

# (Ir)responsible Takeovers\*

Philip Bond<sup>†</sup>

Doron Levit<sup>‡</sup>

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## Abstract

We analyze takeover efficiency when socially conscious acquirers and target shareholders respond to externalities. Despite the Grossman-Hart “holdout” problem and free-riding in externality production, takeovers are socially efficient when target shareholders are consequentialist and acquirers are purely profit-driven. More generally, we identify a balanced-preferences condition under which externalities are fully internalized. Both increases and decreases in the strength of externality-preferences disrupt this balance and lead to inefficiency. We apply our framework to pre-takeover trading dynamics, exchange offers, leveraged buyouts, minority shareholder protections, and the strategic use of social responsibility as both a takeover defense and a bidding tactic.

**Keywords:** Takeovers, Mergers and Acquisitions, ESG, Externalities, Corporate Social Responsibility, Responsible Investment, Corporate Governance

**JEL classifications:** D62, D74, G34, K22, M14

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<sup>†</sup>University of Washington. Email: [apbond@uw.edu](mailto:apbond@uw.edu).

<sup>‡</sup>University of Washington. Email: [dlevit@uw.edu](mailto:dlevit@uw.edu).

# 1 Introduction

Responsible investment aims to balance financial returns with the broader environmental and social (ES) impact of capital allocations. Its effectiveness in shaping corporate policies is a topic of ongoing research and debate,<sup>1</sup> which raises the question of where it is most likely to have meaningful impact. One particularly important setting is the market for corporate control—through mergers, acquisitions, and leveraged buyouts (LBOs). These high-stakes transactions typically require shareholder approval and fundamentally reshape firm operations while generating significant externalities that affect a wide range of stakeholders, including employees, consumers, and the environment.<sup>2</sup> Although a growing body of empirical research and industry surveys suggests that ES considerations are an increasingly important factor in deal-making,<sup>3</sup> a theoretical framework to understand these dynamics has yet to be developed.

In this paper, we take a first step toward analyzing how socially conscious acquirers and targets respond to the externalities generated by takeovers, and whether such considerations enhance or undermine market efficiency. Specifically, we introduce externalities and social preferences into the canonical takeover model of Bagnoli and Lipman (1988). Their model extends Grossman and Hart’s (1980) analysis by considering a tender offer with a finite number of target shareholders, thereby incorporating strategic interaction and pivotal decision-making.

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<sup>1</sup>Several studies find limited impact: Teoh, Welch, and Wazzan (1999) show minimal valuation effects from the South Africa exclusion campaign; Berk and van Binsbergen (2025) argue ES exclusions barely affect capital costs; Gibson et al. (2022) find U.S. institutional investors following responsible investment principles don’t improve portfolio ESG scores; and Heath et al. (2023) show ES funds target but don’t enhance strong performers. Conversely, other research demonstrates significant effects: Zerbib (2022) reports substantial return premiums from exclusion; Green and Vallee (2025) find bank divestment reduces coal firms’ debt and assets; Hartzmark and Shue (2023) show higher financing costs drive negative impact changes in brown firms; and Gantchev, Giannetti, and Li (2022) demonstrate that exit threats following negative ES incidents motivate performance improvements. Additionally, shareholder activism and engagement effectively influence ES policies (Dimson, Karakas, and Li, 2015; Hoepner et al., 2024; Naaraayanan, Sachdeva, and Sharma, 2021; Akey and Appel, 2020; Chen, Dong, and Lin, 2020).

<sup>2</sup>Takeover-related externalities include employment effects such as layoffs (Dessaint, Golubov and Volpin 2017) or improved workplace safety (Cohn, Nestoriak, and Wardlaw 2021); market impacts including increased concentration and reduced consumer welfare (Eckbo 1983; Borenstein 1990) or innovation changes—both positive (Phillips and Zhdanov 2013) and negative (Cunningham, Ederer, and Ma 2021); environmental consequences such as pollution (Bellon, forthcoming); and broader societal effects on free speech (e.g., Musk’s Twitter buyout), journalism (Ewens, Gupta, and Howell 2022), education (Eaton, Howell, and Yannelis 2019), and healthcare (Gupta et al. 2024; Liu 2022). For recent literature reviews of empirical evidence on takeover externalities, see Golubov (2025) and Sorensen and Yasuda (2023).

<sup>3</sup>For recent empirical evidence see Duchin, Gao, and Xu (2025); Li, Peng, and Yu (2023); Berg, Ma, and Streitz (2023). For recent surveys see [Deloitte 2024 M&A ESG Survey](#) and [PwC Responsible Investment Survey](#).

Importantly, in our model, a takeover affects not only the firm’s value but also the externalities it generates—positive or negative. As a result, a takeover may be privately efficient by increasing firm value, yet socially inefficient due to negative externalities; or vice versa. Our framework is sufficiently flexible to accommodate both consequentialist social preferences and “warm-glow” motivations.

Social preferences over externalities introduce new trade-offs: by accepting a large premium, shareholders sell their cash-flow claims but, in doing so, may facilitate a takeover that generates negative externalities—externalities to which they remain exposed. Similarly, when designing an offer, the bidder considers not only the expected financial returns but also the broader social impact of the takeover.

Despite these additional considerations, the equilibrium characterization remains surprisingly clean: it depends on the total surplus generated by the takeover and the *balance* of social preferences between the bidder and target-shareholders. This sharp characterization delivers novel insights on a wide range of issues, including the trade-offs between socially responsible investing and strict adherence to profit-maximization (Friedman doctrine), the impact of pre-takeover trading with financial investors such as arbitrageurs, the role of payment methods and leverage in acquisitions, legal protections for minority shareholders, and the strategic use of externality choices as takeover defenses or bidding tactics. Our analysis also offers novel predictions about takeover outcomes when investor decisions are shaped by concerns over externalities.

Our first result establishes that when the social preferences of target shareholders and the bidder are *balanced*—meaning the externalities that shareholders ignore upon divestment are fully internalized by the bidder upon acquisition—the market for corporate control is efficient in the sense that, regardless of how dispersed shareholders are, socially inefficient takeovers are always blocked, and socially efficient takeovers succeed with the same probability as a privately efficient takeover would in the absence of social preferences or takeover externalities.

To build intuition, consider a takeover that is privately efficient but socially inefficient due to negative externalities. One might expect such a takeover to succeed due to free-riding: even a socially responsible shareholder may feel too small to prevent external harm and therefore choose to accept a relatively large premium. However, the classic “holdout” problem identified by Grossman and Hart creates opposing incentives—individual shareholders may prefer to

retain their shares and become minority owners in the post-takeover firm and thereby capture the full cash flow improvement. When social preferences are exactly balanced, this holdout incentive offsets the public goods free-rider problem, safeguarding against socially harmful takeovers. The intuition for the success of socially beneficial but privately inefficient takeovers follows a symmetric logic.<sup>4</sup> Overall, when social preferences are balanced, the market for corporate control achieves efficiency.

The efficiency result described above breaks down when social preferences are imbalanced. Specifically, if takeover externalities are negative then some socially inefficient takeovers succeed in equilibrium. Conversely, if externalities are positive then socially efficient takeovers may fail with high probability. Social preferences are imbalanced when, for example, target shareholders have warm-glow preferences while the bidder is profit-maximizing. Warm-glow shareholders prefer to hold in their portfolios firms that generate positive externalities and avoid those that cause harm, affecting their willingness to tender their shares. When a takeover creates negative externalities, the bidder can effectively “threaten” shareholders with these harms—becoming a minority shareholder in a post-takeover firm is particularly undesirable. As a result, shareholders may tender their shares for a lower premium, allowing the bidder to earn positive profits and complete a socially inefficient takeover. In contrast, when a takeover generates positive externalities, shareholders may resist tendering—because remaining a minority shareholder is especially attractive. This forces the bidder to offer a higher premium, eroding their profits and preventing a socially efficient takeover.

More broadly, and perhaps surprisingly, greater social responsibility on the part of shareholders or the bidder can lead to inefficient outcomes. The key intuition is that efficiency depends not only on the extent to which externalities are internalized, but also on the *balance* of social responsibility between target shareholders and the bidder. Our analysis therefore suggests that the social responsibility of the financial sector—including the mandates given to asset managers—should be aligned with that of the corporate sector to promote socially efficient outcomes.

A common argument is that the presence of hedge funds in financial markets can dilute, or even nullify, the impact of responsible investment. To examine this in the context of takeovers,

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<sup>4</sup>In this case, the force that offsets the public goods free-rider problem—which might lead a shareholder to reject a modest premium despite positive expected externalities from the takeover—is the “pressure to tender” identified by Bebchuk (1987).

we consider a scenario in which target shareholders may sell their shares to purely financial investors before the takeover occurs. Interestingly, such trades arise in equilibrium, and when social preferences are imbalanced, they can actually enhance social efficiency in the market for corporate control. The intuition is as follows: financial investors, who disregard externalities, are less vulnerable to the threats posed by negative externalities. As a result, they may be more willing to block socially inefficient takeovers that rely on such threats to pressure socially responsible shareholders. At the same time, they are also more likely to support takeovers with positive externalities, as they do not require the excessively high premiums that socially responsible investors might demand. In this way, non-social capital can help correct inefficiencies caused by imbalanced social preferences.

Publicly traded companies sometimes use equity rather than cash as payment in acquisitions. Our model reveals a novel role for payment methods when externalities are present. We show that while the payment method is irrelevant under balanced social preferences, it becomes important when preferences are imbalanced. Intuitively, if externalities are negative (positive), shareholders with pure warm-glow preferences dislike (like) holding the target shares and are more (less) willing to accept cash offers, which benefits (harms) the bidder. Equity offers mitigate these effects by preserving shareholders' exposure to externalities through continued ownership in the bidding firm. As a result, bidders prefer cash (equity) offers when the target's externalities are negative (positive). This logic extends to bidder's existing operations: cash (equity) offers are optimal if the bidder's own externalities are negative (positive). Our analysis further demonstrates that payment methods can be used to infer bidders' social preferences: when bidders generate negative externalities (such as established fossil fuel companies), cash offers signal profit motives, while equity offers indicate that reducing environmental impact is the primary acquisition motive. We also note that our extension of Bagnoli and Lipman (1988)'s framework to equity offers is new to the literature, even in the case without externalities.<sup>5</sup>

In practice, bidders often finance acquisitions with debt secured by the target's assets—a common strategy employed by private equity firms in LBOs. Mueller and Panunzi (2004) show that, absent takeover externalities, leverage improves takeover efficiency by mitigating the holdout problem through the dilution of minority shareholders. Building on this insight, we

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<sup>5</sup>For existing studies on the method of payments in takeovers, see, for example, Hansen (1987); Fishman (1989); Eckbo, Giammarino, and Heinkel (1990); and Rhodes-Kropf and Viswanathan (2004).

show that when takeovers generate positive externalities, leverage similarly promotes socially efficient outcomes—even when those takeovers are privately inefficient (i.e., reduce firm value). Thus, our analysis provides a normative justification for relaxing legal protections of minority shareholders when bidders create positive externalities, allowing them to employ higher leverage ratios. Conversely, when takeovers generate negative externalities, leverage can *exacerbate* inefficiencies by facilitating socially inefficient takeovers and potentially deterring efficient ones. In such cases, our findings support the use of targeted leverage caps as a means to strengthen minority shareholder protections and hence market efficiency.

