Isolating Limited Liability as a Financial Friction

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We investigate how a presence of limited liabilities distorts firms' investment decisions. We consider a simple model where firm owners are protected by limited liabilities and have to decide how much to invest as well as how to finance their investment. In contrast to earlier work, we find that, depending on the firm's fundamentals, limited liabilities can lead to either under- or over-investment; and discuss when over-investment is more likely to occur. We then characterize condition under which over-investment happens and provide intuition for why it occurs. We also investigate how our results depend on the type of claims issued by the firm and their relative priority. Finally, we provide empirical evidence consistent with predictions of our model..

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