A firm issues a convertible bond. At each subsequent time, the bondholder must decide whether to continue to hold the bond, thereby collecting coupons, or to convert it to stock. The bondholder wishes to choose a conversion strategy to maximize the bond value. Subject to some restrictions, the bond can be called by the issuing firm, which presumably acts to maximize the equity value of the firm by minimizing the bond value. This creates a two-person game. We show that if the coupon rate is below the interest rate times the call price, then conversion should precede call. On the other hand, if the dividend rate times the call price is below the coupon rate, call should precede conversion. In either case, the game reduces to a problem of optimal stopping.

Keywords: Convertible bonds, optimal stopping, two-person game, viscosity solutions, free boundary

Mathematics Subject Classification (1991): 90A09, 60H30, 60G44
1 Introduction

Firms raise capital by issuing debt (bonds) and equity (shares of stock). The convertible bond is intermediate between these two instruments. A convertible bond is a bond in that it entitles its owner to receive coupons plus the return of principal at maturity. However, prior to maturity the holder may convert the bond, surrendering it for a pre-set number of shares of stock. The price of the bond is thus dependent on the price of the firm’s stock. Finally, prior to maturity, the firm may call the bond, forcing the bondholder to either surrender it to the firm for a previously agreed price or else convert it for stock as above.

After issuing a convertible bond, the firm’s objective is to exercise its call option in order to maximize the value of shareholder equity. The bondholder’s objective is to exercise the conversion option in order to maximize the value of the bond. If stock and convertible bonds are the only assets issued by a firm, then the value of the firm is the aggregate value of these two types of assets. In idealized markets where the Miller-Modigliani [29], [30] assumptions hold (see Hennessy & Tserhukevich [18] for a model in which they do not), changes in corporate capital structure do not affect firm value. In particular, the value of the firm does not change at the time of conversion, and the only change in the value of the firm at the time of call is a reduction by the call price paid to the bondholder if the bondholder surrenders rather than converts the bond. By acting to maximize the value of equity, the firm is in fact minimizing the value of the convertible bond. By acting to maximize the value of the bond, the bondholder is in fact minimizing the value of equity. This creates a two-person, zero-sum game. The game is complicated by the fact that one can expect the dividend payment policy of the firm to depend on the bond price, a feature explicitly modeled in this paper. This feature causes the bond price to be governed by a nonlinear second-order partial differential equation, a novel feature of this paper.

This is a companion paper to Sîrbu, et. al. [33]. In [33], the bond did not mature and hence time was not a variable, whereas in the present paper, the bond has finite maturity and the bond price depends on the time to maturity.

Brennan & Schwartz [8] and Ingersoll [20] address the convertible bond pricing problem via the arbitrage pricing theory developed by Merton [28] and underlying the option pricing formula of Black & Scholes [7]. In the Brennan & Schwartz [8] model, dividends and coupons are paid at discrete dates. Between these dates, the value of the firm is a geometric Brownian
motion and the price of the convertible bond is governed by the *linear* partial differential equation developed by Black & Scholes [7]. This sets up a backward recursion over payment dates, which permits a numerical solution of the bond pricing problem but is not readily amenable to qualitative analysis. In Ingersoll [20], coupons are paid out continuously. For most of the results obtained, dividends are zero, and because of this, the bond price is again governed by a *linear* partial differential equation.

The present paper differs from the classical literature in a second respect. In [8], the bond should not be converted except possibly immediately prior to a dividend payment; in [20], the bond should not be converted except possibly at maturity. Therefore, neither of these papers needs to address the *free boundary problem* that arises if early conversion (other than at discrete dates) is optimal.

Ingersoll [20] provides a heuristic argument that the firm should call as soon as the conversion value of the bond (the value the bondholder would receive if he converts the bond to stock) rises to the call price. It is observed that firms tend to call later than this, and several reasons have been advanced to explain this departure from the model; see, e.g., [2], [3], [15], [17] [21]. We show here by a rigorous analysis of the model that although the Ingersoll conclusion is often valid, it is also possible that the firm should call *before* the conversion value of the bond rises to the call price. In these cases, explanation of observed firm behavior is more difficult than previously believed.

The present paper assumes that a firm’s value comprises equity and convertible bonds. To simplify the discussion, we assume the equity is in the form of a single share of stock, and there is a single convertible bond. We assume the value of the issuing firm has constant volatility, the bond continuously pays coupons at a fixed rate, and the firm pays dividends at a rate that is a fixed fraction of equity. Default occurs if the coupon payments cause the firm value to fall to zero, in which case the bond has zero recovery. In this model, both the bond price and the stock price are functions of the underlying firm value. Because the stock price is the difference between firm value and bond price, and dividends are paid proportionally to the stock price, the differential equation characterizing the bond price as a function of the firm value is *nonlinear*.

Once the firm and the bondholder choose their call and conversion strategies, the price of the bond is the expected value under the *risk-neutral measure* of the cash flows that accrue from ownership of the bond. In [33], Theorem 2.1, this risk-neutral pricing is justified by no-arbitrage considerations.
The determination of the call and conversion strategies is a Dynkin game between the firm and the bondholder, and the bond is almost a game option in the sense of Kifer [24]. In contrast to [24], here the evolution of the underlying process, the firm value, depends on the solution to the game. Kallsen & Kühn [22] consider a game option setting that includes this possibility.

Recognition that convertible bond pricing is a game is implicit in previous work. For example, [8] observes that the pricing problem “...results in a pair of conversion-call strategies which are in equilibrium in the sense that neither party could improve his position by adopting any other strategy”. Here we make the game explicit and obtain a good qualitative description of its value. In particular, if the dividend rate is below the interest rate, then the game reduces to one of two possible optimal stopping problems, either the problem of optimal call or the problem of optimal conversion, and we are able to determine in advance from the model parameters which of these two problems is relevant.

Convertible bonds can have several features that must be captured by any model intended for practical application; see [27]. These include periods of call protection, time-dependent conversion factors, and exposure to interest rate and default risk. The model of this paper captures only the default risk, and that via a simple structural model in which default occurs at the time the firm value falls to zero. Loshak [25] allows nonconvertible senior debt and uses a more sophisticated structural model for default. Brennan & Schwartz [9] also allow senior debt. Another interesting issue is the process of conversion when bonds are held by competing investors; see Constantinides [11] and Constantinides & Rosenthal [12].

Practical models have been built around the idea that the cash flow from a convertible bond can be separated into an “equity” part, which should be discounted at the interest rate, and a “bond” part, which should be discounted at the interest rate plus a credit spread. Papers taking this approach are McConnell & Schwartz [26], Cheung & Nelken [10], Ho & Pteffer [19], Tsiveriotis & Fernandes [36], and Yigitbasioglu [37]. Ayache, et. al. [4] analyze some of this work and conclude that its failure to account for the effect of default on equity introduces significant pricing errors. This deficiency is corrected in Davis & Lischka [14], Takahashi et. al. [35], and Andersen & Buffum [1], who build intensity-based models for default affecting equity value.

We describe our model in Section 2 and report our main results in Section 3. In particular, the Dynkin game that describes the bond price reduces to...
one of two optimal stopping problems and a fixed point problem. Section 4 provides a probabilistic justification for the reduction of the game to optimal stopping. Viscosity solution results concerning the Hamilton-Jacobi-Bellman equations governing the optimal stopping problems are provided in Section 5. This permits the proof in Section 6 of the existence and uniqueness of the solution to the fixed point problem, and this solution is the bond pricing function. Section 7 relates this paper to perpetual convertible bonds. In Section 8 we provide some results on the nature of the stopping and continuation regions of the optimal stopping problems of this paper.

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2 The model

We assume the value of the firm consists of equity and debt. The debt $D_t$ is due to a single outstanding convertible bond. This assumption of a single bond means that all debt is called and/or converted simultaneously. We denote by $S_t$ the total value of equity. The value of the firm is then

$$X_t = S_t + D_t.$$  \hfill (2.1)

Equity owners receive dividends paid continuously over time at a rate $\delta S_t$, and the bondholder receives coupons paid continuously over time at a rate $c$. We assume $\delta \geq 0$ and $c > 0$ are both constant. If there is no call or conversion prior to maturity $T$, then at maturity the bondholder receives the par value $L$ from the firm, provided $X_T \geq L$. Otherwise, the bondholder receives $X_T$. However, at any time $t \in [0, T]$, the bondholder may convert the bond to stock, thereby immediately receiving stock valued at the conversion factor $\gamma \in (0, 1)$ times the firm value $X_t$. The firm value is not affected by this conversion. On the other hand, at any time $t$ when $X_t \geq K$, the firm may call the bond, forcing the bondholder to either immediately surrender the bond in exchange for the call price $K$ or else immediately convert the bond as described above. We assume $K \geq L > 0$; it is common to have $L = K$. If $K$ were less than $L$, then $L$ would be irrelevant since the firm could always call at maturity to avoid paying $L$.

We assume that the firm value is driven by a Brownian motion and has constant volatility $\sigma > 0$. Under the risk-neutral measure $\mathbb{P}$, it must then
have the form
\[ dX_t = rX_t \, dt - c \, dt - \delta S_t \, dt + \sigma X_t \, dW_t, \] (2.2)
where the interest rate \( r \geq 0 \) is constant and \( W_t, 0 \leq t \leq T, \) is a standard Brownian motion under \( \mathbb{P}. \) We adopt throughout the \textit{standing assumption}
\[ 0 \leq \delta < r, \] (2.3)
but see Remark 3.4 below. Equation (2.2) says that under the risk-neutral measure the mean rate of growth of \( X_t \) is the interest rate \( r \) adjusted by the payouts being made. If there were no probability measure \( \mathbb{P} \) supporting this evolution of the firm and pricing the bond by (2.4) below, then under mild assumptions one could construct an arbitrage by trading in the stock, the bond, and the money market account; see equation (2.5) and Theorem 2.1 of [33] for the argument in the case of a perpetual convertible bond.

The process \( S_t \) in (2.2) is not yet defined. For the moment, let us suppose that it is some exogenously specified process. We shall price the bond at time \( s \in [0,T] \) under the assumption that \( X_s = x. \) Given these initial conditions, we denote by \( X_{t}^{s,x} \) the solution to (2.2) at time \( t \in [s,T] \) and set
\[ \theta_{s,x}^{y} \triangleq \min \{ t \in [s,T] : X_{t}^{s,x} = y \}, \quad y \geq 0, \]
where we adopt the convention that \( \min \emptyset = \infty. \) The firm defaults on the bond at time \( \theta_{s,x}^{0} \) if \( \theta_{s,x}^{0} \leq T, \) and \( \theta_{s,x}^{0} = \infty \) corresponds to no default.

The firm adopts a \textit{call strategy} \( \rho \) and the bondholder adopts a \textit{conversion strategy} \( \tau. \) Both of these are stopping times for the filtration generated by \( W_u - W_s, u \in [s,T] \) (augmented by \( \mathbb{P}-\)null sets), and they must satisfy \( \rho, \tau \in [s,T] \cap \theta_{0}^{s,x} \cap \{ \theta_{0}^{s,x} \}. \) We denote the set of all such stopping times by \( S_{s,x}^{s,x}. \) We interpret \( \rho \) and \( \tau \) to be the times of call and conversion, respectively, except that on the set \( \{ \rho = \theta_{0}^{s,x} \}, \) there is no call. Similarly, on the set \( \{ \tau = \theta_{0}^{s,x} \}, \) there is no conversion. On the set \( \{ \rho = \tau < \theta_{0}^{s,x} \}, \) there is simultaneous call and conversion, and the conversion takes priority. The firm can call at time \( \rho < \theta_{0}^{s,x} \) only if \( X_{\rho}^{s,x} \geq K. \) We denote by \( S_{K}^{s,x} \) the set of stopping times in \( S_{s,x}^{s,x} \) satisfying this additional condition, and require that \( \rho \in S_{K}^{s,x}. \) Once the call and conversion strategies \( \rho \in S_{K}^{s,x} \) and \( \tau \in S_{s,x}^{s,x} \) are chosen, the value of the bond at time \( s \) if the firm value is \( x \) is
\[ J(s,x;\rho,\tau) \triangleq e^{rs} \mathbb{E} \left[ \int_{s}^{\rho \land \tau \land T} e^{-ru} c \, du + e^{-r(\rho \land \tau \land T)} (I_{\{\tau \leq \rho \land T\}} \gamma X_{T}^{s,x} + I_{\{\rho < \tau\}} K + I_{\{\rho \land \tau = \infty\}} (X_{T}^{s,x} \land L)) \right]. \] (2.4)
3 The method and principal results

We must deal with the fact that the process $S_t$ is Section 2 is endogenous. In fact, the bond price, the firm value and the equity value $S_t$ are related by (2.1). We seek a function $g(t, x)$ such that prior to call and conversion, $D_t = g(t, X_t)$ and hence $S_t = X_t - g(t, X_t)$. We eventually see (Lemma 4.1 below) that if $\gamma X_t \geq K$, then it is optimal to convert and hence $D_t = \gamma X_t$. Hence, the function $g(t, x)$ should satisfy

\[ g(t, x) = \gamma x \text{ for } 0 \leq t \leq T \text{ and } x \geq \frac{K}{\gamma}. \tag{3.1} \]

Also, we expect both the value of the bond and the value of the equity to increase with increasing firm value, which is equivalent to

\[ 0 \leq g(t, y) - g(t, x) \leq y - x \text{ for } 0 \leq t \leq T \text{ and } 0 \leq x \leq y. \tag{3.2} \]

The bond is never worth less than its conversion value and never worth more than the firm value. Since the firm can always call, if $\gamma x \leq K$ so that call does not result in conversion, the bond is not worth more than the call price. In other words,

\[ \gamma x \leq g(t, x) \leq x \wedge K \text{ for } 0 \leq t \leq T \text{ and } 0 \leq x \leq \frac{K}{\gamma}. \tag{3.3} \]

We shall show that the bond price is of the form $g^*(t, X_t)$ for some $g^*$ in $G = \{ g : [0, T] \times [0, \infty] \rightarrow [0, \infty] : g \text{ is continuous and (3.1)-(3.3) hold} \}$.

To get started, we simply choose an arbitrary $g \in G$ and define

\[ S_t = X_t - g(t, X_t). \tag{3.4} \]

We substitute this value of $S_t$ into (2.2), thereby obtaining a stochastic differential equation for $X$. The Lipschitz continuity (3.2) guarantees that this equation has a strong solution corresponding to every initial condition $(s, x) \in [0, T] \times [0, \infty)$, and we thus obtain $X^{s,x}$. We proceed as in Section 2, and conclude with the function $J$ of (2.4), which we now denote $J_g$.

