The Costs of Encrusted Contract Terms

Mitu Gulati & Robert E. Scott *

Abstract

The fact that repetitive or rote use of a standard form contract term can erode its meaning, especially when encrusted by legal jargon, is not a new observation. This process weakens the communicative properties of boilerplate terms, reducing their reliability as signals of what the parties really mean. What is less certain is what interpretive strategy courts should use to give meaning to encrusted boilerplate that is the focus of litigation. Standard doctrine holds that a textual analysis of the language should suffice, particularly in worlds populated by sophisticated parties, even if the meaning is not clear. After all, if the sophisticated parties disagree with the court’s interpretation, they have strong incentives to revise the standard language to exclude the aberrant interpretation. And surely, the assumption goes, they can easily do so. But what if the foregoing assumptions about the costs of revising boilerplate are wrong? What if there are circumstances where sophisticated commercial parties systematically fail to react promptly to judicial errors in interpreting boilerplate terms, or are unable thereafter easily to convert the encrusted boilerplate into a new and intelligible formulation. In this paper we seek to gain some purchase on these questions by reporting the results of an extensive case study of the pari passu clause, a standard boilerplate formulation common to sovereign debt contracts for over 150 years. The first disputed interpretation of the clause occurred in 2000, was affirmed by a different court in 2011, and affirmed again on appeal in that same case in 2012 and 2013, despite the fact that the aberrant interpretation was almost universally condemned by market participants. Yet, meaningful change in the language of the boilerplate term did not begin to appear until late 2014. And, as of January 2016, while one segment of the sovereign market has repudiated the 2000 interpretation wholesale, change in the other segments has still not occurred. This data, together with interviews with market participants, points to agency costs as the friction that may explain why daunting collective action problems impaired the efforts of public institutions to assist the market in clarifying the meaning of the boilerplate term. And, in turn, that suggests that courts should not necessarily assume that errors in interpreting encrusted boilerplate will be easily corrected by the market.

*Faculty at the law schools at Duke and Columbia University.
The Costs of Encrusted Contract Terms

Mitu Gulati & Robert E. Scott *

I. Introduction

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 contract. This goal implies that courts will attempt to interpret even ambiguous terms in a manner consistent with the ex ante intentions of the contracting parties in so far as a court can recover those intentions from the contract.1 But in the case of ambiguous standardized terms—the boilerplate terms in contracts between sophisticated parties--courts may be practically incapable of recovering the possible meanings behind the apparent ambiguity.

The dilemma that courts face when interpreting boilerplate is an inherent cost of the reliance on standardized contract terms in commercial contracts. Boilerplate terms are ubiquitous in commercial contracting because they offer the efficiency advantages of standardization. Those advantages include the development of a uniform system of communication that is independent of any particular contractual context.2 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

---

1Faculty at the law schools at Duke and Columbia University. We owe an enormous debt to the many market participants—lawyers, debt managers, international organization officials and investors—who talked to us about their views on what transpired in response to the NML v. Argentina series of cases. For conversations about the paper itself, thanks to Lee Buchheit, Stephen Choi, Anna Gelpern, Alan Schwartz and Mark Weidemaier. Thanks also to Guangya Liu for her assistance with the data.


unchanging meaning that make boilerplate terms attractive are the same elements that can contribute to the erosion of that meaning over time. In addition to the ordinary risks of obsolescence, the repetitious use of boilerplate has two pernicious effects that render the life span of some boilerplate terms needlessly short. The first effect is “rote usage”: over time some standardized terms get used by rote so consistently that they lose their meaning. Nonetheless, the terms may continue to be employed because parties see no reason to eliminate a term they view as costless and thus incur a risk, however small, of jeopardizing the understood meaning of their agreement. 3 “Encrustation” is a second cost of too much repetition: the intelligibility of language deteriorates significantly as legal jargon is overlaid on standard linguistic formulations. This process weakens the communicative properties of boilerplate terms, reducing their reliability as signals of what the parties really mean. 4 Whenever boilerplate terms lose their meaning, either through rote usage or encrustation, there is a heightened risk that courts may be persuaded to adopt an interpretation of the term(s) at issue that is antithetical to the conventional understanding of the commercial parties who had adopted the formulation. 5

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

3 Id. at 288.

4 Id. at 289.

5 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.
as possible and, given the scale of the problem, leaving encrusted boilerplate provisions unamended produces unacceptable levels of uncertainty.

But what if the foregoing assumption how markets will spontaneously evolve towards correcting errors is incorrect? It is after all an assumption based on little in the way of empirical or theoretical work on what one might call the production process of contracts (and in our case boilerplate contracts). What if there are circumstances where sophisticated commercial parties systematically fail to react promptly to judicial errors in interpreting boilerplate terms, or are unable thereafter easily to convert the encrusted boilerplate into a new and intelligible formulation? What if there are daunting collective action problems that impair the efforts of public institutions to assist the market in clarifying the meaning of the boilerplate terms? These conditions appear to describe the peculiar case of the pari passu clause, a standard boilerplate formulation common to sovereign debt contracts for over 150 years. The first disputed interpretation of the clause occurred in Brussels, in September 2000, in a case against the Republic of Peru, was affirmed by a different court in a case against the Republic of Argentina in December 2011, and affirmed again on appeal in that same case in October 2012 and August 2013. Yet, meaningful change in the language of the boilerplate term did not begin to appear until late 2014. And, as of this writing in January 2016, while one segment of the sovereign market (the most elite) has repudiated the Brussels 2000 interpretation wholesale, change in the other segments has still not occurred. The questions we ask are: why did this action take 15 years, what kinds of efforts had to be made to induce changes, and what were the market consequences of the delay?

---

6 Until recently, scholars in contract law largely ignored the study of how contracts are produced—even though assumptions about contract production and (in our case) the revision of standard terms underlie many doctrines of contract interpretation. For an exception along these lines, see Barak D. Richman, *Contracts Meet Henry Ford*, 40 Hofstra L. Rev. 77 (2011).

Under the circumstances presented by the pari passu saga, if the costs of delay are sufficiently high (in terms of the number of suboptimal contracts containing the rote or encrusted terms), and if the costs of inducing change in response to judicial error are similarly high (in terms of agency costs and the burden of overcoming collective action problems), the standard interpretive command to courts to “find” what the parties to the litigation “meant” by the boilerplate terms may be misguided. Instead, social welfare considerations support interpreting boilerplate terms “infected” by rote usage or encrustation in ways that reduce the costs of an erroneous interpretation. \(^8\) This argues, in turn, for a shift in contract doctrine away from the entirely futile and ultimately costly effort to discover a meaning that no longer exists. \(^9\) To be sure, the extent of rote usage and encrustation in commonly used boilerplate remains an open question. In the analysis that follows we have a more modest goal: to use both qualitative and quantitative data to support the claim that the courts’ search for intent in the case of the pari passu clause in sovereign debt contracting has resulted in substantial costs without any appreciable benefits.

The article is structured as follows. Part I describes the basic inquiry and the background of the celebrated dispute over the meaning of the pari passu clause. In Part II, we evaluate the data on pari passu clauses assembled from over 1000 sovereign and quasi-sovereign issuances in the period from May 2011 to January 2016, together with extensive interviews with the key participants in the market. Part III discusses the implications of our finding that, at least in certain markets, sophisticated commercial actors face significant difficulties in repairing boilerplate terms following an aberrant judicial interpretation of the terms’ contemporary meaning. These difficulties present a

\(^8\) This method of thinking about contract interpretation techniques as being a function of social welfare considerations is articulated in Richard A. Posner, The Law and Economics of Contract Interpretation, 83 Tex. L. Rev. 1581 (2005).

\(^9\) The underlying canon of contract interpretation directs courts to give every term and clause in a contract a meaning, under the assumption that parties have drafted terms in contract to convey their collective purposes, The Second Circuit, NML v. Argentina, put it this way: “A contract should not be interpreted in such a way as would leave one of its provisions substantially without force or effect.” NML v. Republic of Argentina, 69 F.3d 246, __ (2d Cir. 2012) (citing Singh v. Atakhanian, 818, N.Y.S.2d 524, 526 (N.Y. App. Div. 2d Dep’t 2006).
collective action problem whose solution appears daunting owing to the substantial agency costs that impair the efficiency of the sovereign bond market.

**A. The Inquiry**

Our normative claim that courts should in some cases abandon a search for party intent when interpreting certain boilerplate terms is difficult to support empirically in most instances. Whenever there is a meaningful delay in the market’s reaction to what it perceives as a misinterpretation of standard boilerplate, it will be challenging to discern whether, in fact, the court erred in its interpretation. This is so for several reasons. First, even if market actors face hidden costs that impede efforts to amend the boilerplate term at issue, they are unlikely to concede that inaction is a function of a constraint on their actions. Instead, a common response to inaction in the face of an apparently erroneous interpretation is that the particular court decision was an aberration and that the “true” or conventional meaning of the clause would be clear to any sensible court. Second, 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 a prompt response to interpretation errors, the absence of revision is also consistent with the possibility that the court did not err.

What evidence is sufficient to support the claim that courts should not attempt to find an evanescent intent in interpreting certain boilerplate terms? Ideally, we would hope to see multiple courts interpreting a boilerplate term, followed by numerous contracts containing the same unrevised term, followed by an eventual and wholesale change in the contract term that reestablishes its conventional meaning. With the multiple instances of judicial interpretation, particularly if some of the courts are authoritative, researchers can more credibly dismiss the explanation that the interpretive error was from an aberrant court. And with the eventual changes to the boilerplate that resurrect the conventional understanding, even if it takes a long time to occur, researchers can dismiss the explanation that the reason for the absence of change was that the judicial
interpretation was in fact a meaning that the market accepted. The foregoing conditions are, unsurprisingly perhaps, hard to find. However, the decade long litigation between the U.S. billionaire, Paul Singer’s, hedge fund, NML Capital, and the Republic of Argentina, has provided a natural experiment that allows us to do the test described above.

B. Background

To understand why this natural experiment is good for our purposes, it helps to go back fifteen years to a 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. Obtaining a judgment against Peru for nonpayment of the debt was easy (there was no dispute that Peru had not paid). Enforcement of the judgment was the difficult part, as it always is with sovereign debtors (which is also why defaulted sovereign debt tends to trade at a deep discount on the secondary market). Elliott Associates had purchased the discounted debt and was trying to use its legal expertise (along with its unusually deep pockets) in recovering from recalcitrant debtors so as to make a hedge-fund worthy profit. As part of that endeavor, Elliott was chasing Peruvian assets in a variety of jurisdictions around the world, including Brussels. And there Elliott hit gold: The commercial court in Brussels ruled, on an ex parte motion, that the pari passu clause—an obscure clause in the Peruvian debt contracts that no one had paid attention to for at least a half century—meant that Peru could not pay any other creditors without paying Elliott a pro rata share. 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.

