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Indiana Jones, contracts originalist

W. Mark C. Weidemaier*

Key points

- The meaning of the *pari passu* clause in sovereign bonds is disputed and uncertain. Modern explanations for the purpose of the clause have significant flaws.
- In ‘Santa Anna and His Black Eagle’, also published in this volume, Ben Chabot and Mitu Gulati suggest what might be termed an ‘originalist’ approach to contract interpretation—that courts adopt the meaning intended by the very first drafters of the clause. They present evidence about the first known use of the *pari passu* clause, in a bond issuance by Mexico in 1843.
- This essay comments on the value of originalism as an approach to contract interpretation. It also canvasses the limited historical record, finding no support for a controversial interpretation recently adopted, by the US Court of Appeals for the Second Circuit, in *NML v Argentina*.

‘X never, ever marks the spot.’

— Indiana Jones, from the movie *Indiana Jones and the Last Crusade*

Contracts are artefacts, and artefacts tell stories.¹ The story of the Black Eagle bond is a good one. A chance discovery of an old contract in a hotel basement yields a tale of political intrigue and gunboat diplomacy and reveals cryptic links between such seemingly unrelated figures as General Antonio López de Santa Anna and JRR Tolkien. Might this story, recounted elsewhere in this volume by Ben Chabot and Mitu Gulati,² reveal something important about modern international finance? The authors imply that it might.

Chabot and Gulati tell the story of the first (known) use of the *pari passu* clause in connection with a sovereign bond issue. Today, virtually all sovereign bonds include a variant of the clause, the most relevant version of which reads something like this: ‘The Notes will rank equally (or *Pari Passu*) in right of payment with all other present and future unsecured and unsubordinated External Indebtedness of the issuer.’ In a corporate liquidation, the clause helps ensure that *pari passu*-ranking creditors receive equal shares of the proceeds. As Chabot and Gulati explain, its meaning is less clear in the sovereign debt context, where no liquidation is possible.

In an important recent case, *NML v Republic of Argentina*, the US Court of Appeals for the Second Circuit interpreted the clause to prevent Argentina from paying holders of

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1 MC Suchman, ‘Contract as Artifact’ (2003) 37 Law & Soc’y Rev 91.

2 ‘Santa Anna and His Black Eagle: The Origins of *Pari Passu*’ (2014) 9 CMLJ 216. The article is also available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2397929> accessed 1 May 2014.

bonds issued in connection with its 2005 and 2010 restructurings unless the country also paid restructuring holdouts in full.³ The court approved injunctive relief to remedy Argentina's breach of this covenant. The injunction forbids Argentina to maintain debt service without paying the holdouts and targets financial and other intermediaries in an effort to make Argentina comply.⁴ The decision surprised many market participants, few of whom had interpreted the clause to allow holdouts such a potent weapon.⁵

Chabot and Gulati are wary of firm conclusions but imply that we can improve our understanding of the modern *pari passu* clause by learning what the earliest drafters of the clause meant by it. Contract production can be routine, almost automated.⁶ Over a long enough time, lawyers and other market participants may stop paying attention to contract language or even forget why it is there. This may have happened with the *pari passu* clause.⁷ In a market populated by amnesiacs, perhaps the intent of the original drafters is what matters.⁸ As Chabot and Gulati put it:

Even if lawyers today are copying the clause by rote, surely the earliest drafters of the clause were not doing that. Someone had to have thought of this clause first. If we could find them, and figure out what they were thinking, that we potentially have a way of cutting the Gordian knot.⁹

This proposition is not easy to square with modern contract law. When asked to interpret an ambiguous clause, judges do not normally become amateur archaeologists. They do not try to unearth the first relevant usage of the disputed clause—perhaps long ago, in other contracts between other parties—with a mind to impute that usage to these parties. Instead, they look to the circumstances surrounding the parties' transaction, including pre-contract negotiations, evidence of the broader commercial context, etc.¹⁰ Even if this inquiry turns up little of value, few judges would don khakis and a pith helmet. Courts describe the interpretive task in different ways, but it will suffice to say that interpretation

3 See *NML Capital Ltd v Rep of Argentina*, 727 F3d 230 (2013).

4 For further discussion of the injunction and its effects, see WMC Weidemaier and A Gelpert, 'Injunctions in Sovereign Debt Litigation' (2014) 31 *Yale J Reg* 189. <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2330914> accessed 1 May 2014.