An efficient market for corporate control requires that socially efficient takeovers succeed—even when they are privately inefficient. When social preferences are balanced, such efficiency can arise because some shareholders are willing to tender their shares at a discount, anticipating positive externalities from the takeover. However, legal protections that allow minority shareholders to sue the bidder for post-takeover declines in firm value—if such declines occur—undermine this mechanism. We show that in the presence of takeover externalities, these protections may backfire and reduce social efficiency. Intuitively, the prospect of post-takeover litigation discourages socially responsible shareholders from tendering, even when the takeover would yield a socially beneficial outcome.

Finally, post-takeover externalities are influenced by the bidder’s production plans, while pre-takeover externalities are shaped by the incumbent’s operational choices. In both cases, there is a trade-off between minimizing negative externalities and maximizing firm value. We endogenize these takeover-related externalities and show that when social preferences are balanced, both the bidder and the incumbent choose socially efficient production plans. In contrast, when preferences are imbalanced, they may adopt socially inefficient strategies. Our analysis thus identifies the conditions under which corporate social (ir)responsibility can be strategically employed—either as an effective bidding tool to enhance acquisition prospects or as a defensive mechanism to deter unwanted takeover attempts.

Overall, our analysis demonstrates that externalities in takeovers and social responsibility have significant positive and normative implications for the market for corporate control.

## Related Literature

Our paper is related to two main strands of literature. First, we contribute to the theoretical literature on takeovers. In addition to Bagnoli and Lipman (1988), variants of tender offer models with a finite number of shareholders are studied by Holmstrom and Nalebuff (1992), Gromb (1993), Cornelli and Li (2002), Marquez and Yilmaz (2008), Dalkır and Dalkır (2014), Dalkır (2015), Ekmekci and Kos (2016), Dalkır, Dalkır, and Levit (2019), and Voss and Kulms (2022). Unlike these studies, we examine the effects of takeover externalities and social preferences on the takeover dynamics.<sup>6</sup> Related work examines models with a finite numbers of socially responsible agents in non-takeover contexts. Kaufmann, Andre, and Kőszegi (2024) analyze consumer behavior in competitive product markets, while Lee and Wang (2025) study socially responsible depositors during bank runs. Meirowitz, Pi, and Ringgenberg (2023) study voting over corporate policies when investors balance firm profits against social impact.

Second, we contribute to the theoretical literature on the effects of responsible investment on corporate policies. A growing number of papers studies the effects of portfolio allocations and divestment strategies on corporate policies: Heinkel, Kraus, and Zechner (2001), Davies and Van Wesep (2018), Oehmke and Opp (2025), Edmans, Levit, and Schneemeier (2022), Landier and Lovo (2025), Green and Roth (2025), and Chowdhry, Davies, and Waters (2019), Huang and Kopytov (2022), Gupta, Kopytov and Starmans (forthcoming), Piccolo, Schneemeier, and Bisceglia (2022), Pastor, Stambaugh, and Taylor (2021), Pedersen, Fitzgibbons, and Pomorski (2021), Baker, Hollifield, and Osambela (2022), and Goldstein et al. (2022). Broccado, Hart, and Zingales (2022) and Gollier and Pouget (2022) also study engagement and voting as alternative mechanisms to affect firm’s externalities. Relative to this burgeoning literature, we study responsible investment in the context of takeovers. The decision of shareholders to tender can be viewed as combination of exit (selling the firm to the bidder) and voice (influencing who controls the target). Moreover, while the existing literature focuses on the classic free-rider problems in public goods, we highlight its interaction with another well-known free-rider problem, namely, the holdout problem of Grossman and Hart (1980).

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<sup>6</sup>A larger body of literature followed Grossman and Hart (1980) and studied various implications and variants of the holdout problem in takeovers when shareholders are infinitesimal: Yarrow (1985), Shleifer and Vishny (1986), Hirshleifer and Titman (1990), Kyle and Vila (1991), Burkart, Gromb, and Panunzi (1998, 2000), Mueller and Panunzi (2004), Marquez and Yilmaz (2012), Gomes (2012), At, Burkart and Lee (2011), Levit (2017), Burkart and Lee (2015, 2022), Burkart, Lee and Petri (2023), and Burkart, Lee and Voss (2024).



## 2 Model

There are  $N \geq 2$  shareholders, indexed by  $i$ , each of whom owns a single share in a target firm. Each share carries one vote. A bidder is interested in acquiring the firm and changing its operations. The value of the firm is  $V_0$  under its incumbent management, and will change to  $V_1$  if acquired by the bidder. The firm also produces externalities. The externality is  $\Phi_0$  under the incumbent, and will change to  $\Phi_1$  if the firm is acquired by the bidder. For use throughout, we define the per-share firm analogues of these quantities:  $v_0 \equiv \frac{V_0}{N}$ ,  $v_1 \equiv \frac{V_1}{N}$ ,  $\phi_0 \equiv \frac{\Phi_0}{N}$ , and  $\phi_1 \equiv \frac{\Phi_1}{N}$ .

The bidder makes a cash tender offer  $p$  per share. The takeover is successful—and the bidder gains control of the firm—if at least  $K$  shares are tendered, where  $K < N$ . Define  $\kappa = \frac{K}{N} \in (0, 1)$ ; that is,  $\kappa$  is the majority rule. The bidder’s offer is conditional on success; if fewer than  $K$  shares are tendered, the bidder doesn’t acquire any shares and the takeover fails. If  $K$  or more shares are tendered, the bidder buys all tendered shares, the takeover succeeds, and any shareholders who did not tender retain their shares and become minority holders. Conditional offers of this kind are the most common form of tender offer in practice.<sup>7</sup>

Given the offer  $p$ , all shareholders simultaneously decide whether to tender or retain their shares. Let  $\gamma_i \in [0, 1]$  denote the endogenously-selected probability that shareholder  $i$  tenders.

As discussed in the introduction, our goal is to study the consequences of shareholders taking seriously the externalities generated by a firm. Accordingly, we assume that a shareholder’s utility from holding a share depends not only on its financial value but also on the associated externalities, weighted by a parameter  $\alpha \in [0, 1]$  that captures the extent to which investors internalize these externalities. Specifically, a shareholder’s utility from holding a share is  $v_0 + \alpha\phi_0$  if the incumbent retains control, and  $v_1 + \alpha\phi_1$  if the bidder acquires the firm.

From the perspective of an individual shareholder, a takeover creates surplus

$$s \equiv v_1 + \alpha\phi_1 - v_0 - \alpha\phi_0. \tag{1}$$

Throughout, we label takeovers with  $s > 0$  as *socially efficient* and those with  $s < 0$  as *socially inefficient*.<sup>8</sup> Similarly, we label takeovers with  $v_1 > v_0$  as *privately efficient* and those

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<sup>7</sup>Online Appendix C analyzes freeze-out mergers. Online Appendix E compares conditional and unconditional offers, and identifies a large subset of the parameter space under which a bidder prefers conditional offers. The Online Appendix is available [here](#).

<sup>8</sup>In adopting this labeling, we are implicitly assuming that  $\alpha$  is sufficiently close to 1 that the sign of  $s$



with  $v_1 < v_0$  as *privately inefficient*. We assume  $s \neq 0$  in order to avoid this economically insignificant boundary case. Analogous to other notation, define  $S = Ns$ .

Shareholders may care more about the externalities generated by firms they still own than by those they have divested from. We capture this with the parameter  $\eta \in [0, \alpha]$ . Specifically: if a takeover succeeds then each tendering shareholder receives utility  $p + \eta\phi_1$ . That is, if  $\eta < \alpha$  then shareholders have what are commonly referred to as *warm-glow* preferences. In contrast, if  $\eta = \alpha$  then shareholders' internalization of externalities is unrelated to share ownership, consistent with fully consequentialist preferences.<sup>9</sup>

The bidder (or its shareholders) internalizes both the financial impact of the takeover on the firm's value and any associated externalities. Formally, the bidder's payoff per share acquired in a successful takeover is given by  $v_1 - p + \delta\phi_1$ , where  $\delta \geq 0$  represents the degree of the bidder's social responsibility.<sup>10</sup> Note that the model of Bagnoli and Lipman (1988) is a special case in which  $\alpha = \eta = \delta = 0$ , or alternatively  $\Phi_0 = \Phi_1 = 0$ .

Before proceeding, we highlight the two key respects in which a firm's externalities  $(\Phi_0, \Phi_1)$  conceptually differ from its cash flows  $(V_0, V_1)$ . First, tendering shareholders do not care about post-takeover cash flows  $V_1$ , but (provided  $\eta > 0$ ) they do care about post-takeover externalities  $\Phi_1$ . Second, the bidder's weights on cash flows  $V_1$  and externalities  $\Phi_1$  generally differ from target shareholders' weights.

### 3 Analysis

We focus on symmetric Nash equilibria, as standard in the literature, and denote the equilibrium offer and tendering strategy by  $(p^*, \gamma^*)$ .

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coincides with the sign of the overall surplus associated with the takeover,  $V_1 + \Phi_1 - V_0 - \Phi_0$ . We regard this as the right starting point for our analysis, since it corresponds to assuming that if shareholders could perfectly coordinate then they would reach the socially optimal decision. Our analysis characterizes the distortions from this benchmark that are created by decentralized decision-making and by preference shifts associated with transferring share ownership.

