

# PRIVATE RENEGOTIATIONS AND GOVERNMENT INTERVENTIONS IN DEBT CHAINS\*

Vincent Glode<sup>†</sup>

Christian C. Opp<sup>‡</sup>

October 14, 2021

## Abstract

We propose a model of strategic debt renegotiation in which businesses are sequentially interconnected through their liabilities. This financing structure, which we refer to as a debt chain, gives rise to externalities, as a lender's willingness to provide concessions to its privately-informed borrower depends on how the lender's own liabilities are expected to be renegotiated. We highlight how government interventions that aim to prevent default waves should account for these private renegotiation incentives and their interlinkages. In particular, we contrast the consequences of targeted subsidies vs. debt reduction programs following economic shocks such as a pandemic or financial crisis.

*Keywords:* Debt Renegotiation, Credit, Bargaining Power, Default Waves.

*JEL Codes:* G21, G32, G33, G38.

---

\*The authors thank Manuel Adelino, Eduardo Dávila, Simon Gervais, Stefano Giglio, Joao Gomes, Ben Iverson, Charles Kahn, Ron Kaniel, Stefan Nagel, Greg Nini, Martin Oehmke, Michael Roberts, Juan Sagredo, Michael Schwert, Amir Sufi, Mathieu Taschereau-Dumouchel, Wei Wang, Yao Zeng, Xingtian Zhang, Hongda Zhong and seminar participants at Frankfurt, LSE, Notre Dame, Queen Mary, Tilburg, Warwick, Wharton, the EFA Meetings, the Financial Theory Webinar, the NFA Meetings, the SFS Cavalcade, the SITE Workshop on Banks and Financial Frictions, and the Virtual Finance Theory Seminar for their helpful comments.

<sup>†</sup>Wharton School - University of Pennsylvania. 3620 Locust Walk, SHDH 2300, Philadelphia, PA 19104. Phone: 215-898-9023. Email: vglode@wharton.upenn.edu. (Corresponding Author)

<sup>‡</sup>University of Rochester and NBER. 3-110N Carol Simon Hall, Rochester NY 14627. Phone: 585-275-1023. Email: opp@rochester.edu.

# 1 Introduction

The COVID-19 pandemic has imposed unprecedented hardships on businesses worldwide. During the second quarter of 2020, more than 20% of U.S. small businesses either permanently or temporarily shut down.<sup>1</sup> In response to these events, private parties and governments have been implementing measures aimed at preventing large-scale default waves. Whereas businesses have renegotiated debt contracts, a pervasive response to changes in economic conditions (see Roberts and Sufi 2009, Cherry et al. 2021), governments have enacted policies providing subsidies (e.g., the CARES act passed by the U.S. Congress) and have intervened in private contracts (e.g., the CDC’s eviction moratorium).<sup>2</sup>

In this paper, we argue that the effectiveness of such private and public efforts is crucially influenced by the fact that businesses tend to be sequentially interconnected through their liabilities, a financing structure we refer to as a *debt chain*. For example, a small business like a restaurant might owe rent payments to its landlord. The landlord, in turn, might have a mortgage loan outstanding with a local credit union, which has financial obligations to a large national bank. Perhaps this large national bank is partly financed with bonds held by a pension fund that owes retirement benefits to workers, etc.

Practitioners involved in renegotiations recognize these interlinkages, as highlighted for example by the following depiction of commercial lease renegotiations in the midst of the COVID-19 pandemic:

*I don’t want to say that even a nice landlord or having a good relationship with the landlord, in my experience, has ensured a better lease deal (...) especially if the landlord has a mortgage on the property or is otherwise leveraged or otherwise has their own liquidity or cashflow issues. Some of those folks, their hands are just tied. They’re like, ‘We’ve talked to the bank, the bank is only going to give us as much. We can’t give you the kind of discount you’re asking for.’ (...) a good relationship or a nice landlord, isn’t even the end-all-be-all, it depends on what the surrounding situations are for that specific landlord.*<sup>3</sup>

Correspondingly, it is also important for governments to account for these interlinkages when designing interventions. Yet, as noted by the Washington Post, policymaking in this context is a complex undertaking:

*The problem for the broader U.S. economy is that when businesses like Ross Stores and T.J. Maxx stop paying rent, it sets off an alarming chain reaction. Landlords are now at risk of bankruptcy, too. (...) and cash-strapped city and local governments are realizing the property taxes they usually rely on from business*

---

<sup>1</sup>See Casselman, Ben. (Sept. 1, 2020.) “Small-Business Failures Loom as Federal Aid Dries Up.” New York Times. <https://www.nytimes.com/2020/09/01/business/economy/small-businesses-coronavirus.html>

<sup>2</sup>See U.S. Treasury Department (2020) and CDC (2020) for the details of these policies.

<sup>3</sup>Kludt, Amanda. (Aug 17, 2020.) “What It’s Like to Negotiate With Landlords Right Now.” Eater’s Digest. <https://www.eater.com/2020/8/17/21372431/what-its-like-to-negotiate-with-landlords-rent-relief-restaurants-covid-19>

*properties are unlikely to be paid this summer and fall. (...) Many small companies are asking landlords for a break, but commercial properties often have a complex chain of owners. (...) Lawmakers are trying to figure out how to prevent businesses — as well as their landlords — from going out of business, but government leaders are struggling to figure out how to help.*<sup>4</sup>

Motivated by these challenges, we develop a tractable model of strategic renegotiation in debt chains. Our model accounts for two key frictions affecting renegotiation in practice. First, agents are generally heterogeneously exposed to economic shocks and have private information about their individual financial conditions (see Chava and Roberts 2008, Adelino, Gerardi, and Willen 2013, Roberts 2015, for related empirical evidence). Second, bargaining between a borrower and its lender is bilateral, giving rise to the possibility that an agent’s bargaining power impedes the efficiency of not only one credit relationship but that of a whole chain (see Chava and Roberts 2008, Roberts and Sufi 2009, Denis and Wang 2014, for related empirical evidence). Each lender decides whether to reduce the present value of payments promised by its borrower, accounting for the fact that a decrease in the probability of default lowers expected default costs.

Our analysis reveals how private renegotiation decisions are interrelated in a debt chain: a lender’s willingness to provide concessions to its borrower — sometimes referred to as “taking a haircut” — depends on its own liabilities and how they are expected to be renegotiated (see Murfin 2012, Chodorow-Reich and Falato 2021, for related empirical evidence). In particular, the more a lender’s own liabilities are reduced, the greater is that agent’s exposure to losses that are incurred when its own borrower defaults. This increased exposure, in turn, makes it optimal for the lender to be more lenient with its borrower as well. On the other hand, a lender who does not receive concessions and remains deeply indebted typically finds it suboptimal to reduce its borrower’s liabilities. High lender indebtedness implies that knock-on defaults (i.e., default waves) are more likely, in which case the inefficiencies caused by a borrower’s default are not fully internalized by the lender (who is protected by limited liability), as they also affect the lender’s lender. Limited exposure to default losses and a resultant tough renegotiation strategy may then be privately optimal, yet it not only increases the potential for costly default in the specific bilateral credit relationship but also creates negative externalities to renegotiation efforts elsewhere in the chain. If a lender such as the local credit union in the example above takes a tough stance with its borrower (i.e., the landlord), so will the landlord with its

---

<sup>4</sup>Long, Heather. (June 4, 2020.) “The next big problem for the economy: Businesses can’t pay their rent.” Washington Post. <https://www.washingtonpost.com/business/2020/06/03/next-big-problem-businesses-cant-or-wont-pay-their-rent-its-setting-off-dangerous-chain-reaction/>

own borrower (i.e., the restaurant). Furthermore, if the large national bank expects the credit union to take this tough stance with the landlord, it might reduce the bank's incentives to renegotiate the credit union's liabilities. As a result, an unaccommodating renegotiation strategy in one particular credit relationship tends to trigger tough renegotiations and higher debt levels among "downstream" agents (whose debt payments are expected to flow up the chain). The direction of these renegotiation externalities differs from that of widely studied balance-sheet externalities in the presence of fixed debt contracts whereby a shock to "downstream" agents' assets spills over to "upstream" agents.

Accounting for the endogenous responses of all debt-chain members, we analyze how targeted government policies affect, and potentially complement, private renegotiations throughout a chain. First, we show that providing subsidies to downstream borrowers like the restaurant can be particularly effective in eliminating default waves. Such subsidies generally have to cover only a fraction of the potential shortfall the targeted borrower is facing, since the lender also has private incentives to reduce the debt to a default-free level. That is, private renegotiation is an important factor determining the magnitudes of government subsidies needed to avoid default, and our analysis reveals under which economic conditions these subsidies can be small yet fully effective. Importantly, providing subsidies to a borrower like the restaurant also strengthens upstream lenders' incentives to renegotiate their borrowers' debt to default-free levels. By boosting the maximum debt payment the restaurant can owe without defaulting on its landlord, a subsidy to the restaurant can first lead the landlord, then the local credit union, and then the large national bank to more efficiently renegotiate with their respective borrowers. As a result, awarding a subsidy to a downstream borrower can be highly effective in preventing default waves, compared to awarding the same subsidy to an upstream borrower, due to the recursivity of debt-chain members' optimal renegotiation decisions.

Second, we show how government interventions affecting the allocation of bargaining power in private renegotiations can help prevent default waves. In particular, mandating that an upstream agent be lenient with a borrower also tends to incentivize downstream agents to voluntarily renegotiate the liabilities of their respective borrowers. For example, reducing how much the local credit union owes to the large national bank may first lead the credit union, and then the landlord to more efficiently renegotiate with their respective borrowers. If poorly designed, this type of intervention can, however, backfire. For instance, instead mandating a reduction of the restaurant's rent owed to its landlord would reduce how much the credit union

could collect from efficiently renegotiating the landlord's mortgage. Such an intervention could thereby result in the credit union toughening its renegotiation strategy with the landlord and increasing default risk in the chain.

A key friction impeding efficient renegotiation in our environment is that lenders making renegotiation offers do not have access to all the information that their borrowers might use when payments come due. Otherwise, if a lender had this information when renegotiating, it would have no incentive to ask for more than the borrower can actually pay. As a result, inefficiencies associated with default would be avoided throughout the chain. In contrast, when information sets differ, each lender faces a generic tradeoff when renegotiating with its borrower. On the one hand, significantly lowering how much a borrower owes increases the probability of repayment and reduces the probability of triggering the inefficiencies associated with bankruptcy. On the other hand, not providing concessions implies a higher amount being collected if the borrower happens to be able to make its payment. The uncertainty the lender faces about the borrower's financial condition as well as the expected renegotiation outcomes elsewhere in the chain drive the tradeoff associated with a lender's renegotiation decision. How much the landlord knows about the restaurant's ability to pay its debt and whether it expects to have its own loan renegotiated by the credit union determine the optimal renegotiation strategy regarding the restaurant's liabilities.

Finally, as a third policy implication, our analysis reveals how the timing of the renegotiation process, relative to the actual payment dates, can be an important determinant of inefficiencies. In particular, we show conditions under which a default-free equilibrium can only exist if renegotiation occurs before agents collect all the information they might use to make their ultimate default decisions. If, at the time of renegotiation, an agent in the chain has only imprecise information about the conditions it will face at a future payment date, this agent still has more optimistic beliefs about its asset values than under the worst possible ex-post scenario. As a result, relative to this agent-specific worst-case scenario, this agent still assigns positive probabilities to higher asset values and thus, has stronger incentives to follow a lenient renegotiation strategy with its own borrower. In other words, since incentives to be lenient are non-linear in a lender's beliefs about its own assets, renegotiation outcomes in the whole chain are more efficient when they occur before each agent has had the chance to obtain sufficiently precise negative information about its idiosyncratic condition. As a result, government policies facilitating *early* renegotiation following a large shock tend to facilitate

more lenient renegotiation throughout a debt chain.<sup>5</sup>

**Literature review.** Our paper sheds light on debt renegotiation decisions in debt chains and how they are impacted by government interventions. We contribute to the existing literature on renegotiation that abstracts from debt chains and the associated externalities of each renegotiation decision. Riddiough and Wyatt (1994a) study the dynamic decision whether to reorganize a single distressed firm, and Riddiough and Wyatt (1994b) analyze reputational effects of renegotiation when a lender has several loans that mature sequentially. Bolton and Scharfstein (1996) show how creditor dispersion can impede the efficient renegotiation of debt (see also He and Xiong (2012), Brunnermeier and Oehmke (2013), Donaldson et al. (2020), and Zhong (2021) for related analyses of the effects of creditor dispersion). Gârleanu and Zwiebel (2009) analyze the design and renegotiation of debt covenants, showing that adverse selection problems lead to the allocation of greater ex-ante decision rights to the creditor.

Our paper is related to models of sequential strategic interactions in financial and product markets. In an unpublished working paper, Kiyotaki and Moore (1997) analyze shock propagation in a supply chain context where term credit is provided. As part of their analysis, the authors consider the effects that arise when unpaid debts are postponed and find that while doing so may be bilaterally efficient, it may be socially worse, since postponement, relative to liquidation, does not lead to the injection of additional liquidity. In contrast, our analysis reveals how unaccommodating renegotiation in one credit relationship leads to tougher renegotiation strategies among downstream agents, and we show how prevalent government interventions that target specific borrowers can complement private renegotiation incentives. Di Maggio and Tahbaz-Salehi (2015) study sequential lending relationships, but unlike us, they are interested in the use of collateral in origination decisions, rather than in debt renegotiation (see also Park and Kahn 2019). They show how the allocation of collateral affects an intermediation chain's ability to shepherd liquidity towards a good investment opportunity. Relatedly, shedding light on the benefits of intermediation chains, Glode and Opp (2016) show that trading through moderately informed intermediaries can improve the efficiency of asset allocations in over-the-counter markets. Doepke and Schneider (2017) highlight the benefits of a dominant unit of account (e.g., a specific currency) when agents can be both suppliers and customers in sequential, bilateral

---

<sup>5</sup>More generally, the benefits of early renegotiation uncovered by our analysis shed light on the fact that renegotiation indeed tends to occur early in the life of most loans (see Roberts and Sufi 2009).

interactions subject to random matching. Our focus on chains of bilateral renegotiations also differentiates our paper from the sequential principals literature, where multiple principals deal sequentially with a single agent (see, e.g., Bizer and DeMarzo 1992, Kahn and Mookherjee 1998).

Our paper also contributes to the theoretical literature studying the impact of debt and limited liability on firm decisions. This literature shows how outstanding debt can affect firms' incentives to invest (see Myers 1977), take risks (see Jensen and Meckling 1976, Inderst and Mueller 2008), charge high prices for their products (see Brander and Lewis 1986), and negotiate with stakeholders like unionized workers (see Perotti and Spier 1993, Matsa 2010). In our model of debt chains, most agents are both lenders and borrowers, and we show how an agent's outstanding debt as a borrower, which depends on renegotiations with its lender, weakens that agent's willingness as a lender to renegotiate its borrower's liabilities. By providing concessions to a struggling borrower, a lender makes the distribution of payment outcomes more concentrated and reduces the probability that its borrower will default. Due to limited liability, the benefits of these concessions are, however, not fully internalized by a lender who is at risk of defaulting on its own liabilities. Moreover, optimal renegotiation decisions and equilibrium default risk are generically interrelated across debt-chain members, due to the presence of externalities. Our policy analysis provides insight on how the targeting of specific debt-chain member(s) by government interventions can maximize efficient renegotiations throughout a whole chain.

Finally, our analysis complements insights from the existing literature on cascades and contagion in financial networks, which abstracts from the strategic renegotiation of debt contracts. We show how upstream renegotiation outcomes affect the optimal renegotiation decisions of downstream agents, contrasting with a typical default cascade which would propagate from the final borrower's balance sheet to that of the initial lender (i.e., from downstream to upstream agents). Allen and Gale (2000), Elliott, Golub, and Jackson (2014), and Acemoglu, Ozdaglar, and Tahbaz-Salehi (2015) study different channels through which small economic shocks can spread and expand through networks of firms connected by financial obligations. Allen, Babus, and Carletti (2012) study the interaction between asset commonality and funding maturity in generating this type of contagion. Babus and Hu (2017) study how agents' incentives to default on their financial obligations can be weakened by a star network, in which a central intermediary monitors everyone's trading history. Taschereau-Dumouchel (2020) studies how firms' failure to produce inputs can lead

to cascades of firm shutdowns.

## 2 The Environment

In this section, we introduce our model of renegotiations in debt chains.

