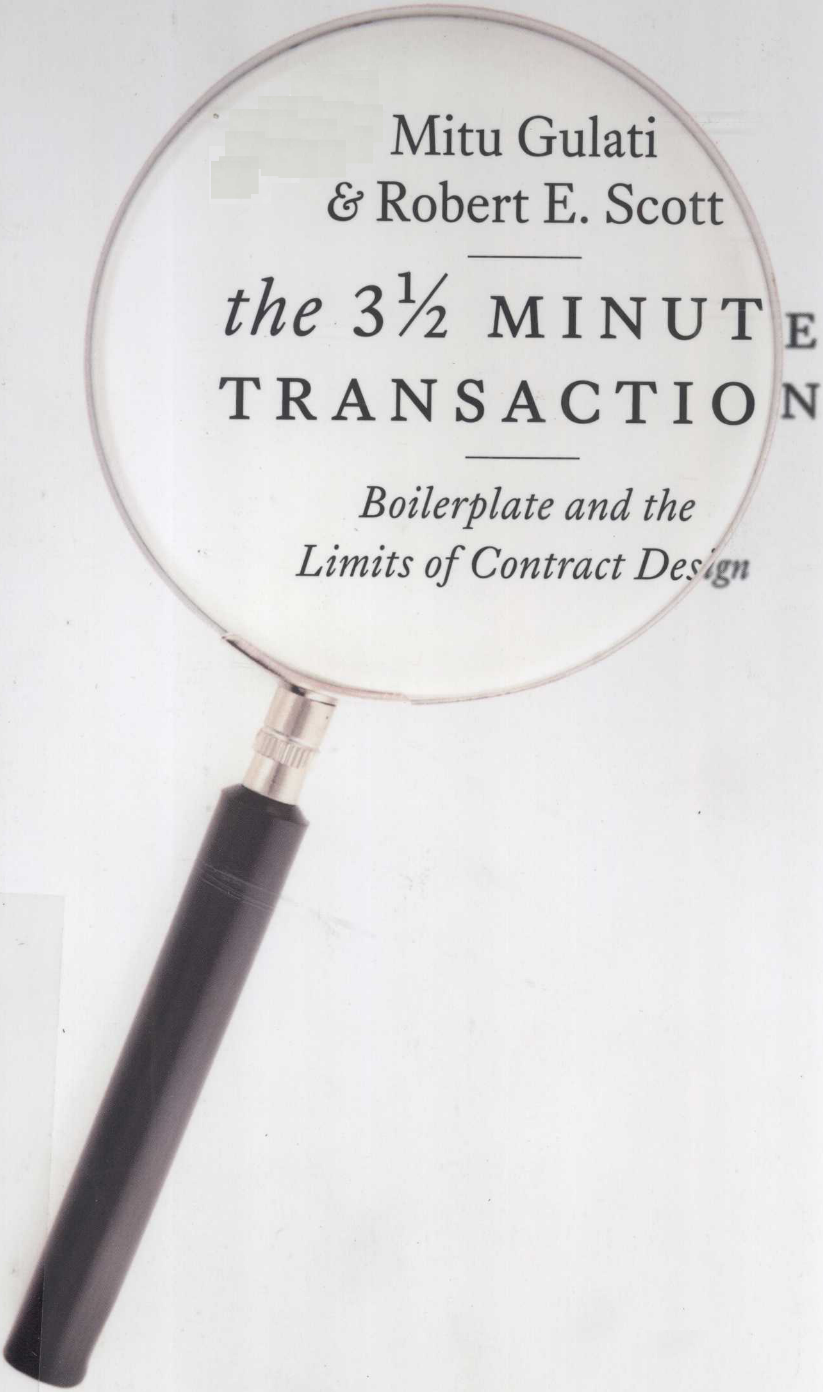
Mitu Gulati
& Robert E. Scott

the 3½ MINUTE TRANSACTION

Boilerplate and the Limits of Contract Design



The Three and a Half Minute Transaction

Boilerplate and the Limits of Contract Design

MITU GULATI AND ROBERT E. SCOTT

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Introduction

Many of us who purport to study and explain human behavior secretly dread becoming the punch line of the story about the jumping frog. In that tale, a scientist sets out to measure how far a bullfrog can jump. On the first day of the experiment, the scientist prods the creature's posterior while commanding "jump frog, jump." The frog jumps 9 feet. The scientist records in his notebook: "Day one—frog jumps 9 feet."

