When Boilerplate Changed With Lightning Speed (But Did Not)

Mitu Gulati and Marcel Kahan*

Very Preliminary Draft

Draft Date: April 8, 2019

I. Introduction

Courts seeking to interpret a long-used, but rarely litigated, provisions in a standard-form contracts are periodically faced with choosing between the following perspectives. One side advances a position that it says is dictated by the strict text of the contract provision and the other counters by saying that the textual reading advanced by their opponents is illogical and inconsistent with historic market understandings of this boilerplate provision.[1]

Figuring out market understandings when limited to the materials proffered by interested parties in a litigation is a fraught task. And judges in the majority of U.S. jurisdictions take this position that they would rather not be conducting trials into the market understandings of contract clauses.[2] Most important, they take this view in the courts of New York, which is the leading legal jurisdiction for contracts of this type.[3] Two key elements of this logic are: (1) Sophisticated commercial actors and their expensive lawyers are both fully capable of articulating, and have adequate incentives to articulate, in plain text, the clear meaning of their contract provisions (ergo, the plain meaning is the market understanding); and (2) if the judge errs in determining what the clear meaning of the clauses is, the parties are fully capable of quickly revising the clauses to articulate what they really meant.

So much for the theory. For some time now, scholars have been skeptical about the extent to which the foregoing assumptions hold up in the world of boilerplate contracts. Based on the studies that have been done, it turns out that: (1) the most sophisticated of commercial parties do sometimes enter into contracts containing provisions that are unclear, ambiguous and quite

---

* NYU Law School and Duke Law School, respectively. We owe an immense debt to our many respondents who were immensely generous with their time. This research was done under Duke University IRB protocol 1192.

[1] This is a version of the classic "text versus context" debate in contract interpretation. *See, e.g.,* Alan Schwartz & Robert E. Scott, *Contract Interpretation Redux*, 119 YALE L.J. 926,957–63 (2010); Steven J. Burton, *A Lesson on Some Limits of Economic Analysis: Schwartz and Scott on Contract Interpretation*, 88 IND. L.J. 339 (2013); Juliet P. Kostritsky, *Plain Meaning vs. Broad Interpretation: How the Risk of Opportunism Defeats a Unitary Default Rule for Interpretation*, 96 KY. L.J. 43 (2008); David V. Snyder, *Language and Formalities in Commercial Contracts: A Defense of Custom and Conduct*, 54 SMU L. REV. 617, 617–18 (2001).

[2] See Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Text and Context: Contract Interpretation as Contract Design*, 100 CORNELL L. REV. 23, 26 n.6 (2014); Ted Eixenberg & Geoffrey Miller, *The Flight to New York: An Empirical Study of Choice of Law and Choice of Forum Clauses in Publicly-Held Companies' Clauses*, 30 CARDOZO L. REV. 1473 (2009).

[3] *See* Gilson et al, *supra* note __. at n.34 (describing New York contract law on the matter).

possibly altogether unknown to the parties to the contracts (and the lawyers);[4] and (2) changes to the standard forms take a long time to occur, even in circumstances in which there appears to be widespread agreement that a court has erred in the interpretation of a clause.[5]

Our focus is the second of the two observations above: the inertia phenomenon. The pace of contract change in the world of standard-form or boilerplate contracts is often extremely slow, even in the face of an incorrect court interpretation.[6] The question we are interested in is the why. Scholars, including us, have advanced a variety of theories such as network externalities, the endowment effect, first-mover problems, agency costs and so on, for why stickiness in commercial boilerplate occurs.[7] But figuring out which of those theories provides a better foundation for the observation of stickiness is the real world has proved difficult.

Our foil in this article is the opinion in *Wilmington Savings Fund FSB v. Cash America International Incorporated,* issued on September 19, 2017.[8] A well respected judge, Jesse Furman, of the Southern District of New York, interpreted both the contract and existing precedent in the Second Circuit to dictate that bondholders receive what is called the "make-whole" premium on account of the bond issuer having "voluntarily" breached a covenant in the

---

[4] *See, e.g.,* John Coyle & Mark Weidemaier, *Interpreting Contracts Without Context*, 67 AM. U. L. REV. 1673 (2018); Robert Anderson & Jeffrey Manns, *Boiling Down Boilerplate in M&A Agreements*, 67 DUKE L. J. 220 (2017). In the world of practice, this phenomenon is a familiar one. Bryan Garner, the legal writing guru, wrote recently:

> *The lunacies [of contract drafting] involve using pastiche forms riddled with wildly inconsistent ways of expressing simple duties, absurd archaisms whose purpose few lawyers can explain, and repellent typographic practices that still today make many if not most contracts grotesque to read.*
>
> *What I'd like to explore in this column is the curiosity of "busts"—the prevalence of contractual provisions, sometimes perpetuated in deal after deal, that make no literal sense at all. That they exist at all is something of a marvel. After all, you'd think that transactional lawyers would adopt a protocol of reading and rereading each contract that goes out the door. Given that critical thinking and close reading are prized habits for lawyers, contradictory or outright nonsensical provisions should be exceedingly rare. Alas, they're not.*
>
> *Most experienced lawyers can recall anecdotes of contractual monstrosities. One involves a malpractice claim against a law firm: A mortgage had somehow been prepared in the early 1980s with a crucial line dropped. The sentence made no sense. The firm had prepared dozens if not hundreds of mortgages with the same language missing, resulting in an incomplete sentence that made little sense—and the sense it did seem to make resulted in a disposition that no sane drafter could have wanted. It seems that a typist had simply skipped a line and continued typing. Nobody caught the error—until a problem erupted in the early 2000s.*
>
> *By that time, the faulty contract had long since become entrenched as the "firm form." A secretarial error from a generation before had become permanently ensconced in the form.*

Bryan Garner, Contract "Busts": Trying to Decipher Provisions That Literally Make No Sense", ABA J. *(Dec. 2018), available at http://www.abajournal.com/magazine/article/contract_busts_decipher_provisions*

[5] For a smattering of the theoretical and empirical articles on inertia in standard-form contracts, see Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Terms*, 73 CAL. L. REV. 261 (1985); Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, 83 VA. L. REV. 713 (1997); Omri Ben-Shahar & John A. E. Pottow, *On the Stickiness of Default Rules*, 33 FLA. ST. L. REV. 651 (2006); Christopher R. Drahozal & Peter B. Rutledge, "*Sticky" Arbitration Clauses?* 67 VAND. L. REV. 955 (2014); Stephen J. Choi, Robert E. Scott & Mitu Gulati, *Contractual Black Holes*, 67 DUKE L. J. 1 (2017); Florencia Marotta-Wurgler & Giuseppe Dari-Mattiachi, Learning in Standard-Form Contracts: Theory and Evidence, NYU Law & Econ Working Paper (Mar. 2018), at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3133791

[6] *See, e.g.,* William A. Klein, Mark Ramseyer & Stephen M. Bainbridge, BUSINESS ASSOCIATIONS, Chapter 8 (2017). For more on sticky contracts, see Gordon Smith & Brayden King, *Contracts as Organizations*, 51 ARIZ. L. REV. 1 (2009); Anna Gelpern, Mitu Gulati & Jeromin Zettelmeyer, *If Boilerplate Could Talk*, L. & SOC. INQUIRY (forthcoming 2019), at https://www.cambridge.org/core/journals/law-and-social-inquiry/article/if-boilerplate-could-talk-the-work-of-standard-terms-in-sovereign-bond-contracts/B552F863A9B9A578267FD3A5D807B5D9

[7] *See* Kahan & Klausner, *supra* note __; Douglas Baird, *Pari Passu Clauses and the Skeumorph Problem in Contract Law*, 67 DUKE L. J. 84 (2017); Robert E. Scott & Mitu Gulati, THE THREE AND A HALF MINUTE TRANSACTION: BOILERPLATE AND THE LIMITS OF CONTRACT DESIGN (2013).

[8] No. 1:2015cv05027 - Document 49 (S.D.N.Y. 2016).

bond indenture. The case caused a ruckus in the elite corporate bar because few seemed to think that this was what the contract provided.[9]

What happened next is what interested us, as having the potential to yield insight as to the causes of contract stickiness in the commercial boilerplate world. The elite bar, contrary to what we expected based on the prior research on contract stickiness, reacted remarkably fast: within less than a month, it coordinated around remedial language that explicitly rejected the *Cash America* result and that was henceforth to be included in all bonds. But then, more interesting, after the new language (the "*Cash America* patch") made its way into about a dozen deals, there was an angry reaction from the investor world and the move was quashed. As of this writing in April 2019, the provisions being used are the pre-*Cash America* ones. That is, billions of dollars in bond issuances are being done with provisions that pose a risk to issuers that was not present – or rather that few thought to be present -- prior to *Cash America*.

The aftermath of *Cash America* raises important issues. As we will argue, many of the standard explanations for contractual inertia do not seem to apply to the *Cash America* setting. We therefore provide several additional explanations that may account for the phenomenon that courts' interpretations of contracts that are surprising and "incorrect" do not lead to revisions of these terms in future contracts. We then conducted detailed interviews with over [forty] senior lawyers at over two dozen top international law firms who work on these bond transactions. Our interviews were designed to determine both why the court ruling in *Cash America* was not anticipated by transactional lawyers and which of the explanations for contractual inertia, if any, would be consistent with the lawyers' assessments.

II. The *Cash America* Case

a. Converting the Issuer's Option into a Creditor Remedy

At issue in the *Cash America* case was a claim by Wilmington Savings, the trustee on a $300 million bond issued by Cash America some years prior, that Cash America had breached one of its covenants by spinning off a major subsidiary and that this breach had resulted in a covenant event of default.[10] The court ruled in favor of the investors on the question of the breach. What got the attention of the elite corporate bar, however, was not the ruling on the breach. It was the remedy.

The standard remedy for garden variety covenant violations that result in an event of default is acceleration – the payment of the obligations at par. But because the covenant breach was deemed "voluntary", the court awarded the creditors the amount that Cash America would have owed them had it chosen to redeem the bond early – par plus a sizeable, contractually pre-specified "make-whole" redemption premium. In a "make-whole" optional redemption provision, such as the one included in the *Cash America* bonds, the company has to pay as the

[9] For reports in the financial press, see, e.g., Matt Levine, *Bondholders Want to Keep What They Didn't Know They Wanted*, BLOOMBERG VIEW, July 24 (2018); Eric Platt, *Bond Investors Rebel Against Weaker Deal Terms*, FIN. TIMES, Jan. 11 (2017).
[10] 2016 WL 5092594.

redemption price the higher of par and the discounted value (at a low discount rate) of the future principal and interest payments.

