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THE INTERPRETATION OF CONTRACTS GOVERNING CORPORATE DEBT RELATIONSHIPS

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INTRODUCTION

There is a generally accepted picture of corporate debt relationships under which the entire responsibility for governance falls to the contract drafter. Contracts governing corporate debt instruments—trust indentures in the case of bonds and debentures, and loan agreements in the case of privately placed notes and long-term bank loans—are generally viewed as the only meaningful source of rights and duties in corporate debtor-creditor relationships.¹ State business corporation laws provide no alternative, as their creditor protection

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¹[A] fundamental characteristic of long-term debt financing is that the rights of the 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 unsecured debt securities against harmful acts by the debtor except in the most extreme situations. Short of bankruptcy, the debt securityholder can do nothing to protect himself against actions of the borrower which jeopardize its ability to pay the debt unless he takes a mortgage or other collateral or establishes his rights through contractual provisions set forth in the debt agreement or indenture.

American Bar Foundation Corporate Debt Financing Project, Commentaries on Indentures 2 (1971) [hereinafter cited as ABF Commentaries], quoted in *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929, 940 n.10 (5th Cir.) (en banc), cert. denied, 454 U.S. 965 (1981).

It should be noted that a different picture obtains if a corporate debtor becomes insolvent. At that point, the law of fraudulent conveyances restricts corporate management's discretion to do business for the stockholders' benefit and imposes duties to creditors. See, e.g., *Unif. Fraudulent Conveyance Act* §§ 4, 6, 7A U.L.A. 205, 240 (1978).

While this Article discusses "debt contracts" that govern secured and unsecured borrowings, it does not discuss the law of security interests and mortgages or the interpretation of security agreements or mortgage documents.

A "trust indenture" is a contract entered into between a corporation issuing bonds or debentures and a trustee for the holders of the bonds or debentures. It delineates the rights of the holders and the issuer. Corporate practice distinguishes "bonds" from "debentures." "Bonds" are secured long-term notes issued pursuant to a trust indenture. "Debentures" are unsecured long-term notes issued pursuant to a trust indenture. See ABF Commentaries, *supra*, at 7 n.3. A "loan agreement" is a contract entered into between a corporation issuing long-term notes and the purchasers of the notes. Like a trust indenture, it delineates the rights of the holders and the issuer. See *id.* at 4-14.

Loan agreements involve the issuer and the holders in a direct contractual relationship. They tend therefore to govern transactions, like bank loans and insurance company private

provisions are notoriously ineffective.² Nor, traditionally, have judicially imposed duties entered into the governance of these relationships.³

Complicated contract forms fill this governance vacuum. These forms have been worked and reworked by successive generations of lawyers to deal with the remotest of contingencies relating to the future course of the transaction and the borrower's business. The very thoroughness of these contracts limits the role of courts in adjudicating controversies between corporate borrowers and long-term lenders. In the generally accepted picture, the judge ascertains and enforces the drafter's directions—a matter of "interpretation" rather than "law-making"—without further involvement in the transaction. So conceived, debt contract interpretation is a highly technical but cut-and-dried exercise, lacking the ethical element presented by governance disputes between corporations and common stockholders.

This Article tests the accuracy of the generally accepted picture against the evidence contained in some recent debt contract interpretation cases. The cases support a recomposition of the picture, with the interpreting judge put in the more prominent position of secondary lawmaker. But the picture emerging from the cases lacks focus: The courts vacillate in familiar ways, sometimes inclining to respect the drafter's primacy and the authority of words, and other times inclining to intervene in the relationship to effect a fair result. Indeed, the struggle for primacy between the exacting view of contract interpretation of Williston and the first Restatement of Contracts⁴ (herein denoted "classical") and the more relaxed view of Corbin and the

placements, involving small numbers of lenders. Trust indentures, by contrast, facilitate the borrowing of small amounts of money on a long-term basis from larger numbers of lenders on identical terms by channelling administration and enforcement through a single party, the indenture trustee. See V. Brudney & M. Chirelstein, *Corporate Finance* 82 (2d ed. 1979). Accordingly, trust indentures govern publicly issued bonds and debentures. Model forms of both types of contract are readily available. For trust indentures, see ABF Commentaries, *supra*; Committee on Developments in Business Financing of the Section of Corporation, Banking and Business Law of the American Bar Association, *Model Simplified Indenture*, 38 *Bus. Law.* 741 (1983). For loan agreements, see Nassberg, *Loan Documentation: Basic But Crucial*, 36 *Bus. Law.* 843 (1981); Simmons, *Drafting of Commercial Bank Loan Agreements*, 28 *Bus. Law.* 179 (1972); Simpson, *The Drafting of Loan Agreements: A Borrower's Viewpoint*, 28 *Bus. Law.* 1161 (1973).

² See generally B. Manning, *A Concise Textbook on Legal Capital* 84-90 (2d ed. 1981) ("statutory legal capital machinery provides little or no significant protection to creditors of corporations").

³ Cf. ABF Commentaries, *supra* note 1, at 2-3 ("There is no governing body of statutory or common law that protects the holder of unsecured debt securities . . .").

⁴ Restatement of Contracts (1932).

Restatement (Second) of Contracts⁵ (herein denoted "neoclassical")⁶ continues in the debt contract context.⁷

This Article concludes that courts should stop vacillating and take a fully neoclassical approach to debt contract interpretation. The analysis that follows shows that the arrogation of judicial governance authority entailed thereby will not impair corporate debtor-creditor relationships.

I. STANDARD PRINCIPLES OF INTERPRETATION

The first part of this Article recounts some basic principles of contract interpretation, both classical and neoclassical, and demonstrates that several of these must be modified if they are to meet the special requirements of the debt contract context.

A. *Standards of Interpretation*

Contract interpretation is the process by which courts ascertain the meaning of unclear contract language.⁸ Contract law provides norms to guide the process.

In their classical formulation, these norms direct the court to adhere to the text and look to standard English usage to supply meaning.⁹ They envision an "objective" judicial inquiry: A correct

⁵ Restatement (Second) of Contracts (1981).

⁶ The terms "classical" and "neoclassical" are Professor Macneil's. See Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 Nw. U.L. Rev. 854 (1978).

⁷ The struggle continues in other contexts as well. Compare *Interform Co. v. Mitchell*, 575 F.2d 1270 (9th Cir. 1978) (neoclassical approach to interpretation of sales contract) with *Freeman v. Continental Gin Co.*, 381 F.2d 459 (5th Cir. 1967) (classical approach to interpretation of sales contract).

The conflict between classical and neoclassical approaches to interpretation tends to be conceived historically: Time marches on from the early modern era of Williston to the complete modernity of Corbin; classicism is past and neoclassicism is present. This historical picture oversimplifies matters considerably, however. Interpretive classicism is fully discredited only in neoclassical commentary. Classical approaches (if not the full classical program) live on in the same reporters and sometimes the same opinions as their neoclassical counterparts. This Article examines the ramifications of this tense coexistence in respect of judicial interpretation of debt contracts.

⁸ See E. Farnsworth, *Contracts* § 7.7, at 477 (1982). This Article follows the distinction between vagueness and ambiguity noted in *W. Quine, Word and Object* 85 (1960), and amplified by Professor Farnsworth, *supra*, § 7.8, at 479-80. Under this distinction, words are vague to the extent they define a "distribution about a central norm" rather than a "neatly bounded class." Ambiguity occurs when a term or phrase is susceptible to two or more discrete readings. "Unclear" language can be either "vague" or "ambiguous." *Id.*

⁹ For a classic classical opinion, see *Eustis Mining Co. v. Beer, Sondheimer & Co.*, 239 F. 976, 984-85 (S.D.N.Y. 1917) (L. Hand, J.). Classical standards of interpretation are well explained in Farnsworth, "Meaning" in the Law of Contracts, 76 Yale L.J. 939, 946-47 (1967).

meaning exists and can be discovered through proper analysis. That meaning attaches whether or not intended by the parties. Contracting parties, it is thought, should be forced to express themselves in clear standard English.

Neoclassical norms, in contrast, direct the court to protect the particular parties' expectations. They abandon classical "objectivity" in favor of responsiveness to the particular transactional context. The parties' "subjective" understanding of the contract's meaning becomes a relevant—even critical—contextual element.

Of course, opposing parties only rarely appear in court confirming a commonly held subjective meaning and leaving the judge with the ministerial job of attaching their meaning to the contract language. More commonly, the judge must take a more active role in shaping the relationship. For example, if two parties have conflicting understandings, the judge must choose between them. A similar choice must be made where one party has a subjective understanding of a provision's meaning and the other party, having neither read nor thought about the provision, has no subjective understanding at all. The neoclassical Restatement (Second) includes norms for the resolution of such cases. Where subjective understandings conflict with one another or with standard usage, the Restatement (Second) finds fault with the party with "knowledge" or "reason to know" of the other party's understanding. The party with "reason to know" loses.¹⁰ This approach protects the less well-informed party while encouraging the better informed party to make disclosures regarding the contract's legal effect.

In a case where neither party has a subjective understanding of a provision's meaning, the neoclassical judge may play an even more prominent role in the relationship. If the provision is very unclear, the judge acts as drafter of last resort and, looking to the context, formulates the necessary term.¹¹

¹⁰ See Restatement (Second) of Contracts §§ 20, 201(2), 220 (1981); see also Speidel, *Restatement Second: Omitted Terms and Contract Method*, 67 Cornell L. Rev. 785, 793-96 (1982) (describing the "reason to know" test in the Restatement (Second)).

Note that the party with "reason to know" is at fault both in the sense of being culpable and in the sense of having caused the loss. Note also the efficiency judgment implicit in the approach—the better-informed party more cheaply can prevent the interpretation problem ever from arising by proposing better-drafted contract language. Cf. Phillips, *The Commercial Culpability Scale*, 92 Yale L.J. 228, 251-61 (1982) (discussing the moral and instrumentalist functions of culpability based rules in commercial law).

¹¹ But see the recent debt contract opinion, *Morgan Stanley & Co. v. Archer Daniels Midland Co.*, 570 F. Supp. 1529 (S.D.N.Y. 1983), in which the following reason is given for rejection of an interpretation: "[I]t appears keyed to the subjective expectations of the bondholders The approach . . . reads a subjective element into what presumably should be an

To apply “subjective” neoclassical interpretation principles to debt contracts successfully, one must be sensitive to several contextual peculiarities. Consider first one species of debt contract, the trust indenture governing publicly-traded bonds or debentures. Trust indentures contain mostly standardized provisions. With the assistance of the American Bar Foundation’s readily available Model Indenture,¹² considerable uniformity has been achieved among the standard provisions contained in trust indentures governing different issues of bonds and debentures on the market. Standardization benefits the market by making the valuation process simpler and less costly. In valuing an issue, the prospective investor may assume the presence of standard terms and focus exclusively on business points such as the soundness of the issuer, the interest rate, redemption rights and the like.¹³

Now consider how the trust indenture’s marketplace function bears on the judicial interpretation process. If a material variance were to open up between the standard form’s legal meaning and investors’ assumptions concerning its meaning, market prices no longer would reflect the value of bonds and debentures accurately.¹⁴ A

objective determination based on the language appearing in the bond agreement.” *Id.* at 1535–36. There follows immediately a second, subjective reason for rejecting the same interpretation—the “uncertainty among bondholders” that the reading would prompt. *Id.* at 1536. This reasoning is incoherent. Bondholder “uncertainty” and bondholder “subjective expectations” are the same thing; to prevent uncertainty is to protect expectations.