**Agents and asset endowments.** We consider an environment with  $N \geq 3$  agents. At date  $t = 1$ , each agent  $j$  owns an endowment asset that takes a random value  $v_j$  at date  $t = 2$ . All agents discount future values at a rate of zero. The cumulative distribution function (CDF) of  $v_j$ , based on public information available at date  $t = 1$ , is denoted by  $F_j(v_j)$ . We respectively denote the lower and upper bounds of the support of  $v_j$  by  $\underline{v}_j (> 0)$  and  $\bar{v}_j (> \underline{v}_j)$ . As of date  $t = 1$ , the asset values  $v_j$  are independently distributed across agents, reflecting the notion that agents face heterogeneous financial conditions. Yet, this specification does allow for the possibility that aggregate shocks hit before date  $t = 1$  and shaped the distributions  $F_j(v_j)$  as of date  $t = 1$  (see Section 5 for a related discussion). For example, a large aggregate shock like COVID-19 hitting before date  $t = 1$  would have resulted in distributions  $F_j(v_j)$  that are shifted to the left.

The endowment asset value realizations in excess of their lower bounds,  $(v_j - \underline{v}_j)$ , are observable at date  $t = 2$  but not verifiable, in the sense of Grossman and Hart (1986). Subject to the constraint that its assets have a verifiable component  $\underline{v}_j$ , an agent  $j$  can underreport its value realization at date  $t = 2$  in order to reduce payments to security holders and divert the additional residual value. A special feature of debt contracts in this environment is that they provide security holders with a foreclosure right: they allow a lender to seize a borrower's assets in case of default. This feature of debt contracts can mitigate the implications of borrowers' strategic incentives to underreport their asset value realizations.

**Existing debt obligations.** Capturing the central notion of a debt chain, the  $N$  agents are linked through existing debt obligations (e.g., personal or commercial loans, accounts payable to suppliers, rent payments due to landlords). In particular, at date  $t = 1$ , each agent  $j \geq 2$  owes agent  $(j - 1)$  a payment equal to  $\bar{d}_j$  that is due at date  $t = 2$ . We consider a setting where the initial face values  $\bar{d}_j$  were chosen at a prior date (e.g., at an unmodeled date  $t = 0$ ) based on the information available at that time. Our paper's focus on the renegotiation of existing contracts (rather than the process of establishing a liability initially) is motivated



by the relevance of such phenomena after an economy is hit by large negative shocks such as the current worldwide pandemic, which was essentially unanticipated prior to the end of 2019.<sup>6</sup> Yet, as noted above, the non-verifiability of asset values provides a rationale for the prevalence of debt contracts in our environment (see Bolton and Scharfstein 1990, Bolton and Scharfstein 1996, Hart and Moore 1998).

**Debt contract settlement and default costs.** If at date  $t = 2$ , an agent  $j$  defaults on the payment of its (potentially renegotiated) face value  $d_j$ , the lending agent  $(j - 1)$  aims to seize the remaining assets that agent  $j$  owns, which generally consist of the endowment asset worth  $v_j$  at  $t = 2$  and the funds agent  $j$  collects from agent  $(j + 1)$ . However, agent  $(j - 1)$  can collect only a fraction  $(1 - \rho) < 1$  of agent  $j$ 's assets, where the parameter  $\rho$  captures the deadweight losses associated with liquidation, the bankruptcy process, and the potential losses of customers, employees, and suppliers.<sup>7</sup> These deadweight losses are the key source of surplus losses in the model (see Section 5 for an alternative specification of default costs).

This specification of default costs implies that if two neighboring agents default, say agents 3 and 4, then agent 2 collects a fraction  $(1 - \rho)^2$  of agent 4's assets, that is, inefficiencies accumulate in the case of knock-on defaults. This effect captures the notion that directly connected agents tend to be closer in terms of their business operations and expertise (e.g., in the context of a supply chain) and a lender is likely to be more efficient in extracting value from a direct neighbor's assets in default. While we take agents' existing debt obligations as given in our analysis, this property of default costs provides a potential rationale for the initial formation of a debt chain (before date  $t = 1$ ) in a setting like ours: a lender has a competitive advantage in providing credit to a directly-connected agent, since it obtains higher recovery rates in default than other potential lenders would.

Debt contracts are settled at date  $t = 2$  starting with agent  $N$ 's liability, then agent  $(N - 1)$ 's liability, up until agent 2's liability that is owed to agent 1. This specification increases the tractability of our model by ensuring that each agent  $j$  observes the realized value of its debt claim to agent  $(j + 1)$  (i.e., the face value

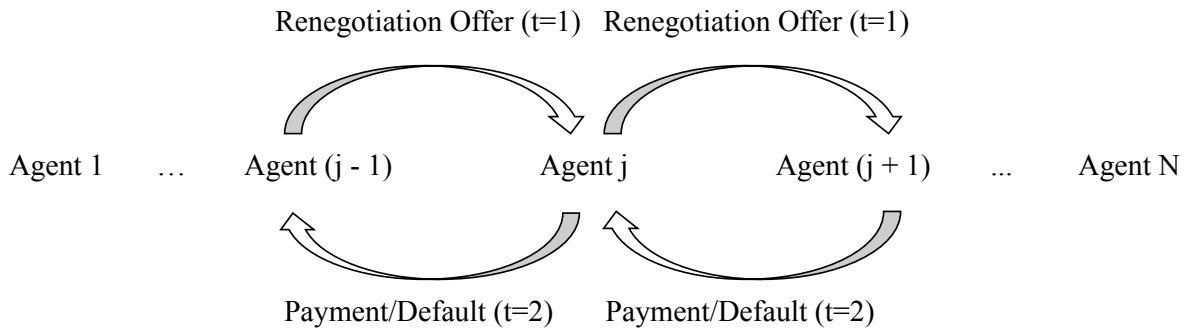
---

<sup>6</sup>For example, the commissioner of the National Basketball Association (which generates over \$8B of worldwide revenues per year) explained the need to renegotiate the league's collective bargaining agreement (CBA) with the players as: "*This CBA was not built for an extended pandemic (...) There's not a mechanism in it that works to properly set the cap when you've got so much uncertainty, when our revenue could be \$10 billion or it could be \$6 billion. Or less.*" Wojnarowski, Adrian. (October 15, 2020.) "Sources: NBA, NBPA extend negotiating window on CBA modifications to Oct. 30." ESPN. [https://www.espn.com/nba/story/\\_/id/30123004/nba-nbpa-extend-negotiating-window-cba-modifications-oct-30/](https://www.espn.com/nba/story/_/id/30123004/nba-nbpa-extend-negotiating-window-cba-modifications-oct-30/)

<sup>7</sup>Andrade and Kaplan (1998), Almeida and Philippon (2007), Korteweg (2010), Davydenko, Strebulaev, and Zhao (2012), Glover (2016), Greenwood, Iverson, and Thesmar (2020), and Dou et al. (2021) provide empirical evidence of the magnitudes of these costs.

payment or the recovery value) before deciding on whether to default itself on what it owes to agent  $(j - 1)$ .<sup>8</sup>

**Private information.** At date  $t = 1$ , each agent  $j$  obtains a private signal  $s_j \in \Omega_s$  that is informative about the future realization of the endowment asset value  $v_j$ . We denote by  $F_j(v_j|s_j)$  the conditional CDF of  $v_j$  as perceived by agent  $j$ . Introducing this private signal allows us to identify relevant differences in the implications that imperfect vs. private information have for the efficiency of the strategic renegotiation process. When dates  $t = 1$  (renegotiation) and  $t = 2$  (payment due date) are very close to each other, agent  $j$  is likely to have almost perfect information at date  $t = 1$  about its endowment asset value at date  $t = 2$ . In contrast, when renegotiation ( $t = 1$ ) occurs a long time before the actual payment is due ( $t = 2$ ), then, at date  $t = 1$ , agent  $j$  is likely to face significant uncertainty (imperfect information) about this value.



**Figure 1:** The figure illustrates a chain of renegotiation offers, payments, and default decisions.

**Renegotiation.** At date  $t = 1$ , agents can renegotiate their debt contracts. Specifically, agent  $(j - 1)$  chooses whether to make a concession to agent  $j$  by lowering the face value of the debt contract to  $d_j \leq \bar{d}_j$ . Formally, agent  $(j - 1)$  proposes the new face value with a take-it-or-leave-it offer to agent  $j$ . It is a dominant strategy for agent  $j$  to accept a new face value as long as it is weakly lower than the initial face value  $\bar{d}_j$ . However, at date  $t = 2$ , agent  $j$  will optimally use its limited liability and potentially default on this renegotiated face value. Renegotiation offers and outcomes are not publicly observable at date  $t = 1$ . Figure

<sup>8</sup>If contracts were settled in the reverse order, agents could not rely on payments from the debt claims they own to fulfill their financial obligations. In this case, a firm could consider issuing additional securities to bridge a temporary shortfall caused by the delayed settlement of the debt claim it owns. However, such issuance would generally involve a security design decision and associated signaling concerns, thereby complicating the model and obfuscating its main insights.

1 gives an overview of the setup by illustrating the chain of renegotiation offers, payments, and default decisions (see Section 5 for a discussion of renegotiation in alternative network structures).

As we show below, it is without loss of generality to focus on renegotiations that adjust existing debt contracts rather than introducing other types of securities, since debt securities are optimal in our environment. Moreover, while renegotiation in our model pertains to adjusting the face value of debt, considering other contractual features and renegotiation margins that also change the *present value* of payments promised by a borrower (e.g., payment delays or adjustments to coupon payments) would yield similar economic insights.

**Timeline.** To summarize, the timeline of the model is as follows.

- Date  $t = 1$ : Renegotiation
  - (i) Each agent  $j$  obtains a signal  $s_j$  that is informative about its future endowment asset value  $v_j$ .
  - (ii) Each agent  $j = 1, \dots, (N - 1)$  simultaneously makes a take-it-or-leave-it offer to its debtor ( $j + 1$ ), specifying a new face value  $d_{j+1}$ .
  - (iii) Each agent  $j = 2, \dots, N$  decides whether to accept the newly proposed face value.
- Date  $t = 2$ : Payment
  - (i) Each agent  $j$  observes its endowment asset value  $v_j$ .
  - (ii) Debt contracts are settled sequentially, starting with the contract owed by agent  $N$ , then the contract owed by agent  $(N - 1)$ , and so on.

### 3 Equilibrium Renegotiation and Default

In this section, we first establish the optimality of debt contracts in our environment and characterize agents' optimization problems as borrowers and lenders. Then, for our baseline analysis, we derive explicit conditions for default-free equilibrium outcomes in debt chains, considering both discrete and continuous distributions.

**Lemma 1.** *For any lender making a renegotiation offer it is optimal to propose a new debt contract with a face value  $d_j \leq \bar{d}_j$ .*

*Proof.* See the Appendix. □

Consistent with insights from the existing literature, debt is an optimal contract in our environment due to the non-verifiability of asset values and the foreclosure right that debt provides. Borrowers would like to report the lowest possible asset value realizations (which is the only verifiable component), unless they face a debt contract, in which case doing so can trigger default and the seizing of their assets. Anticipating this strategic behavior by borrowers, lenders find it optimal to propose a new debt contract when making a renegotiation offer.

### 3.1 Renegotiation and Equity Values

Our analysis primarily focuses on the conditions under which efficient renegotiation can occur, that is, the conditions under which default-free, subgame-perfect Nash equilibria (which are equivalent to Perfect Bayesian equilibria in our setting) exist.<sup>9</sup> This focus shares similarities with many papers in the economics and finance literature where commitment problems lead to endogenous no-default constraints (see, e.g., Kehoe and Levine 1993, Alvarez and Jermann 2000, Albuquerque and Hopenhayn 2004) and the large literature highlighting the special role of risk-free debt in financial markets (see, e.g., Diamond 1984, Gorton and Pennacchi 1990).

Importantly, the conditions we derive below emphasize each agent’s incentives to deviate to strategies that trigger defaults among debt-chain members and how to dampen these incentives. Apart from our interest in efficient renegotiation, this approach greatly improves the tractability of our analysis, which features  $(N - 1)$  rounds of strategic debt renegotiation with asymmetric information. Moreover, we show in Section 5 and in the Appendix that the main insights derived from this baseline analysis also apply when default occurs on the equilibrium path.

---

<sup>9</sup>Given this focus, our analysis does not investigate equilibrium multiplicity, but rather establishes necessary and sufficient conditions for the existence of equilibria where default does not occur on the equilibrium path. Consistent with many papers in the economics and finance literature we focus on equilibria that maximize total surplus (Grossman and Hart 1980, Albuquerque and Hopenhayn 2004, Acemoglu, Golosov, and Tsyvinski 2008, Aguiar, Amador, and Gopinath 2009). When it exists, a default-free equilibrium maximizes the social surplus in our environment. Moreover, for the distributional assumptions and parameterizations we consider as examples in the main text, such multiplicity does not exist. More generally, renegotiation complementarities could become particularly relevant in the presence of circular debt linkages (i.e., if agent 1 owed a payment to agent  $N$  and agent  $N$  would strategically renegotiate agent 1’s liabilities). Yet we intentionally consider a chain structure in our baseline model to account for typical asymmetries across agents in their upstream vs. downstream positions in credit relationships. In Section 5 we also discuss the robustness of our main insights to alternative network structures.

Agents' optimal renegotiation strategies are driven by equity-value maximization. Each agent's equity value depends on where this agent is located in the debt chain and on other agents' renegotiation strategies.

**Agent N.** Agent  $N$  is special in that it does not hold a claim against any other agent in the chain. At date  $t = 1$ , it is a dominant strategy for agent  $N$  to accept any renegotiation offer below the pre-existing face value,  $d_N < \bar{d}_N$ . At date  $t = 2$ , agent  $N$  knows the endowment asset value  $v_N$  and, using its limited liability, optimally pays the face value  $d_N$  as long as:

$$d_N \leq v_N. \quad (1)$$

Otherwise, agent  $N$  defaults.

**Agent ( $j - 1$ ).** In a default-free equilibrium, agent  $(j - 1) < (N - 1)$  can rationally anticipate that agent  $j$  will collect the anticipated equilibrium face value  $d_{j+1}$  from agent  $(j + 1)$ , which helps predict agent  $j$ 's wealth.<sup>10</sup> Given this, agent  $(j - 1)$  anticipates that agent  $j$  will not default on an offer  $d_j$  as long as:

$$d_j \leq v_j + d_{j+1}. \quad (2)$$

In the baseline setting of our model, borrowers' strategic default occurs exactly in those states where existing assets do not cover liabilities. In contrast, in Section 5 we consider an extension of our model with an alternative specification of default costs where "firm owners" may strategically inject additional funds to ensure firm survival.

For agent  $(j - 1)$ , proposing a new face value  $d_j$  is equivalent to choosing a *marginal debtor type*  $v_j^* = d_j - d_{j+1}$  that would be just indifferent between defaulting and not defaulting at date  $t = 2$ . All date-2 debtor types greater or equal to  $v_j^*$  will be *included* by this offer, in the sense that they will not default on the new face value. All debtor types below  $v_j^*$  will be *excluded* in the sense that they will default at date  $t = 2$ . Correspondingly, we can write agent  $(j - 1)$ 's optimization problem as choosing a marginal debtor type  $v_j^*$

---

<sup>10</sup>Agent  $(N - 1)$  differs from agents 1 to  $(N - 2)$  in that its debtor, agent  $N$ , does not have a debt claim to another agent's assets (or equivalently, we could assume that there was an agent  $(N + 1)$  but with  $\bar{d}_{N+1} = 0$ ).

to maximize its expected equity value given its signal  $s_{j-1}$ :

$$\begin{aligned} \Pi_{j-1}(v_j^*) &= \Pr[v_j < v_j^*] \cdot \mathbb{E}[\max(v_{j-1} + (1 - \rho)(v_j + d_{j+1}) - d_{j-1}, 0) \mid s_{j-1}, v_j < v_j^*] \\ &\quad + \Pr[v_j \geq v_j^*] \cdot \mathbb{E}[\max(v_{j-1} + v_j^* + d_{j+1} - d_{j-1}, 0) \mid s_{j-1}]. \end{aligned} \quad (3)$$

The equity value (3) shows that agent  $(j - 1)$ 's renegotiation offer will generally depend on the agent's private information about  $v_{j-1}$ , as represented by the signal  $s_{j-1}$ . The max operators in equation (3) reflect agent  $(j - 1)$ 's own limited liability: whenever the total payoff would be negative after paying off the debt, agent  $(j - 1)$  prefers to default and get a payoff of zero. The extent to which the agent anticipates using limited liability depends on its information about the future value of its endowment asset and on the expected renegotiation offer from agent  $(j - 2)$ .

