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Sticky Forms, Property Rights, and the Law

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I. INTRODUCTION

Mitu Gulati and Robert E. Scott have written a fascinating study that touches on some of the most important issues in lawyering and law.[1] A Belgian court rendered a judgment that highlights a significant risk in a common sovereign bond provision.[2] Specifically, the court interpreted a contract requiring the Republic of Peru to pay its creditors *pari passu*[3] to say what it seemed to say—that Peru had to treat its creditors equally.[4] The court accordingly enjoined a clearing house from allocating to creditors funds it received from the Peruvian government pursuant to a restructuring agreement without proportionally paying the plaintiff, a hedge fund which had declined to join the agreement.[5]

Since these are high-value deals negotiated by prestigious and expensive lawyers, one might expect sovereign bond contracts to have swiftly changed to mitigate the risk. But this did not happen. Gulati and Scott seek to explain this puzzle by interviewing hundreds of lawyers with knowledge of the relevant contracts and distilling their responses. They make the mass of raw material cogent by viewing it through the lens of legal and economic theory.

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* Mildred van Voorhis Jones Chair, University of Illinois College of Law. Thanks to Mitu Gulati, Bruce Kobayashi, and Mark Weidemaier for their helpful comments. Professor Larry Ribstein passed away while this piece was in the final editorial stages. All through the process, Professor Ribstein had been a genuine pleasure to work with, always generous and encouraging to the *Hofstra Law Review* Board of Editors. It is a great honor for the *Hofstra Law Review* to publish one of the final pieces by Professor Ribstein, not only one of the most prolific legal scholars in the academy, but one of the most beloved.

1. *See generally* MITU GULATI & ROBERT E. SCOTT, THE THREE AND A HALF MINUTE TRANSACTION: BOILERPLATE AND THE LIMITS OF CONTRACT DESIGN (forthcoming 2012) (on file with the Hofstra Law Review).

2. Elliott Assocs., L.P., General Docket No. 2000/QR/92, ¶¶ 6, 8 (Court of Appeal of Brussels, 8th Chamber, Sept. 26, 2000) (unofficial translation on file with the Hofstra Law Review).

3. GULATI & SCOTT, *supra* note 1 (manuscript at 21).

4. *Elliott Assocs.*, ¶ 6.

5. *Id.* ¶ 8.

The authors find the answer to the puzzle in the fact that law firms preferred to use little understood mass-produced contracts they could pull off the shelf in "three and a half minutes" (hence the title of the book).[6] They conclude that "[t]he lawyers producing these contracts seem, for the most part, to follow the herd. There is safety . . . in following what everyone else does, regardless of whether it makes sense. Maybe there isn't enough time to figure out whether it makes sense or not."[7]

Gulati and Scott attribute this phenomenon to "the organizational structure of law firms, including hourly billing and compensation, the secondary role given to [research and development], and the manner in which legal services are marketed."[8] They propose addressing these issues through:

> [G]overnance mechanisms that facilitate and support innovation. New forms of governance that overcome the obstacles to innovative contract design can preserve a meaningful role for the modern law firm and the legal profession in the full range of corporate and commercial transactions including, but certainly not limited to, the field of sovereign debt.[9]

My approach to the problem is similarly institutional but differs in focus. I suggest that the problem lies deeper than the modern law firm—in the structure of what lawyers do and in the weak intellectual property rights available to creators of law. Part II defines the problem, while Part III examines the institutional factors that impede a solution.

II. DEFINING THE PROBLEM

This Part analyzes three potential views of the "three and a half minute" problem: there was no problem after all because the *pari passu* clause was what the parties wanted; there was a problem but it was not worth trying to fix it; or there was a problem that was worth fixing but existing institutions were not up to the task. I conclude that the third view best fits Gulati and Scott's evidence. Part III discusses the institutional reforms necessary to fix the problem.

6. GULATI & SCOTT, *supra* note 1 (manuscript at 12).
7. *Id.* (manuscript at 193).
8. *Id.* (manuscript at 181).
9. *Id.* (manuscript at 182).

