Multiple Lenders, Strategic Default and Covenants
Andrea ATTAR

Toulouse School of Economics
and Università di Roma Tor Vergata

Abstract
We study capital markets subject to moral hazard when investors cannot prevent side trading, thereby facing an externality if firms raise funds from multiple sources. We analyze whether investors’ ability to design financial covenants that may include exclusivity clauses mitigates this externality. Following covenant violations, investors can accelerate the repayment of their loan, adjust its size, or increase interest rates. Enlarging contracting opportunities generates a severe market failure: with covenants, equilibria are indeterminate and Pareto ranked. We show that an investors-financed subsidy scheme to entrepreneurs alleviates the incentive to overborrow and sustains the competitive allocation as the unique equilibrium one.

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