th>
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<tbody>
<tr>
<td>Pay Equally and Ratably</td>
<td>High</td>
</tr>
<tr>
<td>Rank Equally in Payment</td>
<td>Medium</td>
</tr>
<tr>
<td>Rank</td>
<td>Low</td>
</tr>
<tr>
<td>Mandatory Law</td>
<td>Zero</td>
</tr>
</tbody>
</table>

B. Minor Revisions: Modifications That Might Influence Interpretation or Scope

Our starting assumption was that if parties disagreed with a court’s interpretation of a boilerplate clause in a standard form contract (and even accounting for ordinary friction costs), they ultimately would adopt what we have called a “major change”: either delete the term or revise its core language to reject the now-disfavored meaning. Instead, what we found in the data are a number of minor changes that we had not envisioned.

1. The Evidentiary Patch.

The most common minor modification reflected in the data was the introduction of an “evidentiary patch”—a supplementary sentence in the offering prospectus explaining what the clause did not mean. As a matter of contract doctrine, such a modification that is made outside the core language of the relevant contract provision is less effective than a major change to the contract language itself. After all, a court will focus first on the language of the clause in the contract: even if there is elsewhere in the offering documents a disavowal of one particular meaning, the risk of misinterpretation remains. In an analogous evidentiary patch, some bonds in the database include a further “supplementary explanation regarding risk.” Here, issuers report in the risk disclosure section of the offering prospectus that the pari passu clause in the contract poses a risk of an adverse interpretation for investors.96

95 See e.g., the Republic of Honduras, Offering Circular, 8.75% Notes Due 2020, at p.10:
To ensure clarity on the point, Honduras intends to take the position that the pari passu clause in the terms and conditions of the Notes does not obligate it to pay Public External Indebtedness on a ratable basis.

96 The operative language from Paraguay’s Offering Circular from January 2013 says:
In ongoing litigation in federal courts in New York captioned NML Capital, Ltd. v. Republic of Argentina, the U.S. Court of Appeals for the Second Circuit has ruled that the ranking clause in bonds issued by Argentina prevents Argentina from making payments in respect of the bonds unless it makes pro rata payments in respect of defaulted debt that ranks pari passu with the performing bonds. The judgment has been appealed.

We cannot predict when or in what form a final appellate decision will be granted. Depending on the scope of the final decision, a final decision that requires ratable payments could potentially hinder or impede future sovereign debt restructurings and distressed debt
2. Scope of the Clause.

Our final coding references the scope of the clause. *Pari passu* clauses vary in terms of the breadth of the promise they make. Most *pari passu* provisions in international bonds promise that the bonds will rank *pari passu* with some portion of the sovereign’s other unsecured and unsubordinated obligations.\(^{97}\) The size of that portion ranges from the sovereign’s “external indebtedness” (which is usually defined as the indebtedness of the sovereign that is denominated in a foreign currency) to “all unsecured and unsubordinated obligations,” which is sufficiently broad to include the salaries owed by the sovereign to its domestic employees. As long as the clause was seen by the contracting parties as a meaningless artifact, the breadth of the clause did not matter to the parties. However, under the court’s injunction in *NML v. Argentina*, the scope of the clause became of paramount importance: the breadth of the court’s injunction halting payments to other (non-holdout) creditors was directly dependent on whether the holdout creditors had been promised *pari passu* treatment with respect to that particular set of creditors. If not, then there was no right to an injunction against those creditors.\(^{98}\)

Our purpose here was to see whether, once the ratable payments interpretation was issued, parties became concerned about the scope of their *pari passu* clauses. Assuming that there was disagreement with the court’s interpretation, we should see a narrowing of the scope of *pari passu* in the post *NML v. Argentina* clauses. We coded for whether the clause was framed in terms of external indebtedness (the narrowest version), indebtedness (the intermediate category) or obligations (the broadest version).\(^{99}\)

C. The Empirical Results of the Post-Litigation Study

1. All Issuers

Our starting hypothesis was that the commercial parties to sovereign bond contracts—realizing that a clause whose purpose they did not understand was adding unnecessary risk—would either delete the clause or amend its core language to reject the courts’ “ratable payments” interpretation explicitly.\(^{100}\) This hypothesis seemed even more plausible after the widely-condemned ratable payments interpretation was indorsed by the most important commercial courts in

\(^{97}\) For a description of these variations, see Lee C. Buchheit & Mitu Gulati, *Sovereign Debt Restructuring After NML v Argentina*, CAP. MkTS. L. J. (2017, forthcoming).

\(^{98}\) Id.

\(^{99}\) Id. at Appendix (describing the versions).

\(^{100}\) Leading lawyers in the field also shared this assumption. See, e.g., Goss, *supra* note 55; Buchheit & Martos, *supra* note 89 at 491-492.
the United States.\textsuperscript{101} Parties that are concerned about similar interpretations of a clause whose meaning is unclear should either delete the clause or clarify its meaning.

Commentary at the time of the SDNY interpretation proposed deletion as a response. Buchheit and Martos, from the leading sovereign debt firm of Cleary Gottlieb, wrote in the wake of the \textit{NML v. Argentina} decision:

The clause serves \textit{no useful function} in countries whose laws do not permit the involuntary subordination of an existing creditor, which is why it does not appear in the standard documentation for domestic debt issuances in most countries. So \textit{jettisoning the clause altogether will not adversely affect the position of creditors and will avoid the risk of further aberrant judicial interpretations down the road.}\textsuperscript{102}

The image accompanying the cover page article in the New York Law Journal by an Arnold & Porter lawyer (another leading law firm in the sovereign space) is equally illustrative.\textsuperscript{103}

\begin{flushright}
\textsuperscript{101} See text accompanying notes 62 to 69 \textit{supra}.
\textsuperscript{102} Buchheit & Martos, \textit{supra} note 86 at 491-492.
\textsuperscript{103} Berry, \textit{supra} note 47.
\end{flushright}
Despite this commentary from prominent sovereign debt lawyers, we found no evidence in our dataset that parties deleted the *pari passu* clause after the SDNY opinion. Indeed, not a single issuer deleted the *pari passu* clause in response to any of the iterations of the case or to the IMF report condemning the decision. Moreover, not a single bond added language that purported to articulate clearly the rights of creditors or the obligations of sovereign debtors under the clause.

What we did find in the data are the major and minor changes to the clause of the types mentioned above; revisions that appear designed to reduce the risk of
future courts adopting the ratable payments interpretation. We use our dataset to
examine the pattern of adoption of these major and minor modifications in the June
2011 to May 2016 period. What the data show is that there was no real movement
to change any of the language of the core portion of the clause in any direction for
almost three years after the federal district court handed down its first ratable
payments interpretation. In late 2014, however, revisions began to move
dramatically toward the low risk, Rank version of pari passu by removing the
word “payment” from the boilerplate term. This convergence on a single type of
pari passu clause served to eliminate the language that supported the ratable
payments interpretation in the New York and Brussels cases.

For our analysis, we start with 1,691 issuances between June 1, 2011 to
May 30, 2016 and examine whether the pari passu clause for a sovereign’s
issuances on a particular day is different from the sovereign’s last issuance prior to
the start of our dataset on June 1, 2011. For our analysis, we collapsed multiple
issuances on the same day into one observation (leaving us with 1,389 unique
issuer-issue date observations) and treated a change as occurring if a particular
change occurred for any of the issuances on that day relative to the last issuance
prior to June 1, 2011.

We first report the percentage of issuances for all issuers in our dataset that
contain at least one change, whether major or minor, to the pari passu clause. To
determine a change, we use the pari passu clause in a sovereign’s last offering
prior to the start of our dataset in 2011 but after 2005 as our point of
comparison (the “initial pari passu clause”). Figure 1 reports for all of the
issuers in our data. The data is reported on a quarterly basis starting from second
quarter of 2011 to the second quarter of 2016. For each quarter we report the
percentage of bonds issued that quarter containing changes to the clause relative to
the initial pari passu clause. The vertical lines in Figure 1 are the points at which
key events occurred such as the SDNY decision (December 2011), the two
appellate court decisions (October 2012 and August 2013), and the Supreme Court
denial of certiorari (June 2014).

What we see is that the 2011 SDNY decision produced no immediate
reaction in the data. For an entire year after that decision, only a small fraction of
sovereign or quasi sovereign issuers made any major or minor changes to their pari
passu clauses. The inactivity in the market is even more vivid if one considers the
dollar amount of bond debt that was issued during this period with unmodified
versions of the clause. Figure 2 depicts the aggregate dollar amount of issuances
by quarter for the bonds in our dataset categorized by those with and without a
change in the pari passu clause, where change is measured relative to a sovereign’s
initial pari passu clause. Figure 2 excludes those issuers that had a low risk Rank

104 See IMF, Progress Report on the Inclusion of Enhanced Contractual Protections in
International Sovereign Bond Contracts, International Monetary Fund Staff Paper, September 2015,
clause as their initial *pari passu* clause. As Figure 2 shows, over $2.6 trillion worth of sovereign and quasi sovereign bond debt was issued during 2012 alone with unmodified clauses.

One might wonder here whether the market thought that the SDNY decision was an outlier that was certain to be overturned and therefore did not need to be taken seriously. Yet, we see from Figures 1 and 2 that in October 2012 the Second Circuit Court of Appeals affirms the trial court’s decision. Though some changes in the *pari passu* clause begin to occur, the large majority of issuances in both numbers and aggregate dollar amount remain unchanged. During 2013, there were another $1.7 trillion of bonds issued, again without any revision to *pari passu*. A handful of issuers do revise the contract language in 2013, but again the overwhelming majority of bonds are issued without any attempt to modify or clarify their *pari passu* clauses.\(^\text{105}\) The first nine months of 2014 continue in the same fashion with another $1.2 trillion in bonds issued without any revisions in the issuers’ clauses, even though in June 2014 the U.S. Supreme Court denied an appeal from the Second Circuit.\(^\text{106}\)

Figures 1 and 2 illustrate a simple point: If we assume that continuing to use a clause presenting a significant risk of an interpretation error imposes costs on the parties to the contract, then it follows that substantial social costs were incurred as a result of an apparently high level of inertia that impeded change during this period. Between June 1, 2011 and May 30, 2016, roughly $8 trillion dollars’ worth of sovereign and quasi sovereign bonds were issued with terms that were likely suboptimal.\(^\text{107}\) To be sure, the precise costs (in terms of the additional risk of holdouts caused by using the risky term) vary across bond issues depending on the likelihood of default and the precise wording of the clause in question. But it seems plausible to conclude that substantial costs were incurred because the market was so slow in adjusting to the decisions of the New York courts.\(^\text{108}\)

While change in the *pari passu* clause came only slowly after June 1, 2011, the pace of change increased after October 1, 2014. In Figure 1, note that the percentage of issuances with *pari passu* revisions increases more than 100%,

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\(^\text{105}\) As an aside, the Second Circuit reaffirmed its decision in August 2013, but that action does not seem to have had much of an effect.