---

10 The Latin translation for *pari passu* is “in equal step.” The clause has been a standard provision in sovereign debt instruments since at least the late nineteenth century. MITU GULATI & ROBERT E. SCOTT, THE THREE AND ½ MINUTE TRANSACTION: BOILERPLATE AND THE LIMITS OF CONTRACT DESIGN 13 (2013).
(who were being paid in full on their restructured amounts) unless Elliott got its full payment (on its unrestructured amount).  

The international financial community reacted with outrage. 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 outrage expressed in dozens of academic and policy articles, and even a proposal for a new IMF-led international bankruptcy court for sovereign debtors, for over a decade not a single pari passu provision in sovereign debt contracts was modified to clarify this supposedly universal understanding. The same ambiguous language that had led to the supposedly outrageous decision in Brussels was used over and over again for a decade in literally hundreds of contracts.

The two of us were fascinated by this disjunction: the same law firms whose senior lawyers were declaiming that the Brussels interpretation was outrageously wrong were simultaneously continuing to use the same problematic clause in their own documents for their sovereign clients.  

To understand why this “patent judicial error” was uncorrected in subsequent contracts, we conducted close to a hundred interviews with leading sovereign debt lawyers in New York, London, Paris, and Frankfurt. Answers

---


13 We were not the only ones to be fascinated by failure of the lawyers to correct in their contracts what they were shouting from the rooftops was a grievous error in court interpretation. See Umakanth Varottil, Sovereign Debt Documentation: Unraveling the Pari Passu Mystery, 7 DEPAUL BUS. & COMM. L. J. 119 (2008); Leland Goss, NML v. Argentina: the Borrower, the Banker and the Lawyer: Contract Reform at a Snail’s Pace, __ CAP. MKTS. L. J. __ (2014); Stephen Nelson, Market Rules: Social Conventions, Legal Fictions and the Organization of Sovereign Debt Markets in the Long Twentieth Century, in CONTRACTUAL KNOWLEDGE: ONE HUNDRED YEARS OF LEGAL EXPERIMENTATION IN GLOBAL MARKETS (Grégoire Mallard & Jérôme Sgard, eds., 2016).
varied, but the typical one 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, it was an ex parte decision.\textsuperscript{14} If Peru’s lawyers had had a chance to argue their position, the case would never have come down this way.”\textsuperscript{15}

Ten years later, in December 2011 a federal district court in New York shattered the assumptions of the 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 \textit{pari passu} clause. This time the litigation was not \textit{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 before and had access to a decade’s worth of academic research studying the impact of the \textit{Elliott v. Peru} cases. Nevertheless, after hearing extensive argument from both sides, the court held that the \textit{pari passu} clause required a pro rata payment to all creditors, including hold outs, in essentially the same way as had the Brussels court.\textsuperscript{16}

The financial community again expressed outrage at the court’s interpretation of the \textit{pari passu} boilerplate language.\textsuperscript{17} The almost universal assumption 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

\textsuperscript{14} The context was a request for injunctive relief. See Gulati & Scott, \textit{supra} note __.

\textsuperscript{15} 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, \textit{supra} note __.

\textsuperscript{16} Like in Brussels, the judge granted an injunction. This one applied to the the institutions that might have otherwise helped Argentina pay the non holdout creditors – they were put at risk of being found in contempt of court if they aided or abetted the debtor.

\textsuperscript{17} Ungenerously, some in the financial community even intimated that the judge’s advancing age (he was an octogenarian) may have played a role in his decision. For discussions of the case and the reactions to it, see, e.g., Tim Samples, \textit{Rogue Trends in Sovereign Litigation: Argentina, Vulture Funds and Pari Passu Under New York Law}, 35 \textit{Northwestern J. Int’l Bus. L.} 49 (2014); Theresa Monteleone, \textit{A Vulture’s Gamble: High-Stakes Interpretation of Sovereign Debt Contracts in NML Capital v. Argentina}, ___ \textit{Cap. Mkts. L. J.} ___ (2013).
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 *pari passu*. 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 International Monetary Fund, with the support of the French 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

---

18 Indeed, the Second Circuit had reversed the district court judge, Judge Thomas Griesa, on a few occasions on other matters in this same litigation.

19 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.

20 Not only did the Supreme Court decline to reinterpret *pari passu*, but in a related dispute over the scope of discovery NML was allowed, the Court ruled in a fashion that made things easier for Singer’s hedge fund 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), https://www.asil.org/insights/volume/18/isssue/23/us-supreme-court-denies-certiorari-and-affirms-discovery-bondholder

Bank meetings in October 2013. In mid 2014, after extensive discussions with the foregoing committee of experts, the leading industry group (ICMA) issued new proposed versions of the *pari passu* clauses. 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 of this writing in early 2016, we know from the IMF’s latest report on the topic that a large fraction of pure sovereign issuers have now clarified their *pari passu* clauses. What the foregoing provides, now that widespread changes in the clause have appeared, is the opportunity to unpack the mechanics of how this change in boilerplate terms occurred. 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 judicial errors in interpreting boilerplate that is (apparently) infected both with rote usage and encrustation can be 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 do precisely that. What we do not know, however, are the dynamics of the process of revision.

---


24 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* Agrawal & De Long, *supra* note __. 
Understanding those dynamics is critical to answering the question with which we began: How accurate is the assumption that sophisticated commercial actors will react promptly to perceived errors in judicial interpretations of boilerplate terms by revising the encrusted language to reject the aberrant interpretation? Our study suggests, at least in the context of this one market (albeit, a multi trillion dollar market), that the standard assumption is false. Changing boilerplate terms takes years and the process can prove enormously costly. Those costs support our claim that a search for party intent is both futile and counterproductive when boilerplate with these characteristics is included in industry contracts. Instead, we argue that courts should adopt an interpretation that recognizes the reality: when encrusted boilerplate is repeated by rote for many years without legal challenge, and no party has reason to know a different meaning attached to the clause by another party, the clause is legally meaningless and should not be given operational effect. Put differently, the canon of contract interpretation that directs courts to give every provision in a contract a meaning--under the assumption that provisions in contract are there only because the parties want them there for a reason—should be ignored in the set of cases where the provisions in question can be identified as encrusted and whose meaning has been lost. To hold otherwise is to risk imposing decades-long costs on the affected market.

II. Data Analysis

A. Data Sources and the Coding of Variables

To unpack the boilerplate revision process, we assembled a dataset of all of the available sovereign and quasi sovereign bonds that were issued after the plaintiff’s briefs in NML v. Argentina began circulating. We first learned that the argument in the case was to be held in June 2011 (we did not see the briefs until they were in the public record some months later). We began collecting data at the time the briefs began circulating because at least some lawyers would likely have recognized, after reading the briefs, that
the plaintiffs argument—that the *pari passu* clause required pro rata payment to hold out creditors—had a meaningful chance of prevailing in a New York court.\(^{25}\)

For data sources, we used Thomson One Banker and Perfect Information, the two primary public data sources that make available offering circulars and prospectuses for public debt offerings. As of this writing, our dataset continues up to January 20, 2016.

Before describing the coding process we can provide some background on the types of bonds available on these datasets. The datasets provide documentation on what the industry designates as “managed deals.” These are deals where bankers and lawyers tend to be involved in preparing the contract documentation, setting the initial prices and finding the initial customers. The strongest issuers, the U.S., U.K., Netherlands, Japan, Germany and France (the traditional AAA issuers) are not included because their credit is so strong they do not need lawyers, bankers or even traditional contracts to sell their bonds. More relevant for our purposes, however, is that these issuers do not use *pari passu* clauses and therefore fall outside the universe that we are investigating.\(^{26}\)

The foregoing cut of the available sovereign bond data produced a set of over 1000 bonds, from over [50] different issuers, and under [five] different governing laws. For each of these bonds, we coded a set of five basic bond characteristics. These were:

---

\(^{25}\) 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 disagreement with the interpretation of the clause given by the Brussels court a few years before. Indeed, the plaintiffs had withdrawn their *pari passu* argument, presumably for fear of losing the case (we are inferring here from the fact that the argument was made but then withdrawn after the U.S. government filed its brief arguing against the ratable payments interpretation of the *pari passu* clause). Between 2003 and 2011 there was, however, a key development. Argentina passed a law in 2005 effectively subordinating all creditors who had not agreed to restructure their debts in the two exchange offers that had been conducted by Argentina in 2003 and 2005. The passage of the law made all the difference: plaintiffs realized that even though no one seemed to know what the *pari passu* clause meant, the defendants themselves had argued in a brief during the 2003 portion of the legal battle that the passage of a law subordinating creditors would constitute a violation of the promise of *pari passu* ranking. In our prior work, we make the argument that the foregoing is probably not what the clause meant. But having advanced this interpretation in their prior brief, the defendants were shackled with that argument. See Gulati & Scott, *supra* note __ at __.

\(^{26}\) 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.
**Type of issuer.** We broke down the types of sovereign and quasi sovereign issuers into four sub categories, 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. This latter aspect is particularly important because the supposedly dastardly 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. The **first** category are the pure sovereign bonds, which are the bonds issued by nations. **Second** are the sovereign guarantees, which are bonds guaranteed by a sovereign where the sovereign promises *pari passu* treatment of some kind if and when the guarantee is called. **Third** are the sub sovereigns, which are cities and provinces in countries that do not appear to be subject to any domestic bankruptcy regime. And **fourth** are supra sovereign institutions--entities where sovereigns collectively issue bonds for which their liability is shared and where (and this is the key) the institution has some version of sovereign immunity and is not subject to any bankruptcy regime.

**Bond Rating.** As a measure of the risk level of the issuer, we use Standard and Poors (S&P), the most widely used credit rating for sovereign type issuers.

**Governing Law.** We code the governing law variable as either local law (that is, the sovereign’s contracts are governed by its own law) or some foreign law that the sovereign cannot change at its discretion. To the extent the law is foreign, we code for the specific jurisdiction (which, for over 95% of our data, is either New York or English law).

**Issuer’s Counsel.** Here, we code for the law firm that represents the issuer. Sometimes there are multiple law firms representing the issue; usually one foreign firm and one local firm. In that case, we code the identity of the firm that the sales document refers to as having done most of the work preparing the documents (usually, the foreign firm).

**Underwriter’s Counsel.** The formula we follow here is the same as above, coding for the underwriter’s counsel.
We turn next to focus on the question that is our primary interest—whether and how the *pari 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 the *pari passu* provisions in terms of five different aspects.