**Agent 1.** The first agent in the chain is special in that it does not owe anything to another agent. We can again write this agent's expected equity value for a given signal  $s_1$  as a function of the marginal debtor type:

$$\Pi_1(v_2^*) = \mathbb{E}[v_1 \mid s_1] + \Pr[v_2 < v_2^*] \cdot (1 - \rho) (\mathbb{E}[v_2 \mid v_2 < v_2^*] + d_3) + \Pr[v_2 \geq v_2^*] \cdot (v_2^* + d_3). \quad (4)$$

### 3.2 Default-Free Renegotiation

To capture the prevalent view that default waves are undesirable outcomes, we have introduced deadweight losses that are realized in the event of bankruptcy.<sup>11</sup> For a default-free equilibrium to occur, all agents must find it optimal to renegotiate their debt contracts to levels that are guaranteed to be repaid by the borrowers at date  $t = 2$ . We denote this level of debt for borrower  $j$  by  $\underline{d}_j$ . Conditional on its information at  $t = 1$ , an agent  $j$ 's endowment asset delivers at least a value equal to  $\underline{v}_j$  at date  $t = 2$ . Moreover, in a *default-free* equilibrium, agent  $j$  also collects the renegotiated face value  $d_{j+1}$  from agent  $(j + 1)$  with probability 1. As a result, the *total* value of agent  $j$ 's assets at date  $t = 2$  is bounded from below by  $(\underline{v}_j + d_{j+1})$ . Note that

---

<sup>11</sup>Even when borrowers use their debt issuance proceeds to fund negative-NPV projects, renegotiating their liabilities at  $t = 1$  can be efficient, provided that their investment decisions were already made prior to  $t = 1$  and liquidation is not optimal at that point. Moreover, a default that appears to be efficient from a partial equilibrium perspective (i.e., for a given credit relationship) might, in bad economic times, trigger default waves elsewhere in the debt chain that are harmful to the whole economy. Overall, we view the deadweight losses from excessive defaults as a first-order concern after large economic shocks such as the COVID-19 pandemic (see, e.g., Becker and Oehmke 2021).

$\underline{d}_j$  is not per se the lowest possible value of an agent's total assets. Rather it is the lowest possible value conditional on its information at  $t = 1$  and on being in an equilibrium in which agents  $(j + 1)$  through  $N$  do not default, that is, the newly proposed face values are indeed collected with probability 1. In contrast, if a default did occur on the equilibrium path among agents  $(j + 1) \dots N$ , then agent  $j$  would possibly end up having less financial wealth than  $(v_j + d_{j+1})$ .

The new face values proposed by the lenders in a default-free equilibrium correspondingly satisfy the recursive relation:

$$\underline{d}_j \equiv v_j + d_{j+1}, \quad (5)$$

provided that the initial face value  $\bar{d}_j$  exceeds this value, that is,  $\bar{d}_j \geq \underline{d}_j$ . Otherwise, the face value remains at its initial level. Moreover, if  $\bar{d}_j \geq \underline{d}_j$  for all  $j$ , the recursive relation (5) yields the explicit formulae:

$$\underline{d}_j = \sum_{i=j}^N v_i. \quad (6)$$

Whereas equation (6) indicates that the default-free renegotiated face values represent the accumulated lower bounds of the endowment asset values, higher renegotiated face values would apply if we introduced additional default costs that are internalized by the debtors, such as for example, a reputation cost from defaulting (see Section 5 for details). Moreover, it is important to note that conceptually, the endowment assets in our setup represent firms' tangible and intangible assets gross of any liabilities that a firm might have to suppliers, customers, debt holders, or landlords, etc. Whereas equity values can naturally turn zero in our model and in practice, this is not the case for asset values: empirically, despite the presence of bankruptcy costs, the combined recovery value for all agents holding the liabilities of a defaulting firm is virtually always positive (see, e.g., Dou et al. 2021, who estimate both the potential liquidation proceeds and the reorganization values of a large sample of U.S. bankrupt firms).

### 3.3 The Case with Binomially Distributed Asset Values

To illustrate our main insights, we first consider the case in which each agent's endowment asset value is binomially distributed. Specifically, each agent  $j$  owns an asset that might either be worth  $\underline{v}_j$  or  $\bar{v}_j$  at date

$t = 2$ , where  $\underline{v}_j < \bar{v}_j$ . Furthermore, to make every negotiation decision non-trivial, we consider the case where  $\bar{d}_j > \underline{v}_j + \underline{d}_{j+1} = \underline{d}_j$  for each agent  $j$ , that is, all initial face values are greater than their default-free counterparts (relaxing this assumption would simply add credit relationships that do not need to be renegotiated). We also assume that  $\bar{d}_j < \bar{v}_j + \underline{d}_{j+1}$  so that no agent  $j$  defaults with probability 1 if its debt is not renegotiated down. We now state our first main result.

**Proposition 1.** *In the case of binomially distributed asset values, private renegotiation leads to a default-free debt chain on the equilibrium path whenever the following conditions hold:*

$$\frac{1 - F_2(\underline{v}_2)}{F_2(\underline{v}_2)} (\bar{d}_2 - \underline{d}_2) \leq \rho \cdot \underline{d}_2, \quad (7)$$

and for  $j = 3, \dots, N$ :

$$\frac{1 - F_j(\underline{v}_j)}{F_j(\underline{v}_j)} (\bar{d}_j - \underline{d}_j) \leq \mathbb{E}[\min(\rho \cdot \underline{d}_j, v_{j-1} - \underline{v}_{j-1}) \mid s_{j-1}] \quad \forall s_{j-1} \in \Omega_s. \quad (8)$$

In what follows, we prove the results of Proposition 1 and discuss them in detail.

**Agent ( $j - 1$ ).** In a default-free equilibrium, agent ( $j - 1$ ) expects that the debt of any agent  $k \neq j$  will be renegotiated to  $\underline{d}_k = \sum_{i=k}^N \underline{v}_i$ . Thus, agent ( $j - 1$ ) faces the following renegotiation choices. First, agent ( $j - 1$ ) can keep agent  $j$ 's debt at the initial level  $\bar{d}_j$ . Agent  $j$  then makes the promised debt payment at date  $t = 2$  when its type is  $v_j = \bar{v}_j$  (recall that  $\bar{d}_j < \bar{v}_j + \underline{d}_{j+1}$ ), but defaults when it is  $v_j = \underline{v}_j$  (recall that  $\bar{d}_j > \underline{v}_j + \underline{d}_{j+1} = \underline{d}_j$ ). That is, the marginal included type is  $\bar{v}_j$ ; the low type  $\underline{v}_j$  is excluded. Given this strategy, agent ( $j - 1$ )'s equity value at  $t = 1$  is:

$$\begin{aligned} \Pi_{j-1}(\bar{v}_j) &= F_j(\underline{v}_j) \cdot \mathbb{E}[\max(v_{j-1} + (1 - \rho)(\underline{v}_j + \underline{d}_{j+1}) - \underline{d}_{j-1}, 0) \mid s_{j-1}] \\ &\quad + (1 - F_j(\underline{v}_j)) \cdot (\mathbb{E}[v_{j-1} \mid s_{j-1}] + \bar{d}_j - \underline{d}_{j-1}). \end{aligned} \quad (9)$$



Alternatively, agent  $(j - 1)$  can renegotiate agent  $j$ 's liabilities to a default-free level  $\underline{d}_j$ , in which case the marginal included type is  $\underline{v}_j$ . Agent  $(j - 1)$  then collects:

$$\begin{aligned}\Pi_{j-1}(\underline{v}_j) &= \mathbb{E} [\max(v_{j-1} + \underline{d}_j - \underline{d}_{j-1}, 0) \mid s_{j-1}] \\ &= \mathbb{E}[v_{j-1} \mid s_{j-1}] - \underline{v}_{j-1}.\end{aligned}\tag{10}$$

Correspondingly, efficient renegotiation to the default-free level is privately optimal for agent  $(j - 1)$  whenever  $\Pi_{j-1}(\underline{v}_j) \geq \Pi_{j-1}(\bar{v}_j)$  for all possible signal realizations  $s_{j-1}$ . This condition for the private optimality of efficient renegotiation simplifies to inequality (8) in Proposition 1.

One can think of the left-hand side of condition (8) as the benefit of following a tough renegotiation strategy and the right-hand side as its cost. When the benefit is lower than the cost (i.e., when condition (8) holds), agent  $(j - 1)$  is lenient, ensuring that agent  $j$  does not default. The left-hand side of condition (8) shows that the benefit of following a tough renegotiation strategy is higher when the initial face value  $\bar{d}_j$  is large relative to the level that would be required to avoid default,  $\underline{d}_j$ . Moreover, the benefit of this strategy is affected by the relative odds of facing a high vs. low borrower type, as represented by the odds ratio  $\frac{1-F_j(\underline{v}_j)}{F_j(\underline{v}_j)}$ .

On the other hand, the cost of following a tough renegotiation strategy, as represented by the right-hand side of condition (8), is affected by two channels. First, default costs are incurred through a tough renegotiation strategy. If agent  $j$  is the low type, it has assets worth  $\underline{d}_j$ . Under a tough renegotiation strategy, this low type defaults, leading to default costs  $\rho \cdot \underline{d}_j$ . If agent  $(j - 1)$  did not have any liabilities, it would fully internalize those losses. However, when a lender is indebted, a second channel applies: in this case, the lender internalizes losses only to the extent that it has sufficient equity value to absorb them. The condition for a default-free equilibrium thus reveals that knock-on defaults (i.e., when at least two directly connected agents default) in a debt chain limit the extent to which agents internalize the inefficiencies caused by their own tough renegotiation stances. In a default-free equilibrium, agent  $(j - 1)$ 's equity value at  $t = 2$  is given by  $(v_{j-1} - \underline{v}_{j-1})$ . As such, in each state of the world at  $t = 2$ , agent  $(j - 1)$  at the margin internalizes at most the minimum of the default costs and its equity value (absent default), as indicated by the min operator in condition (8). The possibility of a positive equity value for agent  $(j - 1)$  stems from an information rent. In a default-free equilibrium, agent  $(j - 1)$ 's lender, agent  $(j - 2)$ , chooses a new face value that allows agent

$(j - 1)$  to avoid default even if it is the lowest type  $\underline{v}_{j-1}$ . Agent  $(j - 2)$  optimally makes that choice given the limited information it has about agent  $(j - 1)$ 's asset values and given that agent  $(j - 1)$  also makes a renegotiation offer to agent  $j$  at a time when it has imperfect information about its own future asset value  $v_{j-1}$ . As a result, when agent  $(j - 1)$ 's actual type exceeds this lowest type, the equity value at date  $t = 2$  is strictly positive. A higher equity value and the associated skin-in-the-game, in turn, discourage agent  $(j - 1)$  from choosing a tough renegotiation strategy for its own borrower, agent  $j$ .

**Discussion: The role of private information and the timing of renegotiations.** The magnitude of this skin-in-the-game effect depends on the private signal  $s_{j-1}$  that agent  $(j - 1)$  obtains at date  $t = 1$ . The worse the signal, the less likely it is that agent  $(j - 1)$  will have an asset worth more than the lower bound  $\underline{v}_{j-1}$  at date  $t = 2$ . Thus, agent  $(j - 1)$  is less willing to renegotiate down its borrower's liabilities after receiving a bad interim signal about the value of its own endowment asset. In fact, if agent  $(j - 1)$  is perfectly informed about  $v_{j-1}$  and observes a bad asset value realization  $v_{j-1} = \underline{v}_{j-1}$ , the right-hand side of condition (8) takes the value zero. Given our initial assumption that all contracts need to be renegotiated to ensure a default-free equilibrium,  $\bar{d}_j > \underline{d}_j = \sum_{i=j}^N \underline{v}_i$ , condition (8) then cannot be satisfied. If, at the renegotiation stage, agent  $(j - 1)$  already observes that its asset value is  $\underline{v}_{j-1}$ , the agent knows that a default-free renegotiation strategy will generate zero equity value. Thus, the agent is better off taking a harder stance by keeping agent  $j$ 's debt at its initial level  $\bar{d}_j$ . This optimal response to a bad signal implies that an equilibrium without default risk does not exist if the signals agents obtain are perfectly informative (that is, if agent  $j$  observes  $v_j$  already at  $t = 1$ ).

An immediate implication of this channel is that the timing of the arrival of private information, relative to the renegotiation process, is an important determinant of default risk in a debt chain. If the timing of renegotiation ( $t = 1$ ) is such that agents still learn a substantial amount of information about their asset values after the renegotiation, the information rent entering condition (8) is larger, facilitating efficient renegotiation. In practice, agents are likely to learn more after the renegotiation process if the renegotiation takes place early, relative to the actual payment date. As a result, *early* renegotiation after a large shock tends to facilitate lenient private renegotiation throughout a debt chain. We investigate this issue in more detail in Section 4.

**Agent 1.** As stated above, agent 1's decision to renegotiate with agent 2 is different due to the fact that agent 1 does not owe liabilities to another agent. In a default-free equilibrium, if agent 1 keeps agent 2's face value at its initial level  $\bar{d}_2$ , agent 1 can expect to collect:

$$\Pi_1(\bar{v}_2) = \mathbb{E}[v_1 | s_1] + F_2(v_2)(1 - \rho)(v_2 + \underline{d}_3) + (1 - F_2(v_2))\bar{d}_2. \quad (11)$$

If, on the other hand, agent 1 renegotiates agent 2's debt to its default-free level  $\underline{d}_2$ , agent 1 can expect to collect:

$$\Pi_1(v_2) = \mathbb{E}[v_1 | s_1] + \underline{d}_2. \quad (12)$$

The condition for the optimality of agent 1's efficient renegotiation simplifies to inequality (7) in Proposition 1. Agent 1 fully internalizes the default costs that are triggered when a low agent-2 type defaults, because agent 1 does not have any lenders that would potentially participate in absorbing these losses.

**Discussion: The role of lender indebtedness.** An important feature of our analysis is the fact that lenders are generally indebted themselves. We now analyze how being indebted reduces lenders' incentives to renegotiate with their own borrowers.

In our baseline setting, agent 1 is by definition the first chain member and thus, solely a lender. Without any liabilities, agent 1 is willing to renegotiate with agent 2 if and only if condition (7) is satisfied. Suppose instead that agent 1 owed  $\bar{d}_1$  to a fictional agent 0. Using the derivations above, we know that, as part of a default-free equilibrium, agent 1 would then be willing to renegotiate with agent 2 if and only if:

$$\frac{1 - F_2(v_2)}{F_2(v_2)}(\bar{d}_2 - \underline{d}_2) \leq \mathbb{E}[\min(\rho \cdot \underline{d}_2, v_1 - v_1) | s_1]. \quad (13)$$

This condition is more restrictive than the one derived in our original environment for a given signal  $s_1$  whenever:

$$\mathbb{E}[\min(\rho \cdot \underline{d}_2, v_1 - v_1) | s_1] \leq \rho \cdot \underline{d}_2. \quad (14)$$

This inequality is guaranteed to be weakly satisfied and is strictly satisfied if default costs are large and the

signal agent 1 receives is bad enough (i.e.,  $v_1 - v_1 < \rho \cdot \underline{d}_2$  with positive probability).

When owing debt to another agent, a lender internalizes in expectation only a fraction of the deadweight costs of default. Thus, agent  $j$  has lower incentives to renegotiate down the debt of agent  $(j+1)$  if agent  $j$  is also indebted. Importantly, agent  $(j-1)$ 's bargaining power generally leads to higher liabilities for agent  $j$ , rendering this channel more severe. Agent  $(j-1)$  is expected to use its bargaining power to extract any safe gains that agent  $j$  might secure when renegotiating with agent  $(j+1)$ . Thus, agent  $j$  has stronger incentives to take risks by opting for a tougher renegotiation stance with agent  $(j+1)$ .

**Numerical example.** We now illustrate the intuition behind our first results with a numerical example of a chain with  $N = 3$  agents. Agent 3 owes  $\bar{d}_3 = \$125K$  to agent 2 who owes  $\bar{d}_2 = \$325K$  to agent 1. Each agent  $j$  has an endowment asset that is equally likely to take the values  $\underline{v}_j = \$100K$  or  $\bar{v}_j = \$250K$ . We set  $\rho = 0.6$ , that is, only 40% of the borrower's asset value can be recovered in case of default.

