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Contracts of Inattention

Marcel Kahan and Mitu Gulati

The standard paradigm of contracting assumes that parties will revise subsequent contracts if a court interpretation of a clause does not reflect their intent. This assumption, however, often does not match behavior—particularly, in boilerplate contracts. We examine the aftermath of an (in)famous 2016 case, Wilmington Savings Fund v. Cash America, *to unpack possible reasons for this mismatch between theory and practice. We find evidence of a phenomenon in contracts that involves sophisticated parties who are nevertheless not represented by their own lawyers, lack full awareness of the fine print of the contractual terms, and, having devoted little attention to them, may be eclectic as to their meaning when they enter into these contracts. In these contracts, which we call contracts of inattention, a gap between lawyers' understanding of a provision and the understanding of market participants is prone to emerge. The potential for such gaps has implications for how courts should interpret contracts of inattention and for how market participants will react to court rulings.*

INTRODUCTION

Courts seeking to interpret long-used, but rarely litigated, provisions in a standard-form contract are periodically faced with choosing between the following perspectives. One side advances a position that is based on the strict text of the contract provision and the other counters that such a textual reading is illogical and inconsistent with the historic market understandings of this boilerplate provision. 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 US jurisdictions take the position that they would rather not inquire into the market understandings of contract clauses (Gilson, Sabel, and Scott 2014, 26). Most importantly, they take this view in the courts of New York, the leading legal jurisdiction for large commercial contract disputes (35, n. 34). This logic rests on two key premises: first, that sophisticated commercial actors and their expensive lawyers are capable of articulating, and have adequate incentives to articulate, the clear meaning of their contract provisions in plain text (*ergo*, the plain meaning is the market understanding) and, second, that, if a judge were to err in interpreting a clause, the parties are capable of quickly revising the clause in future contracts to articulate what it really meant.

So much for the theory. For some time now, scholars have been skeptical about the extent to which the foregoing premises hold up in the real world (Radin 2013;

Marcel Kahan is George T. Lowy Professor of Law, New York University, United States
Mitu Gulati is Professor of Law, Duke University, Durham, United States; email: gulati@law.duke.edu
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Bakos, Marotta-Wurgler, and Trossen 2014). It turns out that (1) even the most sophisticated lawyers sometimes draft contracts that contain unclear or ambiguous provisions (Anderson and Manns 2017; Coyle and Weidemaier 2018) and (2) changes to the standard forms take a long time to occur, and often do not occur at all, even in circumstances in which there appears to be widespread agreement that a court has erred in the interpretation of a clause (Kahan and Klausner 1997; Drahozal and Rutledge 2014; Choi, Gulati, and Scott 2017). Our focus is on the second of these two observations: the inertia phenomenon (Smith and King 2009; Gelpern, Gulati, and Zettelmeyer 2019). We are interested in why the pace of contract change in the world of standard-form or boilerplate contracts is so slow. Scholars have advanced a variety of theories to explain contractual inertia, such as network externalities, endowment effects, and agency costs (Kahan and Klausner 1997; Gulati and Scott 2013). But these theories do not always prove satisfying for explaining instances of inertia in the real world.

Our foil is the opinion in *Wilmington Savings v. Cash America*, which was issued on September 19, 2016.[1] *Cash America* involved a dispute about provisions in a bond indenture, a contract between the company that issued the bonds and the indenture trustee in which the bondholders are third-party beneficiaries. The *Cash America* indenture, as indentures typically do, contained various covenants limiting the kind of transactions that Cash America could undertake, provisions specifying when a violation of a covenant constitutes an "event of default," and a section enumerating the remedies available to the bondholders and the trustee upon an event of default. The key controversy in *Cash America* related to remedies. The standard remedy for covenant violations is acceleration, making the principal amount of the outstanding bonds payable immediately. But Judge Jesse Furman of the Southern District of New York, applying Second Circuit precedent, interpreted the bond indenture at issue to afford bondholders the right to receive not just the principal amount but also a "make-whole" redemption premium. The case caused a ruckus in the elite corporate bar as no one seemed to think that this was what the indenture provided (Levine 2018).

What happened next is what interested us as having the potential to yield insight into the causes of contractual inertia. The elite bar reacted fast. Within a month, it rejected the *Cash America* result and a corrective patch was henceforth to be included in future bond indentures. But then, after the *Cash America* patch had made its way into about twenty deals, investors started to object to the new language and the move to include the patch was quashed. As of mid-2020, the remedy provisions being used in indentures are again the pre-*Cash America* ones. That is, hundreds of billions of dollars in bonds are issued subject to provisions that pose the risk that the issuer may have to pay a make-whole premium upon a default, a risk that was not thought to be present prior to *Cash America*.

The aftermath of *Cash America* raises important questions. To explore this aftermath, we conducted detailed interviews with forty senior transactional lawyers at more than thirty top law firms who work on high-yield bond transactions. As a supplement, we also spoke to a dozen investment managers who had observed the repercussions of

1. *Wilmington Savings v. Cash America*, 2016 WL 5092594 (SDNY 2016).

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Cash America.[2] Our interviews were designed to determine both why the court ruling in *Cash America* was not anticipated by transactional lawyers and why bond indentures were not revised after *Cash America*. As we will argue, the standard accounts of contractual inertia do not explain the reaction to *Cash America*. Instead, the failure of the *Cash America* patch to take hold appears due to the peculiar features of the contracts at issue. Even though bond purchasers are, in principle, sophisticated parties with bargaining power, they are not represented by their own lawyers when bond indentures are drafted and are not fully aware of the fine print contained in these agreements.

In these respects, bond purchasers differ both from consumers who enter into contracts of adhesion (who lack sophistication and bargaining power) and from parties to one-on-one contracts such as merger agreements (where both sides are represented by lawyers). In contracts that share these features of bond indentures—contracts that we call "contracts of inattention"—gaps may form between the understanding of contractual terms by lawyers who are familiar with the fine print and by market participants who have focused neither on the contractual language nor on the underlying issues. Moreover, as one side is not advised by its own lawyers, such gaps can persist without either lawyers or market participants being aware of them, especially if the term at issue is not frequently litigated or otherwise made salient. A court interpretation of a contract term around which such a gap has formed can cause lawyers and market participants to realize the existence of this gap and to address it. As a result of the ensuing dynamic, even a court ruling that is inconsistent with a consensus lawyers' understanding of a contractual term may fail to lead to revisions that realign the contractual term with that understanding.

THE RATIONALE OF *CASH AMERICA* AND *SHARON STEEL*

Cash America involved a claim by Wilmington Savings, the indenture trustee for a $300 million bond issue, that Cash America had breached one of the covenants in the bond indenture by spinning off a major subsidiary and that this breach had resulted in an event of default. The court ruled in favor of Wilmington Savings on the question of the breach and resulting default. What got the attention of the elite corporate bar, however, was not the ruling on the breach. Rather, it was the ruling on the remedy. The standard remedy upon an event of default, and the only remedy specifically identified in a standard bond indenture, is acceleration—the right of bondholders to demand the immediate payment of the principal amount of their bonds. But because the covenant breach at bar was deemed "voluntary," the court awarded the bondholders the amount that Cash America would have had to pay had Cash America exercised its option to redeem the bonds early—the principal amount ("par") plus a sizeable "make-whole" redemption premium.

Corporate bond indentures often contain optional redemption provisions that give the issuer the right to repay bonds prior to their maturity. In a "make-whole" optional

2. Thanks to one of our respondents, we have the results of a January 24, 2017, survey of twenty-eight investment managers done by the Credit Roundtable (in conjunction with the Fixed Income Forum) on our topic of interest. Credit Roundtable materials are available at https://www.iimemberships.com/Credit-Roundtable.