¹² The Model Indenture is incorporated in the ABF Commentaries, *supra* note 1. For further discussion of the market function of the Model Indenture, see Bratton, *The Economics and Jurisprudence of Convertible Bonds*, 1984 *Wis. L. Rev.* (forthcoming).

¹³ A large degree of uniformity in the language of debenture indentures is essential to the effective functioning of the financial markets; uniformity of the indentures that govern competing debenture issues is what makes it possible meaningfully to compare one debenture issue with another, focusing only on the business provisions of the issue (such as the interest rate, the maturity date, the redemption and sinking fund provisions and the conversion rate) and the economic conditions of the issuer, without being misled by peculiarities in the underlying instruments.

Broad v. Rockwell Int’l Corp., 642 F.2d 929, 943 (5th Cir.) (en banc), cert. denied, 454 U.S. 965 (1981).

¹⁴ Whereas participants in the capital market can adjust their affairs according to a uniform interpretation, whether it be correct or not as an initial proposition, the creation of enduring uncertainties as to the meaning of boilerplate provisions would decrease the value of all debenture issues and greatly impair the efficient working of capital markets. Such uncertainties would vastly increase the risks and, therefore, the costs of borrowing with no offsetting benefits either in the capital market or in the administration of justice. Just such uncertainties would be created if interpretation of boilerplate provisions were submitted to juries sitting in every judicial district in the nation.

Sharon Steel Corp. v. Chase Manhattan Bank, N.A., 691 F.2d 1039, 1048 (2d Cir. 1982), cert. denied, 103 S. Ct. 1253 (1983). The notion that neoclassical inquiry “would vastly increase . . . the costs of borrowing” is discussed critically *infra* at notes 106–17 and accompanying text.

court could create such a variance by interpreting a trust indenture in a way contrary to its generally accepted marketplace meaning. Since judicial interpretation of one such standard form contract affects the meaning and effect of hundreds of other such contracts, an aberrant interpretation could create market-wide uncertainty. Such uncertainty would increase the costs of valuing existing issues and drafting the language of future issues. If an aberrant interpretation gained general judicial currency, rights respecting all outstanding issues would be altered and market-wide wealth transfers between bondholders and stockholders would result.

Thus, we find that the contract law "expectations" of holders of publicly-traded debt securities and the assumptions underlying the market pricing process amount to the same thing. For the neoclassical interpretation process to protect these expectations, the marketplace's understanding of trust indenture terms must prevail over conflicting judicial concepts in the rare case where the marketplace's understanding conflicts with the meaning dictated by standard English usage.

Whether marketplace understanding should also prevail over conflicting understandings of particular issuers or trustees presents a more difficult question.¹⁵ The bondholders probably still have the best of the argument. Consider the following hypothetical case: A bond issuer and the indenture trustee secretly agree as to their "subjective" understanding of the meaning of standard trust indenture language while on notice of facts suggesting that bondholders in the marketplace do not share their understanding. Note that here, the "intent of the parties" corresponds to the secret meaning. A trust indenture is entered into between the issuer and the trustee for the benefit of the bond or debenture holders; strictly speaking, the holders are not "parties" to the contract. In this hypothetical, then, an interpretation that follows the "intent of the parties" would frustrate the bondholders' conflicting expectations and penalize them for relying on publicly available information and the market pricing process.¹⁶ But such

¹⁵ This issue almost arose in *John Hancock Mut. Life Ins. Co. v. Carolina Power & Light Co.*, 717 F.2d 664 (2d Cir. 1983). The case, further discussed *infra* note 68, concerned the meaning of the redemption provisions in the supplemental indenture governing an issue of privately placed utility bonds. Each side presented conflicting evidence of "industry understanding." 717 F.2d at 668, 670.

¹⁶ Even so, courts routinely state that the "intent of the parties" is their guide in interpreting trust indentures. See, e.g., *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929, 947 (5th Cir.) (en banc), cert. denied, 454 U.S. 965 (1981). But see *Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*, 691 F.2d 1039, 1048 (2d Cir. 1982) (particularized intentions of parties to standard form trust indentures found irrelevant), cert. denied, 103 S. Ct. 1253 (1983); *Broad*, 614 F.2d 418, 429 (5th Cir. 1980) (panel opinion in the same case as above).

results can be avoided by invoking the "reason to know" test against the issuer, as it has "reason to know" of the different understanding prevailing on the marketplace.

The hypothetical becomes much more difficult if the issuer formulates its understanding without collusion, secrecy, or notice of tell-tale facts indicating a contrary understanding in the marketplace. Yet so long as "reason to know" is a concept sufficiently elastic to encompass determinations that one party "should know" the meaning attached by the other party,¹⁷ then it provides a means of protecting marketplace expectations even here. The issuer arguably "should know" because it has an informational advantage. It can more efficiently ascertain the market's understanding (by questioning its investment bankers or taking a survey) than marketplace investors can ascertain the subjective understandings of different bond issuers (by means of separate interrogations). The issuer's fault ripens when it places the bonds in the stream of commerce without disclosing its subjective understanding.

We have seen that the most basic of rubrics—intrepretation in accordance with the intention of the parties—cannot be applied literally in the interpretation of trust indentures. But hornbook standards of interpretation may be applied without apparent need for adjustment in the context of the other major species of debt contract, agreements governing bank loans and private placements. In those arrangements, borrowers and lenders contract directly; extensive face-to-face negotiations are likely to occur.¹⁸ Since the parties to the contract are the parties interested in the contract, interpreting in accord with the "intent of the parties" presents no problem. Even so, marketplace understanding remains a potentially decisive, albeit secondary, source of meaning. Private loan agreements contain "boilerplate" provisions as well as heavily negotiated provisions. Such boilerplate may track or closely resemble the language of standard trust

¹⁷ The Restatement (Second) concept of "reason to know" seems to encompass "should know," although its explanatory comment is far from clear. Restatement (Second) of Contracts § 19 comment b (1981); see also *id.* § 220(2) (interpretation in accord with outside usage prevails over the subjective understanding of a party having reason to know of that usage).

¹⁸ The practice in insurance company private placements has each lender enter into a separate note agreement with the issuer. But negotiations may be carried on between the borrower and a "lead" lender acting informally on behalf of other institutions in the group of lenders. Bank arrangements also feature larger institutions acting as leads. The relations between the participating banks, however, tend to be formalized in participation agreements. In "true" participations, only the lead bank contracts with the borrower. It thereafter sells participations in its loans to other banks under the participation agreement. "Agented" participations make the lead bank the agent of the others in dealing with the borrower and may vest more or less control of the administration of the loan in the lead. See Nassberg, *supra* note 1, at 859-60.

indentures. The particular parties very well may have no subjective understanding of the meaning of such provisions. Absent subjective understanding, the understanding prevailing in the relevant marketplace—here, the community of investment bankers, institutional investors and other leading institutions—would be the meaning most likely to protect justified expectations.¹⁹ The special place held by trade usage in the interpretation of commercial contracts provides a persuasive analogy.²⁰

B. *The "Reasonableness" Rubric*

The standards of interpretation discussed above are more significant in theory than in practice. Litigated questions of debt contract interpretation tend to concern either unnoticed drafting defects or unforeseen situations. Such cases result from failures of perception and prediction by those involved in the contractual relationship. As a result, no one interested in the relationship has an articulable understanding of the contract's meaning to put before the court. Accordingly, courts often have to interpret debt contracts (and many others as well) without the aid of clarifying evidence of the parties' subjective understanding or of outside usages. In such cases, the neoclassical interpreter, like his classical counterpart, falls back on the rubric "reasonableness."²¹

Reasonable interpretation rests on what courts and lawyers assume to be the linguistic usages and other patterns of mind of ordinarily reasonable persons. Courts and lawyers employ these assumptions as interpretive rules.²² The Restatement (Second) contains the familiar catalogue. It assumes that reasonable persons employ standard English usage. It thus includes the rule that language be interpreted in accord with its "generally prevailing meaning."²³ It assumes that

¹⁹ An entirely different line of reasoning may be offered to support the argument that the marketplace's prevailing understanding ought to be imposed.

[One] economic function [of the law of contracts] . . . is to reduce the complexity and hence [the] cost of transactions by supplying a set of normal terms that, in the absence of a law of contracts, the parties would have to negotiate expressly. This function of the law is similar to that performed by a standard or form contract.

R. Posner, *Economic Analysis of Law* 69 (2d ed. 1977). Thus, by choosing the interpretation that most parties *would* choose, and allowing the minority to negotiate out of such an interpretation, courts are likely to reduce the cost of negotiation—or so the theory goes.

²⁰ See U.C.C. §§ 1-205, 2-208 (1978). The generalized concept of a "usage" as any "habitual or customary practice" found in the Restatement (Second) could be applied to marketplace understanding of debt contract meaning. Restatement (Second) of Contracts §§ 219, 220 (1981).

²¹ See E. Farnsworth, *supra* note 8, § 7.9, at 491.

²² *Id.* § 7.11, at 495.

²³ Restatement (Second) of Contracts § 202(3)(a) (1981).

reasonable persons draft internally consistent documents. It thus includes the rules that writings in a single transaction be interpreted together, and that an interpretation giving effective meaning to all terms of an agreement prevail over an interpretation leaving a part with an unreasonable or ineffective meaning.²⁴ It assumes that even reasonable persons fail to focus their attention with equal intensity on all points in the transaction. It thus includes the rules that specific terms outweigh general terms, express terms outweigh courses of performance and trade usages, and separately negotiated terms outweigh standardized terms.²⁵

Both classicists and neoclassicists use these rules, but they justify them on different grounds. Take the rule favoring interpretation in accordance with generally prevailing meaning as an example. The classicist would impose it on contracting parties as a requirement. The neoclassicist would rely on it only absent a contrary showing of actual intent, reasoning that the parties probably shared its underlying assumption, and therefore that its use probably will advance their actual expectations.

The neoclassicist would find it especially easy to justify using these rules to ascertain the meaning of terms in debt contracts governing large loans. Trust indenture and loan agreement forms tend to be inspected again and again by experienced corporate lawyers as they attempt to provide answers to all foreseeable questions within the four corners of the document. Such lawyers expect their contracts to be interpreted in accord with standard English usage and standard rules of interpretation. Thus, the standard rules will tend to produce meanings corresponding to the meanings attached by the drafters of such well-drafted contracts, and, presumably, thereby will protect the expectations of the interested parties.

C. Construction Against the Drafter

This section considers the application to debt contracts of another hornbook rule of interpretation—the maxim of interpretation *contra*

²⁴ Id. §§ 202(1)–(2), 203(a).

²⁵ Id. § 203(b)–(d).