\(^\text{106}\) The Supreme Court’s refusal to review the interpretation issue was likely anticipated by the market in any event since the Supreme Court almost never takes contract interpretation cases in the current era.

\(^\text{107}\) For a report on views of market actors early on from the Managing Editor of the major practitioner periodical in the area, see Lucy McNulty, *The Future for Pari Passu*, INT’L. FIN. L. REV. 19-20 (March 2013) (reporting from a survey of market actors in the sovereign debt industry that there was widespread agreement as to the need for contract reform, yet tremendous inertia as a result of the difficulties in coordinating a move to a new standard).

\(^\text{108}\) An illustration of the costs that are embedded in the use of a “risky” clause in bonds that were issued during this period is the looming problem in Venezuelan bonds that are on the verge of default. *See* Robin Wigglesworth, *Small Print on Venezuelan Debt Will Pique Wall Street’s Interest*, FIN. TIMES, JUNE 17, 2016.
from 9% in the third quarter of 2014 to 19% in the fourth quarter of 2014. In Figure 2, note that bond offerings with a revised term accounted for 18% of the aggregate dollar amount of all offerings in the third quarter of 2014 and then increased to 60% of the aggregate dollar amount of all offerings in the fourth quarter of 2014. By the second quarter of 2016, bond offerings with a revised contract clause or evidentiary patch accounted for 67% of the aggregate dollar amount of all offerings. Moreover, all the major and minor changes during this period were attempts to constrain or repudiate the effects of the NML decision.

In sum, we see evidence of an extended period of inertia followed by increasing volume of changes to the *pari passu* clause, particularly after October 1, 2014. Our conjecture from observing this phenomenon is that once clauses such as *pari passu* are encrusted with legal jargon and repeated by rote over many years they are impervious to amendment for a considerable period. The eventual shift in the market to adopt changes repudiating the ratable payment interpretation to the *pari passu* clause allows us to rule out a plausible competing hypothesis—that market participants in fact agreed with the SDNY opinion and were thus content with their existing *pari passu* terms.

As part of an effort to determine what caused the extended delay in effecting the revisions to *pari passu*, we delve into the dynamics of the changes once they began to occur. Of the bond issues in our dataset that reveal a change in the *pari passu* clause relative to their last issuance before June 1, 2011, 93.6% involve bonds issued directly by the sovereign (what we refer to as “pure sovereign” issuances). Accordingly, we next focus on the dynamics of *pari passu* changes for the Pure Sovereign issuers.

### 2. Pure Sovereign Issuers

We start with an examination of major changes in *pari passu* language for the pure sovereign issuers: these major revisions involve the greatest reduction in the risk of holdouts that variations in the *pari passu* clauses pose. We posit that sovereigns face the greatest inertia costs in undertaking a major modification of the *pari passu* clause. We focus on pure sovereign issuers that are governed by foreign law. Sovereigns that issue under their own local law will have other means

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109 Our hypothesis that black hole clauses are subject to extra-ordinary inertia costs finds support in the reaction of the market to the Brussels decision in 2000. Rather than revise the *pari passu* clause to eliminate the risk of a ratable payments interpretation, the market chose instead to coordinate on revising the no-modification (or unanimous action) clauses in New York bonds that required unanimous approval of all creditors to change contract terms prior to a restructuring. Coordinating an agreement on revisions that lowered the vote to modify to 75% (thus increasing the burden on holdouts to obtain a blocking position) was accomplished in a little over two years, from late 2001 to mid-2003. This revision ameliorated but did not solve the holdout problem: it was preferred, we surmise, because, unlike *pari passu*, the no-modification clauses were well understood and familiar to the market. For discussion see Anna Gelpen & Mitu Gulati, *Public Symbol in Private Contract: A Case Study*, 84 WASH. U. L. Q. 1627 (2006).

110 As contrasted to “quasi sovereign” issues, which are issuances by cities, states, regions within the sovereign state or issuances by some public or private corporate entity backed by a sovereign guarantee.
to protect themselves against holdouts besides modifying the *pari passu* clause. We therefore expect that changes in the *pari passu* clause itself will occur primarily for those pure sovereigns that issue bonds under foreign law (typically English or New York law). Restricting our analysis to pure sovereign issuances under foreign law left us with 718 issuances from June 1, 2011 to May 30, 2016. We examine whether the *pari passu* clause for a sovereign’s issuances on a particular day differs from the sovereign’s last issuance prior to the start of our dataset on June 1, 2011. For our analysis, we collapsed multiple issuances on the same day into one observation (leaving us with 495 unique issuer-issue date observations for pure sovereigns under foreign law) and treated an amendment as occurring if a particular modification occurred for any of the issuances on that day relative to the last issuance prior to June 1, 2011.

In Figure 3, we report the percentage of bond issues by pure sovereign issuers under foreign law by quarter that involve a major revision in the *pari passu* clause relative to the sovereign’s initial *pari passu* clause. Note the dramatic increase in major revisions to the *pari passu* clause after October 1, 2014. The percentage of revised clauses issued by pure sovereigns under foreign law increases from 9% in the third quarter of 2014 to 40% in the fourth quarter of 2014. We use both quantitative and qualitative data to explain below why October 2014 was so important.

Prior to October 2014, very few bonds issued by pure sovereigns under foreign law included a major change to the *pari passu* clause.\footnote{The first bond to disavow explicitly the ratable payments interpretation was an issuance by Belize in June 2013, roughly eighteen months after the NML decision in the trial court. See Buchheit & Martos, supra note 86 at 492. One reason why Belize was a first mover was that Belize had just gone through a restructuring, the first restructuring after the NML decision. See Robin Wigglesworth, Belize Does “Superbond Deal with Lenders,” FT, TIMES, (Feb. 13, 2013).} A different story emerges when we examine, in addition, the minor modifications made in response to the court cases in NML v. Argentina. As described earlier, none of these minor modifications would have fully corrected for the courts’ interpretation. Yet, minor modifications do appear and potentially tell an interesting story.

To provide an example, Brazil reported to investors in the risk disclosure section of its July 2014 prospectus supplement, the following:

> Recent federal court decisions in New York create uncertainty regarding the meaning of ranking provisions and could potentially reduce or hinder the ability of sovereign issuers, including Brazil, to restructure their debt.\footnote{Federated Republic of Brazil, Prospectus Supplement, 5% Global Bonds Due 2045, July 23, 2014, at page 5-8.}

It is perhaps an overstatement to suggest that this statement qualifies even as a minor modification of *pari passu*. The disclosure here does little more than
inform the investor that there is a new risk that remains in the documentation: at best, the statement conveys an undertone of disapproval of the NML v. Argentina decision to a future court.\footnote{This sense of disapproval would be amplified further if one were to look at the amicus brief filed by the government of Brazil asking the U.S. Supreme Court to hear the pari passu dispute and reverse the lower court. Brief available at \url{http://www.shearman.com/~media/Files/Services/Argentine-Sovereign-Debt/2014/Arg49-13_990ac-Fed-Rep-O-fBrazil-032514.pdf}}

Figure 4 reports minor modifications relative to a sovereign’s initial pari passu clause as a percentage of all pure sovereign issuances under foreign law for each quarter in our dataset. Figure 3 showed that there were no major shifts to the NML decision throughout 2012, and very little response in 2013. When look at minor shifts in Figure 4, the data show some changes in 2012 and increasing changes in 2013 and 2014. Market participants appeared much more willing to experiment with minor shifts prior to October 2014 compared with major shifts. This is consistent with higher inertia costs to modify directly the risk level of a pari passu clause as opposed to modifications designed to provide evidence on the meaning of the pari passu clause (given the evidentiary vacuum on meaning for a black hole term). Notwithstanding the evidentiary patches and other minor changes in the offering prospectuses prior to October 2014, the overall pattern shown in Figure 3 remains the same for minor shifts. After October 2014 there is a marked increase in the minor modifications to the pari passu clause. And to emphasize again, all of the changes we see in Figure 4 are in the direction of constraining the effects of the NML decision (by limited the risk of the pari passu clause).

3. The October Meetings

The timing of the cluster of changes, and the sudden increase in the rate of change in October 2014 correlates with a set of meetings at which a number of the key players in the sovereign debt law world gathered. The first of those gatherings occurred somewhat inadvertently; it was held at Columbia Law School immediately prior to the annual IMF/World Bank meetings in Washington DC. The second was held shortly thereafter at the New York Federal Reserve. Two of us hosted the Columbia Law School meeting: at that juncture we had collected roughly three quarters of the dataset, which showed clearly the slow response to NML v. Argentina that we report above. We were puzzled both by the lack of revision to the core language of the various pari passu clauses despite the expressed dismay over the NML litigation, and by the prevalence of a strategy that relied on minor modifications to the risk disclosure sections of the bonds. To understand the data better, we invited thirty of the most knowledgeable parties from both London and New York to participate in a discussion of what the data revealed. We report in Part IIC the content of our conversations with these senior practitioners. Relevant here, however, is the fact that many of the practitioners expressed dissatisfaction with the draft clauses that ICMA and the official sector
had promulgated. Some were unhappy at not being consulted during the ICMA drafting process, others objected to the clause that had been proposed, and still others had clients who were uncertain whether any revisions to the ratable payments interpretation would advance their interests. At the conclusion of the Columbia meeting, we assumed that any significant movement toward wholesale revision of the clause was unlikely in the near term.

Senior representatives of the IMF, the US Treasury and ICMA, as well as senior lawyers who had been on the drafting committee for the proposed revised clauses attended the meeting at Columbia. Dismayed by the conversation (as we were later told), senior statesmen in the group convened a second meeting a few weeks later.\textsuperscript{114}

Unlike the Columbia meeting, this next session, hosted at the offices of the New York Federal Reserve, was by invitation only (we were not invited). From what we have learned, the Fed meeting comprised a select group of elite lawyers, most of whom were at the Columbia meeting, but some who were not. Almost all of the lawyers represented the pure sovereign issuers, mostly emerging market sovereigns from Latin America issuing bonds under New York or English law. Each of the invitees understood that they were being asked by the public sector authorities to contribute to a coordinated effort to combat the danger posed by NML’s ratable payment interpretation.\textsuperscript{115} Sources who attended reported that the dynamics of the second meeting were remarkably different from the Columbia session: instead of the dissension and disagreement at the first meeting, a consensus quickly emerged that everyone involved needed (and was willing) to cooperate in trying to solve the systemic problem caused by a rogue interpretation

\textsuperscript{114} A key participant explained:

The Columbia meeting set the cat among the pigeons. [What we saw at the meeting] was a good deal of unhappiness among the NY lawyers (and some of the large Latin American sovereign issuers) with the drafting of the [ ] clauses. [That drafting had been done primarily by the English lawyers in collaboration with ICMA and had an English law style]. [In response to the problem] Cleary Gottlieb and Sullivan & Cromwell quickly drafted “New York versions” of the clauses, intended to be substantively the same but written in a more plain-speaking, Yankee homespun manner. FRBNY was chosen because of its gravitas—the participants needed to understand this was important [and that meeting at Columbia might have had the opposite effect].