In devising this remedy, the *Cash America* court followed *Sharon Steel Corporation v. Chase Manhattan Bank*, a canonical Second Circuit opinion by Judge Ralf Winter from multiple decades prior. *Sharon Steel* reasoned that the redemption provision set the effective price for a company that chooses to violate a covenant.[11] It, therefore, ordered the payment of the redemption price as specific performance of the optional redemption clause.[12]

There are reasons to doubt that the reasoning of *Sharon Steel*, which was followed in *Cash America*, comports with the provisions of the indenture. The indentures at issue, as indentures generally, do not explicitly provide for a right to receive a redemption price as a remedy upon an Event of Default and nowhere distinguish between voluntary and involuntary covenant violations. Rather, the expressly provided remedy in the indentures is acceleration: declaring the outstanding principal due and payable immediately.

To be sure, indentures include an additional provision entitled "Other Remedies" which provides that the trustee may "pursue any available remedy by proceeding at law or in equity to collect the payment of principal or of interest ... or to enforce the performance of any provision" in the indenture. This broad provision clearly includes specific performance as a remedy. And as specific performance is an equitable remedy, the court in its exercise of its equitable powers, could decide to afford this remedy only for a subset of breaches – such as voluntary covenant violations.

Still, specific performance is available only to enforce an obligation that already exists. Moreover, the indenture section on "Other Remedies" encompasses only the collection of payment of principal and interest – which would include only the par amount, but no premium – and the performance of an indenture obligation. Thus, both because of the inherent nature of specific performance and because of this indenture provision, a court cannot create a new obligation that is then specifically enforced but can only enforce performance of a provision that is already contained in the indenture.

The redemption clauses that were specifically enforced in *Sharon Steel* and *Cash America*, however, gave the bond *issuer* an *option* to redeem the bonds, exercisable at its discretion. In other words, redemption is not a creditor option. The literal provisions neither contain any suggestion that the issuer is ever required to exercise the option nor specify that the function of redemption is to set the price the company is required to pay for a covenant violation. Under the terms of a bond, therefore, until the issuer decides to avail itself of the redemption option by redemption notice, bondholders have no right to have their bonds redeemed.

[11] *Id.* at *5-8.
[12] *Id.*

The history of make-whole redemption provisions cast further doubt on the notion that these provisions were intended to determine the price for covenants violations. Private placements have long both provided for make-whole redemption long before these provisions were included in publicly issued bonds.[13] But private placements typically included a second provisions that *explicitly* require the company to pay an equivalent make-whole amount upon acceleration ("make-whole acceleration"). By contrast, when make-whole provisions made it into publicly issued bonds, only the optional redemption make-whole clauses were included while the make-whole acceleration clauses were omitted. This partial incorporation of make-whole provisions from private placements to public issues would seem to suggest that the drafters wanted to provide for make-whole redemption but did not mean to require the company to pay a make-whole amount upon acceleration. To be sure, specific performance is technically a different remedy than acceleration; moreover, the redemption premium in public bonds is payable only upon voluntary covenant violations and that remedy is thus narrower than the make-whole acceleration clauses in privately-placed bonds. Functionally, however, "specific performance" of a redemption provision and acceleration are similar: they involve a termination of the debtor-creditor relationship upon a payment to the creditors (as opposed to, say, some damage payment and a continuation of the debtor-creditor relationship). To us, the failure to reference at all the possibility of a make-whole payment upon acceleration when make-whole redemption provisions were incorporated in public bonds indicates that the drafters did not intend to provide for such payment upon default – whether the default was caused by voluntary or involuntary actions.

b. *The* Sharon Steel *Backdrop*

To set the stage, we dig into the crafting of the remedies in *Sharon Steel* and *Cash America*. For now, we take it that the holding of both cases is that, if a company *voluntarily* breaches a covenant in an indenture and an Event of Default ensues, the court should order the company, as specific performance, to redeem the bonds and pay the redemption premium (plus accrued interest) provided for in the (separate) indenture provisions giving the company the option to redeem the bonds. Since the redemption premium will ordinarily exceed par, this remedy will be more attractive to bondholders than acceleration, which is a specific remedy provided in the indenture and entitles bondholders to receive par (plus accrued interest).

Our own view is that the construction of the specific performance remedy in *Sharon Steel* and *Cash America* does not comport with the wording of the underlying indentures and the intent of the drafters. But this being said, Judge Furman also appeared to be engaged in a straightforward application of the most relevant precedent in his jurisdiction. Given *Sharon Steel*, an opinion from the Court of Appeals for the Second Circuit which a district court in the Southern District of New York was bound to follow, the threshold question is: Why were lawyers so outraged by *Cash America*? And *Sharon Steel* is not some obscure case. Other portions of the case, dealing with general principles of indenture interpretations in general and

[13] *See* Marcel Kahan & Bruce Tuckman, *Private Versus Public Lending: Evidence From Covenants*, in THE YEARBOOK OF FIXED INCOME INVESTING 1995, 253 (John D. Finnerty & Martin S. Fridson eds. (1996).

specifically with the interpretation of the successor obligor clause, make it one of the most famous and most cited cases on bond indenture interpretation. Extensive excerpts from the case, including excerpts dealing with the specific performance remedies, are found in almost every US law school casebook on Corporate Finance or Corporate Debt.

So how did *Sharon Steel* come up with the specific performance remedy and what did lawyers make of it before *Cash America*? Since *Sharon Steel*'s discussion of the remedy is short, we quote it in its entirety.

> [The District Court] held that the redemption premium under the indentures need not be paid by UV [the company that had breached the covenant at issue]. His reasoning was essentially that UV defaulted under the indenture agreement and that the default provisions provide for acceleration rather than a redemption premium. We do not agree. The acceleration provisions of the indentures are explicitly permissive and not exclusive of other remedies. We see no bar, therefore, to the Indenture Trustees seeking specific performance of the redemption provisions where the debtor causes the debentures to become due and payable by its voluntary actions.
>
> This is not a case in which a debtor finds itself unable to make required payments. The default here stemmed from the plan of voluntary liquidation approved on March 26, 1979, followed by the unsuccessful attempt to invoke the successor obligor clauses. The purpose of a redemption premium is to put a price upon the voluntary satisfaction of a debt before the date of maturity. While such premiums may seem largely irrelevant for commercial purposes in times of high interest rates, they nevertheless are part of the contract and would apply in a voluntary liquidation which included plans for payment and satisfaction of the public debt. We believe it undermines the plain purpose of the redemption provisions to allow a liquidating debtor to avoid their terms simply by failing to take the steps necessary to redeem the debentures, thereby creating a default. We hold, therefore, that the redemption premium must be paid. See Harnickell v. Omaha Water Co., 146 A.D. 693, 131 N.Y.S. 489 (1st Dep't 1911), aff'd, 208 N.Y. 520, 101 N.E. 1104 (1913).

This reasoning is dodgy. The Circuit Court is correct in stating that "the purpose of a redemption premium is to put a price upon the voluntary satisfaction of a debt before the date of maturity." But it does not follow that "it undermines the plain purpose of the redemption provisions to allow a ... debtor to avoid their terms simply by failing to take the steps necessary to redeem the debentures, thereby creating a default" and leaving bondholders to the default remedy of acceleration – which involves a payment *lower than* the redemption premium. Likely, a purpose of optional redemption is to enable the company to violate covenants without generating a default. Defaults can have adverse collateral consequences (generate cross-defaults, cause reputational harm, etc.), so a company may want to avoid a default even if doing so is costly. But even to that extent, optional redemption does not obligate the company to redeem bonds. A provision that gives the company the option to redeem bonds to avoid a default is not the same as one that requires the company to do so. Most telling, this holding

generates the perverse result that a company that contracted for a right to optionally redeem may have to pay more, upon a default, than a company that did not obtain this right.

Moreover, *Sharon Steel* cites only a single New York state court precedent in support of its holding. But as discussed below, this precedent does not support the proposition that, if a company voluntarily breaches a covenant in an indenture and an Event of Default ensues, the court should order the company, as specific performance, to redeem the bonds and pay the redemption premium. *Cash America*, in turn, cites only *Sharon Steel* and its progeny in support of its holding.

While we question the doctrinal underpinnings of *Sharon Steel*, we read the *Cash America* case as being a straightforward application of *Sharon Steel*. As a district court judge in the Second Circuit, Judge Furman is supposed to follow the precedent laid down by the Second Circuit, whether this precedent was correctly decided or not. Having found that *Cash America* violated a covenant, that the violation was voluntary, and that it has ripened into an Event of Default, Judge Furman was bound to follow *Sharon Steel* as to the available remedies. So why were lawyers were outraged at the *Cash America* decision, when the real outrage should have been the analysis in *Sharon Steel*. Put differently, what was the understanding of *Sharon Steel* prior to *Cash America*? There are four possibilities that we came up with that might explain the disjunction between the negative reaction to *Cash America* and the general reverence given to *Sharon Steel.* We explore these subsequently through our interviews.

i) Bond drafters did not recall *Sharon Steel*. Lore is that transactional lawyers, as compared to litigators or restructuring lawyers, generally have only a vague sense of the case law. They do deals, and parsing the wording of cases is not part of that.[14]

That said, *Sharon Steel* is a leading opinion, one of the few opinions on indenture interpretation, written by a legendary corporate law figure, Judge Ralph Winter. As noted earlier, it is perhaps better known for its interpretation of the successor obligor clause and for its general approach to indenture interpretation than for the short discussion of remedies. Still, the section on remedies is excerpted or mentioned at least half the casebooks on the topic (every leading casebook uses *Sharon Steel*). The reason the level of knowledge lawyers have about the caselaw is relevant in that it sheds light on their ability to revise their provisions based on caselaw they are unhappy with.

ii) *Sharon Steel* was seen as *sui generis*. Perhaps *Sharon Steel* was viewed as not laying down a general principle that, if a company voluntarily breaches a covenant in an indenture and an Event of Default ensues, the court should order the company, as specific performance, to redeem the bonds and pay the redemption premium. Rather, maybe the widespread view of the case is that its dictates apply only to the narrow set of bad faith defaults where the