On the second day, the scientist surgically removes one of the frog's legs. When prodded with the instruction "jump frog, jump," the frog jumps five feet. The notebook entry for that day reads: "Day two: frog with three legs, jumps 5 feet."

Day three is a repeat of the experiment, but the poor frog now has two of its legs removed. "Jump frog, jump." Notebook entry: "Day three: with two legs, frog jumps 18 inches."

On day four, the frog loses yet another leg in the interests of science. "Jump frog, jump." Notebook entry: "Day four: with one leg, frog jumps 1.5 inches."

The scientist removes the last of the poor frog's legs on day five and issues the by-now familiar command, "jump frog, jump." No response. The scientist says in a louder and more imperious voice, "jump frog, jump!" And again, "jump frog, jump!!" The animal still does not stir.

Notebook entry: "Day five: frog went deaf."

Attempting to deduce the motivation or rationale for human behavior based solely on the record of that behavior is not so different from the study of jumping frogs. The observer can get it badly wrong. Law professors can study the practices of lawyers in preparing the tens of thousands of commercial contracts that are signed each day. From the textual evidence of those contracts, many of them in utterly standard boilerplate form, academics might ascribe rational motivations and objectives to the drafters. Fair enough, you say. After all, these documents are prepared by seasoned, highly paid members of what still styles itself a learned profession. The contracts themselves are intended to embody legally binding commitments of their clients, enforceable if necessary with all the majesty of the law. It is hardly the place where one would expect to encounter the casual, the unpremeditated, or the indecipherable text.

And then, every once in a while, the frog goes deaf.

In the story we tell in this book, a novel (some might say singular) judicial interpretation of an obscure clause in cross-border financial contracts—the *pari passu* clause—briefly rattled the chandeliers of international finance. One might have expected the elite practicing bar to have quickly clarified their forms so as to discredit what they universally believed was a heretical interpretation of this boilerplate provision before the heresy could spread and gain traction. But that did not happen. In more than 90 percent of the contracts subsequently issued, no attempt was made to clarify the imprecise language of the clause. To be sure, over time a small number of contracts did incorporate new provisions that had the effect, if not the clear purpose, of reversing the aberrant interpretation. But the fact that these changes were limited to a small minority of the outstanding contracts served to only deepen the puzzle. In this book, we unpack the puzzle of why the response that standard theory would predict did not occur. The story that emerges is partly about why these financial contracts did not change despite the ongoing risk of other courts or adjudicative bodies adopting the same destabilizing interpretation.

At bottom, though, this is a story of forgetfulness. It is a story of how a remarkably unconfiding contractual provision was introduced into international financial contracts over a hundred years ago (presumably to deal with a risk or contingency that arose at that time). This contractual provision was promptly absorbed into the lumpish boilerplate of such contracts and then came to be replicated, thousands upon thousands of times, even while the knowledge of its origin and purpose insensibly faded from the minds of its remote drafters. If anything, the increase in the popularity of this clause in international financial contracts seems to have been inversely related to market understandings of its meaning. As the clause became more widely used over the past century, shared understanding of its intended meaning actually diminished—so much so that this clause appears today in almost every one of the cross-border documents that form the subject of our study. Despite the fact that the clause is frequently displayed prominently on the front page, almost no one seems to understand what it means.

This is also a story about the organic life form known as a standard commercial contract and about how such documents pass relatively untouched through the hands of generations of lawyers much like a seed can pass unharmed through the intestinal tract of a bird. The story can be told from the standpoint of basic human psychology; novelty sparks curiosity, repetition stupefies it. Or it can be told from the perspective of a legal profession in which new lawyers are expected to learn the lore of their craft from their elders in a tutorial, master/apprentice system that no longer exists in most major law firms. Or the tale can be brought down to the individual lawyer working on a financial document at 3:00 a.m., and who briefly scratches her head over the significance of a *pari passu* representation in her agreement, only to yawn and pass on, comforted by the thought that someone at the firm must know why it is there. The document is, after all, the firm's standard form for this type of deal.

