

Microfoundation of capital structures

- *Assumption:* value of assets $p_t k_t^i$ is contractable, k_t^i not
- Agency problem of entrepreneur
 - Can take projects w/NPV < 0, private benefit $b(m) < 1$ per \$1 destroyed
 - m is amount of monitoring by intermediary
 - **Incentive constraint:** $\alpha^E \geq b(m)$, binds in equ. $\Rightarrow \alpha^E(m)$
- Agency problem of intermediary
 - Save monitoring cost $c(m)$ per \$1 if shirking
 - **Incentive constraint:** $\alpha^I \geq c(m)$
- **Solvency constraint:** $n_t \geq 0$ (implied by IC constraints)
- Assume $c(m) + b(m)$ is a constant for all m
entrepreneurs' & intermediaries' **net worth are substitutes**
 - Special case: if entrepreneurs' net worth = 0, then m s.t. $b(m) = 0$