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redemption provision, such as the one included in the *Cash America* bonds, the redemption price is the higher of par and the value of the future principal and interest payments discounted at a contractually specified discount rate. Because the discount rate used in this calculation is typically set well below the issuer's borrowing costs, a "make-whole" redemption often entails the payment of a substantial premium over par (Arnold et al. 2020). In devising its remedy, the *Cash America* court followed *Sharon Steel Corporation v. Chase Manhattan Bank*, a canonical Second Circuit opinion from 1982 by Judge Ralph Winter, which awarded bondholders the optional redemption price (par plus a redemption premium) as a "specific performance" remedy for a voluntarily covenant violation.[3] But there are reasons to doubt that the reasoning of *Sharon Steel*, which *Cash America* followed, comports with the provisions of the indenture.

The indentures at issue, as indentures generally do, did not explicitly provide for a right to receive the redemption price as a remedy upon an event of default and nowhere distinguish between voluntary and involuntary covenant violations. Rather, if bondholders choose to terminate the lending relationship and ask for immediate payment in response to an event of default, the acceleration provisions in indentures just provide for the payment of the principal amount (par) without any premium. To be sure, an additional standard indenture provision entitled "Other Remedies" 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 (American Bar Association Ad Hoc Committee 2000, 1137). This broadly worded "Other Remedies" provision includes specific performance as a potential remedy. And as specific performance is an equitable remedy, a court, in the exercise of its equitable powers, could decide to afford this remedy only for a subset of breaches, such as voluntary covenant violations.

But specific performance of what? The provision on "Other Remedies" is limited to the collection of principal and interest, which does not include the payment of any redemption premium, and the enforcement of any provision contained in the indenture. Even setting aside the scope of the "Other Remedies" provision, under general principles of contract law, specific performance is available only to enforce a contractual obligation that already exists, not to fashion a new obligation.[4] Thus, both the "Other Remedies" provision in the indenture and the inherent nature of specific performance require a pre-existing contractual obligation to be enforced but do not permit a court to create a new obligation that is then specifically enforced.

The redemption provisions that were the basis for specific performance in *Sharon Steel* and in *Cash America*, however, were standard optional redemption clauses that gave the company, as the bond issuer, an option to redeem the bonds, exercisable at the company's discretion, and contained no suggestion that the company would ever be required to exercise its option.[5] Under the terms of such standard clauses, therefore, unless and until the company decides to avail itself of the redemption option by giving a

3. *Sharon Steel Corporation v. Chase Manhattan Bank*, 691 F.2d 1039 (2d Cir. 1982).

4. "Specific performance is by definition limited to the enforcement of contract duties." Restatement of the Law (Second), Contracts (1979), Introductory Note, Topic 3, ch. 16.

5. See, for example, *Sharon Steel Corporation v. Chase Manhattan Bank*, 521 F.Supp. 104, 127 (SDNY 1981) ("[t]he redemption provisions of the Indentures state rather generally that the debentures may be redeemed at the option of the company at any time after a certain date").

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redemption notice, bondholders have no right to have their bonds redeemed and, hence, no right that can be specifically enforced (American Bar Association Ad Hoc Committee 2000, 1133).[6]

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 spans only two paragraphs, we quote it in full:

> [The District Court judge] 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).[7]

6. The history of make-whole provisions casts further doubt on the notion that these provisions were intended to give bondholders the right to receive a redemption premium upon a default. Private placements have provided for make-whole redemption long before these provisions were regularly included in publicly issued bonds. But private placements typically included a separate provision that explicitly required the issuer to pay an equivalent make-whole amount upon acceleration ("make-whole" acceleration clauses) (Kahan and Tuckman 1996, 253). When make-whole provisions made it into publicly issued bonds, only the optional make-whole redemption clauses were included, while the make-whole acceleration clauses were omitted. This partial incorporation of make-whole provisions from private placements to public issues suggests that the drafters of public issues wanted to provide for make-whole redemption but did not mean to require the issuer to pay a make-whole amount upon acceleration. While specific performance is technically a different remedy than acceleration, and while the redemption premium in public bonds is payable only upon voluntary covenant violations and, thus, narrower than the make-whole acceleration clauses in privately placed bonds, functionally, both "specific performance" of a make-whole redemption clause and a make-whole acceleration clause entitle bondholders to receive the redemption premium upon an event of default. To us, the failure to also include make-whole acceleration clauses when make-whole redemption clauses were incorporated in public bonds thus indicates that the drafters did not intend to require a make-whole payment upon default.

7. *Sharon Steel*, 691 F.2d 1039, 1053.

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This reasoning is problematic. Even if we accept that a "purpose of a redemption premium is to put a price upon the voluntary satisfaction of a debt before the date of maturity," 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."[8] Contrary to the court's implication, a covenant violation resuting in an event of default does not entitle the company to repay its bonds before maturity; it merely gives bondholders the option to seek acceleration.

Moreover, the court's characterization of the purpose of a redemption provision is inaccurate. The purpose of a redemption provison is to set the effective maximum price a company would have to pay if it wanted to repay its bonds early, whether to avoid a default or for some other reasons. Defaults can have adverse collateral consequences (they can generate cross-defaults, cause reputational harm, and so on), so a company may want to avoid a default even if doing so involves payment above par. But why should that imply that the company is required to pay that price if it violates a covenant—a remedy that easily could have been, but was not, included in the indenture? Even more perversely, the holding of *Sharon Steel* implies that a company that contracted for a right to optionally redeem its bonds at a premium may have to pay more, upon default, than a company that is not entitled to redeem its bonds.

While we question the doctrinal underpinnings of *Sharon Steel*, we read *Cash America* as a straightforward application of *Sharon Steel*. Having found that Cash America had violated a covenant, that the violation was voluntary, and that it had ripened into an event of default, Judge Furman of the Southern District of New York was obliged to follow the Second Circuit opinion in *Sharon Steel* as to the available remedies. So why were lawyers so outraged at *Cash America*, when the real outrage was *Sharon Steel*? And *Sharon Steel* is not some obscure case. Other portions of the case, dealing with general principles of indenture interpretation and the successor obligor clause, make it one of the best known bond indenture cases. There are four possibilities.

Transactional Lawyers Did Not Recall *Sharon Steel*

Transactional lawyers, unlike litigators, tend to have only a vague sense of the case law. They do deals. Parsing the wording of judicial opinions is not part of their day-to-day job. Perhaps transactional lawyers were surprised by *Cash America* because they did not remember the relevant parts of *Sharon Steel*.

Sharon Steel Was Seen as *Sui Generis*

Maybe *Sharon Steel* was viewed as providing for the redemption remedy only for a narrow set of circumstances involving extreme facts, such as bad faith defaults where the issuer took steps knowing that those steps violated the indenture and for the purpose of inducing bondholders to accelerate so that it could retire the bonds without payment of

8. *Sharon Steel*, 691 F.2d 1039, 1053.

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a premium.[9] *Sharon Steel*, however, did not involve an issuer that violated the indenture for the purpose of inducing bondholders to accelerate. The main portion of *Sharon Steel* addresses whether UV Industries sold substantially all of its assets to Sharon Steel. Had the court found that it had, as Sharon Steel and UV Industries had argued, Sharon Steel would have assumed the indenture obligations and the bonds would not have been paid until maturity. UV Industries and Sharon Steel, in other words, did not want to repay early, whether at par or at a premium.

Lawyers Did Not Focus on the Interaction of *Sharon Steel* and Make-Whole Redemption

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 fixed declining fractions of the coupon, and it was unlikely that premia would be high at the time of any default. So maybe no one cared all that much about the remedy that Judge Winter granted. A make-whole premium, by contrast, can be much higher than the old "fixed declining fraction of a coupon" premium.[10] 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.

