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Boilerplate, Contract Interpretation and *Pari Passu*

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Commercial contracts come in two forms: durable and transient. By durable contracts I mean those involving parties that expect to remain bound by the agreement during some or all of its life. By transient contracts I mean agreements that are formatted in the expectation that one of the parties will promptly transfer the entirety of its interest in the agreement to one or more third parties. Debt instruments like bonds are transient contracts. They are initially negotiated between the issuer and a financial institution acting as an underwriter or placement agent. Immediately after issuance, however, the bonds are sold to holders who are distant -- increasingly so as the bonds trade multiple times in the market -- from the original negotiation of the terms of the instrument. At any given point in time, however, a transient contract will constitute a binding agreement between the issuer and the then-current holders of the instrument.

When called upon to interpret the meaning of a disputed provision in a durable contract a court can reasonably ask "what did the parties intend when they signed the agreement?". In a durable contract the parties expect to remain parties for at least a portion of the life of the agreement. They can therefore be presumed to have negotiated the contract in line with their commercial and legal objectives. The parties' intention at the time a durable contract was signed is therefore what counts.

The remote holders of a transient contract can never be said to have had an "intention" with respect to the meaning of the contract, for the very good reason that the identity of the remote holders was not even a twinkle in the eye of anyone present at the creation of the contract. Moreover, even the underwriter or placement agent will not have approached the negotiation of a transient contract with the goal of reflecting *its* commercial or legal objectives in the agreement. Why? Because the underwriter never expected to be a party to the agreement for any more than a few hours before selling it to investors. The underwriter will have seen its job in those negotiations as ensuring that the market's expectations are reflected in the terms of the instrument.[1] By the "market" the underwriter will mean the body of investors that may ultimately come to own the instrument during its life. The interpretation of a standard provision in a transient contract thus requires an inquiry

[1] The underwriter will also know that any material departure from the market's expectations with respect to the drafting of a boilerplate clause in a transient contract will need to be highlighted in the disclosure document for the issue. Above all else, underwriters fear that prospective investors will exact a basis point penalty for an idiosyncratic drafting of a boilerplate provision.

into what the market understood the import of the clause to be at the time the contract was signed.

The bonds at issue in the *NML* case were transient contracts. When a question was raised, years after the bonds were issued, about the meaning of a standard provision in those instruments (the *pari passu* clause), the views of the then-current holders of the bonds -- the plaintiffs in the *NML* case – about the meaning of that clause were entirely irrelevant. The only possible entities whose intentions might have been relevant were the issuer, Argentina, and the underwriters. For the reasons discussed above, however, the underwriters would have approached the drafting of the terms and conditions of the bonds not with a view to ensuring that their own preferences were reflected in the instrument (because the underwriters never expected to be a durable party to the instrument), but rather with a view to ensuring that the *market's* expectations about the operation of these provisions were satisfied. It therefore follows that in interpreting the *pari passu* provision in the terms and conditions of Argentina's bonds, the courts should have looked to the market's understanding and expectations -- circa 1994, the year in which Argentina's Fiscal Agency Agreement was signed -- regarding the meaning of that provision.

The Market's Understanding

The federal courts in the *NML* case appeared to misprize the market's understanding of the meaning of a *pari passu* clause in favor of the interpretation being urged upon them by the plaintiffs (to the effect that the clause promised ratable payment of all equally-ranking debt). The industry understanding was that the clause promised only that the issuer would maintain the legal ranking of its bonds. This could be inferred from, among other things, (i) an *amicus* brief filed by the New York Clearing House (representing the largest financial institutions in New York) saying that the market did *not* understanding a *pari passu* clause in a sovereign debt instrument to require ratable payment of all equally-ranking debt[2], (ii) a history of sovereign debt restructurings over the prior 40 years that invariably involved sovereign debtors making non-ratable payments of equally-ranking debt despite ubiquitous *pari passu* clauses in their debt instruments[3] and (iii) juristic opinion over those 40 years that uniformly endorsed the equal ranking interpretation of the clause (with many commentators also expressly rejecting the ratable payment interpretation).[4] Any doubt about the market's understanding of the clause was removed when market participants subsequently revised the wording of the *pari*

