case can be made from the *absence* of the adoption of protections for bondholders during the early and mid 1980s.[213]

In fact, the brief appearance of event risk covenants occurred near the end of the takeover period previous to which there was early general knowledge of the potential for bondholder harm from leveraged acquisitions. This delay in the adoption of protective covenants suggests that bonds were issued for a considerable period of time when the risk of takeovers and associated diminution in the market value of bonds was known to a largely sophisticated community of purchasers consisting of insurance companies and mutual funds. Although data does not appear to be available for this period, and the data for the period commencing with the introduction of event risk covenants concludes that the presence of such protection reduced the interest rate by between twenty-four and thirty-two basis points.[214] Arguably, bond buyers before the inception of the event risk covenants were under-compensated for the risk of takeovers that would depress the prices of their bonds.[215] The obvious difficulty of isolating and quantifying the pricing variable points out the inherent difficulty of either proving or disproving remediable suboptimality, thus establishing third-degree path dependence. The availability of protective covenants was known, but the failure to adopt them until late in the decade of the 1980s does not establish conclusively the existence of inefficiency in the bond indenture.[216] Again, the tendency of investors, particularly the institutions that dominate the bond market, to diversify portfolios minimizes the attention to covenants governing such events as leveraged acquisitions.[217]

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[213]*See infra* Part IV.

[214]Kahan, *supra* note 196, at 575-76 (citing Crabbe, *supra* note 203). The Crabbe study covers event risk covenants in bonds issued between November 1988 and December 1989. *Id.* at 575. This was immediately after the RJR Nabisco transaction dramatized the potential harm to bondholder from leveraged buy outs. *See infra* Part IV.

[215]*See infra* Part IV.

[216]*Infra* Part IV discusses the similarly elusive effect of judicial decisions on the adoption of optimal indenture covenants. Briefly stated, there is an argument that the doctrine reflected in one of the cases discussed creates incentives to adopt inefficient indenture terms. Specifically, when courts invoke a default standard of "what the parties would have wanted," they entertain an *ex post* inquiry into what, with *ex ante* knowledge, the parties would have wanted if they had bargained without transaction costs. *See, e.g.*, Ayres & Gertner, *supra* note 25, at 90 (using term "would have wanted"). The learning effects generated by this approach to resolving bondholder disputes contributes to an environment of adoption of suboptimal indenture provisions. If courts are likely to inquire *ex post* as to the most efficient term that the parties would have adopted, the result is a shifting of *ex ante* contracting costs to arguably less efficient and costly *ex post* judicial inquiry. Specifically, indenture terms may be adopted that insufficiently address contingencies that could have been resolved by covenant protection for bondholders. *See infra* Part IV.

[217]*Id.*

E. *Summary and Conclusion*

Is the case made for pervasive third degree path dependence in the general realm of contracts and specifically with respect to the corporate contractual paradigm? For the vast array of contracts where multilateral negotiation results in agreed-upon exchange, the nature of the contracting process seems sufficiently different from tangible product development to suggest a negative answer. Nevertheless, there are species of noncorporate contracts, such as insurance, and unique corporate contracts, such as the indenture, where strong evidence exists for an environment conducive to the adoption of suboptimal terms where efficient alternatives could be developed. Empirical proof of third-degree path dependence in the indenture, however, is hampered by the necessity to make subjective judgments about the relative optimality of terms.[218] In each case, one must look back to determine at the time the indenture was framed not only (a) whether a better known term existed, but also (b) whether the arguably less efficient term adopted was, nevertheless, efficiently priced by the bond market.

Studies suggesting efficiency of the market for the initial offering of bonds do not specifically address the pricing of legal terms in the indenture.[219] Third-degree path dependence, in tandem with the normative issues arising from the corporation as a nexus of contracts, remains unproved. But neither is it disproved.[220] Moreover, the collective work of Professors Kahan and Klausner, and their empirical study of event risk covenants, strongly suggest the potentiality for adoption of inefficient contract terms influenced by the same externalities influencing adoption of suboptimal technologies. The authors suggest an agenda for further research,[221] which includes "the role of judicial interpretation [which] should be to promote the functions of standard terms . . . while allowing firms to opt out of those standards and customize their own terms."[222] This is the subject of Part IV.

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[218]Kahan & Klausner, *supra* note 35, at 749-50.

[219]Fung & Rudd, *supra* note 211, at 643-44.

[220]Kahan & Klausner, *supra* note 35, at 760.

[221]*Id.*

[222]*Id.* at 764-765.

IV. THE UNCERTAIN IMPLICATIONS OF PATH DEPENDENCE TO THE RESOLUTION OF BONDHOLDER DISPUTES

The foregoing discussion concludes that the case for path dependent suboptimality in the vast majority of contractual settings has not been made by commentators who have sought to import increasing returns from technological product development. Nevertheless, unique characteristics of the bond indenture invite the adoption and replication of terms that may reflect learning and network externalities that result in inefficient uniform provisions or the absence of tailored provisions governing specific potential problems in the corporate debt relationship. One of the questions raised by the susceptibility of the bond indenture to inefficient drafting relates to the manner in which courts adjudicate disputes that arise between bondholders and corporate issuers. Specifically, do doctrines employed by courts enhance or minimize incentives for the creation of optimal indenture terms? The question implicates the judicial approach to gap-filling in the situation where contracts are incomplete either by design or inadvertence.[223] Presumably, indenture ambiguity or incompleteness may be traceable to the influence on drafters of learning externalities of which judicial decisions may be an important part. It is important, therefore, to explore the effects of judicial decision-making to determine whether a normative argument exists for altering existing doctrine. This is best accomplished in the context of specific transactions that have given rise to prominent court decisions.[224]

Subpart A describes the leveraged buyout as a unique transactional innovation of the 1980s giving rise to lawsuits between bondholders and issuing corporations. The absence of indenture protections for bondholders in leveraged buyouts is an arguable instance of inefficient corporate contracting influenced at least in part by a variant of path dependence that Professors Klausner and Kahan established with respect to event risk covenants.[225] The question framed by the susceptibility of indentures to suboptimality is whether traditional interpretive doctrine sufficiently takes into account the need to create incentives toward more complete contracting. This implicates a discussion of the law and economics

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[223]*See* RESTATEMENT (SECOND) OF CONTRACTS § 204 (1992) (setting forth that "[w]hen the parties to a bargain sufficiently defined to be a contract have not agreed with respect to a term which is essential to a determination of their rights and duties, a term which is reasonable in the circumstances *supplied by the court*") (emphasis added).

[224]*See infra* Part IV.B.

[225]Kahan & Klausner, *supra* note 35, at 740-49.

literature advocating theories of penalty default rules and standards as means of addressing contractual incompleteness. This, in turn, lays the groundwork for a discussion of specific cases in Subpart B, which speculates on whether the existing doctrine could be improved to minimize the resort to courts as *ex post* public resources for curing contractual inefficiency.

A. *Contractual Incompleteness and Default Rules*

1. The Problem of Corporate Opportunism and Indenture Incompleteness

In general, bondholders allege that corporate issuers undertake transactions that result in benefits to equity participants at the expense of bondholders in the form of decreased market values for the bonds.[226] The simplest example is the leveraged buyout or takeover, which uses the security of the assets and creditworthiness of the target company as a means of borrowing money to finance the acquisition. This sounds counterintuitive. How does the *buyer* use the assets of the *target* to borrow money to buy the target?[227] It is a novel transaction where the acquiring

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[226]The perceived vulnerability of bondholders to the strategic activities of management on behalf of shareholders caused some commentators to argue for heightened duties to bondholders from corporate issuers. *Bondholders I*, *supra* note 17, at 442-50; *Bondholders II*, *supra* note 17, at 206; *see generally* Brudney, *supra* note 17 (suggesting throughout the article a heightened need to protect bondholders). Others such as Brudney view the relationship as purely contractual. *Id.*

[227]There are several steps in the transaction and they are important in order to understand the novelty of the acquisition and how bondholders of the target suffer a decline in the value of their bonds. The buyer makes a public tender offer through a wholly-owned shell corporation that has borrowed the money and pledged the target stock as security until the second stage of the transaction. The buyer, having acquired a supermajority of the stock of the target, causes the target to merge with the wholly-owned shell corporation. In the merger, all the stock of the target is canceled and the remaining minority shareholders are cashed out at the same price as the public tender offer. The merger burdens the target with debt incurred by the buyers through the shell corporation. The surviving corporation is in all respects the same as the target from a financial and operational standpoint, except that it now has much more debt. The former equity holders of the target are gone, having tendered their stock or having been cashed out in the merger. The former creditors of the target company, however, remain, including the bondholders. The bondholders typically suffer a decline in the market price for their bonds reflecting the added debt burden and lessened creditworthiness of the leveraged entity. *See infra* note 228.

party borrows money in a shell entity and then merges it into the target, which then is liable for the debt.[228]

This essentially is the story of the RJR Nabisco takeover and the factual scenario giving rise to one of the cases analyzed in Part IV.B. Of course, the transaction is not possible if the bondholders' indentures contain a simple limitation on incurring additional debt. Nevertheless, the bondholders as bystanders absorbing the reduction in market value of their bonds assert that the *intent* of the bond indenture had been violated such that a court should step in to supply a contractual term that the parties would have asked for if they had thought about it. In the case of the leveraged buyout, the term to be supplied is a limitation on additional indebtedness, unless there is prior consent or redemption at par of the pre-existing bondholders. There are other patterns, but each has a common element: the assertion of *opportunistic conduct* by the issuing corporation against its bondholders and the assertion of *incompleteness* in the indenture instrument.