Courts make ample use of these rules of interpretation in debt contract cases. See, e.g., *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929, 947 (5th Cir.) (en banc) (effect to all terms), cert. denied, 454 U.S. 965 (1981); *Prescott, Ball & Turben v. LTV Corp.*, 531 F. Supp. 213, 218 (S.D.N.Y. 1981) (same); *Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*, 521 F. Supp. 104, 127–28 (S.D.N.Y. 1981) (specific terms over general terms), *aff'd in part, rev'd in part*, 691 F.2d 1039 (2d Cir. 1982), cert. denied, 103 S. Ct. 1253 (1983); *Zeiler v. Work Wear Corp.*, 450 F. Supp. 891, 895–96 (S.D.N.Y. 1978) (effect to all terms).

proferentem, or, interpretation against the drafter. The Restatement (Second) styles this a rule of "construction" as well as interpretation.²⁶ Corbin calls it a rule of "last resort."²⁷ Either way, the judge applies it only when the process of interpretation produces two or more reasonable meanings and he needs a basis for choosing among them.²⁸ Underlying the rule is the assumption that the drafter knows more than the other parties about the document's inner workings and inherent ambiguities. The rule alleviates this inherent informational disparity by forcing him to accomplish his purposes clearly and in plain view.²⁹ As such, it provides a tool for judicial regulation of the imposition of standard form contracts by parties with superior bargaining power.

Courts routinely invoke the rule in debt contract cases.³⁰ This seems appropriate at first glance. Debt contracts follow standard forms. Their complexity makes it possible for a drafter to bury a surprise directive unfavorable to the other side deep within the form's convoluted paragraphs. But further inspection leads to questions as to

²⁶ See Restatement (Second) of Contracts § 206 comment a (1981). The Restatement (Second) catalogues this traditional rule with a group of rules described as embodying considerations of "fairness and the public interest." E.g., *id.* §§ 205, 208 (good faith; unconscionability).

²⁷ 3 A. Corbin, *Contracts* § 559 (1960).

²⁸ See Restatement (Second) of Contracts § 206 (1981); *Franklin Life Ins. Co. v. Commonwealth Edison Co.*, 451 F. Supp. 602, 616 (S.D. Ill. 1978), *aff'd per curiam*, 598 F.2d 1109 (7th Cir.), *cert. denied*, 444 U.S. 900 (1979).

²⁹ See Restatement (Second) of Contracts § 206 comment a (1981).

³⁰ See, e.g., *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929, 947 n.20 (5th Cir.) (en banc), *cert. denied*, 454 U.S. 965 (1981).

Calling "*contra proferentem*" a "rule" overstates matters somewhat. In practice, the doctrine is so maleable that it rarely keeps a court from doing as it pleases. Consider three debt contract cases, each decided in the Southern District of New York.

In *Prescott, Ball & Turben v. LTV Corp.*, 531 F. Supp. 213 (S.D.N.Y. 1981), the court began its discussion by noting that it was bound by "the basic rule of contract construction which requires a court to resolve ambiguities in an agreement against the party which drafted the agreement." *Id.* at 217. "[T]he only way in which defendants may prevail," the court went on, "is if the terms of the Trust Indenture [are] unambiguously . . . clear." *Id.* But the defendants prevailed anyway, though the language at least was ambiguous, see *infra* notes 76-80 and accompanying text. The court had no trouble ordering its inquiry to avoid the doctrine's constraints.

In *Zeiler v. Work Wear Corp.*, 450 F. Supp. 891 (S.D.N.Y. 1978), the court avoided imposing the "rule" on the issuer defendant as follows:

While it is true that this general rule of contractual interpretation applies to obligations found in debentures, the central task of the court is always to discern the actual intent of the parties, not to penalize any of them for failing to clarify the meaning of a given provision. The terms of the debentures must therefore be "fairly construed in light of the context and all surrounding circumstances," no matter who was responsible for drafting them.

Id. at 894 (citation omitted). For authority, the court cited *Buchman v. American Foam Rubber Corp.*, 250 F. Supp. 60 (S.D.N.Y. 1965), a case that also advanced the proposition that "doubt or ambiguity is generally said to be resolved against the issuing corporation." *Id.* at 75.

whether the factual assumptions supporting the rule obtain in the debt contract context. Take first a loan agreement drafted for a private placement between a large corporate borrower and an institutional lender. Judicial intervention to adjust an imbalance of bargaining power seems unnecessary. So long as both sides are represented by experienced counsel, the potential for drafting abuse seems unlikely to be realized. The more experienced the counsel, the more arbitrary a judicial decision based on parties' allocation of drafting responsibilities at the negotiating table.³¹

Trust indentures present a different problem, as they tend to be drafted by counsel for the underwriters. The underwriters cease to be parties interested in the contract immediately after the securities' initial issue and sale. As a result, when a dispute between the issuer and the bondholders arises at some later date, there is no drafter against whom to interpret. The issuer might be selected as a second choice, since it attended the negotiations and had the power to influence the drafting. But this seems a tenuous basis for ascribing to it an outcome-determinative fault. Particular issuers have no real role in drafting the boilerplate in standard trust indenture forms. The very need for standardization makes it unlikely that anyone involved in the transaction would propose changes in such language. Moreover, the public availability of standard trust indenture forms gives institutional bond investors equal reason to know of their contents and equal long-term ability to influence the drafting process.³²

D. *Context v. Plain Meaning*

The goal of protecting the parties' expectations makes neoclassical interpretation utterly flexible. Thus, the foregoing "relational"³³

³¹ Of course, one could inquire into the relative capabilities of the parties' respective counsel and base the rule's application on the result. Courts have occasionally done so. See, e.g., *Gulf Oil Corp. v. American La. Pipe Line Co.*, 282 F.2d 401, 404 (6th Cir. 1960) (noting that counsel was "skilled in this field of the law"); *Weiland Tool & Mfg. Co. v. Whitney*, 44 Ill. 2d 105, 111, 251 N.E.2d 242, 248 (1969) (noting that drafter was "a lawyer with a number of years . . . experience as a legal advisor in commercial transactions"). But determined pursuit of the inquiry probably would produce a complex collateral jurisprudence unappealing to the bar and lacking in both efficiency and fairness. At all events, competent counsel fairly can be assumed in respect of all of the debt contract cases this Article discusses.

³² But it must also be noted that less sophisticated individual bond investors will not have this long-term ability to influence the drafting process. Faulting such investors for the unused power of richer and better-informed investors may be unfair.

In *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929, 947 n.20 (5th Cir.) (en banc), cert. denied, 454 U.S. 956 (1981), the Fifth Circuit suggests that holders, as purchasers from underwriters, could be found to stand in the underwriters' shoes for purposes of interpretation *contra proferentem*. The text above is intended to rebut this suggestion.

³³ See Macneil, *supra* note 6, at 886-89. Elsewhere, Professor Macneil argues that debt contracts may not be "relational." Macneil, *Economic Analysis of Contractual Relations: Its*

alterations of neoclassical rules for the debt contract context advance neoclassical ends. The only absolute in neoclassical interpretation is the flexible rule that words be "interpreted in light of all the circumstances,"³⁴ and the rule's supporting assumption that words do not have immutable meanings. A corollary also bears mention: The more one knows about the context in which the words are used, the more likely that one's interpretation will accord with the parties' expectations.

This neoclassical contextualism undercuts the classical requirement that parties clearly manifest their expectations in standard English prose. This conflict between the two schools customarily arises with respect to the admission of extrinsic evidence of meaning. The classicists employ standard English usage as a bar to an expanded inquiry into context—if the meaning of the words is "plain" to the judge, no extrinsic evidence as to meaning is admissible; evidence is admissible only if the words are unclear when read within the four corners of the document.³⁵ In contrast, the neoclassical denial of the immutability of words causes the plain meaning bar to disappear. If one has no way of knowing whether or not the language is clear until all the circumstances have been considered, it follows that extrinsic evidence must be admitted for interpretation purposes despite the apparent clarity of the text's meaning.³⁶

The interpretive conflict between plain meaning and context does not end once extrinsic evidence has been admitted. The court still must decide which of the two competing meanings, one "plain" and the other derived from the extrinsic evidence, carries more weight.

Shortfalls and the Need for a "Rich Classificatory Apparatus," 75 *Nw. U.L. Rev.* 1018, 1042 (1981). But the analysis in the text will show that they are. Their relational aspects simply are less fundamental than those of many other contract relations, such as output, requirements and exclusive dealing contracts.

³⁴ See Restatement (Second) of Contracts § 202(1) (1981). For application of the rule in a debt contract case, see, e.g., *Buchman v. American Foam Rubber Corp.*, 250 F. Supp. 60, 75 (S.D.N.Y. 1965).

³⁵ For advocacy of the plain meaning rule in contract interpretation, see Holmes, *The Theory of Legal Interpretation*, 12 *Harv. L. Rev.* 417, 420 (1899). For a contemporary discussion of the rule's use in statutory interpretation, see Murphy, *Old Maxims Never Die: The "Plain-Meaning Rule" and Statutory Interpretation in the "Modern" Federal Courts*, 75 *Colum. L. Rev.* 1299 (1975).

³⁶ See *Pacific Gas & Elec. Co. v. G.W. Thomas Drayage & Rigging Co.*, 69 Cal. 2d 33, 39, 442 P.2d 641, 645, 69 Cal. Rptr. 561, 565 (1968) (Traynor, C.J.) ("The fact that the terms of an instrument appear clear to a judge does not preclude the possibility that the parties chose the language of the instrument to express different terms."); 3 A. Corbin, *supra* note 27, § 572B (Supp. 1971); Restatement (Second) of Contracts § 212 comment b (1981).

Neoclassical doctrine specifies no "correct" mode of analysis at this point. When confronted with two competing meanings, the neoclassicist will, of course, test them out "in the particular context," but will not discount the force of standard usage. As the late Judge Robert Braucher, a leading neoclassicist, wrote: "The transaction may be shown in all its length and breadth, but 'the words themselves remain the most important evidence of intention; to put them altogether aside may at times be necessary but it always somewhat savors of usurpation.'"³⁷

Thus, the decisive stage of neoclassical interpretation consists of an ad hoc balancing which is cognizant of classical values. Part II of this Article examines the dynamics of this balancing process in contemporary debt contract cases. Part III evaluates the competing interpretive norms available for debt contracts.

II. CASES

Interpretation cases turn on their own facts. Nevertheless, some generalizations can be made about the dynamics of the decision process. The following discussion of debt contract interpretation makes a few such generalizations. It relies on two assumptions in so doing: First, contractual language lacks clarity by degrees; and second, judicial intervention in contractual relationships becomes more strongly justified as the governing contract provisions become less clear.

Two types of cases define the extremes. At one extreme lies the case of the clear contract provision. Here, the judge plays a passive, ministerial role, enforcing the provision unless some overriding law or policy bars the way. Most standard debt contract provisions lie at this extreme. For example, when, upon a payment default, the lender accelerates and demands judgment for the entire outstanding principal amount, the standard form provides clear directions and no interpretation question arises. Such a case rarely results in litigation³⁸ since the expected benefit (here, zero) falls far short of the expected litigation costs. At the other extreme lies the case of the entirely unclear contract provision. Here, whether the interpreter reads the provision

³⁷ Braucher, *Interpretation and Legal Effect in the Second Restatement of Contracts*, 81 *Colum. L. Rev.* 13, 16-17 (1981)(quoting *Robert Indus., Inc. v. Spence*, 362 *Mass.* 751, 755, 291 *N.E.2d* 407, 410 (1973)(quoting *National City Bank v. Goess*, 130 *F.2d* 376, 380 (2d Cir. 1942))).

