Convertible bonds with specific and general knowledge*

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Abstract

This paper examines optimal financial contracts under the presence of specific and general knowledge (in the sense of Jensen and Meckling (1992)) about the profitability of an investment opportunity and offers a rationale for using convertible bonds. We consider the model in which only a borrower can receive an information about the marginal productivity of his effort and a lender can decides whether continue the project or not after the contract is concluded. We show that, if the ex-ante profitability of the project is low, convertible bond contracts improve the expected profit from the investment opportunity.

JEL Classifications Code: G32; D86.

Keywords: Convertible bonds; Financial contracts; specific and general knowledge.

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