In this scenario, agent 2 can choose between keeping agent 3's debt at its existing level  $\bar{d}_3 = \$125K$  or renegotiating it to its default-free level  $\underline{d}_3 = \underline{v}_3 = \$100K$ . Now, suppose that before renegotiating with agent 3, agent 2 receives a signal  $s_2$  that either updates the probability of its own endowment asset value being high to 0.75 (i.e., the good signal) or to 0.25 (i.e., the bad signal). If agent 2 expects agent 1 to renegotiate its debt to  $\underline{d}_2 = \underline{v}_2 + \underline{v}_3 = \$200K$ , agent 2 is unwilling to renegotiate agent 3's debt to  $\underline{d}_3 = \$100K$  after the bad signal realization. Agent 2 prefers to keep asking agent 3 for  $\$125K$ , despite the 50% probability of default, than renegotiating agent 3's debt to its default-free level of  $\$100K$ . Formally, condition (8) is violated when agent 2 receives the bad signal:

$$\begin{aligned} \frac{1 - F_3(\underline{v}_3)}{F_3(\underline{v}_3)} (\bar{d}_3 - \underline{d}_3) &= \left( \frac{1 - 0.5}{0.5} \right) (\$125K - \$100K) = \$25K \\ &> \mathbb{E}[\min(\rho \cdot \underline{d}_3, v_2 - v_2) \mid s_2] = 0.25 \cdot 0.6 \cdot \$100K + 0.75 \cdot \$0 = \$15K. \end{aligned} \quad (15)$$

Moreover, even if agent 1 expects agent 2 to renegotiate down agent 3's debt (which will not happen in equilibrium), agent 1 is unwilling to renegotiate agent 2's debt from its existing level  $\bar{d}_2 = \$325K$  to its

default-free level  $\underline{d}_2 = v_2 + v_3 = \$200K$ . Formally, condition (7) is violated:

$$\begin{aligned} \frac{1 - F_2(v_2)}{F_2(v_2)} (\bar{d}_2 - \underline{d}_2) &= \left( \frac{1 - 0.5}{0.5} \right) (\$325K - \$200K) = \$125K \\ &> \rho \cdot \underline{d}_2 = 0.6 \cdot \$200K = \$120K. \end{aligned} \tag{16}$$

Thus, absent outside interventions, no lender is willing to renegotiate its borrower's debt to an efficient, default-free level in this example (even if it expects that the other lender would do so). We will revisit this example below when we analyze the impact of prevalent types of government interventions.

### 3.4 The Case with Continuously Distributed Asset Values

While the binomial case above illustrates intuitively many of our main insights, our results are by no means specific to this distributional assumption. In this section, we investigate the case with continuously distributed asset values. Specifically, the distribution of each asset value  $v_j$  has a density function  $f_j(v_j)$ , which takes strictly positive and finite values everywhere on the support  $v_j \in [\underline{v}_j, \bar{v}_j]$ . Unlike in the binomial setting where a lender's renegotiation decision effectively involves choosing either  $\bar{d}_j$  or  $\underline{d}_j = v_j + \underline{d}_{j+1}$  as the face value, the continuous setting enriches the renegotiation stage in that the lender optimally chooses from a larger relevant set of marginal borrower types  $v_j^* \in [\underline{v}_j, \bar{v}_j]$  and corresponding face values  $d_j = v_j^* + \underline{d}_{j+1}$ .

For tractability, we impose a standard regularity condition that the hazard rate  $\frac{f_j(v_j)}{1 - F_j(v_j)}$  is increasing on the support  $[\underline{v}_j, \bar{v}_j]$ . This condition ensures that (local) first-order conditions are sufficient for global optimality. Moreover, agent  $j$  obtains a signal  $s_j \in \Omega_s = [\underline{s}_j, \bar{s}_j]$  at date  $t = 1$  that implies that the conditional density of the value of its endowment asset at date  $t = 2$  is given by  $f_j(v_j | s_j)$ . We assume that this conditional density takes finite values everywhere on the support  $[\underline{v}_j, \bar{v}_j]$  for all possible signal realizations  $s_j \in \Omega_s$ . Further, let  $f_j(v_j, s_j)$  denote the joint density of  $v_j$  and  $s_j$ .

**Proposition 2.** *In the case of continuously distributed asset values, private renegotiation leads to a default-free debt chain on the equilibrium path whenever the following conditions hold:*

$$\frac{1 - F_2(v_2)}{f_2(v_2)} \leq \rho \cdot \underline{d}_2, \tag{17}$$

and for  $j = 3, \dots, N$ :

$$\frac{1 - F_j(\underline{v}_j)}{f_j(\underline{v}_j)} \leq \mathbb{E}[\min(\rho \cdot \underline{d}_j, v_{j-1} - \underline{v}_{j-1}) \mid s_{j-1}] \quad \forall s_{j-1} \in \Omega_s. \quad (18)$$

Again, we prove and discuss the results of the proposition in the main text.

**Agent (j-1).** If agent  $(j-1)$  expects the debt of any agent  $k \neq j$  to be renegotiated to  $\underline{d}_k$ , its marginal benefit of increasing the marginal debtor type  $v_j^*$  is given by (see the Appendix for the derivation of this expression):

$$\begin{aligned} \Pi'_{j-1}(v_j^*) &= f_j(v_j^*) \cdot \mathbb{E}[\max(v_{j-1} + (1 - \rho)(v_j^* + \underline{d}_{j+1}) - \underline{d}_{j-1}, 0) \mid s_{j-1}] \\ &\quad - f_j(v_j^*) \cdot \mathbb{E}[\max(v_{j-1} + v_j^* + \underline{d}_{j+1} - \underline{d}_{j-1}, 0) \mid s_{j-1}] \\ &\quad + (1 - F_j(v_j^*)) \Pr[v_{j-1} \geq \underline{d}_{j-1} - \underline{d}_{j+1} - v_j^* \mid s_{j-1}]. \end{aligned} \quad (19)$$

The necessary and sufficient condition for an equilibrium in which agent  $(j-1)$  chooses a face value that ensures that agent  $j$  does not default is:

$$\Pi'_{j-1}(\underline{v}_j) \leq 0, \quad (20)$$

that is,  $v_j^* = \underline{v}_j$  is the optimal choice for agent  $(j-1)$ . A default-free equilibrium requires this condition to hold for all possible signal realizations  $s_{j-1} \in \Omega_s$  that agent  $(j-1)$  might observe. Plugging in the relation for default-free debt levels derived in Section 3, we obtain condition (18) in Proposition 2 (see the Appendix for details).

This condition is similar to the one we obtain in the case of binomially distributed asset values (see condition (8)). In particular, the right-hand sides of the two conditions (8) and (18) are identical. Moreover, the left-hand side of condition (18) is the continuous analogue of the corresponding terms in condition (8). While the lender considers a discrete deviation from  $\underline{d}_j$  to  $\bar{d}_j$  in the binomial setting, condition (18) now focuses on a marginal increase from  $\underline{d}_j$ . As a result, the initial face value  $\bar{d}_j$  does not explicitly enter the condition for a default-free equilibrium in the case of continuously distributed asset values.

**Agent 1.** As explained previously, agent 1’s decision to renegotiate with agent 2 is special since agent 1 does not owe debt to another agent. With continuously distributed asset values, the condition for the optimality of agent 1’s efficient renegotiation simplifies to inequality (17) in Proposition 2.

## 4 Policies Supporting Efficient Renegotiation

In this section, we analyze and compare how prevalent types of government interventions affect renegotiation outcomes in debt chains. Specifically, we consider two types of interventions that aim to reduce the shortfall between a targeted borrower’s assets and liabilities: government subsidies and mandated debt reductions. We also show that policies that incentivize early renegotiation may reduce the negative impact of private information on efficient renegotiation (i.e., private renegotiation that avoids costly default on the equilibrium path).

In practice, subsidies and mandated debt reductions are policy tools associated with significant costs and constraints (e.g., budget constraints, taxation costs, moral hazard, and reputational concerns). Absent such costs and constraints, preventing default would be straightforward to achieve: the government could either mandate that all debt contracts are nullified, or provide abundant subsidies that ensure that all borrowers can fulfill their financial obligations. However, recognizing the presence of significant costs and constraints related to a large-scale implementation of these policies in practice, we analyze the effectiveness of *minimal* targeted interventions in eliminating inefficient default waves. We highlight the endogenous responses by all debt-chain members to policies that only target a subset of agents. The tractability of our model allows our analysis of these government interventions to center around corollaries to Propositions 1 and 2.

### 4.1 Subsidies

We now characterize how providing a subsidy to a borrower does not only improve the recipient’s ability to make its payments, but also incentivizes upstream lenders to renegotiate the debt that is owed to them to default-free levels.<sup>12</sup> Thus, a subsidy provided to downstream borrowers can have a large effect in a debt chain due to the interconnectedness of renegotiations.

---

<sup>12</sup>Several policy proposals that circulated at the onset of the COVID-19 crisis suggested awarding grants and subsidies to struggling businesses. See, for example, Hanson et al. (2020), Hubbard and Strain (2020), and Saez and Zucman (2020).

For ease of exposition we focus in the following corollary on the case of continuously distributed asset values. Thereafter, we provide a numerical example with binomial distributions to further illustrate the effects of government subsidies.

**Corollary 1.** *Let  $\Psi$  denote the set of joint distribution functions  $f_j(v_j, s_j)$  for  $j = 1, \dots, N$  associated with efficient renegotiation in a debt chain of  $N$  agents for a given value of  $\rho$  and absent government interventions. Further, let  $\Psi^{g_k}$  denote the corresponding set if the government provides a subsidy  $g_k = g > 0$  to agent  $k$ . Suppose that  $g < \bar{d}_j - \underline{d}_j$  for all  $j$ . Providing the subsidy to agent  $k = N$  is most effective in expanding the set of default-free debt chains, that is,  $\Psi^{g_k=g} \subset \Psi^{g_N=g}$  for any  $k < N$ .*

*Proof.* First, note that providing a subsidy to agent 1 has no effect on renegotiation outcomes. Next, suppose the government provides a subsidy  $g_k = g$  to an agent  $k \geq 2$ . Agent  $k$  then effectively obtains an endowment cash flow of  $(v_k + g)$  instead of  $v_k$  absent subsidies and we can adjust the efficient-renegotiation conditions provided in Proposition 2 as follows:

$$\frac{1 - F_2(\underline{v}_j)}{f_2(\underline{v}_j)} \leq \rho \cdot (g + \underline{d}_j), \quad (21)$$

$$\frac{1 - F_j(\underline{v}_j)}{f_j(\underline{v}_j)} \leq \mathbb{E}[\min(\rho \cdot (g + \underline{d}_j), v_{j-1} - \underline{v}_{j-1}) \mid s_{j-1}] \text{ for } j = 3, \dots, k \text{ and } \forall s_{j-1} \in \Omega_s, \quad (22)$$

$$\frac{1 - F_j(\underline{v}_j)}{f_j(\underline{v}_j)} \leq \mathbb{E}[\min(\rho \cdot \underline{d}_j, v_{j-1} - \underline{v}_{j-1}) \mid s_{j-1}] \text{ for } j = (k + 1), \dots, N \text{ and } \forall s_{j-1} \in \Omega_s. \quad (23)$$

The conditions (21) and (22) are relaxed by the subsidy term  $g$ , whereas the conditions (23) are not. Moreover, no matter which agent  $k \geq 2$  receives the subsidy  $g$ , a marginal increase in this subsidy leads to a positive change equal to  $\rho$  in the right-hand side of condition (21). Similarly, no matter which agent  $k \geq 3$  receives the subsidy  $g$ , a marginal increase in the subsidy leads to the following positive change in the right-hand side of condition (22):

$$\rho \cdot \Pr[\rho \cdot (g + \underline{d}_j) < v_{j-1} - \underline{v}_{j-1} \mid s_{j-1}]. \quad (24)$$

The condition that  $g < \bar{d}_j - \underline{d}_j$  for all  $j$  implies that absent private renegotiation, credit relationships would exhibit a non-zero probability of default even in the presence of the government subsidy. However, we show that the pass-through of resources in a debt chain implies that a subsidy provided to agent  $k$  affects the



efficient renegotiation condition for agent  $(k - 2)$  in just the same way that a subsidy to the direct borrower  $(k - 1)$  would. Yet by providing the subsidy to agent  $k = N$ , all conditions are relaxed by the maximum amount attainable with a given subsidy, providing the maximum expansion of the default-free set  $\Psi$ .  $\square$

Our model reveals that providing subsidies does not just mechanically avoid insolvency but also facilitates efficient private *renegotiation* of upstream lenders, without affecting downstream borrowers. Awarding a subsidy to a downstream borrower expands the set of chains that become default-free more than awarding the same subsidy to an upstream borrower, provided that, absent private renegotiations, all credit relationships would exhibit a non-zero probability of default.<sup>13</sup> If the value of the last borrower's assets increases due to the collection of a subsidy (or even just the anticipation of a future subsidy payment), the lender realizes that there is a greater downside from pushing that borrower into default.<sup>14</sup> Moreover, since there is pass-through of resources in a debt chain, every other upstream lender also recognizes that its respective borrower has more value conditional on surviving, thereby providing heightened incentives for lenient private renegotiation throughout the whole chain.

Further, the optimal renegotiation channel featured in our model highlights that government subsidies can prevent default even when the amount injected is not large enough to make up for a borrower's maximum possible shortfall. The reason for this is that the lender might optimally respond to the associated change in the distribution of this shortfall by more efficiently renegotiating agent  $j$ 's liabilities. In the following, we investigate the forces determining how potent a given subsidy can be in averting default waves.

**Discussion: Multiplier effects of subsidies in the presence of renegotiation.** Consider the impact that a subsidy has for the first borrower, agent 2, in the case where all other downstream lending relationships are already efficiently renegotiated in equilibrium. Absent renegotiation between agents 1 and 2, the maximum shortfall that agent 2 may experience is then equal to  $\bar{d}_2 - \underline{d}_2$ . To ensure that agent 2 does not default in equilibrium, the government does not necessarily have to provide a subsidy equal to that maximum shortfall.

---

<sup>13</sup>Otherwise, the positive spill-over effects on upstream renegotiations would only extend to the set of sequentially connected agents that are not unambiguously solvent under the original debt contract.

<sup>14</sup>If the subsidy were expected to be paid by the government after date  $t = 2$ , the lender would in fact realize that pushing the borrower under water would potentially eliminate this whole asset from the borrower's balance sheet (rather than just eliminating a fraction  $\rho$  of it). Anticipating the subsidy, a borrower's equity holders would optimally inject additional funds at date  $t = 2$  to keep the firm afloat only if the firm's asset value including the anticipated subsidy exceeds the renegotiated debt value.

Rather, it suffices to provide a subsidy in the amount of:

$$g_{min} = \min \left( \frac{1}{\rho \cdot f_2(v_2)} - \underline{d}_2, \bar{d}_2 - \underline{d}_2 \right), \quad (25)$$

which accounts for the fact that it may be sufficient to have the efficient renegotiation condition (21) holds with equality. The ratio of the minimum subsidy to the maximum shortfall, that is:

$$\frac{\text{Minimum subsidy required to rule out default}}{\text{Maximum shortfall absent renegotiation}} = \min \left[ \frac{\frac{1}{\rho \cdot f_2(v_2)} - \underline{d}_2}{\bar{d}_2 - \underline{d}_2}, 1 \right], \quad (26)$$

highlights that subsidies are particularly effective in the presence of private renegotiation when agent 2 is more likely to obtain a low cash-flow realization (a high value of  $f_2(v_2)$ ) and default is particularly inefficient (a high value of  $\rho$ ). In those cases, the government has to provide a smaller subsidy to rule out default, once the endogenous private renegotiation decisions are taken into account.

While an equivalent closed-form expression is not available for the renegotiation decisions involving agents  $j \geq 3$ , we can define  $g_{min}$  in those cases as follows:

$$g_{min} = \min \{ g \geq 0 : 1/f_j(v_j) \leq \mathbb{E}[\min(\rho \cdot (g + \underline{d}_j), v_{j-1} - \underline{v}_{j-1}) \mid s_{j-1}] \forall s_{j-1} \in \Omega_s, \\ \text{or } g \geq \bar{d}_j - \underline{d}_j \}. \quad (27)$$

An increase in  $g$  is then less effective in relaxing the efficient renegotiation constraints associated with downstream lenders (relative to those pertaining to agent 1), since those agents' existing debt and associated limited liability reduce the extent to which they internalize inefficiencies. Moreover, ceteris paribus (assuming identical  $f_j(\cdot)$  functions for all agents), downstream constraints are more binding since downstream borrowers collect less (i.e.,  $\underline{d}_{j+1} < \underline{d}_j$ ). Thus, in that case, the downstream constraints are more likely to be binding and require the highest subsidy values to ensure a default-free debt chain.