³⁸ But *In re North Am. Acceptance Corp. Sec. Cases*, 513 *F. Supp.* 608 (N.D. Ga. 1981), discusses an issue stemming from what could be considered a clear provision. The court turns to the dictionary to give "shall" its imperative meaning with respect to a trust indenture provision that the trustee "shall" give the holders notice of events of default. *Id.* at 641.

within the four corners of the document or within the circumstances as a whole, interpretation fails to point to any particular meaning, plain or otherwise. As a result, judicial intervention to supply a term is a precondition to enforcement. Such a case might arise respecting a debt contract if a technical financial term were left undefined and standard business usage offered an array of reasonable denotations. Few cases arise at this extreme, either, as debt contracts tend to be too well drafted to leave entire fields of subject matter open to judicial intervention.

There follows a comparative analysis of seven debt contract cases,³⁹ all arising between the poles. The cases deal with contract provisions lacking clarity in differing degrees and thus raise questions of proportionately differing degrees of difficulty. Conflicts of proportionately differing intensity arise between plain meanings and meanings derived from context.

A. *Cases Interpreting Open-Ended Provisions*

Even complex contracts occasionally contain provisions left vague by design. The drafter structures the provision to cover a concretely envisioned situation. But the drafter recognizes the possibility of related future situations unforeseeable in many particulars. Considerations of the limits of the human imagination or the politics of the particular transaction cause postponement of a precise drafting decision as to these contingencies. The drafter accomplishes this by drafting broadly and vaguely enough to bring such cases within the provision's arguable scope. Such drafting implicitly invites judicial intervention to establish the provision's precise parameters. Such provisions appear in all debt contracts.⁴⁰

The debt contract's standard "successor obligor clause"⁴¹ has this open-ended design. It requires the purchaser of "all or substantially

³⁹ The seven cases do not constitute a complete collection of contemporary debt contract cases. But the sample is broad enough to afford a basis for this Article's conclusions about the judicial interpretation process. Other debt contract cases are discussed in Bratton, *supra* note 12.

⁴⁰ Such provisions are more prevalent in standard form trust indentures than in loan agreements. Open-ended provisions applicable to borrowers with widely different characteristics serve the public's need for standardization.

⁴¹ The Model Indenture's sample successor obligor clause provides:

The Company shall not consolidate with or merge into any other corporation or convey or transfer its properties and assets substantially as an entirety to any Person, unless:

(1) the corporation formed by such consolidation or into which the Company is merged or the Person which acquires by conveyance or transfer the properties and assets of the Company substantially as an entirety shall be a corporation organized and existing under the laws of the United States of America or any

all” of the borrower’s assets to assume the indebtedness governed by the contract, and makes the purchase of “all or substantially all” of the borrower’s assets by a nonassuming purchaser an event of default. The phrase “substantially all” is vague and could be drafted more concretely.⁴² But it embodies an efficient compromise. The lender wants the borrower’s existing assets, or at least “substantially all” of them, kept intact to protect its investment. The borrower wants the freedom both to dispose of minor assets and to effect fundamental corporate changes without the lender’s permission. The “substantially all the assets” concept, highly developed in corporate law,⁴³ occupies com-

State or the District of Columbia, and shall expressly assume, by an indenture supplemental hereto, executed and delivered to the Trustee, in form satisfactory to the Trustee, the due and punctual payment of the principal of (and premium, if any) and interest on all the Debentures and the performance of every covenant of this Indenture on the part of the Company to be performed or observed;

(2) immediately after giving effect to such transaction, no Event of Default, and no event which, after notice or lapse of time, or both, would become an Event of Default, shall have happened and be continuing; and

(3) the Company has delivered to the Trustee an Officers’ Certificate and an Opinion of Counsel each stating that such consolidation, merger, conveyance or transfer and such supplemental indenture comply with this Article and that all conditions precedent herein provided for relating to such transaction have been complied with.

ABF Commentaries, *supra* note 1, at 292 (sample provision § 8-1)

Upon any consolidation or merger, or any conveyance or transfer of the properties and assets of the Company substantially as an entirety in accordance with Section 801, the successor corporation formed by such consolidation or into which the Company is merged or to which such conveyance or transfer is made shall succeed to, and be substituted for, and may exercise every right and power of, the Company under this Indenture with the same effect as if such successor corporation had been named as the Company herein; *provided, however*, that no such conveyance or transfer shall have the effect of releasing the Person named as the “Company” in the first paragraph of this instrument or any successor corporation which shall theretofore have become such in the manner prescribed in this Article from its liability as obligor and maker on any of the Debentures or coupons.

Id. at 295-96 (sample provision § 8-2)(italics in original).

⁴² For example, a fixed percentage of book value might be set to define “substantially all” the assets. The Model Indenture appears to reject rigid limitations on an issuer’s ability to dispose of assets. It does provide a sample clause requiring prepayment of a portion of indebtedness as assets are sold, *id.* at 427-28 (sample provision § 10-13 example 3), but notes that such clauses are rarely used, *id.* at 424. “In most cases,” it notes, “no attempt is made to provide a definition of ‘substantially all’, even though there is no generally recognized definition of that term.” *Id.* at n.1.

⁴³ See Model Business Corp. Act § 79 (1982). See generally *Gimbel v. Signal Cos.*, 316 A.2d 599 (Del. Ch.) (leading case interpreting the “substantially all” concept), *aff’d per curiam*, 316 A.2d 619 (Del. 1974).

promise ground, substantially protecting each side's interests while saving the costs of negotiating a more specific provision.

*B.S.F. Co. v. Philadelphia National Bank*⁴⁴ concerned a successor obligor clause governing an investment company borrower. Seventy-five percent of the value of the borrower's assets lay in a block of common stock of a single manufacturing company. The borrower sold this stock, taking the position that the stock did not constitute "substantially all" of its assets within the meaning of the clause. It drew upon an old common law doctrine under which assets sold did not amount to "substantially all" the assets where the sale advanced the selling corporation's purposes.⁴⁵ The borrower had held the stock for the purpose of maintaining working control over the manufacturing company, but such working control had been lost. Therefore, it argued, the sale advanced its purposes, and as such, was not of "substantially all" the assets.⁴⁶

The court rebutted this contextual argument with a different contextual argument. It emphasized the provision's purpose of protecting the lenders against dissipation of the borrower's asset base. The debentureholders had relied on the block of stock in valuing the debentures. Therefore, accomplishing the provision's protective purpose required a finding that "substantially all" the assets had been sold.⁴⁷

The court's result follows from both classical and neoclassical perspectives. The classicist would agree that the provision's vagueness necessitates judicial line-drawing. But since seventy-five percent falls within a very standard usage meaning of "substantially all," the court's line of reasoning better respects what little integrity the language possesses. The language's vagueness prevents the neoclassicist from being absolutely certain that a given result fully accords with the parties' expectations. The neoclassicist, accordingly, will make reference to context in order to ascertain which meaning more probably advances expectations. In *B.S.F.*, the probabilities favor the meaning chosen by the court. Tying the debt obligation to the borrower's asset base is the provision's central business function from the lender's point of view. The "purpose" test proposed by the borrower, in contrast,

⁴⁴ 42 Del. Ch. 106, 204 A.2d 746 (1964).

⁴⁵ See, e.g., *Lange v. Reservation Mining & Smelting Co.*, 48 Wash. 167, 93 P. 208 (1908) (case cited by the issuer in *B.S.F.*)

⁴⁶ *B.S.F.*, 42 Del. Ch. at 110, 204 A.2d at 749.

⁴⁷ *Id.* at 115, 204 A.2d at 752.

stems from old law regulating stockholders' relations with the corporate entity and has no bearing on the business needs of either party.

B.S.F. is a relatively easy case. The more recent *Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*,⁴⁸ also involving the standard successor obligor clause, presented a more difficult problem. There, the issuer of bonds and debentures liquidated on a piecemeal basis. First it sold a substantial division. Then it sold a smaller division and secured its stockholders' approval of a "Plan of Liquidation and Dissolution."⁴⁹ After this, only one operating division remained. Before the piecemeal liquidation started, this division had produced thirteen percent of the issuer's profits and thirty-eight percent of its revenues, and had comprised thirty-four percent of the book value of its fixed assets and forty-one percent of its operating assets.⁵⁰ The issuer found a buyer for this division, and the two entered into an agreement providing that the buyer assume the issuer's outstanding bonds and debentures.⁵¹ The issuer and buyer took the position that this sale constituted a "sale" of "all assets" within the meaning of the successor obligor clause, binding the bond and debentureholders to the buyer's assumption. Under this analysis, the bond and debentureholders could not declare a default.⁵²

The bond and debentureholders objected, claiming that, for purposes of applying the successor obligor clause, the issuer's asset base should have been calculated as of the time the issuer formulated the plan of liquidation. Under this analysis, the sale of the last operating division constituted a sale outside of the clause because the division contained substantially less than one-half of the issuer's assets calculated at the time of formulation of the plan. Thus, the issuer's subsequent dissolution would be deemed to have constituted a default under the trust indentures.⁵³

⁴⁸ 691 F.2d 1039 (2d Cir. 1982)(Winter, J.), cert. denied, 103 S. Ct. 1253 (1983).

⁴⁹ Id. at 1045.

⁵⁰ Id.

⁵¹ Id. at 1042-46.

⁵² Id. at 1049.

⁵³ Id. at 1051. It might be asked why the *Sharon Steel* holders objected so strenuously to the assumption. From what appears on the face of the Second Circuit's opinion, the assets of the purchasing corporation provided better security than the original issuer's assets did prior to the liquidation. Rising interest rates very probably provide the answer. Given below market coupon rates on the debentures, it would be rational for the issuing and assuming corporations to attempt to keep the debt tied to the assets so as to lock in the financing at low cost. Conversely, a default declaration greatly would benefit the holders. The resulting acceleration of the maturity date would permit them to realize the difference between the face value and the discounted value of the debentures.

The case showed the successor obligor clause working at cross purposes⁵⁴—the clause's purpose of offering the issuer flexibility in accomplishing fundamental corporate changes supported one interpretation, while its purpose of keeping the debt obligation tied to the issuer's asset base supported another. Any decision, therefore, had to impair one party's expectations to some extent.⁵⁵ The Court of Appeals for the Second Circuit ruled for the holders, breaking this impasse by assessing the probabilities and adopting the least impairing meaning:

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.⁵⁶

The court balanced the interests in favor of the holders. The holders' interpretation would leave the issuer's interest in flexibility largely unimpaired; all kinds of fundamental corporate changes still could be structured within the clause. In contrast, the issuer's interpretation would open a significant loophole through which issuers could use sequential liquidations to separate their debt obligations from their asset bases.

