COMPLETE CONTRACTS IN FINANCE

ELISABETH DE FONTENAY*

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INTRODUCTION

When law students question the importance of studying contract law, it may help to point out that a recent contract dispute brought a major economy to its knees, created an international political incident, and prompted popular protests in the streets. The hedge fund Elliott Associates, L.P. single-handedly succeeded in holding up Argentina's sovereign debt restructuring, by litigating for fifteen years over an arcane contract term that had been ubiquitous in sovereign bond indentures for over a century.[1] Elliott's maneuver is not a unique occurrence—such

* Professor of Law, Duke University; defontenay@law.duke.edu.

1. *See* Renae Merle, *How One Hedge Fund Made $2 Billion from Argentina's Economic Collapse*, WASH. POST (Mar. 29, 2016), https://www.washingtonpost.com/news/business/wp/2016/03/29/how-one-hedge-fund-made-2-billion-from-argentinas-economic-collapse/. Elliott Associates emerged victorious in its battle with Argentina, when the Second Circuit sided with its proposed interpretation of the *pari passu* clause in the indenture. *See generally NML Capital, Ltd. v. Republic of Argentina*, 699 F.3d 246 (2d Cir. 2012). Yet market participants and experts in the industry overwhelmingly disagreed with Elliott's (and the court's) interpretation of the clause. *See* Mitu Gulati & Robert E. Scott, *Foreword: The Three and a Half Minute Transaction:*

"contract arbitrage" has become an investment strategy in its own right.[2] Hedge funds scour transactional agreements for provisions that they can sue to enforce or otherwise employ to their benefit.[3] Often such provisions have consequences or interpretations that the parties did not intend when they first entered into the agreement.[4]

Most observers tend to view these disputes as mere disagreements over contract interpretation. If so, one plausible view is that the parties themselves are to blame for the eventual litigation, because they used ambiguous language in their contract, left gaps in coverage, and so forth. Viewed in this light, disputes such as Argentina's battle with Elliott Associates could be avoided if parties simply wrote better contracts.[5] But what does writing "better" contracts mean in this context? If it means writing contracts that avoid all unexpected outcomes and all potential for litigation, is such a goal achievable? And if it *is* possible to write such "complete" contracts, why do parties fail to do so in the first place? Are they (or their lawyers) simply lazy, ill-informed, or incompetent drafters?

The latter possibility seems unlikely. In these disputes, the contract parties and their advisors tend to be highly sophisticated, and most are repeat players. If there were an obvious way to make their contracts litigation-proof, one would need a convincing theory for why the parties failed to employ it.[6] Instead, parties appear to be devoting ever more effort and resources to drafting financial and transactional contracts, as evidenced by their increasing length and complexity. Today, bond indentures such as Argentina's and other transactional agreements among sophisticated parties may be hundreds of pages long.

Boilerplate and the Limits of Contract Design, 40 HOFSTRA L. REV. 1, 2–4 (2011) (describing the role of the *pari passu* clause in Elliott's dispute with Argentina).

2. See, *e.g.*, Anna Gelpern, *Russia's Contract Arbitrage*, 9 CAP. MKTS. L.J. 308 (2014) (employing the term "contract arbitrage" to refer to a party's actions that ensure it will profit from a given contract).

3. A hedge fund typically profits in such cases by buying the relevant securities (or derivatives tied to them) and suing to enforce the relevant provisions.

4. *See* Gulati & Scott, *supra* note 1, at 2–3 (noting that Elliott's interpretation of the *pari passu* clause at issue in the litigation with Argentina was one that market participants would overwhelmingly have rejected).

5. The view further implies that contract arbitrage by hedge funds is arguably efficient, as it provides strong incentives for contract parties to write better contracts going forward.

6. For the skeptical view of sophisticated parties' attention to drafting concerns, see, e.g., Anna Gelpern, Mitu Gulati & Jeromin Zettelmeyer, *If Boilerplate Could Talk: The Work of Standard Terms in Sovereign Bond Contract*s, 44 LAW & SOC. INQUIRY 617 (2019) (arguing that sovereigns prioritize other concerns such as liquidity over the efficiency of their indenture contract terms); MITU GULATI & ROBERT E. SCOTT, THE THREE AND A HALF MINUTE TRANSACTION: BOILERPLATE AND THE LIMITS OF CONTRACT DESIGN (2013) (arguing that lawyer agency costs may cause them to fail to update inefficient contract terms).

Why do parties write such complex, detailed contracts if these agreements still leave the parties vulnerable to opportunistic enforcement by actors such as Elliott Associates? This Essay argues that the answer has to do at least in part with judicial expectations for what transactional agreements should look like. Judges tend to believe that sophisticated parties should write lengthy agreements that explicitly provide for the parties' conduct under every contingency, because, in their view, such "complete" contracts come closer to expressing the parties' entire bargain. Parties whose agreements do not conform to this expectation risk an array of negative consequences when those agreements are enforced in court. If that is the case, then disputes such as Argentina's battle with Elliott are only superficially about contract *interpretation*; they owe instead to contract *design*, or even what we might call contract style—specifically, judges' beliefs about the manner in which such contracts should be drafted.