[14] *See* Gulati & Scott, *supra* note __ (noting this disjunction between the transactional lawyers and litigators in the sovereign debt context).

company took steps knowing that they violated the indenture and for the purpose of inducing bondholders to accelerate.[15]

But the argument advanced in *Sharon Steel* as to the underlying issue of covenant violations were far from preposterous. In the case, UV Industries Inc. (UV) sold its operating assets piecemeal as part of a plan of liquidations. Sharon Steel was the third, and last, buyer of the remaining assets of UV (which included a portion of the original operating assets and substantial cash proceeds from the earlier sales). UV argued that the sale to Sharon Steel constituted a sale of substantially all of its assets under the indentures, which would require Sharon Steel to assume the obligations under the indentures and result in a release of UV of these obligations. The court held that the relevant point of time for application of the "substantially all" test was the time UV adopted its plan of liquidation, and not the time of the sale to Sharon Steel. Though the court's view is sensible, the court nowhere suggest that it regarded UV's position as outlandish. To the contrary, the court suggests that, from a literal perspective, UV's position is plausible, and notes that it arrives at its view based on "the particular context and evident purpose" of the relevant clause. And this is not due self-restraint. Elsewhere, the court did not mince words – characterizing antitrust claims by Sharon Steel as "border[ing] on the frivolous."

iii) <u>Drafters did not focus on the interaction of *Sharon Steel* and make-whole redemption</u>. The cost of the "specific performance" remedy of *Sharon Steel* depends on the size of the redemption premium. When *Sharon Steel* was decided, redemption premia were set at a fixed declining fraction of the coupon and it is unlikely that premia were high at the time of a default. So, maybe no one noticed the remedy that Judge Winter granted. The make-whole premium, by contrast, can be much higher than the old "fixed declining fraction of a coupon" premium. Bond lawyers, while aware of *Sharon Steel,* may not have fully thought through the implications of the case in a world of make-whole redemption or somehow assumed that the holding did not apply to specific performance of make-whole redemption clauses.

iv) <u>*Sharon Steel* was seen as applying only to cases where the company is liquidating and therefore needs to pay off the bonds early</u>. A close reading of *Sharon Steel* indicates that this is a possible interpretation. To be sure, the first paragraph of the remedies section suggests that bondholders can seek "specific performance of the redemption provisions where the debtor causes the debentures to become due and payable by its voluntary actions" as a default remedy. The second paragraph, however, thickens the plot. It notes that the default here

---

[15] For example, from the lawyers at Kramer, Levin, Naftalis & Frankel, LLP:

> Prior to *Cash America*, most market participants believed that such a remedy would only be available where an issuer intentionally defaulted for the purpose of avoiding paying the redemption premium (under the reasoning set forth in Sharon Steel Corp. v. Chase Manhattan Bank NA, *691 F.2d 1039 (2d Cir.1982)*). After *Cash America*, an issuer financially capable of refinancing bonds and paying the redemption premium that defaults under an indenture other than by reason of an involuntary default (e.g., a bankruptcy or insolvency default, judgment default, cross default, or loss of collateral or guarantees) can be compelled to redeem the bonds and pay the applicable redemption premium. In response to this extension of the redemption premium remedy, issuers have recently attempted (successfully, in certain instances) to include language in indentures that eliminates the redemption premium remedy — but not only in circumstances when there is no bad faith . . .

Available at https://casetext.com/case/sharon-steel-corp-v-chase-manhattan-bk-na/analysis?citingPage=1&sort=relevance (Jan. 19. 2017).

"stemmed from the plan of voluntary liquidation" and that redemption premiums "would apply in a voluntary liquidation which included plans for payment and satisfaction of the public debt."

Because there was no proper sale of substantially all assets that would have invoked the successor obligor clause, UV – which wanted to liquidate – remained liable for payment. The court then concludes that "it undermines the plain purpose of the redemption provisions to allow a liquidating debtor to avoid their terms simply by failing to take the steps necessary to redeem the debentures, thereby creating a default" – suggesting that, *if the debtor wants to liquidate and hence to repay the debt,* it has to pay the redemption premium. Under that reading of *Sharon Steel*, the default in *Cash America*, where the debtor had no intention to liquidate and would have been happy to pay interest and principal on its bonds according to their terms, would not call for the payment of a redemption premium.

Indeed, the single New York cited by *Sharon Steel*, an opinion by the New York Appellate Division in *Harnickell v. Omaha Water Co.*, supports this reading. *Harnickell* did not involve any default. It did, however, involve a debtor that wanted to eliminate a mortgage on its properties and asked the trustee to provide a release in exchange for payment of the principal. The court, after concluding that the bonds, under the special circumstances of the case, had not become due, held that the debtor would have to redeem the bonds under the optional redemption provisions if it wanted to obtain the release. *Harnickell* – like *Sharon Steel* but unlike *Cash America* – thus involves a case where it is the debtor that wants to pay prior to maturity.

This interpretation of *Sharon Steel* also has the plus that it does not involve an absurd rewriting of the contract. It makes sense to hold that, if the debtor wants to repay, the debtor has to invoke its rights to redeem the bonds optionally and cannot *force* an early repayment by triggering a default. This preserves the option of bondholders in the case of default to either accelerate – and require early payment of par without a premium – or not accelerate – and maintain the right to payment under the original payment terms, perhaps in conjunction with other remedies. On the other hand, this reasoning would not justify the "specific performance" remedy. While UV would not be entitled to pay off its bonds at par and liquidate, it should have the choice between abandoning the liquidation plan altogether, setting aside sufficient funds to pay principal and interest as they become due, or redeeming the bonds.

Something close to this argument does get a mention in the briefs by the defendants in *Cash America*.[16] But neither the casebooks that refer to *Sharon Steel* nor the earlier cases interpreting *Sharon Steel* mention it, and Judge Furman does not address it in his opinion.

To reiterate, we use the foregoing frame to investigate the following: If the various law firm memos are to be believed, then Judge Furman's view of how the redemption provisions in the Cash America bonds should operate is inconsistent with what the drafters of those boilerplate provision (the lawyers) intended. Contract law is all about the intent of the drafters. Deviate

[16] *See* Reply Brief in Support of Defendant's Cross-Motion for Summary Judgment, Wilmington Savings Fund Society, FSB v. Cash America Int'l Inc.(SDNY) (pg. 12-13) No. 15-cv-5027 (JMF) (filed 4/1/16). [expand]

from, or even muddy, what the sophisticated drafter intended, conventional contract theory tells us, will result in the redrafting of contracts to clarify what they mean. We've known for some time that that is not how real world lawyers and, therefore, contracts, always behave. Question is, why?

III. Explanations for Contracting Inertia

As noted, the failure of the market to change the terms post-*Cash America* is surprising from a plain vanilla contractarian perspective. Assuming that lawyers did not anticipate the outcome of *Cash America* – as indicated by the flourish of memos critical of the case and by the initial attempts to change the terms post-*Cash America* – one would think that the standard terms as understood pre-*Cash America* were not optimal or that the standard terms as interpreted by *Cash America* were not optimal. Then why were the terms not modified?

From a more nuanced contractarian perspective, there are several explanations posited in the literature on contract stickiness. In our preliminary assessment, situated within the events surrounding *Cash America*, none of these explanations is satisfying. We take the explanations in turn.

a) *Network and Learning Effects*: Learning effects derive from what happened in the past; network effects derive from what is expected to happen in the future, as a result of the future use of contract terms.

i) Learning Effects: Learning benefits, to the extent they were present here, would have been generated by the long-standing experience in calculating redemption amounts with the clauses at issue in situations where there was a voluntary breach of a covenant. But, as we know, this premise fails on its face for at least two reasons. First, there seems to have been little understanding among the parties – at least not in terms of any of the materials referred to in any of the cases – about how these provisions were to apply in cases of voluntary breaches. Indeed, there does not seem to have been much understanding of what a "voluntary" breach is. The reason for stickiness, therefore, could not have been the clear prior understanding of how this clause was to operate. If anything, the existing understanding of what was to happen in the case of a "voluntary" or "intentional" breach of a covenant in the non-bankruptcy context seems to have been unclear.

Further, it was easy to draft a contractual provision that would put in place a clear articulation of how the bondholder remedies would work in the case of the types of breaches at issue. The technology for drafting a clause that either rejected *Cash America's* view or confirmed it was readily available to all. Bottom line: Accumulated learning about a clause from the past was not the reason for stickiness in this case.

ii) Network Effects Dependent on Expectations of Future Market Practices. The idea behind network effects causing stickiness in the boilerplate world is that there is value to having the same clause as everyone else, even if that clause brings some risks with it. When the court

misinterpreted the redemption provisions, therefore, it reinterpreted all of the standard redemption provisions. And altering these provisions, particularly for individual issuers, would have produced the risk of this issuer now having non-standard clauses that would, for example, cause traders to have to consider whether to price the bonds with these clauses differently. Complications might multiply if that particular issuer had multiple pre-existing bonds with the older version of the provisions, causing the need for these different bonds of the same issuer to be put on different yield curves and so on.[17]

We are skeptical. The pricing story about network benefits would hold only if the different versions of the clause were to result in different bond prices (unlikely, in our view, given that such minor nuances in covenants are unlikely to show up in anything but near-crisis pricing). The value of future interpretive externalities would result only if one expected more cases to add clarity (but these cases occur rarely). Lawyer externalities in understanding the old term are only plausible if lawyers already had a robust understanding of the old term that was superior to the new version. In this case, the new version would have actually been clearer to the lawyers.

b) *Black Holes*: On occasion, with boilerplate contracts whose terms have been repeatedly copied from deal to deal, the market understanding of certain provisions – particularly if they are rarely the subject of dispute – can get lost. In such a case, where there is no clear understanding as to what function the term serves, revision of the term can be difficult because the industry has to figure out what meaning to give the term. But it is implausible that redemption provisions, that do get utilized regularly, are anywhere near the paradigmatic contractual black hole. Lawyers understand these terms; and they know what function they are supposed to perform and when. There is no contractual black hole that might produce coordination problems.

c) *Adverse Inference for Pre-Existing Contracts with Old Clauses (Negative Signal)*: Another barrier to change that lawyers often talk about is that, if an issuer changed the standard terms of the indenture to specify that holders are not entitled to a "redemption premium upon voluntary default, par upon involuntary default" remedy, a court may draw adverse inferences against existing bonds, issued prior to the clarification and be more likely to conclude that holders of these bonds are entitled to a "redemption premium upon voluntary default, par upon involuntary default" remedy.[18]

There are multiple shortcomings to this negative signal argument. First, it does not apply to issuers that have no outstanding bonds or to issuers that only have bonds that will mature shortly. In the corporate bond market, issuers in these categories will account for a non-trivial

---

[17] Going deeper, Mike Klausner identified several sources of network effects: interpretive network externalities (resulting from future court cases interpreting the common term), common practice network externalities (resulting from the accumulation of business practices implementing the widely used term), legal services network externalities (resulting from greater ease in obtaining legal advice regarding the widely used term, because lawyers already know about it), and marketing network externalities (resulting from familiarity with a term by market participants to do things like set prices). *See* Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757 (1995).