5 Detailed coverage of the litigation can be found on the FT Alphaville Blog at <<http://ftalphaville.ft.com/tag/pari-passu-saga/>> and on the blog *Credit Slips* at <<http://www.creditslips.org/creditslips/sovereign-debt/>> accessed 1 May 2014.

6 See B Richman, 'Contracts Meet Henry Ford' (2011) 40 *Hofstra L Rev* 77.

7 On the history of the clause and the explanations offered by modern lawyers, see M Gulati and R Scott, *The Three and a Half Minute Transaction: Boilerplate and the Limits of Contract Design* (University of Chicago Press 2013) and M Weidemaier, R Scott and M Gulati, 'Origin Myths, Contracts, and the Hunt for *Pari Passu*' (2013) 38 *L Social Inquiry* 72.

8 For a variant of this argument, see SJ Choi and M Gulati, 'Contract as Statute' (2006) 104 *Michigan L Rev* 1129.

9 Chabot and Gulati (n 2).

10 See, eg EA Farnsworth, *Farnsworth on Contracts* (3rd edn, Aspen 2004) §7.10; GH Treitel, *The Law of Contract* (9th edn, Sweet and Maxwell 1995) 181–3. I do not view the Second Circuit's result as the product of an overly formalist legal regime. Even a relatively formalist contract law—including that of New York, see GP Miller, 'Bargaining on the Red Eye: New Light on Contract Theory' (2008) NYU Law & Econ Working Paper No 131 (6 May 2008) <http://lsr.nellco.org/nyu_lewp/131> accessed 1 May 2014 will take into account evidence of context when language is ambiguous. And while parts of the Second Circuit's opinion imply that the *pari passu* clause is unambiguous, the court considered and rejected Argentina's primary contextual evidence, which the country proffered to show that the interpretation advanced by the plaintiffs contradicted the understanding of most market participants. See *NML Capital Ltd v Rep of Argentina*, 699 F3d 246, 258 (2012). Argentina lost because its evidence of context did not persuade, not because the court dismissed that evidence as irrelevant to the interpretive task.

involves a guess as to how the parties would have resolved their dispute if they had foreseen it during negotiations.¹¹

In making this guess, a sensible judge will assign the clause its historically accepted meaning, if one exists. This is especially true when the contract itself is a commodity, for this interpretive presumption matches investors' likely expectations.¹² But when current market participants have 'no' expectations about the clause's meaning, why should the judge try to uncover the intentions of the first drafters? Why not just pick a meaning that seems to make sense in the modern context, leaving parties to amend the clause if they prefer something else? Whatever the merits of originalism as an approach to constitutional interpretation,¹³ surely the originators of a contract term have only a modest claim to authority.

The contracts originalist also may struggle to identify the first relevant usage of the disputed clause. As any good treasure hunter knows, the path to buried loot is circuitous; X rarely if ever marks the spot. Until the discovery of the Black Eagle bond, the first known use of the *pari passu* clause in a sovereign bond occurred in an issuance by Bolivia in 1872.¹⁴ The drafters of these two clauses, separated by nearly three decades, might have had different things in mind. Should a modern court revise its understanding as researchers excavate ever-older uses of the *pari passu* clause? As a prospective matter, it might make some sense to adopt a default rule privileging the intentions of a clause's original drafters. Such a rule encourages drafters to document the purpose of their creation and might provide an incentive for trade associations or other groups to improve contract boilerplate.¹⁵ There may indeed be such seminal moments in the sovereign debt markets.¹⁶ In the 1930s, for example, the League of Nations undertook a major project to improve the quality of sovereign loan contracts.¹⁷ Alas, they mostly focused on the potential merits of trustee clauses and did not seem to view the *pari passu* clause as a problem.

Despite these caveats, the story of the Black Eagle bond is a remarkable one that invites reflection on the relevance (and limits) of history as a guide to contract interpretation. The historical record remains murky as to original purpose of the *pari passu* clause, but the available evidence undercuts the Second Circuit's interpretation. As the court interpreted and enforced it, the *pari passu* clause grants each bondholder a unilateral right to block payments to bondholders who assent to a government's restructuring proposal.