How did this judicial stance come about? One can think of contract parties, on the one hand, and judges, on the other, as being in an ongoing strategic game, with each side updating its behavior based on the other side's most recent move. As contracts have grown more complex and more rule-based over time (at least in part for unrelated reasons),[7] judges have come to expect contracts to be drafted in this way and, therefore, to punish parties who fail to conform to these expectations. In addition, judges with no particular expertise in a complicated area such as corporate finance naturally prefer contracts that are virtually self-executing, in spelling out precisely what conduct is permitted or prohibited, and such contracts can be interpreted formally. This strong judicial expectation and preference, in turn, prompts parties to draft contracts that are still longer and more detailed, in a ratchet effect.

The difficulty is that there is no reason to believe that more detailed, rule-based contracts come closer to the parties' desired bargain or to economic efficiency than do short, simple contracts. It could even be the opposite. That is, more detailed contracts may leave the parties even more vulnerable to unexpected outcomes down the road and to opportunistic enforcement by parties such as hedge funds engaging in contract arbitrage.[8] This is because the parties' efforts to provide for as many future contingencies as possible in response to judges' expectations may yield undesirable results as the underlying facts and the parties' incentives change in unanticipated ways. In sum, while transactional agreements have become significantly more detailed and complex over time, it is difficult to say whether this amounts to progress, in the sense of greater efficiency and getting the parties closer to their desired outcomes, or instead mere adaptation to judges' preference for more complete contracts.

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7. *See infra* Part I (discussing the evolution of transactional agreements).
8. *See infra* Part III (discussing the implications of transactional agreements).

Yet if contracts by some of the most sophisticated parties in the world fail at times for being overly complex and rule-based, it is not clear that there is a solution. The alternative of writing short contracts that rely on standards to fill any gaps—a return to earlier practice—would give generalist judges considerably more power and discretion to interpret and delimit the parties' bargain. That approach is risky in a context where extreme specialization and complexity have become the norm, and where long-term relationships based on reputation and trust have been replaced by arm's-length, even anonymous interactions. More importantly, for our purposes, that approach is effectively ruled out by judges' implicit dismissal of incomplete contracts in finance.

In the end, we are left with the unsatisfying conclusion that the considerable efforts and cost devoted to drafting complex transactional agreements need not pay off for the parties, but that the plausible alternatives are likely worse. We should, therefore, expect such contracts to continue to grow longer and more complex, and we should expect opportunistic parties and third parties to continue to exploit them. Perhaps the most we can say is that slowing down the expansion of transactional agreements will require, at a minimum, that judges adopt a more realistic, less heroic view of contract. Courts will have to acknowledge that even with the best lawyers assigned to the task, parties cannot or should not necessarily put their entire bargain into words.

The Essay proceeds as follows. Part I summarizes what we know about the evolution of transactional and financial contracts and possible explanations. Part II describes the theory of incomplete contracts and argues that judges involved in contract disputes among sophisticated parties often misapply it. Part III describes the consequences of this judicial approach for contract enforcement and contract design and discusses potential solutions.

I. THE EVOLUTION OF FINANCIAL AND TRANSACTIONAL AGREEMENTS

When wealthy, sophisticated parties (such as large firms, financial institutions, and institutional investors) enter into contracts, we generally assume that any agreement reached reflects both parties' desired bargain. Yet the design of such contracts has evolved significantly over a relatively short period of time. By now, it is well documented that transactional

agreements have become dramatically longer[9] and more complex[10] over the last few decades. A merger that required only a twenty page agreement in 1990 might well require over one-hundred pages today. Credit agreements and indentures appear to have grown far more than that over the same period.

Transactional agreements have also become more rule-based, with the parties preferring narrowly tailored provisions to broad standards.[11] A provision requiring the sponsor of an investment fund to avoid "material" conflicts of interest might today be replaced by pages and pages, specifically listing what types of transactions are permitted or prohibited.

What do these changes entail for the parties? As a functional matter, what is the difference between (1) a short contract that relies heavily on standards to fill any gaps in coverage; and (2) a long, rule-based contract that is intended to specify the parties' conduct in detail under the various possible future states of the world? Important literature in the law and economics of contracts suggests that short, standard-based contracts have relatively low "front-end" costs (the costs of negotiating and drafting the agreement), and higher "back-end" costs (the costs of litigation and enforcement).[12] Employing standards means that the parties need not anticipate and plan for every future contingency during their negotiations. Instead, they agree to simple, broad standards of conduct ("reasonableness," "best efforts," "due care," etc.) that will apply throughout the life of the contract. In doing so, the parties are handing over

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9. *See* Robert Anderson & Jeffrey Manns, *The Inefficient Evolution of Merger Agreements*, 85 GEO. WASH. L. REV. 57, 76 (2017) (finding that the median word count in their sample of merger agreements increased substantially between 1994 and 2014); John C. Coates IV, *Why Have M&A Contracts Grown? Evidence from Twenty Years of Deals* 14 (European Corp. Governance Inst. (ECGI), Working Paper No. 333, 2016), https://ssrn.com/abstract=2862019 (finding that merger agreements have more than doubled in length and increased significantly in complexity over the same twenty-year period).

10. *See* Coates, *supra* note 9.

11. *C.f.*, Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 583 (2003) (arguing that commercial parties generally prefer courts to interpret their agreements narrowly, using a textualist approach). A "rule" in this context is a contract provision that establishes a relatively bright line for what conduct is called for and under what conditions. A standard, by contrast, establishes only a broad normative goal to serve as a benchmark against which the parties' eventual actions will be judged. *See generally* Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992) (providing the seminal economic analysis of the use of rules versus standards in law).