1. *Changes to the Core Language*

Our first line of inquiry was with respect to the clause itself. The question was did the clause change in the direction of either the pro or anti-ratable payments interpretation? As mentioned earlier, the clause is an historical artifact that our research suggests no one quite understands. Our hypothesis was that once the relevant parties began viewing *pari passu* as a source of uncertainty they would either delete the clause or revise it 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 clause itself.

The typical *pari passu* clause that is found in almost every sovereign or quasi sovereign bond contract, states something along the lines of:

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

Prior to the *pari passu* litigation, the most eminent practitioners in the field had freely acknowledged puzzlement over why this boilerplate clause was ever used in a sovereign debt instrument.\(^{27}\) 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

\(^{27}\) Scott & Gulati, *supra* note ___ (quoting from Lee Buchheit (New York) and Philip Wood (London), among others).
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 that was a holdover from a distant era when its inclusion in these sovereign instruments might have made more sense. 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. But almost no one among the parties to the current transactions seemed aware of that earlier interpretation. From the viewpoint of the contemporary market participants, the pari passu clause in sovereign debt instruments was precisely the kind of encrusted boilerplate that over the years had lost its meaning as a result of rote usage.

Over the roughly 200 years that the clause has been found in debt instruments (steadily increasing in popularity, even as contemporary understanding diminished), the encrustation developed variations; lawyers added and subtracted a word or two here and there in the clause. And sometime in the 1980s, one version of the clause began to promise investors something along the following lines:

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

This was the version of the clause seized upon by Mr. Singer’s hedge fund. 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. And further (and this was the key given that a court’s

---

28 Scott & Gulati, supra note __.
order to pay is largely meaningless as against a sovereign debtor), Lowenfeld explained that the clause entitled a creditor who was not paid his pro rata share to an injunction against other creditors who were paid that share.\textsuperscript{31} In the context of a debt restructuring, where some creditors had agreed to take a haircut on their bonds and were being paid the reduced amount of the debt 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 \textit{pari passu} clause at issue in both the Argentine and Peruvian litigations was particularly vulnerable to Lowenfeld’s pro rata or ratable payment interpretation: a version of 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 “rank equally” language that used to be standard to include phrasing along the lines of “the bonds rank and will rank \textit{pari passu} in right of payment.” We rated the vulnerability of the different clauses, therefore, on a scale of 1 to 10, with 10 being maximal vulnerability (where the contract language said explicitly that each creditor was entitled to ratable payments as the plaintiffs had argued in the aforementioned cases), to 5 (the type of clause that used the word “payment” to modify “rank”) to 1 (which only articulated the concept of ranking). We had also envisioned coding some bonds as 0 risk, where the \textit{pari passu} clause had been deleted altogether. But we found none of these.

\textbf{2. The Clarifying Patch}

In the event that some issuers would be reluctant to risk changing the core language of the clause itself, we turned next to the option of revising the clause by adding a “clarifying patch.” Here, we looked to see whether there was supplementary language in the documentation that purported to explain that the clause \textit{did not mean} that a creditor was ever entitled to ratable payments with all other creditors of equal rank. In theory, it

\textsuperscript{31} \textit{Id.} at __
was also possible that some issuers might have included language explicitly endorsing the ratable payments interpretation, but there were no such cases in the data.

3. **Supplementary Explanation Regarding Risk**

A third modification to the documentation is one that we did not envision at the outset. Our starting assumption was that if parties disagreed with a court’s interpretation of a clause in their contracts, they would revise the clause to make the meaning of the clause clear. And, if they wanted to ensure that such an interpretation did not occur in the future, they might explicitly disavow the interpretation of the clause given by the court. Indeed, our view was that it is malpractice for a lawyer to fail to clarify a clause in a client’s contract whose language she knew posed a meaningful risk of an interpretation adverse to the client’s interests. What we did not envision was a scenario where the lawyers would leave the clause unchanged, but would instead report in the risk disclosure section of the prospectus that the *pari passu* clause in the contract posed a risk of erroneous interpretation for investors. To take account of this response, we coded each bond for whether, following the *NML v. Argentina* interpretation of *pari passu*, there was a provision in the risk disclosure portion of the prospectus telling investors about this new risk.

4. **The Other Encrustation**

Having been shown to be vulnerable to attack in terms of the language of “payment,” the next question is whether there are other phrases and bits of encrusted language in the clause that might similarly produce the risk of interpretive error. One such phrase that we discovered in the course of our prior study is found in a subset of clauses primarily governed by English law: in these bonds, the standard *pari passu* language gets supplemented by such words as “except as subject to provisions of mandatory law.”

\[\text{E.g., This provision has come to light in the context of Ukraine that has recently engaged in a restructuring exercise. While we continue to believe these words are a meaningless encrustation, in theory the phrase can give Ukraine leverage against any of its creditors trying to argue for ratable payments under}\]
language does. The words make sense in the context of a corporate issuer that has to pay
domestic taxes because the local mandatory laws of the issuer’s nation will often give
statutory priority to the tax authorities. But sovereign issuers don’t have to worry about
taxes; they are the taxing authority. Moreover, many of these bonds are governed by
foreign laws. Would it make any sense for New York based investors in bonds issued by
Mozambique under English law to care about the statutory priorities specified by English
law (which would presumably have no relevance to either the non English issuer or the
investors)?

The question that interested us was whether this additional and quite puzzling
formulation might get clarified if the clause itself was refurbished. Hence, we coded
every pari passu clause for whether the “mandatory law” formulation was present or not.

5. Scope of the Clause

Our final variable was the scope of the clause. Pari passu clauses vary widely 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. 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 so broad that it could even include the salaries
owed by the sovereign to its domestic employees. As long as the clause was seen by the
contracting parties as an essentially meaningless historical artifact, it likely did not matter
to the parties how broad or narrow the clause was. 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 creditors. If not, then there was no right to an
injunction against those creditors.

the pari passu clause. See Joseph Cotterill, Ukraine’s Bonds: A Little Local Leverage? FT ALPHAVILLE,
Our reason for coding this variable 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 in fact widespread 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 specifically, therefore, for whether the clause was framed in terms of external indebtedness (the narrowest version), indebtedness (the intermediate category) or obligations (the broadest version).

B. Results

1. Changes to the Core Language of the Clause

Our central hypothesis throughout the project has been that commercial parties—realizing that a clause whose purpose they did not understand was adding unneeded risk—would either delete the clause completely or amend its language explicitly to clarify its meaning. This hypothesis seemed even more plausible after the widely condemned ratable payments interpretation was indorsed by the most important commercial court in the United States. In the same vein, basic theory supported the prediction that parties would modify those versions of the clause that included the problematic “payments” language that increased the risk of a successful challenge to a restructuring. As the overall data in Figure 1 shows, none of our predictions materialized.

Figure 1 reports on the evolution in the relative risk of the various versions of the pari passu clauses in our data, over the June 2011-January 2016 period. The three lines represent the different versions of the core portion of the clause, as coded by the level of risk they posed vis-à-vis the ratable payments interpretation. We had expected to graph

---


34 Leading lawyers in the field also shared our assumption on this point. See, e.g., Leland Goss, NML v. Argentina: The Borrower, the Banker, the Lawyer—Contract Reform at a Snail’s Pace, ___ CAP. MKTS. L. J. ___ (2014); Buchheit & Martos, supra note ___.
the evolution in zero risk bonds as well, but there were no observations with which to plot that line. Figure I shows that the overall patterns in the use of the different types of clauses remain essentially unchanged through the four and a half year period that we examine.

The foregoing should be puzzling whether one takes the position that the ratable payments interpretation enhances market efficiency and should be retained or that it does not and thus should be revised or eliminated. Regardless of the different views of the merits of the interpretation that emerged from the series of cases in New York, the courts’ decisions made one outcome more likely than the other as a function of whether the “payment” language was used in drafting the clause. Hence, parties should have either systematically moved away from or toward the key “payment” language. But as Figure 1 suggests, for a full four years after Judge Griesa handed down his first ratable payments interpretation there was no real movement to change the language to the core portion of the clause in any direction. In prior work on the pari passu clause with Mark Weidemaier, we observed a stunning phenomenon: there was a steady increase in the use of the clause in sovereign bonds during the 1970-2000 period during which its understanding was probably the least (and diminishing). Table 1 reports this result from our prior work. We speculated that perhaps the clause had become an emblem or a necessary talisman. No industry participants knew what the clause meant, but everyone seemed to be including it in their bond contracts. The dynamics would change, we assumed, once the clause was seen as producing a real risk of substantial monetary losses.

Figure 1 suggests that yet again our assumptions were incorrect. Given that the core of the clause has still not been revised or deleted, it is safe to conclude that an encrustation such as the pari passu clause, repeated by rote over many years in contractual boilerplate, is impervious to amendment for a considerable period. This appears to be so even though there is no contemporary understanding (or value) of what

35 Weidemaier et al., supra note __.
36 Id.
the clause means and no consensus as to its historic meaning either. Buchheit and Martos, from the leading sovereign debt firm of Cleary Gottlieb wrote, in the wake of the NML v. Argentina decision:

The clause serves 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 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.\(^{37}\)

As we will see below, however, it is not just that the market is slow to remove or reformulate the encrusted clause. It is quite possible that the effect of a court’s interpretation of an encrusted clause is to further entrench the boilerplate as further language adds to the existing encrustation.

2. The Clarifying Patch

Figure 1 suggests that there have been very few changes to the various pre-litigation formulations of the core language of the pari passu clause. We know from the IMF’s 2015 report, however, that there have been some revisions that the IMF and leading industry groups believe will eliminate the risk of a future court interpreting the pari passu clause as including a ratable payments gloss.\(^{38}\) But the revisions that the IMF and industry groups such as ICMA have been urging issuers to adopt do not alter the core language of the clause. Instead, the revisions take the form of “clarifying patches”: the core clause is largely left unchanged and additional sentences added that purport to clarify the meaning of the clause. We will return to the implications of a design strategy that elects to patch in a clarification rather than to delete or revise the core boilerplate language. First, however, is the question of when and how much of this effort to clarify occurred in the period between June 2011 and January 2016.

\(^{37}\) Buchheit & Martos, supra note __.

We coded two distinct types of clarifying patches that were implemented in the wake of Judge Griesa’s ruling in December 2011. The first was a risk disclosure: the prospectus would report to investors that the *pari passu* clause was at risk of being interpreted by a court in a problematic way. Brazil, for example, 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.  

The second was to add a caveat--either in the risk disclosure section or to the boilerplate itself--stating that it was understood that the provision did not mean that the creditors were entitled to ratable payments. Turkey, for example, stated in its April 2015 prospectus supplement:

The notes rank and will rank without any preference among themselves and equally with all other unsubordinated public external indebtedness of the Republic. [Note: the foregoing is the standard *pari passu* language] It is understood that this provision shall not be construed so as to require the Republic to make payments under the debt securities ratably with payments being made under any other public external indebtedness.

