Wind-Down Plans, Incomplete Contracting, and Renegotiation Risk: Lessons From Tiger Woods

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The recent financial crisis has focused regulators on the difficulties encountered when attempting to shut down large, complex, systemically important financial institutions. A frequently cited statistic observes that Lehman Brothers had 2,985 distinct legal entities strewn across the globe, and that its collapse has spawned a bankruptcy proceeding of Brobdingnagian proportions. To address these concerns, regulators in Europe and the United States are promoting the concept of “wind-down” plans for all Systemically Important Financial Institutions (“SIFI’s”).

The basic concept behind a wind-down plan is simple. SIFIs would be required to define, in advance, how they can be efficiently shut down, restructured, or sold off in pieces without causing or increasing systemic risk. These wind-down plans would be subject to governmental review and approval. A common observation is that plans of this sort should cause firms to map their lines of business more rationally to their complex corporate structures, identify and manage operational interdependencies that might impede a break-up or dissolution of the firm (e.g., shared information technology systems, cross-guarantees, or intra-corporate loans), and maintain an operational plan that would allow regulators quickly to take control of the SIFI in order to shut it down or break it up with minimum muss and fuss. The goal is to transform SIFIs from complex webs of intricately linked international operations that are as hard to untangle as a giant bowl of spaghetti into simpler, modular structures that can be snapped apart like a large set of Lego blocks.

Governance experts also suggest that the adoption of wind-down plans would have salubrious effects even if they are never implemented. Boards forced to consider and review these plans might cause banks to focus more closely on core lines of business, shed operations that are overly complex and difficult to wind down, rationalize internal financial flows, and simplify corporate structures. To some, if a bank is too complex to manage through a wind-down procedure, it is also probably too complex to operate on a day-to-day basis.

Opponents of wind-down plans offer many criticisms of the concept. The Economist suggests that “the whole idea of an “orderly failure” is a bit fantastical” for if a “death panel seeks to unwind a bank it will induce, not prevent, panic among its counterparties and creditors.”¹ Other critics see wind-down plans as a means of forcing SIFIs to establish ring fenced subsidiaries in each country in which the SIFI operates. That would make life easier for regulators but potentially less profitable for bankers. Some observe that wind-down plans are

¹ The Economist, Death Warmed Up: Are Living Wills Really the Answer to Banks That Are Too Big to Fail?, Oct. 1, 2009 at 87.
intended more to make it difficult for banks to engage in tax or regulatory arbitrage than actually
to facilitate a smooth wind-down of troubled SIFI operations.

For present purposes I remain entirely agnostic as to whether wind-down plans are a good
or bad idea. In practice, I suspect that the merit of the concept will depend critically on the
details of its implementation. Because wind-down plans can be done poorly or well, and because
my observations relate to limitations on wind-down plan operations even under the best of
circumstance, I accept the utopian assumption that regulators will adopt and enforce optimally
structured wind-down plans that take into account the costs and inefficiencies that these plans
might impose on SIFIs before they fail, or on SIFIs that do not fail. My concern, instead, is on a
different question. Will even the best designed wind-down plan ever operate as intended?

Incomplete Contracts and Renegotiation Risk

German Field Marshall von Molte famously observed that no battle plan withstands
contact with the enemy. Similarly, no wind-down plan is likely to withstand contact with a
systemic financial crisis. Two predictable forces will likely prevent wind-down plans from
operating as crafted, even if the plans are drawn with the greatest care and precision by the most
competent legal and financial engineers.

First, wind-down plans cannot possibly anticipate every set of circumstances that arise in
the midst of a systemic failure. Wind-down plans are therefore incomplete contracts. But every
contract is, in some sense, incomplete, either because it is inefficient to contract for every
foreseeable contingency or because unforeseen contingencies arise. Simply observing that a
contract is incomplete is therefore an insufficient critique: there must be some ex ante reason to
expect that the contract is incomplete in a manner likely to cause a material operational failure
when time comes to execute on the agreement. Put another way, in order for incompleteness to
constitute a meaningful criticism, there has to be good cause for the contracting parties to know
at the time of execution that they are signing on to a plan that is unlikely to be implemented in
accordance with its terms in the event it is ever executed.