There are several possible approaches a court may take in resolving this kind of dispute.[229] First, it may find the indenture to be a complete statement of the terms of the corporate debt relationship and reject both the claims of opportunism and the incompleteness. This was the holding of the court that adjudicated the RJR Nabisco litigation.[230] Second, although the court may find that the indenture is a complete statement of the intended relationship, the conduct of the issuing corporation constitutes fraudulent conduct. There are very few such cases.[231]

A third possibility reflects the approach of courts in many of the bond dispute cases.[232] The alleged wrongful conduct of the bond issuer is

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[228]*See Bondholders I, supra* note 17, at 452-55; *Bondholders II, supra* note 17, at 304-07; Brudney, *supra* note 17, at 1876-68.

[229]Incomplete contracts are said to have "gaps" that arise from incomplete contracting by the parties, which may derive from the avoidance of costs or strategic conduct thought at the time of the contract to be beneficial to a party leaving a material issue unaddressed. RESTATEMENT (SECOND) OF CONTRACTS § 208 (1992) (suggesting language of unconscionability). The RESTATEMENT (SECOND) OF CONTRACTS § 204 (1992) adopts a standard requiring the gap to be filled by a "term which is reasonable in the circumstances."

[230]The court that adjudicated *RJR Nabisco* was the United States District Court for the Southern District of New York.

[231]In *Harff v. Kerkorian*, 324 A.2d 215 (Del. Ch. 1974), *rev'd* 347 A.2d 133 (Del. 1975), the court addressed the legality of an extraordinary dividend that was not prohibited by the indenture which contained no limitations on distributions to shareholders. Both the trial court and the Supreme Court rejected the existence of a fiduciary duty to bondholders, but the Delaware Supreme Court holding permitted the case to go forward on the theory of fraudulent conduct of the issuer in spite of the clarity of the indenture provisions. *Harff*, 347 A.2d at 134.

[232]*See infra* Part IV.B (discussing judicial interpretation in an environment of network externality).

not specifically prohibited by the indenture. Yet, the court still undertakes an analysis of whether the express terms of the indenture raise an inference that the parties would have agreed to proscribe the conduct if they had focused on it.[233] Frequently the analysis of alleged opportunistic conduct by the bond issuer proceeds under the doctrinal rubric of whether there has been a breach of the implied covenant of good faith and fair dealing.[234] The traditional concept of good faith and fair dealing has a parallel in the literature analyzing how courts fill gaps in contracts.[235] In the academic literature, this inquiry invokes the theory of default rules and standards,[236] which encompass the broad subject of legislative and judicial mandates that apply in absence of contrary agreement by parties.[237] With incomplete contracts, default rules provide a background set of principles to assist a court in ordering or withholding relief when a dispute arises about an issue not addressed by the formal agreement of the parties.[238] Default theory, on the one hand, and the doctrine of implied covenant of good faith and fair dealing, on the other, seek, respectively, (a) to reduce contracting costs and (b) enforce the spirit of an otherwise complete contract. Tied closely, the application of each is the question of whether the parties intended to omit the provision that one party asserts should be supplied by the court.

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[233] *Id.*

[234] *Id.*

[235] Good faith is read into contracts. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1992).

[236] *See generally* Steven J. *Burton, Default Principles, Legitimacy, and the Authority of Contract*, 3 SO. CALIF. INTERDISCIPLINARY L.J. 115, 130 (1993) (discussing, *inter alia*, implications for default principles). The scholarship is wide-ranging. One commentator disputes the validity of the concept. W. David Slawson, *The Futile Search for Principles for Default Rules*, 3 S. CALIF. INDISCIPLINARY L.J. 29, 29 (1993) (stating that "[d]efault rule analysts have contributed nothing new to the subject except the new word they have coined for it"). Another commentator approaches the issue of default rules from a philosophical standpoint and argues that default rules lack legitimacy. Burton, *supra*, at 117 (stating that "I argue, default rules based on efficiency principles, communitarian values, and relational contract norms either lack a legitimating basis or fail to respect the authority of the contract"). Ian Ayres extends his earlier work with Robert Gertner to consider "tailored" default rules that draws on concepts of rules versus standards. Ian Ayres, *Preliminary Thoughts on Optimal Tailoring of Contractual Rules*, 3 SO. CALIF. INTERDISCIPLINARY L.J. 1, 2 (1994) (stating that "[t]he rather minimal thesis of this paper is that the ability of private parties to contract around rules or standards affects their optimal level of precision").

[237] Ayres & Gertner, *supra* note 25, at 90-91; Issac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257 (1974); Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992).

[238] *See generally* RESTATEMENT (SECOND) OF CONTRACTS § 204 (1992) (discussing omitted terms supplied by courts).

2. Majoritarian Default Rules

Until the late 1980s, the law and economics literature was virtually unanimous in advocating an overall theory of default rules based upon what the parties to a given contract would have bargained for in a costless setting.[239] Thus, in framing corporate codes containing general provisions, the legislature should reduce transaction costs by providing applicable off-the-rack provisions that parties usually would choose.[240] These provisions, of course, would be optional and could be modified in any given circumstance.[241] According to the law and economics proponents of enabling systems of corporate governance, default rules should have two characteristics. They should be (1) *majoritarian*, reflecting what most contracting parties would want, and they should be (2) *mutable*, that is, tailorable to the specific needs of specific situations.[242] Mutable, majoritarian default theory seeks to reduce the costs of contracting and thus promote optimality in the various components of the corporate contract through the operation of free market forces. Easterbrook and Fischel observe:

> The normative thesis of the book is that corporate law should contain the terms people *would have negotiated*, were the costs of negotiating at arm's length for every contingency sufficiently low. The positive thesis is that corporate law almost always conforms to this model. It is enabling rather than directive.
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> All the terms in corporate governance are contractual in the sense that they are fully priced in transactions among the

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[239]RICHARD POSNER, ECONOMIC ANALYSIS OF LAW 81 (3d ed. 1986); Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829, 835-36 (1985) (stating that default rule in debtor-creditor relationship should provide parties with "the type of contract that they would have agreed . . . [upon] if they had had the time and money to bargain over all aspects of their deal"); Charles J. Goetz & Robert E. Scott, *The Mitigation Principle: Toward a General Theory of Contractual Obligation*, 69 VA. L. REV. 967, 971 (1983) (writing that "[i]deally, the preformulated rules supplied by the state should mimic the agreements contracting parties would reach were they costlessly to bargain out each detail of the transaction").

[240]*See* Goetz & Scott, *supra* note 239, at 971 (providing standardized, off-the-rack provisions would eliminate the cost of negotiating every detail of the proposed arrangements).

[241]*Id.* (remaining free to bargain for customized provisions).

[242]Ayres & Gertner, *supra* note 25, at 91.

> interested parties. They are thereafter tested for desirable properties; the firms that pick the wrong terms will fail in competition with other firms competing for capital. *It is unimportant that they may not be "negotiated"; the pricing and testing mechanisms are all that matter,* as long as there are no effects on third parties. This should come as no shock to anyone familiar with the Coase Theorem.[243]

Accordingly, the shorthand term "what the parties would have wanted"[244] describes the general approach of law and economics to both filling gaps in incomplete contracts and legislatively framing the off-the-rack terms that create the nexus of contracts of the corporation unless parties otherwise agree. Recent contract scholarship, however, introduces the concept that default rules may promote optimality in contracting by consisting of legislative provisions and rules *contrary* to what the parties would have wanted.[245] These are called penalty defaults.[246]

They have potential significance to path dependence in the corporate indenture because they are designed to cause parties to expend *ex ante* resources to avoid contractual incompleteness and thus minimize the potential for expenditure of *ex post* judicial resources. Stated a little differently, if bond indentures contain inefficient terms or inefficiently omit terms, a penalty default regime might plausibly operate to grant or withhold relief so as to create an *ex ante* incentive to allocate risk with specificity.

3. Penalty Defaults

In promoting the discussion of penalty defaults, commentators have suggested a novel deviation from the majoritarian default regime. They seek to avoid the *ex post* costs of judicial inquiry into what contracting parties would have bargained for costlessly. Ayres and Gertner describe the basis for penalty defaults as follows:

> We suggest that efficient defaults would take a variety of forms that at times would diverge from the "what the parties

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[243]EASTERBROOK & FISCHEL, *supra* note 6, at 15, 17 (emphasis added).

[244]Ayres & Gertner, *supra* note 25, at 89-91.

[245]*See supra* note 27 and accompanying text.

[246]Ayres & Gertner, *supra* note 25, at 91 (stating that "penalty defaults give . . . one party to the contract an incentive to contract around the default rule").