Sharon Steel Was Seen as Applying Only to Cases Where the Issuer Is Liquidating

The first paragraph of the remedies section suggests that bondholders can seek "specific performance of the redemption provisions as a default remedy where the debtor causes the debentures to become due and payable by its voluntary actions."[11] The second paragraph, however, thickens the plot. It notes that the default here "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 released UV Industries from the indenture obligations, UV Industries, which wanted to liquidate,

9. For example, from the lawyers at Kramer, Levin, Naftalis & Frankel, LLP. Prior to *Cash America*, 2016 WL 5092594, 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*, 691 F.2d 1039). 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 (for example, 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. *The Redemption "Make Whole" Remedy Controversy: An Easy Fix*, January 19, 2017, https://casetext.com/case/sharon-steel-corp-v-chase-manhattan-bk-na/analysis?citingPage=1&sort=relevance.

10. See, for example, *Chesapeake Energy v. Bank of New York*, 957 F. Supp. 2d 316 (SDNY 2013), rev'd 773 F.3d 110 (2d Cir. 2014) (awarding four hundred million dollar make-whole premium on 1.3 billion dollar bond issue). For analyses of the costs and benefits of using make-whole provisions, see Brown and Tsyplakov 2008; Brown and Powers 2020.

11. *Sharon Steel*, 691 F.2d 1039, 1053.

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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.[12] *Harnickell v. Omaha Water*, the New York case cited by *Sharon Steel*, likewise involved an entity that wanted to pay off bonds early.[13] 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.[14]

This reasoning, however, would still not have justified the specific performance remedy in *Sharon Steel*. To be sure, UV Industries may not have been entitled to pay off its bonds at par just because it wanted to liquidate. But UV Industries could have either abandoned the liquidation plan altogether or set aside sufficient funds to pay the principal and interest as they became due as part of its liquidation.[15] Or bondholders could have chosen to seek immediate payment by accelerating. The fact that UV Industries had intended to liquidate when it had hoped to be released from its payment obligation upon Sharon Steel's assumption of the debt is not a sufficient basis to order UV Industries to redeem the bonds when it turned out that it was not so released.

THE FOLKLORE OF *SHARON STEEL*

To get a better sense of what accounted for the strong reaction to *Cash America*, we interviewed forty senior lawyers who work either on the issuer or the underwriter side in bond issuances. To find these senior lawyers, we used the resources of the placement office at one of the institutions at which we teach, where a large fraction of students go into the practice of corporate law. The placement office gave us a list of forty-four lawyers, and we contacted all of them via email. We offered to either meet with them in person at their offices or talk via telephone. Forty of the forty-four responded affirmatively to our request, and all forty opted for the telephone option. Of the forty lawyers, three were women and the rest were men. We did not collect any other demographic information.

Because we wanted to make sure that the lawyers we were speaking to were experienced enough to be familiar with the *Cash America* litigation, we asked the placement office to list only lawyers that had at least a half dozen years of practice experience in the area of corporate debt. As it turned out, all but one had more than twelve years of

12. *Sharon Steel*, 691 F.2d 1039, 1053 (emphasis added).

13. *Harnickell v. Omaha Water Company*, 146 A.D. 693, 131 N.Y.S. 489 (1st Dep't 1911), aff'd, 208 N.Y. 520, 101 N.E. 1104 (1913).

14. Something close to this argument gets a mention in the defendants' briefs in *Cash America*. See *Cash America*, 2016 WL 5092594, Reply Brief in Support of Defendant's Cross-Motion for Summary Judgment, No. 15-cv-5027 (JMF), 12–13 (filed April 1, 2016). But neither do the earlier cases interpreting *Sharon Steel* mention this argument nor does Judge Furman address it in his opinion.

15. Indeed, UV Industries's liquidation plan required "that at all times there be retained an amount of cash and other assets which the Board deems necessary to pay, or provide for the payment of, all of the liabilities, claims and other obligations" of UV Industries. *Sharon Steel*, 521 F.Supp. 104, 108.

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experience, and all but one were partners at the firms in question. In three cases, we interviewed two lawyers from the same firm. In all other cases, the lawyers were from different firms. Finally, all the lawyers in our sample were transactional lawyers. We spoke to one litigator with familiarity with the actual *Cash America* litigation, but that was to obtain background on what happened in the litigation itself.

In every case, we began the discussion by assuring our respondents that nothing they said was for attribution and then set forth several core questions. Then, we allowed our respondents to talk, interjecting follow-up queries when the responses called for them. Each interview lasted between thirty minutes and an hour, with an average time of roughly forty minutes. We are under no illusions that our respondents did not sometimes have their own agendas in talking to us. Our primary goal though was to understand how these lawyers—all of whom were participants in the events we were interested in—articulated the reasons for whether, and why, they regarded the outcome in *Cash America* as a change in the law and, as we will report later, why the attempt to change the remedies provisions had failed so far.

Our starting point for every interview was: why the outrage over *Cash America* when it was but an application of *Sharon Steel*, the controlling precedent in the Second Circuit? 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. Uniformly, almost no one took the position that Judge Winter's construction of the remedy in *Sharon Steel* itself was flawed. Instead, respondents embraced a version of the second explanation put forth above—namely, that *Sharon Steel* was *sui generis*. The most common answer we received was that Judge Furman had misunderstood the deeper context of *Sharon Steel*. *Sharon Steel* was a case about an issuer that had acted with bad faith *vis-à-vis* its bondholders. UV Industries had needed to liquidate for tax reasons but was trying to mischaracterize that liquidation as a sale of substantially all of its assets (which would have resulted in the passing of the debt to the buyer of those assets, so long as some procedural requirements were satisfied). *Cash America*, by contrast, involved an issuer taking a perfectly defensible position regarding an alleged covenant breach.

There are several flies in this buttermilk. First, nowhere in *Sharon Steel* is there mention of bad faith or intentional misbehavior on the part of UV Industries. If anything, Judge Winter makes it clear that the provisions at issue in that case did not provide a clear answer and even indicated that a formalist reading would give an answer in favor of UV Industries. He wrote:

> Sharon's argument is a masterpiece of simplicity: on November 26, 1979, it bought everything UV owned; therefore, the transaction was a "sale" of "all" UV's "assets." In Sharon's view, the contention of the Indenture Trustees and Debentureholders that proceeds from earlier sales in a predetermined plan of piecemeal liquidation may not be counted in determining whether a later sale involves "all assets" must be rejected because it imports a meaning not evident in the language.[16]

16. *Sharon Steel*, 691 F.2d, 1049.

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Judge Winter proceeds to reject this "literalist approach" not because it lacks a literal basis but, rather, because "a literal reading of the words 'all or substantially all' is not helpful apart from reference to the underlying purpose to be served." Identifying that purpose as "protection for borrowers as well as for lenders"—and rejecting Sharon Steel's position that the sole purpose of the clause is to permit borrowers to sell assets and liquidate—the court then resolved that "[a]n interpretation which sacrifices a major interest of one of the parties while furthering only a marginal interest of the other should be rejected in favor of an interpretation which sacrifices marginal interests of both parties in order to protect their major concerns." While the case was maybe not close, the court's reasoning indicates that UV Industries and Sharon Steel both had a plausible literal basis and an arguable purpose-based basis for their interpretation.