\textsuperscript{115} According to one source:

[It was made clear to the participants] that no one wanted to open the door on substantive points being renegotiated. [The goal was to] spend a sufficient amount of time describing the collaboration/engagement/orchestration between the parties and the significant period of discussion on the substance that preceded it in the hope that we could obtain buy in.

[Lengthy calls were had, I believe] with [many] of the participants on the contract reforms and it was only after they understood the level of discussion and collaboration and the “settled” nature of the end product (and its advantages fully) that they came on board with not unpicking key elements.
by the New York courts.\footnote{According to a participant: Sitting at that table at the Fed were lawyers representing a substantial part of the Latin American sovereign issuer and underwriter community. So when the U.S. Treasury [representative] pronounced at the meeting that a consensus seemed to have been reached, everyone left with the sense that they were morally committed to encourage their clients to use the new NY clauses. Or at least not to discourage their clients from using the clauses. INT-Email-File #8-14-2016-L}

We cannot prove causation, but the data for the sovereign issuers shows a remarkable change in late October 2014 coinciding with the two New York meetings. And there were more conversations about this topic at the annual World Bank/IMF meeting during the roughly three-week period between the two meetings.\footnote{In particular, there were multiple sessions during the IMF/World Bank meetings for debt managers around the globe where experts on the pari passu litigation were asked to conduct seminars explaining the implications of the ratable payments interpretation and how the contracts could be reformed.}

4. The Pattern of Changes in Boilerplate: Evolution or Intelligent Design

Figures 1 through 4 tell us that changes to the pari passu clauses were slow to occur. But they do not give us many clues as to why, other than to show that something happened in October 2014 that increased the rate of change significantly. To get a sense of the dynamics of change, we draw here from a companion empirical article where we conduct an econometric analysis of that question.\footnote{Choi et al., supra note 13.}

As described earlier, and as Figure 5 shows, we know that sovereign issuers were not all using the same pari passu clauses at the outset: some were more vulnerable than others to the risk of erroneous interpretation posed by the \textit{NML v. Argentina} litigation.\footnote{See also Weidemaier et al., supra note 89 at Figure 1 (describing the data from 1945 to 2011 for pure sovereign issuers).} Moreover, some sovereigns with very high credit ratings might be thought to present such a low probability of default that they were indifferent to the type of pari passu clause used in their contracts. Thus, one might wonder whether the issuers that modified their clauses earlier than the others had the most vulnerable clauses and/or also had the lowest credit ratings. Affirmative answers to both those questions would suggest that the substantial social costs we described earlier were exaggerated. Yet no such neat pattern appears in the data. There are some clearly identifiable subsets of issuers for whom changes occur earlier than others. But the pattern is not a clear correlation between speed of revision and strength of credit ratings or vulnerability to the interpretation in \textit{NML v. Argentina}. Moreover, the initial revisions we observe do not involve major changes to the contract language but rather are the more evidentiary focused minor modifications. The evidence of sovereigns avoiding major changes and
THE BLACK HOLE PROBLEM

attempting instead to add evidence of their understanding of the meaning of the existing contract language is consistent with the kind of evidentiary vacuum on the meaning characteristic of a black hole clause.

The clearest identifier of the subset of issuers who undertook either minor or major revisions are the pure sovereigns issuing bonds under either English or New York law. Almost none of the changes that we observe come from the quasi sovereign issuers, such as government guaranteed bonds, bonds from cities and provinces, and supra national bonds. And, importantly, these quasi sovereign issuers are often the riskier debtors as compared to the corresponding pure sovereign issuers. In our empirical paper, we analyze the dynamics of change more specifically within the subset of pure sovereign bonds issued under New York and English laws. There, we run a statistical test of the predictions drawn from two competing models of the dynamics of change in boilerplate contracts.

The first model is the traditional conception of contracting, what we call the “Intelligent Design” model. Here, contracting parties are assumed to rationally and optimally tailor contract terms to their needs. If courts appear to err in interpreting contract language, parties will respond promptly by revising the terms to clarify their joint intent. In markets using standard forms, this process of error correction may be slower owing to ordinary inertia costs: individual parties may, for example, rationally prefer the network benefits from retaining the original terms. Nevertheless, ultimately variation in the terms among parties doing the same type of deal will result from the different characteristics of the contracting parties. Intelligent Design predicts that parties will adjust their pari passu clauses to account for different perceptions of the risk of future default. For example, sovereigns who anticipate a very low risk of default will be motivated to pre-commit not to restructure in the future by writing pari passu terms that increase the risk of holdouts. In this model, contractual black holes do not arise and, even if they did, they would not persist.

In the second, “Evolutionary” model, contract language in standardized boilerplate is assumed to follow an essentially random evolutionary path. Standardized contracts are rarely drafted from scratch: they are largely copied from prior deals by agents with imperfect and incomplete understanding of prior deals and the terms that regulate them. Rote usage and encrustation will occur,
particularly with contract terms that are widely used but are not regularly tested or otherwise updated, and the result will be the periodic creation of contractual black holes. Attempting to fit the standard form to the particular requirements of an individual client produces variation in the formulation of contractual black holes. In this model, repairing black holes is more difficult because of uncertainty: parties are ignorant of the terms’ meaning (and of any incentive effects) and in this evidentiary vacuum coordination is required to effect a revision.

After running a battery of tests pitting the two models against each other, we find there little evidence in the data to support the Intelligent Design model. A case such as *NML v. Argentina* should motivate a revision of the contracts under both the Intelligent Design and Evolutionary models, but the character of the revisions should be dramatically different in each case. The clearest differential prediction from the two models is that revisions should result in the *same amount of variation* across issuers if the Intelligent Design story is true (after all, variation is optimal, rational and desired). In contrast, the revisions should result in a *reduction in variation* under the Evolutionary model (where variation is essentially random, unintended and creates unnecessary risk). Figure 5 provides a graphical depiction of the frequency of different sovereign offerings by type of *pari passu* clause. From 2011 to 2016 we see a dramatic reduction in the variation in the types of clauses in response to *NML v. Argentina*. Prior to the case, there was a range of *pari passu* clauses of different risk levels. After the case, all of the changes that take place push towards a single form of the clause—the low risk Rank version which is also the original version of *pari passu*. This movement to eliminate the variation is consistent with the Evolutionary model and not with the Intelligent Design model. Interestingly, the movement of these revisions toward the oldest variant of *pari passu* does not eliminate the risk of holdouts entirely as the adoption of a Mandatory Law clause would do (see our categorization in Table 1). Instead these market-wide effects appear to reflect a conscious decision in the market to return to the original version of *pari passu*.

In sum, as of June 2016, what we see in the data on bonds issued by the pure sovereigns under New York and English law is the vast majority of new issuances moving to the low risk Rank form of the clause and explicitly rejecting the ratable payments interpretation. And, invariably, this new language is the formulation prescribed by ICMA and endorsed by the IMF’s report, thus highlighting the importance of coordinating forces in spurring the movement in the market to return to the original version of *pari passu*.

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126 See Choi et al., *supra* note 13.
127 The ICMA recommended clause from August 2014 reads as follows:

The Notes are the direct, unconditional and unsecured obligations of the Issuer and rank and will rank *pari passu*, without preference among themselves, with all other unsecured External Indebtedness of the Issuer, from time to time outstanding, *provided, however*, that the Issuer shall have no obligation to effect equal or ratable payment(s) at any time with respect to any such other External Indebtedness and, in particular, shall have no obligation to pay other External Indebtedness at the same time or as a condition of paying sums due on the Notes and vice versa.
In our empirical paper, we also find that the following indicators correlate with the likelihood of a sovereign modifying the *pari passu* clause earlier rather than later: (1) representation by a law firm that is a market leader in terms of the volume of clients it represents;\(^{128}\) (2) location in Latin America, a region whose New York lawyers constituted the bulk of the participants at the two coordination meetings held in October 2014;\(^{129}\) and (3) whether the issuer had defaulted and restructured sometime over the past ten years.\(^{130}\) These factors, as we explain in Part IV, point towards the reasons for resistance to change being a combination of (a) difficulties in coordinating change; and (b) the agency costs of lawyers and government debt managers being focused on the short-term goal of getting deals done.\(^{131}\)

**D. Interviews with Market Players**

The data -- showing extraordinary resistance to changes in *pari passu* language for the first three years of our study followed by a dramatic shift toward uniformity in pure sovereign issuances that is accelerating to the present day -- reveals patterns of behavior that are both puzzling and confounding. To understand better what the data tell us about how and when encrusted boilerplate is modified in response to an adverse legal interpretation, we turned first to the transactional lawyers who produced the contract terms and disclosure documents for the bonds in our data. As noted above, we hosted a conference at Columbia University Law School in early October 2014, shortly before the Fall IMF/World Bank meetings. We asked the gathered experts\(^ {132}\) if they might help answer two core questions: First, what explains the failure of the sovereign debt industry to modify or amend *pari passu* now that multiple New York courts have handed down a ratable payments interpretation? And, second, what was the best strategy going forward to combat this problematic interpretation?

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\(^{128}\) Chois et al., * supra* note 13.

\(^{129}\) *Id.*

\(^{130}\) *Id.*

\(^{131}\) See text accompanying notes 166 to 178 *infra.*

\(^{132}\) We explained that we would present our initial findings from the data and hoped to gather their reactions. On hearing about the gathering, a number of other senior lawyers, bankers and policy makers also asked to be included in the discussion. This resulted in a session with roughly thirty senior sovereign debt lawyers from both the private and public sectors.

Our process of selection was simple. Using prior research on the role of lawyers in the sovereign debt market, we invited the senior partners from the ten leading firms in New York and London (the two leading jurisdictions for sovereign debt issuances). This gave us an initial set of roughly twenty invitees. A handful of the London lawyers (three) who were not planning to be in the U.S. for the World Bank/IMF meetings later that week declined. However, a number of those who we did invite asked whether they could bring colleagues from their firms, which resulted in total of twenty-four attendees from major law firms. In addition, we invited senior counsel from the major Official Sector institutions such as the US Treasury, the IMF and the Fed, and the major industry groups such as EMTA and ICMA, which gave us a total of thirty participants.
We recorded what was said at the meeting and then had individual conversations (or email exchanges) with each of the attending lawyers (a handful did not respond). One theme was expressed by a number of the lawyers, and echoed in our conversations after the October 2014 meeting: sovereign clients were not yet comfortable making changes to their clauses. To pursue this theme, one of us then conducted a series of interviews with sovereign clients (senior officials at government debt offices). In Part IIIE we report on what we heard from these government debt managers. Finally, we spoke to senior managers at a half dozen investment firms that had specialties investing in government debt. Taken together, we spoke to over seventy-five different individuals actively involved in the sovereign debt markets. We report below on what we were told.

1. Reasons for the Lack of Revision as of October 2014

We had asked the same lawyers we interviewed during 2008-11 why they had not modified or amended their clauses in response to the ratable payments interpretation from Brussels in 2000. The two primary responses then were: (1) ratable payments was a bizarre interpretation from an inexpert court in Brussels made in the context of an ex parte hearing: no New York or London court would rule in such a fashion; and (2) modifying the clause would send a negative signal to any future court faced with the same interpretive issue: it would imply that the original boilerplate was ambiguous and thus make it more susceptible to the ratable payments meaning.