> would have contracted for" principle. To this end, we introduce the concept of "penalty defaults." Penalty defaults are designed to give a least one party to the contract an incentive to contract around the default rule and therefore to choose affirmatively the contract provision they prefer. In contrast to the received wisdom, penalty defaults are purposefully set at what the parties would not want — in order to encourage the parties to reveal information to each other or to third parties (especially the courts).[247]

Ayres and Gertner theorize that "[w]hen parties fail to contract because they want to shift the *ex ante* transaction cost to a subsidized *ex post* court determination,"[248] resources are suboptimally misallocated to judicial gap filling. When such shifting exists, they suggest the application of a penalty default, which can consist merely of judicial passivity or nonenforcement — leaving the parties where they stand rather than completing the contract.[249] Consequently, they assert that the gap-filling analysis should be preceded by inquiries into why the gap exists and whether the *ex post* remediation is efficient.[250] Where it is inefficient to shift the cost of contracting from the parties to the courts, "[c]ourts, which are publicly subsidized, should give parties incentives to negotiate *ex ante* by penalizing them for inefficient gaps."[251]

The previous assessment of the uncertain case for remediable path dependence in the bond indenture emphasized the subjective nature of suboptimality and the difficulties of verification.[252] Nevertheless, there was observed an environment surrounding the issuance of corporate debt that has the potential to be influenced by externalities resulting in the adoption of an inefficient term when better ones could be chosen or devised. The question arises as to whether courts faced with bondholder disputes could usefully employ penalty defaults, rather than the traditional majoritarian default of "what the parties would have wanted"[253] to minimize the potential for adoption of suboptimal terms. There are several aspects of debt financing that suggest the relevance of a penalty default analysis.

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[247] *Id.*

[248] *Id.* at 127-28 (emphasis added).

[249] *Id.* at 128.

[250] Ayres & Gertner, *supra* note 25, at 95.

[251] *Id.* at 93 (emphasis added).

[252] *See supra* Part III; *supra* notes 185-216 and accompanying text.

[253] Ayres & Gertner, *supra* note 25, at 89-91.

First, the selling of corporate bonds to the public involves substantial amounts of money.[254] The transaction is uniquely able to bear its full costs. Arguably it is a transaction in which the central contractual component, the indenture, should be created with as little incentive as possible for incompleteness and resulting potential for the incurrence of judicial costs of remediation.

Second, there exists (in the form of the *Commentaries on Indentures*) a vast array of standard and optional provisions that may be adopted or modified to prohibit virtually every kind of financial and transactional activity that would be deemed harmful to the payment capability or creditworthiness of a bond issuer.[255] The silence of an indenture in the face of this broad array of easily-adoptable terminology should have at least some implication for the trier of a dispute where a party seeks an *ex post* judicial insertion of a missing term. Arguably in the case of silence, the invocation of the penalty default of judicial passivity — leaving the parties where they stand — would create positive learning benefits in the form of incentives to avoid indenture incompleteness by utilizing and tailoring the forms found in the *Commentaries*.[256] This, of course, is complicated by the requirement of a judicial finding that the indenture is in fact silent.

Also, it is problematic to assume that silence necessarily equates to the inefficiency associated with path dependent suboptimality.[257] It may be that the drafters of the indenture and the purchasers of the bonds fully took into account the absence of protective terms. This, of course, makes a case for passivity on the part of courts asked to imply missing terms. It says little or nothing, however, about the connection between judicial attitudes and indenture inefficiency.

The penalty analysis in the context of the interpretation of an ambiguous term, as distinguished from silence, raises separate issues. Mere passivity does not serve as an interpretive approach here because the existence of an ambiguity by no means suggests that a court should simply

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[254]Kahan, *supra* note 197, at 566 n.4. The author notes that the Board of Governors of the Federal Reserve reported the issuance of $1,883 billion in face amount of corporate and foreign bonds for the year 1992. *Id.*

[255]AMERICAN BAR FOUNDATION, COMMENTARIES ON INDENTURES 202-77, 290-311, 368-421, 558-83(1971). The form provisions govern, *inter alia*, limitation on incurrence of additional debt, payment of dividends, mergers and sales of assets, sale and leaseback transactions, subordination, and definitions of events of default and acceleration of payment of principal.

[255]Strong proponents of extra-contractual protection for bondholders are skeptical that any formulation of the indenture can effectively insulate bondholders from opportunistic issuer conduct that creatively evades covenants. *See* Brudney, *supra* note 17, at 1850-51.

[257]*Id.*

ignore it. This raises another potential objection from commentators who believe that bondholders are always vulnerable to creative avoidance of bond covenants.[258] The burden of a general penalty default rule in the form of judicial passivity may be seen as unfairly falling on the bondholder as the primary seeker of relief.[259] Again, it must be remembered that we are analyzing judicial attitudes toward *path dependent inefficiency*. Recall, furthermore, that the case for remediable suboptimality in the indenture rests on subjective assumptions and eludes verifiability. Thus, the antidote for what has been found to be at most an environment conducive to the potential for path dependence must not sacrifice the demonstrated worth of the majoritarian default rule. Professor Klausner, writing alone and then with Professor Kahan, addresses the competing values of majoritarian versus penalty defaults.[260] He first notes the problems associated with the search for a majoritarian default rule in the general context of contract suboptimality:

> The presence of network externalities thus complicates at the outset the search for a majoritarian default rule. Even after a majoritarian default is identified, however, the presence of network externalities must be taken into account in determining whether the default rule will be "tailored" or "untailored" in its application.
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> Finally, even if . . . [a] court selects the optimal majoritarian default rule, later changes in the business environment can render the rule suboptimal. If this occurs, accrued network externalities may lock firms into an obsolete default rule. . . . The point again is that, if a default term that has accrued network benefits becomes obsolete, the contractarian assumption that firms will opt out of it and into socially optimal contracts may not be valid.[261]

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[258] *Id.* at 1853-55.

[259] Virtually all cases are brought by bondholders alleging a form of corporate opportunism that has expropriated bond value. Conceivably, of course, collective action by bondholders could raise questions of indenture interpretation. For example, an institution could amass a sufficient principal amount of bonds and compel a trustee to declare a default under conditions for which the literature has not reasonably provided. One might argue, however, that this eventuality is governed by the law of lender liability.

[260] Klausner, *supra* note 35, at 826-41.

[261] *Id.* at 831, 833.

The search for "what the parties would have wanted"[262] in connection with incomplete contracts is a tailored rule that is designed to inquire about what the actual parties would have wanted in a given contract or what *most* parties would have wanted at contractual inception. Thus, the generalized concern about changes in the business climate may be exaggerated. A court employing the tailored majoritarian rule will inquire how the parties would have intended to address such changes.

The question remains whether a penalty default leaving an incomplete indenture unremedied is superior to the majoritarian alternative. When first invoked, the penalty default rule operated to punish parties that may have relied upon the majoritarian rule.[263] Presumably, they reasonably relied upon the courts to provide suppletory terms. Thus, there is a strong argument for a prospective application of any penalty rule.

These, however, are not the only problems with the penalty default rules. Professor Klausner notes, in connection with penalty defaults, that "[i]n the corporate law context, . . . [the penalty default] would be a term that managers, who dominate the writing of the contract, disfavor."[264] He further states that "[b]y inducing explicit contracting, penalty defaults may expose the contracting process to suboptimal diversity."[265] These are general observations about the corporate contract and they may be valid in certain instances. For example, a penalty default rule involving the fiduciary relations between managers or majority shareholders, on the one hand, and minority shareholders, on the other, may need to be framed to induce managers or controlling parties to opt for alternative terms.[266] It is not unreasonable to write background rules with an eye toward protection of those to whom fiduciary duties run.[267]

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[262]Ayres & Gertner, *supra* note 25, at 89-91.

[263]Klausner, *supra* note 35, at 834 (stating that "firms contracting in response to penalty defaults will be less able to coordinate with one another to obtain network benefits"). Klausner notes this is the opposite of a situation involving majoritarian defaults. *Id.*

[264]*Id.*

[265]*Id.*

[266]Section 102(b)(7) of the Delaware Corporation Code permits a corporation to alter the otherwise applicable fiduciary duty of care of directors. Of course, if no action is taken to include a provision in the Certificate of Incorporation, then the cases defining duty of care continue to apply. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 873, 893 (Del. 1985) (retaining standard of gross negligence, but holding it was a violation of due care to accept an offer to buy the company at almost $20 per share over the prevailing market price for the common stock).

[267]Indeed those commentators favoring mandatory corporate terms would make them *immutable* and thus incapable of being altered even with the knowledgeable consent of parties owed the fiduciary duties. *See supra* note 17. In the purely contractual realm of the bond indenture, the issues arguably are different, but commentators such as Professor Brudney would

The purely contractual nature of the bond indenture, however, derived as it is from standardized but modifiable terms, may differ from corporate contracts that involve fiduciary duty. Here Professor Klausner's concern with suboptimal diversity does not seem as relevant as it may be in other contexts. Diversity among bond indentures presumably reflects the distinct financial attributes and credit risks among bond issuers. Thus, diversity of terms reflects greater attention *ex ante* to the particulars of each separate bond transaction. A penalty default of judicial passivity and nonintervention should motivate underwriters, who exert significant independent influence over the managers of a corporation, to focus *ex ante* on terms that would result in a more complete indenture.[268] This argument is now tested by reference to cases resolving disputes between bondholders and issuing corporations. Recall that the intent is to assess whether doctrines of interpretation can influence the avoidance of suboptimality in the environment of path dependence discussed in Part III.