12. *See* Robert E. Scott & George G. Triantis, *Incomplete Contracts and the Theory of Contract Design*, 56 CASE W. L. REV. 187, 190 (2005) [hereinfafter Scott & Triantis, *Incomplete Contracts*] (defining the "front-end" and "back-end" costs of contracting); Robert E. Scott & George G. Triantis, *Anticipating Litigation in Contract Design*, 115 YALE L.J. 814 (2006) (explaining why parties may sometimes employ standards in lieu of rules to optimize the tradeoff between front-end and back-end contracting costs).

to judges the power to interpret their bargain in the future, to fill in the gaps, and to enforce a particular outcome ex post. The hope is that once a dispute arises, judges will tend to enforce—with some acceptable error rate—the deal that the parties would have wanted ex ante had they anticipated and provided for the state of the world that eventually occurred. Yet because standards do not specify the parties' exact conduct, the prediction is that more disputes will arise and that they will be relatively costlier to resolve than for rule-based contracts.

Conversely, lengthy, rule-based contracts should involve relatively high front-end costs and low back-end costs. Envisioning and planning for various future states of the world takes time, information, and expertise, as does translating this information into narrow provisions that specify the parties' intended conduct precisely. Yet the greater effort and expense upfront should translate into lower costs at the back-end, according to this view, as the detailed, rule-like provisions should make disputes less common and easier to enforce by the meritorious party.

Given the direction in which transactional agreements have evolved—towards greater length, complexity, and reliance on rules—we should, therefore, expect that the number and cost of contract disputes surrounding corporate transactions have declined over time. Unfortunately, it is impracticable to confirm whether this is indeed the case, because one would need to hold all other factors constant throughout the period (such as applicable law, the cost of litigation generally, the nature of the transaction, the number of parties, and so forth). Yet purely as a matter of casual observation, there is no obvious evidence of a decline in back-end costs for transactional agreements. Commercial litigation is alive and well. The significant changes in contract design over the last few decades do not appear to have reduced unexpected outcomes, opportunistic behavior by parties or third parties, or the amount of litigation ex post.

If that is indeed the case, then we are faced with two puzzles. First, why are parties expending so much effort on writing longer, more detailed contracts, if they are not producing better outcomes? Second, why are these contracts unsuccessful ex post? (Or, in the jargon of contract theory, why are contracts becoming ever more "complete" over time, yet failing to reduce the parties' back-end costs?)

The existing literature offers many potential answers to the first question. (The second question is addressed in Part II.) First, some of the increasing length and complexity in contracts may result from innovation in contract terms (the development of new, efficient private-ordering solutions to common contract problems such as dispute resolution, etc.).[13] Second, it may reflect an increase overall in applicable regulation.[14] Third,

13. *See* Coates, *supra* note 9, at 1–2.

14. *See id.*

agency costs and collective action problems involving the parties' legal counsel (such as excessive risk aversion or the lack of incentives to agree on standardized forms for transactional agreements) may lead to inefficient path-dependence in contract drafting and an overall accretion in length.[15]

Fourth, corporate finance as a whole has been rapidly evolving away from long-term relationships—both among the parties and between a party and its financial and legal advisors—towards arm's-length transactions with a larger number of parties.[16] When transactional parties are in a long-term relationship, such as a company borrowing solely from the same bank over multiple decades, ultimately, the terms of the contract between them may matter relatively little. Other constraints on their behavior, such as reputation and norms, matter significantly more. In such cases, the parties may be perfectly comfortable relying on broad standards rather than detailed rules, because they expect the other party to abide by the "spirit" of the agreement and not to enforce the contract opportunistically. By contrast, now that finance itself has become more transactional (rather than relational), arm's-length, and disintermediated, the parties are perhaps wise to spell out each other's prescribed and proscribed behavior specifically in their agreement, rather than relying on standards and the other party's good faith.

Fifth, as corporate transactions and corporate finance themselves have become more complex and more specialized, the error rate for generalist judges enforcing transactional agreements may be higher than in the past, all else equal.[17] This implies that sophisticated parties should want to move away from standards in drafting agreements and away from contextual interpretation in their enforcement, towards rules and formalist interpretation. (Read together, points four and five suggest that the back-end costs of contract enforcement have increased relative to the front-end costs of contract drafting over the last few decades.)

Each of the above theories is surely correct as an explanation for why transactional agreements continue to expand and to shift toward detailed, rule-based provisions. This Essay merely offers one additional hypothesis for why parties have shifted to more complete contracts over time, which is that *judges punish sophisticated parties for writing incomplete*

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15. *See* Anderson & Manns, *supra* note 9, at 61.

16. *See* Ronald J. Gilson, *The Devolution of the Legal Profession: A Demand Side Perspective*, 49 MD. L. REV. 869 (1990) (describing the decline in professionalism and gatekeeping among lawyers, due to the decline in long-term relationships between clients and their lawyers).

17. *See* Alan Schwartz, *Incomplete Contracts*, *in* 2 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 277, 282 (1998) (advocating for judges to interpret contracts among sophisticated parties formally, rather than contextually); *see also* Robert E. Scott, *The Case for Formalism in Relational Contract*, 94 NW. U. L. REV. 847, 875 (2000) (same).

contracts. Further, judges do so in a way that cannot easily be corrected for at the time the contract is entered into. This hypothesis is discussed in the next Part. (As discussed in Part III, this hypothesis also provides an answer to our second puzzle of why these more complete contracts do not appear to be reducing parties' back-end costs.) This requires a brief detour through the theory of incomplete contracts, to which we now turn.