But in October 2014 neither of the prior explanations for inaction seemed valid. A New York federal district court had affirmed a ratable payments interpretation that was endorsed unanimously (twice) by the leading appellate court in the country on business matters, followed by a denial of certiorari by the US Supreme Court despite amicus briefs in favor of reversal by four different nations, a Nobel Laureate in economics and a former Deputy Director of the IMF. So, the question was: Why had the clause still not been modified?

2. The Perfect Storm

The initial response from the New York lawyers was that the New York interpretation was a function of unusual facts (“a perfect storm,” stated one senior attorney). Argentina had apparently angered trial judge Thomas Griesa to an unusual degree owing to the lack of respect it had shown him and his rulings over

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133 We also asked these questions at a meeting in Paris, in October 2014, with a number of European sovereign debt lawyers and policy makers. This meeting was organized by Rodrigo Olivares-Caminal of Queen Mary School. The format of this second conference followed the presentation plus audience questions format, and there were fewer lawyers and policy makers (roughly a dozen) than in New York the month before. We presented the same data and took notes on the responses: the responses were substantially similar to the ones we received in New York.

134 The majority of this latter set of interviews were done as part of a project that one of us is doing with Anna Gelpern that is focused on the question of how market participants think (and talk) about the price impact of making contract modifications. See Gelpern et al., supra note 24.

135 Available at http://argentine.shearman.com/
the decade or so that the litigation had proceeded.\textsuperscript{136} Argentina also made the strategic error of passing an explicit law that made the holdout creditors functionally junior to everyone else. But neither the trial or appellate court clarified whether its decision was based on the unusual facts at issue (the law that Argentina passed, its unusually bad behavior, etc.) or on its finding that the explicit terms of the \textit{pari passu} clause required Argentina to pay the holdouts ratably.\textsuperscript{137} If it wasn’t before, it now was clear that (a) the clause lacked any plausible shared meaning, and (b) there was a substantial risk that a court would resolve the linguistic uncertainty in favor of the ratable payments interpretation. And those two facts argued for repairing the clause promptly, regardless of any complaints about what the courts had done. That did not happen. Instead, these same lawyers devoted considerable efforts over the next two years pursuing every available avenue to have the ratable payments interpretation overturned in court.

Our conclusion from the foregoing is that the lawyers across the industry—who worked diligently to generate support for numerous amicus briefs—must have believed it would be more difficult to persuade the industry to modify the boilerplate than to organize industry efforts to persuade the appellate courts to reverse the trial court. And the difficulty the proponents had in generating the industry-wide litigation position opposing \textit{NML} implies that it must be even more difficult to change certain boilerplate contract terms. But why?

\textbf{3. British Courts Are Better}

The English lawyers had a different response from their U.S. counterparts. They claimed that no British court would ever rule in the same narrowly textualist fashion as had the New York courts.\textsuperscript{138} Their confidence that, unlike the U.S. courts, a British court would look to market practice to rule out a ratable payments interpretation struck us as unwarranted, especially since there was no clear market understanding of the clause’s meaning. A British court had been asked to

\textsuperscript{136} Accounts of how Argentina had angered and frustrated Judge Griesa are numerous. See, e.g., Tomas M. Araya, \textit{A Decade of Sovereign Debt Litigation: Lessons From the \textit{NML v. Argentina Case and the Road Ahead}}, INT’L BAR ASSOC. (May 2016) (“\textit{[t]he 2012/2014 decisions from Judge Griesa and the Court of Appeals were undoubtedly connected with the Republic’s attitude of disrespect of the US judicial system}’’); see also Sheelah Kholhatkar, \textit{A Judge’s Rage Goes Ignored While Argentina Sidesteps Holdout Hedge Funds}, BLOOMBERG, Sept 30, 2014; Alexandra Stevenson, \textit{Frustrated Judge Scolds Argentina but Does Not Hold it in Contempt}, N.Y. TIMES, Aug. 21, 2014.

\textsuperscript{137} See \textit{NML}, 699 F.3d at 258-260 & n.16; see also Buchheit & Gulati, \textit{supra} note 94 (discussing this aspect of the cases).

interpret *pari passu* in *Kensington International v. Republic of Congo* but had elected to sidestep the interpretive question.\(^{139}\) And, more recently, a former President of the U.K. Supreme Court opined on behalf of the holdout creditors that Judge Griesa’s ratable payments interpretation was correct in his view under English contract law.\(^ {140}\) Nevertheless, the British lawyers were unmoved: this episode was the result of the flaws in U.S. contract law and many predicted that sovereign issuers, unhappy with the U.S. courts’ failure to examine market understandings, would now issue their bonds under English law rather than New York law.\(^{141}\)

In fact, our data show that since October 2014 lawyers at the big British law firms have been altering the *pari passu* clauses in pure sovereign issuances governed by English law at roughly the same high rate as their U.S. counterparts. We asked a subset of the British lawyers about the apparent inconsistency between their current actions and their prior assertions. They explained that despite the trivial risk of an incorrect interpretation by a British court, revisions were necessary because the standard documentation “package” for sovereigns issuing under foreign laws has now been changed. And clients want the standard package of clauses that is appropriate for their type of issuer, whatever that package is.

4. Our Clients are Uncertain What to Do

At the public discussion at Columbia Law School in October 2014, one of the participating lawyers raised the matter of client preferences. This lawyer, an industry group representative rather than a senior law firm partner, said quietly that perhaps one reason the clauses were not being modified was that some of the clients were not as confident as the lawyers in the room that the New York courts’ interpretation should be disavowed. Thereafter, a number of the participants agreed with this evaluation of their clients’ interests. In effect, we were told: ‘We haven’t been able to modify the clause because (at least some of) our clients are not convinced that is the best thing to do.’ The inference was that while *they* agreed with the IMF and others that the courts’ decisions were incorrect,\(^ {142}\) clients had not seen any strong negative reaction from the market to the *pari passu*

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\(^{139}\) April 16, 2003 decision, QBD approved by the Court at EWCA. Discussed in Allen & Overy, Global Intelligence Unit, The *Pari Passu* Clause and the Argentine Case, available at 10 (Dec. 2012).

\(^{140}\) Former Lord Chief Justice Phillips, in his filing in support of the plaintiffs, wrote:

An English court would approach the problem of interpreting the [*pari passu*] clause with a wish, if possible, to give it the same meaning as that which it now bears under the law of New York … I consider that the application of the principles of construction that apply under English law would result in it doing just that.

*See* Chris Spink, *Russia to Fight Ukraine in Court*, *Int’l Financing Rev.* 2115, Jan. 9 (2016). For the full text, see http://ftalphaville.ft.com/files/2015/12/PP-Declaration-of-Lord-Nicholas-Phillips-in-favour-of-Plaintiff-copy.pdf. As his declaration tells us, Judge Phillips was quite familiar with the *NML v. Argentina* litigation, since the appeal in that case in 2011 had come before him; although the *pari passu* interpretation issue was not raised.

\(^{141}\) The data we collected for this paper shows that, as of May 31, 2016, not a single issuer switched from New York to English law in the wake of Judge Griesa’s decision in December 2011.

\(^{142}\) See text accompanying notes 151-163.
decisions in *NML v. Argentina* (other than for Argentina itself).143

Lee Buchheit, the dean of sovereign debt lawyers, explained why lawyers had not been able simply to delete the *pari passu* clause after *NML v. Argentina*:

The principal drawback of a textual amputation of the clause is optical; it will leave a gaping hole in the term sheets, rating agency reports and tick-the-box summaries of the features of new debt issuances. *Never having had a clear idea of what purpose the pari passu clause actually served in a cross-border debt instrument, underwriters and most investors will surely not have a clear idea of the implications of not having it*. The guiding principle of the underwriting community in matters of documentation has always been that *if it was good enough for my father, it’s good enough for me*. Excising the clause altogether could therefore entail a significant educational initiative.144

5. The Past is Irrelevant

Perhaps unsurprisingly given the drama caused by the *pari passu* litigation, a number of scholars have embarked on investigations into the original meaning of the clause in sovereign instruments.145 Both Sung Hui Kim and Anna Gelpern, each examining different sets of archival records,146 found evidence that the most likely understanding of the clause in a dispute over Nazi bonds in the 1930’s was that it required ratable payments. Ben Chabot’s archival research into the infamous Black Eagle bonds issued by Mexico a century ago suggests that ratable payments was the most likely understanding of the clause at that time as well.147

Given that no one currently in the industry appeared to understand the meaning of the clause, we asked whether this historical evidence affected the thinking of contemporary lawyers. But the lawyers did not find the historical research to be relevant to the question of what the clause meant in the contemporary context.

One eminent lawyer responded:

The context today is completely different. You are dredging up meanings from a period where there was absolute sovereign immunity and

143 This lack of a negative market reaction perceived by our respondents is consistent with what the most recent research shows as well. See Faisal Ahmed & Laura Alfaro, *Market Spillovers from Sovereign Litigation* (2016 draft).
144 Buchheit & Martos, *supra* note 89 (emphasis ours).
147 Chabot & Gulati, *supra* note 47. For other historical examination of the origins of the *pari passu* clause, see Pablo Triana, *The First Pari Passu: It’s all Scottish to me* (2015 draft) (finding a *pari passu* clause in the bonds of a sub sovereign, the City of Edinburgh, in 1838).
where gunboats were the primary means of enforcement. We don’t have either of those things today.\textsuperscript{148}

Fair enough, but that just brought us back to the question: If history was irrelevant to unearthing the meaning of the clause \textit{and} there was no real contemporary understanding, why was the clause being used at all?

\subsection*{6. The Courts Failed Us}

Despite the often-puzzling responses to our questions, a coherent story does emerge from our interviews with the leading lawyers in the sovereign bond industry. All of these elite lawyers share the strong view held by the official sector (the IMF, the U.S Treasury, Paris Club, etc.) and by the ICMA that by undermining the ability of a defaulting sovereign to restructure its debt, the ratable payments interpretation was systemically harmfully to the global economy in general and to the market for sovereign bonds in particular.\textsuperscript{149} Yet, the lawyers were reluctant to act on that belief because their commitment to the industry may have conflicted with the interests of at least certain clients. Taking their statements at face value, the U.S. lawyers viewed the risk of future courts following the “precedent” of \textit{NML v. Argentina} as very small owing to the “perfect storm” that engulfed that case. Similarly, the British lawyers held the view that British courts would rely more heavily on industry “experts” than on the textualist jurisprudence of the Second Circuit. To be sure, one could interpret those beliefs as simply a justification for inaction in the face of perceived conflicts among client interests. Given those conflicts, the lawyers all agree that by applying the reigning principles of contract interpretation the courts in \textit{NML v. Argentina} failed to protect the systemic risk to the industry and left individual law firms in a quandary: how can a standard boilerplate contract adequately represent the interests of diverse clients with very different interests?