The contextual circumstances favored the holders less heavily than the Second Circuit's opinion indicates. The Model Indenture contains a covenant explicitly prohibiting the sort of piecemeal asset sale and liquidation carried out in *Sharon Steel*.⁵⁷ The *Sharon Steel*

⁵⁴ The court made appropriately short shrift of a literal reading that favored the issuer. Under a different literal reading, "assets" could include the undistributed proceeds of the earlier sales, forestalling application of the clause to the last purchaser. *Id.* at 1049.

⁵⁵ Farnsworth notes that "purpose interpretation" is a problematic exercise because different parties to a single contract can have different purposes. He suggests that a "reason to know" test be used to break the impasse: "It seems proper to regard one party's assent to the agreement with knowledge of the other party's general purposes as a ground for resolving doubts in favor of a meaning that will further those ends, rather than a meaning that will frustrate them." E. Farnsworth, *supra* note 9, § 7.10, at 494. The problem with this approach is that the fault identified will not necessarily obtain on either side, or, as in *Sharon Steel*, it will obtain equally on both sides.

⁵⁶ *Sharon Steel*, 691 F.2d at 1051.

⁵⁷ The Model Indenture provides:

Subject to the provisions of Article Eight, the Company will not convey, transfer or lease, any substantial part of its assets unless, in the opinion of the Board of Directors, such conveyance, transfer or lease, considered together with all prior conveyances, transfers and leases of assets of the Company, would not materially

trust indentures do not appear to have included it. One can infer from this that the drafters did not "intend" to extend protection from piecemeal liquidations. The existence of commentary on the point in the Model Indenture⁵⁸ permits the public holders in the marketplace to be charged with reason to know of this intention.

But the commentary also permits a conflicting inference to be drawn. It notes that in practice, the asset sale covenant has been utilized only rarely.⁵⁹ The clause's absence as plausibly could stem from a market-wide failure to focus on the problem as from a design to allow piecemeal liquidations. Given such a market-wide failure, the successor obligor clause's open-ended nature leaves the court with discretion to decide the question either way. And a court granted this discretion legitimately might incline toward imposing on the issuer the burden of drafting a provision explicitly sanctioning an action (such as a piecemeal liquidation) so destructive of the holders' bargain.

Thus, the contextual evidence respecting the meaning of the *Sharon Steel* successor obligor clause gives conflicting signals. Such a cloudy contextual picture makes it difficult to justify a given interpretation on the ground that it more likely protects the parties' expectations.⁶⁰ The judicial decision, accordingly, begins to become a matter of allocating the drafting burden, and the judge begins to displace the parties as law-giver in the relationship. Drafting burdens, whether imposed for reasons of efficiency or fairness, amount to norms imposed on the parties. The Second Circuit's "purpose" interpretation of the successor obligor clause in *Sharon Steel*, for all its conscientious cognizance of the parties' business expectations, in part may reflect the court's intuition regarding the fair allocation of benefits and burdens in debt transactions.

B. Cases Interpreting Closed-Ended Provisions

Contract drafters occasionally design provisions to cover only one concrete situation. Judicial contraction or expansion of such provisions is neither contemplated nor invited. All debt contracts contain such

and adversely affect the interest of the Holders of the Debentures or the ability of the Company to meet its obligations as they become due.

ABF Commentaries, supra note 1, at 426-27 (sample provision § 10-13 example 1).

⁵⁸ Id. at 423.

⁵⁹ Id. at n.1.

⁶⁰ We thus approach neoclassical "construction," where the court, rather than the parties, determines the legal effect of the language. See 3 A. Corbin, supra note 27, § 534.

provisions. Some, such as payment, repayment and redemption provisions, regulate the course of the transaction. Others, such as business covenants, regulate the course of the issuer's business.⁶¹

When these highly technical provisions give rise to interpretive disputes, classical and neoclassical values can come into sharp conflict. For example, an event might occur which, under a literal reading, falls within the scope of the provision. But consideration of contextual evidence might demonstrate that the same event probably lies outside of the discrete class of events contemplated by the drafter and, if included in the class, would probably frustrate expectations. Here, classical values point to the literal meaning while neoclassical reference to context counsels a narrower reading. In contrast, an event might occur which, under a literal reading, lies outside the scope of the provision. But contextual evidence could indicate that including the event within the scope of the provision probably will protect expectations. Again, classical and neoclassical values point in different directions. Things get more complicated still if nothing in the language or circumstances clearly indicates whether the drafter contemplated a closed- or open-ended class of transactions or events.

*Harris v. Union Electric Co.*⁶² concerned a provision in the supplemental indenture governing an issue of bonds. The provision prohibited any redemption effectuated with the proceeds of a debt issue bearing a lower coupon rate, or preferred stock having a lower dividend payment rate, than that of the issue governed by the indenture. A parenthetical in the provision excepted redemptions from a "maintenance fund." This maintenance fund had been set up in earlier supplemental indentures and was intended to force a partial redemption to the extent the issuer had failed to devote fifteen percent of any year's earnings to property maintenance. The issuer had always satisfied the requirement with actual investment in property.⁶³ Unfortunately for the bondholders, the earlier supplemental indentures limited neither the source of money nor the occasion for use of the maintenance fund. Taking advantage of these loopholes, the issuer floated a new issue of bonds at a lower coupon rate, put the proceeds in the maintenance fund and redeemed the original bonds at face value out of the maintenance fund.⁶⁴ It thereby avoided the redemp-

⁶¹ Business covenants tend to be more extensive and complicated in heavily negotiated private placement and bank loan agreements than in public issue trust indentures.

⁶² 622 S.W.2d 239 (Mo. Ct. App. 1981).

⁶³ Id. at 244-45.

⁶⁴ Id. at 242.

tion prohibition (along with a redemption premium also provided for in the supplemental indenture).

A literal reading of the indentures supported the issuer's right of redemption. But all contextual evidence, including the subjective understanding of officers of the issuer, pointed to the opposite result—that the bonds had redemption protection.⁶⁵ A “glitch” probably lay behind this mess; the drafter failed to mark up and splice together the constituent forms so as successfully to manifest the deal contemplated by the parties.⁶⁶

Harris does not involve facially vague or ambiguous language. The *Harris* debt contract is clear when read within its four corners. The interpretation problem becomes apparent only when the context is considered.⁶⁷ The choice between classical and neoclassical alternatives could not be more clear. Strict classicism permits the court to remove the discordant contextual elements from its field of vision. Neoclassicism permits it to intervene in the relationship, in effect to

⁶⁵ Neoclassical interpretation might have led to a different result regarding another fund created in the *Harris* indenture, the so-called “improvement fund.” This fund was excepted from the refunding limitation in the same parenthetical as the maintenance fund. But, unlike the maintenance fund, the availability of this fund was limited to one percent of the issue per year. *Id.* at 243. Thus, as to the improvement fund, a court could apply the parenthetical and interpret all parts of the documents consistently while simultaneously substantially protecting the expectations of all parties.

The evidence mentioned in the opinion shows that no one involved with the transactions foresaw that the maintenance fund could be used to circumvent the refunding limitation. *Id.* at 248.

⁶⁶ The “glitch” seems to have been repeated in other deals. Substantially the same question arose in *John Hancock Mut. Life. Ins. Co. v. Carolina Power & Light Co.*, 717 F.2d 664 (2d Cir. 1983) (discussed *infra* note 68). Indirectly confirming this Article's characterization of the problem as a “glitch,” the *Carolina Power* bondholders requested reformation of the contract (albeit without success). 717 F.2d at 671.

⁶⁷ The great pathological bond decision of the depression era, see J. Kennedy & R. Landau, *Corporate Trust Administration and Management* 142–43 (2d ed. 1975), that of the district court in *Kelly v. Central Hanover Bank & Trust Co.*, 11 F. Supp. 497 (S.D.N.Y. 1935), *rev'd*, 85 F.2d 61 (2d Cir. 1936), is similar in this respect. The question in *Kelly* was whether a standard negative pledge clause covered secured bank borrowings. At first glance, the language did seem to cover such bank borrowings. But the court took a closer look both at the language and particular bank borrowings and discovered a bad fit. The language of the covenant contemplated mortgages or pledges created by the same instrument governing the underlying debt obligation, and the particular pledges and bank borrowings had been created pursuant to different instruments. Not resting on a mere technicality, the court went further to show hypothetical circumstances in which application of the negative pledge clause to secured bank borrowings would block a deal beneficial to all parties. 11 F. Supp. at 504.

The *Kelly* court's mistake lay in taking the contextual inquiry only halfway. Further hypotheticals would have shown that its hypertechnical reading drained the clauses' protective content and frustrated the debentureholders' expectations.

rewrite the contract to accord with the context. The *Harris* court chose the classical alternative.⁶⁸ It found the language "unambiguous on its face," and permitted the force of the "unambiguous" language to outweigh the contextual evidence.⁶⁹

C. Cases Interpreting Provisions Unclear in Scope

There follows a comparative discussion of four cases, each of which concerns a vaguely designed provision susceptible to both closed- and open-ended interpretation. As the cases show, such vagueness makes the meaning of such provisions highly sensitive to contextual influence. The discussion closes by returning to the Second Circuit's *Sharon Steel* opinion to examine its treatment of a second, more difficult interpretation question.

*Zeiler v. Work Wear Corp.*⁷⁰ concerned a dispute that arose when an issuer of debentures was required to divest a block of assets

⁶⁸ As did the Second Circuit when a slightly different version of the same question came up in *John Hancock Mut. Life Ins. Co. v. Carolina Power & Light Co.*, 717 F.2d 664 (2d Cir. 1983).

Carolina Power concerned privately placed utility bonds. As in *Harris*, the utility redeemed the bonds with cash deposited in a "maintenance fund," thereby circumventing a refunding limitation. But the issue of interpretation was slightly different. In *Carolina Power*, the refunding limitation applied only to "general redemptions" provided for in one paragraph of the governing supplemental indenture; maintenance fund redemptions were "special redemptions" provided for in a separate paragraph of the indenture. No plausible reading of the language could have brought "special redemptions" within the scope of the refunding limitation. The bondholders took a different tack, going to the provisions governing the maintenance fund and arguing that these did not provide for cash redemptions in respect of years during which property maintenance expenditures equalled or exceeded the minimum fifteen percent of gross revenues. They took the position that the phrase "Property additions . . . which the Company elects to make the basis of a credit" required the issuer to apply all available maintenance expenditures to satisfy the maintenance fund requirement, limiting its "election" to the choice of particular properties to be applied to the maintenance fund in case of an excess. *Id.* at 667-68 (emphasis in original).

The issuer took the position that the phrase permitted the issuer to "elect" between a cash redemption and application to the fund of available maintenance expenditures. *Id.* at 666-67. The Second Circuit decided for the issuer, citing the "plain language" of the disputed clause, *id.* at 669, and not very much else.

The case was not as clear cut as the Second Circuit indicated. The court's reading surely respected the language, history and purpose of the special redemption provision at issue. Even so, the language by no means compelled the result. Furthermore, respect for the purpose and history of the refunding limitation points to a result in the bondholders' favor. The court's classical "plain meaning" rationale cuts off the possibility of a balancing analysis like that utilized by a different panel of the same court in *Sharon Steel*. See *supra* text accompanying notes 48-56.