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probably agree that any penalty default should operate to resolve ambiguities and fill gaps in favor of bondholders. *See* Brudney, *supra* note 17, at 1821. This is consistent with his view that holders of publicly issued bonds are constantly vulnerable to creative avoidance of bond indenture covenants.

[268]*But see* Kahan & Klausner, *supra* note 35, at 765. In their suggestion of an agenda for future research to which this article responds they include the topic of interpretation of corporate contracts. They leave open the question of the appropriate rule of interpretation with the following statement:

> Interpretation of standard terms should be treated like the interpretation of laws: Judges, not juries, should interpret them, and their interpretations should have precedential value. Where a standard term is the product of an explicit standard-setting process such as the model bond indenture or the model simplified indenture, commentaries of the standard-setting organization should be accorded authoritative weight. *In contrast, courts should interpret customized terms in a particularized fashion with specific reference to the circumstances of the parties that have customized a term, including a presumptive intent to depart from the standard term. Ambiguity in the customized term should be resolved to give the term a meaning distinct from that of its standard counterpart.*

Id. (emphasis added) (footnotes omitted).

Of course, this does not address whether optimality is best promoted by a majoritarian default rule or a penalty default.

B. *Judicial Interpretation in an Environment of Network Externality*

1. *Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*[269]

In *Sharon Steel*, a Second Circuit panel consisting of experienced judges[270] interpreted a boilerplate[271] term in indentures covering bonds issued by UV Industries (UV).[272] Each indenture contained a standard "successorship"[273] clause that prohibited UV from entering into mergers or sales of substantially all of its assets unless the acquiring corporation assumed all of the terms of the indenture and was in compliance with all of its terms.[274] There were no other terms in the indentures that limited the ability of UV to merge or sell substantially all of its assets.[275] Thus, UV was free to merge or sell its assets subject only to the acquiring corporation assuming the debt and not being in default of the UV indenture terms. The failure to meet these conditions required that UV redeem the debt obligations, which contained provisions entitling the holders to premiums for early redemption.[276]

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[269]691 F.2d 1039 (2d Cir. 1982).

[270]The panel consisted of Chief Judge Feinberg, Judge Jon Newman, and Judge Ralph Winter, formerly on the faculty of the Yale Law School. *Id.* at 1041.

[271]"Boilerplate" in this context means that the term is one that is contained in virtually all indentures and is not subject to alteration by the parties. *Id.* at 1048. Another example of a boilerplate term is the covenant that the corporate issuer will maintain its corporate existence. These terms are distinguished from negotiated terms that cover the specific considerations of a particular bond issuance. Examples of negotiated terms include limitations in any one year of more than a certain dollar amount of distributions to shareholders (or a complete prohibition). Negotiated terms may be found in many indentures, but they are subject to being shaped to limit corporate financial and transactional conduct inimical to the ability of bondholders to be paid principal and interest.

[272]*Id.* at 1042.

[273]The language from the Manufacturers Indenture, § 11.01, which was in form similar to the other indentures, reads as follows in relevant part:

> [N]othing contained in this Indenture or in any of the Debentures shall prevent any consolidation or merger of the Company . . . or any sale, conveyance or lease of all or substantially all of the property of the Company to any other corporation . . .; provided, however . . .[UV] hereby covenants and agrees . . . that (a) immediately after such consolidation, merger, sale, conveyance or lease the [acquiring] corporation . . . shall not be in default in the performance or observance of any of the terms, covenants and conditions of this Indenture . . . and; (c) . . . this Indenture . . . shall be expressly assumed, by supplemental indenture satisfactory in form to the Trustee . . . .

Sharon Steel Corp., 691 F.2d at 1044 n.7.

[274]*Id.* at 1044-45.

[275]*Id.* at 1044 n.7.

[276]*Id.* at 1045.

Sharon Steel agreed to acquire all of the assets of UV in exchange for cash and the assumption of the debt governed by the indentures.[277] It had served notice to the indenture trustees that it intended to assume the obligations in the indentures containing the successorship clauses.[278] The various indenture trustees refused to allow the assumption of the debt by Sharon Steel and instituted proceedings to compel UV to redeem the debt and pay the early redemption premiums.[279] There were significant financial implications to the bondholders and Sharon Steel as the acquiror seeking to assume the debt. Specifically, the prevailing interest rate at the time of the acquisition ranged from four to six hundred basis points[280] *above* the various rates of interest on the bonds. Accordingly, the indenture trustees, on behalf of the bondholders, were seeking to compel redemption and the payment of the premiums in order to permit the reinvestment of the proceeds at considerably higher rates of return.[281] If Sharon Steel could not assume the existing low-interest debt, then it would pay some lower amount reflecting the increased cost of money in the transaction. The shareholders of UV would, of course, receive less money if the UV debt could not be assumed. Thus, while the case was styled as one between the indenture trustees of UV and the acquiror, Sharon Steel, the real conflict was between the financial interests of the bondholders and shareholders of UV. The legal question was a rather simple one: Did the successorship clauses permit Sharon Steel to assume the debt?[282] Yet, there were other facts clouding what appeared to be a simple issue of indenture interpretation.

Before Sharon Steel agreed to buy all of UV's assets, UV adopted a plan of liquidation and sold two of its three lines of business.[283] What remained constituted assets that produced thirty-eight percent of UV's operating revenues, forty-one percent of the book value of all of its operating properties, and fifty-one percent of its assets when certain items of cash were added to its operating properties.[284] The indenture contained no limitations on UV's sale of less than substantially all of its assets, so the

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[277]*Sharon Steel Corp.*, 691 F.2d at 1046.

[278]*Id.* at 1046-47.

[279]*Id.*

[280]One basis point equals one-hundredth of a percentage point. Thus, the interest rate prevailing at the time of the UV/Sharon Steel deal was four to six percent above the rate of interest due on the bonds. Obviously, if the bondholders could require the redemption of the bonds, they could invest the proceeds at these higher rates.

[281]*Sharon Steel Corp.*, 691 F.2d at 1046-47.

[282]*Id.* at 1048-49.

[283]*Id.* at 1045-46.

[284]*Id.* at 1051.

previous transactions were perfectly legal. Additionally, there were no limitations on mergers or sales of assets. Consequently, UV could probably have *merged* with Sharon Steel or any other company without redeeming the public debt so long as the resulting company assumed the debt and complied with the indenture limitations. There was no dispute that Sharon Steel, after the purchase of assets, met all of the terms of the indentures.[285]

The indenture trustees argued that the terms of the successorship clauses were violated when a sale of all the assets was preceded by transactions undertaken as part of a plan of liquidation.[286] The sale to Sharon was not a sale of substantially all of the assets; therefore, the UV debt could not be assumed by Sharon Steel.[287] Otherwise, the trustees argued, a company could sell in piecemeal fashion all of its assets for cash and then "sell" the cash to an acquiror in exchange for cash and the assumption of the debt.[288] Such a transaction would not be a conventional sale of assets, but rather a sham that would harm the bondholders by avoiding their rights to redemption. The possibility of such a transaction — not present in the Sharon-UV transaction — constituted the basis for the argument that Sharon should not be allowed to assume the debt under the successorship clauses.[289]

Sharon Steel urged that the successorship clauses of the indenture were designed to benefit the *issuer* of the bonds by giving it a measure of flexibility to merge or sell all of its assets and enter into other transactions free from the debt that would be assumed by the acquiring corporation.[290] It pointed to two basic characteristics of corporate debt set forth in the Commentaries. The first proposition embodies the notion that bondholders are entitled only to the timely payment of principal and interest throughout the life of the bond.[291] Accordingly, a bond may rise or fall in price based upon movements in the interest rates in the financial markets but this is a risk assumed by the bondholder who has agreed to wait until the designated maturity date to receive final payment of principal.[292]

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[285] *Sharon Steel Corp.*, 691 F.2d at 1051.

[286] *Id.* at 1047.

[287] *Id.* at 1051-52.

[288] *Id.* at 1049.

[289] *Sharon Steel Corp.*, 691 F.2d at 1050-51.

[290] *Id.* at 1050.

[291] *Id.* at 1048.

