Topics in Financial Economics: Hart's Hard Budget Constraint Model

Tianxi Wang

Economics Department, U of Essex

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- Based on the book by Oliver Hart (1995), "Firms, Contracts and Financial Structure" (Chapter 6, page 126-140).

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- The management cannot divert the company's cash into its own pocket. Otherwise, we would not see the public company.

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- Investors are risk neutral, and the risk free rate is 0.

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- The core of the model consists in how to decision capital structure to constrain the manager, so as to enforce the optimal liquidation.

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- therefore, liquidation happens if and only if

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- If debt renegotiation is possible:

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  3. Myers-Majluf: It depends on the seniority of debt, but it presumes the manager acts in the interest of old shareholders; if the manager only cares the firm's value, he has no incentive to issue debt.

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- As , It can hardly explain outside equity, in two senses: The firm's value can be maximized without any outside equity; in the extension, the manager will use free cash up for empire building rather than for dividend, so outside equity is infeasible.