<sup>9</sup>If  $\eta > \alpha$ , shareholders internalize externalities more when selling than when retaining ownership—potentially reflecting a sense of responsibility for outcomes they have actively contributed to. Our framework accommodates such cases, though we do not explore them in detail.

<sup>10</sup>The bidder's social preferences resemble warm-glow preferences, in the sense that the bidder only internalizes externalities if the takeover succeeds and only in proportion to the shares acquired. See Online Appendix D for an alternative formulation in which the bidder exhibits consequentialist preferences.

### 3.1 Preliminaries

We introduce notation that we use throughout. Consider the decision of an individual shareholder  $i$ , taking as given that each of the other  $N - 1$  shareholders tenders with probability  $\gamma \in [0, 1]$ . If shareholder  $i$  retains his/her share then the probability of a successful takeover is

$$q(\gamma) \equiv \sum_{j=K}^{N-1} \binom{N-1}{j} \gamma^j (1 - \gamma)^{N-1-j}. \quad (2)$$

Similarly, the probability that shareholder  $i$ 's tendering decision is pivotal is

$$\Delta(\gamma) \equiv \binom{N-1}{K-1} \gamma^{K-1} (1 - \gamma)^{N-K}. \quad (3)$$

Hence  $q + \Delta$  is the probability of a successful takeover if shareholder  $i$  tenders; and if all shareholders tender with probability  $\gamma$  then the takeover succeeds with probability

$$\Lambda(\gamma) \equiv (1 - \gamma)q + \gamma(q + \Delta) = q + \gamma\Delta, \quad (4)$$

To enhance readability we generally suppress the argument  $\gamma$  in the functions  $q$ ,  $\Delta$ , and  $\Lambda$ .

### 3.2 Benchmark: No externalities, $\phi_0 = \phi_1 = 0$

As a benchmark, consider the case in which the target firm doesn't generate any externalities under either the incumbent or bidder. In this case, the social preferences of both the bidder and the shareholders are irrelevant.

**Proposition 1** *Suppose  $\phi_0 = \phi_1 = 0$ . There is a unique equilibrium. The tendering probability is  $\gamma^* = 0$  if  $v_1 < v_0$  and is  $\gamma^* = \kappa$  if  $v_1 > v_0$ .*

This benchmark case is covered by Bagnoli and Lipman (1988). Privately inefficient takeovers always fail, while privately efficient takeovers succeed with a probability strictly between 0 and 1—and converging to  $1/2$  as the number of shareholders  $N \rightarrow \infty$ . Bagnoli and Lipman also establish that as the target's ownership becomes increasingly dispersed the bidder's profits converge to zero, reflecting the holdout problem in takeovers. In what follows, we examine how social preferences over externalities change these conclusions.

### 3.3 Tendering decisions

We start by analyzing the tendering subgame given an offer price  $p$ . We again consider the utility of an individual shareholder  $i$  as a function of that shareholder's tendering decision, taking as given that all  $N - 1$  other shareholders tender with probability  $\gamma$ . If shareholder  $i$  retains, the takeover succeeds with probability  $q$ , and shareholder  $i$ 's expected utility is

$$v_0 + \alpha\phi_0 + q(v_1 + \alpha\phi_1 - v_0 - \alpha\phi_0), \quad (5)$$

reflecting that if the takeover succeeds then the shareholder benefits from the full post-takeover value of the firm as a minority shareholder, along with the externalities generated by the takeover. If instead shareholder  $i$  tenders, the takeover succeeds with probability  $q + \Delta$ , and shareholder  $i$ 's expected utility is

$$v_0 + \alpha\phi_0 + (q + \Delta)(p + \eta\phi_1 - v_0 - \alpha\phi_0). \quad (6)$$

This expression reflects both the fact that the offer is conditional and so shareholder  $i$  receives  $p$  only with probability  $q + \Delta$ ; and also that because tendering involves divestment, the weight placed on externalities drops from  $\alpha$  to  $\eta \leq \alpha$ .

Consequently, shareholder  $i$ 's net gain from tendering is

$$\tau(\gamma; p) \equiv \Delta s - (q + \Delta)(v_1 + (\alpha - \eta)\phi_1 - p). \quad (7)$$

Equation (7) is simple but marks an important first step in our analysis: the act of tendering is isomorphic to making a public-good contribution. By tendering, a shareholder effectively contributes  $\Delta s$  to overall surplus. The cost of this contribution corresponds to the foregone private value identified by Grossman and Hart, namely  $v_1 - p$ , adjusted for  $(\alpha - \eta)\phi_1$ , the change in the shareholder's concern for externalities resulting from divesting the share.

In particular, if post-takeover externalities are negative ( $\phi_1 < 0$ ) then shareholders with warm-glow preferences ( $\eta < \alpha$ ) are more inclined to tender than otherwise, because doing so relieves them of responsibility for negative externalities. Conversely, if post-takeover externalities are positive ( $\phi_1 > 0$ ), warm-glow shareholders find retention more attractive than

otherwise, since tendering prevents them from fully enjoying the takeover's social benefit.

Expression (7) highlights that a shareholder's total utility from a successful takeover,  $v_1 + \alpha\phi_1$ , *isn't* a sufficient statistic for the gain to tendering  $\tau$ . The economic reason is that, provided that  $\eta > 0$ , tendering shareholders care about the externalities  $\phi_1$  generated by the takeover, but they don't care about the cash flows  $v_1$ .

### Equilibrium of tendering subgame

In the tendering subgame,  $\gamma^* = 0$  is an equilibrium if  $\tau(0; p) \leq 0$ ;  $\gamma^* = 1$  is an equilibrium if  $\tau(1; p) \geq 0$ ; and  $\gamma^* \in (0, 1)$  is an equilibrium if

$$\tau(\gamma^*; p) = 0. \quad (8)$$

The tendering subgame potentially has multiple equilibria. For example, if  $K > 1$  then everyone-retains ( $\gamma^* = 0$ ) is an equilibrium, regardless of the offer  $p$ . We impose the following standard stability criterion, which reduces (but doesn't eliminate) equilibrium multiplicity. An equilibrium is stable if a small increase (decrease) in the tendering probability of  $N - 1$  shareholders makes tendering less (more) attractive for the remaining shareholder. Graphically, an equilibrium is stable if  $\tau(\cdot; p)$  crosses zero from above. Formally:

*Stability condition:* An equilibrium  $\gamma^*$  of the tendering subgame is stable if for all  $\epsilon > 0$  sufficiently small: either  $\gamma^* = 0$  or  $\tau(\gamma^* - \epsilon; p) > 0$ ; and either  $\gamma^* = 1$  or  $\tau(\gamma^* + \epsilon; p) < 0$ .

Hereafter, we refer to a stable equilibrium simply as an equilibrium.

**Lemma 1** *An equilibrium  $\gamma^*$  of the tendering subgame exists. For socially inefficient takeovers ( $s < 0$ )*

$$\gamma^* = \begin{cases} 0 & \text{if } p \leq v_1 + (\alpha - \eta)\phi_1 \\ \{0, 1\} & \text{if } p \in (v_1 + (\alpha - \eta)\phi_1, v_1 + (\alpha - \eta)\phi_1 - s) \\ 1 & \text{if } p \geq v_1 + (\alpha - \eta)\phi_1 - s. \end{cases} \quad (9)$$

*For socially efficient takeovers ( $s > 0$ ), define*

$$\mu(\gamma) \equiv v_1 + (\alpha - \eta)\phi_1 - \frac{\Delta}{q + \Delta}s; \quad (10)$$

then

$$\gamma^* = \begin{cases} 0 & \text{if } p \leq v_1 + (\alpha - \eta) \phi_1 - s \\ \mu^{-1}(p) \in (0, 1) & \text{if } p \in (v_1 + (\alpha - \eta) \phi_1 - s, v_1 + (\alpha - \eta) \phi_1) \\ 1 & \text{if } p \geq v_1 + (\alpha - \eta) \phi_1. \end{cases} \quad (11)$$

As one would expect, the tendering probability  $\gamma^*$  is increasing in the offer  $p$ . In particular, all shareholders tender if the bidder offers  $p$  in excess of the post-takeover value of the firm  $v_1$ , adjusted by the shift-in-preferences term  $(\alpha - \eta) \phi_1$ .

If the takeover is socially efficient ( $s > 0$ ) then a mixed-strategy equilibrium arises for moderate offers. In this case, shareholders are indifferent between tendering and retaining their shares, i.e.,  $\tau(\gamma^*; p) = 0$ .

In contrast, if the takeover is socially inefficient ( $s < 0$ ) then a mixed-strategy equilibrium doesn't exist. Instead everyone-retaining ( $\gamma^* = 0$ ) and everyone-tendering ( $\gamma^* = 1$ ) coexist as equilibria for moderate offers

$$p \in (v_1 + (\alpha - \eta) \phi_1, v_1 + (\alpha - \eta) \phi_1 - s). \quad (12)$$

From (7), this case is the reverse of the well-known holdout problem. Specifically, the individual cost of tendering is the increased probability of an undesirable takeover with  $s < 0$  occurring; while the individual benefit is that, conditional on takeover success, a shareholder gets  $p$  instead of the preference-shift-adjusted post-takeover value  $v_1 + (\alpha - \eta) \phi_1$ . Consequently, if an individual shareholder anticipates a low takeover probability then retention dominates tendering, while the reverse is true if a high takeover probability is anticipated. The everyone-tenders equilibrium is a manifestation of Bebchuk's (1987) "pressure to tender" effect. In our context, it arises precisely because of preferences over social externalities; absent externalities, the case arises only if the offer  $p$  exceeds post-takeover value  $v_1$ , but bidders never make such an offer.

Looking ahead (Theorem 1), the tendering subgame has multiple equilibria even once the bidder's offer is endogenized. This stands in sharp contrast to the case without externalities ( $\phi_0 = \phi_1 = 0$ , Proposition 1), in which case the multiplicity condition (12) never holds in equilibrium. Consequently, shareholders' social concerns about externalities lead to variation

in takeover outcomes, even after fully controlling for bidder, target and deal characteristics.