The following numerical example illustrates the effects of subsidies on private renegotiations in the case of binomially distributed asset values, highlighting the difference between maximum shortfalls and the minimum subsidies that are required to avoid default in a debt chain.

**Numerical example.** Consider a government intervention where the government awards a subsidy  $g_3 = \$20K$  to agent 3 to help meet its financial obligations. Note that when agent 3's asset value is low (i.e., when  $v_3 = \$100K$ ) the subsidy  $g_3 = \$20K$  is insufficient to allow agent 3 to make its debt payment  $\bar{d}_3 = \$125K$ . However, in that case, agent 2's efficient-renegotiation condition after observing the bad signal  $s_2$  is satisfied:

$$\begin{aligned} & \frac{1 - F_3(v_3)}{F_3(v_3)} (\bar{d}_3 - (v_3 + g_3)) = \left( \frac{1 - 0.5}{0.5} \right) (\$125K - (\$100K + \$20K)) = \$5K \\ & \leq \mathbb{E}[\min(\rho(v_3 + g_3), v_2 - v_2) \mid s_2] = 0.25 \cdot 0.6 \cdot \$120K + 0.75 \cdot \$0 = \$18K. \end{aligned} \quad (28)$$

Agent 2 is then willing to renegotiate agent 3's debt to a new default-free level  $\underline{d}_3 = v_3 + g_3 = \$120K$ . Moreover, agent 1 is also willing to renegotiate agent 2's debt since its efficient-renegotiation condition is satisfied:

$$\begin{aligned} & \frac{1 - F_2(v_2)}{F_2(v_2)} (\bar{d}_2 - (v_2 + v_3 + g_3)) = \left( \frac{1 - 0.5}{0.5} \right) (\$325K - \$220K) = \$105K \\ & \leq \rho \cdot (v_2 + v_3 + g_3) = 0.6 \cdot \$220K = \$132K. \end{aligned} \quad (29)$$

Overall, while a subsidy of  $\$20K$  is not enough to enable agent 3 to pay its existing liabilities of  $\$125K$  with probability 1, it is enough to incentivize agent 2 to renegotiate agent 3's debt from  $\bar{d}_3 = \$125K$  to its new default-free level  $\underline{d}_3 = v_3 + g_3 = \$120K$ . And while the subsidy is far from covering agent 2's shortfall of  $\bar{d}_2 - v_2 - v_3 = \$125K$  when both asset values happen to be  $v_j = \$100K$ , it is enough to convince agent 1 to renegotiate agent 2's debt from  $\bar{d}_2 = \$325K$  to its new default-free level  $\underline{d}_2 = v_2 + v_3 + g_3 = \$220K$ . In both renegotiation decisions, the default-free debt level (i.e., the minimal value of the borrower's assets) is increased by the subsidy, which contributes to making efficient debt renegotiation more attractive to the lender. This example therefore highlights that relatively small subsidies to downstream agents can incentivize upstream lenders to renegotiate down their borrowers' liabilities to prevent default.

In the Appendix, we show through a different numerical example that a subsidy that is insufficient to completely eliminate the possibility of default throughout the chain can still incentivize upstream agents to be more lenient when renegotiating with their own borrowers, consistent with the insights above. This example also shows how default risk impairs the pass-through of downstream resources to upstream agents,

relative to the case with no default.

## 4.2 Mandated Debt Reductions

We now turn our attention to how government interventions that target the private bargaining process can be effective in preventing default waves. We show how eliminating a lender's bargaining power by mandating a debt reduction can incentivize downstream lenders to renegotiate the liabilities owed to them to default-free levels. As observed above, the fact that agents  $j > 1$  owe debt to lenders with bargaining power weakens their incentives to efficiently renegotiate down the debt of their downstream borrowers. As a result, if the government were to forgive or reduce part of the debt an agent owes, it would relax this agent's efficient-renegotiation conditions with downstream borrowers.

Formally, suppose that after a mandated debt reduction, agent  $(j - 1)$  owes a face value  $\hat{d}_{j-1}$  that can be fully repaid even after efficiently renegotiating agent  $j$ 's debt, that is:

$$\hat{d}_{j-1} \leq v_{j-1} + \underline{d}_j. \quad (30)$$

We obtain the following corollary revealing how the efficient-renegotiation conditions depend on  $\hat{d}_{j-1}$ .

**Corollary 2.** *When expecting efficient renegotiation by downstream lenders (i.e.,  $d_i = \underline{d}_i$  for all  $i > j$ ), agent  $(j - 1)$  optimally renegotiates down agent  $j$ 's debt in the binomial case if:*

$$\frac{1 - F_j(v_j)}{F_j(v_j)} \left( \bar{d}_j - \sum_{i=j}^N v_i \right) \leq \mathbb{E} \left[ \min \left( \rho \cdot \sum_{i=j}^N v_i, v_{j-1} + \sum_{i=j}^N v_i - \hat{d}_{j-1} \right) \middle| s_{j-1} \right] \quad \forall s_{j-1} \in \Omega_s, \quad (31)$$

and in the continuous case if:

$$\frac{1 - F_j(v_j)}{f_j(v_j)} \leq \mathbb{E} \left[ \min \left( \rho \cdot \sum_{i=j}^N v_i, v_{j-1} + \sum_{i=j}^N v_i - \hat{d}_{j-1} \right) \middle| s_{j-1} \right] \quad \forall s_{j-1} \in \Omega_s. \quad (32)$$

*Proof.* See the Appendix. □

Corollary 2 reveals that the efficient-renegotiation conditions are relaxed by a reduction of agent  $(j - 1)$ 's liabilities  $\hat{d}_{j-1}$ . Thus, forgiving agent  $(j - 1)$ 's debt to agent  $(j - 2)$  might incentivize agent  $(j - 1)$  to

renegotiate down agent  $j$ 's debt and avoid default, which then incentivizes agent  $j$  to do the same with agent  $j + 1$ 's debt and so on.

The impact of this type of intervention on upstream lenders greatly depends on what happens to agent  $(j - 2)$ . If the government solely reduces the amount that is transferred from agent  $(j - 1)$  to agent  $(j - 2)$ , this intervention also reduces agent  $(j - 3)$ 's incentives to efficiently renegotiate how much agent  $(j - 2)$  owes. By reducing how much agent  $(j - 2)$  collects from agent  $(j - 1)$ , the government effectively lowers how much agent  $(j - 2)$  and all upstream agents can pay without defaulting. It thus makes efficient renegotiation behavior less attractive for upstream lenders. A poorly designed intervention can therefore lead to higher default risk in the debt chain. As a result, debt reduction policies that do not involve subsidies for the lenders become more effective if the targeted liabilities are owed to lenders that are still expected to have their own (upstream) liabilities renegotiated down after the intervention, or lenders that have low levels of liabilities (like agent 1, who has none). If on the other hand, the government lowers agent  $(j - 1)$ 's debt owed to agent  $(j - 2)$  but also gives agent  $(j - 2)$  the difference between the renegotiated debt amount without intervention and the new debt amount, then the efficient-renegotiation conditions of upstream lenders is unchanged by the intervention.<sup>15</sup> This intervention relaxes downstream lenders' efficient-renegotiation conditions without affecting upstream lenders'.

**Numerical example.** Consider a government policy that reduces agent 2's debt to agent 1 from  $\bar{d}_2 = \$325K$  to  $\hat{d}_2 = \$175K$ . In this case, the lower level of debt entices agent 2 to renegotiate agent 3's debt from  $\bar{d}_3 = \$125K$  to  $\underline{d}_3 = \$100K$ , even after observing the bad signal  $s_2$ , since:

$$\begin{aligned} \frac{1 - F_3(v_3)}{F_3(v_3)}(\bar{d}_3 - v_3) &= \left( \frac{1 - 0.5}{0.5} \right) (\$125K - \$100K) = \$25K \\ \leq \mathbb{E} [\min(\rho v_3, v_2 + v_3 - \hat{d}_2) \mid s_2] &= 0.25 \cdot 0.6 \cdot \$100K + 0.75 \cdot \$25K = \$33.75K. \end{aligned} \quad (33)$$

Thus, by effectively forgiving part of agent 2's debt, the government is incentivizing agent 2 to renegotiate down agent 3's debt and avoid default. In a debt chain, upstream debt reductions can incentivize downstream lenders to renegotiate their borrowers' liabilities to default-free levels.

<sup>15</sup>One way of compensating a lender for a debt reduction is through a tax credit provided by the government, as was proposed by Greenwood and Thesmar (2020) at the onset of the COVID-19 pandemic.

In the Appendix, we show through a different numerical example that a mandated debt reduction that is insufficient to completely eliminate the possibility of default throughout the chain can still incentivize downstream agents to be more lenient when renegotiating with their own borrowers, consistent with the insights above.

**Discussion: Debt reductions vs. subsidies.** As shown above, a government can help avoid default waves in a debt chain by providing subsidies to a subset of borrowers or by mandating that their liabilities be reduced. These two policies might look similar at first as they both reduce the gap between a targeted borrower's assets and liabilities: a subsidy reduces this gap by increasing the targeted borrower's assets, whereas a debt reduction lessens its liabilities. Our analysis, however, shows that these policies affect renegotiation outcomes differently when the targeted credit relationship is part of a debt chain. First, comparing conditions (32) and (22) shows that mandated debt reductions differ from subsidies in how they affect renegotiation within a given credit relationship. A subsidy increases the costs a lender faces when its borrower defaults. In contrast, a mandated debt reduction increases the information rent a lender might lose by defaulting on its own liabilities. Second, subsidies can relax the efficient-renegotiation conditions of upstream lenders, whereas mandated debt reductions can relax the efficient-renegotiation conditions of downstream lenders. These differences in how targeted subsidies and debt reductions impact the private renegotiation process throughout a chain should thus inform the choice and design of government interventions.

### 4.3 Early vs. Late Renegotiation

Subsection 3.3 highlighted the insight that a lender's information at the time of renegotiation affects its incentives to efficiently renegotiate its borrower's liabilities. In particular, if at the renegotiation stage an agent knows that its future asset value will be low, a lenient renegotiation strategy generates little equity value. Thus, the agent might be better off gambling for a positive profit by keeping its borrower's debt at a higher level.

In contrast, if each agent in the chain has only imprecise information about its future asset value, beliefs are more optimistic than they would be under the worst possible ex-post scenario. As a result, relative to this agent-specific worst-case scenario, each agent has stronger incentives to follow a lenient renegotiation strategy with its own borrower. Since incentives to be lenient are non-linear in an agent's asset value,

obtaining efficient renegotiation outcomes in *all* states of the world (i.e., a default-free equilibrium) is easier to achieve when renegotiation occurs before agents have had the opportunity to acquire precise information about their individual asset values.

An immediate implication of this channel is that the timing of the renegotiation process is an important determinant of inefficiencies, as it affects the quality of information available to agents. Formally, we obtain the following result highlighting how late renegotiation and associated precise information can in fact eliminate default-free equilibria altogether.

**Corollary 3.** *Suppose  $\bar{d}_j > \underline{d}_j$  for some  $j \in \{2, \dots, N\}$ . If the renegotiation date ( $t = 1$ ) is immediately followed by the payment date ( $t = 2$ ) such that agents have perfect information about the realizations of their own endowment asset value  $v_j$  at the time of renegotiation ( $t = 1$ ), a default-free equilibrium does not exist.*

*Proof.* Under the conditions laid out in Corollary 3, an agent ( $j - 1$ ) may already know during the renegotiation process (at  $t = 1$ ) that the realization of its asset value is the worst-possible outcome,  $v_{j-1} = \underline{v}_{j-1}$ , implying that the right-hand sides of conditions (8) and (18) take the value zero. Thus, these conditions cannot be satisfied in all states of the world, ruling out the existence of an equilibrium where default does not occur on the equilibrium path.  $\square$

When knowing that  $\underline{v}_{j-1}$  is realized, a lender anticipates that a renegotiation strategy that avoids its borrower's default will generate zero equity value for the lender. Thus, the lender is better off taking a harder stance by keeping agent  $j$ 's debt level at the initial level  $\bar{d}_j$ . In contrast, if renegotiation occurs sufficiently early, so that no agent might already know with certainty that it received the lowest possible asset value, default-free equilibria can exist.

In practice, agents are likely to know less about how an economic shock will affect their financial conditions if the renegotiation takes place right after the shock hits. As a result, a government policy that promotes early renegotiations after a large economic shock can facilitate private parties' efforts to curb inefficient default waves.<sup>16</sup> The following numerical example illustrates these benefits of early renegotiation.

<sup>16</sup>See Agarwal et al. (2017) for an example of a government policy intervention that incentivized debt renegotiation during the most recent financial crisis, i.e., the 2009 Home Affordable Modification Program.

**Numerical example.** We now revisit the numerical example from Section 3 and analyze how reducing the strength of agent 2’s private signal, perhaps by initiating the renegotiation process earlier, would affect its incentives to renegotiate with its borrower. For now, assume that agent 2 expects its existing debt to agent 1 to be renegotiated to its efficient, default-free level  $\underline{d}_2 = v_2 + v_3 = \$200K$ . Agent 2, in turn, decides whether to renegotiate agent 3’s liabilities from  $\bar{d}_3 = \$125K$  to  $\underline{d}_3 = \$100K$ . Suppose a government program ensures that agent 2 makes the renegotiation offer before having collected any private information about the value of its endowment asset  $v_2$ . Thus, just like other agents, agent 2 believes that its endowment asset is equally likely to be worth  $\bar{v}_2 = \$250K$  and  $\underline{v}_2 = \$100K$ . Using these unconditional probabilities, agent 2’s efficient-renegotiation condition is satisfied:

$$\begin{aligned} \frac{1 - F_3(v_3)}{F_3(v_3)}(\bar{d}_3 - v_3) &= \left(\frac{1 - 0.5}{0.5}\right) (\$125K - \$100K) = \$25K \\ &\leq \mathbb{E}[\min(\rho v_3, v_2 - \underline{v}_2)] = 0.5 \cdot 0.6 \cdot \$100K + 0.5 \cdot \$0 = \$30K. \end{aligned} \quad (34)$$

Unlike in the original example from Section 3, agent 2 is now willing to renegotiate agent 3’s debt to its default-free level  $\underline{d}_3 = \$100K$ .

Early renegotiation does not, however, change agent 1’s willingness to renegotiate down agent 2’s debt as agent 1’s private information does not enter its efficient-renegotiation condition. Thus, other interventions like those we analyzed above are needed to incentivize agent 1 to provide concessions. Yet, our analysis highlights how a government can reduce some of the inefficiencies associated with default by designing policies aimed at accelerating when renegotiation among debt-chain members will occur.

## 5 Robustness

In this section, we discuss the robustness of our key insights to the presence of default risk on the equilibrium path, alternative types of default costs, asset value dependence, and alternative network structures such as debt trees.



## 5.1 Default Risk on the Equilibrium Path

In our baseline analysis, we analyzed the conditions under which lenders' private renegotiation decisions lead to default-free debt chains on the equilibrium path. These conditions allowed us to characterize which economic forces and policies support efficient outcomes. Moreover, focusing on the conditions for default-free equilibria facilitated the tractability of our analysis, which involves  $N$  strategic, privately informed agents. Specifically, we did not have to keep track of the plethora of cases that exist when defaults occur on the equilibrium path. Yet, one may wonder how our insights are affected when socially efficient outcomes cannot be achieved, which might be the case when government interventions are constrained after large economic shocks. In this section, we discuss how the forces highlighted in our baseline analysis are robust to such cases.

Formally, suppose agent  $(j-1)$  expects to owe a face value  $d_{j-1}$  to its lender and is considering whether to make a concession to agent  $j$  by lowering the face value of the debt contract to  $d_j < \bar{d}_j$ . Unlike in our baseline analysis, agent  $(j-1)$  may not expect agent  $j$  to collect  $\underline{d}_{j+1}$  from agent  $(j+1)$  with probability 1. Correspondingly, we denote the *stochastic* transfer from agent  $(j+1)$  to agent  $j$  as  $\tilde{d}_{j+1}$ . This transfer might be equal to the (potentially renegotiated) value of the debt that agent  $j$  collects in case of full repayment, but it might also be less, in case of default.