II. PROBLEMS IN THE ENFORCEMENT OF INCOMPLETE CONTRACTS

A. The Theory of Incomplete Contracts

Trillions of dollars of corporate loans provide for interest payments tied to the London Inter-bank Offered Rate (LIBOR), the world's most commonly used interest rate index. During the global financial crisis, however, there were times when either there was no published rate for certain categories of LIBOR, due to insufficient quotes from banks, or—as we learned after the fact—LIBOR was being manipulated by traders at the major investment banks.[18] Under such circumstances, should the borrower have been permitted to simply stop paying interest? Or could the lenders require the borrower to use an alternate interest rate index? Few loan contracts at the time perfectly addressed such contingencies, despite being drafted by the most sophisticated financial institutions in the world.[19] Did these parties act foolishly in failing to provide for disruptions to LIBOR, or, as seems more plausible, did they have good reasons for drafting contracts that later proved to have gaps?

The theory of incomplete contracts[20] has been enormously influential, not only in explaining a wide swath of economic arrangements and contracting practices but also in shaping contract law and other areas of law that touch on economic relationships. The theory begins with the observation that parties to a voluntary arrangement cannot provide for every possible contingency in a contract. This is so for one or more of the following reasons: (i) the parties cannot predict every such contingency; (ii) they do not have the information they would need to evaluate their

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18. *See* Gabriel Rauterberg & Andrew Verstein, *Index Theory: The Law, Promise and Failure of Financial Indices*, 30 YALE J. REG. 1, 2–4 (2013) (describing the importance of LIBOR and its potential for manipulation).

19. Many loan contracts at the time did include so-called "market disruption clauses," yet these did not necessarily cover the LIBOR-related problems that occurred during the financial crisis. *See* Practical Law, Glossary (defining "market disruption clause").

20. For the seminal works establishing the theory of incomplete contracts, see generally Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691 (1986); Oliver Hart & John Moore, *Incomplete Contracts and Renegotiation*, 56 ECONOMETRICA 755–57 (1988); OLIVER HART, FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE 1–12 (1995).

respective payoffs under each such contingency; or (iii) they cannot translate into enforceable contract language certain future contingencies or the precise outcome that they would want in the event of such contingencies. The theory of incomplete contracts thus posits a particular type of contracting friction—one that is due to information costs (the difficulty of identifying all possible future states of the world); transaction costs (the difficulty of planning for such states of the world in a contract); and agency costs (the expectation that each party will behave strategically in future states of the world). (These costs should increase with the expected duration of the parties' contract, among other factors.)

These contracting frictions pose a problem for the parties' voluntary bargain, because depending on what states of the world eventually materialize after the contract is entered into, one party may have the opportunity to exploit the other opportunistically—an outcome referred to as the "hold-up" problem[21]—often resulting in renegotiation of the contract. This is economically inefficient, because worry about the hold-up problem may cause the parties to contract and invest in the enterprise differently than they otherwise would ex ante, or to avoid contracting altogether.

There are several approaches to mitigating this problem through both contractual and non-contractual means. (An important one in the context of transactional agreements, as we have seen in Part I, is to use standards in the contract. Rather than seek to provide for every future outcome, the parties can effectively direct the court to fill in every missing term ex post by resorting to the agreed-upon standard (e.g., "reasonableness"). The upshot is that parties lacking perfect information will write contracts that are incomplete—that is, contracts that do not provide for every possible contingency in the manner originally intended by the parties.[22]

The theory of incomplete contracts permeates the contemporary corporate finance literature. Investment and financing involve ongoing and often long-term arrangements. Given their significant time component, such relationships are subject to numerous contingencies, with outcomes that cannot be predicted in advance by the parties. This is precisely the world envisioned by the theory of incomplete contracts. Indeed, the theory has been used to explain all of the basic features of both equity and debt that we commonly observe in practice.[23] It is no

21. For the classic treatment of the hold-up problem, see OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES, ANALYSIS AND ANTITRUST IMPLICATIONS: A STUDY IN THE ECONOMICS OF INTERNAL ORGANIZATION (1975).

22. *See* Eric A. Posner, *Economic Analysis of Contract Law after Three Decades: Success or Failure?*, 112 YALE L.J. 829, 833 (2003) (noting that "contracts are usually quite incomplete").

23. *See generally* Philippe Aghion & Patrick Bolton, *An Incomplete Contracts Approach to Financial Contracting*, 59 REV. ECON. STUD. 473 (1992) (providing a model

exaggeration to state that contract theory today in corporate finance rests almost entirely on the twin problems of agency costs and information costs, of which the theory of incomplete contracts is a significant outgrowth.

B. How Judges Address Incomplete Contracts

A crucial implication of this theory is that incomplete contracts may be the best that the parties can do from the standpoint of ex ante efficiency. It is not laziness, lack of foresight, or incompetent drafting to leave gaps in contracts. Yet despite the prominence of incomplete contracts theory in the scholarly literature, this Essay claims that courts sometimes simply ignore or misunderstand it in disputes involving corporate transactions. Courts implicitly hold the view that sophisticated parties can—and should—write complete contracts, and they will punish the party deemed responsible for any failure to do so.

