Abstract
We study a dynamic contracting problem in which the firm's size is variable. Cashflows increase in size but downsizing may be necessary to prevent the agent from taking on excessive risk. We characterize incentive compatibility and the downsizing process, which is active only at the boundary. We treat two cases: the liquidation value may be linear in size, or constant. This strongly influence the results. The first case is "standard" and yields homogeneity of the value function, which we fully characterize. In the second case, homogeneity must be forsaken, which results in the existence of an optimal liquidation size. At that scale the value of the firm as an ongoing concern is the same as the principal's outside option. Firms with good prospects can boost their size; hence, their value. The interaction of these two mechanisms results in rich firm-size dynamics. We suggest an implementation in securities and highlight potential conflicts between security holders.