For each fixed $g \in G$, we can construct a Dynkin game, where now the evolution of the underlying process is specified by (2.2) and (3.4). This game has lower and upper values

\[ v_g(s, x) \triangleq \sup_{\tau \in S^{s,x}} \inf_{\rho \in S^x_K} J_g(s, x; \rho, \tau), \quad \pi_g(s, x) \triangleq \inf_{\rho \in S^x_K} \sup_{\tau \in S^{s,x}} J_g(s, x; \rho, \tau), \]
respectively. Clearly, \( v_g \leq \bar{v}_g \). In fact,

\[
v_g(s, x) = \bar{v}_g(s, x) \quad \text{for} \quad 0 \leq s \leq T \quad \text{and} \quad x \geq 0.
\] (3.5)

This is a consequence of the theory of Dynkin games, but rather than appeal to that theory, we obtain (3.5) as a by-product of our characterization of the solution of the game; see Lemma 4.1 and Propositions 4.5 and 4.6 below.

The function \( v_g = \bar{v}_g \) would provide the price of the convertible bond if we chose \( g \) to be the pricing function of the convertible bond. That is to say, we want to find a function \( g^* \in \mathcal{G} \) such that \( v_{g^*} = \bar{v}_g = g^* \). Let us define the operator \( T \) on \( \mathcal{G} \) by \( Tg \triangleq v_g = \bar{v}_g \). We shall prove the following.

**Theorem 3.1** \( T \) maps \( \mathcal{G} \) into \( \mathcal{G} \) and has a unique fixed point \( g^* \).

The convertible bond pricing function \( g^* \) satisfies the terminal condition

\[
g^*(T, x) = (x \land L) \lor (\gamma x) \quad \text{for} \quad 0 \leq x \leq \frac{K}{\gamma}.
\] (3.6)

Because \( g^* \) also satisfies (3.1), we only need to describe this function on \( [0, T) \times [0, \frac{K}{\gamma}] \). From (3.3) we have the boundary conditions

\[
g^*(t, 0) = 0, \quad g^*(t, \frac{K}{\gamma}) = K \quad \text{for} \quad 0 \leq t \leq T.
\] (3.7)

**Theorem 3.2 (Case I)** If \( c \leq rK \), the time of optimal call is the first time the conversion value \( \gamma X_t \) rises to the call price \( K \). The bond pricing function \( g^* \) is determined by solving the problem of optimal conversion in \( [0, T] \times [0, \frac{K}{\gamma}] \). In particular, \( g^* \) is the unique continuous viscosity solution of the variational inequality

\[
\min \left\{ -v_t + rv - (rx - c)v_x + \delta(x - v)v_x - \frac{1}{2}\sigma^2x^2v_{xx} - c, v - \gamma x \right\} = 0
\]

satisfying (3.6) and (3.7).

**Case II** If \( \delta K \leq c \), the time of optimal conversion is the first time the conversion value \( \gamma X_t \) rises to the call price \( K \), or at maturity if the conversion value exceeds the par value. The bond pricing function \( g^* \) is determined by
solving the problem of optimal call in \([0, T] \times [0, K]\). In particular, \(g^*\) is the unique continuous viscosity solution of the variational inequality

\[
\max \left\{ -v_t + rv - (rx - c)v_x + \delta(x - v)v_x - \frac{1}{2}\sigma^2 x^2 v_{xx} - c, v - K \right\} = 0
\]

satisfying (3.6) and (3.7).

**Remark 3.3** Because of standing assumption (2.3), Cases I and II overlap. In other words, we can have \(\delta K \leq c \leq rK\), and optimal call and conversion both occur the first time \(\gamma X_t\) rises to \(K\). In this case, \(g^*\) is the unique continuous viscosity solution on \([0, T] \times [0, K]\) of the partial differential equation

\[
-v_t + rv - (rv - c)v_x + \delta(x - v)v_x - \frac{1}{2}\sigma^2 x^2 v_{xx} = c
\]

satisfying (3.6) and (3.7).

**Remark 3.4** The proofs in this paper do not actually require standing assumption (2.3), but rather that either \(c \leq rK\) or \(\delta K \leq c\). Under either of these conditions, Theorems 3.1 and 3.2 hold. However, Theorem 3.5 below requires (2.3) for the pricing of the perpetual convertible bond; see [33].

**Theorem 3.5** As the time to maturity approaches \(\infty\), the price of the finite-maturity convertible bond approaches the price of the perpetual convertible bond of [33], and this convergence is uniform in the firm value.

## 4 Construction and properties of \(v_g\)

### 4.1 Reduction to \([0, T] \times [0, K/\gamma]\)

**Lemma 4.1** Assume that \(g\) defined on \([0, T] \times [0, \infty)\) satisfies (3.2), so that (3.4) and (2.2) uniquely determine a process \(X^{s,x}\) for \((s, x) \in [0, T] \times [0, \infty)\). Then

\[
v_g(s, x) = \underline{v}_g(s, x) = \gamma x \quad \text{for} \quad 0 \leq s \leq T \quad \text{and} \quad x \geq \frac{K}{\gamma}.
\]

**Proof:** With \(\tau \equiv s\), (2.4) implies \(J_g(s, x; \rho, s) = \gamma x\) for \(\rho \in \mathcal{S}_K^{s,x}\), and thus

\[
v_g(s, x) \geq \inf_{\rho \in \mathcal{S}_K^{s,x}} J_g(s, x; \rho, s) = \gamma x.
\]
For \( x \geq \frac{K}{\gamma} \), we may set \( \rho \equiv s \), and then have for every \( \tau \in S^{s,x} \) that

\[
J_g(s, x; s, \tau) = \gamma x \mathbb{I}_{\{\tau = s\}} + K \mathbb{I}_{\{s < \tau\}} \leq \gamma x,
\]

and hence

\[
\nu_g(s, x) \leq \sup_{\tau \in S^{s,x}} J_g(s, x; s, \tau) \leq \gamma x.
\] (4.3)

But directly from their definitions, we know that \( \nu_g \leq \overline{v}_g \).

We fix a function \( g \in G \) for the remainder of Section 4.

### 4.2 Modification of payoffs

We wish to restrict attention to stopping times in

\[
S_{T}^{s,x} \triangleq \{ \theta \in S^{s,x} : \theta \leq T \}.
\]

In particular, we do not want to allow stopping times to take the value \( \infty \), and we do not want to require the call strategy \( \rho \) to satisfy \( X_{\rho}^{s,x} \geq K \) on \( \{ \rho < \theta_0^{s,x} \} \). To replace \( S^{s,x} \) and \( S_{K}^{s,x} \) in the definition of \( v_g \) and \( \overline{v}_g \), it is necessary to change the payoffs appearing in (2.4). We define

\[
\psi(t, x) \triangleq \begin{cases} 
\gamma x & \text{for } 0 \leq t < T, x \geq 0, \\
(x \wedge L) \vee (\gamma x) & \text{for } t = T, x \geq 0,
\end{cases}
\]

\[
\varphi(t, x) \triangleq \begin{cases} 
(x \wedge K) \vee (\gamma x) & \text{for } 0 \leq t < T, x \geq 0, \\
(x \wedge L) \vee (\gamma x) & \text{for } t = T, x \geq 0.
\end{cases}
\]

Then \( \psi < \varphi \) on \([0, T) \times (0, \frac{K}{\gamma})\) and \( \psi = \varphi \) on the parabolic boundary

\[
\partial_p D_0 \triangleq \left( [0, T) \times \left\{ 0, \frac{K}{\gamma} \right\} \right) \cup \left( \{ T \} \times \left[ 0, \frac{K}{\gamma} \right] \right). \quad (4.4)
\]

For \( \rho, \tau \in S_{T}^{s,x} \), we define

\[
\tilde{J}_g(s, x; \rho, \tau) \triangleq e^{rs} \mathbb{E} \left[ \int_s^{\rho \wedge \tau} e^{-ru} c \, du + e^{-r(\rho \wedge \tau)} (\mathbb{I}_{\{\tau < \rho\}} \psi(\tau, X_{\tau}^{s,x}) + \mathbb{I}_{\{\rho \leq \tau\}} \varphi(\rho, X_{\rho}^{s,x})) \right].
\]

The interpretation of \( \tilde{J}_g \) is that if the firm value is insufficient to pay the call price at the time of the call, then the bondholder receives the firm value. Also, call takes priority over conversion, but the bondholder receives the conversion value if that is greater than the call price at the time of the call.

The following modification of Lemma 4.1 is straightforward.

**Lemma 4.2** For \( 0 \leq s \leq T \) and \( x \geq \frac{K}{\gamma} \), we have

\[
\inf_{\rho \in S_{T}^{s,x}} \sup_{\tau \in S_{T}^{s,x}} \tilde{J}_g(s, x; \rho, \tau) = \sup_{\tau \in S_{T}^{s,x}} \inf_{\rho \in S_{T}^{s,x}} \tilde{J}_g(s, x; \rho, \tau) = \gamma x.
\]
4.3 Technical preparations

Itô’s formula implies that if \( h \) is a continuous function on \([0, T] \times [0, \frac{K}{\gamma}]\) and \( h \) is \( C^{1,2} \) on the interior of its domain, then for \((s, x) \in [0, T] \times [0, \frac{K}{\gamma}]\),

\[
\begin{align*}
\int_s^t e^{-ru}c du + e^{-rt}h(t, X_t^{s,x}) \\
&= e^{-rt} \left[ -L_g h(t, X_t^{s,x}) + c \right] dt + e^{-rt} \sigma X_t^{s,x} h_x(t, X_t^{s,x}) dW_t
\end{align*}
\]

(4.5)

for \( t \in [s, \theta_{\theta_0}^{s,x} \wedge \theta_{\frac{K}{\gamma}}^{s,x} \wedge T] \), where

\[
L_g h(t, x) \triangleq -h_t(t, x) + rh(t, x) - (rx - c)h_x(t, x) + \delta(x - g(t, x))h_x(t, x) - \frac{1}{2} \sigma^2 x^2 h_{xx}(t, x).
\]

(4.6)

**Lemma 4.3** Let \( \bar{c} > 0 \) be given, and for \( 0 \leq s \leq T \) and \( 0 \leq x \leq \frac{K}{\gamma} \), define

\[
k(s, x) \triangleq e^{rs} \mathbb{E} \left[ e^{-ru}c \int_s^t e^{-ru} \psi \left( \theta_0^{s,x} \wedge \theta_{\frac{K}{\gamma}}^{s,x} \wedge T \right) du + \varphi \left( \theta_0^{s,x} \wedge \theta_{\frac{K}{\gamma}}^{s,x} \wedge T \right) \right]
\]

\[
= e^{rs} \mathbb{E} \left[ e^{-ru} \psi \left( \theta_0^{s,x} \wedge \theta_{\frac{K}{\gamma}}^{s,x} \wedge T \right) \right] du + \varphi \left( \theta_0^{s,x} \wedge \theta_{\frac{K}{\gamma}}^{s,x} \wedge T \right)
\]

(4.7)

where we have used the fact that \( \psi \) and \( \varphi \) agree on the parabolic boundary \( \partial_p D_0 \). Then \( k \) is continuous and satisfies \( k = \varphi = \psi \) on \( \partial_p D_0 \).

**Remark 4.4** We would expect the function \( k \) to satisfy the partial differential equation \( L_g k = \bar{c} \), but since \( g \) is only continuous, not Hölder continuous, with respect to time, we do not know that this equation has a classical solution. Hence, we give a probabilistic proof of Lemma 4.3.

**Proof of Lemma 4.3:** It is apparent that \( k = \psi \) on \( \partial_p D_0 \). It remains to prove the continuity.

We extend \( g \) to a jointly continuous function, globally Lipschitz in its second variable, defined on \([0, T] \times \mathbb{R}\), so that for every \((s, x) \in [0, T] \times [0, \frac{K}{\gamma}]\),

\( X_t^{s,x} \) can be defined by (2.2) and (3.4) for all \( t \in [s, T] \). We define \( X_t^{s,x} = x \)
for \( t \in [0, s) \). All the processes \( X^{s,x} \) are defined on the same probability space \((\Omega, \mathcal{F}, \mathbb{P})\) and take values in \( C[0, T] \).

For \((s, x) \in [0, T] \times [0, \frac{K}{\gamma}]\), denote by \( \mathbb{P}^{s,x} \) the distribution of \( X^{s,x} \) on \( C[0, T] \). According to [34], p. 152, \( \mathbb{P}^{s,x} \) is continuous in \((s, x)\). For \((s, x) \in [0, T] \times \mathbb{R}\), we define the measure \( \mathbb{Q}^{s,x} \triangleq \mathbb{P}^{s,x} \) on \([0, T] \times C[0, T]\), where \( \delta_s \) denotes the unit point mass at \( s \). Then \( \mathbb{Q}^{s,x} \) is also continuous in \((s, x)\) ([6], Theorem 2.8, p. 23), which means that

\[
\int_{C[0,T]} f(s_n, y) d\mathbb{P}^{s_n,x_n}(y) \to \int_{C[0,T]} f(s, y) d\mathbb{P}^{s,x}(y) \tag{4.8}
\]

whenever \( s_n \to s \), \( x_n \to x \) and \( f \) defined on \([0, T] \times C[0, T]\) is a bounded function that is continuous except on a \( \mathbb{Q}^{s,x} \)-null set.

We define \( \tau : [0, T] \times C[0, T] \to [0, T] \) by

\[
\tau(s, y) \triangleq T \wedge \min \left\{ t \in [s, T] : y(t) \notin \left(0, \frac{K}{\gamma}\right) \right\},
\]

so that \( \theta_{0}^{s,x} \wedge \theta_{\frac{K}{\gamma}}^{s,x} \wedge T = \tau(s, X^{s,x}) \). For \( \mathbb{P} \)-almost every \( \omega \), we know that if \( \tau(s, X^{s,x}(\omega)) < T \), then there is a sequence \( \epsilon_n \downarrow 0 \), depending on \( s \), \( x \), and \( \omega \), such that \( X_{\tau(s, X^{s,x}((\omega)) + \epsilon_n)}^{s,x} \notin [0, \frac{K}{\gamma}] \) for every \( n \). Indeed, if \( X^{s,x}(\omega) \) exits \((0, \frac{K}{\gamma})\) at \( \frac{K}{\gamma} \), this is a consequence of the non-degeneracy of the diffusion term in (2.2) at the time of exit; if \( X^{s,x}(\omega) \) exits \((0, \frac{K}{\gamma})\) at \( 0 \), it follows from the fact that \( c > 0 \) and all other terms on the right-hand side of (2.2) are zero at the time of exit. Using this fact, it is straightforward to show that for every \((s, x) \in [0, T] \times \mathbb{R} \), \( \tau \) is continuous except on a \( \mathbb{Q}^{s,x} \)-null set.