A. *The Clause Was What the Parties Wanted All Along*

Gulati and Scott suggest that, while the troublesome *pari passu* clause may have been appropriate in a corporate bond to deal with liquidation and distribution of a limited fund, it makes no sense in a sovereign bond because sovereigns cannot be liquidated.[10] This suggests an easy fix: eliminate the provision.

There are, however, several reasons why these provisions may be useful outside of bankruptcy, and therefore why simply deleting the provision might not work. First, the authors cite historical evidence suggesting that creditors were concerned about the risk of "earmarking" funds.[11] Second, the authors discuss cases which seem to involve risks of the sort a *pari passu* clause could deal with in sovereign bonds and therefore suggest the clause had a purpose in this context, particularly protecting creditors from being coerced into a below-value settlement.[12] Lucian Bebchuk recognized this coercion problem in corporate takeover cases not involving bankruptcy.[13] William Bratton has specifically noted the coordination problem addressed by *pari passu* and other sovereign bond clauses.[14] Third, a *pari passu* clause arguably enables the issuing country to commit not to fail given the high cost of failure from empowering holdouts.[15] Indeed, Gulati and others show elsewhere that sovereign bonds containing the type of *pari passu* clause that fit the interpretation Elliott Associates, L.P. ("Elliott") was arguing traded at a higher price than bonds that had a more ambiguous clause.[16]

Yet Gulati and Scott argue that what really matters is "that the vast majority of the respondents we interviewed *believed* that the clause made little or no sense in the sovereign context."[17] But perhaps we should not take the lawyers' protestations at face value. They may have had strategic reasons for discounting the importance of the protection the *pari passu* clause provides if their clients were trying to promote non-

10. *See id.* (manuscript at 34-35).

11. *Id.* (manuscript at 125-26, 141-42) (internal quotation marks omitted).

12. *Id.* (manuscript at 148-49).

13. *See generally* Lucian Arye Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1693 (1985) (discussing the unequal distribution of a takeover's total acquisition price among the target's shareholders).

14. William W. Bratton, Pari Passu *and a Distressed Sovereign's Rational Choices*, 53 EMORY L.J. 823, 828-32 (2004).

15. *See* GULATI & SCOTT, *supra* note 1 (manuscript at 31-32).

16. Michael Bradley et al., *The Market Reaction to Legal Shocks and Their Antidotes: Lessons from the Sovereign Debt Market*, 39 J. LEGAL STUD. 289, 312-13 (2010).

17. GULATI & SCOTT, *supra* note 1 (manuscript at 21).

pari passu settlements.[18] So whatever the lawyers say, it is worth keeping in mind the possibility that the clause did not change because bondholders wanted to keep it.

B. *The Clause Was Not What the Parties Wanted But Is Now Hard to Change*

Even if the *pari passu* clause may have been what the parties initially wanted, their reaction to the Belgian judgment indicates they no longer wanted it. Even if, for example, the parties want a *pari passu* clause at the time of issuance for protection from unequal treatment or as an issuer commitment not to fail, they also want to be able to restructure bonds in times of trouble. This would support the Belgian court's result but still raises the question of why the parties did not change the contracts by eliminating the clause.

One reason for not changing a contract clause that has stopped making sense is that the costs of change outweigh the benefits. Given the above arguments for the clause, the fix is more complicated than just deleting it. The parties may want some kind of *pari passu* clause but not necessarily the one involved in the Peruvian bond. In other words, the clause is more than an infection of an appendix, as one of the interviewed attorneys suggested.[19] Also, substituting a new clause could force the parties to incur significant learning costs,[20] disrupt the market "network" that facilitates trading of bonds based on the bonds' similarity at any given time[21] or across time,[22] arouse creditors' suspicion about the debtor's intentions,[23] affect the courts' interpretation of the bond provision,[24] disrupt firm routines for producing contracts,[25] intensify cognitive heuristics that resist change,[26] or increase the risk of unknown consequences of change.[27]