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[2] Memorandum of Amicus Curiae the New York Clearing House Association L.L.C. in Support of Motion Pursuant to CPLR § 5240 to Preclude Plaintiff Judgment Creditors from Interfering with Payments to Other Creditors, Macrotenic Int'l Corp. v. Republic of Argentina and EM Ltd. v. Republic of Argentina (S.D.N.Y. Jan 12, 2004) (No. 02 CV 5932 (TPG), No. 03 CV 2507 (TPG).

[3] *See* L. C. Buchheit and J. S. Pam, *The Pari Passu Clause in Sovereign Debt Instruments*, 53 EMORY L.J. 869, 883-84 (2004).

[4] *Id.*, at 872, ftnt 3.

passu clause in sovereign debt instruments to disavow the ratable payment interpretation adopted by the District Court and the Court of Appeals in the *NML* case. This is the story so ably described by Professors Choi, Gulati and Scott in their article *The Black Hole Problem in Commercial Boilerplate*.

The Alpha and the Omega

The Beginning. Scholars can rarely identify the precise point at which an aberrant interpretation of a standard contractual provision enters the legal discourse, as well as the precise point at which it exits the picture. Such an assessment is possible, however, with respect to the ratable payment interpretation of the *pari passu* clause in sovereign debt instruments. This interpretation of the clause was first posited in 2000 in a Declaration prepared by Professor Andreas Lowenfeld in litigation captioned *Elliott Associates, L.P. v. Banco de la Nacion*. The Declaration is dated August 31, 2000. In it, Professor Lowenfeld declared:

> I have no difficulty in understanding what the *pari passu* clause means: it means what it says -- a given debt will rank equally with other debt of the borrower, whether that borrower is an individual, a company, or a sovereign state. A borrower from Tom, Dick and Harry can't say "I will pay Tom and Dick in full, and if there is anything left over I'll pay Harry." If *there is* not enough money to go around, the borrower faced with a *pari passu* provision must pay all three of them on the same basis . . . [5]

No authority was cited for this proposition.

Professor Lowenfeld reaffirmed his opinion four years later in yet another Declaration submitted in a case pending before a Belgian court.[6] This time Professor Lowenfeld opined that the ratable payment interpretation was the "plain meaning" of a *pari passu* clause. He writes:

> There can be no doubt about the plain meaning of the clause, whether under the law of New York or of any other jurisdiction. . . . Every obligation subject to the [*pari passu*] Covenant -- i.e. any portion of the debt issued under the Credit Agreement -- is to have at least *equal rank in priority of payment* with all other external indebtedness of the Republic. If at a given time when payments are due -- whether of principal or interest --

5 Declaration of Professor Andreas F. Lowenfeld dated August 31, 2000, at 11-12 (footnote omitted). *Elliot Assocs.*, 2000 WL 1449862 (96 Civ. 7916 (RWS), 96 Civ. 7917 (RWS)).

6 Declaration of Professor Andreas F. Lowenfeld dated January 27, 2004, La Republique du Nicaragua v. LNC Investments LLC and Euroclear Bank S.A.C., Cour d'Appel de Bruxelles, R.K. 240/03.

> the issuer does not have sufficient funds to satisfy all of its obligations, it must allocate the funds equally among the persons entitled to payment in proportion to the amounts then due. By agreeing to rank all the holders of its debt *pari passu* in priority of payment, the issuer of the debt obligates itself not to rank one creditor higher and another lower, i.e., not to pay one creditor while declining to pay another.

The last sentence in the text quoted above unmistakably links the legal ranking of a debt instrument with an obligation to pay it ratably with the other equally-ranking claims.