We conclude by rewriting (4.7) as

\[
k(s_n, x_n) = e^{rs_n} \int_{[0,T]} \left[ \int_{s_n}^{\tau(s_n, y)} e^{-ru} \psi \left( \tau(s_n, y), y \left( \tau(s_n, y) \right) \right) \right] d\mathbb{P}^{s_n,x_n}(dy)
\]

and observing that because the argument of \( \psi \) is in \( \partial_p D_0 \), where \( \psi \) is bounded and continuous, (4.8) implies \( k(s_n, x_n) \to k(s, x) \) as \( s_n \to s \), \( x_n \to x \). \( \diamond \)
4.4 Characterization of game value

Proposition 4.5 (Case I) Assume \( c \leq rK \). In this case, we define

\[
v_g(s,x) \equiv \sup_{\tau \in S^{s,x}_T, \tau \leq \theta^{s,x}_K} e^{rs} \mathbb{E} \left[ \int_s^\tau e^{-ru} c \, du + e^{-r\tau} \psi(\tau, X^{s,x}_\tau) \right]
\]

(4.9)

for \((s, x) \in [0, T] \times [0, K \gamma]\). Then \( v_g = v_g = v_g \) on \([0, T] \times [0, K \gamma]\). Furthermore,

\[
v_g(s,x) = \inf_{\rho \in S^{s,x}_T} \sup_{\tau \in S^{s,x}_T} \tilde{J}_g(s, x; \rho, \tau) = \sup_{\tau \in S^{s,x}_T} \inf_{\rho \in S^{s,x}_T} \tilde{J}_g(s, x; \rho, \tau).
\]

(4.10)

**Proof:**

**Step 1:** Construction of an upper bound on \( v_g \). Define \( h_1(t, x) \equiv K \) and \( h_2(t, x) \equiv x \) for \( 0 \leq t \leq T \) and \( 0 \leq x \leq K \gamma \). Both \( h_1 \) and \( h_2 \) dominate \( \psi \) on \([0, T] \times [0, K \gamma]\). Because \( c \leq rK \), we have \(-L h_1 + c \leq 0\). Therefore, for any stopping time \( \tau \in S^{s,x}_T \) satisfying \( \tau \leq \theta^{s,x}_K \), (4.5) implies

\[
h_1(s, x) \geq e^{rs} \mathbb{E} \left[ \int_s^\tau e^{-ru} c \, du + e^{-r\tau} h_1(\tau, X^{s,x}_\tau) \right]
\]

\[
\geq e^{rs} \mathbb{E} \left[ \int_s^\tau e^{-ru} c \, du + e^{-r\tau} \psi(\tau, X^{s,x}_\tau) \right].
\]

(4.11)

It follows that \( v_g \leq h_1 \) on \([0, T] \times [0, K \gamma]\). On the other hand,

\[
L h_2 = c + \delta(x - g(x)) \geq c
\]

(4.12)

because of (3.3), and the above argument applied with \( h_2 \) in place of \( h_1 \) yields \( v_g \leq h_2 \) on \([0, T] \times [0, K \gamma]\). We conclude that

\[
v_g(s, x) \leq x \wedge K \text{ for } 0 \leq s \leq T, \ 0 \leq x \leq K \gamma.
\]

(4.13)

By definition, \( v_g(T, \cdot) = \psi(T, \cdot) = \varphi(T, \cdot) \). Because of this and (4.13),

\[
v_g(s, x) \leq \varphi(s, x) \text{ for } 0 \leq s \leq T, \ 0 \leq x \leq K \gamma.
\]

(4.14)

**Step 2:** Optimal stopping time. The theory of optimal stopping we use here requires that we replace \( \psi \) on the right-hand side of (4.9) by a continuous
function. Let \( \bar{c} \in (0, c) \) be given, and let \( k \) be the continuous function defined by (4.7). For \( 0 \leq s < T \) and \( 0 < x < \frac{K}{\gamma} \), we have

\[
k(s, x) < e^{rs} \mathbb{E} \left[ \int_s^T e^{-ru}c \, du + e^{-r(\theta_0^{s,x} \wedge \theta_{\frac{K}{\gamma}}^{s,x} \wedge T)} \psi(\theta_0^{s,x} \wedge \theta_{\frac{K}{\gamma}}^{s,x} \wedge T, X^{s,x}_{t \wedge \theta_0^{s,x} \wedge \theta_{\frac{K}{\gamma}}^{s,x} \wedge T}) \right] \leq v_g(s, x). \tag{4.15}
\]

We set \( \bar{\psi} = \psi \vee k \). Since \( k(T, x) = \psi(T, x) \geq \gamma x \) for \( 0 \leq x \leq \frac{K}{\gamma} \) and \( \psi(s, x) = \gamma x \) for \( 0 \leq s < T \) and \( 0 \leq x \leq \frac{K}{\gamma} \), we have \( \bar{\psi}(s, x) = \max\{\gamma x, k(s, x)\} \) for \( 0 \leq s \leq T, 0 \leq x \leq \frac{K}{\gamma} \). Being the maximum of two continuous functions, \( \bar{\psi} \) is continuous. Also, \( \psi \leq \bar{\psi} \leq v_g \). It follows that

\[
v_g(s, x) \triangleq \sup_{\tau \in S_{s,x}^{s,x}} \mathbb{E} \left[ \int_s^\tau e^{-ru}c \, du + e^{-r\tau} \bar{\psi}(\tau, X^{s,x}_\tau) \right]. \tag{4.16}
\]

We fix \((s, x) \in [0, T] \times [0, \frac{K}{\gamma}]\) and define

\[
Y^{s,x}_t \triangleq e^{rs} \left[ \int_s^t e^{-ru}c \, du + e^{-rt}v_g(t, X^{s,x}_t) \right] \text{ for } s \leq t \leq \theta_0^{s,x} \wedge \theta_{\frac{K}{\gamma}}^{s,x} \wedge T.
\]

We set \( \tau \triangleq \min\{t \in [s, T] : v_g(t, X^{s,x}_t) = \psi(t, X^{s,x}_t)\} \). Since \( v_g = \bar{\psi} \) on \( \partial \rho D_0 \), we have \( \tau \leq \theta_0^{s,x} \wedge \theta_{\frac{K}{\gamma}}^{s,x} \wedge T \). According to the theory of optimal stopping applied to (4.16) (see, e.g., [23], Theorems D.12, D.13 or [32], pp. 124–127), \( Y^{s,x}_{t \wedge \theta_0^{s,x} \wedge \theta_{\frac{K}{\gamma}}^{s,x}} \) is a supermartingale and the stopped process \( Y^{s,x}_{\tau \wedge \theta_0^{s,x} \wedge \theta_{\frac{K}{\gamma}}^{s,x}} \) is a martingale.

**Step 3: Optimal strategies for the game.** From (4.15) and the fact that \( \bar{\psi} = \psi \vee k \), we see that \( \tau = \min\{t \in [s, T] : v_g(t, X^{s,x}_t) = \psi(t, X^{s,x}_t)\} \) and

\[
v_g(\tau, X^{s,x}_\tau) = \psi(\tau, X^{s,x}_\tau) = \begin{cases} \gamma X^{s,x}_\tau & \text{if } \tau < T, \\ (X^{s,x}_\tau \wedge L) \vee (\gamma X^{s,x}_\tau) & \text{if } \tau = T. \end{cases} \tag{4.17}
\]

Define \( \tau^* = \infty \) if \( \tau = T \) and \( 0 < X^{s,x}_T < \frac{L}{\gamma} \) and define \( \tau^* = \tau \) otherwise, so that \( \tau^* \in S^{s,x} \) and \( \tau = \tau^* \wedge T \). We have

\[
v_g(\tau^*, X^{s,x}_{\tau^*}) = \gamma X^{s,x}_{\tau^*} \text{ if } \tau^* \leq T. \tag{4.18}
\]
For every $\rho \in S^{s,x}_K$, (4.18), (4.13), and the fact that $v_g(T, x) = x \wedge L$ when $0 \leq x \leq \frac{L}{\gamma}$ imply
\[
J_g(s, x; \rho, \tau^*)
= e^{rs}E \left[ \int_{s}^{\rho \wedge \tau^* \wedge T} e^{-ru} c\, du + e^{-r(\rho \wedge \tau^* \wedge T)} \left( \mathbb{I}_{\{\tau^* \leq \rho \wedge T\}} \gamma X^{s,x}_{\tau^*} + \mathbb{I}_{\{\rho < \tau^*\}} K \right) \right.
\left. + \mathbb{I}_{\{\rho \wedge \tau^* = \infty\}} (X^{s,x}_T \wedge L) \right]
\geq e^{rs}E \left[ \int_{s}^{\rho \wedge \tau^* \wedge T} e^{-ru} c\, du + e^{-r(\rho \wedge \tau^* \wedge T)} v_g(\rho \wedge \tau^* \wedge T, X^{s,x}_{\rho \wedge \tau^* \wedge T}) \right]
= \mathbb{E}Y^{s,x}_{\rho \wedge \tau^*} \quad = \quad \mathbb{E}Y^{s,x}_s = v_g(s, x).
\] (4.19)

This implies $v_g(s, x) \geq v_g(s, x)$.

To show that $v_g(s, x) \leq v_g(s, x)$, we set $\rho^* \triangleq \theta^s_{0} \wedge \theta^s_{K/\gamma}$, which is in $S^{s,x}_K$.

For every $\tau \in S^{s,x}$, we have $\rho^* \wedge \tau \wedge T \in S_T^{s,x}$ and thus
\[
J_g(s, x; \rho^*, \tau)
= e^{rs}E \left[ \int_{s}^{\rho^* \wedge \tau \wedge T} e^{-ru} c\, du + e^{-r(\rho^* \wedge \tau \wedge T)} \left( \mathbb{I}_{\{\tau \leq \rho^* \wedge T\}} \gamma X^{s,x}_\tau + \mathbb{I}_{\{\rho^* < \tau\}} K \right) \right.
\left. + \mathbb{I}_{\{\rho^* \wedge \tau = \infty\}} (X^{s,x}_T \wedge L) \right]
\leq e^{rs}E \left[ \int_{s}^{\rho^* \wedge \tau \wedge T} e^{-ru} c\, du + e^{-r(\rho^* \wedge \tau \wedge T)} \psi(\rho^* \wedge \tau \wedge T, X^{s,x}_{\rho^* \wedge \tau \wedge T}) \right]
\leq v_g(s, x).
\] (4.20)

This implies $v_g(s, x) \leq v_g(s, x)$. We conclude that $v_g = v_g = \bar{v}_g$.

**Step 4: Proof of (4.10).** With $\tau \in S^{s,x}_T$ as defined in Step 2, we have from (4.14) and (4.17) that for every $\rho \in S^{s,x}_T$,
\[
\bar{J}_g(s, x; \rho, \tau)
= e^{rs}E \left[ \int_{s}^{\rho \wedge \tau} e^{-ru} c\, du + e^{-r(\rho \wedge \tau)} \left( \mathbb{I}_{\{\tau \leq \rho\}} \gamma X^{s,x}_\tau + \mathbb{I}_{\{\rho \leq \tau\}} \varphi(\rho, X^{s,x}_\rho) \right) \right]
\geq e^{rs}E \left[ \int_{s}^{\rho \wedge \tau} e^{-ru} c\, du + e^{-r(\rho \wedge \tau)} v_g(\rho \wedge \tau, X^{s,x}_{\rho \wedge \tau}) \right]
= \mathbb{E}Y^{s,x}_{\rho \wedge \tau} \quad = \quad \mathbb{E}Y^{s,x}_s = v_g(s, x).
\]
On other hand, with $\rho^*$ defined as in Step 3 and

$$\bar{\rho} \triangleq \rho^* \wedge T = \theta_{0}^{s,x} \wedge \theta_{K}^{s,x} \wedge T \in S_{T}^{s,x},$$

(4.21)

we have $\varphi(\bar{\rho}, X^{s,x}_{\bar{\rho}}) = \psi(\bar{\rho}, X^{s,x}_{\bar{\rho}})$. Thus, for every $\tau \in S_{T}^{s,x}$,

$$\tilde{J}_{g}(s, x; \bar{\rho}, \tau) \leq \psi(\bar{\rho}, X^{s,x}_{\bar{\rho}}).$$

(4.22)

We complete the argument as in Step 3.

\[ \Diamond \]

**Proposition 4.6 (Case II)** Assume $\delta K \leq c$. In this case, we define

$$v_{g}(s, x) \triangleq \inf_{\rho \in S_{T}^{s,x}, \rho \leq \theta_{K}^{s,x}} e^{rs}E \left[ \int_{s}^{T} e^{-ru}c \, du + e^{-r(\rho^{s,x})}(1_{\{\tau < \rho\}} \gamma X^{s,x}_{\tau} + 1_{\{\rho \leq \tau\}} \varphi(\bar{\rho}, X^{s,x}_{\bar{\rho}})) \right].$$

(4.23)

for $(s, x) \in [0, T] \times [0, K]$. Then $v_{g} = \underline{v}_{g}$ on $[0, T] \times [0, K]$. Furthermore,

$$v_{g}(s, x) = \inf_{\rho \in S_{T}^{s,x}} \sup_{\tau \in S_{T}^{s,x}} \tilde{J}_{g}(s, x; \rho, \tau) = \sup_{\tau \in S_{T}^{s,x}} \inf_{\rho \in S_{T}^{s,x}} \tilde{J}_{g}(s, x; \rho, \tau).$$

(4.24)

**Proof:** Step 1: Construction of bounds on $v_{g}$. Define $h_{3}(t, x) \triangleq \gamma x$ and $h_{2}(t, x) \triangleq x$ for $0 \leq t \leq T$ and $0 \leq x \leq \frac{K}{\gamma}$, so that $h_{3} \leq \varphi \leq h_{2}$. For $(t, x) \in [0, T] \times [0, \frac{K}{\gamma}]$, we have (4.12) and

$$\mathcal{L}g_{h_{3}}(t, x) = c\gamma + \delta \gamma(\delta \gamma x \leq c \gamma - c) \leq c \gamma - c \leq c. \quad (4.25)$$

Let $\rho \in S_{T}^{s,x}$ satisfy $\rho \leq \theta_{K}^{s,x}$ and apply (4.5) and (4.25) to conclude

$$h_{3}(s, x) \leq e^{rs}E \left[ \int_{s}^{T} e^{-ru}c \, du + e^{-r\rho}h_{3}(\rho, X_{\rho}^{s,x}) \right] \leq e^{rs}E \left[ \int_{s}^{T} e^{-ru}c \, du + e^{-r\rho}\varphi(\rho, X_{\rho}^{s,x}) \right].$$

(4.26)
Taking the infimum over $\rho$, we obtain
\[ \gamma x \leq v_g(s, x) \text{ for } 0 \leq s \leq T, 0 \leq x \leq \frac{K}{\gamma}. \] (4.27)

We repeat the above argument with $h_2$ and $\rho = \theta^{s,x}_0 \land \theta^{s,x}_K \land T$, using (4.12) to reverse the first inequality and $\varphi \leq h_2$ to reverse the second, to obtain
\[ h_2(s, x) \geq e^{rs} \mathbb{E} \left[ \int_s^{\rho} e^{-ru} c \, du + e^{-r\rho} h_2(\rho, X^{s,x}_\rho) \right] \]
\[ \geq e^{rs} \mathbb{E} \left[ \int_s^{\rho} e^{-ru} c \, du + e^{-r\rho} \varphi(\rho, X^{s,x}_\rho) \right] \]
\[ \geq v_g(s, x) \text{ for } 0 \leq s \leq T, 0 \leq x \leq \frac{K}{\gamma}. \] (4.28)