Second, Judge Winter was writing for the Second Circuit on appeal. The trial court, the one that saw the parties and interacted with them, had ruled that UV Industries was only required to pay par, not the redemption premium. In doing so, the trial court found that the voluntariness of the default was irrelevant to the remedy.[17] While the Court of Appeals disagreed with this assessment, neither court opinion suggests that UV Industries acted, or was accused of acting, in bad faith. Under these conditions—ones that would have been obvious to Judge Furman—it would probably have been reversible error for Judge Furman to have read *Sharon Steel* to be about bad faith conduct on the part of the issuer. To be fair to our respondents, there were a couple of bankruptcy court cases in the thirty-five years between *Sharon Steel* and *Cash America* that, *in dicta*, had taken that position. But the authoritative case for Judge Furman was *Sharon Steel*.

Third, the line between bad intent/bad faith and voluntary breach is a fuzzy one. In both *Sharon Steel* and *Cash America*, the respective issuers took positions on the interpretation of a covenant that turned out to be wrong and took voluntary actions based on these positions. The court in *Cash America* noted that the issuer had been warned that bondholders interpreted the indenture differently—that is, Cash America was on notice that its interpretation was controversial. And, to us, Cash America's interpretation borders on the frivolous. The covenant at issue in *Cash America* prohibited certain transfers unless "the aggregate book value of properties disposed of .... does not exceed" 10 percent of the issuer's "Consolidated Total Assets."[18] Although the indenture clearly referred to the book value of *properties*, and the benchmark was a percentage of 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 value of the liabilities disposed with the assets. Under this contorted interpretation, even a transfer of all one's assets, if accompanied by sufficient liabilities, may not exceed 10 percent of consolidated total assets.

But the clincher in the case was that the assets at issue consisted of stock of a subsidiary. The covenant further 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

17. *Sharon Steel*, 521 F.Supp. 104, 128.
18. *Cash America*, 2016 WL 5092594, *1.

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such capital stock or similar equity interests."[19] Unlike the court in *Sharon Steel*, Judge Furman did not have to resort to context and purpose or weigh major and marginal interests: he held that the "plain language" of the indenture "compelled" a ruling for the bondholders. If bad faith or bad intent is to be inferred from the weakness of the arguments put forth by the issuer, the bondholders in *Cash America* win hands down.

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 among its most colorful characters. He was the paradigmatic corporate raider of the 1980s, who managed to get into trouble with the tax authorities and the Securities and Exchange Commission. Sharon Steel was his company. Everything we have heard suggests that Judge Winter, a former corporate law professor at Yale, would have been familiar with Victor Posner. Sharon Steel, however, was only the buyer of the assets from UV Industries, and UV Industries was the issuer of the bonds and the entity that breached the covenants in the bond indentures. UV Industries appears to have sold its other assets prior to being in contact with Sharon Steel and Posner. Perhaps Sharon Steel and Posner had suggested that UV Industries 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 Industries.

More to the point, Judge Winter, in his Second Circuit opinion, never mentioned Victor Posner and said nothing suggesting that his actions had affected the holding. Even if Judge 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 zero likelihood that *Sharon Steel* would have been read by a lower court with those atmospherics in mind. Our conjecture is that a folklore had developed around the meaning of *Sharon Steel* over the thirty-five years since it had been decided. Every transactional lawyer we talked to claimed to have been familiar with the broad contours of what happened in the case. But what he or she had taken from it deviated significantly from what the court had actually done in the case. To transactional lawyers, the notion that a regular voluntary covenant breach would require an issuer to pay a redemption premium would be so far removed from the wording of the indenture that this could not possibly have been the ruling in *Sharon Steel*. Accordingly, they searched for narrower grounds, like bad faith or unique circumstances involving Victor Posner. Each lawyer's assessment that *Sharon Steel* must have involved extreme facts was likely reinforced by the fact that this assessment was widely shared by transactional lawyers, who we suspect talk more often to each other about indentures than they talk to litigators, and that few of these lawyers had recently read *Sharon Steel*. Boiled down, the primary objection to *Cash America* seems to have been that Judge Furman should have been, or should have tried to become, aware of this folkloric, shared understanding of the relevant precedent held by transactional lawyers who were experts on bond indentures.

19. *Cash America*, 2016 WL 5092594, *4.

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The concept of "interpretive communities" may be thus helpful to explain the assessment of transactional lawyers (Coyle and Weidemaier 2018, 1709–11). Transactional bond lawyers, who make up one such community, focused on the language of the remedies provisions in the indenture—language that they had drafted and the meaning of which they knew—and accorded a narrow scope to *Sharon Steel*. Judge Furman, a former assistant US attorney and now a trial court judge, focused on the governing precedent that had interpreted the same provisions that were now in front of him. Judge Furman was thus a member of a different interpretive community—specialists in litigation who, while sophisticated and well versed in commercial disputes, are more attuned to paying attention to precedents and are less familiar with indenture provisions.

The view of a senior litigator we spoke to comports with our assessment. This lawyer noted that his transactional colleagues rarely spoke to him about the risks that many of their standard form clauses posed and remarked: "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."

STANDARD EXPLANATIONS FOR CONTRACTING INERTIA

Transactional lawyers dealing with indentures viewed *Cash America* as changing the law on bondholder remedies for voluntary covenant violations. Although, in our view, *Cash America* does not go beyond *Sharon Steel*, the notion that *Sharon Steel* afforded bondholders the right to seek specific performance of redemption only in a much narrower set of circumstances—involving bad faith, an intent to induce acceleration, and perhaps unsavory characters—was widely held. In this part of the article, we proceed on the assumption that *Cash America*, at least as perceived by market participants, indeed created new law. From that perspective, parties entered contracts pre-*Cash America* that they read to afford bondholders a very narrow (if any) right to specific performance of redemption. Post-*Cash America*, they found themselves in a situation where the words that they traditionally used had been interpreted to provide bondholders with a much broader right to specific performance.

From a contractarian perspective, one would expect the parties to change the wording of the indenture to bring it in line with what they originally intended and presumably wanted. Lawyers drafted such a change in wording, and it was initially included in several contracts, but the new wording did not take hold. The aftermath of *Cash America* was thus characterized by contractual inertia: a failure to change a common term when logic and standard economics would suggest that a change is warranted. Contractual inertia is a familiar phenomenon and has received substantial attention in the literature. In this part, we review the standard explanations for contractual inertia. We argue that *Cash America* and its aftermath involve specific features that make the standard explanations for contract inertia unsatisfactory. Although we cannot disprove these explanations, they ring hollow. In the following part, we present a different explanation for why the *Cash America* patch failed to take hold.

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Network and Learning Benefits

Network and learning benefits are related, yet distinct, concepts. The distinction between learning and network benefits is particularly important in contexts such as ours where a court interprets a common term in a novel fashion. Learning benefits derive from past use of a term and include familiarity with a term due to past use, ability of market participants to value a term due to past experience, and accumulated precedent interpreting a term. Examples of learning benefits involving a common contractual term include, for example, the prior case law interpreting the term, the familiarity of investors with the term that makes it easier to market a contract containg the term, or the familiarity of lawyers and other service providers with the term that enables them to provide services associated with the term (such as legal advice or accounting treatment) more cheaply. Learning benefits can induce parties not to change a contractual term that has been frequently used in the past even if, absent such use, a different term would be superior.

Network benefits result from contemporaneous and expected future use of a term. Network benefits for legal terms could thus derive from the willingness of market participants to develop expertise in valuing or giving advice with respect to a term because they anticipate that it will be frequently used or from the precedent expected to accumulate in the future as a term becomes widely used (Klausner 1995).[20] Network benefits often have analogous learning benefits. For example, the existing accumulated precedent involving a term constitutes a learning benefit, while the precedent that is expected to accumulate in the future is a network benefit. But, while learning benefits derive from past use (and thus do not depend on future use), network benefits derive from expected future use and can thus accrue even on a novel term as long as market participants believe that the term will become standardized. Network benefits can induce parties to use a term they expect to be used by many other parties even if, absent such expectation, a different term would be superior.

