

Seminar VI

Problem 1 (exam 2014)

Andy runs a business and plans to expand. He has, however, insufficient own assets available and therefore seeks external financing.

- (i) By setting up a simple model, explain how the problem of moral hazard may cause Andy not to receive the required external funding even if his expansion plans have a positive net present value.
- (ii) In an attempt to facilitate external funding of his expansion plans, Andy considers asking Bart to sit on the board of directors. Bart has skills in active monitoring and would, at a cost, be able to collect value-enhancing information about Andy's business. Discuss – by extending the model in part (i) – whether enlisting Bart is helpful for Andy. In particular, discuss whether it is a problem
 - i. if Bart does not have own funds available for investing in Andy's business.
 - ii. if Andy and Bart are friends, so that they may be prone to collude against other investors.
- (iii) Another possibility for Andy is to ask Claire to sit on the board of directors. She has no particular skills in active monitoring but knows Andy's line of business well and will be able to give advice. Discuss – again by extending the model in part (i) – whether having Claire on the board is helpful for Andy.
- (iv) A concern of Andy is that committing all his available assets to this expansion makes it difficult for him to engage in other investment projects along the way. Extend the model of part (i) to include a short-term return of his expansion plans and discuss how Andy's concern for his liquidity can be balanced against investors' concern for keeping Andy accountable.

(cont.)

- (v) Following up on part (iv), a similar concern for lack of liquidity may arise for Bart in part (ii). Discuss briefly how Andy can resolve this concern. Discuss also how the general need for society to have investors that are both liquid and accountable may have implications for public policy.