Here, that condition is satisfied because systemic crises are largely unanticipated. If the
regulatory, financial and legislative system accurately anticipated the circumstances of a looming
systemic crisis, then they could take steps to prevent that crisis. Systemic financial crises are
therefore, by their very nature, surprises. Wind-down plans will be unable to anticipate (and
therefore to contract for) the nature of the surprise that requires that the plan be implemented, or
the circumstances that arise in the midst of the crisis that could implicate the operation of the
wind-down plan. Wind-down plans are thus profoundly incomplete in the sense that they are
likely to be needed most under circumstances that are expected least and that maximize the
probability of a problem generated by the incomplete nature of the agreement.

The legal system also tends to operate on the basis of precedent. The outcome of
litigation that raises novel questions of law can be very difficult to predict. Because systemic
financial crises occur infrequently (we hope), it is impossible, as a practical matter, to build a
body of legally cognizable precedent that would provide guidance as to how the legal system in
the United States, or any other nation, would address the challenges posed by a wind-down plan.
This simple fact compounds the incomplete contracting problem by adding an additional layer of uncertainty.

This critique should not, however, be over-interpreted. Wind-down plans might well operate exactly as planned in the event of an isolated failure that is unrelated to a systemic crisis. Also, even if a systemic crisis renders a wind-down plan profoundly incomplete, the plan might usefully resolve many issues that would be left up in the air in the absence of a plan, and a partial resolution is likely better than none at all. Nonetheless, regulators and market participants should be suitably modest regarding their expectations as to how these plans will operate in the event of a systemic crisis.

Renegotiation risk is the second factor likely to prevent wind-down plans from being implemented as intended. A wind-down plan is, in large part, a contract between a financial institution and a government. Governments, however, are able unilaterally to renegotiate contracts, or to impose post-hoc terms and conditions, with a facility that eludes the vast majority of private sector counterparties. Governments can unilaterally renegotiate a wind-down plan’s terms by enacting legislation, adopting new regulations, amending existing regulations, or exercising moral suasion, among many other techniques. Incentives for governments to renegotiate are particularly strong in the midst of systemic financial crises when global financial and political risks are elevated. This simple fact further increases the risk that a wind-down plan will not be implemented as anticipated.

Again, the presence of renegotiation risk is not an argument against all forms of wind-down plans. Indeed, to the extent that a wind-down plan is in place, and has been previously approved by regulatory authorities, the plan’s presence could help constrain governmental action by persuading regulators to allow the plan to operate as initially intended. The presence of a pre-approved wind-down plan can also operate as a focal point, or anchor, in later negotiations, and reduce the uncertainty that could otherwise exist if financial institutions and regulators were forced to start working with a blank piece of paper in the event of a systemic crisis. The presence of significant governmental renegotiation risk is, instead, counsel for caution, and suggests that drafters understand that their work can be most easily undone precisely at the time that it might be needed the most.

Wind-Down Plans, Prenuptial Agreements, and Tiger Woods

Wind-down plans are also known as recovery and resolution plans, living wills, rapid resolution plans, and funeral plans. A better analogy might, however, be to prenuptial agreements. And, the best example of incomplete contracting and renegotiation risk in a prenup that anticipates the problems likely to arise in wind-down plans might well involve Tiger Woods, a figure who, until not long ago, was also viewed as too big and too connected to fail.

Prenups, like wind-down plans, are implemented only in the event of institutional failure. They are then used to divide and reallocate assets in a predetermined manner designed to minimize resolution costs and externalities on third parties. Couples with simpler, segregated physical and financial assets find it easier to implement prenup agreements. Couples with hard-to-value unvested stock options and other contingent claims, or balance sheets that are
overweight in non-divisible assets, such as real estate, encounter more difficulties when implementing prenups. The parallel to financial sector wind-down plans is frighteningly close.

When prenups were in their infancy, they were fraught with legal and operational risk. How much disclosure do parties have to make regarding their assets and earnings potential in order that a prenup be binding? Do the parties to a prenup have to be represented by competent counsel in order to execute a binding agreement? How much time does a person need in order to review a proposed prenup so that the agreement won’t late be thrown out for being obtained under conditions of duress? Springing a prenup on the bride while standing at the altar might be out of the question, but does that mean the prenup has to be signed, sealed and delivered a week prior to the blessed day? How about a month in advance? Longer? And, when do the terms of a prenup become so one-sided that courts will refuse to enforce the agreement as against public policy? Experienced practitioners are today able to answer these and many other questions about the optimal structuring of enforceable prenups because the courts have sufficient experience with failed marriages that they have been able to generate a body of precedent that provides useful guidance to the newly, but skeptically, betrothed. There is no equivalent body of experience or precedent relevant to wind-down plans.