### 3.4 Bidder's payoff

The bidder's expected payoff from making an offer to an individual shareholder—conditional on that shareholder tendering and all other shareholders following strategy  $\gamma$ —is

$$(q + \Delta)(v_1 - p + \delta\phi_1). \quad (13)$$

That is, in the probability  $q + \Delta$  event that the takeover succeeds, the bidder makes a profit of  $v_1 - p$  per share, along with additional warm-glow utility of  $\delta\phi_1$ . If instead the takeover fails the bidder's payoff is zero, because the offer is conditional. Given that each shareholder tenders independently with probability  $\gamma \in (0, 1)$ , and there are  $N$  shareholders making independent decisions, the bidder's expected total payoff is simply  $N\gamma$  times the expected payoff (13), i.e.,

$$N\gamma(q + \Delta)(v_1 - p + \delta\phi_1). \quad (14)$$

Naturally, the bidder's payoff depends on the spread between post-takeover cash flows  $v_1$  and the offer  $p$ . From (7), this same spread affects a target shareholder's gain  $\tau$  from tendering. Consequently, whenever the equilibrium condition (8) holds, the bidder's expected payoff is

$$N\gamma\Delta s + N\gamma(q + \Delta)(\eta + \delta - \alpha)\phi_1. \quad (15)$$

To understand (15) it is helpful to consider first the case of target shareholders with consequentialist preferences ( $\eta = \alpha$ ) and a bidder motivated purely by profit ( $\delta = 0$ ). In this case, (15) reduces to simply its first term  $N\gamma\Delta s$ . As we noted above, the post-takeover cash flows  $v_1$  and externalities  $\phi_1$  have different “exclusion” characteristics: tendering shareholders are excluded from  $v_1$ , leading to the holdout problem, but aren't excluded from  $\phi_1$ . The important implication of (7) is that, nonetheless, both components of a target shareholder's preferences can be mapped into a general public-good contribution setting, in which a target shareholder compares the benefit from a contribution to the public good,  $\Delta s$ , with the cost,  $(q + \Delta)(v_1 - p)$ . In particular, for any given tendering probability  $\gamma$ , the takeover surplus  $s$  directly determines

the spread  $v_1 - p$  that the bidder makes on each share acquired.

The second term in (15) can be understood by considering perturbations away from the benchmark just described. Bidder preferences over externalities ( $\delta > 0$ ) change the bidder's payoff exactly as one would expect. Perhaps less immediate, warm-glow preferences for target shareholders ( $\alpha > \eta$ ) force the bidder to increase its offer if post-takeover externalities  $\phi_1$  are positive, since shareholders have a direct incentive to retain their shares in this case.

The bidder's payoff is given by (15) only if tendering shareholders are indifferent between tendering and retention. More generally, the bidder's expected total payoff is

$$\Pi(\gamma; p) = \begin{cases} \gamma \Delta S + \gamma (q + \Delta) (\eta + \delta - \alpha) \Phi_1 & \text{if } \gamma \in [0, 1) \\ V_1 - p + \delta \Phi_1 & \text{if } \gamma = 1. \end{cases} \quad (16)$$

We let  $\Pi^*$  be the bidder's expected profit in equilibrium.

## 4 Equilibrium and takeover efficiency

The equilibrium of the overall game follows from (16)'s characterization of the bidder's payoff.

### Theorem 1

*Socially inefficient takeovers,  $s < 0$ : If  $s \leq (\alpha - \eta - \delta) \phi_1$  then  $\gamma^* = 0$  is an equilibrium. If  $(\alpha - \eta - \delta) \phi_1 < 0$ , then  $\gamma^* = 1$  is an equilibrium. No other equilibrium exists.*

*Socially efficient takeovers,  $s > 0$ : There is a unique equilibrium:*

- (a) *If  $(\alpha - \eta - \delta) \phi_1 < 0$  then  $\gamma^* > \kappa$ , and  $\Lambda^* \rightarrow 1$  as  $N \rightarrow \infty$ .*
- (b) *If  $(\alpha - \eta - \delta) \phi_1 = 0$  then  $\gamma^* = \kappa$ , and  $\Lambda^* \rightarrow (0, 1)$  as  $N \rightarrow \infty$ .*
- (c) *If  $(\alpha - \eta - \delta) \phi_1 > 0$  then  $\gamma^* < \kappa$ , and  $\Lambda^* \rightarrow 0$  as  $N \rightarrow \infty$ .*

Theorem 1 has several interesting implications, which we present as a series of corollaries—each effectively a special case.



## 4.1 Balanced preferences: $\eta + \delta = \alpha$

We first consider the case in which shareholders' and the bidder's social preferences exactly balance out,  $\eta + \delta = \alpha$ . That is, any externalities that shareholders ignore upon divestment (because  $\eta \leq \alpha$ ) are picked up by the bidder (since  $\delta = \alpha - \eta$ ). This case serves as an important benchmark, and elucidates economic forces that shape outcomes more generally. A leading case in which balanced preferences arise is that of target shareholders with fully consequentialist preferences ( $\eta = \alpha$ ) and a purely profit-motivated bidder ( $\delta = 0$ ).

**Corollary 1** *If  $\eta + \delta = \alpha$  then socially inefficient takeovers always fail ( $\gamma^* = \Lambda^* = 0$ ) while socially efficient takeovers frequently succeed ( $\gamma^* = \kappa$  and  $\Lambda^* \rightarrow 1/2$  as  $N \rightarrow \infty$ ).*

For intuition, consider the leading case just noted of consequentialist shareholders and a profit motivated bidder ( $\eta - \alpha = \delta = 0$ ). Corollary 1 first says that, no matter how dispersed shareholders are, a socially inefficient takeover is always blocked. To better understand this result, consider a takeover that is privately efficient ( $v_1 > v_0$ ) but sufficiently socially costly ( $\phi_1 < \phi_0$ ) that  $s < 0$ . One might initially expect successful bids in such cases, reasoning that shareholders face a free-rider problem: even socially responsible shareholders might reason that individually they have little power to prevent the negative externality and thus prefer to accept the a premium offer  $p > v_0$ . However, tendering a share is subject to the well-known holdout problem—itsself a free-rider problem—in which an individual shareholder is tempted to keep their share, become a minority shareholder in the acquired firm, and benefit from the increase in private value  $v_1 - v_0$  rather than accept the smaller bid premium  $p - v_0$ . Corollary 1 thus establishes that the holdout problem in takeovers safeguards against the free-rider problem in social externalities (public good provision).

Corollary 1 further says that socially efficient takeovers succeed with exactly the same probability as a privately efficient takeover would in the absence of social preferences over externalities. To better understand this result, consider the opposite scenario from that discussed above: a privately inefficient takeover ( $v_1 < v_0$ ) that nonetheless generates sufficient social benefits ( $\phi_1 > \phi_0$ ) so that overall surplus is positive ( $s > 0$ ). Because the bidder is profit-motivated, certainly the offer  $p$  is below  $v_1$ , which is in turn below  $v_0$ . Consequently, one might initially expect that the takeover would fail, on the grounds that even socially responsible shareholders might individually reason that they have little ability to affect the takeover's

success, and hence no reason to bear the individual cost of accepting an offer  $p < v_0$  in order to contribute to the public good. But this reasoning is incorrect, and the takeover has significant probability of success. The reason lies in the flip side of the classic holdout problem—what Bebchuk (1987) describes as the “pressure to tender.” Individual shareholders fear that if they do not tender and the takeover succeeds then they will be left holding a share in a less valuable company (valued at  $v_1 < v_0$ ). This creates strong incentives to tender; in particular, it means that shareholders tender even when the offered premium is minimal or negative.

These arguments generalize to any case in which the warm-glow preferences of the bidder and shareholders are balanced in the sense  $\eta + \delta = \alpha$ . Corollary 1 can be summarized as saying that externalities are fully internalized; the market for corporate control operates as efficiently as it would have absent any externalities. Specifically, the market for corporate control facilitates socially efficient takeovers even if they are privately inefficient, and preventing socially inefficient takeovers even if they are privately efficient.<sup>11</sup>

A final point to note is that, precisely because social externalities are effectively internalized, the bidder’s expected profit approaches zero as shareholder dispersion grows large:

$$\Pi^* \rightarrow 0 \text{ as } N \rightarrow \infty \quad (17)$$

This is immediate from (16); as  $N$  grows large, the probability  $\Delta$  that an individual shareholder is pivotal converges to 0. Economically, the bidder’s limited ability to profit from a takeover is a manifestation of the holdout problem. Our contribution is to show that this result extends to the case of social preferences over externalities.

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<sup>11</sup>When  $\eta + \delta = \alpha$ , it turns out that there is an easy way to map the standard setting without social externalities to the case of social externalities. Consider two sets of parameters:  $(\bar{v}_0, \bar{v}_1, \bar{\phi}_0, \bar{\phi}_1)$  and  $(\tilde{v}_0, \tilde{v}_1, \tilde{\phi}_0, \tilde{\phi}_1)$  where  $\bar{\phi}_0 = \bar{\phi}_1 = 0$ ,  $\tilde{v}_0 + \alpha\tilde{\phi}_0 = \bar{v}_0$  and  $\tilde{v}_1 + \alpha\tilde{\phi}_1 = \bar{v}_1$ . That is: the “bar” parameters correspond to the standard case without social externalities, and the “tilde” parameters introduce social externalities while leaving the combination of pecuniary and social value unchanged. Consider an arbitrary offer by the bidder,  $\bar{p}$ , made under the bar parameters. From (10), an offer  $\tilde{p} = \bar{p} - \eta\tilde{\phi}_1$  made under the the tilde parameters induces exactly the same tendering behavior as the offer  $\bar{p}$  under the bar parameters. Moreover, the bidder’s payoff is also exactly the same in the two cases: if the offer is rejected, its payoff is 0 in both cases, while if the offer is accepted, the offer  $\tilde{p}$  entails paying  $\eta\tilde{\phi}_1 = \alpha\tilde{\phi}_1 - \delta\tilde{\phi}_1$  less for a firm that generates  $\alpha\tilde{\phi}_1$  less of pecuniary value but  $\delta\tilde{\phi}_1$  more of warm-glow utility.