⁶⁹ For other glitches respecting closed-ended provisions, see *Merritt-Chapman & Scott Corp. v. New York Trust Co.*, 184 F.2d 954 (2d Cir. 1950) (anti-dilution provision governing warrants); *Mueller v. Howard Aircraft Corp.*, 329 Ill. App. 570, 70 N.E.2d 203 (1946) (call provision).

⁷⁰ 450 F. Supp. 891 (S.D.N.Y. 1978).

pursuant to an antitrust consent decree. The issuer accomplished the divestiture by spinning off to its shareholders the stock of a newly created subsidiary to which the assets had been transferred. A debentureholder claimed that the divestiture came within a standard trust indenture provision creating an event of default in case: “[The issuer] shall . . . be adjudicated a bankrupt or a court . . . shall enter an order . . . approving a petition filed against it seeking reorganization . . . under the Federal bankruptcy laws or any other . . . statute of the United States . . . or any State”⁷¹

Under a literal reading, the provision picked up an antitrust divestiture as a “reorganization . . . under [a] . . . statute of the United States.” But, of course, “reorganization” also can be given a more closed-ended reading as a category limited to insolvency reorganization proceedings.

Interpretive rules of preference favor the narrow reading, as did the *Zeiler* court.⁷² The *ejusdem generis*⁷³ maxim, with its bias against broad readings, comes to bear. Further, the narrow reading better suits the structure of the standard trust indenture. The standard form explicitly covers asset dispositions in its business covenants rather than in default provisions, such as that at issue in *Zeiler*.⁷⁴ And, as shown by the foregoing discussion of the successor obligor clause, the business covenants tend to treat asset dispositions flexibly, avoiding the sort of per se treatment this default clause applies to “reorganizations.” Nor do any facts indicate that the narrower reading might have frustrated the debentureholders’ expectations.⁷⁵ We have, in sum, an easy case in

⁷¹ *Id.* at 894.

⁷² *Id.* at 896 (“even if . . . the intent of the paragraph were . . . somewhat unclear . . . the Court would still be obliged to limit the expansive phrase . . . to the confines of the specific language which precedes it”).

⁷³ Or “of the same kind”; that is, provisions should be assumed to include only the genre specifically mentioned. See E. Farnsworth, *supra* note 8, § 7.11, at 496–97; 3 A. Corbin, *supra* note 27, § 552.

⁷⁴ The *Zeiler* court noted this fact as well, and pointed out that “[n]o such covenants appear in the debentures which form the subject matter of this lawsuit.” 450 F. Supp. at 895; see also ABF Commentaries, *supra* note 1, at 205 (“a court could hold that an antitrust divestiture was not a voluntary disposition in violation of the applicable covenant restricting dispositions of assets and therefore would not constitute a ‘default’ under that covenant”).

⁷⁵ Even if the holder had proved that a contrary understanding was widespread in the market place, a strong “reason to know” argument was available in rebuttal. As the court noted, the ABF Commentaries, *supra* note 1, at 204, contain an explanation of the purpose of the provision inconsistent with the holder’s proffered meaning. 450 F. Supp. at 895. The Model Indenture being publicly available, the court reasoned, all holders have “reason to know” of a prevailing narrow interpretation. *Id.*

which all contextual evidence, internal and external, points to the same clarifying limitation. No classical/neoclassical conflict occurs.

*Prescott, Ball & Turben v. LTV Corp.*⁷⁶ also involved the meaning of "reorganization" in respect of the spin-off of the stock of a subsidiary, but "reorganization" as used in a different standard indenture provision. The question was whether the holders of an issue of convertible subordinated debentures had a right to convert into the spun-off stock. The holders claimed conversion rights under the following provision:

In case of any capital reorganization . . . each Debenture shall . . . be convertible into the kind and amount of shares of stock or other securities or property . . . to which the holder of the number of shares of Common Stock deliverable (immediately prior to the time of such capital reorganization . . .) upon conversion of such Debenture would have been entitled upon such capital reorganization⁷⁷

The holders argued for an open-ended interpretation: "reorganization" as including any "reshuffling" of capital structure.⁷⁸ The issuer suggested a narrower meaning limiting "reorganizations" to recapitalizations involving the exchange of one form of participation in the issuer for another.⁷⁹

The court employed the rule favoring interpretations promoting internal consistency of the document. The trust indenture's notice provision required that the holders be given notice of "record" dates in the case of dividends, and "effective" dates of reorganizations, mergers, and a number of other transactions. Since the spin-off was a "dividend" for notice purposes, internal consistency precluded its being deemed a "reorganization."⁸⁰

A look at the broader context reinforces the court's conclusion. Here, as in *Zeiler*, a standard provision more clearly designed to regulate the transaction can be found elsewhere in the standard trust indenture. The provision deals with the impact of dividends on conversion rights and includes spin-offs.⁸¹ It is broadly permissive. Therefore, whether or not the holders disliked the spin-off's negative effect

⁷⁶ 531 F. Supp. 213 (S.D.N.Y. 1981).

⁷⁷ *Id.* at 215.

⁷⁸ *Id.* at 218 (citing *Wood v. Coastal States Gas Corp.*, 401 A.2d 932 (Del. 1979)).

⁷⁹ *Id.* at 219.

⁸⁰ *Id.* at 219-21.

⁸¹ See Bratton, *supra* note 12.

on the value of their conversion privilege, they had some "reason to know" of their exposure. This makes neoclassical protection of their contrary expectations difficult to justify. Here again, neoclassical and classical analyses point to the same, comparatively certain result.

*Buchman v. American Foam Rubber Corp.*⁸² involved yet another vague corporate term—"dividend." In this case, both the stock and debt of the issuer were closely held, the debtholder being the infant child of a member of the stockholder group. The question was whether a member of the ownership group receiving severance pay in connection with his simultaneous resignation and sale of stock to other members of the group received a "dividend" within the meaning of a debt contract prohibition. The court gave the term a narrow reading. To be a "dividend," it held, the payment had to be declared by the board and paid pro rata to all stockholders. Under a more open-ended reading, "dividend" could include any payment made by the corporation in respect of ownership of common stock. The court rejected this reading, citing the understanding of the average businessman.⁸³

The court's intuition regarding business understanding may have been ill founded. It is not immediately apparent that business persons would form expectations about the meaning of "dividend" based on corporate law concepts rather than on economic concepts. The understanding of the average business lawyer or judge may be another matter entirely. Even so, no serious neoclassical challenge can be brought against *Buchman's* result. The limited number of parties involved make inferences regarding subjective intent an appropriate basis for decision.⁸⁴ Intent that "dividend" be construed narrowly can be inferred from the ownership group's acquiescence at the time of the transaction and for years thereafter.⁸⁵

But a factual variation on *Buchman* can be hypothesized which would tempt a neoclassicist to attach a different meaning to the same language. All that is needed is to make the debt publicly held and

⁸² 250 F. Supp. 60 (S.D.N.Y. 1965).

⁸³ Id. at 75-76 ("Without evidence that the term 'dividend' was accorded a special or unusual connotation by the contracting parties . . . that term must be given no more and no less than the scope of its ordinary meaning in the context used.").

⁸⁴ Id. at 73 ("It is noted at the outset that courts are not unfamiliar with the informalities, often irregularities, commonly attendant upon carrying out of the affairs of the closely-held corporation.").

⁸⁵ The creditors' rights were being asserted long after the fact by a trustee in bankruptcy. Id. at 63.

traded. Now, no subjective element or waiver provides a basis for choosing between the competing broad and narrow meanings. A court would have to look elsewhere in the context for clarifying circumstances. Thus, contextual variations affect the clarity of the language.

*Broad v. Rockwell International Corp.*⁸⁶ presents a real interpretive conflict as sharp as that just hypothesized in respect of *Buchman*. The case arose when an issuer of convertible debentures was taken over by means of a successful cash tender offer and subsequent cash-out of the issuer's remaining minority shareholders. The issuer and acquiror took the position that upon the merger's consummation, the holders could convert only into the amount of cash they would have received had they converted their debentures into common stock of the issuer immediately before the merger. The indenture trustee and the debentureholders took the position that the conversion rights carried over after the merger to the common stock of the *acquiror*.

The issue before the *Broad* court was whether cash consideration was "other property" within the meaning of an antidilution clause in the indenture, providing that the holders' conversion rights be transferred to the "stock, securities or other property" received in the merger by the issuer's common stockholders. If "other property" included cash, then the provision froze the value of the conversion rights at the amount of the cash consideration.

The issuer had a strong case. A literal reading of the contested provision favored it: "Cash" falls within a standard definition of "property." And the *Broad* court was nothing if not literal.⁸⁷ A court's duty, it wrote, is to "give the words and phrases employed in the contract their plain meaning."⁸⁸

A contextual argument also was available to the issuer. Standard antidilution provisions tend to have an open-ended design. Thus, the issuer's open-ended reading, sweeping in all conceivable corporate combinations, was consistent with the overall scheme.

A strong contextual argument also can be advanced on behalf of the holder's interpretation. The standard contract clause at issue antedated statutory provisions permitting cash-out mergers.⁸⁹ The cash-

⁸⁶ 642 F.2d 929 (5th Cir.) (en banc), cert. denied, 454 U.S. 965 (1981).

⁸⁷ See *id.* at 948-51. The court's step-by-step approach may be seen as fortitudinous or ham-handed, depending on one's point of view.

⁸⁸ *Id.* at 948.

⁸⁹ At the time the *Broad* trust indenture was executed, the corporate law of the issuer's state of incorporation did not permit cash out mergers. *Id.* at 951; see Bratton, *supra* note 12.

out merger therefore could be characterized as a "new development" outside the universe of possible transactions contemplated by the provisions' drafters. This analysis leaves the provision open-ended, but not quite so open-ended as to encompass a development as radical as the cash-out merger without explicit amendment. The bondholders also could point to the standard antidilution provisions' purpose of protecting their investment in the conversion privilege and the markets' expectations that the standard language effectively achieves this purpose.

Broad closely resembles *Harris*.⁹⁰ In both cases, classical considerations point strongly toward one interpretation, while neoclassical contextual inquiry gives rise to a conflicting signal. And the Fifth Circuit's approach in *Broad* resembles that of the *Harris* court. The issuer wins in both cases due to the weight put on classical "plain meaning" considerations.

D. Good Faith

We return to the Second Circuit's *Sharon Steel* opinion. But, having considered that case's interpretation of the standard successor obligor clause, we move on to its second phase, in which the court interprets standard redemption provisions. Here, the Second Circuit ascribes a very open-ended meaning to an apparently closed-ended provision by making good faith considerations override both contract language and the parties' probable expectations. This interpretation entails a degree of judicial intervention remarkable in the context of debt contracts.

The *Sharon Steel* bondholders, having established that the attempted assumption constituted an event of default, took the position that the trust indenture's redemption provision covered the issuer's piecemeal liquidation. As a result, they argued, the issuer owed them a redemption premium in addition to principal and accrued interest.⁹¹ The issuer responded that it owed no premium because it had not exercised the redemption provisions. The holders' claim to principal and interest arose not from redemption, but from their own declarations of default and concomitant acceleration of the debt's maturity.⁹²

⁹⁰ See *supra* text accompanying notes 62-69.