Many of these explanations for stickiness are, however, suspect. First, issuers did change the clauses over time and offered different types of clauses.[28] Why would they make the change without solving the clause's basic problem of potentially hindering restructuring? Second, if

18. *See infra* text accompanying note 59 (discussing one such reason).
19. GULATI & SCOTT, *supra* note 1 (manuscript at 54).
20. *Id.* (manuscript at 43).
21. *Id.* (manuscript at 43-44).
22. *See id.* (manuscript at 86-87).
23. *Id.* (manuscript at 44-45).
24. *Id.* (manuscript at 97).
25. *Id.* (manuscript at 47).
26. *Id.* (manuscript at 49-51).
27. *Id.* (manuscript at 51).
28. *Id.* (manuscript at 80 tbl.1, 94-95, 158).

there were significant benefits to changing the clauses, why couldn't the parties in this relatively small and sophisticated market have clarified their intentions and eliminated the information problems that cause misleading signals? A few law firms dominate the market and therefore seemingly could eventually recover the costs of overcoming learning and network problems and produce information concerning the effect of changes that would reduce the market's perception of risk. Also, the behavioral theories noted above do not clearly cut against change. For example, the "availability" bias[29] arguably predicts an investor overreaction to the highly publicized Belgian decision that could offset any biases against change.

Pari passu's stickiness is even harder to explain in light of other situations in which bond provisions changed in response to changing circumstances. For example, Marcel Kahan and Michael Klausner chronicle the sudden appearance and disappearance of event-risk covenants in the late 1980s, led by underwriters, in response to a court decision refusing to protect creditors who had no such covenant.[30] Why the change in corporate bonds but not sovereign bonds?

There might be something about sovereign bonds that makes them stickier than corporate bonds. But there is also evidence that sovereign bonds change appropriately in reaction to market conditions. For example, Mark Weidemaier and Gulati show that sovereign bonds evolved quickly in 2003 to include modification clauses even as lawyers claimed that they were simply copying existing provisions.[31] Unlike the tweaks Gulati and Scott report regarding *pari passu* clauses, the modification clauses did fix the problem. However, this example's power is limited by the fact that this change arguably occurred only because the U.S. government actively promoted it.[32]

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29. *See* AMOS TVERSKY & DANIEL KAHNEMAN, *Judgment Under Uncertainty: Heuristics and Biases*, *in* JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES 11 (Daniel Kahneman et al. eds., 1982) (discussing the judgmental heuristic of "availability" which leads people to "assess the . . . probability of an event by the ease with which instances or occurrences can be brought to mind").

30. *See* Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1505, 1519 (S.D.N.Y. 1989) (holding that RJR Nabisco, Inc.'s leveraged buyout of the company's shareholders did not violate any implied restrictive covenant); Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, 83 VA. L. REV. 713, 740-41 (1997) (discussing the development of event-risk covenants).

31. *See* W. Mark C. Weidemaier & Mitu Gulati, *How Markets Work: The Lawyer's Version* 6, 11, 20-21 (Univ. N.C. Legal Studies, Research Paper No. 1886435, 2011), *available at* http://ssrn.com/abstract=1886435.

32. *See* Anna Gelpern & Mitu Gulati, *Public Symbol in Private Contract: A Case Study*, 84 WASH. U. L. REV. 1627, 1643 (2006).

Another change in sovereign bonds is not so easily dismissed: the rapid addition in the 1970s of dispute resolution clauses to sovereign bond contracts after enactment of sovereign immunity statutes that clarified the effect of contractual sovereign immunity waivers.[33] This illustrates that private parties can change sovereign bonds even without government pressure. Why, then, are some provisions, such as *pari passu*, sticky?