## 4.2 Weak warm-glow preferences, $\eta + \delta < \alpha$

In contrast to the generally positive outcomes that emerge when shareholder and bidder social preferences are balanced, equilibrium outcomes are much less desirable when preferences are imbalanced. We consider first the case in which shareholders' and the bidder's warm glow preferences are weak:

**Corollary 2** *If  $\eta + \delta < \alpha$ , then as  $N \rightarrow \infty$  takeovers with positive externalities  $\phi_1 > 0$  fail,  $\Lambda^* \rightarrow 0$ ; and takeovers with negative externalities  $\phi_1 < 0$  potentially succeed: there is a sequence of equilibria in which  $\Lambda^* \rightarrow 1$ , and this sequence is unique if  $s > 0$ .*

Corollary 2 highlights the outsized role of post-takeover externalities  $\phi_1$  in determining the success of an takeover, along with the perverse consequences that follow. Some socially inefficient takeovers ( $s < 0$ ) potentially succeed with high probability, while some socially efficient takeovers ( $s > 0$ ) always fail as shareholder dispersion grows large. This is especially clear when the status quo is associated with zero social externalities ( $\phi_0 = 0$ ). In this case, takeovers that are socially destructive ( $\phi_1 < 0$ ) occur, while takeovers that are socially beneficial ( $\phi_1 > 0$ ) are blocked, independent of either the private ( $v_1 - v_0$ ) or social ( $s$ ) value created. Indeed, Corollary 2 predicts that firms that produce negative externalities will be acquired even absent any change in either pecuniary value or in social externalities (i.e.,  $v_1 = v_0$  and  $\phi_1 = \phi_0 < 0$ ).

To understand these observations, notice that the relative weakness of combined warm-glow preferences ( $\delta + \eta < \alpha$ ) means that a takeover reduces the aggregate extent to which externalities are internalized. If  $\phi_1 < 0$ , then socially-minded shareholders dislike holding the share; and importantly, if  $\eta < \alpha$ , this dislike is alleviated by getting rid of the share. This effect gives shareholders a direct motive to tender, in turn allowing the bidder to reduce its bid. If the bidder's own aversion to negative externalities is small, that is,  $\delta < \alpha - \eta$ , then the discount the bidder can extract is enough to compensate for the exposure to the target's negative externalities, thereby facilitating the takeover even if it's socially inefficient.

Importantly, the direct motive to tender that arises from warm-glow preferences and negative post-takeover externalities operates regardless of whether or not an individual shareholder is pivotal. Hence, the bidder can extract a discount from shareholders even when shareholders are arbitrarily dispersed, i.e.,  $N \rightarrow \infty$ . At the same time, the holdout and public-good free-rider problems prevent the bidder from benefiting significantly from any social value ( $s$ )

created. Consequently, the discount that the bidder obtains from warm-glow shareholders' direct motive to tender dominates when shareholders are sufficiently dispersed. In particular, the equilibrium payoff  $\Pi^*$  approaches  $\max\{0, (\delta + \eta - \alpha) \Phi_1\}$  as  $N \rightarrow \infty$ . That is, if  $\phi_1 < 0$  then the bidder's payoff is strictly positive even when the target's ownership is widely dispersed. Note that this result is not driven by the bidder's social preferences per se; even if the bidder is purely profit-maximizing ( $\delta = 0$ ), its payoff remains strictly positive in the limit.

The case of positive post-takeover externalities ( $\phi_1 > 0$ ) is directly analogous. In this case, warm-glow preferences induce a direct motive for shareholders to *retain* shares. To overcome this, a bidder would have to offer a large premium. But when shareholders are dispersed, the holdout and public-goods free-riding problems imply that the bidder derives little benefit from the value created by the takeover. If the bidder's own warm-glow utility from positive externalities is small,  $\delta < \alpha - \eta$ , the bidder lacks the incentive to offer the premium required to overcome warm-glow shareholders' desire to retain shares, thereby preventing the takeover.

### 4.3 Strong warm-glow preferences, $\eta + \delta > \alpha$

If the combination of shareholders' and the bidder's warm-glow preferences are strong, the conclusions of Corollary 2 are reversed:

**Corollary 3** *If  $\eta + \delta > \alpha$ , then as  $N \rightarrow \infty$  takeovers with negative externalities  $\phi_1 < 0$  fail,  $\Lambda^* \rightarrow 0$ ; and takeovers with positive externalities  $\phi_1 > 0$  potentially succeed: there is a sequence of equilibria in which  $\Lambda^* \rightarrow 1$ , and this sequence is unique if  $s > 0$ .*

The economic forces underlying Corollary 3 are analogous to those underlying Corollary 2. The most transparent case to consider is that of target shareholders with consequentialist preferences ( $\eta = \alpha$ ) and a bidder with a positive weight on externalities ( $\delta > 0$ ). In this case, and unlike the case of warm-glow preferences ( $\eta < \alpha$ ), shareholders don't derive any direct benefit from offloading shares with negative externalities; nor do they experience any direct reluctance to surrender shares with positive externalities. When shareholders are sufficiently dispersed the decisive factor becomes the bidder's preference for positive externalities. Consequently, takeovers yielding negative externalities ( $\phi_1 < 0$ ) fail while those yielding positive externalities ( $\phi_1 > 0$ ) potentially succeed. These observations extend to the case in which

target shareholders have warm-glow preferences  $\eta < \alpha$ , but the bidder's own preferences more than offset that gap between  $\eta$  and  $\alpha$ .

#### 4.4 Bidder's choice of takeover characteristics

So far we have taken the takeover's effect on the target as given, by specifying  $v_1$  and  $\phi_1$  exogenously. What if instead a bidder has some ability to commit to post-takeover policies when making an offer—specifically, to the trade-off between maximizing cash flows  $v_1$  and maximizing broader social value  $\phi_1$ ?

Formally, the bidder faces a technologically determined choice set

$$\left\{ (v_1(\tilde{\phi}_1), \tilde{\phi}_1) \right\} \quad (18)$$

of feasible combinations of cash flows and externalities. Define

$$\phi_1^{**} \equiv \arg \max_{\phi_1} v_1(\tilde{\phi}_1) + \alpha \tilde{\phi}_1$$

as the choice that maximizes the social value of the target under the bidder's control.<sup>12</sup>

The following result extends Theorem 1, demonstrating how the choice of externalities can serve as an effective bidding tactic.<sup>13</sup>

**Proposition 2** *If  $\eta + \delta = \alpha$ , then the bidder chooses  $\phi_1^{**}$ , and if  $\eta + \delta < \alpha$  ( $\eta + \delta > \alpha$ ), the bidder's choice is smaller (larger) than  $\phi_1^{**}$ .*

Consistent with intuitions from Corollaries 1-3, under balanced social preferences the bidder pledges the socially efficient level of externalities. In contrast, if combined warm-glow preferences are weak ( $\eta + \delta < \alpha$ ) the bidder tilts its post-takeover plans towards worse externalities than the socially efficient level. In particular, the bidder can raise its profits by pledging negative post-takeover externalities  $\phi_1 < 0$ , for the reasons covered by Corollary 2.

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<sup>12</sup>We assume that the bidder's choice set (18) includes at least one option with negative externalities,  $\tilde{\phi}_1 < 0$ , that  $\phi_1^{**}$  is well-defined, and that  $v_1(\cdot)$  is differentiable at  $\phi_1^{**}$ .

<sup>13</sup>We adopt the mild assumption that if  $\phi_1'$  leads to a unique equilibrium where the takeover fails, while  $\phi_1''$  generates multiple equilibria with at least one yielding strictly positive bidder payoff, then the bidder prefers  $\phi_1''$  to  $\phi_1'$ .

## 5 Broader effects of social responsibility in takeovers

Our analysis offers novel insights for the desirability of social responsibility in the context of the market for corporate control. We begin by exploring the potential downsides (the “dark side”) of social responsibility. We then extend the framework to allow socially responsible shareholders to trade their shares with financial investors prior to the takeover, shedding light on how such market interactions influence takeover outcomes.

### 5.1 When social responsibility backfires

The comparison between Corollaries 1 and 2 implies that stronger social responsibility can, under certain conditions, undermine efficiency in the market for corporate control.

This result can be illustrated in several ways. Consider the case in which  $s < 0$  and  $\delta + \eta = \alpha$ . From Corollary 1, socially inefficient takeovers are blocked. Relative to this starting point, consider an increase either to the extent to which shareholders care about externalities associated with shares they’ve sold ( $\eta$ ), or to the extent that the bidder weights social factors ( $\delta$ ). From Corollary 2, these stronger social preferences lead to the possibility that takeovers with  $\phi_1 > 0$  succeed—even if such takeovers are socially inefficient ( $s < 0$ ). In this scenario, greater social responsibility—via an increase in either  $\delta$  or  $\eta$ —paradoxically facilitates socially undesirable takeovers. Similarly, if  $\delta + \eta < \alpha$  then Corollary 2 predicts that a socially efficient takeover succeeds if  $\phi_1 < 0$ . In contrast, if either shareholders or the bidder grow sufficiently more concerned about externalities that  $\delta + \eta$  rises above  $\alpha$  then such takeovers fail (Corollary 3). Here, too, heightened social responsibility can prove counterproductive by obstructing socially efficient transactions.<sup>14</sup>

Moreover, even an increase in the baseline level of shareholder social responsibility  $\alpha$  can lead to worse outcomes—specifically, if  $\alpha$  rises but shareholders’ weight on externalities associated with shares that they’ve sold,  $\eta$ , remains unchanged. Consider the case of a socially efficient takeover with positive post-takeover externalities ( $\phi_1 > 0$ ). If preferences are balanced ( $\eta + \delta = \alpha$ ) then the takeover succeeds with strictly positive probability even as  $N \rightarrow \infty$ . However, if the social preference  $\alpha$  increases then (by Corollary 2) the takeover fails, a socially

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<sup>14</sup>Related, in Online Appendix D, we show that if  $\phi_1 < \phi_0$ , then the introduction of consequentialist preferences for the bidder reduces the likelihood of socially efficient takeovers ( $s > 0$ ).

inferior outcome. The economic reason is that the increase in  $\alpha$ , unaccompanied by an increase in  $\eta$ , increases the utility cost to target shareholders of tendering their shares.

In sum, greater social responsibility on the part of shareholders (higher  $\eta$  or  $\alpha$ ) or the bidder (higher  $\delta$ ) can, in some instances, lead to inefficient outcomes. The underlying intuition is that efficiency depends not only on the degree to which externalities are internalized, but also on the *balance* of social responsibility between shareholders and the bidder.