[18] Gulati & Scott, *supra* note __.

fraction of new issues. Second, it assumes that lawyers cannot draft a clause that raises no material prospect of generating an adverse inference. For example, it assumes that a clause that read "For the avoidance of doubt, holders upon an Event of Default are not entitled to seek specific performance of redemption unless the company has issued a notice of redemption" somehow would not do the trick for future courts.

In addition, there are reasons why this argument is unpersuasive in our context. First, bond indentures often include a clause that reads: "This indenture may not be used to interpret any other indenture, loan or debt agreement of the Company or its Subsidiaries or of any other Person. Any such indenture, loan or debt agreement may not be used to interpret this Indenture." Such a clause, of course, could also be included in the indenture for newly issued bonds. But beyond that, many issuers will have such a clause in their existing indentures. The concern that a court would draw an adverse inference from a modified provision in interpreting a pre-existing indenture that lacks the modified provision is basically a concern that the court would ignore the instructions *in both agreements* not to use one agreement to interpret the other one.

Second, the case law specifically suggests that it is more likely that a court will draw an adverse inference from a *failure to include a modified clause*.[19] *Cash America*, and for that matter *Sharon Steel*, invite contract drafters to modify their contracts if they are unhappy with the interpretation accorded to them by the court. A failure to modify the contract would likely be read by a subsequent court as an implicit endorsement of the prior court's interpretation. A similar reasoning is sometimes employed by courts interpreting statutes. Where the statute that has been interpreted was amended, but the amendment does not override the court's interpretation, later courts often reason that the failure by Congress to change the statute, even though an opportunity for doing so was present, acts as an endorsement of the prior court's interpretation. An issuer that included a modified provision in its indentures would, in our view, stand a better chance of convincing a court that the *Cash America* interpretation was wrong with respect to its older bonds and should not be followed than an issuer that did not.

d) *Endowment Effect*: The theory here is that once a court, via its interpretation of a clause, gives one side to a transaction an extra benefit (stronger set of rights), that party will have an unduly strong attachment to keeping those rights. In the *Cash America* context, this would translate to investors not having known or cared much about the right to receive the make-whole premium in the event of voluntary covenant breaches by the issuer prior to the case, but caring considerably about retaining this right after the case.[20]

The endowment effect story is not altogether implausible in this case and we initially thought we had an example of it. But we are also skeptical that the managers of large investment institutions ever get to know much about cases such as *Cash America* or *Sharon Steel*; and

[19] *See* Archer Daniels (cite).
[20] *See* Levine, *supra* note __ (suggesting that the endowment effect explanation for the unusual turn of events post Cash America).

certainly not enough to become irrationally attached to an obscure possible right from a case (that was, in our view, simply restating a right from a case three decades prior).

f) *Agency Problems*: The issuance and negotiation of bond contract terms largely occurs through agents. Issuers and investors are represented by managers, bankers and lawyers who may have strong short-term incentives to get deals done and may undervalue the costs of future negative outcomes. This type of incentive has been posited as an explanation for stickiness in contexts where the agents who will have to tackle the problems of having suboptimal terms in the deals are going to be different from those who garner the benefits from getting the deals done in the first place. For example, transactional lawyers who structure deals and help the company in good times have different incentives from the restructuring/bankruptcy specialists who come in to tackle default scenarios. Our case, however, involves the interpretation of the operation of a clause in the scenario where the company is healthy. So, the story about how the transactional lawyers might not be involved because they have passed responsibility on to the restructuring specialists does not appear to apply. In any case, transactional lawyers did propose a modification and were thus able to overcome any agency problems. Agency problems thus do not appear to explain why the modification was not embraced by market participants.

g) *Drafting Technology, First Mover and Coordination Problems*: Contract theorists occasionally favor contractual solutions that are not observed in reality. At least in some cases, the reasons why we do not observe these solutions is that the requisite drafting technology does not exist – that is, a clause that implements the favored solution and that has received sufficient scrutiny to assume that it works and contains no bugs is difficult to create. One barrier to the development of such a clause is lack of incentives. Contractual clauses cannot be effectively copyrighted and other users may free-ride on the creative efforts of the creator of the clause. On the flip side, there are potential reputational risks from creating a clause either no one follows or that leads to other, unforeseeable, problems in the future.

In our case, we know this explanation to hold relatively little value. The elite bar quickly formulated a response to the problem and was able to effectively coordinate the inclusion of the new language in roughly a dozen deals by both high-yield and investment grade issuers that rejected the *Cash America* interpretation. Coordination was also remarkably effective in terms of prominent lawyers from the firms either publicly condemning or warning clients about the implications of the *Cash America* case (senior lawyers are, understandably, often wary about criticizing a prominent judge in the federal courts in New York who is likely frequently sit on other similar cases). Further, to the extent that the firms that coordinated the above response were outliers and the real market preference was for the *Cash America* interpretation, versions of the clause that would have clearly produced that outcome in future situations already existed in the form of provisions used in the private issuance debt market.

We now turn to additional explanations that we regard as more promising in this case.

h) *Signaling Plus*: Deviations from market practice can create signals. In the case of bondholder remedies, post-*Cash America*, an issuer wanting to provide explicitly for "acceleration at par only" may send a signal that this issuer is relatively more likely to engage in a voluntary breach. Since issuers plausibly have private information about their likelihood to engage in voluntary breach, this story has surface plausibility.

In our case though, the key law firms appear to have solved this problem initially in successfully coordinating around a proposed clarification to the existing contract language. And, initially, with issuers of a variety of types adopting the new language, they appear to bypassed any risk of investors being concerned that these particular firms were likely to engage in opportunistic breaches to be able to redeem bonds at par, even while the firm remained healthy. The standard form looked to have been on its way to changing.

i) *Lawyer Understanding versus Investor Understanding:* Given our skepticism regarding the applicability of any of the standard explanations for contract stickiness in our case, we offer an additional possible explanation. There may be gaps between lawyers' understanding and investors' understanding of provisions in contracts like indentures. Lawyers' understanding is based on a close reading of the words of the provision and on rules of legal interpretation. Lawyers' understanding of the remedy section pre-*Cash America* was that it provided for an "acceleration at par only" remedy. Investors' understanding was less well developed. It was based not only (and perhaps not at all) on a close reading of the words of the provision and on rules of legal interpretation but on market practice: how much do bondholders get paid. Market practice was that companies wanting to retire bonds would generally do a tender offer, where investors would get paid more than par (an outcome consistent with the fact that an Event of Default and acceleration have adverse collateral consequences that companies want to avoid, and are willing to pay to avoid) and some market participants may have been aware of that practice; others may not have focused on whether, why and when they get paid more than par. After all, Events of Default outside of bankruptcy are relatively uncommon.

On this account, what *Cash America* did was to focus investors on their legal entitlement. When confronted with that issue, investors decided that they prefer the "redemption premium upon voluntary default, par upon involuntary default" remedy over the "acceleration at par only" remedy. They didn't care about what the original understanding of the boilerplate clauses in the minds of their lawyers had been; they had simply consented to the standard form terms and those standard terms should not allow issuers to behave in the manner that the issuer in *Cash America* did. A function of high profile litigation, according to this understanding, is that it leads a wider set of market participants to assess what contract provisions are optimal. While before the case, these decisions were made (for many terms) by lawyers, after the case they receive wider input from clients.

This explanation has implications for the circumstances in which contracts terms will be more prone to inertia, both in general and in the wake of court interpretations that conflict with lawyer's understanding of a term. The potential gap between lawyers' and clients' understanding will generally be wider for two types of terms. Terms in contracts where clients

are not represented by their own lawyers who will alert them to the lawyers' understanding; and terms of secondary economic significance that lawyers pay little attention to and that are not discussed between lawyers and clients. The term at issue in *Cash America* fits into both of these categories. Bond indentures are negotiated between the issuer's counsel and the underwriter's counsel. Though bond purchasers are often large financial institutions, they generally do not regularly hire outside counsel to review and advise them on the terms of the indenture. Moreover, the term at issue was a boilerplate term in the remedy section of the indenture and would have been unlikely to have received much attention and analysis.

By contrast, we would for example expect much less inertia in terms such as "materially adverse change" clauses in merger agreements.[21] In merger agreements, acquirers and targets are represented by their own sophisticated law firms and we would expect that lawyers discuss the specific scope of "materially adverse change" clauses with their clients. Such representation and discussion is likely to lead to a substantial alignment of the lawyers' and clients' understanding of the scope of these causes.

j) *Hard to Put Humpty Dumpty Together Again (or Perhaps No-one Tried):* A final explanation for the failure of the market to change the terms post-*Cash America* is that it may have been difficult to get back to the status quo before *Cash America*. As explained, prior to *Cash America*, *Sharon Steel* established that bondholders have the right to receive the redemption premium upon certain defaults. To the extent that market participants were comfortable with the scope of default for which a redemption premium was available under *Sharon Steel* and saw *Cash America* as *expanding* this scope, they would have wanted to revert to the narrower scope that they perceived to have been established by *Sharon Steel*. But the changes proposed by law firms in the wake of *Cash America* went further; they eliminated the right to receive the redemption premium for all defaults.[22]

It is not clear why law firms proposed these changes. The obvious possibility is that they thought that *Cash America* and *Sharon Steel* were equally wrong – which poses the separate question of why they seemed to be surprised by the *Cash America* decision. Alternatively, they may have thought that *Cash America* went beyond *Sharon Steel*, but made the strategic judgment to use *Cash America* to also get rid of *Sharon Steel*. That strategic judgment, in turn, may have backfired in as much as bond purchasers would have been willing to revert to the status quo before *Cash America* but were not willing to give up their rights to the redemption premium under *Sharon Steel.* Third, *Sharon Steel* may have been viewed as a precedent that turned on exceptional facts and would not govern future cases. Finally, they may have had difficulty of coming up with proper language in the indenture that would clearly delineate the

[21] For discussions of, and a debate over, contract change dynamics in the merger context, see John Coates, *Why Have M&A Contracts Grown: Evidence From Twenty Years of Deals*, Harvard Law School Discussion Paper # 889 (Nov. 2016), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2862019; Jeffrey Manns & Robert Anderson, *The Inefficient Evolution of Merger Agreements*, 85 GEO. WASH. L. REV. __ (2017).