Assume for the moment that Tiger Woods and his wife had a state of the art prenup that would be deemed enforceable by any court in the land. If Mr. Woods so desired, he would be able to institute divorce proceedings and cause the plan to be implemented precisely according to its terms in short order and at low cost.

Mr. Woods’ problem, however, is that his infidelities have exposed the incomplete nature of his state-of-the-art prenup. They have also generated a form of renegotiation risk that was almost certainly unanticipated prior to the wedding. When the prenup was drafted, it is safe to assume that neither Mr. Woods nor his counsel anticipated that he would one day be the wealthiest sports figure ever to have two young children with a sympathetic bride while the tabloids race to number his dalliance into the double digits. Simply divorcing Mrs. Woods and implementing the prenup seems to be an unattractive alternative for Mr. Woods, as is made evident by his decision to take an indeterminate leave from the sport of golf while he seeks to rededicate himself to family values.

Instead, press reports suggest that Mr. Woods is attempting to renegotiate arrangements with his wife in order to induce her to remain in the marriage and not to trigger the existing prenup. According to these reports, Mrs. Woods is being offered increasing sums as an inducement for her not to instigate divorce proceedings. The unforeseen circumstances thus seem to have given birth to an entirely new concept: the anti-prenup agreement, or an agreement not to trigger a valid pre-existing prenup because of an unanticipated, uncontracted for, change in circumstance that generates an unanticipated systemic risk.

Given that the incomplete nature of the original contract now forces Mr. Woods to deal with a counterparty who has no obligation to agree to any terms, and who has good emotional reason to want to cause pain to Mr. Woods, Mr. Woods now finds himself confronted with profound renegotiation risk. The analogy in the financial markets is that unforeseen events related to a systemic crisis can cause governments to want to force SIFIs not to implement their
wind-down plans as initially drafted, and to drive a fundamental renegotiation of terms because of those changed circumstances.

To be sure, none of this it to argue that Mr. Woods should not have had a prenup in place, or that SIFIs should not have wind-down plans. Mr. Woods may well be better off because the existing prenup provides a rational focal point for further negotiations, just as the existence of a carefully crafted wind-down plan can provide a reasonable starting point for the renegotiation of terms in light of unforeseen circumstance. The point is, instead, more modest. Just as Mr. Woods is likely surprised by the current operation of his marital wind-down plan, we should all be ready to be surprised by the operation of SIFI wind-down plans in the midst of a systemic financial crisis.

**Incomplete Contracts and Renegotiation Risk in the Recent Crisis**

While the Tiger Woods example is entertaining, it is, no doubt, a stretch from the reality of the recent market crisis. For better or worse, it is possible to point to several recent events that underscore the reality of incomplete contracting and renegotiation risk in the face of systemic financial crisis.

The dispute between Iceland and Britain over the application of British anti-terrorism legislation to freeze the assets of Icelandic banks operating in Britain is, perhaps, the most public example of the circumstances under which incomplete contracting and renegotiation risk can arise during a systemic financial crisis. Icelandic banks had more than 300,000 customers in Britain with deposits in excess of five billion euros when they failed in October of 2008. When it became apparent that the bank would fail, British authorities assured depositors that they would be made whole on their Icelandic accounts, even in amounts in excess of the pre-existing deposit guarantees. To prevent the bank from transferring assets out of Britain, the British government froze the Icelandic bank assets, as well as the assets of Central Bank of Iceland and government of Iceland relating to the failed banks. The freeze was implemented pursuant to the provisions of Britain’s Anti-Terrorism, Crime and Security Act of 2001, and was effected because the British Treasury “believed that action to the detriment of the UK’s economy (or part of it) had been or was likely to be taken persons who are the government of or resident of a country or territory outside the UK.”