In fact, since for $(s, x) \in [0, T) \times (0, \frac{K}{\gamma})$, with positive probability $X^{s,x}$ exits $[0, T] \times (0, \frac{K}{\gamma})$ through the set $\{T\} \times (L, \frac{K}{\gamma}]$, where $h_2$ is strictly greater than $\varphi$, the second inequality in (4.28) is strict for such $(s, x)$. This implies
\[ v_g(s, x) < x \text{ for } 0 \leq s < T, 0 < x < \frac{K}{\gamma}. \] (4.29)

**Step 2: Optimal stopping time.** Let $\tilde{c} \in (c, \infty)$ be given and let $k$ be defined by (4.7). For $0 \leq s < T$ and $0 < x < \frac{K}{\gamma}$, using the second part of (4.7), we have
\[ k(s, x) > e^{rs} \mathbb{E} \left[ \int_s^{\theta^{s,x}_0 \land \theta^{s,x}_K \land T} e^{-ru} c \, du \right. \]
\[ \left. + e^{-r(\theta^{s,x}_0 \land \theta^{s,x}_K \land T)} \varphi(\theta^{s,x}_0 \land \theta^{s,x}_K, X^{s,x}) \right] \]
\[ \geq v_g(s, x). \] (4.30)

We set $\tilde{\varphi} = \varphi \land k$. Because $\varphi(T, x) = k(T, x) \leq x \land K$ for $0 \leq x \leq \frac{K}{\gamma}$, and $\varphi(t, x) = x \land K$ for $0 \leq t < T, 0 \leq x \leq \frac{K}{\gamma}$, we have
\[ \tilde{\varphi}(t, x) = (x \land K) \land k(t, x) \text{ for } 0 \leq t \leq T, 0 \leq x \leq \frac{K}{\gamma}. \]

This shows that $\tilde{\varphi}$ is continuous. From (4.23) we have $v_g \leq \varphi$, and hence $v_g \leq \tilde{\varphi} \leq \varphi$. We can thus replace $\varphi$ by $\tilde{\varphi}$ in (4.23):
\[ v_g(s, x) \triangleq \inf_{\rho \in S^{s,x}_0, \rho \leq \theta^{s,x}_K} e^{rs} \mathbb{E} \left[ \int_s^{\rho} e^{-ru} c \, du + e^{-r\rho} \tilde{\varphi}(\rho, X^{s,x}_\rho) \right]. \] (4.31)
We fix \((s, x) \in [0, T] \times [0, \frac{K}{\gamma}]\) and define

\[
Z_{s,x}^t = e^{rs} \left[ \int_s^t e^{-ru} c \, du + e^{-rt} v_g(t, X_{s,x}^t) \right]
\]

for \(s \leq t \leq \theta_0^{s,x} \wedge \theta_K^{s,x} \wedge T\).

We set

\[
\bar{\rho} \triangleq \min\{t \in [s, T] : v_g(t, X_{s,x}^t) = \bar{\varphi}(t, X_{s,x}^t)\}.
\]

(4.32)

Since \(v_g = \bar{\varphi}\) on \(\partial_{\rho} D_0\), we have \(\bar{\rho} \leq \theta_0^{s,x} \wedge \theta_K^{s,x} \wedge T\). According to the theory of optimal stopping, \(Z_{s,x}^{s,x} \wedge \bar{\rho}\) is a submartingale and the stopped process \(Z_{\gamma s,x}^{s,x}\) is a martingale.

**Step 3: Optimal strategies for the game.** Because of (4.30), we have that \(\bar{\rho} = \min\{t \in [s, T] : v_g(t, X_{s,x}^t) = \varphi(t, X_{s,x}^t)\}\). In particular, \(v_g(\bar{\rho}, X_{\bar{\rho}}^{s,x}) = X_{\bar{\rho}}^{s,x} \wedge K\) on \(\{\bar{\rho} < T\}\). Inequality (4.29) then implies

\[
v_g(\bar{\rho}, X_{\bar{\rho}}^{s,x}) = K < X_{\bar{\rho}}^{s,x}\text{ on }\{\bar{\rho} < \theta_0^{s,x} \wedge T\}.
\]

(4.33)

Define \(\rho^* \triangleq \begin{cases} \infty & \text{if } \bar{\rho} = T \text{ and } X_{\bar{\rho}}^{s,x} < K, \\ \bar{\rho} & \text{otherwise}, \end{cases}\) so that \(\rho^* \in S_{\rho}^{s,x}\) and \(\bar{\rho} = \rho^* \wedge T\). For every \(\tau \in S_{\rho}^{s,x}\), (4.27), (4.33), and the fact that \(v_g(T, x) = \varphi(T, x)\geq x \wedge L\) when \(0 \leq x \leq \frac{K}{\gamma}\) imply

\[
J_g(s, x; \rho^*, \tau) = e^{rs} E \left[ \int_s^{\rho^* \wedge T} c e^{-ru} \, du + e^{-r(\rho^* \wedge T)} (\mathbb{1}_{\{\tau \leq \rho^* \wedge T\}} \gamma X_{\rho^* \wedge T}^{s,x} + \mathbb{1}_{\{\rho^* < \tau\}} K \\
+ \mathbb{1}_{\{\rho^* \wedge T = \infty\}} (X_{\rho^* \wedge T}^{s,x} \wedge L)) \right]
\]

\[
\leq e^{rs} E \left[ \int_s^{\rho^* \wedge T} c e^{-ru} \, du + e^{-r(\rho^* \wedge T)} v_g(\rho^* \wedge T, X_{\rho^* \wedge T}^{s,x}) \right]
\]

\[
= E Z_{\rho^* \wedge T}^{s,x} = Z_{s,x}^{s,x} = v_g(s, x).
\]

(4.34)

This implies \(v_g(s, x) \leq v_g(s, x)\). We set

\[
\bar{\tau} \triangleq \theta_0^{s,x} \wedge \theta_K^{s,x} \wedge T,
\]

(4.35)

\[
\tau^* \triangleq \begin{cases} \bar{\tau} & \text{if } \bar{\tau} < T, \\ T & \text{if } \bar{\tau} = T, \ X_T^{s,x} \geq \frac{L}{\gamma} \text{ or if } \bar{\tau} = T, \ X_T^{s,x} = 0, \\ \infty & \text{if } \bar{\tau} = T, \ 0 < X_T^{s,x} < \frac{L}{\gamma}, \end{cases}
\]

(4.36)
so that \( \tau^* \in S^{s,x} \). For every \( \rho \in S^{s,x}_K \), we have

\[
J_g(s, x; \rho, \tau^*) = e^{rs} E \left[ \int_s^{\rho \land \tau^* \land T} c e^{-ru} + e^{-r(\rho \land \tau^* \land T)} \left( \mathbb{1}_{\{\tau^* \leq \rho \land T\}} \gamma X^{s,x}_\tau + \mathbb{1}_{\{\rho < \tau^*\}} K \right) \right. \\
\left. + \mathbb{1}_{\{\rho \land \tau^* = \infty\}} (X^{s,x}_T \land L) \right] \\
\geq e^{rs} E \left[ \int_s^{\rho \land \tau^* \land T} c e^{-ru} + e^{-r(\rho \land \tau^* \land T)} \varphi(\rho^* \land \tau \land T, X^{s,x}_{\rho \land \tau^* \land T}) \right] \\
\geq v_g(s, x). \quad (4.37)
\]

This implies \( v_g(s, x) \geq v_g(s, x) \). We conclude that \( v_g = v_g = \tau_g \).

**Step 4.** Proof of (4.24). With \( \bar{\rho} \in S^{s,x} \) given by (4.32), we have \( v_g(\bar{\rho}, X^{s,x}_{\bar{\rho}}) = \varphi(\bar{\rho} \land \tau, X^{s,x}_{\bar{\rho} \land \tau}) \), and (4.27) implies that for \( \tau \in S^{s,x}_T \),

\[
\tilde{J}_g(s, x; \bar{\rho}, \tau) = e^{rs} E \left[ \int_s^{\bar{\rho} \land \tau} c e^{-ru} + e^{-r(\bar{\rho} \land \tau)} \left( \mathbb{1}_{\{\tau < \bar{\rho}\}} \gamma X^{s,x}_\tau + \mathbb{1}_{\{\bar{\rho} \leq \tau\}} \varphi(\bar{\rho}, X^{s,x}_{\bar{\rho}}) \right) \right] \\
\leq e^{rs} E \left[ \int_s^{\bar{\rho} \land \tau} c e^{-ru} + e^{-r(\bar{\rho} \land \tau)} v_g(\bar{\rho} \land \tau, X^{s,x}_{\bar{\rho} \land \tau}) \right] \\
= E Z^{s,x}_{\bar{\rho} \land \tau} = Z^{s,x}_s = v_g(s, x).
\]

With \( \bar{\tau} \in S^{s,x}_T \) defined by (4.35), we have for every \( \rho \in S^{s,x}_T \),

\[
\tilde{J}_g(s, x; \rho, \bar{\tau}) = e^{rs} E \left[ \int_s^{\rho \land \bar{\tau}} c e^{-ru} + e^{-r(\rho \land \bar{\tau})} \left( \mathbb{1}_{\{\bar{\tau} < \rho\}} \gamma X^{s,x}_\tau + \mathbb{1}_{\{\rho \leq \bar{\tau}\}} \varphi(\rho, X^{s,x}_{\rho}) \right) \right] \\
= e^{rs} E \left[ \int_s^{\rho \land \bar{\tau}} c e^{-ru} + e^{-r(\rho \land \bar{\tau})} \varphi(\rho \land \bar{\tau}, X^{s,x}_{\rho \land \bar{\tau}}) \right] \geq v_g(s, x). \quad (4.38)
\]

We complete the argument as in Step 3. \( \diamond \)

**Proposition 4.7 (Overlapping case)** Assume \( \delta K \leq c \leq rK \). In this case, \( v_g \) defined by (4.9) agrees with \( v_g \) defined by (4.23), and for \( 0 \leq s \leq T \)
and \(0 \leq x \leq \frac{K}{\gamma}\),

\[
v_g(s, x) = e^{rs} \mathbb{E} \left[ \int_s^{\theta_0^{s,x} \land \theta^{s,x}_K \land T} e^{-ru} c \, du + e^{-r(\theta_0^{s,x} \land \theta^{s,x}_K \land T)} \psi(\theta_0^{s,x} \land \theta^{s,x}_K \land T, X^{s,x}_{\theta_0^{s,x} \land \theta^{s,x}_K \land T}) \right]
\]

\[
= e^{rs} \mathbb{E} \left[ \int_s^{\theta_0^{s,x} \land \theta^{s,x}_K \land T} e^{-ru} c \, du + e^{-r(\theta_0^{s,x} \land \theta^{s,x}_K \land T)} \varphi(\theta_0^{s,x} \land \theta^{s,x}_K \land T, X^{s,x}_{\theta_0^{s,x} \land \theta^{s,x}_K \land T}) \right].
\]

(4.39)

Furthermore,

\[
\gamma x < v_g(s, x) < x \land K \text{ for } 0 \leq s < T \text{ and } 0 < x < \frac{K}{\gamma}.
\]

(4.40)

PROOF: The function \(v_g\) defined by (4.9) satisfies (4.10), the function \(v_g\) defined by (4.23) satisfies (4.24), and so these definitions of \(v_g\) coincide. With \(\overline{\tau} \triangleq \tau\) given by (4.21) and (4.35), inequalities (4.22) and (4.38) imply

\[
e^{rs} \mathbb{E} \left[ \int_s^{\theta_0^{s,x} \land \theta^{s,x}_K \land T} e^{-ru} c \, du + e^{-r(\theta_0^{s,x} \land \theta^{s,x}_K \land T)} \varphi(\theta_0^{s,x} \land \theta^{s,x}_K \land T, X^{s,x}_{\theta_0^{s,x} \land \theta^{s,x}_K \land T}) \right] = v_g(s, x)
\]

\[
\leq e^{rs} \mathbb{E} \left[ \int_s^{\theta_0^{s,x} \land \theta^{s,x}_K \land T} e^{-ru} c \, du + e^{-r(\theta_0^{s,x} \land \theta^{s,x}_K \land T)} \psi(\theta_0^{s,x} \land \theta^{s,x}_K \land T, X^{s,x}_{\theta_0^{s,x} \land \theta^{s,x}_K \land T}) \right],
\]

which gives us (4.39).

We return to (4.11), replacing \(\tau\) by \(\overline{\tau}\) and using the fact that when \(0 \leq s < T\) and \(0 < x < \frac{K}{\gamma}\), there is positive probability that \(X^{s,x}\) exits \([0, T] \times [0, \frac{K}{\gamma}]\) through the set \(\{(t, x) : t = T, 0 < x < \frac{K}{\gamma}\}\), where \(h_1 = K\) is strictly larger than \(\psi\). This implies

\[
K > e^{rs} \mathbb{E} \left[ \int_s^{\theta_0^{s,x} \land \theta^{s,x}_K \land T} e^{-ru} c \, du + e^{-r(\theta_0^{s,x} \land \theta^{s,x}_K \land T)} \varphi(\theta_0^{s,x} \land \theta^{s,x}_K \land T, X^{s,x}_{\theta_0^{s,x} \land \theta^{s,x}_K \land T}) \right] = v_g(s, x).
\]

The second inequality in (4.40) follows from this and (4.29). For the first inequality in (4.40), we replace \(\rho\) in (4.26) by \(\overline{\rho}\) and use the fact that when \(0 \leq s < T\) and \(0 < x < \frac{K}{\gamma}\), there is positive probability that \(X^{s,x}\) exits \([0, T] \times [0, \frac{K}{\gamma}]\) through the set \(\{(t, x) : t = T, 0 < x < \frac{h_3}{\gamma}\}\), where \(h_3 = \gamma x\) is strictly smaller than \(\varphi\), to obtain

\[
\gamma x < e^{rs} \mathbb{E} \left[ \int_s^{\theta_0^{s,x} \land \theta^{s,x}_K \land T} e^{-ru} c \, du + e^{-r(\theta_0^{s,x} \land \theta^{s,x}_K \land T)} \varphi(\theta_0^{s,x} \land \theta^{s,x}_K \land T, X^{s,x}_{\theta_0^{s,x} \land \theta^{s,x}_K \land T}) \right] = v_g(s, x).
\]

\(\Diamond\)
4.5 Membership of $v_g$ in $\mathcal{G}$

To show that $v_g \in \mathcal{G}$ whenever $g \in \mathcal{G}$, we must verify that $v_g$ is continuous and satisfies (3.1)–(3.3). Property (3.1) is provided by Lemma 4.1 and Propositions 4.5 and 4.6. When $c \leq rK$, we obtain the lower bound in (3.3) directly from (4.9) and the fact that $\psi \geq \gamma x$, and (4.13) provides the upper bound. When $\delta K \leq C$, the upper bound in (3.3) comes from (4.23), the fact that $\varphi \leq K$ on $[0,T] \times [0,\frac{K}{\gamma}]$, and (4.28). The lower bound comes from (4.27). It remains verify that $v_g$ is continuous and satisfies (3.2), which is the subject of this section.

