

Exit Options in Corporate Finance: Liquidity versus Incentives

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Abstract

This paper provides a first study of the optimal design of active monitors' exit options in a problem involving a demand for liquidity and costly monitoring of the issuer. Optimal incentives to monitor the issuer may involve restricting the monitor's right to sell her claims on the firm's cash-flow early. But the monitor will then require a *liquidity premium* for holding such an illiquid claim. In general, therefore, there will be a trade off between incentives and liquidity. The paper highlights a fundamental complementarity between *speculative monitoring* in financial markets (which increases the informativeness of prices) and *active monitoring* inside the firm: in financial markets where price discovery is better and securities prices reflect the fundamentals of the issuer better, the incentive cost of greater liquidity may be smaller and active monitoring incentives may be preserved. The paper spells out the conditions under which more or less liquidity is warranted and applies the analysis to shed light on common exit provisions in venture capital financing.

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