We define the variable  $x_j \equiv v_j + \tilde{d}_{j+1}$  and its associated CDF  $H_j(\cdot)$ . The marginal debtor type is now given by  $x_j^* = d_j$ , which is the agent  $j$  that would be just indifferent between defaulting and not defaulting. Agent  $(j-1)$  then chooses the  $x_j^*$  that maximizes the equity value:

$$\begin{aligned} \Pi_{j-1}(x_j^*) &\equiv \Pr[x_j < x_j^*] \cdot \mathbb{E}[\max(v_{j-1} + (1-\rho)x_j - d_{j-1}, 0) \mid s_{j-1}, x_j < x_j^*] \\ &\quad + \Pr[x_j \geq x_j^*] \cdot \mathbb{E}[\max(v_{j-1} + x_j^* - d_{j-1}, 0) \mid s_{j-1}]. \end{aligned} \quad (35)$$

The marginal benefit of increasing  $x_j^*$  can be expressed as follows:

$$\begin{aligned} \Pi'_{j-1}(x_j^*) &= (1 - H_j(x_j^*)) \cdot \Pr[v_{j-1} \geq d_{j-1} - x_j^* \mid s_{j-1}] - \frac{dH_j(x_j^*)}{dx_j^*} \\ &\quad \cdot \mathbb{E}[\max(v_{j-1} + x_j^* - d_{j-1}, 0) - \max(v_{j-1} + (1-\rho)x_j^* - d_{j-1}, 0) \mid s_{j-1}]. \end{aligned} \quad (36)$$

Note that this marginal benefit may be infinite if the distribution  $H_j(\cdot)$  features point masses, which is generally the case when there is default on the equilibrium path. As such, marginal optimality conditions are generally not sufficient conditions, but equation (36) nonetheless illustrates the generic tradeoff agent  $(j - 1)$  faces. In particular, this equation is the analogue of equation (19), which applied when default did not occur on the equilibrium path. The first term on the right-hand side represents the probability that neither agent  $(j - 1)$  nor agent  $j$  defaults. For agent  $(j - 1)$  to benefit from an increased face value  $d_j$ , agent  $j$  has to actually make the requested payment, and agent  $(j - 1)$  needs to be able to make its debt payment to agent  $(j - 2)$  to avoid default. The second term on the right-hand side represents the negative impact of increasing agent  $j$ 's debt on the probability that this agent fully repays its debt multiplied by the expected loss to agent  $(j - 1)$  from agent  $j$ 's default. Consistent with our baseline analysis, the agent makes optimal renegotiation decisions by trading off the amount being collected in case of repayment with the probability that its borrower defaults. Moreover, agent  $(j - 1)$  does not internalize the inefficiencies of its borrower defaulting on a high face value whenever agent  $j$ 's default also pushes agent  $(j - 1)$  into default.

While this tradeoff is consistent with the one featured in our baseline analysis, the tractability of the analysis when default occurs on the equilibrium path is impeded by the fact that the term  $H_j(x_j^*)$  depends on agent  $(j + 1)$ 's stochastic transfer  $\tilde{d}_{j+1}$ . Absent default on the equilibrium path,  $\tilde{d}_{j+1}$  is constant and equal to  $\underline{d}_{j+1}$ , which denoted in our baseline analysis the renegotiated face value associated with no default by agent  $(j + 1)$ . Thus, the impact of increasing the marginal debtor type  $v_j^*$  on the probability of repayment was simply  $-f_j(v_j^*)$ . In the more complex case considered here, however, the distribution of  $\tilde{d}_{j+1}$  accounts for all the possible combinations of default outcomes for every one of agent  $j$ 's downstream borrowers (i.e., from agent  $(j + 1)$  to agent  $N$ ). Thus, agent  $(j - 1)$ 's decision to renegotiate not only depends on the distribution of  $v_j$ , like in the baseline analysis, but also on the distribution functions and debt face values associated with the  $(N - j)$  downstream credit relationships. This complexity impedes general analyses of debt chains with any  $N$  agents and implies that one has to resort to special examples for full solution characterizations. In the Appendix, we present numerical examples for the binomial case with  $N = 3$  agents for which default occurs in equilibrium, but our main insights still apply. In contrast, our baseline analysis provided a full characterizations of the conditions under which default does not occur on the equilibrium path and allowed us to highlight essential forces in agents' renegotiation decisions, including the implications of knock-on

defaults.

## 5.2 Borrower-Specific Default Costs

In our baseline model, we assumed that the only inefficiency associated with default emanates from liquidation costs that reduce the value of the assets a lender can recover from a borrower. The parameter  $\rho$  was used to capture these proportional deadweight costs associated with default. Going beyond these costs, it is plausible that borrowers also internalize a subset of the inefficiencies triggered by default. For example, a defaulting borrower might experience a loss of reputation, which can affect its future labor market outcomes and limit its access to capital markets for future projects. In this section, we highlight that introducing these types of default costs does not alter our model's key insights, although it reveals that such default costs potentially motivate firm owners to inject funds to avoid default, which increases the debt levels that can sustain a default-free equilibrium.

Formally, suppose each borrower internalizes a non-pecuniary fixed cost equal to  $\phi > 0$  upon default. In this case, borrower  $j$  agrees to pay its debt if  $d_j \leq v_j + d_{j+1} + \phi$ , that is, the introduction of borrower-specific costs makes defaulting less attractive for the borrower: the owner of the firm potentially optimally injects additional funds to avert default. As a result, relative to our baseline model, the lender can choose a higher debt level without triggering default. Moreover, borrowers' default costs increase the default-free debt level for each credit relationship, which is now given by:

$$\underline{d}_j \equiv \sum_{i=j}^N v_i + (N + 1 - j)\phi. \quad (37)$$

The conditions ensuring that the renegotiation offers by agents  $(j - 1) = 1, \dots, (N - 1)$  yield a default-free equilibrium outcome for the whole debt chain then take the following form in the case of continuous distributions:

$$\frac{1 - F_j(\underline{v}_j)}{f_j(\underline{v}_j)} \leq \mathbb{E} \left[ \min \left( \rho \cdot \left( \sum_{i=j}^N v_i + (N - j)\phi \right) + \phi, v_{j-1} - \underline{v}_{j-1} \right) \middle| s_{j-1} \right]. \quad (38)$$

As to be expected, this condition reduces to our previous condition (18) when we set  $\phi = 0$ .

Whereas the costs considered here increase the renegotiated face values, the default costs internalized by

the creditor, as captured by the parameter  $\rho$  in our baseline model, do not. The reason for this difference is that in a default-free equilibrium, an agent  $j$ 's borrower, agent  $(j+1)$ , is collecting the full face value from its borrower, agent  $(j+2)$ , so default costs are not incurred in equilibrium. Yet, the marginal borrower type (and the associated renegotiated face value) is increased when default costs are internalized by the debtor, as it is then willing to pay more to avoid incurring these additional default costs.

These results highlight how borrower-specific default costs increase the default-free debt levels and loosen lenders' efficient-renegotiation conditions, yet do so without qualitatively impacting our key insights.

### 5.3 Asset Value Dependence

In our baseline model, endowment asset values were independently distributed across agents as of date  $t = 1$  (while still allowing for an aggregate shock that hit before date  $t = 1$  and shaped the distributions  $F_j(v_j)$ ). Thus, at that time, agent  $(j-1)$  did not use its signal realization  $s_{j-1}$  to update the distribution of agent  $j$ 's asset value,  $F_j(v_j)$ . In contrast, if agent  $(j-1)$ 's signal was also informative about agent  $j$ 's asset value, due to a dependence between asset values, the distribution  $F_j(v_j)$  would be replaced by the updated distribution  $F_j(v_j|s_{j-1})$ . Moreover, if the lower bound of the support of  $v_j$  was still  $\underline{v}_j$  under this updated distribution, then the default-free debt level  $\underline{d}_j$  would stay the same as in the baseline model, and agent  $(j-1)$ 's efficient-renegotiation condition under the binomial distribution (i.e., the analogue of condition (8)) would be:

$$\frac{1 - F_j(\underline{v}_j|s_{j-1})}{F_j(\underline{v}_j|s_{j-1})} \left( \bar{d}_j - \sum_{i=j}^N \underline{v}_i \right) \leq \mathbb{E} \left[ \min \left( \rho \cdot \sum_{i=j}^N \underline{v}_i, v_{j-1} - \underline{v}_{j-1} \right) \middle| s_{j-1}, v_j = \underline{v}_j \right]. \quad (39)$$

This result highlights that positively correlated asset values would partially mitigate the effect that bad signals have on a lender's renegotiation tradeoff. Whereas a bad signal  $s_{j-1}$  reduces the information rents agent  $(j-1)$  expects to earn on the default-free path (as pointed out in our baseline analysis), it also increases the probability that agent  $j$  defaults if  $d_j > \underline{d}_j$ . In sum, while introducing dependence between asset values enriches the role of signals in our model, it does not alter the main takeaways of our baseline analysis.

### 5.4 Debt Trees

In our baseline model, we analyzed the renegotiation behavior of agents that are part of a debt chain, where each lender has one borrower. In reality, however, the network of credit relationships might feature some

lenders deciding on how to renegotiate with multiple borrowers. We now show that, if we consider such “debt trees,” the forces at play in our baseline model still remain relevant.

Formally, suppose agent  $(j-1)$  owes an amount  $\underline{d}_{j-1}$  to another agent and considers renegotiating the liabilities of its  $M$  borrowers, agents  $j_m \in \{j_1, j_2, \dots, j_M\}$ . If we assume independent binomial distributions for simplicity, agent  $(j-1)$  decides whether to keep the face value of each borrower  $j_m$  at  $\bar{d}_{j_m}$  or to renegotiate it to a default-free level  $\underline{d}_{j_m}$ . In contrast to our baseline model, agent  $(j-1)$  now has to make  $M$  renegotiation decisions, which involves comparing agent  $(j-1)$ 's equity value for every possible combination of renegotiation strategies with its borrowers  $j_m \in \{j_1, j_2, \dots, j_M\}$  (i.e., a total of  $2^M$  possible combinations in the binomial case). Yet, it is possible to explore the economic forces and tradeoffs in this setting by zooming in on the decision to renegotiate  $j_m$ 's liabilities when every other liability in the economy, including those of agents  $j_{m'}$  where  $m' \neq m$ , are expected to be renegotiated to their respective default-free levels. Extending our notation, we then can show that agent  $(j-1)$  prefers renegotiating all of its borrowers' liabilities to a default-free level over renegotiating those of all agents except  $j_m$  as long as:

$$\frac{1 - F_{j_m}(v_{j_m})}{F_{j_m}(v_{j_m})} (\bar{d}_{j_m} - \underline{d}_{j_m}) \leq \mathbb{E}[\min(\rho \cdot \underline{d}_{j_m}, v_{j-1} - v_{j-1}) \mid s_{j-1}] \quad \forall s_{j-1} \in \Omega_s. \quad (40)$$

Comparing this condition to the efficient-renegotiation condition in debt chains (i.e., condition (8)) reveals that the strategic decision whether to renegotiate with one specific borrower in order to avoid default in a debt tree (or in many other types of networks) features economic forces and tradeoffs that are consistent with those of our baseline analysis.

## 6 Conclusion

When an economy is exposed to a large shock such as the ongoing COVID-19 pandemic or the most recent financial crisis, many businesses struggle to fulfill their existing financial obligations, especially so if these businesses are interconnected via debt chains. To analyze the effectiveness of private and public interventions aimed at avoiding large-scale default waves, we develop a tractable model of strategic renegotiation in debt chains. Our model shows how private renegotiation decisions are interrelated: a lender's willingness to provide concessions to its borrower depends on how it expects its own liabilities to be renegotiated. Whereas

a tough renegotiation strategy may be privately optimal for the lender, it tends to create negative externalities for renegotiation efforts elsewhere in the chain. In fact, an unaccommodating renegotiation strategy by one lender in a chain can trigger tough renegotiations and increased default probabilities throughout the whole chain.

Our policy analysis reveals how government subsidies to downstream borrowers do not only mechanically improve a recipients' ability to make payments, but importantly, also incentivize upstream lenders to privately renegotiate their borrowers' liabilities. Accounting for the recursivity of the optimal renegotiation decision of each agent, we show that awarding relatively small subsidies to downstream borrowers can be highly effective in preventing default waves compared to awarding the same subsidies to upstream borrowers. We also examine how forgiving a struggling borrower's debt or backing it to prevent default can further incentivize downstream lenders to efficiently renegotiate the debt of their borrowers. Finally, we highlight that facilitating early debt renegotiations after a large shock tends to increase incentives for providing concessions, thus reducing default risk. In sum, our analysis not only sheds light on the implications of different types of government interventions but also reveals how the targeting of specific members of a debt chain optimally complements private renegotiation efforts.

## Appendix

### A Optimality of Debt Contracts

**Proof of Lemma 1:** As is standard in the security design literature, we consider securities satisfying limited liability and monotonicity (see, e.g., Harris and Raviv 1989, Innes 1990, Nachman and Noe 1994). A special feature of debt in our environment with non-verifiability is that it provides a lender with a foreclosure right, that is, a lender can seize the assets in case its borrower does not pay the specified face value. To simplify the exposition, suppose that the total asset value of borrower  $j$  takes the random value  $x_j \geq \underline{x}_j$  at date  $t = 2$ , where  $x_j$  reflects both the endowment asset value and any debt collection from agent  $(j + 1)$ . Since the uncertain component of asset values is non-verifiable and securities are monotone, a borrower always finds it optimal to report the lowest value of its total assets  $\underline{x}_j$ , unless doing so triggers default (in which case the borrower's assets are seized by the lender). Default, in turn, can only be triggered in the case of a debt contract. As a result, the lender anticipates that any security that is not a debt contract will yield a payoff of at most  $\underline{x}_j$  (given limited liability, conditional on reporting  $\underline{x}_j$ , the contract cannot pay more than  $\underline{x}_j$ ).

The only option a lender has to potentially obtain a higher expected payoff than  $\underline{x}_j$  is to propose a new debt contract with face value  $d_j$  where  $\underline{x}_j < d_j \leq \bar{d}_j$  (provided that the face value of the original debt contract satisfies  $\bar{d}_j > \underline{x}_j$ , which is necessary for there to be any scope for renegotiation in the first place): conditional on that debt contract, a borrower at date  $t = 2$  with total assets worth  $x_j$  will optimally pay  $d_j$  when  $x_j \geq d_j$ . On the other hand, there is the possibility of default, which occurs when  $x_j < d_j$  and in which case the lender collects only  $(1 - \rho)x_j$  when seizing the assets. A lender then optimally weighs these potential outcomes when choosing the new face value, as described in our main analysis of Section 3. Using a debt contract, a lender can, at a minimum always replicate the payoff of all other securities,  $\underline{x}_j$ , by choosing  $d_j = \underline{x}_j$ . Yet, debt with an optimally chosen face value generally allows a lender to achieve a higher expected payoff. As a result, offering a new debt security is always weakly optimal, and potentially strictly optimal. This result allows us to restrict attention to renegotiation offers that maintain a liability taking the form of a debt contract. □

## B Optimality Conditions with Continuous Distributions

In this section, we derive the optimality conditions in a more general version of our model with continuous distributions in which a borrower internalizes some of the default costs, substantiating our discussion on this issue in Section 5. Specifically, we consider a setting in which a borrower incurs a loss equal to  $\phi$  when defaulting.