Learning Benefits

Learning with respect to the extent of bondholder remedies accrued on the remedies as they were understood by market participants—that is, the pre-*Cash America* understanding of bondholder remedies. If *Cash America* fashioned a novel interpretation of these remedies, little if any learning would have already accrued on this novel interpretation. For example, neither market participants nor service providers would have developed familiarity with the novel interpretation of the term. Learning benefits would thus constitute a reason why parties would want to revert to the understanding that prevailed prior to *Cash America*, the understanding on which learning benefits had accrued—and, accordingly adopt the *Cash America* patch. Put differently, learning benefits would generate contractual inertia as to the *meaning*, not as to the *wording*, of the

20. Klausner (1995) also identifies common practice network effects (resulting from the accumulation of business practices implementing the widely used term), but such effects are not pertinent to the remedy provisions at hand.

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indenture provisions at issue and thus tend to induce a change in the wording to preserve continuity in the meaning.[21]

Network Benefits

When the court in *Cash America* ruled that bondholders could obtain the redemption premium upon a voluntary covenant violation, market participants likely expected that at least some indentures would retain the standard provisions. As a result, network effects around the *Cash America* interpretation of the standard terms may have formed. In our assessment, however, the initial size of any network benefits around the *Cash America* interpretation would likely have been small.[22] For one, due to the criticisms of the opinion and the quick development of the *Cash America* patch, many market participants may have believed that the wording of the remedy provisions would be changed. Second, network benefits do not accrue instantaneously; they take time to develop. Thus, the network benefits around the *Cash America* interpretation of the standard wording at the time that the patch was proposed were almost certainly below the learning benefits that had already accrued, for a much longer period of time, on the pre-*Cash America* interpretation. It is thus implausible that, taken together, learning and network benefits should account for the contractual inertia in this instance.

Endowment Effect

The endowment effect is another potential cause for contractual inertia. Various experiments on the endowment effect have shown that persons who were randomly given a certain property were unwilling to trade it, indicating that they valued it more than persons who were not given that property (Kahneman, Knetsch, and Thaler 1990). Indeed, experiments have indicated that a valuation gap arises not only for vested contract rights but also for contract default rules and for provisions in form contracts (Korobkin 1998). In principle, at least, an endowment in provisions in form contracts can thus cause an unwillingness to modify these provisions, thereby making it harder to make changes to the form (Kahan and Klausner 1996).

In our case, however, it is unclear why an endowment effect would have been generated. A common explanation for the endowment effect is that it reflects a regret avoidance strategy (Arlen and Tontrup 2015). In the typical case, subjects are reluctant to take actions to depart from the status quo embodied by default law or standard forms

21. The single exception is that *Cash America*, in fashioning its remedy, also supplies a precedent illustrating what is meant by voluntary breach. But the illustrative precedential value of *Cash America* is limited. *Cash America* involved a case where the issuer chose to engage in a spin-off that, in the court's view, violated a covenant. Plus, it had been warned beforehand by the bondholders that they considered this spin-off to constitute a breach. It is hard, therefore, to conceive of an argument why Cash America would not have engaged in a voluntary breach. Thus, *Cash America* itself generated no valuable "accumulated precedent" on what constitutes a voluntary covenant breach.

22. Given that defaults are infrequently litigated, it is unlikely that future interpretations of what constitutes a "voluntary" breach would add value to the term, and lawyers, hence, would have a hard time giving useful legal advice. And while market participants may be more willing to learn how to value bonds employing a common term, they would already know how to value bonds containing the *Cash America* patch.

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because doing so may cause them to feel more regret than maintaining the status quo. But, here, regret would have been minimized by preserving the pre-*Cash America* status quo. Refusing to adopt the *Cash America* patch, which would have preserved that status quo, is the opposite of what the endowment effect story predicts.[23]

Agency Problems

In the drafting and negotiation of bond indentures, issuers and underwriters are represented by lawyers whose incentives are not fully aligned with those of their principals. Transactional lawyers, for example, may have strong short-term incentives to get deals done and may undervalue the costs of future negative outcomes (Scott, Choi, and Gulati 2020). Or transactional lawyers who draft indentures may face an asymmetric reward structure: they receive only a portion of the credit if changing a standard term turns out to be beneficial but the full blame if it turns out to be detrimental (Kahan and Klausner 1996). As a result, agents may fail to revise standard terms. In our case, however, transactional lawyers did propose a modification. They overcame any agency problems and were ready to try to establish a new wording of the remedies provision. Agency problems thus do not explain why the modification was not embraced by market participants.

Adverse Inference for Pre-Existing Contracts with Unmodified Clauses

Another potential barrier to change that lawyers often raise is that modifications in standard terms could lead courts to draw adverse inferences about the meaning of the older contracts with unmodified term (Gulati and Scott 2013). If an issuer adopted the *Cash America* patch to clarify that holders are not entitled to a redemption premium upon voluntary default, a court may thus be more likely to conclude that holders of existing bonds that contained the standard term without the patch are entitled to a redemption premium. To avoid courts drawing such an inference, the reasoning goes, the standard clause is not changed.

There are multiple shortcomings to this adverse inference rationale. For one, 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 reads: "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" would not do the trick for future courts. Second, bond indentures already often include a clause that reads: "This indenture may not be used to interpret any other indenture,

23. There are additional reasons why the findings of experiments are unlikely to explain what we find in our case. First, it is unclear whether the results from experiments on default rules and form contracts really point to an endowment effect. In particular, the fact that a clause is part of a form contract serves as an imprimatur that suggests that the clause is valuable. Second, there is evidence that simple strategies can reduce the endowment effect. For example, in experiments where a trading decision was shared between subjects, the endowment effect largely evaporated (Arlen and Tontrup 2015). These experiments arguably resemble commercial decisions—including decisions on the terms to be included in bond indentures and whether to purchase bonds containing certain terms—more closely than experimental settings where subjects have full responsibility for their decisions.

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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."[24] Such a clause, of course, could also be included in the indenture for newly issued bonds with a modified term. The concern that a court would draw an adverse inference from a modified provision in interpreting a pre-existing indenture amounts to a concern that the court would just ignore these provisions.

Most importantly, however, both *Cash America* and *Sharon Steel* affirmatively 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 thus likely be read by a subsequent court as an endorsement of the prior court's interpretation.[25] Thus, if an issuer was concerned about the impact of a new indenture on its existing bonds, it would have all the more reason to include the *Cash America* patch in the new indenture.

Black Holes

On occasion, with boilerplate contracts whose terms have been repeatedly copied from deal to deal, the market understanding of certain provisions can get lost and these terms can become black holes. In such a case, where there is no clear understanding as to what function the term serves, revising it can be difficult because the industry has to figure out what meaning the term should have (Choi, Gulati, and Scott 2017). The remedy provisions in indentures that were at issue in *Cash America*, however, do not share the salient features that make a clause a plausible candidate for a black hole. The remedy provisions are not mysterious clauses with unknown functions. The transactional lawyers we talked to had a clear sense that these provisions provided, upon an event of default, for a right to accelerate and to seek other remedies to enforce their contractual rights but that this did not encompass a right to receive the redemption price that the indenture did not provide.

Drafting Technology

Academic 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 assure that it works and contains no bugs has not been, and perhaps cannot easily be, created (Boardman 2019). One barrier to the development of such a clause is lack of incentives. Contractual clauses cannot be effectively copyrighted, and others may free ride on the creative efforts of the draftsperson of the clause. Another possibility is that the solution

24. See, for example, Tallgrass Energy L.P. Indenture, February 20, 2020, section 12.09, filed as Exhibit 4.1 to Form 8-K, February 21, 2020, available at https://www.sec.gov/Archives/edgar/data/1633651/000119312520044776/d894672dex41.htm.