There is a well-developed literature on how contracts should be interpreted and enforced, given the problem of incomplete contracts. The primary objective of this scholarship is to provide guidance to courts and legislatures as to how to fill the "gaps" in incomplete contracts. The usual recommendation is to supply terms ex post or to adopt so-called default terms ex ante that maximize efficiency (either for the specific contracting parties at issue or overall) or some version of substantive fairness. There are several plausible candidates for what these gap-filling terms should be:

1) the term that the parties themselves would have wanted had they been able to consider the contingency and contract for it ex ante;
2) the term that a majority of like-positioned parties would have wanted (the "majoritarian default");[24]
3) the term that would cause the parties ex ante to share information efficiently (the "penalty default");[25] or
4) the term that would achieve the "fair" result ex post.[26]

This assumes that once a court has identified a gap in a contract, it will make a good-faith effort to fill the gap (that is, to "complete" the

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in which the incomplete contracting problem of investment is optimally addressed using the commonly observed governance features of debt and equity).

24. *See, e.g.*, Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CALIF. L. REV. 261, 321 (1985).

25. *See* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 89 (1989).

26. *See* Ian R. Macneil, *Economic Analysis of Contractual Relations: Its Shortfalls and the Need for a "Rich Classificatory Apparatus*,*"* 75 NW. U. L. REV. 1018, 1026 (1981).

contract ex post) by applying the appropriate gap-filling principle from among the choices identified above.

That is not necessarily what courts do, however. Instead, judges often chide parties for leaving the contract incomplete and assign the blame for this perceived defect to one of the two parties.[27] Even though the theory of incomplete contracts underlies much of what we observe in corporate finance, judges sometimes hold the view that contractual completeness is not only *achievable* in all cases, but also *desirable*. In disputes between corporate borrowers and their creditors, for example, courts frequently revert to the mantra that creditors should have protected themselves from the disputed outcome by contract, and therefore their failure to do so implies that the borrower should carry the day. As discussed in Part III, however, when judges systematically side with one party each time they identify contractual gaps, the parties cannot efficiently correct for this ex ante, for example by drafting their agreement differently.

C. The Judicial Preference for Complete Contracts

Why do judges expect transactional agreements to be complete? There appear to be four principal reasons: (1) hindsight bias; (2) the difficulty of identifying why a contract was left incomplete; (3) conflation of the two meanings of a "complete" contract; and (4) an overly heroic view of what contract can achieve when the parties are sophisticated.

1. HINDSIGHT BIAS

In arguing that a party should have protected itself by contract from some unfavorable outcome, judicial opinions will often assert that the parties could have included language in the contract to address it. Yet, that observation is unhelpful in resolving the dispute. *After* some event has occurred, it is always the case that each party knows what outcome they wish to follow from the event, and that they could now (ex post) draft language that would have yielded that outcome, had the language been included in the contract originally. But that fact tells us little about (i) whether the parties could reasonably have drafted that language *before* knowing the event would occur and (ii) whether it would have made economic sense for them to do so, given that they were facing an infinite set of possible future events. On its own, the court's ex post reasoning

27. *Metro. Life Ins. Co. v. RJR Nabisco, Inc*., 716 F. Supp. 1504, 1522 (S.D.N.Y 1989) ("[C]ourts are properly reluctant to imply into an integrated agreement terms that have been and remain subject to specific, explicit provisions, where the parties are sophisticated investors, well versed in the market's assumptions, and do not stand in a fiduciary relationship with one another.").

provides no basis for penalizing one or the other parties for failing to include the provision.[28]

This mode of judicial reasoning appears to be an example of hindsight bias—the cognitive tendency to view every event *after the fact* as having been predictable. In reality, parties to long-term contracts face an infinite set of contingencies, including: (i) events that have only a very small probability of occurring (the problem of risk); (ii) events that have no known probability distribution associated with them (the problem of uncertainty); and (iii) events of which the parties are not even cognizant (the problem of unawareness).

2. WHY WAS THE CONTRACT LEFT INCOMPLETE?

The judicial reluctance to enforce incomplete contracts likely stems at least in part from the difficulty of interpreting them. In particular, courts will fill the contractual gaps differently (or decline to do so entirely) depending on the reason why the parties left the contract incomplete. Take the case of a borrower-creditor dispute over whether a borrower's action—which proved harmful to creditors—was permitted by the credit agreement, assuming it was not expressly addressed in the credit agreement. The answer should turn on whether and how the creditors considered the risk of the borrower taking this action when the credit agreement was drafted. Unfortunately, there are many possibilities here at the drafting stage:

1) The creditors could not reasonably have contemplated the risk of this event occurring;
2) The creditors contemplated this risk, but could not devise enforceable language to adequately address it;
3) The creditors contemplated this risk, but deemed it small enough that the transaction costs of contracting for it were not justified;
4) The creditors contemplated this risk but believed that the court would rule in their favor in filling the gap based on the language of the agreement or market practice; or
5) The creditors contemplated this risk, yet decided not to contract around it, in exchange for a higher interest rate or other creditor-favorable terms in the credit agreement.

