The Limited Liability Agency Model with Moral Hazard*

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Abstract

We obtain a full characterization of the optimal contract for the limited liability model of agency with moral hazard using conditions that are generally satisfied in applied problems in economics and finance. We show necessary and sufficient conditions for the optimal contract to take the form of debt. The analysis is based on two conditions: the distribution of shocks has a monotone hazard rate and the shock and the agent's effort are complements. The advantage of this approach is that it is readily satisfied by several distribution and production functions in applied problems. These conditions are commonly applied in adverse selection models of agency. The two conditions replace the traditional MLRP and CDFC assumptions, which are difficult to satisfy in applied problems.

Key Words: Agency, Moral Hazard, Debt, Limited Liability.

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