<u>The End</u>. The mischief caused by the ratable payment interpretation of the *pari passu* clause, both in the Argentine litigation and elsewhere, is described in the literature.[7] The life span of this fallacy, however, appears to be drawing to a close. The same federal District Court that initially granted the injunctions in the *NML* case (requiring Argentina to make ratable payments to its holdout creditors if it wished to continue paying the bonds it issued in connection with the country's debt restructurings in 2005 and 2010) had occasion to clarify its understanding of the *pari passu* clause in a case captioned *White Hawthorne, LLC, et al. v The Republic of Argentina*[8].

In a decision dated December 22, 2016, the District Court held that "[n]onpayment on defaulted debt alone is insufficient to show breach of a *pari passu* clause."[9] What had induced the court to find a breach of the clause in the earlier *NML* decisions, the court explained, was legislation enacted by Argentina in 2005 -- the infamous "Lock Law" -- that forbade the Argentine Government from ever paying or settling with holdout creditors, together with numerous statements by Argentine Government officials to the effect that holdouts were to be consigned to the outer darkness of perpetual payment default. These aggravating factors persuaded the District Court in the *NML* case that Argentina had effectively disturbed the legal ranking of the bonds owned by the holdouts in violation of its *pari passu* undertaking.

Professor Lowenfeld's revelation in 2000 that a *pari passu* clause is breached whenever a borrower pays one lender without ratably paying all the others

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[7] *See*, for example, Mitu Gulati & Robert E. Scott, *THE THREE AND A HALF MINUTE TRANSACTION: BOILERPLATE AND THE LIMITS OF CONTRACTUAL DESIGN* (2013).

[8] The *White Hawthorne* case involved complaints by certain creditors that had declined the Republic of Argentina's offers in early 2016 to settle its defaulted bonds. The plaintiffs sought, among other things, "specific performance" of the *pari passu* clause in the Argentine bonds they held, arguing that Argentina was in continuing violation of that clause. The plaintiffs also sought money damages for this alleged violation of the *pari passu* clause. Argentina moved to dismiss the complaints.

[9] White Hawthorne, LLC et al., v. Republic of Argentina, 2016 WL 7441699 at *3.

was thus rejected in 2016 by the only U.S. federal trial court that had ever given it any credence. Discriminating among one's creditors -- Tom, Dick or Harry -- in making payments does *not* breach a *pari passu* clause. As the *White Hawthorne* decision makes clear, however, in the sovereign context, attempting to legislate a *de facto* subordination of Tom, Dick or Harry may well trigger such a breach.

The *White Hawthorne* decision is consistent with this author's assessment, published 25 years ago,[10] of the meaning of the *pari passu* clause in a sovereign debt instrument:

> If a sovereign borrower intends as a practical matter to discriminate among its creditors in terms of payments, the *pari passu* undertaking will at least prevent the sovereign from attempting to legitimize the discrimination by enacting laws or decrees which purport to bestow a senior status on certain indebtedness or give a legal preference to certain creditors over others.
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> . . .
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> The apparent moral for the sovereign borrower is this: you can do pretty much whatever you want in discriminating among creditors (in terms of who gets paid and who does not), but do not try to justify your behaviour by taking steps that purport to establish a legal basis for the discrimination.[11]

<u>Conclusion</u>

Historians of this affair may eventually conclude that the federal courts in the *NML* litigation only appeared for a time to endorse the fallacious interpretation of the *pari passu* clause promoted by Professor Lowenfeld in his 2000 and 2004 Declarations. As clarified by its decision in the *White Hawthorne* case, the District Court did *not* hold that a *pari passu* undertaking is breached whenever one creditor is paid ahead of another, equally-ranking lender. Rather, the District Court's rulings are consistent with an understanding that the clause prohibits a legislatively-sanctioned subordination of claims, *de facto* or *de jure*. Such an action disturbs the legal ranking of the debts; the very result that the clause, on its face, proscribes.

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10 In an article published three years before the 1994 Argentine Fiscal Agency Agreement containing the *pari passu* language that would eventually be litigated in the *NML* cases 17 years later.

11 L. C. Buchheit, *The pari passu clause sub specie aeternitatis,* 10 INT'L FIN. L. REV. 11, 12 (1991).