⁹¹ *Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*, 521 F. Supp. 118, 127 (S.D.N.Y. 1981), *rev'd*, 691 F.2d 1039 (2d Cir. 1982), *cert. denied*, 103 S. Ct. 1253 (1983).

⁹² 521 F. Supp. at 127-28.

The district court agreed with the issuer.⁹³ It invoked the rule of preference under which specific provisions—here the default provisions—prevail over general provisions—here the redemption provisions.⁹⁴ The Second Circuit reversed, relying on a purpose interpretation. The purpose of the redemption provisions was to “put a price upon the voluntary satisfaction of a debt before the date of maturity.”⁹⁵ The issuer’s actions fell within this purpose, amounting to “a voluntary liquidation which included plans for payment and satisfaction of the public debt.”⁹⁶ In effect, the holders requested—and got—specific performance of the redemption provision.

This purpose interpretation runs counter to the standard debt contract’s language, structure and purpose. First, the interpretation’s characterization of the redemption provisions’ purpose is overly broad. The provisions grant the issuer a right in the nature of an option. The issuer exercises this option when doing so advances its interests.⁹⁷ Thus, while “voluntary,” the provisions serve a much narrower purpose than the Second Circuit indicates. Second, the interpretation relies on incorrect assumptions about the technical operation of the provisions. They come into play only when the issuer follows certain procedures; voluntary liquidations do not of themselves activate them. The procedures were not followed in *Sharon Steel*.⁹⁸

Thus, while a liquidating issuer is free to exercise its option to declare a redemption, nothing in the standard trust indenture requires it to do so. Its failure to do so does not leave the holders without a right to declare the entire principal amount of the debt and accrued interest due and payable. The liquidating issuer eventually will default on its covenant to maintain its corporate existence, thus permit-

⁹³ Id.

⁹⁴ Id.

⁹⁵ 691 F.2d at 1053.

⁹⁶ Id.

⁹⁷ Redemption provisions protect the issuer against a decline in the cost of money. For the price of the premium, the issuer can refund the issue whenever it finds the cost of money advantageous. See J. Kennedy & R. Landau, *supra* note 67, at 188. According to Kennedy and Landau, voluntary redemption provisions reserve to the obligor “the privilege of prepaying . . . at its option.” Id. Despite the Second Circuit’s emphasis on voluntariness, the mainspring of *Sharon Steel* was the issuer’s attempt to avoid repaying the issue.

⁹⁸ Redemption entails setting a call date, see ABF Commentaries, *supra* note 1, at 481 (sample provision § 2-2). No such call date was designated in *Sharon Steel*. The debt had become due and payable by virtue of the holders’ actions of acceleration rather than by virtue of the issuer’s exercise of the redemption option.

ting the holders to accelerate.⁹⁹ Ultimately, dissolution matures all indebtedness by operation of state law.¹⁰⁰

None of this denies the subterfuge and bad faith implicit in the *Sharon Steel* issuer's liquidation and repayment by default. But in the highly stylized world of the trust indenture, bad faith and subterfuge do not bar the conclusion that default provisions may be utilized to advance the issuer's interests. Nor do they compel the Second Circuit's conclusion that redemption provisions were designed to regulate self-interested behavior.

In sum, the probabilities regarding marketplace expectations lie on the side of the issuer's interpretation of the *Sharon Steel* redemption provisions. Nothing in the standard trust indenture gives the market reason to believe that issuers must pay premiums in respect of voluntary liquidations. Nor has past judicial treatment of debt contracts given the market cause to believe that such a premium might be interpolated judicially.

All of this makes *Sharon Steel* hard to defend, even under neoclassical principles. By overlooking strong signals suggesting alignment between marketplace expectations and the issuer's interpretation, the decision effectively frustrates expectations. Cases like *Broad* are distinguishable for, in them, the probabilities regarding marketplace expectations are much less clear and the ambit of judicial discretion correspondingly much wider.

But further reflection shows that even *Sharon Steel* may lie within the ambit of neoclassical judicial discretion. Recall that language is unclear by degrees. Nothing in the *Sharon Steel* trust indentures stated with one hundred percent clarity that the issuer owed no premium. Even though the probabilities regarding expectations pointed toward that interpretation, and even though such probabilities make up the weightiest variable in neoclassical analysis, other variables also can be considered. Good faith is a variable in neoclassical interpretation—a variable available to override expectations in the rare case.¹⁰¹ The Second Circuit, in effect, selected *Sharon Steel* as one

⁹⁹ See ABF Commentaries, *supra* note 1, at 326 (sample provision § 10-7). The Model Indenture's list of "events of default" does not include "dissolution" or "liquidation." *Id.* at 204-214 (sample provision § 5-1).

¹⁰⁰ See, e.g., N.Y. Bus. Corp. Law § 1005(a)(2) (McKinney 1963).

The Second Circuit's "specific performance" characterization of the holder's claim, 691 F.2d at 1053, also makes no sense. One cannot get specific performance of the rights of the other party to the contract.

¹⁰¹ Cf. Speidel, *supra* note 10, at 795-96 (commenting on the Restatement (Second)'s "reason to know" test: "there is room for policy to color the edges of inference").

of these rare cases. The opinion reflects the judgment that the issuer's bad faith course of conduct makes a result other than that chosen by the parties the fairest result.¹⁰²

E. Summary

B.S.F., *Zeiler*, *LTV* and *Buchman* are easy cases. In each, the literal reading and the contextual inquiry point to the same meaning. Both constituencies are satisfied. The classicist has respected the language, and the neoclassicist can be confident that the interpretation advances the parties' expectations.

When, as in these cases, the evidence sends a discernible signal that a given meaning in all probability protects the parties' expectations, interpretation becomes doubly easy. By attaching that meaning, the parties make the law and the court comes as close as it can to inserting the proverbial provision the parties would have inserted had they thought about the matter. This promotes efficiency,¹⁰³ and also solves the fairness problem by allowing the parties to define the fair result for themselves.

Harris, *Broad*, the hypothetical variation on *Buchman* and both phases of *Sharon Steel* are more difficult. In each, the literal reading and the contextual inquiry point in different directions, creating classical/neoclassical conflicts. The variant signals make the cases doubly difficult for the neoclassicist. The probabilities regarding the parties' expectations are less clear cut, forcing the neoclassicist to look to sources other than the parties for law leading to efficient and fair results. In *Broad* and *Harris* the courts turn to classical principles. *Sharon Steel* suggests resort to neoclassical good faith principles and goes so far as to give them determinative weight. The final section of this Article evaluates these alternative approaches to the difficult debt contract interpretation case.

III. INTERPRETIVE NORMS FOR DEBT CONTRACTS

The *Broad* court resolved the interpretation question before it with the help of two classical rules. First, contract provisions are

¹⁰² Even if this strikes the reader as fancy but hollow reasoning shoring up a weak interpretation case, the result still might be defended as punitive damages responding to the issuer's willful breach of the contract. Of course, this association of a redemption "premium" with a "penalty" might make many lawyers uncomfortable. Practitioners (presumably) give opinions that redemption premiums are enforceable obligations based on the analysis that the premium is a compensatory liquidated damages provision and in no way a "penalty."

¹⁰³ Or so Professor (now Judge) Posner tells us. See Posner & Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. Legal Stud. 83, 88-89 (1977).

either ambiguous or unambiguous as a matter of law. Second, conflicts between competing meanings are resolved in favor of "plain meaning," absent some "compelling reason."¹⁰⁴

A neoclassicist would criticize both rules. The first rests on an overly simplified view of the world. Vagueness and ambiguity are not binary concepts; they arise by degree. The precise degree of ambiguity in a given case can be ascertained only by reference to context. The second rule amounts to a presumption against inferring meaning from context. Such a presumption unduly risks frustration of justified expectations.

Ironically, both rules also can be defended on contextual grounds. The *Broad* opinion makes such a neoclassically inspired argument. It surveys the trust indenture's history and economic function, concluding that certain and consistent interpretation aids the bond market.¹⁰⁵ Since these classically biased rules promote certainty and consistency, they are the rules best suited to the debt contract context. An evaluation of this position follows.¹⁰⁶

A. *Certainty and Expectations*

Legal certainty in corporate debtor-creditor relationships does produce economic benefits. Uncertainty as to the parties' rights and duties makes debt securities riskier and therefore less valuable. This uncertainty also makes the valuation process more costly.

A three-pronged argument supports *Broad's* proposition that classically inspired rules promote certainty. First, classical rules restrict the scope of the interpretation inquiry. This limits the range of interpretations to which a given contract is legally susceptible, increasing the likelihood that transacting parties will arrive at a common inter-

¹⁰⁴ *Broad*, 642 F.2d at 948-51. The court comes close to repeating the hoary classical rule that plain meaning controls unless it would lead to "absurdity" or "inconsistency." See Braucher, *supra* note 37, at 14.

¹⁰⁵ *Broad*, 642 F.2d at 940-46, 947-48 & n.20. Interestingly, similar conscientiousness was displayed by the district judge in *Kelly v. Central Hanover Bank & Trust Co.*, 11 F. Supp. 497, 503-04 (S.D.N.Y. 1935), *rev'd*, 85 F.2d 61 (2d Cir. 1936) (discussed *supra* note 67).

¹⁰⁶ The proposition to be examined is not entirely novel. Professor Speidel has noted that the twentieth century tendency towards contextualizing standards may have to be held in check in those contexts requiring more "guidance to, and control over, both the parties and the court" than open-ended neoclassical guidelines provide. Speidel, *supra* note 10, at 789-92. Compare also Professor Farnsworth's advocacy of an "objective" approach to standard form contracts as promotive of consistency and certainty. This "objective" approach entails not a wholesale reversion to classicism, but only the exclusion of evidence as to particular parties' subjective intent. Other contextual evidence may be considered. E. Farnsworth, *supra* note 8, § 7.7, at 491-92.

pretation. The neoclassical inquiry does the opposite by increasing the range of possible legal interpretations. The second phase of *Sharon Steel* aggravates this neoclassical error by introducing an additional unnecessary interpretive variable—judicial punishment of selfish behavior. Second, the narrow classical inquiry forces parties to draft clearly and thoroughly to protect their own expectations.¹⁰⁷ While this may entail additional transaction costs, the savings due to greater certainty very well may be greater.¹⁰⁸ Finally, as the *Broad* court emphasized, classical rules keep the jury out of the picture.¹⁰⁹ Jury participation makes the interpretation process less certain. Classical rules apply as a “matter of law,” while neoclassical contextual inquiries generate questions of fact for the jury.

The classicist could add to this argument a rebuttal of the neoclassical position that classical interpretation frustrates expectations. Debt contracts are well and thoroughly drafted. Their competent drafters contemplate the imposition of classical norms. Therefore, classical rules will advance the parties' expectations in most cases. In addition, the parties interested in debt contracts tend to be sophisticated investors, whose expectations are unlikely to outrun the text's plain meaning.

Acceptance of the above proposition that classicism promotes certainty completes only the first stage of the inquiry. We still must ascertain the expected value of the certainty benefit. A few practical observations show that this value is probably not very great.