**Lemma 4.8** We have

$$0 \leq v_g(s,y) - v_g(s,x) \leq y - x \text{ for } 0 \leq s \leq T \text{ and } 0 \leq x \leq y.$$  \hspace{1cm} (4.41)

**Proof:** In Step 4 of the proofs of Propositions 4.5 and 4.6, we produced stopping times $\rho, \tau \in S_{T}^{s,x}$ such that

$$\tilde{J}_g(s,x;\rho,\tau) \leq v_g(s,x) \leq \tilde{J}_g(s,x;\rho,\tau) \text{ for all } \rho, \tau \in S_{T}^{s,x}.$$  \hspace{1cm} (4.42)

It follows from this that $v_g(s,x) = \tilde{J}_g(s,x;\rho,\tau)$. Relation (4.42) was developed for $(s,x) \in [0,T] \times [0,\frac{K}{\gamma}]$, but in light of Lemma 4.1, it holds as well for $(s,x) \in [0,T] \times [\frac{K}{\gamma},\infty]$ if we define $\rho = \tau = s$ in this case.

We note that $\psi$ and $\varphi$ satisfy (3.2), and we use the representations (4.10), (4.24) to show that $v_g$ does as well. Without loss of generality, we consider only the case $s = 0$. We let $0 \leq x \leq y < \infty$ be given. Then $X_{t}^{0,x} \leq X_{t}^{0,y}$ for $0 \leq t \leq T$, almost surely, and $S_{T}^{0,x} \subset S_{T}^{0,y}$.

Consider the nonnegative martingale $Z_t = e^{-\sigma W_t - \frac{1}{2} \sigma^2 t}$. We compute

$$d((X_{t}^{0,y} - X_{t}^{0,x})Z_t) = (r - \sigma^2)(X_{t}^{0,y} - X_{t}^{0,x})Z_t dt - \delta[(X_{t}^{0,y} - X_{t}^{0,x}) - (g(t,X_{t}^{0,y}) - g(t,X_{t}^{0,x}))]Z_t dt \leq (r - \sigma^2)(X_{t}^{0,y} - X_{t}^{0,x})Z_t dt.$$

Gronwall’s inequality implies $(X_{t}^{0,y} - X_{t}^{0,x})Z_t \leq (y-x)e^{(r-\sigma^2)t}$, or equivalently,

$$e^{-rt}(X_{t}^{0,y} - X_{t}^{0,x}) \leq (y-x)e^{\sigma W_{t} - \frac{1}{2} \sigma^2 t}, \quad 0 \leq t \leq \tau_{0}^{0,x}.$$
Let \( \tau, \rho \in S^{0,x}_T \) be the stopping times appearing in (4.42) corresponding to the initial condition \((0,x)\). For every \( \tau \in S^{0,x}_T \), we have

\[
\tilde{J}_g(0, x; \rho, \tau) = \mathbb{E} \left[ \int_0^{\rho \wedge \tau} ce^{-ru} du + e^{-r(\rho \wedge \tau)} \left( \mathbb{I}_{\{\tau < \rho\}} \psi(\tau, X^0_x) + \mathbb{I}_{\{\rho \leq \tau\}} \varphi(\rho, X^{0,x}_\rho) \right) \right] = \tilde{J}_g(0, y; \rho, \tau) - \mathbb{E} \left[ e^{-r(\rho \wedge \tau)} \left( \mathbb{I}_{\{\tau < \rho\}} \left( \psi(X^0_x, y) - \psi(X^0_x, \rho) \right) + \mathbb{I}_{\{\rho \leq \tau\}} \left( \varphi(\rho, X^0_y, y) - \varphi(\rho, X^{0,x}_\rho) \right) \right) \right].
\]

Furthermore, \( \rho \wedge \tau \in S^{0,x}_0 \) whenever \( \tau \in S^{0,y}_T \), and for \( z = x \) and \( z = y \), we have \( \tilde{J}_g(0, z; \rho, \tau) = \tilde{J}_g(0, z; \rho, \rho \wedge \tau) \). Therefore,

\[
v_g(0, x) + y - x = \tilde{J}_g(0, x; \rho, \tau) + y - x \geq \sup_{\tau \in S^{0,x}_T} \tilde{J}_g(0, y; \rho, \rho \wedge \tau)
\]

This establishes the second inequality in (4.41).

The set of stopping times \( S^{0,x}_T \) is the set of all stopping times of the form \( \tau \wedge \theta^0_{0,x} \), where \( \tau \) is any stopping time in the set \( S_T \) of all stopping times satisfying \( \tau \leq T \) almost surely. Therefore,

\[
v_g(0, x) = \sup_{\tau \in S_T} \inf_{\rho \in S_T} \tilde{J}_g(0, x; \rho \wedge \theta^0_{0,x}, \tau \wedge \theta^0_{0,x}),
\]

\[
v_g(0, y) = \sup_{\tau \in S_T} \inf_{\rho \in S_T} \tilde{J}_g(0, y; \rho \wedge \theta^0_{0,y}, \tau \wedge \theta^0_{0,y}).
\]
Thus, to prove the first inequality in (4.41), it suffices to show that
\[
\tilde{J}_g(0, x; \rho \wedge \theta_{0}^{0,x}, \tau \wedge \theta_{0}^{0,x}) \leq \tilde{J}_g(0, y; \rho \wedge \theta_{0}^{0,y}, \tau \wedge \theta_{0}^{0,y})
\]
for all \(\rho, \tau \in S_T\). This follows from the definition of \(\tilde{J}_g\) and \(\theta_{0}^{0,x} \leq \theta_{0}^{0,y}\). \(\diamondsuit\)

The value functions of optimal stopping problems with continuous payoff functions are continuous (see [5]), and thus the representations (4.16) and (4.31) of \(v_g\) imply continuity of \(v_g\). In this model, however, continuity can be proved without invoking the general theory. We have already shown in Lemma 4.8 that \(v_g(s, x)\) is Lipschitz in \(x \in [0, \infty)\), uniformly in \(s \in [0, T]\). Given this, it is not difficult to show that \(v_g(s, x)\) is jointly continuous in \((s, x)\), and we do that here.

**Lemma 4.9** The function \(v_g\) is continuous on \([0, T] \times [0, \infty)\).

**Proof:** Because of Lemmas 4.1 and 4.8, we only need to show for each fixed \(x \in (0, K/\gamma)\) that the function \(s \mapsto v_g(s, x)\) is continuous. With \(x\) fixed, \(s \in [0, T], \epsilon > 0\), and \(\delta > 0\), we define
\[
A_{s,x}^{\epsilon,\delta} \triangleq \left\{ u \in [s, \theta_{0}^{s,x} \wedge \theta_{0}^{s,x} \wedge (s + \delta) \wedge T] \left| X_{s,x}^u - x \right| \leq \epsilon \right\}.
\]
Because \(g\) is bounded on \([0, T] \times [0, K/\gamma]\), (3.4) and (2.2) imply
\[
\lim_{\delta \downarrow 0} \min_{0 \leq s \in [0, T]} P(A_{s,x}^{\epsilon,\delta}) = 1 \text{ for every } \epsilon > 0.
\]

We proceed under the Case II assumption \(\delta K \leq c\); the argument in Case I is similar. In Case II, the submartingale \(Z_{t,\theta_{0}^{s,x} \wedge \theta_{0}^{s,x}}^{s,x}\) of Step 2 of Proposition 4.6 is a martingale when stopped at \(\overline{\rho}\) given by (4.32). Let \(s\) and \(t\) satisfy \(0 \leq s < t \leq (s + \delta) \wedge T\). Then
\[
v_g(s, x) = e^{rs}E \left[ \int_s^{\overline{\rho} \wedge t} e^{-ru} c \, du + e^{-r(\overline{\rho} \wedge t)} v_g(\overline{\rho} \wedge t, X_{\overline{\rho} \wedge t}^{s,x}) \right]
\]
\[
\leq e^{rs}E \left[ \int_s^{\rho \wedge t} e^{-ru} c \, du + e^{-r\rho} v_g(\rho \wedge t, X_{\rho \wedge t}^{s,x}) \right] \text{ for } \rho \in S_T^{s,x}, \rho \leq \theta_{K/\gamma}^{s,x}. \tag{4.44}
\]
If $\overline{p} < t$, then $v_g(\overline{p} \land t, X_{p^{s,x}}^{s,x}) = \overline{\varphi}(\overline{p}, X_{p}^{s,x})$. But $\overline{\varphi} = \varphi \land k$, and (4.30) shows that for $(u, y) \in [0, T) \times (0, \frac{K}{\gamma})$, we have $v_g(u, y) = \overline{\varphi}(u, y)$ if and only if $v_g(u, y) = \varphi(u, y) = y \land K$. This observation combined with (4.29) yields

$$v_g(u, y) = \overline{\varphi}(u, y) \Leftrightarrow v_g(u, y) = K \text{ for } u \in [0, T), \ y \in \left(0, \frac{K}{\gamma}\right). \quad (4.45)$$

We now choose $\epsilon > 0$ so that $0 < x - \epsilon < x + \epsilon < \frac{K}{\gamma}$. On the set $\{\overline{p} < t\} \cap A_{\epsilon, \delta}^{s,x}$ we have $0 < X_{p^{s,x}}^{s,x} = X_{p}^{s,x} < \frac{K}{\gamma}$ and thus

$$v_g(\overline{p} \land t, X_{p^{s,x}}^{s,x}) = v_g(\overline{p}, X_{p}^{s,x}) = K \geq v_g(t, x) - \epsilon.$$  

On the set $\{\overline{p} \geq t\} \cap A_{\epsilon, \delta}^{s,x}$, we also have $v_g(\overline{p} \land t, X_{p^{s,x}}^{s,x}) \geq v_g(t, x) - \epsilon$, this time because of the Lipschitz continuity (4.41). The equality in (4.44) implies

$$v_g(s, x) \geq e^{rs}E[e^{-r(\overline{p} \land t)}v_g(\overline{p} \land t, X_{p^{s,x}}^{s,x})] \geq e^{-r\delta}P(A_{s, \epsilon, \delta})[v_g(t, x) - \epsilon]. \quad (4.46)$$

On the other hand, on the set $A_{\epsilon, \delta}^{s,x}$, we have $\theta_{0}^{s,x} \land \theta_{\frac{K}{\gamma}}^{s,x} \land t = t$ and the inequality in (4.44) implies

$$v_g(s, x) \leq e^{rs}E\left[\int_{s}^{t_{0}^{s,x} \land \theta_{\frac{K}{\gamma}}^{s,x} \land t}e^{-ru_c}du + e^{-r(\theta_{0}^{s,x} \land \theta_{\frac{K}{\gamma}}^{s,x} \land t)}v_g(\theta_{0}^{s,x} \land \theta_{\frac{K}{\gamma}}^{s,x} \land t, X_{p^{s,x}}^{s,x})\right]$$

$$\leq e^{rs}\int_{s}^{t_{0}^{s,x}+\delta}e^{-ru_c}du + \left[1 - P(A_{s, \epsilon, \delta})\right]K + E\left[I_{A_{s, \epsilon, \delta}^{s,x}}v_g(t, X_{t}^{s,x})\right]$$

$$\leq \frac{c}{r}(1 - e^{-r\delta}) + \left[1 - P(A_{s, \epsilon, \delta})\right]K + P(A_{s, \epsilon, \delta})(v_g(t, x) + \epsilon). \quad (4.47)$$

From (4.46) and (4.47), using the fact $0 \leq v_g(t, x) \leq K$, we obtain

$$-[1 - e^{-r\delta}P(A_{s, \epsilon, \delta})]K - \epsilon \leq v_g(s, x) - v_g(t, x) \leq \frac{c}{r}(1 - e^{-r\delta}) + \left[1 - P(A_{s, \epsilon, \delta})\right]K + \epsilon.$$

Continuity of $s \mapsto v_g(s, x)$ follows from this and (4.43).

\[\diamond\]

5  Viscosity solution characterization of $v_g$

Propositions 4.5 and 4.6 establish (3.5). Except for the fact that we have fixed a function $g \in G$ which may not satisfy the fixed point condition $v_g =
g. Proposition 4.5 says further that when \( c \leq rK \), the convertible bond pricing problem reduces to the problem of optimal conversion in the region \([0, T] \times [0, \frac{K}{\gamma}]\). In particular, (4.19) and (4.20) show that the firm should use the call strategy \( \rho^* = \theta^s_{0,x} \land \theta^c_{0,x} \). Proposition 4.6 shows that when \( \delta K \leq c \), the convertible bond pricing problem reduces to the problem of optimal call. In particular, (4.34) and (4.37) show that the bondholder should use the conversion strategy \( \tau^* \) of (4.36). Note that at maturity, \( \tau^* \) mandates conversion if and only if the conversion value \( \gamma X^{s,x}_T \) exceeds the par value \( L \).

These are the main assertions of Theorem 3.2.

In this section, we examine the versions of (3.8) and (3.9) appropriate for the situation with \( g \in \mathcal{G} \) chosen a priori. These equations are

\[
\begin{align*}
\min \{ \mathcal{L}_g v - c, v - \gamma x \} &= 0, \quad (5.1) \\
\max \{ \mathcal{L}_g v - c, v - K \} &= 0, \quad (5.2)
\end{align*}
\]

where \( \mathcal{L}_g \) is given by (4.6). The proofs that the value function of the optimal stopping problem (4.9) satisfies (5.1) and that the value function of the problem (4.23) satisfies (5.2), both in the viscosity sense on \((0, T) \times (0, \frac{K}{\gamma})\) (see Definition 5.1 below), are standard and are omitted. Uniqueness of the continuous viscosity solutions of (5.1) and (5.2) subject to the boundary conditions (3.6) and (3.7) follows from Lemma 6.1 below; see Remark 6.2.

We refer the reader to [13] and [16] for a detailed development of the theory of second-order viscosity solutions for Hamilton-Jacobi-Bellman equations and to [31] for an application of this theory to optimal stopping.

**Definition 5.1** Let \( v \) be a continuous function defined on \((0, T) \times (0, \frac{K}{\gamma})\).

(a) The function \( v \) is a viscosity subsolution of equation (5.1) (respectively, (5.2)) if, for every point \((t_0, x_0) \in (0, T) \times (0, \frac{K}{\gamma})\) and for every “test function” \( h \in C^{1,2}((0, T) \times (0, \frac{K}{\gamma})) \) satisfying \( v \leq h \) on \((0, T) \times (0, \frac{K}{\gamma})\) and \( v(t_0, x_0) = h(t_0, x_0) \), we have \( \min \{ \mathcal{L}_g h(t_0, x_0) - c, h(t_0, x_0) - \gamma x_0 \} \leq 0 \) (respectively, \( \max \{ \mathcal{L}_g h(t_0, x_0) - c, h(t_0, x_0) - K \} \leq 0 \)).