[292] The Commentaries also set forth a second characteristic of bonds as follows:
The second fundamental characteristic of long term debt financing is that the rights of holders of the debt securities are largely a matter of contract. There is no governing body of statutory or common law that protects the holder of

Sharon Steel argued that the boilerplate successorship clause was not designed to operate as a limitation on mergers and sales of assets; in fact, the language was permissive.[293] The standard forms contained in the Commentaries contain myriad provisions limiting mergers and sales of assets, but none were contained in the UV indentures.[294] Sharon Steel further argued that the successorship clauses would permit mergers and sales of assets to larger companies with different aggregations of assets so that the bondholders would look to an entity with potentially quite different payment capabilities.[295] So long as the requirement of compliance with the terms of the indenture by the acquiring corporation was met, however, the bondholders had no basis to object to the assumption.[296] Accordingly, the sequence of transactions leading up to the sale of assets by UV to Sharon Steel and the assumption of debt was not prohibited by the express terms of the indenture.[297] In short, UV had not given up its right to sell its assets, regardless of the timing and sequence of such sales.[298]

Before turning to the decision of the court, recall the discussion of majoritarian default rules.[299] A majoritarian default seeks to discover what the parties would have wanted if they had addressed the issue.[300] A variant is what *most* parties would have wanted in the situation. Notice the difficulty of undertaking this inquiry in the financial context posed by *Sharon Steel*. The financial goal of the bondholders is to oppose assumption of the UV debt by Sharon Steel. Their goal is to be paid early with a premium for early redemption because interest rates have risen.[301] They will then invest the proceeds of the early repayment at the prevailing higher rates.[302] What if the prevailing rates, however, had been lower? Presumably, the bondholders would have no objection to retaining their

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> unsecured debt securities against harmful acts by the debtor except in the most extreme situations. . . . [T]he debt securityholder can do nothing to protect himself against actions of the borrower which jeopardize its ability to pay the debt unless he . . . establishes his rights through contractual provisions set forth in the . . . indenture.

Id. at 1049.

[293]*Sharon Steel Corp.*, 691 F.2d at 1050.

[294]*Id.*

[295]*Id.*

[296]*Id.*

[297]*Sharon Steel Corp.*, 691 F.2d at 1050.

[298]*Id.*

[299]*See supra* notes 261-65 and accompanying text.

[300]*Id.*

[301]*Sharon Steel Corp.*, 691 F.2d at 1046-47.

[302]*Id.*

bonds, which bear the higher interest. How does the majoritarian default rule help a court faced with a lawsuit with interests motivating opposing interpretations of a contract driven by the fortuity of changed events? It does not seem to provide a realistic and workable standard for determining which party prevails. In contrast, a penalty default of judicial passivity leaves the parties where they stand. They will not be permitted to shift the *ex ante* cost of contracting to the *ex post* judicial resources of conflict resolution.

The *Sharon Steel* court simply cannot resort to a majoritarian default analysis because each party would want an opposite interpretation depending upon the prevailing rates of interest. Thus, in ruling against the right of Sharon Steel to assume the UV debt, the court must employ a variant of the majoritarian default rule. First, the court observes that uniformity requires interpretations of boilerplate indenture provisions to be undertaken strictly as a matter of law.[303] "[U]ncertainties would be created if interpretation of boilerplate provisions were submitted to juries sitting in every judicial district in the nation."[304] The court follows this unproblematic assertion with an analysis that exposes a complete lack of case law addressing the words "substantially all of the assets" contained in the indenture.[305] In short, there was no precedential guidance for whether the last sale of UV assets to Sharon Steel should be viewed along or in series with the earlier sales.

The court considered the competing arguments as to the meaning of the successorship clause and focused upon the Sharon Steel argument that the successorship clauses were designed to benefit corporate bond issuers.[306] Thus, the court rejected the assertion that the permissive indenture language contemplated a wide range of transactional freedom for a corporate issuer to merge with companies of differing sizes, businesses and financial attributes.[307] Specifically, Judge Winter opined:

> We disagree. In fact, a substantial degree of protection against diluting transactions exists for the [bondholder]. . . . [Bondholders] can rely, for example, on the self-interest of equityholders for protection against mergers which result in a firm with a substantially greater danger of insolvency. So far as the sale of assets to such a firm is concerned, that can

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[303] *Id.* at 1048.
[304] *Id.*
[305] *Sharon Steel*, 691 F.2d at 1050.
[306] *Id.*
[307] *Id.*

> occur but substantial protection exists even there since the more debt heavy the purchaser, the less likely it is that the seller's equityholders would accept anything but cash for the assets. *A sale to a truly crippled firm is thus unlikely given the self-interest of the equityholders.* After a sale, moreover, the lenders would continue to have the protection of the original assets. In both mergers and sales, complete protection against an increase in the borrower's risk is not available in the absence of more specific restrictions, but the self-interest of equityholders imposes a real and substantial limit to that increase in risk. The failure of successor obligor clauses to provide even more protection hardly permits an inference that they are designed solely for the benefit of borrowers.[308]

This analysis of the successorship clauses is far from satisfying. The court seems to be saying that stockholders will not enter into transactions that hurt both themselves and the bondholders. As in the Sharon/UV deal, however, when the stockholders approve the sale of assets for cash or approve a merger for cash, *they terminate their investment.* There is no basis for the court's conclusion that a measure of protection exists from the self-interest of shareholders.[309] But, in any event, the court concludes and holds that "protection for borrowers as well as for lenders may be fairly inferred from the nature of successor obligor clauses."[310] It extends this conclusion to encompass the following concept:

> Where contractual language seems designed to protect the interests of both parties and where conflicting interpretations are argued, the contract should be construed to sacrifice the principal interests of each party as little as possible. An 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.[311]

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[308] *Id.* (emphasis added).

[309] *Sharon Steel Corp.*, 691 F.2d at 1051.

[310] *Id.*

[311] *Id.*

While not explicitly stating its analysis in terms of a majoritarian default rule such as "what the parties would have wanted,"[312] the court adopts exactly that approach in devising a solution out of whole cloth that attempts to elevate a housekeeping, boilerplate term to the level of a substantive bilateral provision intended to benefit both the issuer and the bondholders. This may be a slight overstatement. Clearly, the successorship clause contains a substantive component beyond mere housekeeping. The acquiror or merger partner *must* meet all of the assumed indenture provisions after the transaction is completed. Existing, however, as a standard nonnegotiated provision, the successorship clause hardly seems designed to go beyond this limited purpose. The Commentaries do not indicate otherwise.[313] Indeed, under this analysis, there would be no need to ever include an optional term limiting asset dispositions. Specifically, the use of the boilerplate term governing merely technical successorship would confusingly obviate the need for a negotiated term such as the following hypothetical limitation: "Without the consent of the Bondholders, the Company shall not in any twelve month period sell or exchange more than 25% of the book value of its assets."

The invocation of a default standard that would infringe upon the respective parties' principal interests as little as possible involves a judicial inquiry not unlike "what the parties would have wanted."[314] It expends judicial resources *ex post* the contracting process in an attempt to fathom meaning in a standard term. But there simply are no "principal," "major," or "marginal" interests to be balanced and compared from the contractual language involved in *Sharon Steel*. Would a penalty default analysis leaving the bondholders without relief have resulted in lessening the

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[312]*See supra* notes 261-65 and accompanying text.

[313]Professors Kahan and Klausner would accord authoritative importance to guidance in the Commentaries on the Indenture. Kahan & Klausner, *supra* note 35, at 765. They cite *Sharon Steel* for the proposition that "commentaries of the standard-setting organization should be accorded authoritative weight." *Id.* (footnote omitted). If anything the quotations from the Commentaries on the Indenture suggest that, if the parties want protections from issuer conduct, they should bargain for it and spell it out in the indenture. It is true that the *Sharon* court followed the suggestion of Kahan and Klausner that boilerplate should be interpreted by judges and not juries. *See Sharon Steel Corp.*, 691 F.2d at 1048. The method of interpretation still leaves much to be analyzed between the competing claim of majoritarian defaults and penalty defaults.

[314]*See generally* Ayres & Gertner, *supra* note 25 (using the language "what the parties would have wanted").

potential for suboptimality in indentures?[315] The answer is by no means clear.

The Ayres/Gertner penalty default analysis[316] requires a different approach to the issue of interpretation in *Sharon Steel*. We have isolated a gap in the indenture but we need to ask: "[W]hy does the gap exist?"[317] In *Sharon Steel*, there are three possible answers. First, and most likely, the boilerplate term was adopted without any thought beyond its clear requirement that a successor corporation provide identical covenant protection to the UV bondholders by duplicating and meeting in an assumed supplemental indenture all of the protections provided by the original UV indenture.

A second possibility emerges: the underwriters and UV, at the inception of the financing, clearly had *no* intention whatsoever to limit the disposition of assets by UV. They expressly left any limitation on UV out of the covenant protections.

Third, and highly unlikely, the framers of the indenture acted strategically. They knew the successorship clause could be manipulated to keep bondholders from having their bonds redeemed in a sale of assets transaction when interest rates had risen. They intended that UV be able to appropriate the value of the bonds when interest rates rose. This strains credulity. Boilerplate provisions, unlike negotiated provisions, do not create the potential for strategic conduct because they address recurring formalities.[318]

The first and third answers suggest the advisability of a penalty default. They bring into focus the importance of creating learning effects that cause increased transactional attention (and costs) to reach a more detailed agreement. Recall the existence of off-the-rack terms from the *Commentaries* covering virtually every possible limitation on the financial and business behavior of the bond issuer.[319] A penalty default rule leaving the parties where they stand exerts considerable (prospective) force on contracting parties to address *ex ante* specific issues or be left with judicial relief *ex post*. It unburdens the courts from an *ex post* role where public

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[315]Arguably, a court more sensitive to the economic implications of the allocation of costs of contracting and the application of judicial resources might have more painstakingly scrutinized the question of the threshold necessary to create a legitimate ambiguity or gap arising from boilerplate provisions. After all, these are standard provisions whose provisions ordinarily do carry the substantive import of optional covenants reflecting the unique financial and business attributes of the bond issuer.