Suppose that agent  $j$  always collects a face value  $d_{j+1}$  from its borrower, agent  $(j+1)$ . Agent  $j$ , in turn, does not default on an offer  $d_j$  when:

$$v_j + d_{j+1} - d_j \geq -\phi. \quad (\text{B1})$$

Agent  $(j-1)$  chooses a marginal debtor type  $v_j^* = d_j^* - d_{j+1} - \phi$  to maximize its expected payoff (note that the new proposed face value is then:  $d_j^* = v_j^* + d_{j+1} + \phi$ ):

$$\begin{aligned} & \Pi_{j-1}(v_j^*) \\ &= \int_{v_{j-1}}^{\bar{v}_{j-1}} \int_{v_j}^{v_j^*} \max(v_{j-1} + (1-\rho)(v_j + d_{j+1}) - d_{j-1}, -\phi) \cdot f_j(v_j) \cdot f_{j-1}(v_{j-1}|s_{j-1}) dv_j dv_{j-1} \\ & \quad + (1 - F_j(v_j^*)) \cdot \mathbb{E}[\max(v_{j-1} + v_j^* + d_{j+1} + \phi - d_{j-1}, -\phi) | s_{j-1}], \end{aligned} \quad (\text{B2})$$

reflecting that agent  $(j-1)$  gets a signal  $s_{j-1}$  on its income realization  $v_{j-1}$  and can predict the renegotiation offer  $d_{j-1}$  from agent  $(j-2)$ . To derive first-order conditions, we compute the following derivatives of terms in equation (B2):

$$\begin{aligned} & \frac{\partial \int_{v_{j-1}}^{\bar{v}_{j-1}} \int_{v_j}^{v_j^*} \max(v_{j-1} + (1-\rho)(v_j + d_{j+1}) - d_{j-1}, -\phi) f_j(v_j) dv_j f_{j-1}(v_{j-1}|s_{j-1}) dv_{j-1}}{\partial v_j^*} \\ &= f_j(v_j^*) \mathbb{E}[\max(v_{j-1} + (1-\rho)(v_j^* + d_{j+1}) - d_{j-1}, -\phi) | s_{j-1}], \end{aligned} \quad (\text{B3})$$



and

$$\begin{aligned} \frac{\partial \mathbb{E}[\max(v_{j-1} + v_j^* + d_{j+1} + \phi - d_{j-1}, -\phi) \mid s_{j-1}]}{\partial v_j^*} &= \mathbb{E}[\mathbf{1}_{\{(v_{j-1} + v_j^* + d_{j+1} + \phi - d_{j-1}) \geq -\phi\}} \mid s_{j-1}] \\ &= \Pr[v_{j-1} \geq d_{j-1} - d_{j+1} - v_j^* - 2\phi \mid s_{j-1}]. \end{aligned} \quad (\text{B4})$$

Using these results, we can write the marginal net-benefit of increasing  $v_j^*$  as follows:

$$\begin{aligned} \Pi'_{j-1}(v_j^*) &= f_j(v_j^*) \cdot \mathbb{E}[\max(v_{j-1} + (1 - \rho)(v_j^* + d_{j+1}) - d_{j-1}, -\phi) \mid s_{j-1}] \\ &\quad - f_j(v_j^*) \cdot \mathbb{E}[\max(v_{j-1} + v_j^* + d_{j+1} + \phi - d_{j-1}, -\phi) \mid s_{j-1}] \\ &\quad + (1 - F_j(v_j^*)) \Pr[v_{j-1} \geq d_{j-1} - d_{j+1} - v_j^* - 2\phi \mid s_{j-1}]. \end{aligned} \quad (\text{B5})$$

A necessary condition for an equilibrium in which agent  $j$  does not default is:

$$\Pi'_{j-1}(v_j) \leq 0, \quad (\text{B6})$$

that is,  $v_j^* = v_j$  is the optimal choice for agent  $(j - 1)$ . This condition can be rewritten as:

$$\begin{aligned} \frac{1 - F_j(v_j)}{f_j(v_j)} &\leq \frac{\mathbb{E}[\max(v_{j-1} + v_j + d_{j+1} + \phi - d_{j-1}, -\phi) \mid s_{j-1}]}{\Pr[v_{j-1} \geq d_{j-1} - d_{j+1} - v_j - 2\phi \mid s_{j-1}]} \\ &\quad - \frac{\mathbb{E}[\max(v_{j-1} + (1 - \rho)(v_j + d_{j+1}) - d_{j-1}, -\phi) \mid s_{j-1}]}{\Pr[v_{j-1} \geq d_{j-1} - d_{j+1} - v_j - 2\phi \mid s_{j-1}]}. \end{aligned} \quad (\text{B7})$$

For a default-free equilibrium to exist, this condition has to hold for all possible signals agent  $(j - 1)$  might receive,  $s_{j-1} \in [\underline{s}_{j-1}, \bar{s}_{j-1}]$ .

**Renegotiated debt values in a default-free equilibrium.** The renegotiated face values in a default-free equilibrium then can be written in a recursive form as follows:

$$d_j = \underline{d}_j \equiv v_j + d_{j+1} + \phi, \quad (\text{B8})$$

assuming that we have  $\bar{d}_j \geq \underline{d}_j$  for all  $j$ . Otherwise, if  $\bar{d}_j < \underline{d}_j$ , the offer will simply match the previous offer, that is,  $d_j = \bar{d}_j$ . If  $\bar{d}_j \geq \underline{d}_j$  for all  $j$ , we obtain the following explicit formulae:

$$d_N = \underline{v}_N + \phi, \quad (\text{B9})$$

$$d_{N-1} = \underline{v}_{N-1} + d_N + \phi = \underline{v}_{N-1} + \underline{v}_N + 2\phi, \quad (\text{B10})$$

$$d_{N-2} = \underline{v}_{N-2} + d_{N-1} + \phi = \underline{v}_{N-2} + \underline{v}_{N-1} + \underline{v}_N + 3\phi, \quad (\text{B11})$$

$$d_j = \sum_{i=j}^N \underline{v}_i + (N - j + 1) \cdot \phi. \quad (\text{B12})$$

Note that the borrower-specific default costs  $\phi$  enter these debt values, whereas the proportional default costs captured by  $\rho$  do not. The reason for this is that in a default-free equilibrium, an agent  $j$ 's borrower, agent  $(j+1)$  is collecting the full face value from its borrower, agent  $(j+2)$  (remember that default costs do not apply in equilibrium). Yet, the marginal borrower type (and the associated debt value) can be increased by the default cost  $\phi$  in excess of the collateral, since a borrower is willing to pay that extra cost to avoid default.

Suppose that the following default-free face values are charged in equilibrium:

$$\underline{d}_{j-1} = \sum_{i=j-1}^N \underline{v}_i + (N - j + 2) \cdot \phi, \quad (\text{B13})$$

$$\underline{d}_{j+1} = \sum_{i=j+1}^N \underline{v}_i + (N - j) \cdot \phi, \quad (\text{B14})$$

which requires that the initial face value satisfies:  $\bar{d}_j \geq \underline{d}_j$ . Note that:

$$\begin{aligned} d_{j+1} - d_{j-1} &= \left[ \sum_{i=j+1}^N \underline{v}_i + (N - j) \cdot \phi \right] - \left[ \sum_{i=j-1}^N \underline{v}_i + (N - j + 2) \cdot \phi \right] \\ &= -\underline{v}_{j-1} - \underline{v}_j - 2\phi. \end{aligned} \quad (\text{B15})$$

Using this result, we can now simplify the following terms entering our key efficiency condition (B7):

$$\begin{aligned}
& \mathbb{E}[\max(v_{j-1} + \underline{v}_j + d_{j+1} + \phi - d_{j-1}, -\phi) \mid s_{j-1}] \\
&= \mathbb{E}[\max(v_{j-1} + \underline{v}_j + \phi - \underline{v}_{j-1} - \underline{v}_j - 2\phi, -\phi) \mid s_{j-1}] \\
&= \mathbb{E}[\max(v_{j-1} - \underline{v}_{j-1} - \phi, -\phi) \mid s_{j-1}] \\
&= \mathbb{E}[v_{j-1} \mid s_{j-1}] - \underline{v}_{j-1} - \phi,
\end{aligned} \tag{B16}$$

$$\begin{aligned}
& \Pr[v_{j-1} \geq d_{j-1} - d_{j+1} - \underline{v}_j - 2\phi \mid s_{j-1}] \\
&= \Pr[v_{j-1} \geq \sum_{i=j-1}^N \underline{v}_i + (N-j) \cdot \phi - \left( \sum_{i=j+1}^N \underline{v}_i + (N-j) \cdot \phi \right) - \underline{v}_j \mid s_{j-1}] \\
&= \Pr[v_{j-1} \geq \sum_{i=j-1}^N \underline{v}_i - \sum_{i=j}^N \underline{v}_i \mid s_{j-1}] \\
&= \Pr[v_{j-1} \geq \underline{v}_{j-1}] \\
&= 1,
\end{aligned} \tag{B17}$$

$$\begin{aligned}
& \mathbb{E}[\max(v_{j-1} + (1-\rho)(\underline{v}_j + d_{j+1}) - d_{j-1}, -\phi) \mid s_{j-1}] \\
&= \mathbb{E}[\max(v_{j-1} + (1-\rho)\underline{v}_j - \rho d_{j+1} + d_{j+1} - d_{j-1}, -\phi) \mid s_{j-1}] \\
&= \mathbb{E}[\max(v_{j-1} + (1-\rho)\underline{v}_j - \rho d_{j+1} - \underline{v}_{j-1} - \underline{v}_j - 2\phi, -\phi) \mid s_{j-1}] \\
&= \mathbb{E}[\max(v_{j-1} - \underline{v}_{j-1} - \rho \underline{v}_j - \rho d_{j+1} - 2\phi, -\phi) \mid s_{j-1}],
\end{aligned} \tag{B18}$$

and

$$\begin{aligned}
& \mathbb{E}[v_{j-1}|s_{j-1}] - \underline{v}_{j-1} - \phi - \mathbb{E}[\max(v_{j-1} - \underline{v}_{j-1} - \rho \underline{v}_j - \rho d_{j+1} - 2\phi, -\phi) | s_{j-1}] \\
&= \mathbb{E}[v_{j-1} - \underline{v}_{j-1} - \phi - \max(v_{j-1} - \underline{v}_{j-1} - \rho \underline{v}_j - \rho d_{j+1} - 2\phi, -\phi) | s_{j-1}] \\
&= \mathbb{E}[\min(v_{j-1} - \underline{v}_{j-1} - \phi - (v_{j-1} - \underline{v}_{j-1} - \rho \underline{v}_j - \rho d_{j+1} - 2\phi), v_{j-1} - \underline{v}_{j-1} - \phi + \phi) | s_{j-1}] \\
&= \mathbb{E}[\min(v_{j-1} - v_{j-1} + \rho(\underline{v}_j + d_{j+1}) + \phi, v_{j-1} - \underline{v}_{j-1}) | s_{j-1}] \\
&= \mathbb{E}[\min(\rho(\underline{v}_j + d_{j+1}) + \phi, v_{j-1} - \underline{v}_{j-1}) | s_{j-1}]. \tag{B19}
\end{aligned}$$

Using these simplifications, we can rewrite condition (B7) as follows:

$$\frac{1 - F_j(\underline{v}_j)}{f_j(\underline{v}_j)} \leq \mathbb{E}[\min(\rho \cdot (\underline{v}_j + d_{j+1}) + \phi, v_{j-1} - \underline{v}_{j-1}) | s_{j-1}]. \tag{B20}$$

Since we imposed the standard regularity condition that the hazard rate  $\frac{f_j(v_j)}{1-F_j(v_j)}$  is increasing on the support  $[\underline{v}_j, \bar{v}_j]$ , this condition is sufficient for the global optimality of agent  $(j-1)$ 's renegotiation strategy when it expects all other lenders to renegotiate their respective borrower's debt to its default-free level.

## C Mandated Debt Reductions

**Proof of Corollary 2:** We start again with our general condition for a default-free equilibrium:

$$\begin{aligned}
\frac{1 - F_j(\underline{v}_j)}{f_j(\underline{v}_j)} &\leq \frac{\mathbb{E}[\max(v_{j-1} + \underline{v}_j + d_{j+1} + \phi - d_{j-1}, -\phi) | s_{j-1}]}{\Pr[v_{j-1} \geq d_{j-1} - d_{j+1} - \underline{v}_j - 2\phi | s_{j-1}]} \\
&\quad - \frac{\mathbb{E}[\max(v_{j-1} + (1 - \rho)(\underline{v}_j + d_{j+1}) - d_{j-1}, -\phi) | s_{j-1}]}{\Pr[v_{j-1} \geq d_{j-1} - d_{j+1} - \underline{v}_j - 2\phi | s_{j-1}]}. \tag{C1}
\end{aligned}$$

Suppose that we start with a debt level  $d_{j-1}$  such that

$$d_{j-1} - d_{j+1} - \underline{v}_j - 2\phi < \underline{v}_{j-1}, \tag{C2}$$

or equivalently:

$$\underline{v}_{j-1} + \underline{v}_j + d_{j+1} + \phi - d_{j-1} > -\phi. \quad (\text{C3})$$

Then the initial condition can be written as:

$$\frac{1 - F_j(\underline{v}_j)}{f_j(\underline{v}_j)} \leq \mathbb{E}[(v_{j-1} + \underline{v}_j + d_{j+1} + \phi - d_{j-1}) \mid s_{j-1}] \quad (\text{C4})$$

$$- \mathbb{E}[\max(v_{j-1} + (1 - \rho)(\underline{v}_j + d_{j+1}) - d_{j-1}, -\phi) \mid s_{j-1}], \quad (\text{C5})$$

which further simplifies to:

$$\frac{1 - F_j(\underline{v}_j)}{f_j(\underline{v}_j)} \leq \mathbb{E}[\min(\rho \cdot (\underline{v}_j + d_{j+1}) + \phi, v_{j-1} + \underline{v}_j + d_{j+1} - d_{j-1} + 2\phi) \mid s_{j-1}]. \quad (\text{C6})$$

We can take the derivative of the right-hand side with respect to  $d_{j-1}$  and get:

$$\begin{aligned} & -\Pr[v_{j-1} + \underline{v}_j + d_{j+1} - d_{j-1} + 2\phi < \rho \cdot (\underline{v}_j + d_{j+1}) + \phi] \\ & = -\Pr[v_{j-1} < d_{j-1} - (1 - \rho) \cdot (\underline{v}_j + d_{j+1}) - \phi]. \end{aligned} \quad (\text{C7})$$

Note that we had assumed to begin with that:

$$\underline{v}_{j-1} > d_{j-1} - (\underline{v}_j + d_{j+1}) - 2\phi. \quad (\text{C8})$$

Thus, as long as:

$$d_{j-1} \in (\underline{v}_{j-1} + (1 - \rho)(\underline{v}_j + d_{j+1}) + \phi, \underline{v}_{j-1} + (\underline{v}_j + d_{j+1}) + 2\phi), \quad (\text{C9})$$

this probability is strictly positive. That is, a *decrease* in  $d_{j-1}$  loosens the condition for agent  $(j - 1)$  to pick a renegotiated debt level that leads to no default.  $\square$

## D Numerical Examples with Default Risk in Equilibrium

In our baseline analysis, we derived the conditions under which there is no default on the equilibrium path. Doing so kept our analysis tractable despite the presence of  $N$  strategic, privately informed agents. In this Appendix, we present numerical examples for the binomial case with  $N = 3$  agents to illustrate the robustness of our main conclusions to cases when default probabilities are positive even after the government has intervened.

As in our earlier examples, agent 3 is assumed to have an endowment asset that is equally likely to take the values  $v_3 = \$100K$  or  $\bar{v}_3 = \$250K$ . To simplify the computations, we assume that agent 2's endowment asset is equally likely to be worth  $v_2 = \$0$  or  $\bar{v}_2 = \$20K$  whereas agent 1's endowment asset is always worth  $v_1 = 0$ . We now set  $\rho = 0.05$  to make default less costly and efficient renegotiation less attractive (since we want to study situations for which default occurs on the equilibrium path). To further simplify the derivations, we assume that agents do not receive private signals about the value of their endowment assets prior to renegotiating.

### D.1 Example with subsidy

We now show that government subsidies can incentivize upstream agents to renegotiate more efficiently even when some default risk remains despite the intervention. Let's assume that agent 3 owes  $\bar{d}_3 = \$111K$  to agent 2 who owes  $\bar{d}_2 = \$124K$  to agent 1. If agent 2 expects agent 1 to keep asking for  $\bar{d}_2 = \$124K$ , agent 2 finds it optimal to keep agent 3's debt at its existing level  $\bar{d}_3 = \$111K$  rather than renegotiating it to its default-free level  $\underline{d}_3 = v_3 = \$100K$ . In particular, whereas keeping agent 3's debt at  $\bar{d}_3 = \$111K$  yields an equity value of  $\$1.75K$  for agent 2, renegotiating it to  $\underline{d}_3 = \$100K$  implies that agent 2 will default with certainty and thus earn  $\$0$ . Agent 2 is thus unwilling to renegotiate agent 3's debt when expected to owe  $\bar{d}_2 = \$124K$  to agent 1. Expecting agent 2 to keep asking for  $\bar{d}_3 = \$111K$ , agent 1 finds it optimal to keep asking for  $\bar{d}_2 = \$124K$ . In particular, keeping agent 2's debt at  $\bar{d}_2 = \$124K$  yields an equity value of  $\$107.2375K$  whereas renegotiating it to  $d_2 = \bar{v}_2 + (1 - \rho)v_3 = \$115K$  yields  $\$106.425K$ , renegotiating it to  $d_2 = v_2 + \bar{d}_3 = \$111K$  yields  $\$105.8125K$ , and renegotiating it to  $d_2 = v_2 + (1 - \rho)v_3 = \$95K$  yields  $\$95K$ . Thus, absent government interventions, no lender is willing to renegotiate its borrower's debt in equilibrium — as a result, agent 3's default probability is 50% and agent 2's default probability is 75%.