Note that it is only in the fifth case that the court should clearly resolve the dispute in favor of the borrower over the creditors. And yet,

28. To be sure, courts are sometimes justified in penalizing one party for the absence of a particular provision from the contract. That will be the case when the parties are aware of the risk of a particular event occurring, readily have means of addressing it, and choose not to, thereby deliberately placing the risk of that event on one party. *See infra* Part II.C.2.

due to the difficulty of determining which of these five explanations for the contractual gap is the correct one, courts may find it easiest simply to adopt the fifth one in all cases.[29]

3. "COMPLETE CONTRACTS" IN LAW AND IN FINANCE

A third explanation for the judicial preference for detailed, rule-based agreements may stem from the lesser burden such contracts place on judges at the enforcement stage, as compared to standard-based contracts or contracts with obvious gaps. In an important article in this area, Robert Scott and George Triantis identified a mismatch between lawyers' and economists' use of the concept of "complete contracts."[30] In economics and finance, a complete contract is one that is ex ante efficient. Such a contract maximizes the parties' collective expectation of the value ("surplus") from entering into the transaction and provides them with the correct incentives to invest in the relationship.

Yet judges expect transactional agreements to be "complete" in a different sense. They simply mean that the contract specifies precisely what conduct is required of the parties in all cases.[31] The distinction is that in the latter case, although it will always be clear to a judge what the contract requires of the parties, it may very well be that this outcome is not what the parties would have wanted when they entered into the agreement. This would be the case, for example, if circumstances changed materially after the agreement was signed, such that the performance ultimately required by the contract would have been viewed as unexpected and undesirable by the parties at the drafting stage.

I argue that, for corporate transactions, courts tend to insist upon contracts that are complete in the latter sense, without worrying overly much about whether such contracts are complete in the former, economic sense. The likely reason is that contracts lacking any gaps in the parties' required conduct are so much easier to enforce, because they relieve judges of the difficulty of trying to fill contractual gaps and divine the parties' reasons for leaving such gaps, as discussed above.

4. FAITH THAT SOPHISTICATED PARTIES CAN WRITE COMPLETE

29. *See, e.g.*, *Quadrant Structured Prods. Co. v. Vertin*, 23 N.Y.3d 549 (2014) ("Even where there is ambiguity, if parties to a contract omit terms—particularly, terms that are readily found in other, similar contracts—the inescapable conclusion is that the parties intended the omission. The maxim *expressio unius est exclusio alterius*, as used in the interpretation of contracts, supports precisely this conclusion . . . .").

30. *See* Scott & Triantis, *Incomplete Contracts*, supra 12, at 190.

31. *See id.*

CONTRACTS

Not only do judges prefer contracts to be complete in the sense of ensuring that there are no gaps in coverage, they tend to assume optimistically that sophisticated parties can draft them.

At first glance, the judicial scorn for incomplete contracts appears surprising, given that in many contexts, courts are perfectly comfortable with incomplete contracts and appear to enforce them roughly as contract theory would predict (that is, by applying an appropriate principle for filling gaps that only emerge ex post). Employment relationships, for example, amount to astonishingly incomplete contracts: often, there are few or no formal contract terms. Likewise, returning to the corporate finance context, the critical relationship between shareholders and the firm is governed, in part, by an incomplete contract. While Delaware courts often describe the charter and bylaws of a corporation as embodying a contract among shareholders, management, and the firm, one would be hard-pressed to suggest that it is a *complete* contract.[32] (Among other reasons, the fact that charters and especially bylaws are commonly amended at some point in the corporation's life belies the claim that they represent a complete contract, since the defining feature of complete contracts is that there should be no need for the parties to renegotiate them.) By default, the shares of a corporation remain outstanding indefinitely. It is implausible that a firm's charter and bylaws amounting to a dozen or so pages in aggregate could completely specify and govern the parties' relationship forever. And courts behave accordingly: they appear to have no problem resolving corporate disputes involving events not explicitly provided for in the firm's organizational documents.

What explains this difference? Why are courts sometimes forgiving of incomplete contracts and, at other times, highly critical of them? The explanation appears to turn on two factors: (1) the degree of sophistication of the parties and (2) the existence or absence of some non-contractual backstop provided by law that is explicitly intended to govern contractual gaps in the parties' relationship. Agency law and employment law are clearly intended to fill the gaps in employment contracts, for example, while management's fiduciary duties to shareholders perform the same role with respect to a corporation's charter and bylaws. These backstops to the parties' contract—the positive-law equivalent to the use of standards

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32. In fact, several scholars have argued that charters and bylaws are not contracts at all, due to features such as indefiniteness and unilateral amendment of the bylaws. *See* James D. Cox, *Corporate Law and the Limits of Private Ordering*, 93 WASH. U. L. REV. 257, 259, 272, 275, 278 (2015); Ann M. Lipton, *Manufactured Consent: The Problem of Arbitration Clauses in Corporate Charters and Bylaws*, 104 GEO. L.J. 583, 586–87 (2016).

in contracts—effectively grant judges an explicit license to fill gaps in the contract terms.

By contrast, if the parties are sophisticated and there is no such overarching gap-filling standard governing their relationship, then, in the courts' view, the parties are on notice that their relationship is governed wholly by contract, and that any terms or protections that they wish to apply must come from the contract between them. That much is surely correct. Lenders, for example, are well aware that the borrower's management does not owe them any fiduciary duties and that their relationship with the borrower is thus determined by contract, with limited exceptions. Yet this in no way entails that the parties' contract can or ought to be *complete*. Instead, as the theory of incomplete contracts provides, the parties should seek to complete their contract only to the extent that it is efficient to do so at the time they are drafting. In holding this view, courts are therefore conflating two separate inquiries: (1) whether the parties' relationship is determined primarily by contract; and (2) whether the parties had valid reasons for leaving their contract incomplete.[33]

III. IMPLICATIONS FOR CONTRACT DRAFTING AND CONTRACT ENFORCEMENT

A. Three Inefficiencies

If judges do, in fact, hold inaccurate beliefs about the feasibility and benefits of contractual completeness, what is the harm? Judges misapplying the theory of incomplete contracts arguably create three sources of inefficiency:

First, even where the parties acted both deliberately and efficiently in writing an incomplete contract, the courts may not enforce it efficiently. For example, they may systematically side with one side of the transaction (such as sellers in M&A deals, or borrowers in financing deals) over the other whenever they identify a gap in the contract, rather than trying to fill it efficiently.