(b) The function \( v \) is a viscosity supersolution of equation (5.1) (respectively, (5.2)) if, for every point \((t_0, x_0) \in (0, T) \times (0, \frac{K}{\gamma})\) and for every “test function” \( h \in C^{1,2}((0, T) \times (0, \frac{K}{\gamma})) \) satisfying \( v \geq h \) on \((0, T) \times (0, \frac{K}{\gamma})\) and \( v(t_0, x_0) = h(t_0, x_0) \), we have \( \min \{ \mathcal{L}_g h(t_0, x_0) - c, h(t_0, x_0) - \gamma x_0 \} \geq 0 \) (respectively, \( \max \{ \mathcal{L}_g h(t_0, x_0) - c, h(t_0, x_0) - K \} \geq 0 \)).

A function \( v \) is a viscosity solution of one of these equations if it is both a viscosity subsolution and a viscosity supersolution.
In Case I, $c \leq rK$, of Proposition 4.5, we define the continuation set

$$
C^I_T \triangleq \left\{ (t,x) \in (0,T) \times \left( 0, \frac{K}{\gamma} \right) : v_g(t,x) > \gamma x \right\} = \left\{ (t,x) \in (0,T) \times \left( 0, \frac{K}{\gamma} \right) : v_g(t,x) > \tilde{\psi}(t,x) \right\}, \quad (5.3)
$$

where $\tilde{\psi}(t,x) = \max\{\gamma x, k(t,x)\}$ is defined in Step 2 of the proof of Proposition 4.5. Because $k$ satisfies (4.15), $v_g(t,x) > \gamma x$ if and only if $v_g(t,x) > \tilde{\psi}(t,x)$. Because $v_g$ and $\tilde{\psi}$ are continuous, $C^I_T$ is open. Define the stopping set

$$
S^I_T \triangleq \left\{ (t,x) \in [0,T] \times \left[ 0, \frac{K}{\gamma} \right] : v_g(t,x) = \psi(t,x) \right\} = \left\{ (t,x) \in [0,T] \times \left[ 0, \frac{K}{\gamma} \right] : v_g(t,x) = \tilde{\psi}(t,x) \right\}.
$$

The equality is justified by the same argument that justified the equality in (5.3) and the additional observation that $\psi(T, \cdot) = \tilde{\psi}(T, \cdot)$. The set $S^I_T$ is closed. Under the Case I assumption, $v_g$ is a viscosity solution of (5.1), which is equivalent to the three conditions

(i) $v_g \geq \gamma x$ on $[0,T] \times \left[ 0, \frac{K}{\gamma} \right]$,
(ii) $v_g$ is a viscosity supersolution of $L_g v - c = 0$ on $(0,T) \times \left( 0, \frac{K}{\gamma} \right)$, and
(iii) $v_g$ is a viscosity solution of $L_g v - c = 0$ on $C^I_T$.

In Case II, $\delta K \leq c$, of Proposition 4.6, we define the continuation set

$$
C^{II}_T \triangleq \left\{ (t,x) \in (0,T) \times \left( 0, \frac{K}{\gamma} \right) : v_g(t,x) < K \right\} = \left\{ (t,x) \in (0,T) \times \left( 0, \frac{K}{\gamma} \right) : v_g(t,x) < \bar{\varphi}(t,x) \right\}, \quad (5.4)
$$

where $\bar{\varphi} = \varphi \wedge k$ is defined in Step 2 of the proof of Proposition 4.6 and the equality in (5.4) is justified by (4.45). The set $C^{II}_T$ is open. Define the stopping set

$$
S^{II}_T \triangleq \left\{ (t,x) \in [0,T] \times \left[ 0, \frac{K}{\gamma} \right] : v_g(t,x) = \varphi(t,x) \right\} = \left\{ (t,x) \in [0,T] \times \left[ 0, \frac{K}{\gamma} \right] : v_g(t,x) = \bar{\varphi}(t,x) \right\}.
$$

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The equality is justified by the argument that justified (5.4) and the additional observations that \( \varphi(T, \cdot) = \tilde{\varphi}(T, \cdot) \). The set \( S^H \) is closed. Under the Case II assumption, \( v_g \) is a viscosity solution of (5.2), which is equivalent to (iv) \( v_g \leq K \) on \([0, T] \times [0, \frac{K}{\gamma}]\),
(v) \( v_g \) is a viscosity subsolution of \( \mathcal{L}_g v - c = 0 \) on \((0, T) \times (0, \frac{K}{\gamma})\), and (vi) \( v_g \) is a viscosity solution of \( \mathcal{L}_g v - c = 0 \) on \( C^H_T \).

**Remark 5.2** In the overlapping case, \( \delta K \leq c \leq \rho K \), we have from Proposition 4.7 that \( C^I_T = C^I_T = (0, T) \times (0, \frac{K}{\gamma}) \) and \( v_g \) is a viscosity solution of \( \mathcal{L}_g u - c = 0 \) on this set. Remark 4.4 applies in the overlapping case, which is why we require \( \mathcal{L}_g v_g - c = 0 \) to hold only in the viscosity sense.

### 6 Proof of Theorem 3.1

In this section we prove Theorem 3.1 and also prove that the continuous viscosity solutions of (5.1) and (5.2) with boundary conditions (3.6) and (3.7) are unique. In light of Propositions 4.5 and 4.6 and the discussion of Section 5, this provides the final step in the proof of Theorem 3.2.

For \( \epsilon \in [0, \frac{K}{\gamma}) \), we define the sets

\[
D_\epsilon \triangleq [0, T] \times \left[ \epsilon, \frac{K}{\gamma} \right], \quad \tilde{D}_\epsilon \triangleq [0, T] \times \left[ \log \epsilon, \log \frac{K}{\gamma} \right],
\]

their parabolic boundaries

\[
\partial_p D_\epsilon \triangleq \left( [0, T] \times \left\{ \epsilon, \frac{K}{\gamma} \right\} \right) \cup \left( \{T\} \times \left( \epsilon, \frac{K}{\gamma} \right) \right),
\]

\[
\partial_p \tilde{D}_\epsilon \triangleq \left( [0, T] \times \left\{ \log \epsilon, \log \frac{K}{\gamma} \right\} \right) \cup \left( \{T\} \times \left( \log \epsilon, \log \frac{K}{\gamma} \right) \right),
\]

and their topological boundaries

\[
\partial D_\epsilon \triangleq \partial_p D_\epsilon \cup \left( \{0\} \times \left( \epsilon, \frac{K}{\gamma} \right) \right), \quad \partial \tilde{D}_\epsilon \triangleq \partial_p \tilde{D}_\epsilon \cup \left( \{0\} \times \left( \log \epsilon, \log \frac{K}{\gamma} \right) \right).
\]

In the above definitions, we use the convention \( \log 0 = -\infty \), so \( \tilde{D}_0, \partial_p \tilde{D}_0 \), and \( \partial \tilde{D}_0 \) are subsets of the extended real numbers. The following comparison lemma is a modification of Theorem 8.2 of [13], differing by the fact that the functions \( u \) and \( v \) satisfy different rather than the same equation.
Lemma 6.1 (Comparison) Let \( f, g \) in \( C(D_0) \) be given. Let \( u, v \in C(D_0) \) be respective viscosity sub- and supersolutions on \( D_0 \setminus \partial D_0 \) of the equations

\[
\min \{ L_f u - c, u - \gamma x \} = 0, \quad (6.1)
\]
\[
\min \{ L_g v - c, v - \gamma x \} = 0. \quad (6.2)
\]

Alternatively, let \( u, v \) be respective viscosity sub- and supersolutions of the equations

\[
\max \{ L_f u - c, u - K \} = 0, \quad (6.3)
\]
\[
\max \{ L_g v - c, v - K \} = 0. \quad (6.4)
\]

Assume further that one of the functions \( u \) or \( v \) (let us say \( u \)) satisfies

\[
0 \leq u(t,y) - u(t,x) \leq y - x \text{ for } (t,x) \in D_0. \quad (6.5)
\]

Then for every \( \lambda \geq 0 \), we have

\[
\max_{(t,x) \in D_0} e^{\lambda t} (u(t,x) - v(t,x))^+ \leq \max \left\{ \frac{\delta}{r + \lambda} \max_{(t,x) \in D_0} e^{\lambda t} (f(t,x) - g(t,x))^+ , \max_{(t,x) \in \partial D_0} e^{\lambda t} (u(t,x) - v(t,x))^+ \right\}. \quad (6.6)
\]

PROOF: We provide the proof under the assumption \( u \) is a subsolution of (6.1) and \( v \) is a supersolution of (6.2). Because \( f, g, u, \) and \( v \) are continuous, it suffices to prove

\[
\max_{(t,x) \in D_0} e^{\lambda t} (u(t,x) - v(t,x))^+ \leq \max \left\{ \frac{\delta}{r + \lambda} \max_{(t,x) \in D_0} e^{\lambda t} (f(t,x) - g(t,x))^+ , \max_{(t,x) \in \partial D_0} e^{\lambda t} (u(t,x) - v(t,x))^+ \right\}.
\]

for every \( \epsilon \in (0, \frac{\gamma}{\gamma}) \). To do this, we define \( \tilde{u}(t,\xi) \triangleq e^{\lambda t} u(t,\epsilon), \tilde{v}(t,\xi) \triangleq e^{\lambda t} v(t,\epsilon), \tilde{f}(t,\xi) \triangleq e^{\lambda t} f(t,\epsilon), \) and \( \tilde{g}(t,\xi) \triangleq e^{\lambda t} g(t,\epsilon). \) In terms of these functions, we need to prove that for every \( \epsilon \in (0, \frac{\gamma}{\gamma}) \),

\[
\max_{(t,\xi) \in D_0} (\tilde{u}(t,\xi) - \tilde{v}(t,\xi))^+ \leq \max \left\{ \frac{\delta}{r + \lambda} \max_{(t,\xi) \in D_0} (\tilde{f}(t,\xi) - \tilde{g}(t,\xi))^+ , \max_{(t,\xi) \in \partial D_0} (\tilde{u}(t,\xi) - \tilde{v}(t,\xi))^+ \right\}. \quad (6.7)
\]
For $\eta > 0$, we define $\tilde{w}^\eta(t, \xi) \triangleq \tilde{u}(t, \xi) - \frac{\eta}{2}$, so that $\lim_{\xi \to 0} \tilde{w}^\eta(t, \xi) = -\infty$ uniformly in $\xi$. We will show for all $\epsilon \in (0, \frac{K}{\gamma})$ that

$$\max_{(t, \xi) \in \tilde{D}_\epsilon} (\tilde{w}^\eta(t, \xi) - \tilde{v}(t, \xi))^+ \leq \max \left\{ \frac{\delta}{r + \lambda} \max_{(t, \xi) \in \tilde{D}_\epsilon} (\tilde{f}(t, \xi) - \tilde{g}(t, \xi))^+, \max_{(t, \xi) \in \partial \tilde{D}_\epsilon} (\tilde{w}^\eta(t, \xi) - v(t, \xi))^+ \right\}. \quad (6.8)$$

We can then let $\eta \downarrow 0$ in (6.8) to obtain (6.7) and conclude the proof.

The change of variable transforms (6.1) and (6.2) into

$$\min \left\{ -\tilde{u}_t + (r + \lambda)\tilde{u} - \left( r - \delta - \frac{1}{2} \sigma^2 \right) \tilde{u}_\xi - \frac{1}{2} \sigma^2 \tilde{u}_{\xi \xi} - e^{\lambda t} \tilde{f}(t, \xi)\tilde{u}_\xi + ce^{-\xi}\tilde{u}_\xi \right\} = 0,$$

$$\min \left\{ -\tilde{v}_t + (r + \lambda)\tilde{v} - \left( r - \delta - \frac{1}{2} \sigma^2 \right) \tilde{v}_\xi - \frac{1}{2} \sigma^2 \tilde{v}_{\xi \xi} - e^{\lambda t} \tilde{g}(t, \xi)\tilde{v}_\xi + ce^{-\xi}\tilde{v}_\xi \right\} = 0.$$
Let $\alpha > 0$ be given and set

$$M_\alpha \triangleq \max_{(t, \xi), (t, \zeta) \in \bar{D}_c} \left( \tilde{u}''(t, \xi) - \tilde{v}(t, \zeta) - \frac{\alpha}{2} |\xi - \zeta|^2 \right).$$

The maximum is attained at some point $(t_\alpha, \xi_\alpha, \zeta_\alpha)$. According to a slight variant of Lemma 3.1, p. 15 of [13],

$$\lim_{\alpha \to \infty} \alpha |\xi_\alpha - \zeta_\alpha|^2 = 0 \quad \text{and} \quad \lim_{\alpha \to \infty} M_\alpha = \max_{(t, \xi) \in \bar{D}_c} \left( \tilde{u}''(t, \xi) - \tilde{v}(t, \xi) \right). \quad (6.12)$$

Violation of (6.8) implies that for large $\alpha$, the points $(t_\alpha, \xi_\alpha)$ and $(t_\alpha, \zeta_\alpha)$ are bounded away from the parabolic boundary $\partial_p \bar{D}_\epsilon$. Furthermore, because $\lim_{t \to 0} \tilde{v}(t, \xi) = -\infty$, these points are bounded away from the topological boundary $\partial \bar{D}_\epsilon$ as well.