25. See *Morgan Stanley v. Archer Daniels*, 570 F.Supp. 1529 (SDNY 1983). A similar reasoning is 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.

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that appears attractive to a contract theorist entails practical problems that render it difficult to implement.

In our case, this explanation holds no explanatory power. The elite bar quickly formulated a *Cash America* patch and was able to effectively coordinate the inclusion of the new language in roughly twenty deals by both high-yield and investment grade issuers. The *Cash America* patch is thus not some chimera invented by academics but, rather, an actual provision that applies to hundreds of millions of dollars in debt. And the reason why bonds stopped including the patch was resistance by investors, not concern that some technical legal flaw in the patch would render it impractical.

Signaling

Deviations from market practice can create signals (Gelpern, Gulati, and Zettelmeyer 2019). In the case of bondholder remedies, post-*Cash America*, an issuer wanting to explicitly eliminate the right of bondholders to obtain the redemption premium after a covenant violation might be concerned about sending the signal that this issuer is relatively more likely to engage in covenant violations. Since issuers would rather not convey this signal, they do not deviate from the standard practice. In our case though, lawyers were quickly able to get a number of different issuers to quickly adopt the *Cash America* patch, thereby diluting any potential signal. Further, in our interviews, we found no indication that there were concerns on the issuer side about sending a negative signal. The reversal of the attempt to correct the contract language was driven by investors because they did not want the patch to become the new standard rather than because they drew inferences about a particular issuer that proposed the patch.

Idiosyncratic Judge/Facts

If the judge or court in question is viewed as idiosyncratic, and other courts are expected not to follow its lead, then there is less of a reason to change contract language (Boardman 2019, 32). We did hear this explanation from a few respondents who saw the *Cash America* decision as inconsistent with the underlying rationale of a well-known prior Second Circuit case, *Sharon Steel*. However, this reasoning would not explain why the *Cash America* patch, once developed, failed to take hold. Moreover, as discussed earlier, a serious examination of *Sharon Steel* shows that *Cash America* was, if not dictated by, then at least consistent with, this Circuit Court precedent.

Easier to Price the Change Than to Change the Words

A final explanation for contract inertia in response to court decisions is that it may be easier in some contexts to change the price of the product than to change the contract language (Boardman 2006, 2019).[26] Again, while this factor may contribute to

26. There has been no study conducted yet on whether bond prices in fact changed as a result of the *Cash America* case. We did explicitly ask our respondents about this though—about whether investors were willing to pay a higher price for the bonds without the *Cash America* corrective language. And the answer we received uniformly was a resounding no.

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contractual inertia, the lawyers in our case did change the language. What distinguishes the aftermath of *Cash America* from other instances where the legal community failed to react to a court ruling—and what makes it particularly interesing—is that revised contract language was actually drafted, and initially included in several contracts, but then discarded.

CONTRACTS OF INATTENTION

The standard accounts for contract stickiness fail to offer a persuasive explanation for stickiness in our case. We therefore offer a further one. The indenture itself is largely negotiated between the lawyers for the issuer and the lawyers for the underwriter. While the underwriter has reputational interests to assure that the indenture terms conform to a certain standard and needs to ensure that the bonds issued under the indenture can be sold, the underwriter does not have a direct financial interest in the bonds (Kahan 1994). Rather, economically, the real parties in interest are the issuer and the bondholders. Corporate bondholders are typically large, sophisticated financial institutions, such as mutual funds and insurance companies. But bondholders are not represented by their own lawyers in the negotiation or communicate much with the lawyers representing the underwriters, nor do bondholders hire their own lawyers to review the indenture and advise them as to the provisions contained in it. Bond indentures thus fall in a class of contracts that we term contracts of inattention; albeit both sides are sophisticated and have bargaining power, one side is not represented by its own lawyers, lacks full awareness of the fine print contained in these agreements, and, having devoted little attention to fine-print terms, may be eclectic as to their meaning when it enters into the contract. By the same token, the lawyers who draft the contract will tend not to be aware of how bondholders view the contractual provisions.

Other types of contract and contract-like documents that share these hallmark features include charters and bylaws of public companies, certificates of designation governing the rights of holders of preferred stock, contracts governing traded options and credit default swaps, fiscal agency agreements and trust indentures related to sovereign debt, and master trust agreements related to mortgage-backed securities.[27] Conversely, merger and acquisition contracts, where both sides are represented by counsel who pay attention to terms and communicate with their clients, are not contracts of inattention (Scott, Choi, and Gulati 2020).

Contracts of inattention involve a heightened potential for gaps between transactional lawyers' understanding and investors' understanding of contractual provisions. Such gaps in understanding are particularly likely to form on terms that are rarely litigated in high-profile cases. High-profile litigation can result in the identification of such gaps and in efforts to close them, as was the case in the aftermath of *Cash America*.

27. For related research in the sovereign debt area, see Gelpern, Gulati, and Zettelmeyer 2019 (describing how sovereign bond investors focus primarily on whether they have a market standard set of contract provisions). It also seems possible that portions of the insurance industry could fit the contract of inattention model. See also Boardman 2019, 39 (describing the "blank hole" phenomenon where even sophisticated investors in insurance products sometimes are not aware of what coverage certain complex provisions provide).

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Transactional lawyers who deal with indentures—whether they represent the issuer or the underwriter—base their understanding on a close reading of the words of the indenture provision and on their general expertise on indentures. The lawyers' understanding of the remedy section pre-*Cash America* was that it gave bondholders the right to accelerate at par because that is what the indenture said. Transactional lawyers familiar with *Sharon Steel* were also vaguely aware that under some circumstances bondholders could obtain the redemption premium, but, as discussed in the third part of this article, they regarded this set of circumstances as narrow because they viewed the express provisions, which provide only for a right to receive par and not for any right to receive a premium, as clear.

But what was the understanding of investors and from where did it derive? Our original plan for this project had been to speak only to the transactional lawyers since they were the ones who draft contracts. But, as we got through our lawyer interviews, we realized that talking to managers at the investment firms who had resisted the corrective patch was also necessary. From our interviews with a dozen investment managers, all of whom were involved in the debate over whether reform was needed after *Cash America*, we found the following observations. These investors confirmed that they had not focused on the specific wording of the remedy section of indentures and/or consulted with indenture lawyers about what the lawyers thought they had been drafting. In a sense, the investors neither cared nor knew what the lawyers thought they had drafted. Investor understanding, as it was described to us, derived from market practice. Investors' understanding and lawyers' understanding existed side by side, with neither side communicating with the other one or specifically aware that the other side's understanding of available remedies differed from their own.[28]

Since events of default outside of bankruptcy are relatively uncommon and rarely litigated, the most relevant market practice was how much bondholders got paid when an issuer wanted to engage in a transaction that would violate a covenant. And market practice was that such issuers would make a tender offer in which investors were offered a premium above par coupled with a consent solicitation to modify the covenant. To the investors, the *Cash America* corrective patch looked like an attempt to take away that opportunity to get a premium when the issuer needed to modify a covenant. To quote one investor, "[the *Cash America* patch] inserts a par call into the bonds."