Second, knowing that courts penalize sophisticated parties for writing incomplete contracts, parties may respond by devoting too many resources to contract drafting, and by writing contracts that are inefficiently complex and detailed. They may cater to judges' preference for contracts that are complete in appearance (in that they leave no gaps in coverage), but, as discussed, there is no reason to believe that such contracts are more

33. Judges are not alone in assuming that parties can and should contract around all possible future outcomes. Many influential scholars share this view. *See, e.g.*, Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1248 (2006) ("Lenders . . . are quite capable of taking care of themselves.").

efficient than, say, shorter contracts that rely on standards to address gaps. Stated differently, parties today appear to be writing contracts that are more complete in the sense of specifying the parties' required conduct under a long list of potential scenarios, yet they are not complete in the economic sense of specifying conduct that is the *desired* outcome under every state of the world. While the parties' bargain may be extremely detailed, it may well not end up being the bargain that they actually intended at the outset. In this way, the myth that complete contracts are both achievable and desirable may be one explanation, among many others, for the widely documented increase in the length and complexity of transactional agreements.[34]

Third, and finally, this type of contract design may, in turn, be opportunistically enforced ex post by one of the parties or potentially by third parties. Ironically, overly complex and detailed contract language itself gives rise to unpredictable contingencies, which can be exploited. In Elliott's campaign against Argentina, for example, the hedge fund successfully enforced a provision in the bond indenture using an interpretation that was surely unanticipated by the original parties when the indenture was entered into.[35]

Thus, judges' misplaced faith in complete contracts arguably has a pernicious effect on contract enforcement, contract design, and contract outcomes.

B. Examples

1. DISTRESSED BORROWERS

Courts have long held that creditors must protect their interests primarily through contract.[36] Most recently, the Delaware courts have held explicitly that a firm's board of directors does not owe any fiduciary duties to its creditors, *even when the firm is in financial distress*.[37] When a firm is experiencing financial distress, however, there are material conflicts between the interests of its shareholders and those of its creditors. As a result, when initially drafting debt contracts, creditors will wish to limit moral hazard by the borrowing firm down the road, particularly if the firm becomes distressed. For example, debt contracts contain complex

34. *See* Coates, *supra* note 9.

35. *See* Gulati & Scott, *supra* note 1 (describing Elliott's use of the *pari passu* clause in Argentina's bond indenture to thwart the country's attempt to restructure its debt).

36. *See, e.g.*, *Metro. Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1522 (S.D.N.Y. 1989) ("[C]ourts are properly reluctant to imply into an integrated agreement terms that have been and remain subject to specific, explicit provisions, where the parties are sophisticated investors, well versed in the market's assumptions, and do not stand in a fiduciary relationship with one another.").

37. *Quadrant Structured Prod. Co. v. Vertin*, 102 A.3d 155, 167 (Del. Ch. 2014).

covenants, which are provisions designed to constrain the borrower's behavior[38] and to give creditors certain control rights in the firm if the borrower breaches them.[39]

Even though credit agreements and bond indentures can be several hundred pages long, distressed borrowers often manage to take actions that harm creditors, but that are nonetheless not directly addressed by the debt contract. In the resulting disputes, it has become standard for courts to remind creditors that they are expected to protect themselves through contract, and to conclude that they should, therefore, bear the blame for their failure to prohibit explicitly in the debt contract the particular borrower action that gave rise to the dispute.[40]

As discussed, this reasoning only makes sense if the dispute involves a borrower action that was both readily predictable and contractible at low cost. If not, then the court has no basis for faulting creditors for drafting what may well have been an efficient incomplete contract.[41] The court must instead find a different principle or gap-filling term for resolving the dispute. Because creditors cannot easily protect themselves from this type of inefficient enforcement by the courts, the latter increases the risk of corporate debt and should, therefore, also increase companies' cost of debt capital.

Worse still, despite (or possibly due to) the considerable length and complexity of corporate bond indentures, they remain vulnerable to unanticipated and arguably inefficient enforcement by hedge funds and other parties that may buy into the debt.[42] It is, therefore, worth asking what the parties achieve today with such costly and complex agreements, beyond appeasing judges.

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38. *See generally* Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117 (1979) (describing the use of debt covenants in bond indentures to mitigate the agency problem between borrowers and creditors).

39. *See* Aghion & Bolton, *supra* note 23, at 474.

40. *See* Jared A. Ellias & Robert Stark, *Bankruptcy Hardball*, 108 CALIF. L. REV. (forthcoming 2020) (providing several examples of debtor firms taking actions that harm their creditors, but that would be extremely difficult to prevent through additional contract language). These case studies include debtors such as Forest Oil (engaging in "form-over-substance financial engineering" to avoid triggering bondholder put right in connection with a change of control), Cumulus Media (using a debt exchange to effectively subordinate the senior term loan lenders), and Colt Holdings (delaying bankruptcy).