We coded these two efforts to clarify the meaning of the clause separately. Figures 2, 3 and 4 break out the number of bonds that had the different types of clarifying patches over the period, in terms of the four different categories of issuers: sovereigns, sovereign guarantees, sub-sovereigns, and supra-sovereigns.

Figure 2 reports any changes to the overall clause (not just its core, as reported in Figure 1). Figure 3 reports the use of risk disclosures in the prospectuses or offering statements.

---


40 Republic of Turkey, Notes Due 2025, Prospectus Supplement, April 2015, at S-6.
circulars, warning investors about the risks of future pari passu litigation a la NML v. Argentina; and Figure 4 reports on the use of the Clarifying Patch that explains that whatever the core of the clause may mean, it does not mean ratable payments.

What stands out in Figures 2, 3 and 4 is that almost all of the efforts to change, clarify with patches, or disclosure risks occur in only a single category of issuers; the pure sovereign bonds. The bonds of the other issuers—sub-sovereigns, supra-nationals, and sovereign guarantees—do not have any revisions or clarifying language to the pre-litigation boilerplate. And that is so even though they are sometimes bonds issued by the same sovereign that used a clarifying patch in its principal bonds. Generalizing over the full four-year plus period, fewer than 5% of the bonds in the sample have any revisions or clarifications of any variety. More specifically, as we see below, the data show virtually no revisions for the first three years (fewer than 10 bonds) and then a sharp increase in the number of revised bonds, with almost all of the sovereigns issuing under New York and English law rejecting the ratable payments interpretation with some version of a clarifying patch. In a sister paper with Stephen Choi, that investigates the dynamics of change (questions such as which lawyer and law firms were early movers, and which ones were followers) we report the results of a regression analysis that yields essentially the same results.41 Using a predictive model where the dependent variable is whether a clarifying patch was implemented in response to the NML v. Argentina ratable payments interpretation, we examine whether factors such as the type of issuer, the issuer’s credit rating, the size of the offering, the governing laws or the identity of its lawyers (either issuer counsel or underwriter counsel) impact the likelihood of a clarifying patch being adopted. The model also includes time dummies for each of the years for which we have data. We find that that the variables with the strongest predictive power are the dummy variables for the years 2013, 2014, and 2015, whether the bond was governed by English or New York law, and whether the bond was issued by a pure sovereign issuer.42


42 Indeed, when we utilize an interaction term among the variables mentioned in the text as being significant, that swamps the impact of the individual variables.
The data reveals no obvious explanation for why the revisions to *pari passu* are found only for pure sovereign issuers, and only those issuances under either New York or English law. The bonds of the pure sovereign issuers are neither the most or the least risky in our data. For example, other things equal, sovereign guarantees arguably *always* have a lower risk of default than a pure sovereign issuance (there are more assets backing a sovereign guarantee than a pure sovereign issuance for the same issuer). And sub-sovereign bonds arguably *always* carry more risk (there are always fewer assets backing the sub-sovereign issuance than the pure sovereign, especially since a sovereign’s primary asset tends to be its tax base). To reiterate, the most distinctive pattern is that there are almost no changes to the contract provisions of any of the issuers until October 2014. After that, there continue to be almost no revisions in the bonds for sub-sovereigns, sovereign guarantees and supra-nationals. But by the fourth quarter of 2015, there are clarifying patches in nearly [80%] of the sovereigns issuing under New York and English laws.

3. Drilling Down in the Data

In the prior section, we described two types of clarifying patches adopted in response to the *NML v. Argentina* interpretation of *pari passu* that were used in bonds of the pure sovereign issuers: these patches are concentrated in the pure sovereign bonds issued under foreign laws (typically New York or English law). One type of patch was a risk disclosure statement and the other was an explicit disavowal of the ratable payments interpretation. The explicit disavowal appears in the risk disclosure section in some bonds and in the main clause as a supplementary sentence in others. Sovereign issuances under local laws show no changes in their core provisions or any risk disclosures of either

---


44 Some might argue that sovereign guarantee bonds carry more risk than pure sovereign bonds, even though they tend to be harder to restructure, because they are generally less liquid that the pure sovereign issuances. If so, there is even more of a puzzle, since now we are observing that both sets of higher risk issuers are the ones less likely to change their clauses (as opposed to the other way around, which is what we would have predicted based on default risk).
variety. To understand better the different patterns in the attempts to reject the ratable payment interpretation, we break out the data for the pure sovereigns under English and New York law to see how the revision process developed.

Figure 5 shows how the adoption rates of the clarifying patches changed over time. We already know from the prior two sections that there were almost no meaningful changes to the *pari passu* clause until mid 2013 (almost six months after the Second Circuit’s decision affirming Judge Griesa’s ratable payments interpretation; and eighteen months after Judge Griesa’s original decision). Four aspects of Figure 5 stand out. First, we see that nothing occurs with the clauses or contract disclosures in immediate response to the trial court’s decision in December 2011. Second, the responses start, albeit at a snail’s pace, only after the Second Circuit’s decision in October 2012. Third, the modifications that occur between the Second Circuit’s decision and the rejection of certiorari by the Supreme Court in June 2014 are primarily risk disclosures—that is, as we showed above with Brazil’s bonds a statement alerting investors that there is a new risk. Fourth, the volume of clarifying patches to the clause rise sharply—dwarfing the use of the risk disclosures—around the time of the Supreme Court’s denial of certiorari in June 2014 and the publication of draft clauses by the leading industry trade group, the International Capital Markets Association (ICMA) in August 2014.45 To get a clearer picture of the evolutionary pattern in these clauses, we next look more carefully at the specific language used in the patches.

The first bond to disavow explicitly the ratable payments interpretation was an issuance by Belize in June 2013, roughly two years after the briefs in the *NML* case began circulating. The 2013 Belize bond is relevant, not just because it was the first disavowal, but because the terms of the disavowal was so unusual. The repudiation of the ratable payments interpretation was one sided: the bond explicitly stated that the

---

45 For the ICMA proposed revisions to *pari passu*, released in August 2014, see [http://www.icmagroup.org/resources/Sovereign-Debt-Information/](http://www.icmagroup.org/resources/Sovereign-Debt-Information/). Soon thereafter, in October 2014, the IMF released a statement explicitly endorsing the ICMA clauses (the drafting of which the IMF, along with other key policy players such as the US Treasury Department, the Bank of England were actively involved). See [http://www.imf.org/external/pubs/ft/survey/so/2014/NEW100614A.htm](http://www.imf.org/external/pubs/ft/survey/so/2014/NEW100614A.htm) (reporting on an interview with IMF General Counsel, Sean Hagan).
issuer rejected the interpretation. Indeed, the offering circular disclosed to investors that Belize had passed legislation to make clear that the government of Belize did not understand the clause to mean that it would ever have an obligation to make ratable payments. The specific language was:

A contractual provision similar, but not identical, to [the Honduras pari passu clause] has been the subject of on-going litigation in U.S. federal courts in a case captioned NML Capital, Ltd. v. Republic of Argentina. The plaintiffs in that case have argued that the pari passu provision in the defaulted Argentine bonds they are holding requires Argentina, if and when it makes a payment under certain of its other debt instruments, to make a pro rata payment on the bonds held by the plaintiffs. This interpretation of the provision is being contested by the defendant, the Republic of Argentina, and by various other interested parties including the United States Government.

To ensure clarity on the point, Belize does not understand Paragraph 1(c) of the Terms and Conditions of the 2038 Bonds, or any comparable provision in any other debt instrument of Belize, to require Belize to pay all items of its Public Debt on a ratable basis.46

The implication from the express statements about the issuer’s understanding of the meaning of the clause is that the investors in these bonds were not willing to indorse that position. After all, at the time the Belize bond was issued, the most likely default understanding of the pari passu clause was the interpretation given by the Second Circuit eight months earlier. What we have then is a contract provision where one side takes the position that pari passu does not mean ratable payments and the other side by inference is unprepared to reject the ratable payments interpretation.

The foregoing is puzzling to those familiar with basic contract law: it is not at all clear what a court would do if faced with the task of interpreting a contract term where the two sides appear to have had different interpretations of the meaning of the term at the time of contract. As a matter of contract doctrine, if the parties attach different

46 Belize, Luxembourg Listing Memorandum, Dollar Bonds Due 2038, June 14, 2014.
meanings to a contract term, and each has reason to know the meaning of the other, the contract provision is a nullity. Nevertheless, the clause was included in the form we have described. The question is why the parties did not seem concerned about a future court interpretation.

If the foregoing is puzzling, what we describe next is even more confounding. Fifteen other sovereign issuers in 2013 also made modifications in response to the *NML v. Argentina* interpretation. However, in contrast to Belize, none of the other fifteen modifications were made as direct clarifications of the clause itself: these insertions of additional language were made in the Risk Disclosure section of the offering circulars or prospectus supplements. In other words, they were explicitly not part of the bond contract, which raises the question: what objective were the transactional lawyers that added this language seeking to achieve? In theory, the lawyers may have been worried about liability for fraud for failing to disclose the new material risk posed by the *NML v. Argentina* decision interpreting *pari passu*. But that strikes us unlikely, given that *NML v. Argentina* is probably the most famous sovereign debt litigation in history and investors could be safely assumed to have known about the case and its implications.

There were two varieties of risk disclosures. The first type appeared for the first time in bonds for Paraguay and Colombia in January 2013 (there were 10 bonds of the first type in 2013). These bonds are silent about the views of either the issuer or investor on the ratable payments interpretation. Instead, the risk disclosure tells investors that the Second Circuit has interpreted the *pari passu* clause as including a ratable payments obligation on all creditors and there is a risk that the *pari passu* clause in the bond may be interpreted similarly. This provision also seemed inconsistent with basic contract theory. Transactional lawyers design contract provisions to clearly signal to future courts how the risks of future contingencies have been allocated. Here, by contrast, the most prestigious law firms in the world were telling their clients: “We have drafted a contract provision that poses the risk of being interpreted in a manner inconsistent with your interests, but

---

47 See Restatement (Second) of Contracts §201.

48 Legally, if investors knew the information, they cannot have been defrauded.
rather than redraft the clause we prefer simply to let you know that this risk exists.” Indeed, given the uncertain effect of the risk disclosure, it is not clear why the issuers or the investors require a lawyer to announce the existence of this risk. To get a flavor of the risk disclosures, here is the operative language from Paraguay’s Offering Circular from January 2013:

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 management . . . Paraguay cannot predict whether or in what manner the courts will resolve this dispute or how any such judgment will be applied or implemented.49

The second type of risk disclosure appeared in a bond for Honduras in March 2013. Here, the drafter added several additional sentences to the risk disclosure that had appeared in the bonds for Paraguay and Colombia. The additional language showed movement toward disavowing the ratable payments interpretation, but it still left the *pari passu* clause unchanged. Here, the issuer announced in the Risk Disclosure section its plan to litigate against the ratable payments interpretation. The Honduras’ offering circular has disclosure language similar to the Paraguay Risk Disclosure document together with an additional sentence at the end:

The terms and conditions of the Notes confirms that the Notes shall rank *pari passu*, without any preference among themselves, with all other unsecured and unsubordinated obligations of the Republic constituting Public External Indebtedness. A contractual

---

49 Republic of Paraguay, Offering Circular, 4.625% Bonds Due 2023, at p.17.
provision similar, but not identical, to such clause has been the subject of ongoing litigation in U.S. federal courts in a case captioned NML Capital Ltd. v. Republic of Argentina. The plaintiffs in that case have argued that the *pari passu* provision in the defaulted Argentine bonds they are holding requires Argentina, if and when it makes a payment under certain of its other debt instruments, to make a pro rata payment on the bonds held by the plaintiffs.

