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Scope for renegotiation in private debt contracts

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ABSTRACT

I study whether the demand for monitoring explains the scope for renegotiation in private debt contracts. Theory suggests that renegotiation trades off the benefits of enhanced monitoring with the costs of creditor intervention. Consistent with this tradeoff, I show that monitoring demand proxies bear a positive association with renegotiation intensity. In contrast, the costs of creditor intervention are associated with less frequent renegotiations. I also find that contractual monitoring mechanisms, such as covenants and concentrated syndicate structures, are positively related to renegotiation intensity. Furthermore, renegotiations transmit new information to the market, in line with private creditors discovering information during renegotiations.

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1. Introduction

Renegotiation plays a central role in contract theory due to its far-reaching implications for contract efficiency, security design, and the wealth of the contracting parties. A large body of theoretical work addresses contract renegotiation.¹ In the market for private credit—the primary source of external financing around the world—renegotiation is of particular importance because of its inherent link to the monitoring and control functions performed by creditors (e.g., Baird and Rasmussen, 2006; Nini et al., 2012). More specifically, renegotiation is a mechanism through which creditors can participate in a firm's governance. Renegotiation can affect investment decisions, alleviate incentive conflicts, lead to private information discovery, or cause changes in a firm's management team. Despite the primary importance of renegotiation in theoretical work, large

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¹ Theoretical research that addresses contract renegotiation includes Grossman and Hart (1986), Huberman and Kahn (1988a, b, 1989), Hart and Moore (1988, 1998), Hart and Tirole (1988), Tirole (1986), Dewatripont (1989), Dewatripont and Maskin (1990, 1995), Fudenberg and Tirole (1990), Aghion, Dewatripont and Rey (1994), Bergman and Callen (1991), Bester (1994), Noldecke and Schmidt (1995), Hermalin and Katz (1991), Aghion and Bolton (1992), Berlin and Mester (1992), Bolton and Scharfstein (1996), Maskin and Moore (1999), Maskin and Tirole (1999), Segal (1999), Gorton and Kahn (2000), Garleanu and Zwiebel (2009), and Bolton and Oehmke (2011).

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sample empirical evidence on what can explain frequent contract renegotiations is not available. In this study, I address this void by investigating the link between the intensity of debt contract renegotiation and the demand for monitoring by creditors.

In theory, scope for contract renegotiation, i.e., the presence of opportunities for mutually beneficial revisions of a contract, stems from two sources of contractual incompleteness. First, the exogenous uncertainty present *ex ante* implies a large number of possible future states of the world (contingencies) that are impossible to anticipate and incorporate into the initial contract. Once uncertainty is realized, renegotiation becomes a means of completing the contract by responding to the unforeseen contingencies. Exogenous uncertainty is thus the primary driver of renegotiation. Second, for any given level of exogenous uncertainty, contractual outcomes also depend on the agent's endogenous non-contractible *actions*. These actions are difficult to induce via *ex ante* contracts in the presence of agency and information problems, creating a need to monitor and discipline the agent *ex post*, hence prompting future renegotiations. The agency and information problems are thus important theoretical determinants of contract renegotiation (e.g., Huberman and Kahn, 1988a; Aghion and Bolton, 1992; Berlin and Mester, 1992; Gorton and Kahn, 2000; Dessein, 2005).

Prior empirical evidence is consistent with the key driver of renegotiations being the realization of exogenous uncertainty, i.e., the first source of contractual incompleteness. Roberts and Sufi (2009) and Roberts (2015) find that debt contract renegotiation is triggered in response to *ex post* changes in the company or market conditions. While informative, these studies focus on *ex post* triggers of renegotiation and do not investigate the link between renegotiation and contracting frictions, such as hold-up, agency, and information problems, present *ex ante*. This link is the focus of my study. I investigate whether the intensity of contract renegotiation is determined (and anticipated by the contracting parties) *ex ante* as a function of the demand for monitoring stemming from the underlying agency and information problems.²