In practice, the majority of public firms' shares are held by institutional investors. It is often argued that, when these investors do exhibit social preferences, these tend to be of the warm-glow type. That is, institutional investors typically do not internalize externalities generated by firms outside their investment portfolios (i.e.,  $\eta = 0$ ). Our analysis suggests that the social responsibility of the financial sector—including the mandates given to asset managers (captured by  $\alpha$ ), should be aligned with that of the corporate sector (captured by  $\delta$ ). In particular, concerns have been raised that the growing dominance of private equity funds in acquiring publicly held “dirty assets” may be socially inefficient. If this is the case, our model indicates that the market for corporate control would function more efficiently if sell-side asset managers similarly prioritized financial returns over environmental considerations.<sup>15</sup>

## 5.2 Trade with financial investors

A common argument is that the presence of non-social capital in financial markets—such as hedge funds or risk arbitrageurs—dilutes or even nullifies the impact of responsible investment. We show that this argument is incorrect in important cases.

Specifically, we consider a scenario in which target shareholders may first sell their shares to purely financial investors (i.e., those for whom  $\alpha = \eta = 0$ ). We assume decentralized and frictionless financial markets, with trades occurring whenever they generate mutual gains.<sup>16</sup> Once trading concludes, the tender offer proceeds as in the baseline model, with a newly-formed shareholder base that is purely financially motivated. In order to keep our discussion focused we assume the bidder has no social responsibility.

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<sup>15</sup>For example, if  $\delta = \eta = 0$ ,  $v_1 + \phi_1 < v_0 + \phi_0$ , and  $\phi_1 < 0$ , then social efficiency is higher when  $\alpha = 0$  than when  $\alpha = 1$ .

<sup>16</sup>Financial markets may or may not be subject to the same frictions that affect the market for corporate control. Our analysis should therefore be interpreted as an *upper bound* on the impact of trade with financial investors.



**Proposition 3** *Suppose  $\delta = 0$ . (a) If  $\eta = \alpha$  then no trade occurs. If  $\eta < \alpha$  then (b) trade weakly enhances social efficiency if  $\phi_1$ ,  $v_1 - v_0$ , and  $s$  all have the same sign; while (c) trade weakly harms social efficiency if  $\phi_1$  and  $s$  have opposite signs.*<sup>17</sup>

Part (a) of Proposition 3 establishes that there are gains from trade between social and financial investors only if social investors have warm-glow preferences ( $\eta < \alpha$ ). Intuitively, if social investors have consequentialist preferences ( $\eta = \alpha$ ) then takeover outcomes are sufficiently close to social efficiency (Corollary 1) that there is no scope for gains from trade.

Part (b) of Proposition 3 highlights instances in which trades with financial investors can arise in equilibrium, and when they do, they increase social efficiency. From Corollary 2, if  $\eta < \alpha$ , then a socially efficient takeover ( $s > 0$ ) that generates positive externalities ( $\phi_1 > 0$ ) is likely to fail when the target firm's shares are held by social investors. This is because warm-glow investors tend to resist selling their shares under such circumstances. Moreover, if the takeover is both privately and socially efficient ( $v_1 > v_0$ ), the takeover succeeds with higher probability when the target shares are instead held by financial investors. In this case, whenever trade occurs,<sup>18</sup> it enhances social efficiency.<sup>19</sup>

Part (c) of Proposition 3 covers cases in which trade with financial investors harms social efficiency. For example, if a takeover is socially efficient ( $s > 0$ ) and results in negative externalities ( $\phi_1 < 0$ ), then it succeeds with high probability if target shares are held by social investors; because of warm-glow preferences, such investors benefit from divesting their shares in a tender offer. If shares are instead held by financial investors then, even if the takeover is also privately efficient ( $v_1 > v_0$ ), the holdout problem leads to a lower probability of takeover success; and *a fortiori* a privately inefficient takeover has even less probability of success. Trade occurs in these cases even despite harming social efficiency because social investors' warm-glow preferences generate a direct trade surplus to selling shares with negative externalities.<sup>20</sup>

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<sup>17</sup>Note that the cases described aren't exhaustive; the proof covers all cases.

<sup>18</sup>Trade occurs whenever the product of the social surplus  $s$  and the change in takeover probability associated with transferring shares from social to financial investors is sufficiently large.

<sup>19</sup>The case of socially inefficient takeovers ( $s < 0$ ) with negative externalities ( $\phi_1 < 0$ ) that are also privately inefficient ( $v_1 < v_0$ ) is analogous: any trade that occurs in this setting enhances social efficiency because there is an equilibrium in which the takeover succeeds if target shares are held by social investors but it is always blocked when held by financial investors.

<sup>20</sup>Analogously, a socially inefficient takeover that results in positive externalities is blocked by social investors, but succeeds with significant probability if it is privately efficient and shares are held by financial investors; again, trade reduces social efficiency, and again, trade nonetheless occurs if negative externalities generated

## 6 Governance and legal implications

In this section, we extend the analysis to incorporate equity offers, leveraged offers, minority shareholder protections, and social responsibility as a takeover defense.

### 6.1 Equity offers

If the bidding firm is publicly traded it can use its own equity as payment. Unlike a cash offer, an equity offer grants tendering shareholders ownership, thereby exposing them to externalities generated by the combined entity—an effect relevant when shareholders have warm-glow social preferences. We analyze how this effect determines a bidder’s preferences over cash versus equity offers, generating novel insights for this choice-of-payment-method question.<sup>21</sup>

Specifically, consider a bidder with stand-alone value  $V_B$ , externalities  $\Phi_B$ , and  $N_B$  shares outstanding. The bidder offers each tendering target shareholder  $e$  newly-issued shares in itself, conditional on at least  $K$  shareholders tendering. Hence if  $j \geq K$  target shareholders tender, the financial value of each share in the post-takeover bidder is  $\frac{V_B + jv_1}{N_B + ej}$ ; notably, this value varies with the number of tendering shareholders. Similarly, the externalities associated with each share in the post-takeover bidder are  $\frac{\Phi_B + j\phi_1}{N_B + ej}$ .<sup>22</sup> In order to focus on core economic mechanisms we set  $\eta = 0$ , and so in particular abstract from the question of how much target shareholders internalize the bidder’s externalities absent a takeover. We make the mild assumption that all relevant valuations are positive even after accounting for externalities (e.g.,  $V_B + \alpha\phi_B > 0$  etc.; see formal statement in the appendix). Finally, for conciseness, and for this subsection only, we assume that if multiple stable equilibria exist then the one with the highest tendering probability is played.

**Proposition 4** *Suppose  $\eta = 0$ . (a) If  $\delta = \alpha$  then the bidder is indifferent between cash and equity offers. (b) Otherwise, if  $\delta < (>) \alpha$  then the bidder strictly prefers a cash (equity) offer if  $\Phi_B + \max\{\kappa\Phi_1, \Phi_1\} < 0$  and strictly prefers an equity (cash) offer if  $\Phi_B + \min\{\kappa\Phi_1, \Phi_1\} > 0$ .*

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under incumbent management ( $\phi_0 < 0$ ) make share ownership costly for social investors with warm-glow preferences.

<sup>21</sup>Transaction costs and deferred capital gains taxes may discourage tendering shareholders from immediately selling the bidder’s shares they receive.

<sup>22</sup>A successful tender offer does not automatically result in a full merger of the two firms. In such cases, we assume that a post-takeover share in the bidder reflects the target’s externalities in proportion to the bidding firm’s ownership share in the target.

Part (a) of Proposition 4 establishes that if preferences are balanced then the payment method is irrelevant: the bidder's payoff (and also tendering probabilities) under the most profitable cash offer matches the payoff under the most profitable equity offer. However, if preferences are imbalanced then the choice of payment method matters.

Part (b) deals with the case in which the bidder cares differently about externalities than do target shareholders. Consider the case  $\delta < \alpha$ . Recall from Corollary 2 that cash offers in a takeover that results in negative externalities ( $\Phi_1 < 0$ ) benefit from the fact that target shareholders are eager to divest their shares in this case. In contrast, an equity-offer surrenders some of this advantage, since target shareholders who tender still have equity stakes, and hence continue to care about externalities. As Proposition 4 makes clear, the relevant externalities in an equity offer are those of the post-takeover firm, stemming from both the bidder's stand-alone externalities and post-takeover target, and which lie between  $\Phi_B + \kappa\Phi_1$  and  $\Phi_B + \Phi_1$ . Similarly, a bidder benefits from making an equity offer rather than a cash offer if the combined externalities of the post-takeover externality are positive.

Proposition 4 implies that the method of payments in takeovers signals the bidder's social preferences. Specifically, if  $\Phi_B < -\min\{\kappa\Phi_1, \Phi_1\}$  then the bidder uses cash offers if  $\delta < \alpha$  and equity offers if  $\delta > \alpha$ . Thus, when an established fossil fuel company (i.e., firms with sufficiently negative  $\Phi_B$ ) acquires an emerging renewable energy firm (with  $\Phi_1 > 0$ ) using equity the primary motivation is likely a desire to reduce environmental impact ( $\delta > \alpha$ , due to regulatory pressure or shareholder green preferences). Conversely, when it uses cash the primary motivation is likely profit maximization ( $\delta < \alpha$ ).

## 6.2 Leveraged offers

In practice, bidders often finance acquisitions with debt that is collateralized against the target's assets—a common strategy in leveraged buyouts (LBOs), particularly among private equity firms. To examine the effects of such leverage offers in the presence of externalities, suppose the bidder issues debt totaling  $Nd > 0$ , which becomes the obligation of the target if the takeover succeeds. The bidder chooses both leverage level  $d$  and the offer price  $p$  to maximize its payoff, which is given by

$$Nd(\gamma(q + \Delta) + (1 - \gamma)q) + N\gamma(q + \Delta)(v_1 - d - p + \delta\phi_1). \quad (19)$$

The first term is the bidder’s expected proceeds from debt issuance;<sup>23</sup> the second term is simply (14), adjusted for the fact that the target is now encumbered with debt. Expression (19) simplifies to

$$N(1 - \gamma)qd + N\gamma(q + \Delta)(v_1 - p + \delta\phi_1). \quad (20)$$

Legal protections for minority shareholders are typically interpreted to require

$$v_1 - d \geq v_0, \quad (21)$$

a point that we return to below. By requirement (21), leverage is viable only if  $v_1 > v_0$ .

Leverage generates three significant effects, as detailed in the following result. For conciseness, we state the result for just the case of balanced preferences, which exhibits all three effects; but Online Appendix B fully characterizes equilibrium outcomes for all parameter values.