But the preceding story only explains why no efforts to reject the ratable payments gloss on \textit{pari passu} occurred between June 2011 and October 2014. Yet to be explained are two remaining puzzles: What then stimulated the dramatic increase in modified clauses in pure sovereign bonds issued shortly after October 2014? And why are the revisions that reject the ratable payment interpretation confined to pure sovereign issuances but are virtually non-existent in other bond categories (sub-sovereign, sovereign guarantees, etc.) even though the same sovereigns whose clauses have been modified are often ultimately responsible for these other bond issues as well? Put differently, the risks posed by a ratable payments interpretation are the same or worse in those other bonds.

\subsection*{E. Reports from the Clients}

\textsuperscript{148} INT-Burn-8-14-2016
\textsuperscript{149} As an example, Financial Times quotes the Nobel Laureate Joe Stiglitz as saying of the case: “It’s a disaster for the world. It sets an enormously bad precedent and will cause a lot of anxiety in the global financial system.” Robin Wigglesworth & Elaine Moore, \textit{Sovereign Debt: Curing Defaults}, FIN. TIMES June 7, 2016.
In this Section, we report on what we learned from our interviews with the sovereign clients—the government debt managers. In talking to the clients in twenty-one different countries spanning three continents, ranging from AAA issuers to emerging market issuers, we focused on the managers at government debt offices. These debt offices are the primary clients in a sovereign bond deal, even though, in theory, investment banks are on the other side of the transaction. The reason is that the lawyers for the investment banks on a sovereign deal tend to be what are called “designated underwriter’s counsel;” the sovereign debtor is the one who picks the counsel for the investment banks. Bradley and co-authors report that while the investment banks that manage a deal for the sovereign issuer tend to change from issuance to issuance, the designated underwriter’s counsel tend to stay the same over long periods of time. The logic is that these lawyers develop over time a deep understanding of the debtor and can more easily prepare the relevant legal documents. While in some cases the sovereign debtor will have a different law firm as its primary counsel, it is often the case that the designated underwriter’s counsel is the only set of external lawyers for the deal. Further, it is the issuer who usually picks up the cost of the lawyers (whether they use two sets of lawyers or just one).

What we report below is drawn largely from interviews one of us conducted for a project asking how government debt managers think about the pricing of contract provisions in sovereign debt. One of those provisions was the pari passu clause. In particular, we asked the debt managers from the different debt offices two questions: First, what was their view of the risk pose by the ratable payments interpretation in NML v. Argentina for the type of clauses they were using? And, second, to the extent they had issued both sovereign and quasi-sovereign bonds, what were their reasons for using different types of pari passu clauses in these different issuances?

We report below on the main responses we received.


The sovereign debt lawyers had told us that many clients from the government debt offices were unsure of the best response to the NML v. Argentina decisions. The subset of clients we interviewed uniformly confirmed that view. In every case, the debt managers were aware of the litigation by the hedge funds and that payments to the creditors holding restructured bonds had been frozen as a result. But in no case did these debt managers—and we spoke to over fifty senior officials across the various debt offices—seem to have a strong view of what they

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151 Id. at 154.
152 Id.
153 Gelpen & Gulati, supra note 24.
should do in response. We heard few statements of dismay at what the New York courts generally or Judge Griesa specifically had done. And relatedly, there was no expressed desire to avoid New York law or New York courts in future sovereign instruments.

The debt managers for the most part thought that the outcome of the Argentine litigation was bad. But they did not seem particularly concerned that the meaning of a key provision in many of their own bonds had been questioned. The explanation for not immediately changing their clauses was, for the most part, consistent across the debt offices: they would change their *pari passu* clauses when and if their lawyers told them that the standard boilerplate formulations were changing. A number of the debt managers emphasized the importance of having a lawyer who was in constant contact with the IMF legal department and was current on the latest improvements in the standard forms for sovereign bonds. They seemed to care about what the IMF thought was “good practice.” But other than changes to the standard forms that were emanating from the IMF, the primary audience they were serving were the investors who were repeat purchasers of their bonds (specifically the dealers or bankers who were doing the initial placements). And those investors were not clamoring, or even murmuring, that they wanted the clauses changed one way or the other.

We pressed: What if the investors wanted a version of the clause that was even more susceptible to the ratable payments interpretation? Wouldn’t there be a negotiation over how many basis points that would cost? They then explained that we had fundamentally misunderstood the way prices for bonds were set and the relevance of contract terms such as *pari passu* to prices. In fact, there were no pricing decisions based on the “legal terms” of the document (the terms that the lawyers draft) in contrast to the “business terms” that impact the bonds selling price. Legal terms may need to be changed because the relevant standard template has changed. But that, as one senior manager told us, “*is to ensure that the legal terms do not impact the price.*” There are terms that are relevant to the price—such as the currency, maturity, and governing law, the material that appears on the

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154 Our colleague who ran three separate training sessions for the debt managers in Washington D.C. during the period between the first Columbia Law meeting and the N.Y. Fed Meeting, said that the debt managers struck her as annoyed with the NY decisions (at least, more so that they were when we met with them some months later). In an email, she wrote:

> [T]he debt managers were angrier about the [NY] decisions than the lawyers-reaction was anger and disbelief, that is why I was invited to present to the debt managers as a group [three] times in different places (not to or with their lawyers), and that is why all those [debt managers] agreed to see us-they felt like they needed an independent understanding of the matter. But they also thought the problem was with the court and had to be fixed somewhere in a more centralized way, perhaps in the courts or in the legislature (this was [especially] true of non-lawyers and people from continental legal [systems]). The contracts were a fallback, risk management on the margins pending global solution. The [question] for [the debt managers] was whether their existing [contracts] expose them to such a degree that they cannot afford to wait. And for most, the answer was no.

Email, January 10, 2016 (on file)

155 See Gelpen & Gulati, *supra* note 24 (reporting multiple quotes on this point).
term sheet—but legal terms such as *pari passu* and negative pledge are not part of that equation. The job of the lawyer, one of the first debt managers we interviewed explained, was to make sure that he or she was “irrelevant to the transaction.”¹⁵⁶ The managers and their investors want to be able to set the price as a function of the “stuff that matters”—the economics of the sovereign debtor, not whether an obscure clause contained the word “payment.”¹⁵⁷

Undeterred, we asked: “But even if the investors are not sure of what they want and don’t care about the pricing of the legal terms, don’t you want to draft your clauses so that you can ensure a smooth restructuring in the event that you ever go into default?” The answer was that what we were suggesting was simply not done. The job of the lawyers was not to draft terms to protect the sovereign in case an adverse event occurred in the future (that was, we confess, precisely what we thought was the job of the contract lawyer). Instead, the lawyer’s sole task was to ensure that the right standard template was used. If the form is standard for a particular category of issuer, then neither side has to worry about the legal terms: both parties know that they have the standard package and neither side is trying to take advantage of the other in terms of the contract provisions. Pricing then can be done independently of the legal terms, one respondent explained, when neither side is worried about the lawyers inserting terms to help their clients deal with a future event such as a default.

2. The Variation in the Clauses
   Given that our respondents were emphasizing the importance of using “the standard” provisions, our next question was to ask what they meant by ‘standard.’ We knew from our data that standard didn’t mean identical, since there was considerable variation across issuers in terms of the precise wording of the clauses. But in addition – and here is where we focused our questions – many sovereigns had variations in the types of *pari passu* clauses they were using in their own bonds. Standard, to reiterate, didn’t seem particularly standard. So we asked: Why the variation? Was it because the investors in one type of bond (e.g., sovereign guarantees) had made a different bargain with the debtors than in another bond (e.g., pure sovereign issuances).

   Our starting premise was wrong, we were told. There was no bargaining between the issuer and the creditors over the type of *pari passu* (or any other) clause that would be used. Instead, the clauses were the ones that were standard for that type of issuance. The standard template for pure sovereign issuances under New York and English law was changing and that was why the sovereign bond contracts under those laws were changing accordingly. The templates for the other types of issuance, such as sovereign guaranteed bonds or local law governed sovereign bonds, had not been addressed by the IMF/ICMA initiative, so those bonds were not changing. Moreover, our respondents explained further, primary

¹⁵⁶ *Id.*
¹⁵⁷ *Id.*
responsibility for anything but the pure sovereign issuances lay with a different set of bureaucrats and lawyers. To be sure, all of these obligations — and there are many hundreds of them in the period we examine — would probably end up on the sovereign’s balance sheet if there were a sovereign default. But amending or modifying the clauses in those other bonds was not something that concerned the debt managers for the sovereigns, and it was not even something that they planned to discuss with their colleagues who did the other types of issuances.

None of the foregoing is meant to suggest that our respondents were disinterested in learning about the clauses in their own bonds and what the variations were in the clauses within their countries’ issuances. Our respondents were curious about the implications of having one variation in a clause versus another, but nothing they learned about the different levels of risk appeared to motivate them to remedy their clauses: that was just not how the process of changing standard boilerplate worked. They did, however, care about the IMF’s strong support for the new market standards and about being seen as good global citizens from the IMF’s perspective. In this vein, every one of the debt offices where we talked to managers who had not yet changed their clauses in their foreign law bonds told us that they would be changing soon. Their investors would want to have standard clauses and they did not want to be on the IMF’s list of nonresponsive countries.

3. No Midstream Changes

The final question posed to the debt managers concerned the wisdom of

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158 See id. (for greater detail).
159 On the issue of the large number of sovereign debt guarantees outstanding and the prospect of them all migrating to the sovereign’s balance sheet in the event of a crisis, see Elaine Moore, Fears Mount Over Rise of Sovereign-Backed Corporate Debt, FTIMES (Jan 5, 2016).
160 One senior debt manager for a country that had not, as yet [in early 2016] changed its clauses, explained:

We will change the clauses in our foreign law bonds, the next time we do our issuance. Our outside lawyers know the IMF’s recommendations. The local law bonds are different. We have pari passu clauses in them. But we have only one lawyer in our department. We put pari passu clauses in because we wanted outside investors to buy local bonds— and investors are used to seeing these clauses. They have a check list. Pari passu, negative pledge, exchange listing . . . there are a set of things they look to see whether they are present. If so, they are okay with the bond. So, we put pari passu in. Seemed okay, since everyone else has it. [X country] also has it in their local law bonds. We are not a strong issuer; we need to make investors comfortable with our bonds. We only now noticed [after reading your article] that there are differences in the wording of our local law and foreign law pari passu clauses. We will change that.

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161 One debt manager explained why avoiding the IMF’s black list was important:

The investors have not demanded it [change] yet. But they want the standard forms. And if the standard has changed, they will want the new standard. Also, we don’t want to be on the list of countries that have not fixed their contracts. We were on the list that the IMF put out. That was not good. But the bond we did was a small one, private issuance, and the investor did not ask. We tried to explain to the IMF, but they put us on the list [of those who had not changed] anyway. Not good. Next time, we will have changed.