C. *There Is a Need for Change But Lawyers Will Not Do It*

Perhaps issuers did not change *pari passu* clauses despite their inadequacy because lawyers were not faithful agents for their creditor and sovereign clients. More precisely, lawyers know more than clients about the problem but have too little incentive to spend the time to fix it.[34]

There are, however, problems with this explanation as with the others discussed above. As Gulati and Scott note, this would be a failure not just by a single lawyer or firm, but by all the lawyers advising the sovereign bond market.[35] It is therefore unlikely that individual lawyers simply wanted, for example, to protect themselves from blame for drafting the original clauses. Moreover, as discussed immediately above, lawyers did appropriately change other sovereign bond clauses. Why would lawyers be faithless in the *pari passu* situation but not in the other cases?

Recognizing these problems with the faithless agent story, Gulati and Scott turn to "institutional constraints imposed on the transactional lawyer by the contemporary 'big law' business model."[36] They suggest that the problem may lie in law firm structure which erects "significant barriers to innovative contract design."[37] Specifically, increasing partner-to-associate ratios of "big law" firms force them to rely increasingly on standard forms,[38] which high-profit associates can cheaply store and pull off the shelf.[39] This structure leaves no one able to make the needed changes in the standard forms. Gulati and Scott propose solving this problem by restructuring law firms to change their incentives.[40]

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33. *See* W. Mark C. Weidemaier, Contract Change and the Evolution of Sovereign Immunity 1, 10 (unpublished manuscript) (on file with the Hofstra Law Review).

34. *See* GULATI & SCOTT, *supra* note 1 (manuscript at 159-60).

35. *Id.* (manuscript at 122, 156-57).

36. *Id.* (manuscript at 121).

37. *Id.* (manuscript at 156).

38. *See id.* (manuscript at 101-03).

39. *Id.* (manuscript at 162-63, 165).

40. *Id.* (manuscript at 181-82).

This argument resonates with my work suggesting that large law firms have overleveraged their reputational capital into bottom-heavy pyramidal structures that leave little time or incentive for associate monitoring, mentoring, and screening necessary to maintain firms' reputations.[41] This seems at first glance to plausibly explain why large law firms would prefer the "three and a half minute" approach to taking the time to get the contracts right.

A problem with this explanation is that, regardless of how law firms are structured, neither lawyers nor their firms have an incentive to put more than "three and a half minutes" of labor into the contracts. Who would pay for hours of work by senior partner "oracles" to solve the *pari passu* problem, even if these lawyers wanted to invest the time? Gulati and Scott suggest that the cost pressure actually comes from clients who want to economize on attorneys' fees, particularly in the sovereign bond world where time horizons are short and the borrowers are looking for benchmark rates rather than capital.[42]

The law firm structure explanation for contract stickiness also does not explain why "big law" firms *did* swiftly adopt event-risk covenants in corporate bonds and dispute resolution clauses in sovereign bonds. Perhaps there were few enough underwriters' lawyers that they could internalize the benefits of event-risk covenants. But two law firms—Cleary Gottlieb Steen & Hamilton LLP ("Cleary") and Sullivan & Cromwell LLP—each had approximately forty percent of the issuer and underwriter representations in the sovereign bond market.[43] Even if this level of market concentration was inadequate to enable lawyers to solve the "three and a half minute" problem, the problem may run deeper than the death of "big law."

III. TOWARD A PROPERTY RIGHTS EXPLANATION

Although Gulati and Scott see the "three and a half minute" problem inhering in law firm structure, the explanation more likely lies in *any* lawyer's ability to capture the value of innovation in bond covenants. Indeed, Gulati and Scott themselves point to this explanation in noting that law firms do not produce research and development that could benefit contracting parties other than just the individual client paying for a particular contract.[44] They observe that lawyers "evinced

41. *See generally* Larry E. Ribstein, *The Death of Big Law*, 2010 WIS. L. REV. 749.

42. *See* GULATI & SCOTT, *supra* note 1 (manuscript at 162-63, 177-78).

43. *See id.* (manuscript at 69, 71, 72 fig.2, 73 fig.3) (tabulating the concentration of lawyers in the sovereign bond market).

44. *See id.* (manuscript at 164).

little interest in claiming any property rights in . . . innovations."[45] This may be because they had no property rights in contract innovation to claim.