[22] This was one of the explanations given by lawyer-respondents for why, in the wake of the controversial interpretation of the *pari passu* (equal right) clause, it took a long time for lawyers to figure out how to put in place an acceptable revision. The explanation was along the lines of: "How do draft a clause that says there is no right to equal treatment, even though that's what we needed to say?" *See* Gulati & Scott, *supra* note __.

circumstances in which bondholders would be entitled to receive the redemption premium and the circumstances in which they would not. In other words, now that both *Cash America* and *Sharon Steel* were on the books, it was just easier to eliminate the right to receive the redemption premium upon a default in the entirety than to devise inherently imprecise standards for when the premium is available, standards that courts would be likely to interpret with the aid of *Cash America* and *Sharon Steel* and, law firms may have believed, would often not interpret correctly.

IV. The Interviews

For purposes of this paper, we focused on interviewing senior lawyers who did work either on the issuer or investor side in bond issuances. As of this writing in [April 2019], we have spoken to over [forty] of these senior lawyers. Our initial access to this pool of lawyers began fortuitously with our being invited to speak to a meeting of the New York Bar Association in early 2019 on a prior article we had written on the *Cash America* case for a capital markets journal oriented towards both practitioners and academics. There were roughly fifteen senior lawyers in attendance at that meeting, who then gave us recommendations as to others to speak to. We next tapped the alumni networks of our respective institutions for lawyers in the high-yield field who we assumed would be more willing to help us. Finally, since we had prior contacts in the sovereign debt field and since sovereign debt transactional lawyers often also work on high-yield corporate issuances, we had a number of contacts there. We tried to avoid, and did in all except two cases, the authors of the various law firm memos critical of the *Cash America* case, so as to avoid pre-existing biases on that score.

The interviews in the majority of cases lasted for roughly an hour, with follow ups via email where we asked every respondent if there are others they thought we should talk to in order to get a fuller picture (very few gave us suggestions here). All our respondents were assured that nothing that they said would be for attribution, and that they would not be individually identifiable. In every case, we sent them our prior article on the case so that they were aware of our prior views and our specific interest in the question of contract stickiness. Of the approximately forty-five lawyers we reached out to, we were unable to talk to only four. One said that he would have talked to us, but for his firm's policy of not commenting on matters that might impact ongoing cases. Two others never replied. And one (a seventh-year associate) said that we should talk to his senior colleagues since he had been too junior at the time of *Cash America* (late 2016) to have been involved in the discussions about contract revisions.

We are under no illusions that our respondents did not sometimes have their own agendas in talking to us. In a number of cases, our respondents aggressively explained to us why the *Cash America* decision was obviously wrong and in a few of cases why it was obviously right. Our primary goal though was to understand how these lawyers – all of whom were participants in the events we were interested in – articulated both the reasons for the court decision being right or wrong and those for why the attempt to change the clause had failed so far.

Below, we report what we were told in general terms. We are not attempting to report a survey of answers to questions, and do not quantify answers to specific questions except in a broad sense. In every case, we began the discussion by assuring our respondents that nothing they said was for attribution and then setting forth three core questions that we had. Then, we allowed our respondents to talk, interjecting follow up queries when the responses called for them.

The three questions were:

> (1) How is it that the law firm memos were so critical of Judge Furman's decision in *Cash America* when, as best we can tell, he was applying the relevant precedent from a famous case in his circuit, *Sharon Steel*?
>
> (2) Given that both the *Cash America* decision and *Sharon Steel* seem to look to the issuer's option to redeem at particular prices in deciding what the remedy of the creditor would be, and also given that our prior research suggested that issuers almost never utilize the option to pay the full make-whole premium (it is too high), why not just delete the option to pay the make-whole premium?
>
> (3) Why did the strategy of remedying the perceived flaw in the *Cash America* – which was to clarify that the creditors were limited to recovery at par when they accelerated on account of an Event of Default – fail, after having looked to be initially successful?

We report on the answers we received on the three questions below.

1. *The Folklore of* Sharon Steel

Our starting point for every interview was: Why the outrage over *Cash America*, when it could be plausibly argued that it was but an application of *Sharon Steel*, the controlling precedent in the Second Circuit?

Uniformly, across the interviews, almost no one took the position that Judge Winter's construction of the remedy in *Sharon Steel* itself was flawed. Instead, we received three sets of answers explaining why both we and Judge Furman had incorrectly understood the teaching of *Sharon Steel*. We take the explanations in turn.

a. *Sharon Steel* was about Bad Faith/Bad Intent

The most common answer we received was that we had misunderstood the deeper context of *Sharon Steel*. That was a case about a company that had acted with in bad faith vis-à-vis its bondholders. It had needed to liquidate for tax reasons, but was trying to mischaracterize that liquidation as a sale of all or substantially all of the assets (that then allowed it to pass the debt to buyer of those assets, so long as some minimal requirements were satisfied). *Cash America*,

by contrast, we were told, involved a company taking a perfectly defensible position regarding the proper way to do a particular valuation calculation.

As we see it, there are two flies in this buttermilk. First, nowhere in *Sharon Steel* is there mention of bad faith or intentional misbehavior on the part of the company. If anything, Judge Winter makes it clear that the provisions at issue in that case did not provide a clear answer and that a formalist reading might give an answer in favor of the issuer. He was not willing to reach that result under these facts, *but the trial court had*.

Second, Judge Winter was writing for the Second Circuit on appeal. The trial court, the one that saw the parties and interacted with them, ruled in favor of the issuer (in as much as it required UV only to pay par, not the redemption premium). Under these conditions, ones that would have been obvious to Judge Furman, it would arguably have been reversible error for Judge Furman to have read *Sharon Steel* to be about intentional misconduct on the part of the issuer. Although, to be fair to our respondents, there were a couple of bankruptcy court cases in the thirty-five years between when *Sharon Steel* came out in 1982 and Cash America in 2017 that in dicta had taken that position.

Third, the line between bad intent/bad faith and voluntary breach is a fuzzy one. In both *Sharon Steel* and *Cash America*, the issuer took a position on the interpretation of a covenant that turned out to be wrong and took voluntary actions based on this position. The court in *Cash America* noted that the issuer had been warned that bondholders interpreted the indenture differently – i.e. the issuer was on notice that its interpretation was controversial. And to us, Cash America's interpretation is indeed dubious. The covenant at issue in *Cash America* prohibited certain transfers unless "the aggregate book value of properties disposed of .... boos not exceed" ten percent of the company's "Consolidated Total Assets." Although the indenture clearly refers to the book value of "properties", and the benchmark is expressed as a percentage of Consolidated Total Assets, Cash America took the position that "the aggregate book value of properties" referred to the book value of the disposed assets *minus* the book of the liabilities disposed together with the assets. The assets at issue consisted of stock of a subsidiary and another clause in the same covenant provided that "[f]or purposes of determining the book value of property constituting capital stock or similar equity interests of a Subsidiary of the Company disposed of as provided in Section 5.01(2), such book value shall be deemed to be the aggregate book value of all assets of the Subsidiary that shall have issued such capital stock or similar equity interests." Unlike the court the *Sharon Steel*, Judge Furman did not have to resort to context and purpose: he held that the "plain language" of the indenture "compelled" a ruling for the bondholders. If bad faith or bad intent is to be judged by the weakness of the argument put forth by the company, Cash America wins hand down.

Our conjecture here is that what was going on was that a folklore had developed around the meaning of *Sharon Steel* in the thirty-five years since it had been issued. Every transactional lawyer we talked to was familiar with the broad contours of what happened in the case, but what they had taken from it had deviated significantly over the years from what the judge had actually done in the case. The uniformity of these views from the [thirty plus] transactional

lawyers at different firms, who we suspect talk more often to each other about indentures other than they talk to litigators, may have reinforced their perceptions.[23] The one person we spoke to who saw this clearly – and indeed, who had tracked this down to the briefs in *Sharon Steel* – was a senior litigator at one of the big firms; who complained bitterly about how his transactional colleagues never spoke to him about the risks that many of their standard form clauses posed.[24]

b. Victor Posner was a Bad Guy

A different version of the foregoing bad faith/bad intent story that we heard from a subset of veteran respondents, was that "It was all about Victor Posner" or "Victor Posner's presence heavily influenced the atmospherics of the case". Victor Posner was a major figure in the takeover boom of the 1980s, and, along with Mike Miliken and Ivan Boesky, among its most colorful characters. Posner was described by Forbes as having "the arrogance of a banana republic dictator" and by the Economist as the "master of the corporate takeover."[25] He was the paradigmatic ruthless corporate raider of the 1980s, who managed to get into trouble with the tax authorities and the U.S. Securities and Exchange Commission (the latter eventually banned him and his son from having positions in any U.S. public corporations).[26] Sharon Steel was his company.

Everything we have heard suggests that Judge Winter, a prominent corporate law professor at Yale, would have been familiar with Victor Posner and his tactics. Sharon Steel, however, was not the main party at issue. Sharon Steel was the buyer of the assets from UV, and UV was the issuer of the indenture that contained the covenants at issue. UV appears to had sold its other assets prior to being in contact with Sharon Steel and Posner. Perhaps Sharon Steel and Posner suggested to UV to take the position that a sale of the remaining assets to Sharon Steel was a sale of "substantially all" assets under the indenture – and perhaps not. In either case, ultimate responsibility would lie with UV.