Finally there is the obvious question: If the *pari passu* clause could have lain dormant, unchallenged for more than a century in cross-border financial contracts, how many other boilerplate clauses might similarly have outlived the memory of their origins and purpose, making them prime candidates for creative interpretations by highly motivated litigants?

The origins of this project lie in an "incubator lunch" at the University of Virginia Law School roughly six years ago. Those lunches, the brainchild of our friend George Triantis, offered informal settings where faculty could present their ideas for possible research projects to a group of colleagues, who would then shed light on whether the ideas were worth pursuing. One of us, Gulati, who had already spent a number of years studying sovereign debt contracts, pitched the idea that the standard models of contract interpretation might not work well in situations in which the parties to the contract, because they were using historical boilerplate, had no idea what the provisions meant, and nor did anyone else. The example used to illustrate the problem was the *pari passu* clause in sovereign bonds, which no one seemed to understand but which was used everywhere. The lunch group was skeptical about the efficacy of the project—it seemed at once too ambitious and too obvious. Developing a new theory of contract interpretation for boilerplate contracts did not strike them as particularly interesting.

Scott, however, was interested in the example itself—and specifically, the question of why it was that these sophisticated and highly paid lawyers, working at the most elite firms, failed to alter a contract term that not only posed a litigation risk to their clients but that no one understood. He had also noticed this phenomenon while working as an expert on a variety of contract issues in different settings involving sophisticated lawyers and large-scale commercial disputes.

The phenomenon flew in the face of conventional wisdom, at least that of the economic variety, about standard-form contract terms. To quote Smith and Warner's classic 1979 article on financial contracting:

> [Boilerplate contract terms] take their current form and have survived because they represent a contractual solution which is efficient from the standpoint of the firm. . . . Harmful heuristics, like harmful mutations, will die out.[1]

At odds with the quotation above, the *pari passu* example seemed to indicate that inefficient and harmful contract provisions could persist for long periods of time, even in the most sophisticated of financial markets.

The two of us had also long been intrigued by the contrast between the standard justification given to law students as to why they are asked to read hundreds of cases in their first-year contracts classes and the reality of law practice. At the schools we were teaching at then, the majority of our students were hoping to go into transactional practices, where they would be drafting and negotiating contracts. But only a miniscule fraction of contracts are ever litigated, and transactional lawyers are almost never involved in the litigations. Nevertheless, contract law is taught to all students almost exclusively through case law, whether they plan to be transactional lawyers or litigators. If asked why this is so, the explanation we generally give, and that we suspect others also give, is that "students study past disputes in order to draft contractual provisions that will avoid similar disputes in the future."[2]

Yet neither one of us had seen much evidence of transactional lawyers engaged in a dynamic process of regularly reading cases and incorporating that learning into novel innovations in subsequent contracts. Some of the transactional lawyers we knew did not appear to have looked at a case in years. The task of reading cases seemed to be the province of the litigators, while the thinking about contract drafting remained with the transactional lawyers. In theory, the two groups might be specializing and transferring information across the artificial boundary that separated them. However, we had seen little evidence of interaction among transactional lawyers and litigators, let alone a process by which they collaborated in R&D on contract design.

Several hours later, long after the others had left the lunch table, the two of us realized that we could not suggest a plausible answer to why the clause had neither been improved nor, better yet, just deleted. The failure to revise a contract term that, owing to an aberrant interpretation, now carried a nontrivial litigation risk was inconsistent both with the theoretical models of how sophisticated contract drafters behaved and with the dynamic model of case law serving as the basis for contract drafting and innovation. We assumed there had to be a rational explanation for the fact that the frog did not jump. Our speculation was that we would find some form of an "agency problem" driving the phenomenon: Lawyers were failing to represent their clients' interests adequately owing to recognizable conflicts of interest. Perhaps, for example, lawyers were reluctant to admit that they had failed on past deals to exert appropriate efforts on behalf of the clients to remove the litigation risk that ultimately materialized. Agency problems such as this are familiar topics in the legal and economics literature. They illustrate the divergence of interests between the principals (the sovereigns who issue the bonds and the underwriters who market them) who want to maximize the joint value of the contract and their agents (the lawyers) who draft the contract terms that ideally are designed to achieve the principals' objectives. Whether owing to this or other causes, we believed that we would solve the puzzle quickly. Surely, it would take only a few months to find the answers to our questions and to publish the results.