To be sure, the fact that issuers generally offer more than par in tender offers does not signify that an issuer, had it instead chosen to violate the covenant and generate an event of default, was contractually required to pay more than par. Events of default and acceleration can have adverse collateral consequences, and a company may well be willing to pay some extra premium in a tender offer to avoid such consequences or optionally redeem the bonds. We thus do not suggest that investors, based on the market practice, believed that they had a legal entitlement to get more than par in general or to get the redemption premium in particular. Rather, most investors had not focused

28. We do not mean to be saying that the problem is that lawyers do not understand the true intentions of the parties. It is that, with some terms, the parties have not figured out what their understandings of certain clauses are. And the fact that these are widely used standard-form contracts does not solve this problem because the lawyers think that the provisions mean one thing, on the one side, and the investors have not paid attention, on the other side.

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much on their legal entitlement because their main concern was not their abstract legal entitlement but, rather, how much of a premium they got in actual deals.

Put differently, transactional lawyers and investors were members of different interpretive communities. Due to a lack of communication, and due to the fact that the underlying issue had not been salient until *Cash America* was decided, these communities did not intersect. When *Cash America* was decided, the reaction of transactional lawyers, whether they worked for issuers or underwriters, was immediate and clear: this is neither what we wrote nor what we meant; let us change the wording to make this clear to future judges. We believe that transactional lawyers representing underwriters shared the negative reaction to *Cash America* not because underwriters are imperfect agents for investors (which they are) but, rather, because the transactional lawyers working for issuers and underwriters are members of the same interpretive community, and the court's interpretation actually did not reflect the understanding and intentions of that community.

But investors never really cared what the transactional lawyers who drafted the indenture intended. The lawyers who drafted the indenture were not hired by investors, did not communicate much with investors, and investors had neither reason to find out, nor interest in finding out, what these lawyers thought. Thus, while it was clear to transactional lawyers that *Cash America* was wrongly decided, investors did not share this assessment because they lacked any clear *a priori* assessment of their legal entitlements based on the language of the indenture and the intentions of the drafters. On this account, what *Cash America* did was to focus investors' attention on their legal entitlements. When confronted with that issue, investors decided that they preferred the *Cash America* interpretation, not because it correctly interpreted the language of indentures, nor because it correctly applied *Sharon Steel*—the investors we spoke to had never heard of *Sharon Steel*—but, rather, because they wanted to retain the threat of being able to get more than par. And once investors decided that this was what they wanted, they prevailed.

The answers we received in our interviews with both lawyers and investors for why the *Cash America* patch failed to take hold largely support this account. All our respondents, as well as the investors surveyed by the Credit Roundtable in January 2017, pointed to Covenant Review. Covenant Review is a firm that was started by Adam Cohen, a former senior associate at Lathan and Watkins.[29] Cohen, the story goes, worked on debt covenants while at Latham 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. In particular, Covenant Review was to alert investors to any significant deviations from the standard forms that the issuers had put into the deal and that underwriter's counsel might not have adequately flagged for investors.

In the initial attempts to correct for *Cash America*, the issuer's counsel had put in new language to clarify that payment of a redemption premium, as specific performance

29. The fact that Cohen had been a senior associate (that is, not a partner) was one that many of our respondents emphasized in both a positive and negative fashion. As one individual said, this 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.

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or otherwise, is not an available remedy. 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,[30] no premium in respect of the notes shall be payable as a result of any default or Event of Default."[31] We were told that the lawyers doing these deals, on both the underwriter and the issuer side, took the position that they did not need to flag this change since they were just returning to what the contracts meant before *Cash America*. To quote one of our lawyer respondents, "it was not a material change," and, hence, it was not noted on the cover page of the sales documents (the prospectuses or offering circulars) as would have been done with something like the addition of new collective action clauses in sovereign bonds in 2003 and 2014.

Covenant Review seized on these deals to alert investors to what it viewed as an assault on their rights. 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" (Cohen 2017). Similarly, Adam Cohen, the chief executive officer 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" (Caiger-Smith 2017). The majority of our lawyer respondents, by contrast, stated that no such dramatic change to covenant rights was occurring. They thought that Covenant Review was trying to raise its profile and make a mountain out of a molehill.

But while this interpretation makes sense from the perspective of transactional lawyers who believed that the *Cash America* patch was innocuous relative to pre-*Cash America* law, it does not fully address the issues. The issues are not just why Covenant Review rang the alarm bells but also why, having been alerted by Covenant Review, so many institutional investors took the position that they would not buy bonds if they contained the *Cash America* patch.[32] This inquiry brings us back to what the clients of Covenant Review thought about their legal remedies before Covenant Review informed them about the patch. One possibility is that they agreed with the lawyers that we interviewed that *Cash America* went significantly beyond *Sharon Steel* but nevertheless opportunistically resisted the inclusion of the patch to preserve their newly bestowed contractual rights. We cannot disprove this possibility. But, in our view, if investors had agreed that the *Cash America* patch just reverted remedies to the pre-*Cash America* status quo, it is unlikely that they would have put up such a fight.

Another possibility is that investors had always understood *Sharon Steel* to afford broader rights to obtain specific performance of the redemption premium and saw *Cash America* as confirming these long-standing rights. While this would explain the resistance to the patch, the notion that investors got *Sharon Steel* right while transactional

30. One investor newsletter, from XTractResearch, amusingly explained to investors that "[f]or the avoidance of doubt" is legalese 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" (Wallick 2016).

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

32. This was a significant enough issue, according to both our respondents and twenty-three of the twenty-eight investment managers surveyed by the Credit Roundtable in late January 2017.

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lawyers got it wrong flies in the face of the fact that investors have much less legal sophistication and knowledge than transactional lawyers. And if investors were so sophisticated and knowledgeable about *Sharon Steel*, why were so many of them apparently unaware of the existence of the *Cash America* patch until they were alerted by Covenant Review?[33] We therefore also regard this possibility as implausible.

The most plausible account is that investors were eclectic about their legal entitlements pre-*Cash America*. They started dealing with the matter only once they were confronted with the patch and Covenant Review's call for resistance. It was at that point that investors, for the first time, had to make a conscious decision as to the legal remedies that they wanted the indenture to provide. And it was only at that point that they demanded a legal entitlement to receive a redemption premium upon a voluntary default.[34] In other words, Covenant Review was able to succeed because of a pre-existing disconnect between lawyers' and investors' understanding of the remedy provisions in the indenture. Transactional lawyers looked to the wording of the indentures for their understanding and tried to reverse court decisions that they viewed as inconsistent with the wording. Investors looked at past market practice, decided that they were satisfied with it, and insisted that the practice should not be undermined. Whether Covenant Review itself—which, unlike its clients, presumably had a good sense of the legally availably default remedies prior to *Cash America*—had a different understanding of the remedy provisions than the transactional lawyers we interviewed (perhaps because the lawyers at Covenant Review had read *Sharon Steel* more carefully) or whether, as several respondents suggested, it was trying to raise its profile is not relevant from this perspective.

When we inquired why issuers quickly dropped the patch once it encountered resistance, our respondents gave two reasons. First, the event being contemplated—a voluntary default on some covenant while fully solvent—was extremely rare. What was of paramount importance, our respondents agreed, was that the deal get done. To quote one respondent, "[n]o one wants delays because the lawyers want to add in some obscure legalese for an event that won't ever occur." So far, so good. But the second explanation that we received from a handful of respondents holds more interest: they asserted 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.[35] To us, these responses are remindful of the earlier discussion of what transactional lawyers made of *Sharon Steel* and illustrate the persistence of folklore.

33. According to the Credit Roundtable survey, eleven of the twenty-eight managers surveyed had purchased bonds with this language without realizing it was there.

34. There was also another firm, providing a service similar to Covenant Review, that expressed reservations about the *Cash America* corrective patch around the same time. This firm, XTractResearch, however, did not use language that was quite as inflammatory in its description of Cash America and took the position in one of its early reports that future courts were likely to ignore the corrective patch in situations like *Cash America*. Wallick 2016.

