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# Shareholder intervention, managerial resistance, and corporate control: a Nash equilibrium approach<sup>☆</sup>

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## Abstract

Anecdotal and empirical evidence suggest that some large shareholders initiate takeover attempts while others remain passive, and that target managements sometimes cooperate and sometimes resist. We model the takeover mechanism using a two-player game of incomplete information. The results of the paper are contained in three broad classes of equilibria: separating, pooling and partial pooling. The partial pooling equilibria offer the best match to the anecdotal evidence. In these equilibria, all strong and some weak investors attempt to takeover; some managers cooperate while others resist. The model offers various testable implications and links to the empirical corporate control literature.

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## 1. Introduction

An extensive theoretical and empirical body of literature concerning the causes and consequences of takeovers and block share transactions has developed over the past two decades. One segment of this literature is centered on the premise that the characteristics of investors

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attempting a takeover influence the likelihood of successful completion of the takeover. Viewed collectively, this literature suggests that investor characteristics impact the target's willingness to cooperate as well as the investor's own willingness to engage in a hostile takeover. Target willingness to cooperate is a function of two considerations. First, target management considers the expected post-takeover value of the firm. Second, target management considers its personal preference for control, a preference that is offset by the likelihood of a hostile takeover attempt should the target choose to resist. Both of these considerations are themselves functions of the quality of the investor proposing the takeover. A strong investor, broadly defined as one who will increase expected shareholder wealth following the takeover, is much less likely to face resistance by the target. For example, Bethel, Liebeskind, and Opler (1998) find that block purchases by activist investors such as Carl Icahn, Bob Monks, and George Soros are followed by improvements in profitability and shareholder value. This evidence suggests that investor identity influences future share value. This, in turn, suggests that the target considers the investor identity when making decisions.

Investor willingness to engage in a hostile takeover is also a function of its own characteristics. A strong investor is more willing to pursue a hostile takeover than a weak investor. This is due to the strong investor's anticipated value creation, which offsets the costs associated with a hostile takeover.

When the market has complete information regarding investor characteristics, the process through which these characteristics are incorporated into the decision process is straightforward. Both investor and target consider the impact that the investor characteristics have on the expected value of the firm. However, the market does not always have complete information regarding investor characteristics. For example, the investor may be a newcomer into the takeover market, without a track record of value creation through takeovers. Since such information asymmetries are common, understanding investor and target behavior when information asymmetries exist is of interest.

In this study, we explore this issue by developing a model where information asymmetries create uncertainty in the market as to whether the investor is strong or weak, though the investor is aware of its own type. In addition, all parties are uncertain whether the target is capable of resisting an unwanted takeover attempt. The investor decides whether to attempt the takeover. If the investor attempts a takeover, target management decides whether to cooperate or resist.<sup>1</sup> The investor's decision is based on the probability that a randomly drawn target management would resist. Management's decision depends on its prediction of the probability that an attacking investor is in fact weak. The model's outcomes provide answers to the following questions: first, when do investors decide to attempt a takeover? Second, when do takeover targets choose to concede, and when do they choose to resist? Third, what are the empirical implications that can be drawn from the model?

We consider three types of equilibria. First, in a separating equilibrium, strong investors attack and weak investors remain passive, due to management resistance. Hence, management must resist, as otherwise all weak investors would choose to attack. Second, in a pooling equilibrium, both types of investors always attack. Included in this category are two sub-classes: one where management always cooperates, and one where management randomizes between cooperating and resisting. Third, in a partial pooling equilibrium, strong investors attack and weak investors randomize between attacking and remaining passive. Weak investors are indifferent

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