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 certain performing bonds issued in a restructuring of Argentina’s debt unless it makes pro rata payments on defaulted debt that ranks *pari passu* with the performing bonds and has upheld the use of equitable remedies to enforce that decision. The court has stayed the effect of such ruling until any decision on a timely petition to the United States Supreme Court to hear the case.

*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* [emphasis added].

Again, we were perplexed. The foregoing is not a statement about the understanding of the clause of one or both sides to the transaction, but rather a statement regarding a future position that one side was likely to take in litigation. What value did that provide to the issuer? And, more specifically, what use would such a statement be to a future court trying to discern the meaning of *pari passu*? Contract doctrine tells us that the foregoing statement adds no value to the drafting party or to a court intent on recovering the “meaning” of a clause that appears to have lost whatever meaning it had. Moreover, recall that this puzzling disclosure appears only in the pure sovereign bonds. In the hundreds of sub-sovereign, supra-national and sovereign guarantee bonds issued over the same period, each with *pari passu* clauses subjecting the issuer (and with guarantees, the sovereign) to essentially the same risk, there was no such disclosure.

---

50 Republic of Honduras, Offering Circular, 8.75% Notes Due 2020, at p.10.
The patterns of response to the *NML v. Argentina* interpretation--adding language to the Risk Disclosure section of the sales documents, but leaving the clause itself unamended--continued until April 2014 when we see the very first bond that revises the core clause itself (and where there is no suggestion, unlike with the offerings for Belize and Brazil, that the disavowal of the ratable payments interpretation is that of the issuer alone):

The Notes rank, and will rank, equally among themselves and with all other unsubordinated and unsecured borrowed money of the Republic; *provided, however, that*, consistent with similar provisions in the Republic’s other indebtedness, this provision shall not be construed so as to require the Republic to pay all items of its indebtedness ratably as they fall due.\(^{51}\)

Ecuador followed with a substantially similar provision in June 2014, at the time of the Supreme Court’s denial of certiorari. For the balance of 2014, sovereign issuers under English and New York law split roughly equally between the risk disclosure approach and the boilerplate modification approach. By late 2014, however, the boilerplate modification approach began to dominate the risk disclosure approach. That shift in contract design coincides roughly with two gatherings of leading New York and London lawyers held in the fall of 2014 in New York.

The first of those gatherings was held at Columbia Law School immediately prior to the annual IMF/World Bank meetings in Washington DC and the second was held shortly thereafter at the New York Federal Reserve. The 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 response to *NML v. Argentina* that we report above. We were puzzled by both the absence of any modifications to the core clauses despite the expressed dismay about the *NML* litigation and the prevalence of a design strategy that relied on modifications to the risk disclosure sections of the bond clauses. To understand the data better, we invited thirty of the most knowledgeable parties from both London

---

51 Hellenic Republic, Offering Circular, 4.75% Notes Due 2019, at P.1 of Terms and Conditions.
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 having been consulted during the ICMA drafting process, others objected to the clause that had been proposed, and still others had clients who were not sure that their interests favored any revisions to the ratable payments interpretation. 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: there might be some evidence of changes to the core clauses--Belize in 2013, Greece and Ecuador in 2014--but those were idiosyncratic, involving issuers who had recently been through restructurings.

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. To quote one of the participants at the first meeting:

When I came to the Columbia thing, it struck me like a bolt of lightning that the New York lawyers who thought of themselves as movers and shakers had not been sufficiently brought in [to the process].

Another 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].

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.

Unlike the Columbia meeting, this next session, hosted at the offices the New York Federal Reserve, was by invitation only. The two of us were not invited; we suspect our meeting a Columbia was not seen as having encouraged consensus. From what we have heard, the Fed meeting comprised a select group of elite lawyers, most of who were at the Columbia meeting, but some who were not. Almost all of the lawyers represented the pure sovereign issuers, mostly emerging markets issuing bonds under New York or English law (as opposed to domestic law). Each of the invitees clearly understood that they were being asked by the public sector authorities to contribute to a coordinated effort to battle the danger posed by NML's ratable payment interpretation. 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 can 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 "settled" nature of the end product (and its advantages fully) that they came on board with not unpicking key elements.
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 by the New York courts.

We cannot prove causation, but the data for the sovereign issuers shows a remarkable change in late 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.\textsuperscript{52} What we see in the data on bonds issued by the pure sovereigns under New York and English law is that the vast majority of new issuances done after October 2014 (roughly 75%) now add additional language in the main clause itself to negate the ratable payments interpretation. And invariably that additional language is the formulation prescribed by ICMA and endorsed by the IMF’s report.

\textbf{4. The Clean Up}

One of the intriguing aspects of the historical data on \textit{pari passu} clauses, from the early 1800s to today, is the multiplicity of formulations of the clause. As we described above, there are at least three different versions of \textit{pari passu} with distinct levels of vulnerability to a ratable payments interpretation by a court. Further, the clauses also differ significantly in their scope (e.g., the types of sovereign obligations the clause covers—only foreign currency, only exchange traded debt, all debt, all obligations, and so on) and whether the clause is subject to “mandatory provisions of law” (another encrustation that makes little sense). Viewed from the perspective of rational and sophisticated contract design, these variations should mean that default risks are allocated in different ways. Sophisticated contract drafters use different language in formulating

\textsuperscript{52} In particular, there were multiple sessions during the IMF/World Bank meetings for debt managers around the globe where experts on the \textit{pari passu} litigation, such as Anna Gelpern of Georgetown University, were asked to conduct seminars explaining the implications of the ratable payments interpretation and how the contracts could be reformed.
contractual boilerplate in order to modify the conventional meaning of the boilerplate provision. A more cynical perspective—and one offered by many of the sovereign debt lawyers we interviewed—is that these variations appeared over time by happenstance as younger lawyers, not realizing that the clauses had been emptied of meaning by rote use and encrustation, tried to make marginal improvements in the boilerplate language. The key question was whether these encrustations in the clause would remain once the corrections to the clause began to occur in 2014 (perhaps with different issuers using different variations) or we would see a convergence to a new “clean” version of the clause.

We already know from Figure 1 that all three variations in the vulnerability of the clause to the ratable payments interpretation continue to exist in the market and at roughly the same rates. But we focus now on the subset of the bonds that have finally begun to modify their clauses—the pure sovereign issuances made under New York and English law after October 2014. Do variations remain or do we find a convergence towards a single clause with the same risk formulations?

Table [2] shows that almost all of the subset of roughly [50] bonds where there has been some change to the clauses after October 2014 have “cleaned up” the encrustations noted above and have identical language. Roughly [80]% of the bonds that modified the clause to negate the ratable payments interpretation also narrowed the scope of the clause to cover only “external indebtedness” (as opposed to “all obligations” or “all indebtedness”) and deleted the reference to the exception for “mandatory provisions of law.” The comparable fractions of bonds with clean clauses for the rest of the data is well below [50]%, a difference that is statistically significant at the .001 level. In short, once the respective drafters decided to amend the clause with the addition of the caveat regarding the ratable payments interpretation, other problematic aspects of the clause were deleted as well. Although the core problem with pari passu remained—the clause is a relic of little or no contemporary use—the boilerplate is a lot cleaner now.

C. The Interviews
The data on changes to *pari passu* clauses over the four years of our study reveals patterns of behavior that are puzzling in some respects and confounding in others. 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 had produced the contract terms and disclosure documents for the bonds in our data. As described above, as a first step we hosted a conference at Columbia University Law School in early October 2014, shortly before the Fall IMF/World Bank meetings. We invited two dozen of the senior most sovereign debt lawyers from New York and London to a discussion of how the market had reacted to the *NML v. Argentina* decisions. 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. At the session, the two of us began by first reporting on the data we had collected up to October 2014. We next explained what puzzled us most about that data: despite the expressed distress over the ratable payments interpretation at industry meetings and in the press, virtually no one was revising the offending boilerplate. Finally, we asked the gathered experts if they might help us answer two core questions:

- *First*, what explained the failure of the sovereign debt industry, as of October 2014, to modify or amend the clause, now that multiple New York courts had handed down a ratable payments interpretation?
- *Second*, what was the best strategy, going forward, to combat this problematic interpretation?

We recorded what was said at the meeting and also had either individual conversations or email exchanges with each of the attending lawyers afterwards (a
handful did not respond). One clear theme was expressed by a number of the lawyers, and echoed in our follow up conversations with them after the October 2014 meeting: their sovereign clients were not yet comfortable making changes to their clauses. To pursue this theme, one of us conducted a series of interviews with sovereign clients (senior officials at government debt offices). In Part IID 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 [70] different individuals actively involved in the sovereign debt markets.

We report below on what we were told.

1. Reasons for the Lack of Change, as of October 2014

In our prior project, for which we conducted the bulk of our interviews during the period 2008-2011, we had asked almost every one of the same lawyers with whom we spoke in October 2014 why they had not modified or amended their clauses in response to the ratable payments interpretation from Brussels in 2000. The two primary responses were: (1) that 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 susceptible to the ratable payments meaning.

53 We also asked our questions at a follow up meeting in Paris, in November 2014, with a number of European sovereign debt lawyers and policy makers attending. This second meeting was organized by Rodrigo Olivares-Caminal of Queen Mary Law School. The format of this second conference began with a presentation followed by audience questions. There were fewer lawyers and policy makers (roughly a dozen) than in New York a month prior. We presented the same data and took notes on the responses; the responses were not substantially different from the ones we received in New York.