Iceland was both surprised and offended by Britain’s decision to respond to the financial crisis by declaring Iceland to be the equivalent of a terrorist threat, and Britain’s actions have led to long a difficult negotiations between the two nations as they try to mend relations and address the consequences of the financial crisis. From Britain’s perspective, however, it merely did what was necessary in order to safeguard its domestic financial interests in the midst of a serious global financial crisis. British statutory and regulatory authority was incomplete in the sense that the appropriate freeze authority existed nowhere other than in its anti-terrorism legislation, and if in order to protect its interests the British government had to label Iceland a terrorist threat, then so be it. It was, to Britain, far the lesser of the evils. Further, if Icelandic banks thought that they

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would be able to extract funds from the failed British institutions because there appeared to be nothing in British financial law that might have precluded the transfer, the actions of the British government demonstrated that sovereign renegotiation risk is a real threat because governments in crisis can generally find a rationale that supports their desired conclusion.

It is easy to conceive of situations in which financial institutions might attempt to implement wind down plans that could be viewed as inimical to the interests of one nation in which the institution does business, and that the offended nation would take action to prevent implementation of the wind-down plan as written. The implications of such interference - - whether pursuant to traditional banking authority or through imaginative application of alternative legal regimes - - are essentially impossible to predict in the abstract.

The United States government’s involvement with the Chrysler bankruptcy provides a further example of contractual arrangements not operating in accordance with all parties’ expectations. There, secured creditors, including Indiana state pension funds, complained that the federal government’s bailout plan violated their priority positions by favoring the United Auto Workers, who were scheduled to receive a 55 percent equity interest in the reorganized firm, Fiat, who was scheduled to receive a 35 percent stake, and the governments of the United States and Canada who would receive a 10 percent interest. The secured debt holders would receive 29 cents on the dollar for their holdings when, they asserted, there clearly was additional value available that could be used to pay off their secured, priority interests. Some observers suggested that the financial interests of the secured creditors were being subordinated in favor of the financial interests of the United Auto Workers, a union closely allied with the Administration.

Supreme Court Justice Ruth Bader Ginsburg initially issued an order temporarily staying the transaction, but quickly lifted the stay and allowed the deal to move forward, the transaction having already been approved by the lower courts. To be sure, the lower courts found no reason to invalidate the transaction notwithstanding the concerns of the secured creditors, but the very nature of the dispute underscores the extent to which friction and acrimony can arise in these sorts of transactions, and the extent to which wind-down plans will not necessarily operate in a manner that is universally agreed as in accordance with its terms.

The Chrysler transaction underscores a related and important point regarding the operation of the legal system in the course of a fast moving systemic financial crisis: even if the operation of a plan is not changed by the intervention of the legal process, judicial proceedings add complexity and introduce risk that can be highly counterproductive. As a related example, consider the operation of legal proceedings in recent litigation over the operation of the automatic bankruptcy stay in connection with repurchase agreements that covered loans and associated loan servicing rights.3 The court there concluded that the repurchase agreements satisfied the requirements for the Bankruptcy Code’s safe harbor provisions, and would therefore not be subject to the stay. The court, however, also concluded that the associated loan servicing rights were not sufficiently integrated into the repurchase agreement so as to qualify for the safe harbor, and were therefore subject to the stay. Thus, the value of the assets in question had to be

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3 In re: AMERICAN HOME MORTGAGE, CALYON NEW YORK BRANCH, v. AMERICAN HOME MORTGAGE CORP., 379 B.R. 503 (Br. Del. 2008)
bifurcated in order to determine which would be subject to the stay in the bankrupt’s estate and which would not.

The question regarding the scope of the assets subject to the repurchase agreement appears to have presented a question of first impression that was unanticipated by the drafters of the Bankruptcy Code, and therefore presents an additional example of an incomplete contract. In the event of a systemic crisis, we should expect that many such questions of first impression will arise, and if we have to wait for each of these questions to be resolved through the legal process, then wind-down plans will, almost by definition, fail to operate as quick and efficient means of crisis resolution. Close attention will therefore also have to be paid to the extent to which persons adversely implicated by the operation of wind-down plans will have a right to litigate in a manner that could derail, delay, or distort the operation of these plans. The simple fact that material litigation is pending can be enough, in some circumstances, to cause a plan to fail to operate as intended, even if the litigation challenge ultimately fails.

Conclusion

Wind-down plans, properly implemented, may well be a good idea. The probability that these plans will be implemented according to their terms in the midst of a systemic financial crisis is, however, modest because of the dangers posed by incomplete contracting and renegotiation risk. The drafters of any wind-down plan would therefore be wise to consider the limitations inherent in their enterprise, and not to over-state the likely benefits of any wind-down plan.