To address this question, I depart from prior studies in an important way. I construct a novel and comprehensive sample of renegotiations that aims to approximate their population. This data exhibits a rich cross-sectional variation in renegotiation frequency that has not been previously documented or examined. It allows me to focus on understanding the intensive margin of renegotiations by introducing the notion of renegotiation intensity, defined as renegotiation frequency over a given time period or the time between renegotiations. Renegotiation intensity is more suitable for studying the link between monitoring and renegotiation because monitoring is largely a matter of degree rather than a binary choice.³ In contrast, Robert and Sufi (2009) focus on the extensive margin, i.e., the presence of at least one renegotiation before maturity.⁴ However, firms that renegotiate contracts every quarter and those that only do so once before maturity are likely to differ in the intensity of their creditor monitoring. Conceptually, renegotiation intensity is better aligned with the theoretical notion of monitoring intensity, although the two are not equivalent (given that monitoring is not the sole driver of renegotiations). Hence, it is interesting and important to study.⁵

I draw on the incomplete contract theory to formulate two main predictions. Future renegotiations entail a tradeoff from an *ex ante* perspective. On the benefit side, when managerial actions are not contractible, renegotiations allow lenders to monitor and discipline the management *ex post*. In return, lenders will share monitoring benefits with their borrowers, e.g., via lower interest rates. Renegotiations are more likely to be beneficial when agency and information conflicts are more pronounced (Berlin and Mester, 1992; Garleanu and Zwiebel, 2009). Therefore, borrowers with a higher demand for monitoring should exhibit higher renegotiation intensity (the monitoring hypothesis). On the cost side, renegotiations lead to hold-up problems and create inefficiencies to the extent that creditors over-monitor or interfere with a company's optimal investment policies. Creditors who favor safer investments over long-term projects with high future growth opportunities can use renegotiations to curtail profitable investment projects before their payoff is realized or to veto new investments (Hart and Moore, 1994, 1998). Creditors can also use renegotiations as an opportunity to extract rents (Sharpe, 1990; Rajan, 1992). This suggests that companies where the costs of over-monitoring are more severe are expected to have a lower renegotiation intensity (investment efficiency hypothesis).

Testing these predictions requires several proxies for unobservable constructs. I use the *realized* renegotiation intensity as a proxy for the renegotiation intensity implied by the *ex ante* firm and contract characteristics. Some realized renegotiations are bound to be inexplicable from the *ex ante* perspective, which makes the hypotheses above more difficult to test using a

² Renegotiation intensity can thus be thought of as an *ex ante* implied construct. Ideally, I would be able to observe the implied renegotiation intensity at the time of contract initiation. However, empirically, I use realized renegotiation intensity, assuming that the two constructs are closely related.

³ Monitoring is defined broadly and includes different activities by private creditors to acquire timely information about managerial actions and firm performance and to act on this information by exercising control over management or by modifying the contract. For example, monitoring can be interpreted as liquidating bad projects and renegotiating to lower the interest rate to avoid asset substitution (e.g., Gorton and Kahn, 2000).

⁴ The extensive margin captures whether or not a contract is renegotiated over its life, whereas the intensive margin captures the intensity of renegotiation per unit of time. The two constructs are conceptually distinct choices, e.g., whether to work and how much to work in a given day.

⁵ Roberts and Sufi (2009) look for one renegotiation before maturity, whereas Roberts (2015) counts the number of renegotiations before maturity. These constructs, while useful, do not capture the intensity of the monitoring. To see this, suppose we observe a 10-year and a 2-year contract, both renegotiated twice before maturity. To the extent that the renegotiation reflects monitoring, the 2-year contract exhibits higher monitoring intensity. However, this is not captured by the number of renegotiations or by whether at least one renegotiation occurred before maturity. Furthermore, a higher number of renegotiations over the contract duration is often a direct manifestation of a longer maturity. In fact, empirically, long-term contracts exhibit a lower likelihood of renegotiation in a given quarter or year than short-term contracts. The number of renegotiations (or the presence of at least one renegotiation before maturity) also does not properly capture the renegotiation intensity of loans that are prepaid before maturity. Finally, renegotiation intensity, by design, allows for richer heterogeneity and is independent of contract maturity.

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