54 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 Anna Gelpern & Mitu Gulati, How Much is this Clause? Perspectives on Pricing Contract Terms in Sovereign Bonds (draft on file).
But in October 2014 neither one of the prior explanations for inaction seemed valid. After all, a New York federal district court had affirmed a ratable payments interpretation that was endorsed unanimously 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? We received three primary responses to our question that we call, respectively, “The Perfect Storm,” “British Courts Are Better”, and “Our Clients Won’t Let Us.”

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,” was the term used by 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 the decade or so that the litigation had proceeded. Argentina also made the strategic error of passing an explicit law that made the holdout creditors functionally junior to everyone else. And finally, the judge was quite elderly (we assume that the implication we were supposed to draw from this fact was that a more sprightly judge might not have made this decision). Our response was: So what? If the judge had made it crystal clear that his decision was a function of the unusual facts on the ground (the law that Argentina passed, its unusually bad behavior, etc). But he did not do that. Instead, his decision could easily be interpreted as having been driven by a simple combination of the explicit terms of the pari passu clause and Argentina’s failure to pay the holdouts while paying the restructured bonds. In other words, it was clear now that (a) the clause was unclear; and (b) there was a substantial risk that a court would resolve the ambiguity in favor of the ratable payments interpretation. And those two facts should point toward repairing the clause, regardless of any complaints about what the judges had done.

55 This point is made explicitly by the IMF in its 2015 report on contract reform, as the basis for its recommendation that the pari passu clauses be reformed. See IMF Report, supra note __.
Indeed, the foregoing logic should have pointed towards the clauses being modified immediately after the district court’s decision in December 2011. Instead, these same lawyers devoted considerable efforts over the next year trying to persuade the Second Circuit to reverse the trial court (an uphill battle, even without Argentina’s bad behavior). And then, after that strategy failed, even more effort was spent to get the U.S. Supreme Court to take up the issue (even though the Supreme Court almost never addresses matters of state contract law interpretation).

Our conclusion from the foregoing is that the lawyers across the industry--who had put considerable efforts into securing the industry wide support needed to generate numerous amicus briefs--must have believed it would be more difficult to persuade the industry to modify boilerplate than to coordinate industry efforts to persuade the appellate courts to reverse a trial court. And given how hard it is to generate the kind of industry-wide litigation position that was produced in these cases, the implication is that it must be extremely difficult to change boilerplate contract terms. But why?

3. British Courts Are Better

The English lawyers had a different response from their U.S. compatriots. Their reason for not amending their clauses, they explained, was that no British court would ever rule in the same unduly textualist fashion as had the New York courts. We pointed out to the British lawyers that we had heard much the same explanation from the U.S. lawyers years before when we had asked them why they had not revised their pari passu clauses in response to the interpretation in Brussels in September 2000. Moreover, their confidence that, unlike the U.S. courts, a British court would look to market practice struck us as unwarranted, especially since there was no clear market understanding of the clause’s meaning (other than it did not mean ratable payments).

56 On this point we have more than our interviews, since two of these practitioners have expressed these views in print. See Tolek N. Petch, Pari Passu in an English Setting, 9 CAP. MKTS. L. J. __ (2013); Lachlan Burn, Pari Passu Clauses: English Law After NML v. Argentina, 9 CAP. MKTS. L. J. 2 (2013).

57 See Scott & Gulati, supra note __.
Indeed, a British court was asked to interpret *pari passu* in *Kensington International v. Republic of Congo*, and, after obtaining the assistance of a neutral Queen’s counsel, decided to duck the interpretive question on other grounds.\(^5^8\) And, more recently, a former President (the first one) of the U.K. Supreme Court has written an opinion on behalf of the holdout creditors saying that his view on English contract law is that Judge Griesa’s ratable payments interpretation was correct.\(^5^9\) Nevertheless, the British lawyers were unmoved by our arguments: 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.

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

\(^5^8\) April 16, 2003 decision, QBD approved by the Court at EWCA. Discussed in Scott & Gulati, *supra* note ___.

\(^5^9\) 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 had not come up there. The reason for this submission is that the question of the interpretation of the Argentine *pari passu* clause under English law is currently before Judge Griesa— with the unrestructured holders of English-law bonds asking for the same relief that their U.S. counterparts received. 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.

As an aside, our data shows that, as of January 1, 2016, not a single issuer switched from New York to English law in the wake of either Judge Griesa’s decision in December 2011 or that of the Second Circuit in October 2012.

4. Our Clients Won’t Let Us

At the public portion of the discussion at Columbia Law School in October 2014, only 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 (many talking to us after the formal session was over) agreed with this evaluation of their client’s 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 court’s decision was incorrect, clients had not seen any strong negative reaction from the market to the pari passu decisions in *NML v. Argentina* (other than for Argentina itself).60

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

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

---

60 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* (Jan 2016 draft; on file with authors).
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.\textsuperscript{61}

5. The Source of the Nile

The final observation we heard from the conference participants was indifference. Perhaps unsurprisingly, given the drama caused by the \textit{pari passu} case, a number of scholars embarked on investigations into the original meaning of the clause in sovereign instruments. In separate research projects, Sung Hui Kim and Anna Gelpern found evidence of a shared meaning of \textit{pari passu} in the sovereign context held both by the parties and a series of Swiss courts in the mid 1930s.\textsuperscript{62} The context was the Nazi default on the famous Young and Dawes loans issued to Germany to help its recovery during the interwar period. Germany had defaulted on some creditors and not others, and the plaintiffs were asserting that this behavior violated the \textit{pari passu} clauses in these loans. Since Germany had sovereign immunity, suit was brought against its agent, the Bank of International Settlements. Both Kim and Gelpern, each examining different sets of archival records (Kim looking at diplomatic correspondence and Gelpern looking at court decisions), found concrete evidence that the most likely understanding of the clause then was that it required ratable payments. And indeed, Ben Chabot’s archival research into the infamous Black Eagle bonds issued by Mexico a century ago under its strongman, General Santa Anna (quite possibly the very first use of the \textit{pari passu} concept in a sovereign bond), suggests that ratable payments was the most likely understanding of the clause at that time as well.\textsuperscript{63}

Given that no one in the industry currently seemed to understand the meaning of the clause, our question was whether this very concrete evidence regarding the historical understandings of the clause might impact the thinking of the contemporary lawyers.

\textsuperscript{61} Buchheit & Martos, supra note __ (emphasis ours).


Surely, these articles would be game changers, was our thought. So prior to the conference we emailed all of the participants copies of Anna Gelpen’s as yet unpublished piece “Pari Passu’s Golden Fossils” and references to the recently published papers by Sung Hui Kim and Ben Chabot. The reaction could not have been more tepid. The lawyers did not find the historical research to be at all relevant to a discussion of what to do with the clause in the contemporary context. They didn’t even seem to find the history interesting as a general educational matter; even though the stories involved Nazis, gold, General Santa Anna, JRR Tolkien, the French bombardment of Vera Cruz and the original vulture investors. Not one of them mentioned the historical research as being the least bit relevant at the meeting, and only one of them reacted via email by making a condescending comment on the relaxed life of academics who can afford to waste their time doing historical research.

6. Summary: The Courts Failed Us

Despite the often-puzzling responses 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 harmful to the global economy in general and to the market for sovereign bonds in particular. Yet, the lawyers were reluctant to act on that belief because their commitment to the industry 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 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 custom than on the plain meaning jurisprudence of the Second Circuit. To be sure, one could interpret those beliefs as simply a justification for inaction in the face of conflicts among client interests. Given those conflicts, the lawyers all agree that by applying the reigning principles of contract interpretation the courts in 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 risk profiles?

But the preceding story only explains why no efforts to reject the ratable payments gloss on 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 sovereign whose clauses have been modified is often going to be ultimately responsible for these other issuances as well? Put differently, the risks posed by a ratable payments interpretation are the same or worse in those other bonds.

D. The Clients

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 issuance, 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.\(^\text{64}\) The logic is that these lawyers develop over time a deep understanding of the debtor and can more easily prepare the relevant legal documents.\(^\text{65}\) While in some cases the sovereign debtor will have a different law firm as

\(^{64}\) Bradley et al., *supra* note __.

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 on below is drawn largely from interviews that one of us conducted with Anna Gelpern 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 twenty-one different debt offices two questions.

- **First,** assuming they knew of the *NML v. Argentina* decisions on *pari passu* (they all had), what was their view of the risk the ratable payments interpretation posed for the type of clauses they were using?
- **Second,** to the extent they had issued different types of sovereign and quasi-sovereign bonds, what were their reasons for using different types of *pari passu* clauses in different issuances?

We report below on the main responses we received.

**1. The Reasons That Might Induce Change**

The lawyers 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 what the lawyers had told us. In every case, the debt managers were aware of the litigation by the vulture 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 people across the various debt offices—seem to have a strong view of what they should do in response. Unlike the lawyers, we heard very few statements of outrage were at what the New York courts generally or Judge

---

66 Gelpern & Gulati, *supra* note __.
Griesa specifically had done.\textsuperscript{67} And relatedly, there was no expressed desire to avoid New York law or New York courts in future sovereign instruments.

To the extent we could discern any sentiment, the debt managers for the most part thought that the outcome of the Argentine litigation was bad. But at least to us they did not seem particularly concerned that the meaning of a key provision in many of their 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 \textit{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 up to date on the latest improvements in the standard forms for sovereign bonds. 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 on the matter. 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

\textsuperscript{67} Our Georgetown colleague, Anna Gelpern, has a somewhat different perspective on the debt managers that she explained to us in an email. Her perspective was informed in large part by the fact that she 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. And at those meetings, she 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 to us, 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 from Anna Gelpern, January 10, 2016 (on file)
had fundamentally misunderstood the way prices for bonds were set and the relevance of contract terms such as \textit{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, “\textit{is to ensure that the legal terms do not impact the price.}”\textsuperscript{68} There are terms that are relevant to the price—such as the currency, maturity, governing law—the material that appears on the term sheet, but legal terms such as \textit{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.” 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 had the word “payment” in it or not.

Undeterred, we asked next: “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 for the documents to protect the sovereign in the event something bad 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 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 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.

\textbf{2. The Variation in the Clauses}

\textsuperscript{68} \textit{See} Gelpen \& Gulati, \textit{supra} note ___ (reporting multiple quotes on this point).
Given that our respondents were emphasizing the importance of using “the standard” provisions, our next question was to ask them 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 bonds (e.g., sovereign guarantees) had made a different bargain with the debtor than in another (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 issuances under those laws were changing accordingly. The templates for the other types of issuance, such as sovereign guaranteed bonds, had not been addressed by the IMF/ICMA initiative, so those bonds were not changing. Moreover, our respondents further explained, primary 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 the question of what kinds of clauses their country had and what the variations were in

---

69 See id. (for greater detail).

70 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, Fin. Times (Jan 5, 2016).
clauses within their own issuances. They were extremely interested, and they invariably wanted us to show them the variation we had seen in the data and explain the implications of the different wording. It was clear, however, that these were not matters they had discussed with their lawyers nor were they likely to do so in the future. Our respondents were curious about the implications of having one variation in a clause versus another, but nothing we told them about the different levels of risk was going impel them to remedy their clauses: that was just not how the process of changing standard boilerplate worked.