11 RA Posner, 'The Law and Economics of Contract Interpretation' (2005) 83 Tex L Rev 1581, 1586. This judicial guess need not be the end of it. At times, for example, courts and legislatures arguably should choose default rules that differ from those the parties would have chosen. See I Ayres and R Gertner, 'Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules' (1989) 99 Yale L J 87.

12 See *Broad v Rockwell Int'l Corp*, 642 F2d 929, 943 (5th Cir 1981) (noting that uniformity of contract terms makes it easier for investors and advisors to compare securities).

13 See LB Solum, 'What is Originalism? The Evolution of Contemporary Originalist Theory' in G Huscroft and BW Miller (eds), *The Challenge of Originalism: Theories of Constitutional Interpretation* (CUP 2011) 12–41.

14 Chabot and Gulati (n 2).

15 See Choi and Gulati (n 8) 1164.

16 See WMC Weidemaier, A Gelpert and M Gulati, 'When Governments Write Debt Contracts' (unpublished draft, 2014).

17 *ibid.*

To my knowledge, such a right has no precedent whatsoever. To the contrary, disappointed investors have historically had little power to interfere with the ability of other investors to participate in a restructuring. Their relative powerlessness in this regard cannot be attributed to the lack of enforcement rights. The doctrine of absolute sovereign immunity may have denied access to the courts, but investors with political and economic clout asserted their rights in other ways.

Consider just two examples. First, professional investors akin to today's distressed debt buyers were active before the London Stock Exchange by the early nineteenth century. The LSE refused to list new securities of sovereign defaulters that had not reached a 'satisfactory arrangement' with bondholders. Marc Flandreau has documented how the LSE adjudicated objections to proposed restructuring plans and how LSE rules allowed a qualified majority of bondholders to override a dissenting minority.¹⁸ Dissenters could decline to participate in the restructuring but could not prevent other investors from exchanging their old (non-performing) bonds for new (performing) ones.

The second example involves what may be the best available evidence of how investors interpreted the *pari passu* clause in the first half of the twentieth century. Elsewhere in this volume, Sung Hui Kim recounts how, in the 1930s, US investors objected to the German government's selective default on the American tranche of the Dawes and Young loans.¹⁹ The general bond for these loans included a *pari passu* clause, and the US investors argued that the German government violated the clause by treating investors from other countries more favourably.²⁰ Yet neither the aggrieved investors nor the trustee for the loan (the Bank for International Settlements) seem to have interpreted the clause as a tool by which one investor could interfere with payments to another.

If history is to be our guide, the Second Circuit's decision in *NML v Argentina* rests on shaky ground. Even if intrepid researchers manage to unearth the very first *pari passu* clause in a sovereign bond, their discovery is unlikely to change this fact. If the Second Circuit's decision can be justified at all, it is only by focusing on the effects of that decision in the present. In theory, strong enforcement rights benefit both government borrowers and investors. A government that credibly signals its commitment to repayment, as by agreeing to make restructuring as difficult and painful as possible, may lower its borrowing costs. The *pari passu* clause has not traditionally served this function, but perhaps it can be repurposed to do so. If the Second Circuit's decision has done anything, it has imbued the *pari passu* clause with new meaning and vigour. Time will tell if investors welcome this development.²¹ As a nemesis once said about Indiana Jones—although not, alas, about the *pari passu* clause: 'Who knows? In a thousand years, even you may be worth something.'²²

18 M Flandreau, 'The London Stock Exchange and the Early Emergence of Sovereign Debt Collective Action Clauses in the 19th Century (1827-1868)' (4 November 2012) (unpublished draft).

19 SH Kim, 'Pari Passu: The Nazi Gambit' (2014) 9 CMLJ 242.

20 *ibid.* These countries had granted the German government concessions to satisfy its pressing need for foreign exchange.

21 For a sceptical view, see Weidemaier and Gelpern (n 4).

22 The quote is from *Raiders of the Lost Ark*. See <<http://www.imdb.com/title/tt0082971/quotes>> accessed 1 May 2014.