More to the point, Judge Winter, in his Second Circuit opinion, said nothing suggesting that he was limiting the reach of his opinion to intentional misbehavior or bad faith and never mentions Victor Posner. Even assuming arguendo that Winter was influenced by Victor Posner's presence, how is a trial court reading this precedent – thirty-plus years after it was decided – supposed to figure this out. To us, there is a near zero likelihood that *Sharon Steel* would have been read with those atmospherics in mind.[27]

---

[23] Some of the lawyers we spoke to were restructuring specialists, for whom (a) *Cash America* was a relatively unimportant case, and (b) contract drafting was not a significant matter. We do not count them, therefore, as transactional or deal lawyers. In the bankruptcy world, two bankruptcy cases that had drawn on *Sharon Steel*'s teachings in the interim years prior to *Cash America* had, in dicta, described *Sharon Steel* as relating to "intentional" defaults designed to trigger an acceleration.

[24] We had not intended to speak to any litigators for this project. But one of the transactional lawyers who had been extremely helpful to us, insisted that we speak to a friend of his in litigation – and so, we did that out of politeness. It turned out to be one of our most interesting conversations.

[25] See Peter Bernstein & Annalyn Swan, ALL THE MONEY IN THE WORLD 266 (2007); Victor Posner, Master of the Hostile Takeover, ECONOMIST, Mar. 9 (2002).

[26] For more, see *Ratting on the Boss*, N.Y. MAG. April 18. (1977); Nathan Vardi, *All in the Family*, FORBES, Aug. 11 (2003).

[27] Further, an additional fact pointed out by two of our veteran respondents (who also were among those who told the Victor Posner story) cuts further against the view of many of our respondents that *Sharon Steel* should have been read narrowly in light of the bad behavior of the actors

c. Sharon Steel *is not the Right Precedent*

This third criticism of Judge Furman's reading of *Sharon Steel* was one that we only heard from a few respondents (three). Their point was that *Sharon Steel* was not in fact binding precedent on Judge Furman. Judge Winter, after all, was a federal judge interpreting the contract law of New York State. If Judge Furman had looked to the relevant case law from the New York state courts, he would have come to a different outcome. Plus, he would have seen that the contract law of New York state disfavors penalties and does not give specific performance in situations like this where money damages could have easily been estimated.

If there were post-*Sharon Steel* decisions from the New York state courts directly on point, the first part of the foregoing objection might have had more muscle. But *Sharon Steel* was pretty much it in terms of setting remedies for voluntary breaches of covenants for an otherwise financially healthy company. Absent intervening decision by a state appellate court, district courts generally follow the interpretation of state law adopted by their circuit court.[28]

Regardless, to the extent Judge Furman thought he was constrained to follow the Second Circuit's guidance, he did that. Maybe he should have been more skeptical and sent a strong signal in his opinion that he was being forced to do something wrong. But lower court judges rarely do this, and especially not in a commercial contract dispute that the Circuit is unlikely to be eager to wrestle with. Indeed, Judge Furman didn't even think the case important enough to designate his opinion as "for publication" in the Federal Supplement.

Boiled down, the primary objection to *Cash America* seems to have been that Judge Furman should have delved deeper into market understandings and historical context of the relevant precedent rather than simply doing a facial reading of the case. But that's not how judges deal with precedents. This goes back to what the one annoyed litigator we spoke to said:

> My transactional colleagues don't spend any time thinking about how things will play out in litigation. They think that judges will be able to divine what is in their heads.

2. The Loch Ness Monster (Why Not Delete the Make-Whole Premium?)

The core question for this project was: Why didn't you revise the clause, given that you think that the trial court erred in interpretation? (and quite possibly, that the Second Circuit erred thirty years ago too). So as to ground our question in specifics, before moving to the general,

---

there. This is their observation that there were a handful of bond indentures issued in the wake of *Sharon Steel* that did modify the creditors payment rights upon acceleration to specify that the creditors were entitled to the redemption premium in the event of an intentional breach of a covenant (we were able to confirm this fact in the data). Interestingly, this provision only showed up in a few Drexel Burnham (Mike Miliken's firm) deals and then disappeared (as did Drexel). But the point again is that it is hard to fault Judge Furman in 2017 for not reading any of this into his reading of *Sharon Steel*; it is nowhere in that opinion.

[28] Colin E. Wrabley, 3 Seton Hall Circuit Review 1; In Re E & S Dists. Asbestos Litig., tt2 F. Supp. 1380, 1391; Reisner v. Residential Funding Corp., 380 F.3d 1027, 1029 (7th Cir. 2004).

we began this second line of inquiry with: Why not delete the make-whole premium from the issuer option side? The judges in both *Sharon Steel* and *Cash America*, after all, in constructing their specific performance remedy had looked to what amount the issuer had promised to pay in the event of a voluntary redemption and converted that into the appropriate damages measure. For our prior paper, we had looked to data on how often issuers actually exercised the option of paying the make whole premium and we found that the answer was: Almost never, except when the period during which there was an obligation to pay the make-whole premium was almost over and that amount to be paid according to the formula was in effect very small. So, given that this option was almost never exercised, why not just delete it, or at least make it available only for the year prior to the maturity of the bonds or the date when the fixed-premium redemption option becomes available. So confined, the *Cash America/Sharon Steel* problem would be greatly reduced.

Broadly speaking, we got two sets of answers here. The first responding to the specific question about deleting the make-whole premium from the issuer's set of options (after all, it is an issuer option) and second talking more broadly about modifying contract terms that have become relatively standard.

a. Deleting the Make Whole

Not one of our respondents thought what we thought was a clever insight based on a little bit of research was useful. Uniformly, the response was: No one will delete the make-whole premium in high-yield bonds or elsewhere. We suspect most of our respondents thought this question was a bit silly (as one said, "the kind of question academics spend time thinking about, but we don't have time to"). Upon receiving the foregoing response, we asked the follow up of: In *Cash America*, this opinion that so many elite lawyers seem to be unhappy about, one of the sources of the problem is that the judge looked to the issuer's option to pay a highly over compensatory make-whole premium to retire the bonds. Given that no one ever seems to actually pay the full make-whole premium to retire bonds, why not delete it?

We got two answers to our question. The first was that we were wrong that the issuer's option to retire the bonds by paying the make-whole premium was useless. Issuers apparently value the option to retire the bonds, even at a high price, in cases such as a potential acquisition that has a very high upside. There, they are worried about the possibility of holdouts when they conduct a tender offer (which is what they typically do in order to retire the bonds, even if there is a make-whole option). The option to use make-whole premium to retire the bonds will in theory deter potential holdouts because they know they can be forced to sell at that price, in the event that the tender offer does not work. Put differently, it puts an upper bound on the holdout premium.

That said, none of our respondents had themselves worked on deals where the full-blown make-whole had been paid. Some claimed that they had heard that there had been such deals, one respondent mentioned a deal involving a big pharmacy chain that was a possibility, but no one was able to point us to specific deals. Almost everyone though was confident that some

deals had been done in the months before maturity; although those, as our respondents themselves were quick to point out, were deals where the premium would have been small. Like the monster of Loch Ness, deals where a make-whole premium was paid were much talked about, but little evidence for their existence was provided.

Our follow up was to ask about whether, even if the option to pay the make-whole to retire the bonds was necessary, whether – now that, after *Cash America*, the issuer was facing an additional risk for having the make-whole option – the size of the make-whole option might get altered by a few basis points at least.

b. What About Changing the Make-Whole Premium By a Few Basis Points

Our question about whether there was consideration of reducing the make-whole premium in respond to *Cash America* received roughly the same response of puzzlement from all our respondents. The premium on the make-whole, almost always the over-compensatory discount rate of the treasury rate plus 50 basis points, was part of the standard boilerplate. Proposing a change to the standard form was no trivial matter; it would require negotiation – and this was going to be difficult if there was no sign that that rest of the market was changing its clauses. Using the standard form, the one that has enabled prior deals to get completed with no negotiation delays is important for the issuers and the arrangers. Those individuals and institutions are all on the same side; with a focus on getting the deal through. The last thing they want is a delay because some lawyers want to negotiate over some event that is unlikely to occur. Plus, situations such as the one in *Cash America* almost never occur – that's why, as one respondent explained, there had been more than a quarter century between *Sharon Steel* and *Cash America*. And to the extent these events occur, it is in bankruptcy, where the types of investors and even lawyers involved – particularly in disputing the payouts – are very different from those at the front end.

The bottom line, was that small and marginal modifications to the legal terms simply did not get made on the basis of some obscure trial court decision that most likely would get corrected in future litigation.[29] Our response that *Cash America* didn't seem that obscure (and *Sharon Steel* surely was not) did not alter that answer. Standard forms contracts did get changed on occasion, a number of our respondents explained. But the change had to either come as a package of a number of changes where there was broad agreement; and the example of this was from a few years prior when a White Paper had been issued by the Credit Roundtable (an association of fixed income investors) in 2007, that then resulted in broad changes across the industry in the standard forms.[30] The one other instance where provisions might have changed – although the few respondents who mentioned this were not sure how extensive the changes had been – was in response to the trial court decisions on Exit Amendments in *Marblegate* and

[29] *See* Gulati & Scott, *supra* note __ (reporting on how they heard this explanation, repeatedly, with respect to the decision of an obscure Belgian court on the *pari passu* matter, in the *Elliott v. Peru* case).
[30] https://www.iimemberships.com/Credit-Roundtable

Caesars.[31] Those cases addressed an important issue that every high-yield issuer needs to contemplate (apparently because needing to conduct an exchange offer, particularly if the firm is proving successful and wants to remove covenants so as to enable an acquisition for a higher credit firm, is an important contingency to anticipate).

3. Why the Resistance?

Our third and final question was about why the attempt to change that seemed to be on the brink of success in early 2017, when over a dozen deals adopted the *Cash America* corrective patch, and then hit a brick wall. As with our first question, about the disjunction (to us) between views of *Sharon Steel* and *Cash America*, there was remarkable uniformity in the answers we received here. Further, a number of our respondents began our conversation – after we had given them our three core questions -- with something along the lines of: "Your third question is the easiest; I will begin by answering that." The responses to our initial query and follows ups fall into three categories.

a. Mountain out of a Molehill

The answer that we got from almost all our respondents was: Covenant Review. Covenant Review is a firm that was started by a former senior associate at Lathan and Watkins, Adam Cohen.[32] Cohen, while at Latham, worked on debt covenants and had perceived a gap in the market for a service that would examine the covenants in big debt deals and tell investors the basics of what they were receiving. And, in particular, Covenant Review performs the function of alerting investors to any significant deviations from the standard forms that the issuers had put into the deal and that underwriter's counsel – whose focus is on getting the deal done – might not have adequately flagged for investors.