3. No Midstream Changes

Our final observation regarding the debt managers has to do with the question of changing the \textit{pari passu} provisions in their older bonds (assuming their plan was to fix the \textit{pari passu} clauses in their future bonds). To us, in theory, this seemed like something issuers and their creditors should want to do; if it was the case that they feared that the \textit{pari passu} clause might become a weapon in the hands of holdout creditors someday in the future (which was what everyone seemed to be saying). If so, then why not change the clauses with a vote of the creditors during the good times when there were no holdout creditors in the picture (a vote between 50\% and 75\% of the bondholders could have deleted or modified the \textit{pari passu} clauses in every one of the bonds at issue)?

As it turned out, none of the debt managers bar one seemed to have given this issue even the slightest bit of consideration.\footnote{The one debt manager who had considered doing an exchange of his old bonds struck us as wanting to be seen as being 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.} They were willing to consider changing new bond issues because the the IMF, ICMA and their outside lawyers were telling them that the standard forms were changing. Plus, this change was important for systemic reasons and they were willing to do their bit to be good global citizens. But they were not willing to go through the exercise of doing a bond exchange to fix their old bonds; that would cost money—and neither they nor their investors were willing to pay those costs.
4. We Don’t Begin Reading Until Things Get Really Bad

Although our primary focus in the “client” interviews was the government debt managers, they had told us 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 find themselves holding sovereign bonds at the time of a crisis—and the firms we spoke to had held some bonds in every recent sovereign debt crisis (Argentina, Greece, Ukraine, Cyprus, etc.)—they see first hand how the legal terms of the contract can matter a great deal. Our starting premise here was that surely 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 what contract provisions were in the bonds.

The answer was a yes and a no. 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, don’t come in to play until very late in the game when the sovereign (and pretty much everyone else—such as the IMF and the investors) are trying desperately to avoid default. It is only when those efforts fail that the lawyers get called in to determine what the legal terms mean and whether they might provide an advantage or disadvantage. The foregoing, to us, seemed illogical. If contract terms such as the form of the pari passu clause mattered ex post, in a near default state, ceterus paribus, they necessarily should matter ex ante as well. Many of the players at the investment firms had quantitative backgrounds and so they understood precisely our puzzle. The explanation was the market reality: no one paid attention to anything but whether the bond had the “standard documentation;” that is, until the very end, when everyone scrambles to find a good lawyer to tell them what their documents mean.\textsuperscript{72} 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

\textsuperscript{72} See id. (for greater detail).
risk altering term was added. What does not seem to matter is what constitutes the standard.

III. 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 contract drafters will promptly revise standard contract terms when faced with an interpretation adverse to their client’s interests.\(^{73}\) That no corrective changes were made to the pari passu boilerplate for over four years after federal courts in New York indorsed the ratable payments interpretation is perplexing. This is especially true because the drafting lawyers (and the entire sovereign bond industry) were near 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 late fall of 2014 rather than by the succession of adverse court decisions by the leading commercial courts in the U.S. Adding to the mystery, the clarifying revisions that began to appear in many bond issues in late 2014 were limited to bonds issued directly by a sovereign (pure sovereign bonds). But almost no similar changes have 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 had been “repaired.”\(^{74}\)

\(^{73}\) There is a literature on standard form contracts suggesting that such boilerplate contract terms might be slow to change because of network or learning externalities—the value of having identical terms that everyone understands and can easily and accurately price (and litigate), precisely because they have been used over a long period of time and their understanding has become enhanced. That rationale may apply in the case of some boilerplate contract terms, but the inevitable trade-off is the risk that a boilerplate provision may become encrusted and unintelligible by rote use such that pricing is nonexistent. The classic statement of the externality argument is in Marcel Kahan & Michael Klausner, Standardization and Innovation in Corporate Contracting (or “The Economics of Boilerplate”), 83 VA. L. REV. 713 (1997). For a further explanation of why the Kahan and Klausner argument does not apply to our context, see GULATI & SCOTT, supra note __.

\(^{74}\) 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 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
Notwithstanding the apparent contradictions, however, a coherent and consistent story does emerge from the data. We don’t suggest that this is the only story that explains the *pari passu* puzzle, but it is the only explanation that fits all the data sources we have collected. 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 common meaning in encrusted boilerplate like the *pari passu* clause?

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

The best explanation of the *pari passu* puzzle, we believe, is a variant of a collective action problem: The individual or private interests of the key participants—the elite lawyers and their clients (the sovereigns and the investors or, more properly, the agents for the sovereigns and the investors)—are inconsistent with those parties’ collective interests. The private interests of the elite lawyers are the mirror image of their de facto clients, the debt managers and the investment banks. And both sets of agents are powerfully subject to hyperbolic discounting: they are motivated to minimize the ex ante costs of a bond issue (transaction costs plus price discounts) even where expected ex post costs (restructuring cost, the cost of holdouts, etc.,) are thereby increased by an even greater amount. On the other hand, the collective interests of the same set of elite lawyers are to protect the "industry" and the market for sovereign bonds so that future issuances proceed smoothly and future business can grow. The public sector (the IMF, the U.S. Treasury, etc.,) and the industry trade associations (ICMA, IIF) do internalize the collective problem but they are helpless to act until they are able to assemble the critical mass of key players to coordinate on the best way to reject the ratable payments 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.

---

75 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, *Anticipating Litigation in Contract Design*, 115 YALE L. J. 814 (2006).
interpretation. This is because any revision to the clause has to be "settled" among the key players, since those same private interests demand "standard" legal terms that minimize ex ante costs.

This collective action story supports the agency cost hypothesis we advanced in our prior work\(^\text{76}\) and also explains the apparent inconsistency between the expressions of outrage by the elite bar and their concomitant unwillingness to effect any change in the standard boilerplate language. It also explains why there finally was substantial movement to revise the pure sovereign issuances in late fall 2014 and why the apparently coordinated decision to revise *pari passu* was not followed in the quasi-sovereign bonds that were issued during the same time frame. In what follows, we support the collective action/agency cost story by describing in more detail the respective individual and collective interests of each of the principal parties.

\(a.\) The elite lawyers: The private interest of each of the elite lawyers who dominate the sovereign bond market is to process bond issues at least ex ante cost and as quickly as possible, notwithstanding expected default costs. This single minded focus on front end contracting costs is simply a reflection of the fact that the "legal terms" for which the lawyers are responsible and that form the standard boilerplate are seen as immaterial in the initial pricing of the bonds. Thus, any change in the risk of default that results from a change in the legal terms of the contract is ignored by both the debt managers (who act as agent for the sovereign) and the investment bank (that serves as agent for the investors). In short, the ex ante legal meaning of *pari passu* is irrelevant: the clause is essentially meaningless encrustation. Nevertheless, the *pari passu* clause remains as part of the bonds’ contractual boilerplate because it is part of the "standard form," and standardization is valued because it reduces ex ante contracting costs.\(^\text{77}\)

\(^{76}\) *See Gulati & Scott, supra note ___.*

\(^{77}\) For discussions, see Goetz & Scott, *Expanded Choice, supra note ___* at ___; Kahan & Klausner, supra note ___.

53
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 sector and other collective groups) because they saw that the ratable payment interpretation imperiled the very health of the industry itself. If bonds in default cannot be restructured then, over time, the pressure from the 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 future decline in a lucrative legal business. The collective interests of the lawyers who dominate this industry is to maintain a healthy and thriving sovereign bond market where bond issues are produced on an assembly line. And this way of doing business was threatened.

At the same time, these lawyers had no incentive to revise the standard terms for their individual clients. The debt managers for the sovereigns 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.

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.” The evidence we have points to the fact that this session, and the subsequent meeting of an elite subset of the same group (with some additions) several weeks later, was the impetus for coordinating a move to a revised standard (and equally meaningless) pari passu
clause. The lingering agency problem for the elite bar is that the de jure client is the "true sovereign"—the people or at least the duly constituted government—and not just the debt managers. And it is not at all clear that those interests are advanced by treating all sovereigns as having the same default risk and issuing standardized boilerplate for sovereign bonds despite the apparent variance in the probability of a future restructuring between first world countries and developing nations.

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

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

But the preceding does not answer one remaining question: If Jay Newman,
Elliot’s legendary legal arbitrageur, prides himself on reading the bond contracts once
default looms in order to capture rents as a hold out creditor, then doesn’t it follow that he
and other vulture fund hotshots will read the bond contracts at the time of issuance as
well?78 This means there should be arbitrage in the primary market where smart
investors are buying bonds selectively based on their reading of the legal terms because
even if they don’t plan to be there when the default hits, they know that Jay Newman and
others will pay them a higher price for their bonds with better contract terms in that near-
default scenario.79 To be sure, investors act as though the risk of a default without the
ability to restructure is too remote to affect initial price. But will the market adjust if the
vulture funds engage in arbitrage ex ante as well as ex post? Let’s try a simple thought
experiment: Assume sellers and buyers are selling #1 corn: the standardization criterion
is critical to the market because it reduces search costs. Assume as well that 1% of all #1
corn will rot before it reaches the ultimate consumer. Assume finally that consumers
absorb ½ of the $18 costs of rotting and wholesalers absorb the other ½ and that
investigation costs to identify that 1% before the corn is sold to the wholesale market are
$10. Here is it rational for wholesale buyers not to spend $10 to search for the telltale
signs of future rot in order to save $9 in discard costs. In short, so long as the initial
investors only bear some of the price risk caused by legal arbitrage, it still may be
rational for them to sell bonds without discriminating among legal terms that influence
the costs of default.

78 See GULATI & SCOTT, supra note ___; see also Mitt Romney’s Hedge Fund Kingmaker, FORTUNE, March
26, 2012 (describing Elliot’s strategy of figuring out what the documents actually say).

79 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., Foreign Law Bonds: Can They
Reduce Sovereign Borrowing Costs (Working Paper, U. Munich, 2015); Andrew Clare & Nicholas
Schmidlin, The Impact of Foreign Governing Law on European Sovereign Bond Yields, (City University
d. The public sector and industry associations. The IMF, the Paris Club, the IIF, ICMA and so on have only collective interests. Why was it so hard to coordinate with the elite lawyers and solve the problem much earlier? The best inference from our data is that the collective interests believed that the expected costs of litigation in the Second Circuit and the Supreme Court (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 simply 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 all had to coordinate around a common formulation in order to substitute a new standard term in place of the defective one. At the Columbia conference in October 2014, many of the elite lawyers were openly critical of the clarification proposed by the IMF. 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 was all that was needed to do the trick? Was the Columbia conference an important first step for the elite bar to recognize that they all shared the same private and collective interests (and that the Emperor had no clothes)?

