JOURNAL ARTICLE

Optimal Long-Term Financial Contracting

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The Review of Financial Studies, Volume 20, Issue 6, November 2007, Pages 2079–2128, https://doi.org/10.1093/rfs/hhm031

Published: 07 September 2007

Abstract

We develop an agency model of financial contracting. We derive long-term debt, a line of credit, and equity as optimal securities, capturing the debt coupon and maturity; the interest rate and limits on the credit line; inside versus outside equity; dividend policy; and capital structure dynamics. The optimal debt-equity ratio is history dependent, but debt and credit line terms are independent of the amount financed and, in some cases, the severity of the agency problem. In our model, the agent can divert cash flows; we also consider settings in which the agent undertakes hidden effort, or can control cash flow risk.

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