We began by gathering information along two different dimensions. First, we collected data on the contracts themselves—to see whether what we had perceived by casual observation (that the contract provisions had not been revised to fix the offending provision) was actually the case for a large dataset. Second, we asked a sample of the senior New York lawyers who worked on sovereign debt contracts whether we could speak to them about our puzzle. In our original research plan, we proposed to interview 25 to 30 lawyers in New York and to examine 50 to 75 sovereign debt contracts over the period from 2000 to 2005.

Our early optimism turned out to be misplaced. No coherent answers could be gleaned from either the first set of contracts or the interviews. Instead of a straightforward agency problem or other market failure explanation, these hard-nosed Wall Street lawyers told us stories about rituals, talismans, alchemy, the search for the Holy Grail, and Zeus. Frustrated, we assumed that we simply had not talked to enough people or the right people or looked at enough sovereign debt contracts. As we write this introduction, more than six years after we began, we have examined more than 1,500 sovereign debt contracts, covering the period from 1820 to 2010, and conducted more than 200 interviews. As we kept unpacking the story, it became more fascinating, even as a straightforward conflict of interest hypothesis proved ever more elusive. No single agency problem emerged from the data, at least not in a fashion that we could assert with confidence. To be sure, we recognized that the lawyers we talked to would be unself-conscious about the array of possible conflicts that might explain the failure to amend or eliminate a troublesome clause, and also would be quite ignorant of any theoretical explanations for the faithlessness of agents. Nevertheless, the explanations we were given for why a troublesome clause was allowed to remain in subsequent contracts were both diverse and conflicting. Moreover, we determined from our research that these explanations often rested on myths that were based on quite unsupportable factual premises.

Over time, a messy but more consistent hypothesis began to emerge: There are a number of overlapping sources of agency conflicts in contemporary big firm law practice—at least law practice of the sort represented by the firms that draft these contracts and thus have had to grapple with the *pari passu* issue. The myths that we were told are best understood as ways in which the lawyers were able to deflect what would otherwise be obvious failures to correct errors in the formulation of historic boilerplate. "Three and a half minutes" is one explanation that was candidly offered to us by a lawyer who sought to explain the trade-off between the time it took to "draft a new contract" and the effort costs of redesigning boilerplate that was widely used and had been part of the standard-form contract for many years. But "three and a half minutes" is also a metaphor for a business model that relies on herd behavior, fails to provide incentives for innovation and thus rises and falls on volume-based, cookie-cutter transactions. To be sure, we found that in a few instances individual lawyers, who appreciated the litigation risk, did adapt by redesigning sovereign debt contracts (often by adding new terms rather than correcting perceived errors in existing terms). But our evidence suggests that in the great majority of firms, lawyers rely on the herd and on their myths: The returns to the firm in terms of volume transactions outweigh the present value of the risk.[3] This is despite the fact that a social planner seeking to maximize the joint interests of lawyers and their clients would likely choose a different business model. In short, we conclude that social welfare is less than it would be under a different regime, even though the private benefits of volume transactions over careful design may explain the firm behavior that we see.

The book divides informally into three parts. In the first seven chapters, we focus on the question with which we began: the puzzle over the legal market's failure to respond to a litigation event by clarifying the ambiguous provision that was the source of the litigation. Chapter 1 describes the litigation that began the story: Elliott Associates, a vulture fund, attached payments from the government of Peru intended for those bondholders who had agreed to a restructuring of their debt, arguing that the *pari passu* clause entitled them to a pro rata share of the payments. In chapter 2, we lay the groundwork for what follows by describing the archetypical sovereign bond transaction: We focus specifically on the purpose and meaning of the standard-form contract terms at issue in the *Elliott* litigation and the respective roles of the sovereign (who issues the bonds) and the underwriter (who markets the bonds) in the drafting of those contract terms. Chapter 3 sets out the various theories from the academic literature that might explain why the *pari passu* clause would remain unchanged following the *Elliott* litigation. Chapters 4 and 5 describe the nature and extent of the litigation risk generated by the *Elliott* litigation and set out the basics of the qualitative and quantitative datasets that we use to analyze the aftermath of the case. We then turn in Chapters 6 and 7 to the explanations offered by our respondents for why the clause was not revised. In these chapters, our emphasis is on the qualitative—on how our respondents explained the failure to revise a contract term that virtually no one seemed to understand. We juxtapose their explanations with the theoretical explanations for the "stickiness" of standard-form terms in commercial contracts and with the data on the contracts themselves, including the evidence of price effects owing to differences in litigation risk in particular bond issues.