There are two cases to consider. In the first case, $(t_\alpha, \xi_\alpha) \notin \tilde{C}_\tilde{u}$, and so $\tilde{v}(t_\alpha, \xi_\alpha) = \gamma e^{\lambda \alpha + \xi_\alpha} - \frac{\alpha}{2} \leq \gamma e^{\lambda \alpha + \xi_\alpha}$. We have

$$M_\alpha \leq \tilde{u}''(t_\alpha, \xi_\alpha) - \tilde{v}(t_\alpha, \zeta_\alpha) \leq \gamma e^{\lambda \alpha}(e^{\xi_\alpha} - e^{\zeta_\alpha}). \quad (6.13)$$

In the other case, $(t_\alpha, \xi_\alpha)$ is in $\tilde{C}_\tilde{u}$. Because $\tilde{u}''$ is a subsolution of (6.9) in a neighborhood of $(t_\alpha, \xi_\alpha)$, $\tilde{v}$ is a supersolution of (6.10) in a neighborhood of $(t_\alpha, \zeta_\alpha)$, and these points are bounded away from $\partial \bar{D}_\epsilon$, condition (8.5) of Theorem 8.3, p. 48 of [13] is satisfied (our time variable is reversed from that of [13]). That theorem with $\epsilon = \frac{1}{\alpha}$ implies the existence of numbers $b$, $X$ and $Y$ such that $X \leq Y$ and

$$(b, \alpha(\xi_\alpha - \zeta_\alpha), X) \in \bar{P}^{2,+}\tilde{u}''(t_\alpha, \xi_\alpha) \quad \text{and} \quad (b, \alpha(\xi_\alpha - \zeta_\alpha), Y) \in \bar{P}^{2,-}\tilde{v}(t_\alpha, \zeta_\alpha)$$

(see the use of Theorem 8.3 on p. 50 and see also p. 17 of [13]). Because $(t_\alpha, \xi_\alpha)$ and $(t_\alpha, \zeta_\alpha)$ are in the open set $\tilde{D}_\epsilon \setminus \partial \bar{D}_\epsilon$, the semijets $\bar{P}^{2,+}\tilde{u}''(t_\alpha, \xi_\alpha)$ and $\bar{P}^{2,-}\tilde{v}(t_\alpha, \zeta_\alpha)$ do not depend on the domain. Moreover, they provide terms that can replace the time derivative, the spatial derivative, and the second spatial derivative in the subsolution and supersolution inequalities for (6.9) and (6.10):

$$-b + (r + \lambda)\tilde{u}''(t_\alpha, \xi_\alpha) - \left( r - \delta - \frac{1}{2} \sigma^2 \right) \alpha(\xi_\alpha - \zeta_\alpha) - \frac{1}{2} \sigma^2 X + e^{\lambda \alpha} c \leq \delta e^{-\lambda \alpha - \xi_\alpha} \tilde{f}(t_\alpha, \xi_\alpha) \alpha(\xi_\alpha - \zeta_\alpha) - ce^{-\xi_\alpha} \alpha(\xi_\alpha - \zeta_\alpha), \quad (6.14)$$

$$-b + (r + \lambda)\tilde{v}(t_\alpha, \zeta_\alpha) - \left( r - \delta - \frac{1}{2} \sigma^2 \right) \alpha(\xi_\alpha - \zeta_\alpha) - \frac{1}{2} \sigma^2 Y + e^{\lambda \alpha} c \geq \delta e^{-\lambda \alpha - \zeta_\alpha} \tilde{g}(t_\alpha, \zeta_\alpha) \alpha(\xi_\alpha - \zeta_\alpha) - ce^{-\zeta_\alpha} \alpha(\xi_\alpha - \zeta_\alpha). \quad (6.15)$$
Subtracting (6.15) from (6.14) and using \( \sup_{\xi,\zeta \geq \log \epsilon, \xi \neq \zeta} \left| e^{-\epsilon - \xi} \right| = \frac{1}{\epsilon} \), we obtain

\[
M_\alpha \leq \tilde{u}^n(t_\alpha, \xi_\alpha) - \tilde{v}(t_\alpha, \zeta_\alpha) \\
\leq \frac{\delta}{r + \lambda} e^{-\lambda_\alpha - \xi_\alpha} (\tilde{f}(t_\alpha, \xi_\alpha) - \tilde{g}(t_\alpha, \zeta_\alpha)) \alpha(\xi_\alpha - \zeta_\alpha) \\
+ \frac{\delta}{\epsilon(r + \lambda)} e^{-\lambda_\alpha} |\tilde{g}(t_\alpha, \zeta_\alpha)| \alpha(\xi_\alpha - \zeta_\alpha)^2 + \frac{c}{\epsilon(r + \lambda)} \alpha(\xi_\alpha - \zeta_\alpha)^2. 
\]

But also, (6.5) implies, at least formally, that \( 0 \leq \tilde{u}_\xi(t, \xi) \leq e^{\lambda t + \xi} \). Of course \( u_x \) and \( \tilde{u}_\xi \) may not exist, but (6.5) implies that \( \alpha(\xi_\alpha - \zeta_\alpha) \), the surrogate for \( \tilde{u}_\xi(t_\alpha, \zeta_\alpha) \), must satisfy \( 0 \leq \alpha(\xi_\alpha - \zeta_\alpha) \leq e^{\lambda t + \xi} \). Using this inequality in (6.16), we obtain

\[
M_\alpha \leq \frac{\delta}{r + \lambda} (\tilde{f}(t_\alpha, \xi_\alpha) - \tilde{g}(t_\alpha, \zeta_\alpha)) + O(\alpha(\xi_\alpha - \zeta_\alpha)^2) \\
= \frac{\delta}{r + \lambda} (\tilde{f}(t_\alpha, \xi_\alpha) - \tilde{g}(t_\alpha, \zeta_\alpha)) + \frac{\delta}{r + \lambda} (\tilde{g}(t_\alpha, \xi_\alpha) - \tilde{g}(t_\alpha, \zeta_\alpha)) \\
+ O(\alpha(\xi_\alpha - \zeta_\alpha)^2) \\
\leq \frac{\delta}{r + \lambda} \max_{(t, \xi) \in \tilde{D}_\epsilon} (\tilde{f}(t, \xi) - \tilde{g}(t, \xi))^+ + \frac{\delta}{r + \lambda} (\tilde{g}(t_\alpha, \xi_\alpha) - \tilde{g}(t_\alpha, \zeta_\alpha)) \\
+ O(\alpha(\xi_\alpha - \zeta_\alpha)^2). 
\]

Letting \( \alpha \to \infty \) in (6.13) and (6.17), using (6.12) and the uniform continuity of \( \tilde{g} \) on \( \tilde{D}_\epsilon \), we contradict (6.11). \( \diamond \)

**Proof of Theorem 3.1**: Set \( \lambda \triangleq \delta + 1 \) and endow \( \mathcal{G} \) with the metric

\[
d(f, g) \triangleq \max_{(t,x) \in \bar{D}_0} e^\lambda |f(t, x) - g(t, x)| \text{ for all } f, g \in \mathcal{G}. 
\]

Under this metric, \( \mathcal{G} \) is complete. Let \( f, g \in \mathcal{G} \) be given and define \( u = T f \) and \( v = T g \). According to Subsection 4.5, \( u \) and \( v \) are in \( \mathcal{G} \). In particular, (6.5) is satisfied. We apply Lemma 6.1, noting that \( u \) and \( v \) are viscosity solutions of (6.1) and (6.2), respectively, or viscosity solutions of (6.3) and (6.4), respectively, and they agree on \( \partial_p D_0 \), to conclude that

\[
d(u, v) \leq \frac{\delta}{r + \lambda} \max_{(t,x) \in \bar{D}_0} e^\lambda (f(t, x) - g(t, x))^+. 
\]

Reversing the roles of \( f \) and \( g \), we obtain the contraction property for \( T \). \( \diamond \)
Remark 6.2 Uniqueness of the continuous viscosity solution of (6.1) or (6.3) with boundary conditions (3.6) and (3.7) follows from Lemma 6.1 with \( f = g \).

7 Asymptotic behavior

We relate the problem of this paper to the perpetual convertible bond. To do this, we reverse time, denoting by \( u_L(t, x) \) the price of the bond for fixed par value \( L \in [0, K] \) when the time to maturity is \( t \) and the firm value is \( x \). This section requires standing assumption (2.3). We have the following variation of Lemma 6.1.

**Lemma 7.1** Fix \( T > 0 \) and let \( g_1 \) and \( g_2 \) in \( C([0, T] \times [0, K]) \) be a viscosity subsolution and a viscosity supersolution, respectively, of

\[
\min \{ g_t + \mathcal{N} g - c, g - \gamma x \} = 0 \quad \text{on} \quad (0, T) \times \left( 0, \frac{K}{\gamma} \right) \tag{7.1}
\]

or a viscosity subsolution and viscosity supersolution, respectively, of

\[
\max \{ g_t + \mathcal{N} g - c, g - K \} = 0 \quad \text{on} \quad (0, T) \times \left( 0, \frac{K}{\gamma} \right) \tag{7.2}
\]

where \( \mathcal{N} \) is the nonlinear operator

\[
\mathcal{N} g(t, x) \triangleq rg(t, x) - (rx - c)g_x(t, x) + \delta (x - g(t, x))g_x(t, x) - \frac{1}{2} \sigma^2 x^2 g_{xx}(t, x).
\]

Assume that either \( g_1 \) or \( g_2 \) satisfies (3.2). If \( g_1(0, \cdot) \leq g_2(0, \cdot) \) and

\[
g_1(t, 0) \leq g_2(t, 0), \quad g_1\left( t, \frac{K}{\gamma} \right) \leq g_2\left( t, \frac{K}{\gamma} \right), \quad 0 \leq t \leq T,
\]

then \( g_1 \leq g_2 \). In particular, if \( g_1 \) and \( g_2 \) are viscosity solutions of (7.1) or (7.2), \( g_1(0, \cdot) = g_2(0, \cdot) \), and equality holds in both parts of (7.3), then \( g_1 = g_2 \).

**Proof:** Apply the time-reversed version of Lemma 6.1 with \( \lambda = 0, u = f = g_1 \) and \( v = g = g_2 \) to conclude that

\[
\max_{(t, x) \in [0, T] \times [0, \frac{K}{\gamma}]} \left( g_1(t, x) - g_2(t, x) \right)^+ \leq \frac{\delta}{r} \max_{(t, x) \in [0, T] \times [0, \frac{K}{\gamma}]} \left( g_1(t, x) - g_2(t, x) \right)^+.
\]
Since $\delta < r$, we have $g_1 \leq g_2$. ♦

Regardless of the initial time to maturity, as a function of the firm value and remaining time to maturity, the convertible bond price must satisfy one (or both) of the (7.1) and (7.2), depending on whether $c \leq rK$ or $\delta K \leq c$. The uniqueness assertion in Lemma 7.1 guarantees that the bond price does not depend on the initial time to maturity.

A perpetual convertible bond never matures, and hence the time variable and the par value are irrelevant. Its price $p(x)$ is a function of the underlying firm value alone. The following result is proved in [33].

**Theorem 7.2** The perpetual convertible bond price function $p$ is continuous on $[0, \infty)$, continuously differentiable on $(0, K/\gamma)$, and satisfies $0 \leq p'(x) \leq 1$ for $0 < x < K/\gamma$, and $p(x) = \gamma x$ for $x \geq K/\gamma$.

If $c \leq rK$, then $p$, regarded as a function of $(t,x)$ with $p_t = 0$, is a continuous viscosity solution of (7.1) satisfying

$$p(0) = 0, \quad p\left(\frac{K}{\gamma}\right) = K. \quad (7.4)$$

Furthermore, there exists $C^*_o \in (0, K/\gamma]$ such that $p$ restricted to $(0, C^*_o)$ is strictly greater than $\gamma x$ and is a classical solution of $Np = c$, whereas $p(x) = \gamma x$ for $x \geq C^*_o$.

If $\delta K \leq c$, then $p$ is a continuous viscosity solution of (7.2) satisfying (7.4). Furthermore, there exists $C^*_a \in (0, K/\gamma]$ such that $p$ restricted to $(0, C^*_a)$ is strictly less than $K$ and is a classical solution of $Np = c$, whereas $p(x) = K$ for $C^*_a \leq x \leq K/\gamma$.

Uniqueness of $p$ in [33] is proved only in the class of functions that are smooth in the continuation region, not within the class of all continuous functions. We upgrade the uniqueness result to the larger class here.

**Lemma 7.3** Let $p$ be the perpetual convertible bond price function. If $c \leq rK$, then $p$ is the unique viscosity solution of (7.1) on $(0, K/\gamma)$ that is continuous on $[0, K/\gamma]$ and satisfies (7.4). If $\delta K \leq c$, then $p$ is the unique viscosity solution of (7.2) on $(0, K/\gamma)$ that is continuous on $[0, K/\gamma]$ and satisfies (7.4).

**Proof:** We provide the proof for the case $c \leq rK$. In the second case, $\delta K \leq c$, a similar proof is possible.
Let $q \in C\left[0, \frac{K}{r}\right]$ be a viscosity solution of (7.1) on $\left(0, \frac{K}{r}\right)$ satisfying (7.4). Assume

$$\max_{x \in \left[0, \frac{K}{r}\right]} \left(p(x) - q(x)\right) = p(x_0) - q(x_0) > 0. \quad (7.5)$$

Then $x_0 \in \left(0, \frac{K}{r}\right)$ and $p(x_0) > q(x_0) \geq \gamma x_0$, so $x_0 \in (0, C_o^*)$. Because $p$ is twice continuously differentiable in $(0, C_o^*)$, we can use $p + q(x_0) - p(x_0)$ as a test function for the viscosity supersolution $q$ to obtain

$$rq(x_0) - (r x_0 - c)p'(x_0) + \delta (x_0 - q(x_0))p'(x_0) - \frac{1}{2}\sigma^2 x_0^2 p''(x_0) \geq c.$$  

But $p$ satisfies $\mathcal{N}p(x_0) = c$, so

$$rp(x_0) - (r x_0 - c)p'(x_0) + \delta (x_0 - p(x_0))p'(x_0) - \frac{1}{2}\sigma^2 x_0^2 p''(x_0) = c.$$  

Subtracting these relations, we obtain

$$r \left(p(x_0) - q(x_0)\right) \leq \delta \left(p(x_0) - q(x_0)\right)p'(x_0).$$

But $0 \leq p'(x_0) \leq 1$ and $0 \leq \delta < r$, so we have a contradiction to (7.5).

Assume on the other hand that

$$\max_{x \in \left[0, \frac{K}{r}\right]} (q(x) - p(x)) = q(x_0) - p(x_0) > 0. \quad (7.6)$$

Then $x_0 \in \left(0, \frac{K}{r}\right)$ and $q(x_0) > p(x_0) \geq \gamma x_0$. We have $q \leq p + q(x_0) - p(x_0)$, and if $x_0 \neq C_o^*$, so that $p$ is twice continuously differentiable in a neighborhood of $x_0$, we can use $p + q(x_0) - p(x_0)$ as a test function for the viscosity subsolution $q$ to obtain

$$rq(x_0) - (r x_0 - c)p'(x_0) + \delta (x_0 - q(x_0))p'(x_0) - \frac{1}{2}\sigma^2 x_0^2 p''(x_0) \leq c. \quad (7.7)$$

But $\mathcal{N}p(x_0) \geq c$ means that

$$rp(x_0) - (r x_0 - c)p'(x_0) + \delta (x_0 - p(x_0))p'(x_0) - \frac{1}{2}\sigma^2 x_0^2 p''(x_0) \geq c. \quad (7.8)$$

Subtracting these relations, we obtain

$$r (q(x_0) - p(x_0)) \leq \delta (q(x_0) - p(x_0))p'(x_0), \quad (7.9)$$

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and we conclude as before.

The only other possibility is that (7.6) holds and \( x_0 = C^*_o \in (0, K \gamma) \). According to Theorem 7.2, \( p' \) is defined on \( (0, K \gamma) \), and using the equations \( \mathcal{N} p = c \) to the left of \( C^*_o \) and the \( p(x) = \gamma x \) to the right of \( x_0 \), we see that the left- and right-hand second derivatives \( p''(x_0-) \) and \( p''(x_0+) = 0 \) exist. Furthermore, \( p(x) - \gamma x \) attains its minimum value of 0 at \( x_0 \), so \( p''(x_0-) \geq 0 \). We only need to rule out the case \( p''(x_0-) > 0 \), for in the event \( p''(x_0-) = 0 \), the function \( p \) is twice continuously differentiable at \( x_0 \) and we can use \( p + q(x_0) - p(x_0) \) as a test function as above.