[316]Ayres & Gertner, *supra* note 25, at 91.

[317]*Id.* at 127.

[318]*See* BLACK'S LAW DICTIONARY, *supra* note 200, at 175.

[319]*See supra* text accompanying notes 313-18.

and private resources are expended on advocacy clouded by twenty-twenty hindsight and self-interest. Also, recall that a court has access to doctrines of bad faith and fraud.[320] Finally, the context of public financing of corporations is repetitive in nature and presumably will absorb and incorporate the learning and network effects of a decision designed to influence future conduct.

But is any of this realistic? The *ex post* expenditure of judicial resources almost certainly pales in the face of the expenses incurred by the private sector in seeking to vindicate bondholder claims. Also, the penalty default regime *encourages* parties to take the time and expend the resources to specify agreements covering, more specifically, future contingencies. No one, however, expects that the penalty default scheme will *eliminate* incompleteness, even where there are ample *ex ante* resources such as the case of the bond indenture. Finally, are courts equipped to determine the reasons for contractual incompleteness as a precursor to resolving disputes?

Clearly there are cases in which even the most careful drafting and consideration of contingencies could not have focused on legitimately unforeseen events. These cases may most fairly and economically be adjudicated by reference to the majoritarian rule of inquiring what the parties would have wanted or what most parties would have wanted.[321] So, if *Sharon Steel* represents a dramatically *ad hoc* cobbling of intimations and guesses about boilerplate provisions, it nevertheless enhances, to some small degree, the learning benefits available to future framers of indentures.

2. *Metropolitan Life Insurance Co. v. RJR Nabisco, Inc.*[322]

A leveraged buyout, perhaps unlike any other corporate transaction, has the potential to diminish the market value of outstanding bonds.[323] The effects and disparity of treatment are immediately felt. Shareholders get cash for all their stock at a significant premium above the previous prices in the market. At the same time, bondholders watch the market value of their bonds plummet. This *must* violate some indenture provision. The

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[320]*See generally* RESTATEMENT (SECOND) OF CONTRACTS § 208 (1992) (stating that courts may refuse to permit any unconscionable terms in a contract).

[321]*See generally* Ayres & Gertner, *supra* note 25 (using "what the parties would have wanted").

[322]716 F. Supp. 1504 (S.D.N.Y. 1989).

[323]The emotions generated by the leveraged buyout transaction are reflected in Christopher Farrell et al., *Bondholders are Mad as Hell — And They're Not Going to Take It Anymore*, BUS. WK., Feb. 6, 1989, at 82.

leveraged buyout of RJR Nabisco (RJR)[324] sets the stage for a judicial decision that is useful in evaluating whether existing contract doctrine can deter tendencies towards suboptimality in the bond indenture as observed in Part III.

In 1988, RJR Nabisco, Inc. (RJR) was acquired in a massive leveraged buyout under which it became liable for more than $19 billion in debt.[325] Kohlberg Kravis Roberts & Co. arranged the transaction, which was approved over a competing bid and resulted in an offer to all shareholders at a substantial premium over the prevailing price of RJR equity securities.[326] Metropolitan Life Insurance Company (Met Life) owned bonds of RJR before the leveraged buy out and experienced a sharp decline in their market value.[327] Met Life sued RJR for breach of the indentures governing RJR even though no covenants limiting additional indebtedness were contained within.[328] Met Life argued that the indentures were silent because "[s]uch covenants were believed unnecessary with blue chip companies . . . [and] the transaction contradicts the premise of the investment grade market" and "[t]his buy-out was not contemplated at the time the debt was issued . . . ."[329] Met Life implored the court to fill a textual gap in the indentures by reference to what they argued was clearly understood apart from the specific language.[330]

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[324]For a lucid and entertaining history of the RJR transaction and a biography of the various lawyers, investment bankers, and company officials, see BRYAN BURROUGH & JOHN HELYAR, BARBARIANS AT THE GATE — THE FALL OF RJR NABISCO (1990).

[325]*Metropolitan Life Ins. Co.*, 716 F. Supp. at 1505-06.

[326]*Id.* at 1505. The three steps to the transaction consisted (1) of securing and drawing down on loan commitments; (2) paying the tendering shareholders with the proceeds of the loans; and (3) merging the acquiring company with RJR into one surviving company, RJR, that was liable for the debt used to make the acquisition. *Id.* at 1507 n.8. This is a standard for leveraged buy out. Obviously, such a transaction can be effectuated only when at least two conditions exist. First, the stock of the acquired company does not reflect the underlying asset value, thus creating an incentive to buy the company cheaply. Second, the acquired company must be relatively debt free and not restricted from incurring additional debt, thus creating an incentive for lenders to loan the money that is used to buy the stock. The effect of the transaction is almost always dramatic; stockholders are cashed out and the company becomes heavily debt-laden. As a consequence, pre-acquisition creditors find themselves subordinated to, or on a parity with, the usually massive debt incurred to finance the transaction. Because bond prices are partly influenced by the credit rating of the issuing company and since the incurrence of debt always causes a company to be less creditworthy and have its bonds downgraded, pre-acquisition bondholders experience a sharp drop in the market price of their bonds.

[327]*Id.* at 1506.

[328]*Id.* at 1507.

[329]*Metropolitan Life Ins. Co.*, 716 F. Supp. at 1514.

[330]*Id.* at 1516.

Judge Walker[331] did not reject out of hand the theory asserted by the plaintiffs. According to the court, the absence of an express term does not preclude the grant of contract relief in all cases; it simply refocuses the inquiry into whether an implied covenant exists and has been violated.[332] The court stated:

> [t]hat inquiry surfaces where, while the express terms may not have been technically breached, one party has nonetheless effectively deprived the other of those express, explicitly bargained-for benefits. In such a case, a court will read an implied covenant of good faith and fair dealing into a contract to ensure that neither party deprives the other of the "fruits of the agreement."[333]

The implied covenant of good faith and fair dealing exists to fill gaps in contracts because contracts can never fully address every conceivable set of contingencies.[334] As such, it is a majoritarian default rule employed to fill gaps in otherwise express terms, and it is consistent with the economic objective of unburdening contracting parties from the incurrence of unnecessary *ex ante* transaction costs. Judge Walker's decision denying relief to Met Life employs traditional contract doctrine, but employing an analysis consistent with the economic principles addressed in the academic literature of penalty default rules.[335] The reasoning of the decision demonstrates the flexibility of traditional majoritarian default rules in addressing incompleteness in the indenture.

Arguably, it supports the proposition that the concept of penalty defaults[336] is subsumed under the existing doctrine of the implied covenant of good faith and fair dealing. Thus, although Judge Walker does not employ the law and economics verbiage relating to the allocation of *ex ante* and *ex post* cost of contracting, the substantive basis of his reasoning is

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[331]As with the judges in *Sharon Steel*, Judge Walker had significant financial experience before his appointment. He was a partner in the Wall Street firm of Carter, Ledyard & Milburn and was an Assistant Secretary of the Treasury.

[332]*Id.* at 1516-17.

[333]*Id.* at 1517.

[334]*See generally* RESTATEMENT (SECOND) OF CONTRACTS (1992) (setting forth guides on gap-filling).

[335]*See supra* notes 333-35 and accompanying text.

[336]Recall Professor Slawson's assertion that the entire debate over default theory rests upon the academic invention of a new word "default" that adds nothing to the existing theory of contracts. Slawson, *supra* note 236, at 29.

entirely consistent with penalty default theory advocating judicial passivity. He states:

> Plaintiffs' submissions . . . remind the Court that a "fundamental basis" or a "fruit of an agreement" is often in the eye of the beholder, whose vision may well change along with the market, and who may, with hindsight, imagine a different bargain than the one he actually and initially accepted with open eyes.
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> . . . .
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> The sort of unbounded and one-sided elasticity urged by plaintiffs would interfere with and destabilize the market. And this Court, like the parties to these contracts, cannot ignore or disavow the marketplace in which the contract is performed. *Nor can it ignore the expectations of that market — expectations, for instance, that the terms of an indenture will be upheld, and that a court will not, sua sponte, add new substantive terms to that indenture as it sees fit.* The Court has no reason to believe that the market, in evaluating bonds such as those at issue here, did not discount for the possibility that any company, even one the size of RJR Nabisco, might engage in an LBO heavily financed by debt. That the bonds did not lose any of their value until the October 20, 1988 announcement of a possible RJR Nabisco LBO only suggests that the market had theretofore evaluated the risks of such a transaction as slight.[337]

The terminology "fruits of the agreement" bears remarkable resemblance to the language employed by the *Sharon Steel* court.[338] One could argue that the concept of penalty defaults is alive and well under the nomenclature of implied covenant of good faith and fair dealing. Thus, the concept of penalty default rules is subsumed under existing doctrine to be applied under appropriate circumstances. It might follow that *Sharon Steel* was simply a case that was wrongly decided applying conventional majoritarian default doctrine. Are there conclusions that may be drawn about the effect of judicial decisions on the potential suboptimality of

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[337]*Metropolitan Life Ins. Co.*, 716 F. Supp. at 1520 (emphasis added) (footnote omitted).
[338]*Supra* note 313 and accompanying text.

corporate contracts such as the indenture? Did Judge Walker's decision have the effect of causing innovation in *ex ante* contracting? Specifically, if the *Metropolitan Life* ruling influenced the introduction of event risk covenants into bond indentures, then perhaps a tentative case can be made for judicial passivity as a means of enhancing indenture efficiency.