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changing the *pari passu* provisions in their older bonds (assuming their plan was to fix the *pari passu* clauses in their future bonds). In theory, this action would be favored by both issuers and their creditors assuming both feared that the older *pari passu* clauses could be exploited by holdout creditors in the future. If so, then why not change the clauses with a vote of the creditors during the good times when there were no holdout creditors (a vote between 50% and 75% of the bondholders could have deleted or modified the *pari passu* clauses in every one of the bonds at issue).

Few of the debt managers seemed to have given this question much consideration. They were willing to consider changing new bond issues because the IMF, ICMA and their outside lawyers were telling them that the standard forms were changing. Moreover, this change was important for systemic reasons and they were willing to be good global citizens. But there was a limit to what they were willing to do. Even though the IMF was asking them to revise the terms of their old bonds as well, this was not something they were willing to do: those changes would cost money and neither they nor their investors were willing to pay those costs.

4. Interviews with Fund Managers and Bankers

Although our primary focus in the “client” interviews was the government debt managers, we had learned that they looked primarily to their investor bases to discern whether there was a demand for changing boilerplate language. Thus, for our final set of interviews, we tapped seven of the major financial firms that purchase (and sometimes litigate) sovereign debt contracts. To the extent these firms are holding sovereign bonds at the time of a crisis – and the firms we saw held bonds in every recent sovereign debt crisis, including Argentina, Greece, Ukraine and Cyprus – they could see firsthand how the legal terms of the contract can matter a great deal once default looms. Our starting premise was that these firms were making decisions about which bonds to buy and sell (and, at least indirectly, what messages to convey to the debt managers) as a function of the contract provisions in the bonds.

As a general matter, the investors told us that they did not consult their in-house lawyers for advice on which bonds to buy as a function of the legal terms. Legal terms, we were told, are not relevant until very late in the game when the sovereign (and pretty much everyone else) is trying desperately to avoid default. It is only when those efforts fail that the lawyers are asked to determine what the legal terms mean and whether they might provide an advantage or disadvantage in

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162 The one debt manager who had considered doing an exchange of his old bonds appeared to wish to be seen as a leader and innovator in the world of debt managers. But, as of this writing, no real steps seem to have been taken in his office to engineer an exchange of the type we describe.

163 This exhortation to change the terms of earlier-issued bonds came publicly from the director of the IMF, Christine Lagarde, at the June 2016 meetings of the Paris Club.

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restructuring negotiations. This practice seemed inconsistent with rational investment strategy. If contract terms such as the form of the pari passu clause mattered ex post, in a near default state, ceteris paribus, they necessarily should matter ex ante when the bonds are issued as well. Many of the players at the investment firms had quantitative backgrounds and so they understood our puzzle precisely. The explanation offered was the market reality: no one paid attention to anything but whether the bond had the “standard documentation;” that is, not until the very end, when everyone scrambled to find a good lawyer to tell them what their documents mean.\textsuperscript{165} In short, what matters at the front end of the transaction is that the boilerplate form is standard—which appears to mean that the buyer does not have to worry that some risk altering term was added to the contract. What does not seem to matter is what precisely constitutes the standard terms.

\section*{IV. Normative Implications}

We have been gathering data on the pari passu puzzle for more than a decade. At first glance the empirical evidence we have collected—both quantitative and qualitative—seems puzzling and even confounding. Contract theory predicts that despite network and learning externalities contract drafters will revise standard contract terms when faced with an interpretation adverse to their clients’ interests.\textsuperscript{166} That no more than a handful of corrective changes were made to the pari passu boilerplate for over three years after a federal court in New York indorsed the ratable payments interpretation (and roughly fourteen years after the Brussels decision) is perplexing. This is especially true because the drafting lawyers, and the entire sovereign bond industry, were nearly unanimous in condemning the series of judicial decisions that permitted the holdout creditors to prevail. Moreover, when clarifying revisions began to appear, they seemed to be prompted by two conferences held in New York in October 2014 rather than by the succession of adverse court decisions by the leading commercial courts in the U.S. Adding to the mystery, the clarifying revisions that began to appear in many bond issues in late 2014 were limited to bonds issued directly by a sovereign (pure sovereign bonds). But virtually no such changes have yet been made to pari passu clauses in bonds issued by sub-sovereigns even where those bonds in some cases are guaranteed by the same sovereigns whose own pari passu clauses have been “repaired.”\textsuperscript{167}

\textsuperscript{165} See id. (for greater detail).

\textsuperscript{166} The economics literature on standard form contracts that suggests that boilerplate contract terms might be slow to change because of network or learning externalities—such as the value of having identical terms that everyone understands and can easily and accurately price (and litigate) because understanding their legal meaning has become widespread. That rationale may apply in the case of some types of boilerplate contract terms, but the black holes that we are interested in are those clauses whose meaning has dissipated over time and whose pricing is nonexistent. The classic articulation of the externality argument is in Kahan & Klausner, supra note 32. For an articulation of why the Kahan and Klausner argument does not apply to our context, see GULATI & SCOTT, supra note 9 at Chapter 6.

\textsuperscript{167} This is not the case with all the sovereigns in our data because some of the highest rated issuers have no legal clauses at all in their pure sovereign bonds, but have legal clauses (including
Notwithstanding the apparent contradictions, however, a story does emerge from the data. We do not suggest that this is the only story that explains the *pari passu* puzzle, but it is the only explanation that fits all the data sources we have collected. What follows, then, is first an effort to “connect the dots” by integrating both the quantitative and qualitative data. Thereafter, we address the question with which we began: what interpretive rule would motivate courts to better determine the legal meaning in encrusted boilerplate like the *pari passu* clause?

**A. More on Collective Action (With a Heavy Dose of Agency Costs)**

The evidentiary vacuum accompanying a black hole will deter contracting parties from simply changing the language of the black hole unilaterally following an aberrant court interpretation. First movers are unable to rely on contextual cues to discern the true meaning of the black hole clause and the resulting uncertainty creates the risk of idiosyncrasy in a world that depends on standardization. To take just one example, where one party moves unilaterally but others continue to use the same term, the moving party faces a heightened risk that subsequent courts will view the change as confirming the first court’s interpretation. At the same time, the first mover also faces significant uncertainty about how the market will interpret the meaning of the revised clause. These extraordinary inertia costs undermine the incentives to change the actual language of the clause until market participants are able collectively to send a signal rejecting the aberrant court interpretation and adopting a new market standard.

**1. The Coordination Problem: Private versus Collective Interests**

But how can parties in the market coordinate to act collectively? In certain markets, the coordination problem is made worse by the perverse incentives of critical market participants that hinder the market’s ability to overcome the collective action constraint. In the case of the sovereign debt market, the private interests of key participants—the elite lawyers and their clients (the representatives of the sovereigns and the investors)—are inconsistent with those parties’ collective interests. The collective interests of the elite lawyers are to protect the “industry” and the market for sovereign bonds so that future issuances proceed smoothly and future business can grow. Yet, the private interests of the same set of elite lawyers are the mirror image of the interests of their de facto clients, the debt managers and the investment banks. And both sets of agents are subject to hyperbolic discounting: they are motivated to reduce the ex ante costs of a bond issue even where expected ex post costs are thereby increased by an even greater

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*pari passu* in their sub sovereign issuances. When we spoke to the debt managers of these issuers, however, they told us that they would of course revise the *pari passu* clauses in their pure sovereign bonds if that were needed. But since they issue sovereign bonds without any legal terms, there is no problem with those bonds. When asked about their quasi-sovereign bonds, they generally expressed surprise.
This hyperbolic discounting problem exists whenever contracting parties pay more attention to the ex ante or front end costs of the contract (getting the deal done with minimal negotiation costs) than to the ex post or back end costs of default.\textsuperscript{169} This, then, presents a problem that seems unique to boilerplate that has become a black hole. In the case of boilerplate that has been litigated or otherwise updated over time (say, for example, by an industry group) and thus has a recognized contextual meaning, coordination is more tractable: the extant interpretation economizes on transaction costs by providing a focal point that aligns the parties’ expectations and thus permits them to solve the coordination problem more efficiently.\textsuperscript{170} Parties who participate in the sovereign debt market are involved in a mixed motive game. They coordinate on certain expectations but have conflicting interests on others. One way they align their expectations is through shared meaning. When the parties can communicate a shared meaning, experiments show that their “cheap talk” facilitates coordination.\textsuperscript{171} As Schelling famously noted, when the problem is selecting one means of coordinating among many, focal point solutions stand out and attract the attention of both parties.\textsuperscript{172} Once announced, the focal point default economizes on costly precontractual communications: this function is especially valuable when the parties have different possible ways to coordinate, and there is no consensus on how to do so.

This means of coordination is absent in the case of black holes because any attempt at a collective revision to the clause first has to be “settled” among the key players, since those same private interests demand “standard” legal terms that reduce ex ante costs.\textsuperscript{173} The absence of any focal point of meaning sharply conflicts with the high demand for standard terms. If the term in question is one that is on a proverbial check list, then it is the type of term that an investor expects

\textsuperscript{168} Excessive discounting by agents thus leads to bond issuances that are less efficient than they could be. An efficient sovereign bond contract optimizes total contracting costs by trading off the ex ante or front end costs of the contract and the ex post or back end costs of default. For discussion, see Robert E. Scott & George G. Triantis, \textit{Anticipating Litigation in Contract Design}, 115 \textsc{Yale L. J.} 814 (2006).

\textsuperscript{169} See id.

\textsuperscript{170} The presence of a focal point seems to explain the market’s ability to coordinate within several years revise collective action clauses that required unanimity by investors in order to modify contract terms in the bonds. See text accompanying notes 109 to 116 supra.

\textsuperscript{171} See, e.g., Vincent Crawford, \textit{A Survey of Experiments on Communication via Cheap Talk}, 78 \textsc{J. Econ. Theory} 286, 287 (1998) (“When players' preferences are sufficiently close, communication via cheap talk can be informative”).

\textsuperscript{172} \textsc{Thomas Schelling, The Strategy of Conflict} 54-55 (1963).

\textsuperscript{173} In short, the issuers faced a tradeoff: they could either insert language shutting down the hedge funds who might buy up the bonds in times of future distress, but in doing so their action could be construed as watering down a pledge that purchasers had come to expect as a promise of equal treatment. Ex ante, the issuers did not know which move would affect the price of their bonds more. So they adopted a wait and see attitude. Eventually, once they had some assurance that most other sovereign issuers would change the language, meaning they would be at no competitive disadvantage, the big issuers at least agreed to a change.
to see in a sovereign bond.\textsuperscript{174}

This collective action problem is exacerbated by the agency costs that seem to pervade the sovereign bond market\textsuperscript{175} and that explain the apparent inconsistency between the expressions of distress over the \textit{pari passu} litigation by the elite bar and their concomitant unwillingness (or inability) to effect any change in the standard boilerplate language. It also explains why there finally was substantial movement to revise the pure sovereign issuances in late fall 2014 and why this apparently coordinated decision to revise \textit{pari passu} was not followed in the quasi-sovereign bonds that were issued during the same time frame. In what follows, we support the collective action/agency cost story by describing in more detail the respective individual and collective interests of each of the principal parties.