41. *See, e.g.*, Stephen J. Choi et al., *The Evolution of Contractual Terms in Sovereign Bonds*, 4 J. LEGAL ANALYSIS 133 (describing the design of creditor remedies as an incomplete contracting problem).

42. *See* Steven L. Schwarcz, *Indenture Trustee Duties: The Pre-Default Puzzle*, 88 U. CIN. L. REV. (forthcoming 2020).

2. MAE CLAUSES IN M&A

Merger agreements virtually always contain a provision (the "MAE clause") allowing the buyer to walk away from the transaction before it closes, without paying a cent, if the target company experiences a "material adverse event" between signing and closing, subject to various exceptions. Bucking the trend towards greater specificity in transactional contract drafting, the MAE clause is one of the few remaining provisions in merger agreements that remains vague and ill-defined,[43] resembling a standard more than a rule.[44] In particular, the term "material adverse event" itself is not defined in MAE clauses.

Although MAE clauses differ significantly across merger agreements in their wording,[45] they are almost uniformly interpreted against the buyer in court. Indeed, until 2018, the Delaware Chancery Court had not ruled in favor of the buyer in a single one of the disputes over MAE clauses in M&A deals.[46] In its many opinions siding with the seller in such disputes, the court often states that the buyer could have included more detailed language in the merger agreement that would have triggered the MAE clause, and that its failure to do so means that the buyer assumed the risk of whatever event or facts prompted the buyer to claim that an MAE had occurred.[47]

Such opinions, therefore, treat all gaps in MAE clauses as either deliberate risk assumption or poor foresight by the buyer. Yet the parties may have good reasons other than risk-shifting to the buyer to leave their MAE clauses vague. It is at least plausible (though admittedly contestable) that parties rationally keep the MAE clause language relatively short and

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43. *See* Andrew A. Schwartz, *A "Standard Clause Analysis" of the Frustration Doctrine and the Material Adverse Change Clause*, 57 UCLA L. REV. 789, 789 (2010) (stating with regards to the MAE clause that "no one knows what it means").

44. *See* Albert Choi & George Triantis*, Strategic Vagueness in Contract Design: The Case of Corporate Acquisitions*, 119 YALE L.J. 848 (2010) [hereinafter *Strategic Vagueness*].

45. *See* Eric Talley & Drew O'Kane, *The Measure of a MAC: A Machine-Learning Protocol for Analyzing Force Majeure Clauses in M&A Agreements*, 168 J. INSTITUTIONAL & THEORETICAL ECON. 181 (2012) (finding substantial variation in MAE clauses).

46. *Akorn, Inc., v. Fresenius Kabi AG*, C.A. No. 2018-0300JTL (Del. Ch. Oct 1, 2018) is the first and thus far the only Delaware case in which the court found that the MAE clause in a merger agreement had been triggered.

47. *See, e.g.*, *Hexion Specialty Chems., Inc. v. Huntsman Corp.*, 965 A.2d 715, 741 (Del. Ch. 2008) (concluding that the MAE provision in a merger agreement was not triggered, because if the buyer had wanted a decline in the target company's earnings projections to constitute a MAE, "it could have negotiated for that").

vague (and thus incomplete, in the court's eyes), given that their desired outcomes under all states of the world are not necessarily contractible.[48]

C. Solutions?

To summarize, this Essay makes three empirical claims:

1) In corporate finance disputes involving sophisticated parties, whose relationship is governed primarily by contract, courts often hold overly optimistic views about the possibility of contractual completeness. This results in inefficient judicial enforcement—often with a systematic bias toward one side of the transaction.
2) Real-world contracts are drafted with this enforcement problem in mind and are therefore more complex and more detailed than is efficient.
3) Parties and third parties can exploit the inefficiency of overly complex and detailed contracts, such as by identifying and litigating contract provisions with unintended consequences, as they come to light.

These claims are difficult to verify, however. Assuming for purposes of discussion that they are correct, what would be the appropriate solution, if any? Could we ensure that courts enforce incomplete contracts efficiently ex post so that parties will draft efficiently ex ante? This seems unlikely. In a sense, contract parties are stuck between a rock and a hard place. Their principal alternatives are (1) to write very long, complex contracts, which are expensive to draft yet still create inefficiencies ex post; or (2) to write short contracts that use standards as gap-fillers, which arguably hands generalist judges too much discretion to reinvent the parties' bargain and creates uncertainty for the market. It seems likely in the end that sophisticated parties with resources will continue to choose the first option. As a result, we should expect contracts to continue to expand, while opportunistic parties or third parties continue to enforce them in unexpected ways.

CONCLUSION

Notwithstanding its significant influence in corporate finance, the theory of incomplete contracts is arguably misunderstood by courts enforcing contracts governing corporate transactions. In resolving such disputes, judges implicitly assume that complete contracts are both achievable and desirable when the parties are financially sophisticated,

48. *See generally* Choi & Triantis, *Strategic Vagueness*, *supra* note 44 (describing the difficulty of drafting MAE clauses—which were previously known as "MAC clauses"—that achieve the parties' various goals).

and they systematically assign blame to one of the parties for leaving the contract incomplete. This, in turn, prompts parties to write ever longer and more complex agreements. Such agreements do not necessarily produce more efficient outcomes, however. In fact, they may yield unexpected outcomes or interpretations, which can be enforced opportunistically by one of the parties or by third parties.