Our respondents resisted our framing of the problem as a search for explanations for the stickiness of contractual boilerplate. In response to our questions, they frequently attempted to reframe the discussion by answering questions that we were not asking. They appeared to be suggesting that we were asking the wrong question. The right inquiry (the "quest," to quote one of them) was to unearth the historical origins of the offending provision. Once we discovered the true origins of the clause, all would become clear. We took the bait. Chapters 8 and 9 report both on the stories of historical origins of *pari passu* that respondents told us and on our attempt to find those historical origins using what we believe is the largest existing academic database of sovereign debt contracts. We think we managed to come close to determining where the clause originated. Quite possibly, the clause originated in a bond issued by the Republic of Bolivia in 1870, which was issued to finance the attempt of an American adventurer, Colonel George E. Church, to connect Bolivia to the Atlantic Ocean. Colonel Church's expedition failed (among other things, as one commentator reported, he ran into "savage Indians, some of them even cannibals," along the way[4]).

If we had expected to be celebrated when we returned with our tales of Colonel Church and the origins of *pari passu,* we were to be disappointed (admittedly, the story of Colonel Church notwithstanding, we had found ourselves no closer to discerning the original meaning of the clause). Our respondents exhibited a singular lack of interest in learning about the origins of the clause, despite their prior insistence that this was where the answers lay.

In Chapter 10, therefore, we turn to an analysis and interpretation of what we have learned. We conclude that the evidence supports the hypothesis that the financial pressure on big firms to maintain a high volume of transactions contributes to an array of conflicts that are largely hidden from the individual lawyers charged with drafting responsibility—conflicts that are hidden in part by the myths that the members of this legal community collectively tell themselves. Chapter 11 provides an epilogue to the story: The *pari passu* drama has begun a second act in 2011 with the sovereign debt crisis in the eurozone and in litigation against Argentina in federal court in New York, where a district court judge gave Elliott Associates a second victory ten years after their first one.

* * *

Our two perspectives, relative to the events we describe and the people we interviewed, are significantly different. One of us specializes in the area of sovereign debt finance, does both academic and policy work in the area, worked as an expert on one of the early iterations of the *pari passu* litigation and has worked closely with some of the characters in this book. The other is a specialist in contracts and commercial transactions and has spent much of the recent past focusing on contract design and the role of transactional lawyers in drafting complex contracts. Before this project, he had little prior experience with the world of sovereign debt finance, let alone its lawyers. We would like to think that the combination of our two different perspectives and biases has helped make this a better book.

CHAPTER ONE

A Story of Sticky Boilerplate Begins in Brussels

You have to understand the system. No one pays that much attention to the minute details like this. One cannot afford to, if one wants to stay competitive. The firm has a computer program. You know . . . one that a junior associate can go to and plug the relevant parameters into—you know, type of issuance, type of issuer, which side we are representing, etc.,—and the computer generates a standard contract. The firm spent [a large amount] on putting together this system. Associates can now produce a contract for one of these deals in *three and a half minutes*. This is the future of contracting in these markets.[1]

* * *

Had it been your fate to practice law sometime during the relatively uneventful period that elapsed between the end of the Peloponnesian Wars and the first O.J. trial, you would view contract drafting very differently. Every word of every contract you prepared would have called for physical labor on the part of both the author and the typist: hands clutching pens, fingers hitting keys, eyes proofreading text. Not anymore. You have joined the legal profession at a time when the sentence "I drafted the Agreement" is universally understood to mean "I sucked 99.7% of the Agreement off some electronic blob on a word processor." . . .