In order to understand the problem of lack of property rights, it is necessary to understand the type of intellectual property that lawyers would have to create in order to solve the *pari passu* problem. Given Part II's analysis of the potential benefit of the clause, the fix was more complicated than just deleting the clause. Yet, retaining the clause is not necessarily an answer either because equal creditor rights prevent efficient restructuring in bad times. The parties might make squeeze-out more difficult without the high costs of equal treatment by providing for high vote or appraisal rights, as in the corporate context. But it is not clear which rights work best for specific contexts or when the rights should be triggered. Moreover, milder ex post rights dilute *pari passu*'s ex ante commitment effect. Developing efficient contracts and standard forms requires experimentation and investments of time and effort.

Gulati and Scott's examples of situations in which lawyers have partially overcome impediments to investing in creative solutions rather than simply grabbing standard forms off the shelf[46] suggest the role of property rights in innovation. The examples show that lawyers such as Cleary's Lee Buchheit[47] and Elliott's Jay Newman[48] have become leading figures developing creative approaches to sovereign bonds because they work outside traditional law firm channels. Although Buchheit works in a large law firm, he lacks "an institutional base."[49] Newman works for the hedge fund whose challenge led to the Belgian judgment.[50] Buchheit bundles his creativity with general expertise and client contacts while Newman is able to use the capital markets to leverage his expertise.

Buchheit and Newman's ability to capitalize on their investments in information and knowledge about sovereign bonds is, however, limited. Although Buchheit might develop a suitable contract and copyright and sell it for use in bond deals, the contract would lack certainty until a court interpreted and enforced it. As Gulati and Scott note, the Belgian judgment lacked the clarity and credibility of, say, a U.S. Second Circuit

45. *Id.* (manuscript at 107).
46. *Id.* (manuscript at 169-71, 175).
47. *Id.* (manuscript at 168).
48. *Id.* (manuscript at 174).
49. *Id.* (manuscript at 172).
50. *Id.* (manuscript at 20).

Court of Appeals decision.[51] Gulati and Scott observe that the "legal system retains ultimate power over interpretation and enforcement."[52]

Moreover, overcoming the certainty problem complicates the property rights problem. Once the court interprets and enforces the contract, the author loses his property rights in it under current U.S. law.[53] Thus, as soon as the author has something of real value to sell, he loses his ability to capitalize on that value. This rule adversely affects incentives to produce materials that might become part of the law. The discount perversely would increase with the possibility the law might someday make the materials more valuable.

A property rights perspective helps explain why "big law" could change event-risk and dispute resolution but not *pari passu* clauses. Bond clauses changed swiftly when change was relatively easy. The market clearly wanted event-risk clauses after the leveraged buyout threat to bonds become clear, dispute resolution clauses after statutes clarified their effect, and the nature of the appropriate changes was clear. But it was less clear what the parties wanted after the Belgian decision in *Elliott Associates, L.P.*[54] Because the market continued to favor the plaintiff's version of *pari passu* clauses even after that decision demonstrated its potential costs, simply deleting the provision or replacing it with another version would not have been a clear improvement. Although the market might have preferred something other than a *pari passu* clause that would have similar ex ante effects, but less disastrous effects ex post,[55] it was unclear exactly what this term should be.

These problems with changing the *pari passu* clause seem to return to Gulati and Scott's network and heuristics explanations for stickiness.[56] However, the property rights story provides a way to distinguish other

51. *Id.* (manuscript at 110). The Second Circuit did hold that Elliott could enforce its right under the bonds, rejecting the issuer's champerty defense. Elliott Assocs., L.P. v. Banco de la Nacion, 194 F.3d 363, 372, 381 (2d Cir. 1999). However, this case left open the issue of how the bonds would be enforced against Peru. *See* Bradley et al., *supra* note 16, at 292.

52. *See* GULATI & SCOTT, *supra* note 1 (manuscript at 110).