Here, in the initial attempts to put in a correction for *Cash America*, issuer's counsel had put in new language to clarify that the only remedy available upon acceleration was repayment at par. For example, Rackspace did an offering less than a month after the Cash America opinion came out, with the language:

> For the avoidance of doubt,[33] no premium in respect of the notes shall be payable as a result of any default or Event of Default.[34]

---

[31] For a discussion and estimation of some of these changes, see William W. Bratton & Adam Levitan, *The New Bond Workouts*, 166 U. PA. L. REV. 1597 (2018).

[32] The fact that Cohen had been a senior associate (i.e., not a partner), was one that many of our respondents emphasized in both a positive and negative fashion. This, as one said, was the "legal sociology" aspect of the story where a former associate had left to start his own firm to fill a gap in the market (no one reading the covenants in these deals), had taken on the senior partners at the big firms all together at once, and had won (apparently making a bundle in eventually selling his firm to one of the big three rating agencies).

[33] One investors newsletter, from XTractResearch, somewhat amusingly explains to investors that "For the avoidance of doubt" is legales for "this provision is not necessary, as the following words may obviously inferred from other provisions of this contract; therefore, it should be read into every other indenture that I have ever written." See James Wallick, The New Make-Whole Language: Why it Could Become the New Standard, and Why it Might Not Work as Intended, XTractResearch, Nov. 4, 2016.

[34] The Preliminary Offering Memorandum for Rackspace was dated October 17, 2016. The *Cash America* opinion was issued on September 16, 2016.

The lawyers doing these deals, on both the underwriter and issuer sides, took the position that since they were just returning to the view of what the contracts meant before *Cash America*, they did not need to put a big red flag on this change. Reuters quoted a partner at Allen & Overy as explaining: "At the end of the day, what the provision does is to remove any ambiguity and resolve it in favor of the issuer."[35] Since, to quote one of our respondents, "it was not a material change", it was not flagged on the cover page of the sales documents (the prospectuses or offering circulars) as would have been done with something like the addition of a new clause such as the addition of new collective action clauses in sovereign bonds in 2003 and 2014.[36]

Covenant Review seized on these deals to alert investors to what their specialists asserted was an assault on their rights. To illustrate, the title of their January 9, 2017 newsletter, was: "The End of Covenants: The 'No Premium on Default' Language is Spreading Like Wildfire – Your Future Covenant Enforcement is Being Destroyed." Similarly, Adam Cohen, the CEO of Covenant Review, said to Reuters: "In my 20 years as a lawyer in the high-yield bond market, this is the worst potential covenant change I have ever seen."

According to the majority of our respondents, no such dramatic change to covenant rights was occurring. Covenant Review was just being opportunistic in trying to raise its profile. And it succeeded in making a mountain out of a molehill. Crucially, what happened was that Covenant Review managed to persuade enough of the big institutional investors to take the position that they would not buy bonds if they contained the *Cash America* patch. And once deal arrangers realized that, they immediately told their lawyers to stop putting in the *Cash America* corrective language.[37]

At this point, we followed up by asking: But wasn't that corrective language important? Didn't it protect issuers against a contingency they had not anticipated at the outset?

b. Not Important Enough; Future Courts Won't Make This Error

Our respondents gave two reasons for why inserting the corrective language was not particularly important. First, this event being contemplated, where a company is viewed as having voluntarily defaulted on some covenant while fully solvent, was extremely rare. It simply was not going to happen that often, and even if it did the situation would usually be worked out in an amicable fashion. Cases like *Cash America* only arose because activist investors had gotten involved. But these investors typically only got involved in situations of

---

[35] David Scigliuzzo, *New Junk Bond Provisions Called Into Question*, Reuters, Nov. 18, 2016. Available at https://www.reuters.com/article/uscorpbonds-highyield-covenants/new-junk-bond-provisions-called-into-question-idUSL1N1DI1OX

[36] We checked a half dozen of the initial deals with the *Cash America* correction patch and this was correct. The change was not flagged on the cover pages of the prospectuses or offering memoranda as was done with the introduction of collective action clauses in sovereign bonds in 2003 and 2014 and the revisions to the *pari passu* clauses in 2014.

[37] There was also another firm, providing a service similar to Covenant Review, that expressed serious reservations about the Cash America corrective patch around the same time. This firm, XTractResearch, however, didn't use quite the inflammatory language of Cash America and took the position in one of its early reports that future courts were likely to ignore that the corrective patch in situations like *Cash America*. See Wallick, *supra* note __. Further, our understanding is that Covenant Review was much more involved than XTractResearch in organizing resistance to deals with the patch.

deep distress. There was no need to worry about this type of event occurring very often and therefore, if the deal arrangers wanted to just ignore the issue, it was not the place of the lawyers to disagree. What was of paramount importance, our respondents were in agreement on, was that the deal get done. To quote one respondent: "No one wants delays because the lawyers want to add in some obscure legalese for an event that won't ever occur."

Second, and we heard this secondary explanation only from a handful of respondents, they explained that it was unlikely that future courts would make the same errors in terms of understanding *Sharon Steel* and how to determine contract damages that *Cash America* had.[38] One respondent specifically pointed us to a similar case that had come up through the courts around the same time as *Cash America*, *Chesapeake Energy v. Bank of Mellon*, where the court had given essentially the same remedy for a similar set of events.[39] But there, the court had not gone down the *Sharon Steel* specific performance route, but rather used the make-whole remedy as an indicator of what restitution damages would be (the creditors' lawyers in *Chesapeake* argued that this would put them in the position they were in before redemption). And a couple of other respondents pointed to Circuit level decisions from the bankruptcy context (including one from the Second Circuit), where according to them, the courts had in effect taken a different route than Judge Furman had in *Cash America*.[40]

Our final question, in following up at this stage, was: Did investors have to pay anything in basis points in exchange for getting rid of the *Cash America* patch?

c. You Do Not Understand How Covenants Are Priced

The simple answer on our pricing question was: No. We did not push further at this point, but a number of our respondents went on to explain that, in a sense, our question reflected a failure to understand how bonds were priced. One explained:

"The price is set before the legal terms are negotiated. Investors either buy a part of the issue or don't. They don't negotiate in terms of a few basis points for the inclusion or exclusion of language like this provision like this [the *Cash America* patch]. You don't [in academia] understand how covenants are priced. They are priced as a standard package for the category of investment – high-yield bonds or private deals or investment-grade ones.

One respondent, who had attempted to get the *Cash America* patch inserted into their deals and failed because of the deal arrangers had said no, mentioned that there had been some talk from the investor side in her deal that the investors were willing to put in that patch if they were given 5-10 basis points in exchange. But she said that that comment had been made sarcastically; that no one seriously thought this was a matter on which prices would change. If

[38] Two of our respondents were at large UK firms and were qualified to practice in both the US and the UK. We asked them about whether there had been consideration of inserting the Cash America patch in English-law governed high-yield bonds. They both immediately dismissed our question with a: English courts would not make this type error. Our judges are all former barristers and they take market understandings very seriously.

[39] *See* Chesapeake Energy Corp. v. Bank of N.Y. Mellon Tr. Co., No. 13 Civ. 1582 (PAE), 2015 WL 4191419 (S.D.N.Y. July 10, 2015).

[40] Cite to the Momentive and Ultra decisions.

we looked, she said, we'd see that the deals with the corrective patch were priced the same as the ones without it.

V. Lessons About Contract Inertia

As we see it – and we have not completed our research -- the answers to the interviews that we have conducted are most consistent with, and provide support for, two of the explanations for contractual inertia described earlier.

Changes Can Occur Quickly, but Only if They Truly Get Back to the Status Quo

First, one reason for the failure to overturn *Cash America* may have been that the efforts to do so were misguided and overreached. When asked about the state of the law prior to *Cash America*, interviewee responses fell into two broad categories. Some interviewees heavily discounted *Sharon Steel* as precedent, suggesting either that it was *sui generis* (i.e. tied to the particular characters involved) which, by implication, were very unlikely to recur or that it was so clearly inconsistent with other case law that is was unlikely to be followed. For that camp, the state of the law prior to *Cash America* approximated the "par only upon any default" remedy. The same would be true for lawyers who were not aware *Sharon Steel,* though none of our respondents admitted to falling in this category.

Other interviewees, however, accorded a more meaningful role to *Sharon Steel*: for them, *Sharon Steel* applied to bad faith/intentional defaults but not to regular "voluntary" defaults that fell short of bad faith/intentionality. Though the line between voluntary and intentional may be fuzzy, and though the argument that bondholders have no right to have their bond redeemed and that thus there is nothing for a court to enforce specially applies with equal force to bad faith/intentional defaults, these interviewees firmly believed specific performance of redemption would be available in some circumstances, but should not have been awarded in *Cash America*. In fact, one of these interviewees who was critical of the *Cash America* decision, told us that he advised clients that certain transactions would trigger such a remedy and advised them not to take them. For this camp, the "par only upon any default" clause would go beyond reinstating the state of the law prior to *Cash America*. Moreover, the broad language used – *no premium* in respect of the notes shall be payable as a result of *any* default or Event of Default – could eliminate premia even in circumstances where a premium clearly ought to be paid, e.g. in a case where a company actually redeemed the bonds but failed to pay the proper premium.[41]

The reaction by Covenant Review and institutional buyers – that the changes "destroyed" the ability to enforce covenants and amounted to "the worst potential covenant change" – are consistent with this assessment. Discounting the characterization of these changes by Covenant Review for some hyperbole, we think it is possible that that the negative reaction of both Covenant Review and the bond purchaser community had to do with the sweeping

[41] Chesapeake

language of the *Cash America* patch. Put differently, it is conceivable that a narrower patch, which would have retained the availability of specific performance of redemption for bad faith/intentional defaults would have been acceptable.