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

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Rather than rereading *Sharon Steel* and accepting the notion that a district court judge, as a member of a different interpretive community, would take the case for what it says and not for what transactional lawyers thought it must have meant, transactional lawyers maintained their view of *Sharon Steel* and engaged in wishful thinking that *Cash America*—the most important decision applying *Sharon Steel*—would not be followed. This idea, to us, carries the seeds for the emergence of a new folklore that posits that it is widely accepted that *Cash America* was wrongly decided and that the case therefore does not need to be taken seriously—a folklore that shares the feature that it confuses the view of transactional lawyers (who may indeed believe that *Cash America* was wrongly decided) with the way another court would read *Cash America* (as a well-reasoned decision applying binding Circuit Court precedent).

IMPLICATIONS

The presence of gaps between lawyers' and investors' understanding in contracts of inattention raises the question about how courts should interpret contracts when the understanding of a provision held by the lawyers who drafted it differs from the understanding of investors who only focus on the provision when a dispute arises. Currently, most courts treat contracts of inattention like other contracts among sophisticated parties—what the drafter intended is what the parties must have desired. But, as the aftermath of the *Cash America* case shows, the lawyers for the underwriters are too far removed from bond investors to assume that the drafters intentions reflects the parties' objectives.

In the final analysis, it may be that we decide that the traditional mode of contract interpretation is still appropriate. In particular when the terms of a contract are clear, there are strong reasons for courts not to rewrite the contract. However, when a term is ambiguous, or when custom and usage is relevant to interpret a term, there is no inherent reason why the term should be given the meaning intended by the transactional lawyers who drafted it or, for that matter, that courts should resort principally to the usage by transactional lawyers to interpret the term. Rather, in contracts of inattention, the subjective intent of transactional lawyers who draft a provision should not be relevant at all since the lawyers who drafted the term neither represent or communicate with the investors, and while the general understanding of a provision among the transactional lawyer community may be relevant, so is the understanding, or lack thereof, by the bondholder community.

A recent case involving a redemption provision in bonds issued by Chesapeake Corporation exemplifies the different approach courts should take to contracts of inattention. Chesapeake's bonds were subject to redemption provisions that permitted it to call its bonds at par prior to March 15, 2013 and at a make-whole premium thereafter. A dispute arose over whether, under the particular wording of the redemption provisions in the bond indenture, Chesapeake just needed to give a notice of the redemption prior to March 15 or whether it also had to pay for the bonds by March 15.[36] Chesapeake introduced evidence that the lawyers who wrote the provisions meant to permit Chesapeake to redeem the bonds at par as long as it gave notice by March 15. The

36. *Chesapeake Energy*, 957 F. Supp. 2d 316, 323.

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District Court rejected this evidence as inadmissible under the parol evidence rule, finding that the indenture unambiguously provided that giving notice by March 15 was sufficient. On appeal, a majority of the panel on the Second Circuit also rejected the evidence of the lawyers' intent, this time reasoning that the indenture unambiguously provided that payment by March 15 was required.[37] The most interesting opinion for our purposes, however, was a dissent by Judge Katherine Polk Failla. Finding the clause to be ambiguous, Judge Failla nevertheless argued that the intent of the lawyers should not be considered in interpreting it. Rather, Judge Failla opined, the court should have examined how the bonds were marketed by Chesapeake's officials to investors.

While *Chesapeake* addresses the subjective intent of specific lawyers, we believe that the logic of Judge Failla applies equally to the general understanding of terms by transactional lawyers. To be sure, transactional lawyers' general understanding of a term does not share the feature of the subjective intent highlighted by Judge Failla —namely, that investors would have no way of knowing what the lawyers thought. But it would still be wrong to presume that investors ought to be aware of the general understanding of a term by transactional lawyers and to deem them bound by it. Thus, in *Chesapeake*, the relevant inquiries would be not only how the term "redeem" is used in the fine print of the indenture—an inquiry undertaken by the majority Second Circuit opinion—or how it is used in indentures generally but also whether bond investors understand the term "redeem," whether in an indenture, prospectus, or marketing materials, to refer to the notice date or the payment date of a redemption.

Again, the nature of contracts of inattention—that they are written and negotiated by lawyers but that these lawyers neither represent nor communicate with the ultimate purchasers—is important to this conclusion. In agreements negotiated by sophisticated parties that are both represented by their own team of lawyers—say, in merger agreements—we believe that, if both sets of transactional lawyers have a specific subjective intent or if transactional lawyers generally have a clear understanding of what a provisions means, the lawyers' intent and understanding should generally control. In this context, lawyers act as agents for their clients. They have the ability and the incentives to discuss the terms of the contract and their clients' interests with their clients. It is therefore justified to impute their intentions and understandings to their clients. In contracts of inattention, where investors are left to their own devices, the lawyers' understanding should carry less weight.

CONCLUSION

We have examined two issues raised by *Cash America* and its aftermath. First, why was the elite corporate bar so surprised by the outcome of the case. Second, and more importantly, why did the attempts to revise bond indentures in the aftermath of the case fail. The answers to both of these questions is related to gaps in understanding. The failure to foresee the outcome of *Cash America* is due to a gap in understanding of the remedy provisions in an indenture between transactional lawyers, on the one hand, and trial court judges and litigators, on the other hand. Transactional lawyers based their understanding primarily on the language that they have drafted and with which they were familiar. Judge

37. *Chesapeake Energy v. Bank of New York*, 773 F.3d 110 (2d Cir. 2014).

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Furman, who decided *Cash America*, based his understanding on the interpretation that *Sharon Steel*, a prior Circuit Court precedent, had accorded to that language. While transactional lawyers professed to have read *Sharon Steel*, they tried to reconcile the holding of the case with the contractual language and came up with several limitating explanations for the holding—explanations that are not found in *Sharon Steel*, that would not be evident to a neutral reader of the opinion, and that Judge Furman dismissed.

While the failure of transactional lawyers to foresee the outcome of a litigation is perhaps not ununusal, the reaction to *Cash America* was. Within a month, transactional lawyers devised a "*Cash America* patch" that explicitly rejected the *Cash America* result. And, indeed, the *Cash America* patch made its way into about twenty deals. But then investors started to object to the new language and the move to include the patch was quashed. While contractual inertia is a well-known phenomenon, and explanations for it abound, the standard explanations do not work well for the peculiar circumstances of this case: a court opinion that interprets a provision differently from the way lawyers thought it should be interpreted, followed by an actual effort to revise the provision at issue that initially succeeds but that ultimately fails.

We have argued that this ultimate failure is connected to a different gap in understanding: one between transactional lawyers and bond investors. This gap is attributable to a particular set of features of the contract at issue: although bond investors are sophisticated parties, bond indentures are written and negotiated by lawyers that neither represent nor communicate with the ultimate investors. As a result of this lack of communication, bond investors lack full awareness of the remedies provisions in the indenture and, having devoted little attention to them, were eclectic as to their meaning. Once the provision at issue in *Cash America* became salient, bond investors started to pay attention and concluded that—regardless of what the lawyers thought the provision meant and regardless of whether *Sharon Steel* and *Cash America* were rightly decided as a legal matter—they preferred the interpretation accorded to the provision by the courts to the *Cash America* patch proposed by the lawyers.

Gaps in understanding that are formed in such contracts, which we term "contracts of inattention," not only provide an explanation for inertia but also have implications for how courts should interpret contractual provisions. In contracts where all parties are represented by lawyers, it is appropriate for courts to assume that lawyers and their clients communicate about the contract and to impute the intentions and understandings of lawyers to their clients. By contrast, in contracts of inattention, the intentions and understanding of lawyers who drafted the contract should not be given determinative weight.

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