**Proposition 5** *Suppose  $\eta + \delta = \alpha$  and  $v_1 > v_0$ .*

- (a) *If  $s > 0$  and  $\phi_1 > \phi_0$  then leverage increases the probability of a successful takeover and increases social efficiency.*
- (b) *If  $s > 0$  and  $\phi_1 < \phi_0$  then under some conditions leverage decreases the probability of a successful takeover and decreases social efficiency.*
- (c) *If  $s < 0$  then leverage increases the probability of a successful takeover and decreases social efficiency.*

In part (a), leverage increases the probability that socially efficient takeovers succeed. Leverage enables the bidder to “tunnel” resources out of the firm at the expense of minority shareholders: conditional on a successful takeover, the bidder obtains the entire leverage proceeds  $d$ , which are paid back by the target, yet shares the liability with minority shareholders. Consequently, and consistent with Mueller and Panunzi (2004), leverage allows a bidder to capture a greater share of a takeover’s value-creation, mitigating the holdout problem and facilitating socially efficient takeovers.<sup>24</sup>

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<sup>23</sup>If the takeover fails then the bidder immediately repays the debt (or equivalently, simply never issues the loan), and in this case debt has no effect on the bidder’s payoff.

<sup>24</sup>Online Appendix C characterizes the effect of freeze-out mergers. Absent social externalities, leverage and

In part (a), the condition  $\phi_1 > \phi_0$  and the legal protection (21) together rule out “coercive” tender offers in which there is an equilibrium in which a takeover succeeds for sure even though shareholders would prefer to coordinate to play the distinct equilibrium in which the takeover fails for sure. If instead,  $\phi_1 < \phi_0$ , as in part (b), then a second effect of leverage arises. Now, the bidder trades off two alternatives: (i) low leverage ( $d \approx s$ ) and a high offer, and a unique equilibrium in the tendering subgame, versus (ii) high leverage ( $d = v_1 - v_0 > s$ ) and a low offer, with everyone-retaining and everyone-tendering both equilibria in the tendering subgame. There are parameter values under which the latter strategy dominates, due to the bidder’s large profits if the takeover succeeds; but in which the takeover success probability is lower than in the no-leverage baseline.

Finally, part (c) establishes that leverage can increase the probability of a socially inefficient takeover succeeding. The ability to take leverage and dilute shareholders enables the bidder to profit even from socially inefficient takeovers, albeit at the expense of target shareholders.

The negative consequences of leverage in parts (b) and (c) of Proposition 5 are both consequences of the legal protection (21) failing to account for social externalities. If the legal standard (21) were replaced with the alternative standard

$$d < s \tag{22}$$

then full social efficiency is achieved; this standard prevents the use of leverage in part (c) and the use of coercive offers in part (b), while still allowing (and indeed enhancing) the value-creation role of leverage in part (a). Indeed, this conclusion extends beyond the case of balanced preferences:

**Corollary 4** *Under the legal standard (22) the possibility of leverage uniformly improves the social efficiency of takeover outcomes.*

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freeze-out mergers operate broadly similarly as ways for a bidder to capture a greater share of a takeover’s value-creation and thereby mitigate the holdout problem. In contrast, with social externalities there are significant differences between the two mechanisms. First, with freeze-out mergers, greater dilution requires a lower initial offer price, which increases tendering probability but reduces offer attractiveness. Leveraged offers provide bidders more flexibility to maximize profits at social efficiency’s expense. Second, the effectiveness of each mechanism depends critically on the alignment between private and social efficiency. When takeovers are privately inefficient but socially beneficial, legal protections render leveraged offers ineffective while freeze-out mergers remain viable. Conversely, when takeovers are privately efficient but socially harmful, freeze-out mergers lose dilutive power (as shown in Proposition A-1 in Online Appendix C) while leveraged offers retain effectiveness.

As such, our analysis delivers a normative argument for reconsidering the appropriate protections for minority shareholders. It is worth highlighting that replacing legal standard (21) with (22) represents *neither* a uniform strengthening nor a uniform weakening of legal restrictions.

Overlapping with this last point: If  $\phi_1 = \phi_0 = 0$  then leverage has only positive consequences; value-creating takeovers succeed more often, while value-destroying takeovers always fail regardless of whether leverage is possible. It is only in combination with negative takeover externalities ( $\phi_1 < \phi_0$ ) that leverage is a source of social inefficiency in takeovers.

### 6.3 Legal protections for minority shareholders

Proposition 1 and Theorem 1 together establish that privately inefficient takeovers ( $v_1 < v_0$ ) succeed only if either target shareholders or the bidder have social preferences. In many such cases, takeover success requires that shareholders sell their shares for less than the stand-alone financial value  $v_0$ , either because of positive externalities from the takeover, or because of the fear that the takeover will succeed regardless, leaving any minority shareholders with ownership in a firm with a lower valuation and/or negative externalities (“pressure to tender”). Corollary 1 shows that, under balanced social preferences, takeovers that are privately inefficient but socially efficient regularly succeed. However, following a successful privately inefficient takeover, minority shareholders who refused to sell for the offered price may be tempted to sue the bidder, seeking compensation for the post-takeover decline in firm value from  $v_0$  to  $v_1$ . Here, we analyze the effect of such post-takeover litigation.

Specifically, suppose that following a successful takeover non-tendering shareholders litigate and demand that the bidder “make them whole” by purchasing their shares at a price equal to the pre-takeover financial value  $v_0$ .<sup>25</sup> Such litigation occurs if and only if

$$v_0 + \eta\phi_1 > v_1 + \alpha\phi_1. \quad (23)$$

Litigation is successful with probability  $\sigma$ . Since distortions already arise under imbalanced social preferences, we focus on the case of balanced preferences,  $\eta + \delta = \alpha$ .

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<sup>25</sup>Alternatively, litigation might take the form of non-tendering shareholders litigating for a cash payout of  $v_0 - v_1$  while retaining their shares. An analogous version of Proposition 6 holds (see proof in appendix).

**Proposition 6** *Suppose  $\eta + \delta = \alpha$ . If the litigation condition (23) holds then as  $N \rightarrow \infty$  the takeover fails for sure ( $\Lambda^* \rightarrow 0$ ).*

In combination with Corollary 1, Proposition 6 establishes that minority protections that give target shareholders the ability to litigate ex post prevent socially efficient takeovers from succeeding, thereby harming shareholder welfare. The possibility of post-takeover litigation makes shareholders more reluctant to tender, reducing the probability of takeover success. And even when a takeover does succeed litigation harms the bidder. The inability of minority shareholders to commit not to sue following a successful takeover represents a further instance of miscoordination—one that ultimately harms both shareholder value and social welfare.

A final point is that, as in our discussion of legal standards aimed at protecting target shareholders from leveraged takeovers, the problem here is that the litigation standard (23) fails to incorporate social concerns. An alternative litigation standard under which minority shareholders sue only if  $v_0 + \alpha\phi_0 > v_1 + \alpha\phi_1$  straightforwardly (weakly) increases social welfare.

## 6.4 Social responsibility as a takeover defense

Finally, we study how the target’s incumbent management can best use social (ir)responsibility as an effective takeover defense.<sup>26</sup>

Parallel to our discussion in subsection 4.4, the target’s incumbent management selects pecuniary value and social externalities from a technologically determined choice set

$$\left\{ (v_0(\tilde{\phi}_0), \tilde{\phi}_0) \right\} \tag{24}$$

prior to the bidder making an offer. Define

$$\phi_0^{**} \equiv \arg \max_{\tilde{\phi}_0} v_0(\tilde{\phi}_0) + \alpha\tilde{\phi}_0$$

as the choice that maximizes the social value of the target under the incumbent’s control. In order to focus on cases in which the incumbent faces the greatest threat of a takeover, we assume that the bidder adds social value under all possible choices by the incumbent,  $s(\phi_0^{**}) > 0$ .

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<sup>26</sup>See Karpoff and Wittry (2024) for a literature review of takeover defenses.



We consider two types of incumbents: a shareholder-oriented incumbent, whose objective is to maximize the welfare of target shareholders, and an entrenched incumbent, whose objective is to retain control by minimizing the likelihood of a successful takeover.

**Corollary 5** *Suppose  $s(\phi_0^{**}) > 0$ . (a) If  $\eta + \delta = \alpha$  then both shareholder-oriented and entrenched incumbents pick  $\phi_0^{**}$ . If instead  $\eta + \delta < \alpha$  then (b) if  $\phi_1 < 0$  then a shareholder-oriented incumbent picks  $\phi_0^{**}$  while an entrenched incumbent does not, and (c) if  $\phi_1 > 0$  then an entrenched incumbent picks  $\phi_0^{**}$  while a shareholder-oriented incumbent does not.*

Corollary 5 follows directly from our earlier baseline characterization of takeover outcomes—and in particular from the fact that in equilibrium the bidder’s per-shareholder payoff is

$$\gamma \Delta s(\phi_0) + \gamma(q + \Delta)(\eta + \delta - \alpha)\phi_1 \quad (25)$$

while target shareholders are indifferent between retention and tendering, and hence benefit from an increase in their retention (reservation) utility, which is given by

$$v_0 + \alpha\phi_0 + qs(\phi_0). \quad (26)$$

Consistent with the rest of our analysis, part (a) shows that balanced preferences lead to socially desirable outcomes. In this case, the incumbent’s choice of  $\phi_0$  doesn’t affect the takeover’s probability; but socially better choices raise target shareholders’ reservation utility (26), forcing the bidder to improve its offer. The reason that the incumbent’s choice of  $\phi_0$  doesn’t affect the takeover’s probability is that, in this case, the bidder’s payoff stems entirely from its share of the social surplus created by the takeover; and this share is in turn determined by the probability that an individual shareholder is pivotal, which is independent of  $s(\phi_0)$ .

If preferences are imbalanced, however, with  $\eta + \delta < \alpha$  and the bidder creating negative externalities as in part (b), then the bidder’s payoff stems both from a share in the surplus created and from the utility benefit of warm-glow target shareholders divesting their shares. As (25) highlights, the bidder faces a trade-off between the two sources of profit. An entrenched incumbent can exploit this trade-off to reduce the takeover probability. Specifically, an entrenched incumbent chooses a socially suboptimal  $\phi_0$  because by doing so it raises the social surplus created by a takeover, thereby inducing the bidder to put more weight on this part

of its payoff, which it does by reducing its offer. In this case, social *irresponsibility* acts as a takeover defense, albeit at the expense of shareholder welfare.