The timing of the introduction of event risk covenants into the indentures covering publicly issued bonds is not helpful to the argument that the decision was influential. The protective provisions giving bondholders rights in leveraged buyouts were introduced as a result of the RJR *transaction* and were in place well before the final judicial resolution of the Met Life claims.[339] In addition, the question must be asked why some form of bondholder protection did not emerge earlier in the decade when the potential for declines in bondholder value was clearly evident.

In summary, the proof of a causal connection between judicial decisions and transactional innovation may be as elusive as validating a clear-cut case of third degree path dependence generally or specifically in the adoption of bond terms. As stated earlier, although the case can be made that conditions exist promoting locked-in suboptimality in the adoption of bond provisions, the implications for any normative shift toward default rules are uncertain and indeterminate. The timing of the RJR decision and the adoption of event risk covenants suggests that the marketplace responded to the transaction rather than the subsequent decision authored by Judge Walker. This is not to undervalue the meticulous Klausner-Kahan study which suggests at least the existence of *some* learning and network effects in the development of event risk covenants.[340] Indeed, it could be concluded that the application of concepts of implied covenant of good faith and fair dealing and the *Sharon Steel*

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[339]This does not alter the tentative conclusion of Part III that the bond indenture exists as a form of contract with considerable potential for suboptimality. The timing of the introduction may indeed confirm it. Bonds were issued to the public for years before the RJR transaction without protective covenants, but in the face of numerous leveraged transactions. Moreover, Professors Klausner and Kahan's empirical study of over a hundred such covenants in investment-grade debt securities that were issued between 1988 and 1993 concludes that learning and network externalities were present. Their data shows:

> [M]oderate support for the hypothesis that learning or network externalities, or both, are present in contract terms. The support lies in three sources: the bandwagon pattern by which these covenants were adopted; the extent to which they became standardized; and the extent to which quality improvements diffused over time. . . . Although the data suggest that learning as well as network externalities were present, we cannot rule out the possibility that learning alone was responsible for our results.

Kahan & Klausner, *supra* note 35, at 743.

[340]*See generally* Kahan & Klausner, *supra* note 35 (describing event risk covenants vis-à-vis learning and network effects).

"fruits of the agreement" analysis provide useful alternatives for courts faced with ambiguity and silence in bond indentures. Augmented by concepts of fraud and principles of general equity, existing doctrines address the existence of suboptimality — even third degree suboptimality — with sufficient precision. The existence of learning effects driven by traditional judicial doctrines and the forces of the marketplace reduce the potential for misallocation of private contracting and public judicial resources without resorting to innovations such as penalty defaults.

It is important to address one more case of alleged issuer opportunism. What happens when an *insolvent* corporation makes to its bondholders an "offer they can't refuse" as a means of saving itself from bankruptcy?

3. *Katz v. Oak Industries Inc.*[341]

Moise Katz, a bondholder of Oak Industries (Oak), a corporation seeking to restructure itself, sued to enjoin a proposed transaction by Oak wherein it made the following offer to its bondholders.[342] Oak would pay a premium above the market price for each of the bonds, which were trading considerably below the face principal amounts of $1000 because of the troubled financial condition of Oak, which was insolvent.[343] In order to accept the Oak offer and receive payment, which was made on equal terms to each class of bondholders, the bondholder had (1) to tender the bond and (2) to execute a valid "exit consent" waiving virtually all of the negotiated financial covenants in favor of the bondholders.[344]

Furthermore, the offers to each class were conditioned upon the receipt by Oak of sufficient quantities of the principal amount of the bonds so that the consents would effectuate an amendment to each indenture stripping it of the financial covenants.[345] The transaction was designed to reduce the overall debt of Oak and meet a condition put forward by a potential equity investor that would have infused capital, thus saving Oak from bankruptcy.[346] The negative net worth and financial ill health of Oak made it imperative that only through the consummation of the debt

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[341] 508 A.2d 873 (Del. Ch. 1986).
[342] *Id.* at 875.
[343] *Id.* at 875-77.
[344] *Id.* at 877.
[345] *Katz*, 508 A.2d at 877.
[346] *Id.* at 876.

restructuring could the company avoid a formal bankruptcy reorganization.[347]

Katz argued that the offer was unfairly and illegally coercive to the bondholders because they were denied a meaningful choice between tendering and retaining their bonds.[348] Specifically, each bondholder faced the possibility that, if she did not accept the offer and tender her bonds, she would be left with bonds stripped of all financial protection if Oak received the requisite amounts of principal of each class of bonds necessary to amend the indentures.[349] According to Katz, the bondholders not wanting to continue to hold the bonds without the negotiated financial protections would be forced to tender in spite of their desire to hold the full principal amounts of their bonds to maturity, thus taking whatever risks were entailed in Oak's financial survival and retaining their legal obligation to payment in full.[350] Thus, Katz argued that Oak was illegally coercing bondholders to tender their bonds in violation of the respective bond indentures.[351]

Chancellor (now Professor) William Allen, rejecting the application for a preliminary injunction, analyzed the legality of coercion within the doctrinal confines of implied good faith and fair dealing emanating from all contracts.[352] This seeming similarity to the *Met Life* approach was preceded by the problematic assertion that:

> [t]his case does not involve the measurement of corporate or directorial conduct against that high standard of fidelity required of fiduciaries when they act with respect to the interest of the beneficiaries of their trust. . . . Arrangements among a corporation, the underwriters of its debt, trustees under its indentures and sometimes ultimate investors are typically thoroughly negotiated and massively documented. The rights and obligations of the various parties are or should be spelled out in that documentation. *The terms of the contractual relationship agreed to and not broad concepts such as fairness define the corporation's obligation to its bondholders.*[353]

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[347] *Id.* at 875-76.
[348] *Id.* at 878.
[349] *Katz*, 508 A.2d at 878.
[350] *Id.*
[351] *Id.*
[352] *Id.* at 878-79.
[353] *Id.* at 879 (footnoted omitted)(emphasis added).

This black letter recitation of the difference between duties to equity participants in a corporation, on the one hand, and creditor claimants, on the other, disregards a crucial fact underlying the exchange offer: Oak was *insolvent*. In the most basic sense, the bondholders, as claimants prior to equity, had ownership interests to whatever remained of the asset base of Oak before the allegedly coercive exchange offers. Accordingly, a transaction that has as its effect the creation of positive net worth stands on fundamentally different footing from the transactions complained of in *Sharon Steel* and *Met Life*. Judge Allen recognized this distinction five years later in *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*[354] He suggested that an elevated duty runs from the board of directors of a corporation to creditors when the entity is near or on the brink of insolvency.[355] In any event, the failure of the court to discuss the importance of insolvency to its application of the principle of implied good faith does not necessarily constitute a basis for concluding that the result reached was incorrect. Recall that the case was decided in the context of the request for an injunction; a balancing of general equitable considerations played a significant role in the result.[356]

Regardless of the correctness of the result of *Katz*, the decision has normative implications somewhat different from those suggesting that traditional doctrines were properly employed in *Met Life* and *Sharon Steel*. The existence of potential suboptimality in the bond indenture does not implicate any of the incentives that arguably would influence drafters of the indenture to contract more completely *ex ante*. The potential for insolvency exists as an event governing an entirely separate body of law, including fraudulent conveyance, bankruptcy, and theories asserting the superiority of creditors' rights to those of equity holders. Nevertheless, Chancellor Allen, after equating the legal limits of permissible coercion with an inquiry into the obligations arising from the doctrine of implied covenant of good faith, deduced the following test:

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[354]No. 12,150, 1991 Del. Ch. LEXIS 215 (Del. Ch. Dec. 30, 1991).

[355]*Id.* at *108.

[356]The opinion concludes as follows:

> An independent ground for the decision to deny . . . [exists when granting the injunction] threatens the party sought to be enjoined with irreparable injury that, in the circumstances, seems greater than the injury that plaintiff seeks to avoid. . . . It is not unreasonable to accord weight to the claims of Oak that the reorganization and recapitalization of which the exchange offer is a part may present the last good chance to regain vitality for this enterprise. . . . I am satisfied simply to note my conclusion that . . . [plaintiffs injury] is far outweighed by the harm that an improvidently granted injunction would threaten to Oak.

Katz, 508 A.2d at 882.