Suppose \( p''(x_0-) > 0 = p''(x_0+) \). Let \( p \) be the solution in \( (0, K \gamma) \) of the ordinary differential equations \( \mathcal{N} p = c \) satisfying \( p(x_0) = \gamma x_0 \) and \( p'(x_0) = \gamma \). On \( (0, x_0] \), \( p \) is a solution to this terminal value problem and hence agrees with \( q \). In particular, \( p''(x_0) = p''(x_0-) > 0 \), and this implies \( p(x) > \gamma x = p(x) \) for \( x \) in some interval \( (x_0, x_0 + \epsilon) \), where \( \epsilon > 0 \). The function \( q - p \) attains a local maximum at \( x_0 \) because \( q - p \) does, and we can use \( p + q(x_0) - p(x_0) \) as a test function for the viscosity subsolution \( q \) as above. This leads to (7.7) with \( p''(x_0-) \) replacing \( p''(x_0) \). Inequality (7.8) holds for all \( x \in (0, x_0) \), and letting \( x \uparrow x_0 \), we obtain (7.8) with \( p''(x_0-) \) replacing \( p''(x_0) \) as well. This implies (7.9), and (7.6) is contradicted. \( \diamond \)

**Proof of Theorem 3.5**: The terminal condition (3.6), with time reversed, states that for \( 0 \leq L \leq K \), we have

\[
\gamma x = u_0(0, x) \leq u_L(0, x) \leq u_K(0, x) = x \land K, \quad 0 \leq x \leq \frac{K}{\gamma}.
\]

The functions \( u_0 \), \( u_L \) and \( u_K \) are continuous viscosity solutions of (7.1) or (7.2), depending on whether \( c \leq rK \) or \( \frac{\delta K}{\gamma} \leq c \). Lemma 7.1 and the membership of \( u_0 \) and \( u_K \) in \( \mathcal{G} \) (see, in particular, (3.3)) imply that for \( 0 \leq L \leq K \),

\[
\gamma x \leq u_0(t, x) \leq u_L(t, x) \leq u_K(t, x) \leq x \land K, \quad t \geq 0, \ 0 \leq x \leq \frac{K}{\gamma}, \quad (7.10)
\]

For \( 0 \leq t_1 \leq t_2 \), we have \( u_0(0, \cdot) = \gamma x \leq u_0(t_2 - t_1, \cdot) \), and we can apply Lemma 7.1 with \( g_1(0, \cdot) = u_0(0, \cdot) \) and \( g_2(0, \cdot) = u_0(t_2 - t_1, \cdot) \) to conclude that \( u_0(t_1, \cdot) \leq u_0(t_2, \cdot) \). In other words, \( u_0(t, x) \) is nondecreasing in \( t \) for each fixed \( x \). On the other hand, \( u_K(0, x) = x \land K \geq u_K(t_2 - t_1, x) \), and this leads to the conclusion that \( u_K(t, x) \) is nonincreasing in \( t \) for each fixed \( x \). Both \( u_0(t, \cdot) \) and \( u_K(t, \cdot) \) are Lipschitz continuous with constant 1, and
the Arzela-Ascoli Theorem implies that they converge uniformly on $[0, \frac{K}{\gamma}]$ to Lipschitz continuous limits $u_-(\cdot)$ and $u_+(\cdot)$, respectively, as $t \to \infty$. Uniform convergence preserves the viscosity solution property (see [13]), and so $u_-$ and $u_+$ are also continuous viscosity solutions of either (7.1) or (7.2). Lemma 7.3 implies $u_- = p = u_+$. Relation (7.10) then implies $\lim_{t \to \infty} u_L(t,x) = p(x)$ for all $x \in [0, \frac{K}{\gamma}]$, and the convergence is uniform in $x$. Of course, for $x \geq \frac{K}{\gamma}$, $u_L(t,x) = p(x) = \gamma x$.

**Remark 7.4** The proof of Theorem 3.5 shows that for all $t \geq 0$,

\[
 u_0(t,x) \leq \lim_{s \to \infty} u_0(s,x) = p(x) = \lim_{s \to \infty} u_K(s,x) \leq u_K(t,x)
\]

and the convergence is uniform in $x \in (0, \frac{K}{\gamma})$.

## 8 Continuation and stopping sets

We continue with the time reversal introduced in Section 7, denoting by $u_L(t,x)$ the price of the convertible bond when time to maturity is $t$ and the underlying firm value is $x$. Following Section 5, in Case I, $c \leq rK$, we define

\[
 C^I_L \triangleq \left\{ (t,x) \in (0, \infty) \times \left(0, \frac{K}{\gamma}\right) : u_L(t,x) > \gamma x \right\},
\]

\[
 S^I_L \triangleq \left\{ (t,x) \in (0, \infty) \times \left(0, \frac{K}{\gamma}\right) : u_L(t,x) = \gamma x \right\}.
\]

In Case II, $\delta K \leq c$, we define

\[
 C^II_L \triangleq \left\{ (t,x) \in (0, \infty) \times \left(0, \frac{K}{\gamma}\right) : u_L(t,x) < K \right\},
\]

\[
 S^II_L \triangleq \left\{ (t,x) \in (0, \infty) \times \left(0, \frac{K}{\gamma}\right) : u_L(t,x) = K \right\}.
\]

To relate (8.4) to the definition of $S^II_T$ in Section 5, recall (4.45). This section provides some information about the nature of the sets in (8.1)–(8.4).

**Lemma 8.1** For all $t \geq 0$, the mapping $x \mapsto \frac{1}{2}u_L(t,x)$ is nonincreasing.
PROOF: We rescale \( u \). Let \( \ell > 0 \) be given and define \( \overline{u} : [0, \infty) \times [0, \frac{\ell K}{\gamma}] \rightarrow [0, \infty) \) by \( \overline{u}(t, x) \triangleq \ell u\left(t, \frac{x}{\ell}\right) \). Because we have formally that \( 0 \leq u_x(t, x) \leq 1 \), we also have formally that \( 0 \leq \overline{u}_x(t, x) \leq 1 \). Furthermore,

\[
\overline{u}_t(t, x) + \mathcal{N}\overline{u}(t, x) = \ell \left[u_t\left(t, \frac{x}{\ell}\right) + \mathcal{N}u\left(t, \frac{x}{\ell}\right)\right] + c(1 - \ell)\overline{u}_x(t, x). \tag{8.5}
\]

In Case I, \( c \leq rK \), we let \( 0 < a < b < \frac{K}{\gamma} \) be given and set \( \ell = \frac{b}{a} > 1 \). Because \( u_t + \mathcal{N}u \geq c \), (8.5) implies

\[
\overline{u}_t(t, x) + \mathcal{N}\overline{u}(t, x) \geq \ell c + c(1 - \ell)\overline{u}_x(t, x) \geq c. \tag{8.6}
\]

In other words, \( \overline{u}(t, x) \) is a viscosity supersolution of \( \mathcal{N}\overline{u} \geq c \) on \( (0, \infty) \times (0, \frac{\ell K}{\gamma}) \). But also, \( \overline{u}(t, x) \geq \gamma x \) for \( 0 \leq x \leq \frac{\ell K}{\gamma} \) because \( u(t, x) \geq \gamma x \) for \( 0 \leq x \leq \frac{K}{\gamma} \). It follows that for every \( T > 0 \), \( \overline{u} \) is defined and continuous on \( [0, T] \times [0, \frac{K}{\gamma}] \) and is a supersolution of (7.1). Furthermore, \( \overline{u}(0, \cdot) \geq u(0, \cdot) \), \( \overline{u}(t, 0) = u(t, 0) = 0 \), and \( \overline{u}(t, \frac{K}{\gamma}) \geq K = u(t, \frac{K}{\gamma}) \). Lemma 7.1 implies \( \overline{u} \geq u \)

on \( [0, T] \times [0, \frac{K}{\gamma}] \) for every \( T > 0 \). In particular, \( \frac{b}{a} u(t, a) = \overline{u}(t, b) \geq u(t, b) \), which yields the desired result.

In Case II, \( \delta K \leq c \), we again let \( 0 < a < b < \frac{K}{\gamma} \) be given, but now set \( \ell = \frac{b}{a} < 1 \). In this case, \( u_t + \mathcal{N}u \leq c \) and both inequalities in (8.6) are reversed. But also, \( \overline{u} \leq \ell K \leq K \). It follow that \( \overline{u} \) is a subsolution of (7.2), but it is defined only on the set \( [0, \infty) \times [0, \frac{\ell K}{\gamma}] \subset [0, \infty) \times [0, \frac{K}{\gamma}] \). However, on the upper boundary \( [0, \infty) \times \left\{ \frac{\ell K}{\gamma} \right\} \) of this set, \( \overline{u} = \ell K \) and \( u_t\left(t, \frac{\ell K}{\gamma}\right) \geq \ell K \). The function \( u(0, \cdot) \) also dominates \( \overline{u}(0, \cdot) \). We fix an arbitrary \( T > 0 \) and apply Lemma 7.1 on the smaller domain \( [0, T] \times [0, \frac{\ell K}{\gamma}] \) (just take \( \gamma \) in Lemma 7.1 to be \( \frac{\ell}{\gamma} \)) to conclude that \( \overline{u} \leq u \) on this domain. In particular, \( u(t, a) = \overline{u}(t, a) = \frac{b}{a} u(t, b) \), which yields the desired result.

In Case I, we define the free boundary

\[
c_L(t) \triangleq \inf \left\{ x \in \left(0, \frac{K}{\gamma}\right] : u_L(t, x) = \gamma x \right\}, \quad t > 0, \tag{8.7}
\]

and in Case II, we define the free boundary

\[
d_L(t) \triangleq \inf \left\{ x \in \left(0, \frac{K}{\gamma}\right] : u_L(t, x) = K \right\}, \quad t > 0. \tag{8.8}
\]
In the overlapping case $\delta K \leq c \leq rK$, Remark 5.2 says that $c_L(t) = d_L(t) = \frac{K}{\gamma}$ for all $t > 0$. We see in Remark 8.4 below that $c_L(t)$ and $d_L(t)$ are positive, so inf could be replaced by min in (8.7) and (8.8).

**Remark 8.2** Because $u_L(t,x)$ is nondecreasing in $L$, we have $S^L_I \subset S^I_L \subset S^I_0$ in Case I and $S^{II}_0 \subset S^{II}_L \subset S^{II}_K$ in Case II. This implies $c_L(t)$ is nondecreasing in $L$ in Case I and $d_L(t)$ is nonincreasing in $L$ in Case II. In the proof of Theorem 3.5 at the end of Section 7, we saw $u_0(t,x)$ is nondecreasing in $t$ and $u_K(t,x)$ is nonincreasing in $t$. This implies in Case I that $c_0(t)$ is nondecreasing and $c_K(t)$ is nonincreasing, while in Case II, $d_0(t)$ is nonincreasing and $d_K(t)$ is nondecreasing.

The following theorem asserts that the continuation set and stopping set are divided by the free boundary $c_L(\cdot)$ in Case I and $d_L(\cdot)$ in Case II.

**Theorem 8.3** In Case I, $c \leq rK$, we have

$$S^L_I = \left\{ (t,x) \in (0,\infty) \times \left(0, \frac{K}{\gamma}\right) : c_L(t) \leq x \leq \frac{K}{\gamma} \right\}. $$

In Case II, $\delta K \leq c$, we have

$$S^{II}_L = \left\{ (t,x) \in (0,\infty) \times \left(0, \frac{K}{\gamma}\right) : d_L(t) \leq x \leq \frac{K}{\gamma} \right\}. $$

**Proof:** In Case I, we must show that if $u_L(t,x) = \gamma x$ for some $x \in \left(0, \frac{K}{\gamma}\right)$, then $u_L(t,y) = \gamma y$ for all $y \in \left[x, \frac{K}{\gamma}\right]$. This follows immediately from Lemma 8.1. In Case II, the result follows from the nondecrease in $x$ of $u_L(t,x)$. 

**Remark 8.4** Consider Case I. If $(t_0,x_0) \in S^L_I$, then $u_L(t_0,x_0) = \gamma x_0$. Because $u_L$ is a viscosity solution of $\min\{u_t + \mathcal{N} u - c, u - \gamma x\} = 0$, we may use $h(x) = \gamma x$ as a “test function” at the point $(t_0,x_0)$ for the viscosity supersolution property to obtain $\mathcal{N} h(x_0) \geq c$, or equivalently, $x_0 \geq \frac{c}{\delta \gamma}$. It follows that $\min\left\{ \frac{K}{\gamma}, \frac{c}{\delta \gamma} \right\} \leq c_L(t) \leq \frac{K}{\gamma}$ for every $t > 0$. In Case II, we have $K = u_L(t,d_L(t)) \leq d_L(t) \leq \frac{K}{\gamma}$.

**Theorem 8.5** Let $C^*_o$ and $C^*_a$ be as in Theorem 7.2. In Case I, $c \leq rK$, we have $\lim_{t \to \infty} c_L(t) = C^*_o$. In Case II, $\delta K \leq c$, we have $\lim_{t \to \infty} d_L(t) = C^*_a$. 

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Proof: In light of Remark 8.2, it suffices to prove the theorem for the limiting cases \( L = 0 \) and \( L = \frac{K}{\gamma} \). We treat Case I only.

Since \( c_0 \) is nondecreasing and \( c_K \) is nonincreasing, these functions have limits \( c_0(\infty) \) and \( c_K(\infty) \) in \( (0, \frac{K}{\gamma}] \) as \( t \to \infty \) and we must show \( c_0(\infty) = c_0^* = c_K(\infty) \). Because \( c_0^* = \min \{ x \in (0, \frac{K}{\gamma}] : p(x) = \gamma x \} \), we have from the first inequality in (7.11) that \( c_0(t) \leq c_0^* \) and hence \( c_0(\infty) \leq c_0^* \). But \( u_0(t, c_0(t)) = \gamma c_0(t) \) and \( u_0(t, \cdot) \) converges uniformly to \( p(\cdot) \), so \( c_0(\infty) \geq c_0^* \).

Using the second inequality in (7.11), we obtain \( c_K(t) \geq c_K^* \), and hence \( c_K(\infty) \geq c_K^* \). Assume \( c_0^* < c_K(\infty) \leq \frac{K}{\gamma} \). Because \( c_K(\cdot) \) is nonincreasing, \( u_K \) is a viscosity solution of \( u_t + \mathcal{N}u = c \) on \( (0, \infty) \times (0, c_K(\infty)) \). Hence the limit \( p(\cdot) \) is a viscosity solution of this equation on \( (0, c_K(\infty)) \). But \( p(x) = \gamma x \) for \( x \in (c_0^*, c_K(\infty)) \), and this does not satisfy \( \mathcal{N}p = c \). This contradiction implies \( c_K(\infty) = c_0^* \). \( \bigdiamond \)

References


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