First, classically inspired rules will not produce complete certainty. Only perfect drafting can do that, and perfect drafting is unattainable. Thus, costly uncertainty will persist even under the most classical of rules. Moreover, the claim that classical norms best encourage parties to come as close as possible to perfect drafting rings a bit hollow in the debt contract context. Large transactions with sophisticated parties provide economic incentives toward perfect drafting in any event. The resulting documents, while imperfect, certainly tend to be exhaustive. In such a context, the drafter's aversion to the prospect of neoclassical judicial meddling (whether by means of inaccurate notions of the business context or good faith moralizing) could prove a stronger incentive to clear, thorough drafting than aversion to the prospect of classical judicial literalism.

¹⁰⁷ See Friedman, *Law, Rules, and the Interpretation of Written Documents*, 59 *Nw. U.L. Rev.* 751, 774-77 (1965).

¹⁰⁸ See *infra* notes 110-17 and accompanying text.

¹⁰⁹ 642 F.2d at 947-48 & n.20.

It also must be noted that classical rules do not afford certain knowledge that courts will attach standard usage meanings in all cases. Judges circumvented the strictures of the rules even in classicism's palmy days.¹¹⁰ The *Broad* rule builds in such circumvention by permitting unspecified "compelling reasons" to overcome plain meaning. This leaves the judge free to attach a contextual meaning in the first hard case that comes along.

Conversely, the increment of uncertainty resulting from an unrestricted neoclassical approach probably would be trivial in magnitude. Good drafting is the reason once again. Standard form debt contracts limit the room for neoclassical maneuvering. And, as *Zeiler*, *LTV* and *Buchman* demonstrate, inquiry into all the circumstances often only serves to reinforce the literal meaning. Of course, as *Sharon Steel* shows, neoclassical moral impulses can prompt improbable readings of technical provisions. But certainty in corporate debtor-creditor relationships is not seriously undermined even by this sort of decision. The relationships' fundamentals, such as the debtor's promise to pay, remain immune to such interpretive vagaries. And the sort of opportunistic behavior which results in culpability becoming a determinative interpretive factor has its own destabilizing effects.

The problem of inconsistent juries remains. But it only arises in *Broad* because the court takes the neoclassical view that evidence of circumstances from outside the four corners of the document transforms interpretation questions into questions of fact.¹¹¹ The Second Circuit's *Sharon Steel* opinion¹¹² takes another approach. It makes all interpretation matters questions of law unless they involve extrinsic evidence bearing on the credibility of witnesses. Ironically, this is the classical approach, and here, it largely solves the neoclassical consistency problem.¹¹³

Finally, classicism's tendency to advance the expectations of parties to debt contracts has the shortcomings of a tendency. It will not advance expectations in every case. Expectations and plain meanings

¹¹⁰ See E. Farnsworth, *supra* note 8, § 7.9, at 485 & n.8.

¹¹¹ 642 F.2d at 947-948 & n.20.

¹¹² 691 F.2d at 1048-51.

¹¹³ Note that the Second Circuit resorts to this single classical stricture to facilitate a broad neoclassical inquiry while, in the Fifth Circuit, a neoclassical view of the jury function encourages a classical approach to the substantive question. It remains to be seen whether, under the Second Circuit approach, aggressive counsel with platoons of expert witnesses can make every interpretation question a jury question.

can become misaligned even with respect to debt contracts. As in *Broad*, unforeseen financial devices can spring up outside the set of transactions contemplated by the drafter. Or, as in *Harris*, the drafting can contain defects unnoticed by the parties. Classicism risks frustration of expectations in such cases. Such occasional frustration of expectations produces its own transactional uncertainty. A more even-handed analytical balance of linguistic integrity and context would permit courts to protect expectations in these cases, while promoting certainty by respecting the literal word in the broad run of cases.

Standard efficiency claims, too, may be advanced on behalf of the classical approach, but these largely overlap the certainty claims. The argument is as follows: The uncertainty attending neoclassical inquiry imposes risks, and thus costs, on the contracting parties.¹¹⁴ To the extent that classicism avoids this uncertainty cost,¹¹⁵ the costs of borrowing and lending money decline. At the margin, then, classicism facilitates value-enhancing transactions which otherwise might be impossible.

This theoretical argument might carry some weight if accompanied by empirical evidence that neoclassicism in fact is more likely to lead the courts to results that are contrary to the parties' expectations. But even if that proof were made, the net inefficiencies probably would be minimal. Standard debt contracts can be redrafted cheaply to avoid any judicial interpretation the marketplace dislikes.¹¹⁶ Only those existing contracts subject to such an aberrant interpretation would suffer lasting consequences.¹¹⁷

To sum up, the certainty and efficiency advantages of *Broad's* qualified classicism may be more theoretical than real. Contrariwise, uninhibited neoclassicism may produce less uncertainty and less inefficiency than might appear at first glance.

B. Process Considerations

Classical interpretation very well may bring more appreciable savings in the courthouse than in the marketplace. The narrower

¹¹⁴ See *Sharon Steel*, 691 F.2d at 1048 ("uncertainties . . . vastly increase the risks and, therefore, the costs of borrowing"); cf. R. Posner, *supra* note 19, at 76 ("Clearly, then, to the risk averse risk is a cost, and its elimination a gain.").

¹¹⁵ Elsewhere in this Article, I have argued that such extent is likely to be zero. See *supra* notes 109-13 and accompanying text.

¹¹⁶ This point is developed at length in Bratton, *supra* note 12.

¹¹⁷ Of course, the issuer and bondholders could agree to modify the contract so as to avoid the aberrant interpretation. But this is unlikely to occur, as the party benefitted by the interpretation is unlikely to have an economic incentive to surrender the gain.

classical inquiry might be cheaper for the parties to litigate.¹¹⁸ It certainly would be easier on the judge. Classical analysis proceeds along familiar lawyerlike lines. The judge takes a dictionary meaning and checks to make sure it fits smoothly into the document's regulatory scheme. Neoclassical analysis, by expanding the inquiry to include all real world expectations, requires courts to make judgments informed as much by business as by legal considerations. Such business judgments lie outside of what many judges like to see as the ordinary sphere of their competence. These considerations of judicial convenience and judicial competence are buttressed by the substantial self-protective capabilities of the parties to these relationships. Large borrowers and institutional lenders tend to have sufficient means to withstand minor impairments to their expectations and to protect themselves against the recurrence of such impairments.

Of course this theme of self-protection tends as a practical matter to mean self-protection for the lender only. The closing of the loan satisfies most of the borrower's transactional goals. The lender's expectations depend much more on contract rights and judicial enforcement mechanisms. By restricting the interpretation inquiry, the courts increase the lender's burden by making it less likely that the system of contract provisions on which the lender depends actually will protect it.¹¹⁹ The courts thereby also protect the borrower's interest in planning freedom by putting the burden to inhibit it on the lender. By thus burdening lenders and protecting borrowers, contract law does no more than play the theme of creditor self-protection that dominates most debtor-creditor law.

All three of these considerations—judicial convenience, judicial business incompetence and creditor self-protection—are erratically and selectively applied by the courts. With other business relationships, courts routinely give primacy to the strain of contemporary legal values which bids them to go as far as the relevant evidence carries them in pursuit of the fairest result. Consider as an example the extensive jurisprudence of fiduciary duties of management to stockholders and of majority to minority stockholders. Judicial decisions respecting these corporate relationships disregard convenience

¹¹⁸ But it can be noted that the *Broad* opinion's qualified classicism, see *supra* text accompanying notes 86-90, invites litigating parties to try out contextual arguments in case the court might find them "compelling." Thus, some of the costs of neoclassicism are incurred in any event.

¹¹⁹ A different situation arises upon the debtor's insolvency. At this point, the law of fraudulent conveyances and, perhaps, federal bankruptcy law protect the creditor. See Bratton, *supra* note 12.

and involve complex business judgments.¹²⁰ The same point can be made regarding requirements contracts and exclusive dealing contracts. The good faith questions generated by these relationships routinely entail both great judicial effort and difficult judicial business judgments.¹²¹ In both areas, also, moral strictures against selfish behavior figure prominently among the judicial norms' constituent elements. And yet no systematic distinctions can be drawn between the self-protective capabilities of the parties to these relationships and corporate creditors. The cast of characters in all these situations includes large corporate entities and similarly sophisticated individuals. As the old doctrinal barriers to protective judicial intervention fall away with respect to more and more business relationships, the continued presence of such barriers in corporate debtor-creditor relations becomes increasingly anomalous.

The above discussion makes the significance of *Sharon Steel's* second phase all the more apparent. *Sharon Steel* shows that corporate debt relationships may be subject to aggressive modes of interpretation popularly supposed to be applicable only to other contractual relationships. The particular mode utilized shows rare judicial solicitude of creditor interests by shifting the drafting burden to the borrower. Should this approach become widespread, the traditional creditor diligence ethic could lose its place as the primary consideration guiding judicial participation in corporate debtor-creditor relationships.

CONCLUSION

The foregoing defense of the second phase of *Sharon Steel* asserts only that the Second Circuit's interpretation was permissible. The court also could have followed probable expectations with substantial justification. It would not have been *wrong* in either event.

Only a clear contract dictates a single "correct" decision, and, by definition, no interpretation question arises when the contract is clear. Unclear provisions, under this analysis, always admit of more than one interpretation and offer the court a choice.¹²² Interpretive norms,

¹²⁰ See, e.g., *Jones v. H.F. Ahmanson & Co.*, 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969); *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977); *Smith v. Atlantic Properties, Inc.*, 12 Mass. App. Ct. 201, 422 N.E.2d 798 (1981).

¹²¹ See, e.g., *Bloor v. Falstaff Brewing Corp.*, 601 F.2d 609 (2d Cir. 1979).

¹²² H. Kelsen, *Pure Theory of Law* 352 (M. Knight trans. 1970).

embodying the values implicit in much of contemporary contract law, provide judges with reasons for choosing between the competing meanings. Judicial governance of the relationship vindicating one or another of such values is involved in every case. Thus, all interpretation involves judicial "intervention."

Prevailing norms can strongly suggest one meaning in preference to another, as in the easy cases discussed above.¹²³ But, as in the difficult cases, the norms also can leave the court with considerable discretion in choosing between permissible alternatives. Considered in this light, judicial "intervention" occurs when the judge follows norms pointing away from the text of the contract provision at issue.

What distinguishes debt contract relationships from many other contractual relationships is the narrow scope of judicial discretion permitted in the usual interpretation case under prevailing norms. The norms protect expectations, and the debt contract's exhaustive nature and clear drafting tend strongly to indicate where expectations lie. The parties remain the primary law-givers.

Within the narrow area of judicial discretion permitted by debt contracts, we find cases in which expectations and language conflict, and cases in which are presented opportunistic behavior unsanctioned by the debt contract, the particular participants or the marketplace in general. In such cases, courts can select among available norms and vindicate linguistic integrity, the parties' expectations, or more subjective good faith considerations as the situation demands. Given the wide range of possible situations and business interests, restriction to classical norms cannot be justified.

¹²³ Professor Owen Fiss has made a very similar observation regarding constitutional adjudication. See Fiss, *Objectivity and Interpretation*, 34 *Stan. L. Rev.* 739, 744-45 (1982).