> Because it is an implied *contractual* obligation that is asserted as the basis for the relief sought, the appropriate legal test is not difficult to deduce. It is this: *is it clear from what was expressly agreed upon that the parties who negotiated the express terms of the contract would have agreed to proscribe the act* later complained of as a breach of the implied covenant of good faith — *had they thought to negotiate with respect to that matter*. If the answer to this question is yes, then, in my opinion, a court is justified in concluding that such act constitutes a breach of the implied covenant of good faith.[357]

The test framed by Chancellor Allen is by no means evident in the context of a troubled company restructuring. Nevertheless, the implications for potential indenture inefficiency may be at best uncertain. In the previously suggested normative inquiry built on the perception of an environment for potential lock-in of suboptimal indenture terms, a law and economics approach seeks to discourage the potential for cost shifting from private transactional resources to public judicial ones. Thus, two questions arise in the context of exit-consent offers to bondholders: would *Katz* have been better decided under a penalty default analysis? Or, does the *Katz* variant of the majoritarian approach of what the parties would have wanted better satisfy policy objectives such as fairness and good faith? This article suggests a negative answer to both questions.

First, negotiation over indenture covenants emphasizes protections for bondholders' rights to payment of principal and interest. Covenants seek to preserve the issuer's creditworthiness and solvency. Typically, negotiations between the issuer and the underwriters supplement boilerplate provisions with tailored (even if they are off the *Commentaries* "rack") provisions designed to balance the need of the issuer for financial operational freedom with reasonable bondholder protection. The state of insolvency and the context in which it may arise raises problems of predictability and indeterminacy. One simply cannot know with any clarity what the agency issues and costs will be between the equity and creditor claimants when the net worth of the corporation disappears. This suggests that penalty defaults and even majoritarian inquiries such as those employed by Chancellor Allen may fall short of protecting bondholders of an insolvent entity.

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[357] *Id.* at 880 (emphasis added).

Second, as suggested, underwriters and issuers, and their lawyers, properly rely on the learning effects of specialized legal doctrines such as fraudulent conveyance and, ultimately, on those contained in the bankruptcy code, such as equitable subordination, to govern conduct in the context of insolvency. Moreover, there is a trend exhibited in the *Credit Lyonnais*[358] dictum to unite traditional doctrines of fiduciary duty and neoclassical contract interpretation into one another at the margins of or in insolvency. And in the *legal*, as opposed to equitable, analysis denying preliminary relief to the Oak bondholders, Chancellor Allen noted as follows: "Such an implication [of a violation of good faith by Oak], at least *where, as here, the inducement is offered on the same terms to each holder* of an affected security, would be wholly inconsistent with the strictly commercial nature of the relationship."[359]

Returning to the question deemed important from the Ayres/Gertner scholarship:[360] why did the gap in the contract occur? The special circumstances of insolvency and the typical goals of negotiators of bond covenants of a solvent, going concern suggest a low likelihood that *ex ante* contracting costs consciously or unconsciously will be shifted inefficiently to the *ex post* judicial process. This is simply an observation about the conduct of the participants charged with framing the indenture. Moreover, the indeterminability and unforseeability of insolvency do not invite strategic information withholding.

Accordingly, the majoritarian variant of what the express terms of the indenture may reasonably suggest that the negotiators would have agreed upon serves as a valid analytical inquiry. Of course, it is questionable how much guidance can be drawn from indenture terms designed to regulate the behavior of solvent companies. Therefore, the analytical task of a court should simply constitute the fashioning of a fair result under the heightened duty to creditors recognized in the context of insolvency. Finally, it must be concluded that potential suboptimality in the bond indenture should have little influence in the adjudication of bondholder claims that issuers have violated indenture provisions when those issuers are insolvent.

There may be an alternative and more subtle explanation (and justification) for the *Katz* decision that emanates from the unique attribute of the Delaware court system as the principal enunciator of standards of corporate governance. Professor Edward B. Rock has recently written the

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[358]*Credit Lyonnais Bank Nederland*, 1991 Del. Ch. LEXIS 215, at *108.

[359]*Katz*, 508 A.2d at 881 (emphasis added).

[360]Ayres & Gertner, *supra* note 25, at 87.

"story of how a small community [of Delaware judges, lawyers, and corporate officers] imposes formal and informal, legal and nonlegal, sanctions on its members."[361] Accordingly, Delaware decisions may be seen as creating narratives with an unspecific moral force guiding the behavior of directors in the fulfillment of fiduciary duties. He states:

> My claim here — which is a descriptive claim — is that the Delaware courts generate in the first instance the legal standards of conduct (which influence the development of the social norms of directors, officers, and lawyers) largely through what can best be thought of as "corporate law sermons." These richly detailed and judgmental factual recitations, combined with explicitly judgmental conclusions, *sometimes impose legal sanctions but surprisingly often do not.*
>
> Taken as a whole, the Delaware opinions can be understood as providing a set of parables — instructive tales — of good managers and bad managers, of good lawyers and bad lawyers, that, in combination, fill out the normative job description of these critical players. My intuition is that we come much closer to understanding the role of courts in corporate law if we think of judges more as preachers than as policemen.[362]

Seen as a parable in the context of the bondholder complaint in *Katz*, Chancellor Allen's invocation of a majoritarian default analysis in denying the preliminary injunction may simply be a method of encouraging voluntary workouts where there is little palpable harm to bondholders facing the alternative to bankruptcy. This, of course, adds little to the normative inquiry concerning suboptimality in the indenture. But it may explain the apparent insensitivity of the court to the insolvent state of Oak Industries as merely a statement of the court to the Delaware legal community: offers to bondholders on equal terms are permitted absent a showing of some specific harm when the continued viability of the entire enterprise is at stake.

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[361]Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 U.C.L.A. L. REV. 1009, 1014 (1997) (footnote omitted).

[362]*Id.* at 1016 (emphasis added). The article specifically focuses on the relationship between directors and shareholder as the former seeks to fulfill its fiduciary duty to the latter. The observations, however, seem applicable to the issuer/bondholder conflict at issue in *Katz*.

V. CONCLUSION

The purpose of this article has been to trace the development of legal and economic literature invoking path dependence from the familiar example of the arguably inefficient QWERTY typewriter keyboard to the altogether less familiar context of the adoption of corporate contractual terms. If path dependence exists other than as an isolated anomaly, it powerfully describes how economic actors become locked into suboptimal behavior where there exist efficient alternatives. Proponents of conventional economic theory assert that true path dependence can exist under only the most constrained and unlikely assumptions. The debate is far from over, but there are important points of inquiry for legal scholars, particularly those rendering the corporation as an aggregate of efficient contracts.

One of the first points of departure carried forward here, tests whether true path dependence may be isolated in the corporate contractual setting. The author concludes, perhaps somewhat in the vein of the adherents to traditional neoclassical economic theory, that the contracting process differs substantially from product development in several important ways that deter suboptimal adoption of contract terms. Partisan multilateral negotiation increases the probability that parties will frame and seek acceptance of those terms advancing their self-interest. Except where transaction costs must be kept extraordinarily low, parties will rarely resort to inefficient provisions to govern important financial relationships. The learning of lawyers and law firms, and the intense competition among them for state-of-the-art solutions to clients' legal and business objectives, operate to reduce the chance that contracts will reflect suboptimality through herd behavior.

The skeptical view of the transportability of path dependence from product development to a valid general description of corporate contracting, however, does not completely rule out its existence. There are specialized contracts that may not exhibit the typical negotiating framework. The corporate bond indenture is one of these and perhaps not the only one. The unique process of adoption of terms, the existence of the voluminous off-the-rack provisions of the *Commentaries*, the momentum of standardization of the densely detailed indenture and, finally, the attitude of courts responding to claims of contractual incompleteness — all are contributing conditions to an environment where the absence of partisan negotiation *may* result in the adoption of suboptimal terms. Professors Klausner and Kahan's ground breaking work has established a tentatively strong case for network and learning externalities leading to suboptimality

in the narrow context of event risk covenants. Their empirical work is impressive, but so much turns on the subjective and intuitional definition of efficiency in any contractual setting.

With the assumption that some form of susceptibility to inefficiency exists in the creation of the bond indenture, this article has sought to carry on one of the initiatives suggested by the Klausner-Kahan work—an analysis of the implications of network and learning externalities to doctrines of judicial interpretation. To accomplish this, the author employed the work of contract scholars who advocate a broader consideration of default rules and standards beyond the traditional majoritarian inquiry of what the parties would have wanted. Specifically, the author has sought to test the concept of penalty defaults as a remedy for potential indenture suboptimality with specific judicial decisions. In each of the cases, *Sharon Steel*, *RJR Nabisco*, and *Katz*, the author has inquired as to whether a default analysis can deter the shifting of contract costs from the *ex ante* framing of corporate bond indentures to the expenditure of *ex post* judicial resources in adjudicating bondholder claims of issuer opportunism. Can the doctrines employed by courts play a part in the framing of more efficient bond provisions? The author concludes that existing doctrines retain considerable latitude and power to deter inefficiency in bond indentures. The continuing tension between debt and equity participants in the corporation is unlikely to be lessened by major deviations from existing doctrine. Issues of bond indenture interpretation will continue to be joined and it is doubtful that a rational regime of penalty rules and standards can do much to minimize the public and private costs of adjudication. Accordingly, the potential for suboptimality in the bond indenture does not suggest substantial changes in the manner in which courts resolve these disputes.