Our data cannot answer these last questions but we do know that the elite lawyers who were in the room at both the Columbia and New York Fed meetings in October 2014 represented the “pure” sovereign issuers doing offerings under New York and English law. And 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

---

80 One of the key policy makers from the US Treasury told us in January 2016 that, on reflection, persuading ICMA to be involved was especially important. At the time, ICMA was trying to enhance its membership by demonstrate to the market that it was a key actor. ICMA, in other words, had its own incentives to show the market that it could engineer a big change. 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 immediately induce change on the market. The catalysis appears to have occurred in October 2014.
the elite cohort) represent subsidiary sovereign interests that have yet to coordinate around a revision that rejects the ratable payments gloss.

**B. What Should Courts do with Encrusted Boilerplate?**

The Second Circuit 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. 81 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 82 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. 83

There is a powerful justification for giving boilerplate terms in commercial contracts their plain or standard dictionary meaning: a valuable state function is to create

---


82 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.”).

83 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).
standard vocabularies for the conduct of commercial transactions. 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. It is tempting to argue, as the British lawyers did following NML, that such a strict construction might subvert the parties true intentions. However, the ability of commercial actors to select language unencumbered by predefined meaning offers the conventional justification for the rule.

But the preceding exposes a fundamental dilemma that textualist courts confront when applying the plain meaning presumption to standard boilerplate such as the pari passu clause: the interpreter must somehow distinguish between meaningful language and empty boilerplate. This suggests that textualist courts are well advised to interpose a further step before applying the plain meaning presumption when interpreting standardized terms in commercial contracts. The court should first admit evidence on the question of encrustation. The evidence we have described above is illustrative of the proof that the parties alleging encrustation might proffer. Has the clause been repeated by rote over many years, where repetition has robbed the term of any obvious conventional meaning? Has the term been embedded in layers of legal jargon such that its intelligibility is substantially reduced? Is an historic or original meaning of the term accessible and are contemporary commercial actors aware of that meaning? Is there credible evidence that the particular provision was priced at the original issue stage?

If a textualist court finds evidence of encrustation in standard boilerplate, the presumption of shared meaning is no longer apt. Rather, the court might approach a


86 Based on what we have seen, it probably does not mean much if we do not find a pricing effect. But if we do find an effect, it probably means that the clause was intended to have a specific discernable meaning.
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, the court should find that neither party’s interpretation of pari passu was
legally relevant. Alternatively, if the court were to find that NML/Elliot knew or had
reason to know of Argentina’s ex ante understanding that pari passu did not encompass
the ratable interpretation, the court would be directed by the rule to adopt the meaning
asserted by Argentina.

* * *

A natural question for a skeptic is to ask whether our study is idiosyncratic.
Perhaps the pari passu clause is a unique example of encrustation. Perhaps there are few,
if any, other instances of standardized boilerplate that no one understands, but that
nevertheless persist (recall the “perfect storm” explanation many lawyers offered to
explain why they did not respond to the ratable payments interpretation). We do not have
a good answer to this question, other than to say that even within the pari passu clause
itself there is evidence of further encrustation (e.g., the “mandatory law” proviso). But
perhaps even more illustrative of a general problem is the case of the Payments provision
that surfaced as a result of the recent debt travails of the Republics of Cyprus (2013) and

The typical Payments clause states, in essence, that “[a]ll payments are subject in
all cases to any applicable fiscal or other laws and regulations of the place of payment” (a

---

87 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).
relatively safe jurisdiction is typically specified, such as London or Luxembourg.)\textsuperscript{88} The basic idea here is that the bondholder is made aware that he is responsible for any taxes that might be imposed by the (typically neutral) jurisdiction where he has contracted to receive his payments. When the Cypriot debt crisis occurred in 2013, however, and Cyprus and its lawyers had to scramble to find any defenses against creditor claims they might have in their bonds, they discovered that the Cypriot bonds provided that: “All payments are subject in all cases to any applicable fiscal or other laws and regulations.”\textsuperscript{89} The difference between the two provisions is significant: the second version omits the last few words of the first version of the clause—the reference to “place of payment.” And that then creates a loophole that a restructurer could easily exploit. After all, who really knows what “any applicable fiscal or other laws and regulations” means? The debtor could easily take the position that this meant the fiscal laws of the debtor—in other words, creating a local law bond within a foreign law bond (a huge advantage).\textsuperscript{90}

One might have predicted that this gaffe would immediately be corrected once it was noticed (particularly if the key omission was reported in the Financial Times and if no one had any plausible explanation for why the key words were missing—other than it was a gaffe). But that did not occur. Cyprus has continued to issue bonds with this problematic Payment clause: and this is so even though one certainly cannot claim that the risk of default on Cypriot bonds is near zero.\textsuperscript{91} But that’s not the end of the story. Ukraine has the same problem with its Payments clauses.\textsuperscript{92} And when Ukraine had a

\textsuperscript{88} See Joseph Cotterill, FTAlphaville.

\textsuperscript{89} Cyprus, Offering Circular, June 17, 2011.


\textsuperscript{91} See, e.g., Republic of Cyprus, Offering Circular, Apr. 29, 2014, Provision 7(c), at p.25; Republic of Cyprus, Offering Circular, Sept. 4, 2015, Provision 7(c), at p.25.

\textsuperscript{92} In a review of 50 different foreign law sovereign issuances under foreign law over the past two years (2014 and 2015), we discovered the same problem in eight of them. Other recent examples pointed out by the Financial Times were Azerbaijan and Greece. See Joseph Cotterill, \textit{Ukraine’s Bonds: A Little Local Leverage}, FTAlphaville, March 26, 2015.
debt crisis in 2014, the Financial Times again pointed out this anomaly in its contracts that might be exploited by the sovereign in the future. Ukraine restructured a large portion of its bonds on a consensual basis in late 2015 and issued new bonds in the process. And, as the theory of encrusted boilerplate would have predicted, the Payment clause, encumbered with this latent defect, was reproduced by rote in the new bonds (even though the new bonds from the restructuring had newly revised ICMA *pari passu* clauses). 

---

93 *See id.*

94 *See Ukraine, Exchange Offer Memorandum, Sept 23, 2015, Provision 6(b), at p.25.*
Figures and Tables

Readers: Please note that we have a few additional figures here, beyond what we refer to in the text. Those additional figures are to give you more of the background on the story, should you be interested.

Figure 1

Changes to the Core (or Original) Language of the Clause
Background Data from Weidemaier, Scott & Gulati (2013) – (Note: This is only for the sovereign issuers under foreign laws)

<table>
<thead>
<tr>
<th>Decade</th>
<th>Number of issuances</th>
<th>Percent with pari passu</th>
</tr>
</thead>
<tbody>
<tr>
<td>1940s</td>
<td>8</td>
<td>0.0%</td>
</tr>
<tr>
<td>1950s</td>
<td>3</td>
<td>0.0%</td>
</tr>
<tr>
<td>1960s</td>
<td>30</td>
<td>93.3%</td>
</tr>
<tr>
<td>1970s</td>
<td>28</td>
<td>71.4%</td>
</tr>
<tr>
<td>1980s</td>
<td>108</td>
<td>81.5%</td>
</tr>
<tr>
<td>1990s</td>
<td>325</td>
<td>94.5%</td>
</tr>
<tr>
<td>2000-Present</td>
<td>471</td>
<td>99.6%</td>
</tr>
</tbody>
</table>
Background Data – From Weidemaier, Scott & Gulati (2013)

Version of the Results in Figure 1 (Going back to the 1940).

Note: Results are for Pure Sovereign Issuers (whereas Figure 1 was for sovereigns and quasi sovereigns; a much bigger universe).

Figure 1. Versions of *pari passu* over time

![Bar chart showing the percentage of *pari passu* versions over time from 1960s to 2000+ for high, medium, and low risk.]
Figure 2: Number of Changes to the Language of the Full Clause (2011-2016)

(Across the Types of Sovereign Issuers)
Figure 3: Number of Clarificatory Changes to the Clause (2011-2016)

(Across the Types of Sovereign Issuers)
Figure 4: Number of Bonds with Risk Disclosures Regarding Litigation Risk Posed by *Pari Passu* Clauses (2011-2016)

(Across Type of Issuer)
Figure 5: Changes to the PP Clause in the subset of Pure Sovereigns (English + New York law bonds versus Local Law Bonds)
Figure 5b (Separating the New York and English law Pure Sovereigns):

Changes to the PP Clause (in the subset of Pure Sovereign bonds under English and New York)
Table 6. Fraction of Pure Sovereigns Where Other Problems Got Cleaned Up; Along with Change (n=692)

<table>
<thead>
<tr>
<th>PP Mandatory Provision</th>
<th>Count</th>
<th>%</th>
<th>Limited to External Indebtedness Count</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>107</td>
<td>78.1</td>
<td>0</td>
<td>30</td>
</tr>
<tr>
<td>1</td>
<td>30</td>
<td>21.9</td>
<td>1</td>
<td>107</td>
</tr>
</tbody>
</table>

Table 6b. Fraction of the Other Bonds in Data with Messed Up Clauses (n=953)

<table>
<thead>
<tr>
<th></th>
<th>PP Mandatory=0</th>
<th>PP Mandatory=1</th>
<th>% of 0s</th>
<th>Limited to External Indebtedness=0</th>
<th>Limited to External Indebtedness=1</th>
<th>% of 0s</th>
</tr>
</thead>
<tbody>
<tr>
<td>Guarantee</td>
<td>159</td>
<td>125</td>
<td>44.0</td>
<td>272</td>
<td>4</td>
<td>98.6</td>
</tr>
<tr>
<td>Sovereign</td>
<td>177</td>
<td>183</td>
<td>50.8</td>
<td>241</td>
<td>119</td>
<td>66.9</td>
</tr>
<tr>
<td>Sub Sovereign</td>
<td>71</td>
<td>123</td>
<td>63.4</td>
<td>186</td>
<td>7</td>
<td>96.4</td>
</tr>
<tr>
<td>Supranational</td>
<td>53</td>
<td>62</td>
<td>53.9</td>
<td>103</td>
<td>0</td>
<td>100.0</td>
</tr>
<tr>
<td>Total</td>
<td>460</td>
<td>493</td>
<td>48.0</td>
<td>802</td>
<td>130</td>
<td>86.1</td>
</tr>
</tbody>
</table>