Consider a government intervention that provides a subsidy of  $g_3 = \$5K$  to agent 3. If expecting agent 2 to keep asking for  $\bar{d}_3 = \$111K$ , agent 1 now finds it optimal to renegotiate agent 2's debt from  $\bar{d}_2 = \$124K$  to  $d_2 = \bar{v}_2 + (1 - \rho)(v_3 + g_3) = \$119.75K$ . In particular, keeping agent 2's debt at  $\bar{d}_2 = \$124K$  yields an equity value of  $\$109.49375K$  whereas renegotiating it to  $d_2 = \bar{v}_2 + (1 - \rho)(v_3 + g_3) = \$119.75K$  yields  $\$109.928125K$ , renegotiating it to  $d_2 = v_2 + \bar{d}_3 = \$111K$  yields  $\$106.940625K$ , and renegotiating it to  $d_2 = v_2 + (1 - \rho)(v_3 + g_3) = \$99.75K$  yields  $\$99.75K$ . Expecting agent 1 to renegotiate its debt to  $d_2 = \bar{v}_2 + (1 - \rho)(v_3 + g_3) = \$119.75K$  following the subsidy, agent 2 finds it optimal to keep asking for  $\bar{d}_3 = \$111K$  from agent 3 rather than renegotiating the debt to its default-free level  $\underline{d}_3 = v_3 + g_3 = \$105K$ . In particular, while keeping agent 3's debt at  $\bar{d}_3 = \$111K$  yields an equity value of  $\$2.8125K$  for agent 2, renegotiating it to  $\underline{d}_3 = \$105K$  yields  $\$2.625K$ . In equilibrium, agent 3's default probability is still 50% but agent 2's default probability drops from 75% to 50% as a result of this government intervention.

Thus, while a subsidy of  $\$5K$  is insufficient to completely eliminate the possibility of default throughout the chain, it nonetheless incentivizes upstream agents (in this case, agent 1) to be more lenient when renegotiating with their borrowers, consistent with the insights of our baseline analysis. This example also shows how default risk impairs the pass-through of downstream resources to upstream agents, relative to our baseline analysis. In equilibrium, the subsidy  $g_3$  that is given to agent 3 *only partially* reaches agent 1 when agent 2 makes its renegotiated payment of  $d_2 = \bar{v}_2 + (1 - \rho)(v_3 + g_3)$  or when agent 3 defaults and agent 2 collects  $(1 - \rho)(v_3 + g_3)$ . Moreover, when agent 3 makes its promised payment  $\bar{d}_3$  but agent 2 defaults on its debt to agent 1, agent 1 only collects  $(1 - \rho)(v_2 + \bar{d}_3)$ , which is unaffected by the government subsidy.

## D.2 Example with mandatory debt reduction

We now illustrate that mandatory debt reductions can incentivize downstream agents to renegotiate more efficiently even when some default risk remains despite the intervention. Let's assume that agent 3 owes  $\bar{d}_3 = \$105K$  to agent 2 who owes  $\bar{d}_2 = \$124K$  to agent 1. If agent 2 expects agent 1 to keep asking for  $\bar{d}_2 = \$124K$ , agent 2 finds it optimal to keep agent 3's debt at its existing level  $\bar{d}_3 = \$105K$  rather than renegotiating it to its default-free level  $\underline{d}_3 = v_3 = \$100K$ . In particular, while keeping agent 3's debt at  $\bar{d}_3 = \$105K$  yields an equity value of  $\$0.25K$  for agent 2, renegotiating it to  $\underline{d}_3 = \$100K$  implies that agent 2 will default with certainty and thus earn  $\$0$ . Agent 2 is thus unwilling to renegotiate agent 3's debt when

expected to owe  $\bar{d}_2 = \$124K$  to agent 1. Expecting agent 2 to keep asking for  $\bar{d}_3 = \$105K$ , agent 1 finds it optimal to keep asking for  $\bar{d}_2 = \$124K$ . In particular, keeping agent 2's debt at  $\bar{d}_2 = \$124K$  yields an equity value of  $\$105.8125K$  whereas renegotiating it to  $d_2 = \bar{v}_2 + (1 - \rho)v_3 = \$115K$  yields  $\$105K$ , renegotiating it to  $d_2 = v_2 + \bar{d}_3 = \$105K$  yields  $\$101.3125K$ , and renegotiating it to  $d_2 = v_2 + (1 - \rho)v_3 = \$95K$  yields  $\$95K$ . Thus, absent government interventions, no lender is willing to renegotiate its borrower's debt in equilibrium — as a result, agent 3's default probability is 50% and agent 2's default probability is 75%.

Consider a government intervention that mandates that agent 1 reduce agent 2's debt from  $\bar{d}_2 = \$124K$  to  $\hat{d}_2 = \$115K$ . Expecting to owe  $\hat{d}_2 = \$115K$  to agent 1, agent 2 is now willing to renegotiate agent 3's debt to its default-free level  $\underline{d}_3 = v_3 = \$100K$  rather than keeping it at its existing level  $\bar{d}_3 = \$105K$ , as both renegotiation strategies yield the same equity value of  $\$2.5K$ . In equilibrium, agent 3's default probability drops from 50% to 0% whereas agent 2's default probability drops from 75% to 50% as a result of this government intervention.<sup>17</sup>

Thus, while a mandated debt reduction from  $\bar{d}_2 = \$124K$  to  $\hat{d}_2 = \$115K$  is insufficient to completely eliminate the possibility of default throughout the chain, it still incentivizes downstream agents (in this case, agent 2) to be more lenient when renegotiating with their borrowers, consistent with the insights of our baseline analysis.

---

<sup>17</sup>Note also that, if permitted by the government, agent 1 would not find it optimal to renegotiate agent 2's debt further down from  $\hat{d}_2 = \$115K$  to  $\underline{d}_2 = v_2 + v_3 = \$100K$  as its efficient renegotiation condition (7) would be violated.



## References

- Acemoglu, Daron, Michael Golosov, and Aleh Tsyvinski.** 2008. "Political Economy of Mechanisms." *Econometrica* 76: 619-641.
- Acemoglu, Daron, Asuman Ozdaglar, and Alireza Tahbaz-Salehi.** 2015. "Systemic Risk and Stability in Financial Networks." *American Economic Review* 105: 564-608.
- Adelino, Manuel, Kristopher Gerardi, and Paul S. Willen.** 2013. "Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures and Securitization." *Journal of Monetary Economics* 60: 835-853.
- Agarwal, Sumit, Gene Amromin, Itzhak Ben-David, Souphala Chomsisengphet, Tomasz Piskorski, Amit Seru.** 2017. "Policy Intervention in Debt Renegotiation: Evidence from the Home Affordable Modification Program." *Journal of Political Economy* 3: 654-712.
- Aguiar, Mark, Manuel Amador, and Gita Gopinath.** 2009. "Investment Cycles and Sovereign Debt Overhang." *Review of Economic Studies* 76: 1-31.
- Albuquerque, Rui, and Hugo A. Hopenhayn.** 2004. "Optimal Lending Contracts and Firm Dynamics." *Review of Economic Studies* 71: 285-315.
- Allen, Franklin, Ana Babus, and Elena Carletti.** 2012. "Asset Commonality, Debt Maturity, and Systemic Risk." *Journal of Financial Economics* 104: 519-534.
- Allen, Franklin, and Douglas Gale.** 2000. "Financial Contagion." *Journal of Political Economy* 108: 1-33.
- Almeida, Heitor, and Thomas Philippon.** 2007. "The Risk-Adjusted Cost of Financial Distress." *Journal of Finance* 62: 2557-2586.
- Alvarez, Fernando and Jermann.** 2000. "Efficiency, Equilibrium, and Asset Pricing with Risk of Default." *Econometrica* 68: 775-797.
- Andrade, Gregor, and Steven N. Kaplan.** 1998. "How Costly is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions that Became Distressed." *Journal of Finance* 53: 1443-1493.

- Babus, Ana, and Tai-Wei Hu.** 2017. “Endogenous Intermediation in Over-the-Counter Markets.” *Journal of Financial Economics* 125: 200-215.
- Becker, Bo, and Martin Oehmke.** 2021. “Preparing for the Post-pandemic Rise in Corporate Insolvencies.” *ASC Insight* 2: 1-23.
- Bizer, David S., and Peter M. DeMarzo.** 1992. “Sequential Banking.” *Journal of Political Economy* 100: 41-61.
- Bolton, Patrick, and David S. Scharfstein.** 1990. “A Theory of Predation Based on Agency Problems in Financial Contracting.” *American Economic Review* 80: 93-106.
- Bolton, Patrick, and David S. Scharfstein.** 1996. “Optimal Debt Structure and the Number of Creditors.” *Journal of Political Economy* 104: 1-25.
- Brander, James A., and Tracy R. Lewis.** 1986. “Oligopoly and Financial Structure: The Limited Liability Effect.” *American Economic Review* 76: 956-970.
- Brunnermeier, Markus K., and Martin Oehmke.** 2013. “The Maturity Rat Race.” *Journal of Finance* 68: 483-521.
- Centers for Disease Control and Prevention (CDC).** 2020. “Temporary Halt in Residential Evictions To Prevent the Further Spread of COVID-19.” <https://www.federalregister.gov/d/2020-19654>.
- Chava, Sudeer, and Michael R. Roberts.** 2008. “How Does Financing Impact Investment? The Role of Debt Covenants.” *Journal of Finance* 63: 2085-2121.
- Cherry, Susan, Erica Jiang, Gregor Matvos, Tomasz Piskorski, and Amit Seru.** 2021. “Government and Private Household Debt Relief during COVID-19.” Working Paper, Stanford University.
- Chodorow-Reich, Gabriel, and Antonio Felato.** 2021. “The Loan Covenant Channel: How Bank Health Transmits to the Real Economy.” *Journal of Finance*, forthcoming.
- Davydenko, Sergei A., Ilya A. Strebulaev, and Xiaofei Zhao.** 2012. “A Market-Based Study of the Cost of Default.” *Review of Financial Studies* 25: 2959-2999.

- Denis, David J., and Jing Wang.** 2014. “Debt Covenant Renegotiations and Creditor Control Rights.” *Journal of Financial Economics* 113: 348-367.
- Di Maggio, Marco, and Alireza Tahbaz-Salehi.** 2015. “Collateral Shortages and Intermediation Networks.” Working Paper, Harvard Business School.
- Diamond, Douglas W.** 1984. “Financial Intermediation and Delegated Monitoring.” *Review of Economic Studies* 51: 393-414.
- Doepke, Matthias, and Martin Schneider.** 2017. “Money as a Unit of Account.” *Econometrica* 85: 1537-1574.
- Donaldson, Jason Roderick, Edward R. Morrison, Giorgia Piacentino, and Xiaobo Yu.** 2020. “Restructuring vs. Bankruptcy.” Working Paper, Columbia University.
- Dou, Winston Wei, Lucian A. Taylor, Wei Wang, and Wenyu Wang.** 2021. “Dissecting Bankruptcy Frictions.” *Journal of Financial Economics*, forthcoming.
- Elliott, Matthew, Benjamin Golub, and Matthew O. Jackson.** 2014. “Financial Networks and Contagion.” *American Economic Review* 104: 3115-3153.
- Gârleanu, Nicolae, and Jeffrey Zwiebel.** 2009. “Design and Renegotiation of Debt Covenants.” *Review of Financial Studies* 22: 749–781.
- Glode, Vincent, and Christian C. Opp.** 2016. “Asymmetric Information and Intermediation Chains.” *American Economic Review* 106: 2699-2721.
- Glover, Brent.** 2016. “The Expected Cost of Default.” *Journal of Financial Economics* 119: 284-299.
- Gorton, Gary, and George Pennacchi.** 1990. “Financial Intermediaries and Liquidity Creation.” *Journal of Finance* 45: 49-71.
- Greenwood, Robin, Ben Iverson, and David Thesmar.** 2020. “Sizing Up Corporate Restructuring in the COVID Crisis.” *Brookings Papers on Economic Activity*, Fall 2020.

- Greenwood, Robin, and David Thesmar.** 2020. "Sharing the Economic Pain of the Coronavirus." Working Paper, Harvard Business School.
- Grossman, Sanford J., and Oliver D. Hart.** 1980. "Takeover Bids, The Free-Rider Problem, and the Theory of the Corporation." *Bell Journal of Economics* 11: 42-64.
- Grossman, Sanford J., and Oliver D. Hart.** 1986. "The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration." *Journal of Political Economy* 94: 691-719.
- Hanson, Samuel G., Jeremy C. Stein, Adi Sunderam, and Eric Zwick.** 2020. "Business Continuity Insurance: Keeping America's Lights on During the Pandemic." Working Paper, Harvard Business School.
- Harris, Milton, and A. Raviv** 1989. "The design of securities." *Journal of Financial Economics* 24: 255-287.
- Hart, Oliver, and John Moore.** 1998. "Default and Renegotiation: A Dynamic Model of Debt." *Quarterly Journal of Economics* 113: 1-41.
- He, Zhiguo, and Wei Xiong.** 2012. "Dynamic Debt Runs." *Review of Financial Studies* 25: 1799-1843.
- Hubbard, R. Glenn, and Michael R. Strain.** 2020. "A Business Fiscal Response to a COVID-19 Recession." Working Paper, American Enterprise Institute.
- Inderst, Roman, and Holger M. Mueller.** 2008. "Bank Capital Structure and Credit Decisions." *Journal of Financial Intermediation* 17: 295-314.
- Innes, Robert D.** 1990. "Limited liability and incentive contracting with ex-ante action choices." *Journal of Economic Theory* 52: 45-67.
- Jensen, Michael C., and William H. Meckling.** 1976. "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure." *Journal of Financial Economics* 3: 305-360.
- Kahn, Charles M., and Dilip Mookherjee.** 1998. "Competition and Incentives with Nonexclusive Contracts." *RAND Journal of Economics* 29: 443-65.

- Kehoe, Timothy J., and David K. Levine.** 1993. "Debt-Constrained Asset Markets." *Review of Economic Studies* 60: 865-888.
- Kiyotaki, Nobuhiro, and John Moore.** 1997. "Credit chains." Working paper, Princeton University.
- Korteweg, Arthur.** 2010. "The Net Benefits to Leverage." *Journal of Finance* 65: 2137-2170.
- Matsa, David A.** 2010. "Capital Structure as a Strategic Variable: Evidence from Collective Bargaining." *Journal of Finance* 65: 1197-1232.
- Murfin, Justin.** 2012. "The Supply-Side Determinants of Loan Contract Strictness." *Journal of Finance* 67: 1565-1601.
- Myers, Stewart C.** 1977. "Determinants of Corporate Borrowing." *Journal of Financial Economics* 5: 147-175.
- Nachman, David C., and Thomas H. Noe** 1994. "Optimal design of securities under asymmetric information." *Review of Financial Studies* 7: 1-44.
- Park, Hyejin, and Charles M. Kahn.** 2019. "Collateral, Rehypothecation, and Efficiency." *Journal of Financial Intermediation* 39: 34-46.
- Perotti, Enrico C., and Kathryn E. Spier.** 1993. "Capital Structure as a Bargaining Tool: The Role of Leverage in Contract Renegotiation." *American Economic Review* 76: 956-970.
- Riddiough, Timothy J., and Steve B. Wyatt.** 1994a. "Strategic Default, Workout, and Commercial Mortgage Valuation." *Journal of Real Estate Finance and Economics* 9: 5-22.
- Riddiough, Timothy J., and Steve B. Wyatt.** 1994b. "Wimp or Tough Guy: Sequential Default Risk and Signaling with Mortgages." *Journal of Real Estate Finance and Economics* 9: 299-321.
- Roberts, Michael R.** 2015. "The Role of Dynamic Renegotiation and Asymmetric Information in Financial Contracting." *Journal of Financial Economics* 116: 61-81.
- Roberts, Michael R., and Amir Sufi.** 2009. "Renegotiation of Financial Contracts: Evidence from Private Credit Agreements." *Journal of Financial Economics* 93: 159-184.

**Saez, Emmanuel, and Gabriel Zucman.** 2020. “Keeping Business Alive: The Government as Buyer of Last Resort.” Working Paper, University of California at Berkeley.

**Taschereau-Dumouchel, Mathieu.** 2020. “Cascades and Fluctuations in an Economy with an Endogenous Production Network.” Working Paper, Cornell University.

**U.S. Department of the Treasury.** 2020. “The CARES Act Works for All Americans.” <https://home.treasury.gov/policy-issues/cares>.

**Zhong, Hongda.** 2021. “A Dynamic Model of Optimal Creditor Dispersion.” *Journal of Finance* 76: 267-316.