The munificence of these machines is therefore a mixed blessing. On the positive side, they help ensure uniformity throughout the Firm in the drafting of boilerplate provisions, they are the medium through which some carefully considered judgments about contract wording are communicated to succeeding generations of lawyers in the Firm, and they often allow us to meet a cli-

> ent's expectations about delivery schedules and cost. On the darker side, the ready availability of prefabricated contracts means that new lawyers have less of an opportunity to practice the craft of contract drafting. Far too much of the revealed text is preserved in each new incarnation of the document, mostly because an inexperienced drafter will not be sure why it is there or whether taking it out would help or hurt the document.[2]

Long before the days of computers, lawyers were justifying their fondness for standardized contract terms—the paradigmatic "boilerplate" found in virtually all commercial contracts (even those that are carefully negotiated). Paul Cravath, of the Cravath firm, in a speech given in 1916, exhorted his listeners to place their implicit confidence in models and precedents.

> The provisions of the modern reorganization agreement and the modern corporate mortgage are the result of the experience and prophetic vision of a great many able lawyers.... It would indeed be a courageous man who would say that any of the provisions which some of these lawyers have conceived to be wise should be rejected simply because he cannot for the moment think when or how it will become useful."[3]

But we suspect that if Mr. Cravath had been asked how lawyers at his firm should respond to a court decision interpreting a contract provision in a manner different from the intent of its drafters, he would have said that it was unacceptable not to immediately clarify the offending provision. In sophisticated markets, theory tells us that the response from the Cravaths of the world to a court decision misinterpreting the meaning of a widely used standard contract provision should be rapid, if not immediate. Some cases, to be sure, promote legitimate debate about whether the newly minted judicial interpretation is erroneous. In such cases, new formulations may evolve more slowly as parties grapple with the language that best represents the shared understanding of the risks the clause allocates. But sometimes the meaning of a standard, widely used clause is universally accepted in the relevant community. Here an interpretation that differs from that common wisdom is sure to receive quick attention. Subsequently drafted contracts should amend or clarify the meaning of the clause to avoid the risk that the court's erroneous interpretation will apply in the future.

Reality is different, particularly when it comes to contracts with boilerplate clauses.[4] Boilerplate clauses—standardized clauses that have been used by rote over long periods of time—often remain unchanged, even when a court decision has created uncertainty regarding the clauses' meaning. In short, boilerplate clauses are sticky: They seem resistant to amendment even when amendment seems desirable. Multiple theories for contract stickiness have been advanced.[5] But the academic understanding of the stickiness phenomenon sits at the point of post hoc rationalizations—understandable in light of the difficulty of empirically testing for the factors that produce resistance to change. Testing for the factors that might induce a revision in boilerplate language is straightforward; one looks to theory for factors that might cause change and then examines the data to see which of the possible causal factors moved in line with the change.[6] But with factors that impede revision, it is less clear how one might empirically test the theoretical conjectures; nothing changes, meaning there are no correlations to observe.[7]

We attempt to shed light on the question of sticky boilerplate using what will undoubtedly strike some readers as a naïve technique.[8] We went into the field and asked the lawyers drafting these contracts why they had not altered the standard language in light of what they universally claimed was an aberrant interpretation of its meaning. These were sophisticated market actors, many of whom had clear views about why they behaved in certain ways. Our aim was not only to gain traction on the reasons why boilerplate was resistant to revision, but also to obtain insight into the world of elite law firm practice. The production (and maintenance) of boilerplate contracts is, in many respects, the lifeblood of transactional practice in today's law firms. To the extent we are able to understand the assembly-line process that produces these contracts, we can better appreciate both the strengths and the deficiencies of the business model employed by the modern big law firm.

To put our findings in context, we put the views of the respondents together with both the regnant theories accounting for sticky boilerplate and a quantitative analysis of the contracts themselves. Viewing the stories told by the respondents against the backdrop of theory and the available empirical evidence provides a test of a consistency hypothesis: If the stories are neither consistent with theory or the evidence, then what explains what we have been told? Alternatively, if the stories are consistent with the theory but not the evidence, what explains the myths that lawyers tell themselves? We hope this approach reveals a richer picture both of the stickiness phenomenon and the nature of modern law practice.

The form of narrative in this book follows the preceding structure in that explanations from the respondents are juxtaposed against the theories that purport to explain the same phenomenon. The quantitative data