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Debt and Seniority: An Analysis of the Role of Hard Claims in Constraining Management

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WORKING PAPER 4886

DOI 10.3386/w4886

ISSUE DATE October 1994

We argue that long-term debt has a role in controlling management's ability to finance future investments. A company with high (widely-held) debt will find it hard to raise capital, since new security holders will have low priority relative to existing creditors. Conversely for a company with low debt. We show there is an optimal debt-equity ratio and mix of senior and junior debt if management undertakes unprofitable as well as profitable investments. We derive conditions under which equity and a single class of senior long-term debt work as well as more complex contracts for controlling investment behavior.

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[American Economic Review](#), vol. 85, no. 3, pp. 567-585, (June 1995). citation courtesy of

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Supported by the Alfred P. Sloan Foundation grant #G-2023-19633, the Lynde and Harry Bradley Foundation grant #20251294...

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