Spring 2012 Final

2:30

P6

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1) S/H will want more investment in (high) risk projects than B/H will. 8

Reason: B/H have a fixed claim so that the downside hurts them but the upside doesn't really help them.

But S/H have a residual claim w/ limited liability. As a result, the upside benefits them while (the downside doesn't affect them) (once the value of the firm < what owed B/H.)

2) S/H will (pass up projects even if positive NPV) 8

Reason: (if default is likely) then (B/H get much or even all of benefit.)

⇒ S/H may have a (net loss) if (they fund) the project.

Protection: can attempt to prevent high risk investments in debt covenants + to proceed monitoring of mgt 8

46 = 75
28 = 73
25 = 71
24 = 70
20 = 68
18 = 66
16 = 64
14 = 62
10 = 60
8 = 55
6 = 51
5 = 47
4 = 43
2 = 38