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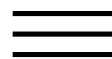

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Journal of Financial Economics

Volume 7, Issue 2, June 1979, Pages 117-161

On financial contracting: An analysis of bond covenants â˜†

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https://doi.org/10.1016/0304-405X(79)90011-4

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Abstract

With risky debt outstanding, stockholder actions aimed at maximizing the value of their equity claim can result in a reduction in the value of both the firm and its outstanding bonds. We examine ways in which debt contracts are written to control the conflict between bondholders and stockholders. We find that extensive direct restrictions on production/investment policy would be expensive to employ and are not observed. However, dividend and financing policy restrictions are written to give stockholders incentives to follow a firm-value-maximizing production/investment policy. Taking into account how contracts control the bondholder- stockholder conflict leads to a number of testable propositions about the specific form of the debt contract that a firm will choose.

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â˜† This research is supported by the Managerial Economics Research Center, Graduate School of Management, University of Rochester. We are indebted to numerous colleagues, both those at the University of Rochester and elsewhere, for their help on this paper. We are especially grateful to Michael C. Jensen for his assistance.

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