\textbf{2. The Incentives of the Elite Lawyers}

The private interest of each of the elite lawyers who dominate the sovereign bond market is to process bond issues at the least ex ante cost and as quickly as possible, notwithstanding expected default costs.\textsuperscript{176} This single minded focus on reducing front end contracting costs is simply a reflection of the fact that the “legal terms” for which the lawyers are responsible and that form the standard boilerplate are seen as immaterial to both sellers and buyers in the initial pricing of the bonds. Thus, any change in the risk of default that results from a change in the legal terms of the contract is ignored by both the debt managers (who act as agent for the sovereign) and the investment bank (that serves as agent for the investors). In short, the ex ante legal meaning of \textit{pari passu} is irrelevant to both sides of the transaction as is the fact that this particular clause has no understood ex ante meaning: it is a black hole with random variations that are meaningless encrustations. This makes \textit{pari passu} a much more difficult problem to repair once the inertia costs of an aberrant interpretation become salient. Nevertheless, the \textit{pari passu} clause remains as part of the bonds’ contractual boilerplate because it is part of the “standard form,” and standardization is valued because it reduces ex ante contracting costs.\textsuperscript{177}

When Elliot Associates succeeded in having a court adopt the ratable payments interpretation in Brussels in 2000, the elite bar was outraged but not because any lawyer’s individual interests were imperiled. As we know, their clients didn’t care. The elite lawyers were outraged (in unison with the public

\textsuperscript{174} One way to understand the stickiness of terms that make it on to the check list is to see them as category defining terms. Scholars in sociology have long observed the importance attached, even by sophisticated market actors, to whether products fit certain defined categories—e.g., a vehicle is not a car unless it has four wheels, and only if it is a car, will it get rated by car magazines and evaluated by car experts and sold by car dealers and so on. \textit{See, e.g.}, Ezra Zuckerman, \textit{The Categorical Imperative: Securities Analysts and the Illegitimacy Discount}, 104 A\textit{MER} J. \textit{SOC}. 1398 (1999).

\textsuperscript{175} See GULATI & SCOTT, supra note 9 at Chapter 10.

\textsuperscript{176} \textit{Id.} at Chapter 10.

\textsuperscript{177} For discussions of the value of these standardized provisions, see Goetz & Scott, \textit{Expanded Choice}, supra note 4 at 286-88; Kahan & Klausner, supra note 32.
sector and other collective groups) because they saw that the ratable payment interpretation imperiled the health of the industry itself. If bonds in default cannot be restructured, then over time the pressure from the vulture funds whenever a sovereign faces default will reduce the demand for issuing debt in this form and the robust market for sovereign bonds will be negatively impacted. This means a decline in a lucrative legal business. The collective interests of the lawyers who dominate this industry is to maintain a thriving sovereign bond market where bond issues are produced on an assembly line. 178 And this way of doing business was threatened.

At the same time, these lawyers had no incentive to revise the standard terms for their individual clients. The debt managers for the sovereigns don't care about the legal terms at the time of issuance: they don't regard the legal terms as relevant to the initial pricing of their bonds because they know that the investment banks charged with marketing the bonds only care about having the standard form. Moreover, the clients affirmatively discourage individualized deviations from the boilerplate formulation because non-standard legal terms make the initial issuance more difficult and costly to get to market. Thus, the lawyers repeatedly demanded that the state solve the problem but did nothing themselves other than to offer empty platitudes about why they failed to act. 179

This saga continued for nearly 15 years until one lawyer at the October 2014 Columbia conference committed a gaffe by telling the truth: “We don’t know how to respond to this problem because the interests of our clients are not identical and many clients do not ask for (or want) any change in the standard legal terms.” 180 The evidence we have points to the fact that this session, and the subsequent meeting of an elite subset of the same group (with some additions) a few weeks later, was the impetus for coordinating a move to a revised (and equally ambiguous) pari passu clause. The lingering agency problem for the elite bar is that the de jure client is the "true sovereign"-- the people or at least the duly constituted government-- and not just the debt managers. And it is not at all clear that those interests are advanced by treating all sovereigns as having the same default risk and issuing standardized boilerplate for sovereign bonds despite the apparent variance in the probability of a future restructuring between first world countries and developing nations.

3. The Sovereigns Incentives. The sovereign’s interests are also skewed

178 See GULATI & SCOTT, supra note 9 at Chapter 10 for discussion of the 3 1/2 minute transaction and the mass production of boilerplate contracts; Richman, supra note 31 (drawing an analogy to Henry Ford’s production line for cars).

179 The exception in this story should be the restructuring lawyers (and perhaps their clients). These lawyers are going to face the consequences of having suboptimal contract terms. So, one should predict that when they have the opportunity to remedy terms (after a restructuring), they will. And, as reported, we see precisely that – the bonds that have the first changes tend to be those in restructurings. See also Choi et al., supra note 13.

180 Audio Transcript 10-2014
by an agency problem. The agents (the debt managers) are only motivated to consider the sovereign’s immediate interests (low transaction costs and a good initial price). Yet, many sovereigns also have a long-term interest in having the capacity to restructure their bonds as economic conditions change and the threat of a default is real. Because they have not incentivized their agents correctly, those interests are underrepresented in the state’s bureaucracy. Thus, the debt managers care primarily about what the investors claim to care about—the business terms that they believe do influence bond prices—and they want the legal terms to remain unchanged and uncontroversial so as to secure the best initial price at the lowest issuance cost.181 In short, the sovereign's agents engage in hyperbolic discounting because that is what they are paid to do. Nevertheless, theory predicts that some (many) sovereigns will have issued bonds prior to the revisions to pari passu that risk imposing substantial costs on their county's citizens in the future.

3. The Investors Incentives.

But why don’t the investors who buy the bonds care about the ability to restructure in the event of default? This is a difficult question, but one hypothesis is that it is too costly to try and match a given sovereign with the optimal clause. Some sovereigns may present a measurable default risk while others may not, and the information to make particularize ex ante calculations is costly to acquire especially in a world of encrusted boilerplate of uncertain meaning. The same holds for the information needed to quantify how changes in pari passu will alter the present value of future repayment if default occurs. A rationalist skeptic might ask: Why is the market so imperfect? Behavioral theory may explain part of the answer as being a function of excessive discounting.182 Another consideration is the fact that this is a liquid market where bonds can easily be resold on the secondary market. In such an environment, the business terms and the bond’s rating are a good enough proxy for future default risks especially where boilerplate terms have been stripped over time of comprehensible legal consequences.

But the preceding does not answer one remaining question: If Jay Newman, Elliot’s legendary legal arbitrageur, prides himself on reading the bond contracts once default looms in order to capture rents as a holdout creditor, then doesn’t it follow that he and other hedge fund hotshots will read the bond contracts at the time of issuance as well?183 This implies that there should be arbitrage in the primary market where smart investors selectively buy bonds based on their reading of the legal terms: even if the initial purchasers don’t plan to be there when default looms, they know that Jay Newman and others will pay a higher price for

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181 Gelpern & Gulati, supra note 24.
183 See Gulati & Scott, supra note 9 at 158-159; see also Mitt Romney’s Hedge Fund Kingmaker, FORTUNE, March 26, 2012 (describing Elliot’s strategy of figuring out what the documents actually say).
the bonds with better contract terms in that near-default scenario.\textsuperscript{184} To be sure, investors act as though the risk of a default without the ability to restructure is too remote to affect initial price. But will the market adjust if hedge funds engage in arbitrage ex ante as well as ex post? Perhaps not. The tradeoff between the ex ante moral hazard risk of a future restructuring and the ex post returns of a successful restructuring to creditors is very difficult to assess. So long as the initial investors only bear some of the price risk caused by legal arbitrage, it still may be rational for them to buy bonds without discriminating among legal terms that influence the costs of default.

5. The Role of the Public Sector and Industry Associations.

The IMF, the Paris Club, the IIF, ICMA and so on only have collective interests. Why was it so hard to coordinate with the elite lawyers to solve the problem much earlier? The best inference from our data is that the \textit{pari passu} clause was emptied of any context that could help determine its most plausible meaning, thus increasing the risks of error to actors who were motivated to revise their boilerplate. What should they do without any context that could point to a plausible meaning to use as a benchmark?\textsuperscript{185} Under these conditions, the collective interests believed that the expected costs of litigation in the Second Circuit and the Supreme Court (discounted by the probability of prevailing) were lower than the costs of coordination given that the elite members of the bar were individually reluctant to do anything. Thus, so long as the courts could be expected to “get it right” in the end, coordination costs were too onerous.

This then leaves the last part of the story. How did they get it done? Recall that solving the collective action problem not only required a willingness to consider the collective interest over private interests but the parties had to coordinate around a common formulation in order to substitute a new standard term in place of the defective one. At the Columbia conference in October 2014, many of the elite lawyers were openly critical of the clarification proposed by the IMF-led process. Yet, once they were invited to a second meeting limited to the most elite among them and asked to participate in solving a common problem of global significance, the attendees quickly and easily reached an agreement and revisions began to appear from that point onward. Is it really true that status and flattery were all that was needed to do the trick? Was the Columbia conference an important first step for the elite bar to recognize that they all shared the same

\textsuperscript{184} There are a number of recent research papers showing that key contract terms such as governing law come into play in near-default scenarios. See, e.g., Marcos Chamon, et al., \textit{Foreign Law Bonds: Can They Reduce Sovereign Borrowing Costs} (Working Paper, U. Munich, 2015); Andrew Clare & Nicholas Schmidlin, \textit{The Impact of Foreign Governing Law on European Sovereign Bond Yields}, (City University Working Paper, 2015).

\textsuperscript{185} It is useful to compare a clause such as \textit{pari passu} where the range of meanings is unaided by any context evidence with ordinary vagueness. For example, a contract that calls for the delivery of 100 “dark red” Macintosh apples is vague because the term does not precisely determine what constitutes a conforming apple; how dark red must the apples be? Nevertheless, in such a case courts can revert to context to resolve the meaning of the contract term. \textit{Pari passu} lacked any such context to aid in fixing its meaning.
private and collective interests (and that the Emperor had no clothes)? Our data cannot answer these last questions but we do know that the elite lawyers who were in the room at both the Columbia and New York Fed meetings in October 2014 represented the “pure” sovereign issuers doing offerings under New York and English law. And that is precisely where the standard revision has now become the norm, whereas other lawyers who were not invited to the meeting with the IMF (and are often partners at the same law firms as the elite cohort) represent subsidiary sovereign interests that have yet to coordinate around a revision that rejects the ratable payments gloss.

B. What Should Courts do with Contractual Black Holes?

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

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186 One of the key policy makers from the US Treasury told us in January 2016 that, looking back, persuading ICMA to be involved was especially important. ICMA was, at the time, trying to demonstrate to the market that it was a key actor (and worth joining). ICMA, in other words, had its own incentives to show the market that it was an important player and could engineer big changes. But our data show that the ICMA publication of draft clauses (released August 2014; but drafts of which were circulated as early as January 2014) was not enough to induce change on the market. The catalysis appears to have occurred in October 2014.

