Default And Liquidation Timing Under Manager-Shareholders Conflicts

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Abstract
We consider a dynamic model in which shareholders delegate a manager, who observes private information about running and liquidation costs of the firm, to operate and default or liquidate the firm. The shareholders offer a contract, which consists of default or liquidation timing and compensation contingent on reported types, so as to make the manager to report a true type about the firm's cost structure. We analytically derive the shareholders' optimal contract and show the following results. In the optimal contract, as in the previous literature, the manager with low costs receives compensation and defaults or liquidates the firm at the first best timing. On the other hand, unlike in the previous literature, the high cost firm's liquidation timing can be earlier or equal to or later than that of the first best case depending on the relation between the degrees of information asymmetry of running and liquidation costs, while the high cost firm's default timing is always earlier than that of the first best case. This leads to new and non-monotonic results about the equity, debt, and firm values as well as social loss due to information asymmetry.

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