To put the foregoing in the terms that a handful of our respondents did, the miscalculation of those who aggressively put the *Cash America* patch was that they tried to sell it as maintaining the status quo; as not being a change to the boilerplate, when it was. One respondent, who told us he had advised his underwriter clients to argue against the inclusion of the corrective patch before Covenant Review's first article explained:

> The reason those first deals, such as Rackspace, got done so quickly with the corrective language was that no one was paying attention. Investors just look at their checklist and this was not on their. And maybe some of the lawyers weren't paying all that much attention. [Investors] are focused on the financial terms; this [redemption payment] is part of the boilerplate that is supposed to remain unchanged from deal to deal. No one looks at the particular terms, because they are supposed to be the same as they were before. Even if they have problems, they are the same problems as the prior deal.
>
> Investors in this market [were] already sensitive to Private Equity sponsors trying to chip away at protections. And . . . I don't think this is a huge problem – these are, for the most part, parties who are repeat players and care about reputation – but it happens here and there. Here, the [deal lawyers] didn't flag the change. Even though it was disclosed, it wasn't done with a big red shiny flag. That is why a bunch of deals got done quickly. Maybe eighteen or so . . . I used to have a file. Had the [deal] lawyers said they were making a substantive change – like putting in the intentionality standard explicitly, there would have had to be negotiations; industry meetings and so on. And no one wanted that. But then, when the investor side realized that the boilerplate was getting messed with to their detriment, they just said no. They just refused to do these deals with the correction. It was an overcorrection maybe followed by overreaction.

We are speculating. But, at bottom, given the strong preference of the parties to keep the status quo, the attempt to negate *Cash America* may well have worked if the patch had taken the parties back to the view of the senior lawyers of *Sharon Steel* (not what it actually said, but what they had come to believe that it said). In other words, contracts can change quickly in response to a decision that the market disagrees with, but the change has to be fine tuned to keep the pre-existing boilerplate unchanged. And that might be an impossibility when we are talking about a world in which there is significant uncertainty about what the pre-existing boilerplate said in the first place.

Lawyer Understandings Versus Client Understandings

The second reason that finds some support in the answers we have received is that there is a disconnect between lawyers' and investors' understanding of certain contractual provisions. To be sure, Covenant Review by all appearances played a crucial role in organizing resistance to

the proposed patch. But even accepting that but for Covenant Review's efforts the patch would have taken hold, this leaves open the question of why Covenant Review was successful. It also bears mention that XTract Research, early in the game (and well before the mud slinging began) had also expressed strong reservations about the corrective patch.

Specifically, what did the clients of Covenant Review think about *Sharon Steel* before Covenant Review informed them about the patch? One possibility is that while they thought (like many of the lawyers we spoke with) that that *Cash America* went significantly beyond *Sharon Steel,* they saw resistance as an opportunity to increase their contractual rights. We cannot exclude this possibility. But we think that it is more likely that clients had no clear conception of when the specific performance remedy afforded by *Sharon Steel* would be available or ever thought much about it. It was only after *Cash America* was decided, the patch was proposed, and Covenant Review focused clients' attention to the patch, that they gave serious thought to the issue. And once they gave thought to the issue, they agreed with (or were persuaded by) Covenant Review that they liked *Cash America*. In other words, Covenant Review was able to succeed because of a pre-existing disconnect between lawyers' and clients' understanding of the remedy provisions in the indenture. Whether Covenant Review itself had a different understanding of these provisions than the corporate lawyers we interviewed or whether, as several respondents suggested, it was trying to raise its profile, is not relevant from this perspective.

It is noteworthy in this regard that covenant violations are typically enforced by activist hedge funds.[42] Activist hedge funds thus stand to derive the most direct gains by being able to obtain the redemption premium – rather than mere par – upon a default. So why did traditional institutional investors who buy bonds when they are issued resist the *Cash America* patch? The answer to this, as we have argued elsewhere, is that a right to obtain a premium upon a voluntary covenant breach – though in our view inconsistent with the wording of indentures – may make sense from a policy perspective. Specifically, there are two reasons why over-compensatory default remedies are desirable. For one, because some covenant violations are hard to detect (opaque defaults), an over-compensatory remedy is needed to generate proper deterrence. Moreover, where a covenant is ambiguous (disputed defaults), an over-compensatory remedy can provide superior enforcement incentives for bondholders and hence superior incentives for issuers to either seek a clarifying amendment before taking an action that may violate a covenant or not to undertake the action at all. In other words, traditional institutional investors would stand to gain from a right to obtain a redemption premium upon default through the lower likelihood that a company would take an action that risks violating a covenant to start with.

Secondarily, the responses that we received also illustrate other barriers to contractual changes in response to legal opinions. First, it appears to us that transactional lawyers may have a tendency to discount opinions that they perceive as outliers excessively. This is true for their reaction to *Sharon Steel*. Rather than read *Sharon Steel* the way it read, they read *Sharon Steel*

[42] Kahan & Rock, ...

in light of their preconceived notions of what would make sense – they read it like transactional lawyers dealing with indentures not like a future district court judge without much knowledge of indentures would be likely to read it. Because *Sharon* Steel as written made no sense to them, they just held fast to the view that *Sharon Steel* was either a narrow opinion or one likely not to be followed. Talking to other transactional lawyers who held a similar view may have reinforced this assessment, an assessment that the few litigators we talked to did not share. Even after *Cash America,* some interviewees professed that next time the result would be different, pointing us to cases that, in our assessment, provided little support for this view. The reaction by transactional lawyers to other "outlier" opinion, such as the Belgian decision and the New York trial court option in the *pari passu* saga also evidences the tendency towards excessive discounting.[43]

What transactional lawyers perhaps fail to understand that issues that are evident to them due to their expertise are not necessarily evident to outsiders who lack this expertise and that the fact that there is a substantial consensus with an expert community is not provable to a judge who is not a member of that community. For lawyers dealing with indentures – such as the lawyers we talked to and ourselves – it may have been clear that *Sharon Steel* was wrongly decided. Even apart from the fact that *Sharon Steel* was binding precedent, this was not equivalently clear to Judge Furman – an experienced judge with a background as prosecutor. If transactional lawyers tend to discount outlier opinions excessively, thinking that no sane judge in the future will follow them, they will be less likely to take forceful steps to correct these opinions.

Second, the responses illustrate the constraint on contractual responses to a problematic court decision. In particular, transactional lawyers were reluctant to embrace responses that mitigated the effect of *Cash America* but had collateral consequences such as increasing the discount rate used to calculate the make-whole premium and limiting the time frame during which bonds could be redeemed with payment of a make-whole premium. Avoiding responses that have collateral consequences is, of course, rational if these collateral consequences are undesirable. However, we suspect that it was the mere presence of such consequences, rather than an assessment of the consequences, that caused the reluctance. Thus, from an economic perspective, the discount rate used to calculate the so-called make-whole premium is systematically too low, with the result that a make-whole redemption confers a windfall on bondholders, whether awarded as specific performance remedy or otherwise. Put differently, there is a strong case that an increase in that rate generates collateral consequences (in circumstances where a company avails itself of the make-whole option) that are *desirable*.

Rather, this reluctance appeared to be due to a combination of marketing network externalities and learning effects. Once a standard form is established, changes to the standard form require explanations, and the difficulty of providing these explanations generates reluctance to make changes. Whereas the *Cash America* patch could be viewed as merely overturning an "erroneous" court decision and reinstating the status quo ante – note the "for the avoidance of

---

[43] *See* Gulati & Scott, *supra* note __

doubt" wording of the *Cash America* patch suggesting that this clause just clarifies what should have been obvious to start with – a change in discount rate formula would primarily affect make-whole redemptions (never mind that they are extremely rare) and only secondarily the specific performance remedy. To market bonds with a non-standard formula, one would thus have to provide a more complex, and time-consuming, explanation than "*Cash America* was wrong" for why such a change is desirable. The notion of doing so seemed to them implausible.[44]

The upshot seems to be that the changes that are easiest to make fall into one of two types. First, substantial changes, changes in a set of provisions, or changes prompted by outside events, that entail benefits large enough to outweigh marketing network externalities and learning effects. These changes, multiple respondents explained, with examples from the past, can be done. But they take time and come in bunches. The reason for that is that the key players have to decide that it is time to negotiate a new boilerplate or make substantive improvements to the old boilerplate. During such windows, change can occur relatively easily. Absent these rare windows where the boilerplate gets improved, the focus is on getting the deals done. Second, "no change" changes, changes in the wording of a provision that can be regarded as either no changes to the substance and thus do not require "marketing," such as changes correcting a flaw, eliminating an ambiguity, or providing clarification, can occur with great speed. As one of the gurus of the debt covenant world, who had been particularly hard for us to grab time with, said cynically: "It is easy to get changes through with lightning speed, if no one is reading. Covenant Review put a magnifying glass on this and that killed it."

VI. Questions for Further Inquiry

The foregoing has opened up a number of questions for us. We list a few below that we are either in the process of investigating or hope to investigate in later projects.

First, we need to talk to some of the investors who took the position – as we have been told – that they would not buy bonds with the *Cash America* corrective patch. Among other things, what was their perception of their redemption rights prior to Cash America? And why did they react so negatively to the corrective patch?

Second, our sample may be biased. We have a large number of transactional lawyers from the elite firms who primarily represent either issuers or underwriters. We only have a small subset of lawyers who represent investors directly. That flaw is in part due to the fact that investors often do not have the large (or any) law firms advising them on matters such as the quality of covenants in the bonds they purchase.

Third, how idiosyncratic is the story we have unearthed? One aspect of the story that we have not explored, but that was mentioned by a few respondents, is that the kind of overreaching in

[44] The reluctance may also be due to agency costs – the possibility that the lawyer may underestimate the collateral consequences and get blamed for the failure.

terms of the corrective patch we saw here occurs rarely (no one could remember any other similar instance). Usually, these corrections take a long time before they occur. Here, the drama, in the words of one respondent, was because there was a clash of egos between one senior partner at an elite firm and someone at Covenant Review. Covenant Review appears to have won. Our initial thought here is that this particular idiosyncracy is not a problem; indeed, it creates the unusual events that help shed light on how things work under normal conditions.

Fourth, the world of bond covenant changes and high-yield debt is a highly dynamic one and has changed dramatically over the past few decades. Not only is the volume of high-yield bond issuances higher today than it has ever been before, but so is prevalence of activist investors who aggressively seek out opportunities to enforce covenant defaults that ordinary institutional investors might not have noticed. It is possible that an important aspect of this story that we have not unpacked adequately is the rise of the activist litigation specialist fund in recent years.