187 Within this group, the lawyers representing Latin American sovereigns were disproportionately represented (they tend to do issuances primarily under New York law).


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

190 The New York courts’ plain meaning rule addresses the question of what legal meaning should be attributed to the contract terms that the parol evidence rule has identified: when words or phrases appear to be unambiguous, extrinsic evidence of a possible contrary meaning is inadmissible. For discussion, see Alan Schwartz & Robert E. Scott, *Contract Interpretation Redux*, 119 *Yale L.J.* 926 (2010).
There is a powerful justification for giving boilerplate terms in commercial contracts their plain or standard dictionary meaning: creating standard vocabularies for the conduct of commercial transactions is a valuable state function. When a phrase has a set, easily discoverable meaning, parties who use it will know what the phrase requires of them and what courts will say the phrase requires. By insulating the standard meaning of terms from deviant interpretations, this strategy preserves a valuable collective good, namely a set of terms with clear, unambiguous meanings that are already understood by the vast majority of commercial parties. To be sure, it is tempting to argue, as the British lawyers did following NML, that such a strict construction might subvert the true intentions of particular parties. However, the ability of commercial actors to select language unencumbered by undisclosed meaning offers the conventional justification for the rule.

But the preceding exposes a dilemma that courts confront when applying a plain meaning analysis to standard boilerplate such as the pari passu clause: the interpreter must somehow distinguish between meaningful language and empty boilerplate. Moreover, this problem is not solved simply by arguing that courts should instead adopt a contextualist interpretive style. Contractual black holes are acontextual: the variations in language among different version of the clause are essentially random and thus context evidence does not aid in determining plausible meanings. This suggests that both textualist and contextualist courts are well advised to interpose a further step when interpreting standardized terms in commercial contracts.

At a minimum, courts should be open to arguments that, as a matter of law, the clause in question has been emptied of meaning and functions as a black hole in the boilerplate. To be sure, the risk of moral hazard claims by a party who has been disadvantaged by fate argues for an initial presumption against the existence of a black hole. But there should be an opportunity to admit evidence sufficient to overcome that initial presumption against encrustation. The evidence we have

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193 Contextualists argue that formal interpretive rules that exclude certain categories of extrinsic evidence deprive the fact finder of indispensable information relevant to deciding the case and thus can distort the court’s assessment of what the parties meant by their agreement. Contextualist jurisdictions, such as California, carry this view to its logical limit and reject the notion that words in a contract can have a plain or unambiguous—context free—meaning at all. By the same logic they favor a soft parol evidence rule. Here the test for integration admits extrinsic evidence notwithstanding an unambiguous merger clause or, absent such a clause, notwithstanding the fact that the writing appears final and complete on its face. Pac. Gas & Elec. Co. v. G.W. Thomas Drayage & Rigging Co., 442 P.2d 641, 645 (1968) (“[R]ational interpretation requires at least a preliminary consideration of all credible evidence offered to prove the intention of the parties.”); Masterson v. Sine, 436 P.2d 561, 564 (1968) (admitting parol evidence to vary terms of deed on ground that “evidence of oral collateral agreements should be excluded only when the fact finder is likely to be misled.”)
described above is illustrative of the proof that the parties alleging encrustation might proffer. Has the clause been repeated by rote over many years, without having been tested in litigation, where repetition has robbed the term of any obvious conventional meaning? Has the term been embedded in layers of legal jargon such that its intelligibility is substantially reduced and variations in the formulation of the term across contracts have no apparent significance? Is an historic or original meaning of the term accessible in a fashion that makes sense in the contemporary context and are contemporary commercial actors aware of that meaning? Is there credible evidence that the particular provision was priced at the original issue stage? 

If a court finds strong evidence of encrustation in standard boilerplate, the presumption of shared meaning is no longer apt: when encrusted boilerplate is repeated by rote for many years without legal challenge, and no party has reason to know a different meaning attached to the clause by another party, the clause has become a legal black hole. Here, the court might approach a resolution of the dispute by shifting to a presumption that the parties have attached different meanings to the term in question. That presumption invokes the common law rule that if parties have attached different meanings to a term neither party is bound by the meaning of the other unless at the time of contracting one party did not know (or have reason to know) the meaning of the counter party, who in turn did know (or have reason to know) the meaning of the first party. Applying this principle to the NML case, and assuming neither party knew or had reason to know of the other’s different ex ante understanding, a court would find that neither party’s interpretation of pari passu was legally relevant. Alternatively, if the court were to find that NML knew or had reason to know of Argentina’s ex ante understanding that pari passu did not encompass the ratable payments interpretation, the court would be directed by the rule to adopt the meaning asserted by Argentina.

CONCLUSION

In this Article we have sought to support three claims. First, contractual black holes can exist as a by-product of the standardization of boilerplate in commercial markets. The boilerplate production process can generate random

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194 A critic might ask whether what we call “layers of legal jargon” or “encrustation” is being dismissed unfairly as meaningless. After all, these encrustations (like the insertion of the word “payment” into the pari passu clause sometime in the 1970s) were presumably chosen by a lawyer to make the clause clearer or more advantageous for the client. If the variation was consciously chosen, isn’t it the very opposite of meaningless jargon. Our response is that the key is whether the underlying core clause has any shared meaning. If not, then adding language intended to clarify increases rather than reduces the linguistic uncertainty infecting the core clause.

195 Based on what we have learned; it probably does not mean much if we do not find a pricing effect. See Gelpen & Gulati, supra note 24. But if we do find an effect, it probably means that the clause was intended to have a specific discernible meaning.

196 See Restatement (Second) Contracts § 201(3). In the case where one party does not know the meaning of the other and the other does know or have reason to know the meaning of the first party, the term is interpreted in accordance with the meaning asserted by the first party. See Restatement (Second) § 201(2).
variations in language that are not the product of rational, contract design. Nonetheless, these variations persist and are cemented over time as part of the market standard. Second, while black holes often remain for many years as relatively harmless surplusage, they can generate substantial social costs once litigation results in an interpretation that introduces inefficiencies into the market. These encrustations then invite opportunistic litigation and require costly collective efforts to repair the now vulnerable terms. Third, those costs are a function of the inherently greater inertia costs that result from an aberrant interpretation of a black hole term and the greater difficulty market players face in overcoming the resulting collective action problem.

We have used the *pari passu* litigation as a prototypical exemplar of the substantial costs that result from inefficient interpretations of black holes, costs that are exacerbated when the interpretations are advanced by contractual arbitrageurs, such as Elliot Associates and NML Capital. Indeed, the costs of *pari passu* in taxpayer payouts to holdout creditors are already enormous and likely to increase even further. As we write this paper, Venezuela is on the verge of default on upwards of $75 billion of debt. Among its bonds are those with different versions of the *pari passu* clauses, including the low risk Rank version and the high risk Rank in Payment version. Comparisons of the price differentials among the bonds that isolate differences other than the contract provisions suggest that holdout activity is underwriting the widening spreads among the bonds.198 Here the resulting social cost is a function of the fact that, despite the revisions that are common in new bonds issued after October 2014, few if any sovereigns have sought to modify the terms of their older bonds.

A natural question to ask is whether our study is idiosyncratic. Perhaps the *pari passu* clause is a unique example of the costs of encrustation. We do not have a good answer to this question, other than to note a) the number of recent papers exploring similar problems in other standard markets199 and b) that within the sovereign debt contract itself there are other terms that are potential black holes. An example that we have described elsewhere is the standard negative pledge clause, a clause that is on the standard check list, appears in almost every sovereign debt bond. Yet, a negative pledge term seems to have little contemporary meaning since it is more than seventy-five years since sovereigns stopped pledging assets as a backstop to their debt.200 And even if they did pledge (which they do not), what

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197 Among the largest of these payouts are the recoveries of holdouts against Argentina in March 2016, with recoveries estimated in the 1000% range for some hedge funds. See Martin Guzman & Joseph E. Stiglitz, *How Hedge Funds Held Argentina to Ransom*, N.Y. TIMES, April 1, 2016.

198 See, e.g., John Dizard, “Complete Chaos in Venezuela’ Invites Vulture Fest,” FIN. TIMES, Sept. 2, 2016. Although we focus in the text on the differences among the bonds in terms of their *pari passu* clauses (which is key to the implementation of a holdout strategy), the bonds also differ in terms of their voting thresholds (which are relevant to whether a holdout strategy can even be attempted). See Elena Carletti et al., *Pricing Contract Terms in a Crisis: Venezuelan Bonds in 2016*, CAP. MCTS. L. J. (2016, forthcoming);

199 See articles cited in note 15 supra.

would it mean to have pledges that rank equally in a context where seizing a foreign sovereign’s assets in its own country is impossible in the modern era?

Outside of the sovereign bond context we have seen what we suspect are black holes similar to pari passu in local municipal bonds in the U.S. Common practice with these municipal bonds, of which tens of billions of dollars are outstanding, is that they are backed by pledges of revenues of the local governments. Sometimes the pledges of revenues are of the general tax revenues and sometimes there are specific streams of revenues from a utility or similar entity. An issue that has become salient in the context of the Commonwealth of Puerto Rico (that has over 50 billion dollars of these types of bonds at risk of default) is how these revenues can be enforced if the Commonwealth or some other such entity defaults. Would a federal or state judge be willing to issue an order asking the government in question to stop doing repairs on its roads or providing basic services to inhabitants in order to pay a contract arbitrageur? Alternatively, is there a risk that the court would order the local government to raise taxes to pay the creditors? And what if the inhabitants simply moved to avoid the taxes? These kinds of revenue pledges are ubiquitous in the U.S. municipal bond market — and there are many variations in how they are formulated (variations that are supposedly priced) — and yet, no one seems to know how they would work.

In short, black holes do exist in standard boilerplate contracts that are used all over the world to regulate important markets. And the principal lesson of the pari passu saga is that once a black hole is discovered and then exploited by a contractual arbitrageur, the social costs of coordinating a move to solve the problem collectively can be extremely high.

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203 See Robbins & Simonsen, supra note 201 at 797-798.
Figure 1: Percent of Issuances by All Issuers with Any Change

Percentage

Quarter

0% 10% 20% 30% 40% 50% 60% 70% 80% 90% 100%


Figure 2: Dollar Amount of Issuances for All Issuers

- Quarter: Q1, Q2, Q3, Q4

Legend:
- Orange: No Change
- Blue: Change

$ Billions

- Q1 to Q2: 2011
- Q3 to Q4: 2011
- Q1 to Q2: 2012
- Q3 to Q4: 2012
- Q1 to Q2: 2013
- Q3 to Q4: 2013
- Q1 to Q2: 2014
- Q3 to Q4: 2014
- Q1 to Q2: 2015
- Q3 to Q4: 2015
- Q1 to Q2: 2016
- Q3 to Q4: 2016
Figure 3: Percent of Pure Sovereigns under Foreign Law with Major Change
Figure 4: Percent of Pure Sovereigns under Foreign Law with Minor Change
Figure 5: Percentage of Sovereign Issuances by Year with Specific Type of Pari Passu Clause