53. This rule was established in two cases dealing with the effect of embodying privately drafted codes into laws. *See* Veeck v. S. Bldg. Code Cong. Int'l, 293 F.3d 791, 793-95 (5th Cir. 2002) (en banc); Bldg. Officials & Code Admin. v. Code Tech., Inc., 628 F.2d 730, 731, 734-35 (1st Cir. 1980). For an analysis of these cases, see generally Bruce H. Kobayashi & Larry E. Ribstein, *Law as a ByProduct: Theories of Private Law Production* (Ill. Law, Behavior & Soc. Sci. Research Paper Series, Research Paper No. LBSS11-27, 2011), *available at* http://ssrn.com/abstract=1884985.

54. Elliott Assocs., L.P., General Docket No. 2000/QR/92 (Court of Appeal of Brussels, 8th Chamber, Sept. 26, 2000) (unofficial translation on file with the Hofstra Law Review).

55. *See* Bratton, *supra* note 14, at 865.

56. *See supra* text accompanying notes 19-26.

changes in bond provisions where the parties could overcome these problems. The *pari passu* clause raised problems not only of effectuating a change in bond contracts, but also of determining what change should be made. Property rights were necessary to give parties adequate incentives to engage in the extensive deliberation and experimentation necessary to come up with the appropriate language.[57]

One more property rights problem remains: how to preserve property rights after a court interpretation. Such an interpretation was necessary even for the relatively easy fixes. Although parties could craft event-risk, modification, and dispute resolution clauses, and overcome other impediments to making these changes, they could not be sure how such changes would affect courts' interpretations of pre-existing bonds. Weidemaier and Gulati hypothesize that lawyers came up with the makeshift solution of telling "stories of standardization . . . [that] deflect attention from the fact that they do make frequent, albeit modest, changes to contract templates," and thereby help "assure that market participants will not react unfavorably" to the change.[58] But no mere story could clarify how a *pari passu* clause could provide both ex ante protection and commitment and ex post flexibility for restructuring. Only a new provision coupled with definitive court interpretations of the new language and its effect on existing provisions could provide the clarity the market demands. Yet, as discussed above, embedding the contract in a legal rule, while increasing its value, would threaten its author's property rights. This illustrates the conundrum the existing law creates for property rights in legal documents.

All of this is not to say that law firm structure is irrelevant to Gulati and Scott's stickiness hypothesis. Rather, the property rights story underlies both lawyers' inadequate incentives to create new contracts and the death of "big law." "Big law" firms' lack of strong property rights helps explain why they had trouble binding their lawyers. This, in turn, accounts for big firms' degeneration as they sought to attract new lateral hires with increasing associate leveraging.[59] In other words, bond provisions are sticky for the same reason that large firms are not. Stronger property rights could help fix law firm structure and motivate better contracts. So while the death of "big law" helps explain bond stickiness, simply looking to law firm structure without delving deeper into property rights may not solve the problem Gulati and Scott address.

57. *See* Kobayashi & Ribstein, *supra* note 53 (manuscript at 18).

58. *See* Weidemaier & Gulati, *supra* note 31, at 29.

59. *See* Ribstein, *supra* note 41, at 774-75.

IV. CONCLUSION

The problem of sticky bond provisions that Gulati and Scott identify inheres in both the nature of law and the structure of property rights for its creation. The *pari passu* problem requires not only drafting creativity, but also legal certainty. Gulati and Scott show that lawyers' creativity is stifled by their firms' desire to commoditize drafting so they can delegate it to associates.[60] But it is necessary to delve deeper to determine why law firms are structured to inadequately serve their clients. The basic reason is that solving problems with complex bonds may require greater investments than individual lawyers or law firms, however structured, were willing to provide in the absence of stronger property rights. Moreover, the solutions demand not only greater investments of time and energy, but also legal certainty. Yet legal certainty collides with creation incentives because judicial interpretation may negate property rights in the interpreted contracts. It follows that part of the solution to the problem of sticky contracts may lie in giving the creation of law intellectual property protection comparable to that for other innovations.

60. *See supra* text accompanying notes 33-39.

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