In contrast, a shareholder-oriented incumbent cares both about the social value of the target and raising the takeover’s success probability (see (26)). The two objectives are aligned: by picking  $\phi_0^{**}$ , the incumbent maximizes the stand-alone value and, by minimizing the social surplus created by the takeover, induces the bidder to focus on maximizing takeover success.

## 7 Conclusion

This paper develops a tractable theoretical framework to study the effects of responsible investment on the market for corporate control. By incorporating social preferences and takeover-generated externalities into a canonical tender offer model, we highlight how the alignment—or misalignment—of social responsibility between acquirers and target shareholders shapes both the efficiency and outcomes of takeovers. A central insight is that market efficiency is not determined solely by the presence of socially responsible investors or bidders, but by the *balance* of their social preferences. When this balance is achieved, the market supports socially desirable outcomes: takeovers that generate positive externalities proceed, while those that cause harm are blocked—even when they are privately profitable.

However, when social preferences are imbalanced—such as when warm-glow shareholders face a profit-maximizing bidder—market outcomes are generally inefficient. In such cases, negative externalities can be strategically deployed to pressure responsible shareholders into tendering, while positive externalities may deter takeovers that would otherwise benefit society.

Our analysis yields several important implications. First, the participation of purely financial investors—often seen as undermining responsible investment—can, in fact, improve the social efficiency of takeover outcomes. Second, equity offers are optimal when target firms generate positive externalities. Third, debt financing can either mitigate or exacerbate inefficiencies depending on the nature of externalities involved. Fourth, the relaxation of legal protections for minority shareholders, which might seem to weaken governance, can support efficient takeovers. Finally, firms can strategically manipulate externalities—either to resist takeovers or as a means to facilitate acquisition—highlighting a novel role for social responsibility in takeover defenses.

More broadly, our results suggest that fostering socially efficient outcomes in corporate control markets requires more than promoting responsible investing in isolation. It calls for better alignment between the mandates of financial intermediaries and the objectives of corporate acquirers. By identifying when and how social responsibility can promote or undermine efficiency, our framework contributes to ongoing debates about the role of ESG in capital markets and offers policy-relevant insights into how corporate takeovers might be shaped to better serve societal goals.

In taking this first step toward integrating social preferences into models of corporate control, we deliberately abstract from several real-world complexities, including shareholder heterogeneity, negotiated transactions, bidder competition, information asymmetries, and regulatory intervention. Incorporating these elements into the analysis of takeovers with externalities presents promising directions for future research.

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## A Proofs of main results

Throughout the appendix we use the following notation:

$$\hat{v}_1 \equiv v_1 + (\alpha - \eta) \phi_1. \quad (\text{A-1})$$

The term  $\hat{v}_1$  represents the post-takeover value adjusted for the shift in preferences associated with moving a share from a target shareholder to the bidder. We also make repeated use of the following pair of results, the proofs of which follow by straightforward manipulation, and are relegated to the Online Appendix, which is available [here](#).

**Lemma A-1** *The following identities hold:*

$$\frac{\partial \Delta}{\partial \gamma} = \left( \frac{K-1}{\gamma} - \frac{N-K}{1-\gamma} \right) \Delta \quad (\text{A-2})$$

$$\frac{\partial q}{\partial \gamma} = \frac{N-K}{1-\gamma} \Delta \quad (\text{A-3})$$

**Lemma A-2** *The ratio  $\frac{q}{\Delta}$  strictly increases from 0 to  $\infty$  as  $\gamma$  increases from 0 to 1.*

**Proof of Lemma 1.** Suppose the bidder makes a conditional tender offer  $p$ . Rearranging (7), and given the definition of  $s$  and  $\hat{v}_1$ , we can write

$$\tau(\gamma; p) = (p - \hat{v}_1 + s)(q + \Delta) - sq. \quad (\text{A-4})$$

Lemma A-1 implies

$$\frac{\partial \tau(\gamma; p)}{\partial \gamma} = \left[ (p - \hat{v}_1 + s) \frac{K-1}{\gamma} - s \frac{N-K}{1-\gamma} \right] \Delta. \quad (\text{A-5})$$

Note that

$$\begin{aligned} \tau(0; p) &= 0 \\ \tau(1; p) &= p - \hat{v}_1. \end{aligned}$$

Since  $\tau(0; p) = 0$ , non-tendering ( $\gamma^* = 0$ ) is always an equilibrium. Similarly, tendering ( $\gamma^* = 1$ ) is an equilibrium if and only if  $p \geq \hat{v}_1$ . Finally, a mixed strategy equilibrium with tendering probability  $\gamma^* \in (0, 1)$  exists if and only if  $\tau(\gamma^*; p) = 0$ . From (A-5), the shape of  $\tau$  is determined by the following four cases:

- (i)  $\tau$  is increasing then decreasing if  $p > \hat{v}_1 - s$  and  $s > 0$
- (ii)  $\tau$  is monotonically increasing if  $p \geq \hat{v}_1 - s$  and  $s < 0$
- (iii)  $\tau$  is decreasing then increasing if  $p < \hat{v}_1 - s$  and  $s < 0$
- (iv)  $\tau$  is monotonically decreasing if  $p \leq \hat{v}_1 - s$  and  $s > 0$

Moreover, in the non-monotone cases (i) and (iii) the interior extremum occurs at  $\hat{\gamma}(p)$ , defined in

$$\hat{\gamma}(p) \equiv \frac{1}{1 + \frac{s}{p - \hat{v}_1 + s} \frac{N-K}{K-1}}. \quad (\text{A-6})$$

Hence:

$\gamma^* = 0$  is an equilibrium if and only if one of cases (iii) and (iv) holds.

$\gamma^* = 1$  is an equilibrium if and only if  $p > \hat{v}_1$ , or if  $p = \hat{v}_1$  and case (i) holds. Note that if  $p = \hat{v}_1$  and  $s > 0$  then  $p > \hat{v}_1 - s$ .

$\gamma^* \in (0, 1)$  is a equilibrium if and only if both case (i) holds and  $p < \hat{v}_1$ . In this case,  $\gamma^*$  is the unique solution to  $\tau(\gamma^*; p) = 0$ , or equivalently,  $\mu(\gamma^*) = p$  where  $\gamma^* \in (\hat{\gamma}(p), 1)$ .

From the above characterization: if  $\gamma^* \in (0, 1)$  is an equilibrium then it is unique. Hence the only case in which multiple equilibria exist is if both  $\gamma^* = 0$  and  $\gamma^* = 1$  are equilibria. Note that if  $p = \hat{v}_1 - s$  and  $s > 0$  then  $p < \hat{v}_1$ , and  $\gamma^* = 1$  isn't an equilibrium. Similarly, if  $p = \hat{v}_1$  and  $s > 0$  then  $p > \hat{v}_1 - s$  and  $\gamma^* = 0$  isn't an equilibrium. Hence  $\gamma^* = 0$  and  $\gamma^* = 1$  coexist as equilibria if and only if  $p \in (\hat{v}_1, \hat{v}_1 - s)$ .

Finally, since  $\tau$  is continuous and increasing in  $p$  it follows that  $\gamma^*$  is continuous and increasing in  $p$ . Moreover,  $\gamma^* \rightarrow 0$  as  $p \rightarrow \hat{v}_1 - s$  and  $\gamma^* \rightarrow 1$  as  $p \rightarrow \hat{v}_1$ . ■

**Proof of Theorem 1.** If  $s < 0$  then Lemma 1 implies that  $\gamma^*$  is given by (9). In this case,  $\Pi(0) = 0$  and  $\Pi(1) = N(v_1 - p + \delta\phi_1)$ . Hence if  $v_1 - \hat{v}_1 + \delta\phi_1 \leq 0$ , or equivalently  $(\alpha - \delta - \eta)\phi_1 \geq 0$ , then the bidder's payoff is strictly negative in any equilibrium with  $\gamma^* = 1$ . In this case,  $\gamma^* = 0$  is the unique equilibrium. Conversely, if  $(\alpha - \delta - \eta)\phi_1 < 0$  then for any  $p \in (\hat{v}_1, \hat{v}_1 - s]$  there is an equilibrium in which the bidder offers  $p$  and  $\gamma^* = 1$ . The bid  $p = \hat{v}_1 - s$  guarantees both  $\gamma^* = 1$  and a positive payoff for the bidder if  $v_1 - (\hat{v}_1 - s) + \delta\phi_1 > 0$ , or equivalently  $s > (\alpha - \eta - \delta)\phi_1$ . Hence an equilibrium with  $\gamma^* = 0$  exists if and only if  $s \leq (\alpha - \eta - \delta)\phi_1$ .

Second, if  $s > 0$  then Lemma 1 implies that  $\gamma^*$  is given by (11). An offer  $p \in (\hat{v}_1 - s, \hat{v}_1)$  delivers tendering probability  $\gamma$  satisfying  $\mu(\gamma) = p$  and an associated per-shareholder bidder-payoff of

$$\frac{\Pi(\gamma)}{N} = \gamma\Delta s + \gamma(q + \Delta)(\eta + \delta - \alpha)\phi_1. \quad (\text{A-7})$$

The offer  $p = \hat{v}_1$  delivers a shareholder acceptance probability of  $\gamma = 1$  and a per-share bidder payoff of  $(\eta + \delta - \alpha)\phi_1$ . Recall from Lemma 1 that as  $p$  increases over the interval  $(\hat{v}_1 - s, \hat{v}_1)$  the shareholder acceptance probability increases continuously from 0 to 1. Hence the bidder effectively picks  $\gamma$  (via choice of offer  $p$ ) to maximize (A-7). By Lemma A-1, the derivative of the bidder's payoff (A-7) with respect to  $\gamma$  equals

$$\left(1 + \gamma \left( \frac{K-1}{\gamma} - \frac{N-K}{1-\gamma} \right)\right) \Delta s + \left( \frac{q}{\Delta} + 1 + \gamma \frac{K-1}{\gamma} \right) \Delta (\eta + \delta - \alpha) \phi_1,$$

i.e., equals  $N\Delta$  times

$$\frac{\kappa - \gamma}{1 - \gamma} s + \left( \frac{q}{N\Delta} + \kappa \right) (\eta + \delta - \alpha) \phi_1. \quad (\text{A-8})$$

There are three subcases to consider:

- Subcase  $(\alpha - \eta - \delta)\phi_1 < 0$ : There exists  $\epsilon > 0$  (independent of  $N$ ) such that (A-8) is strictly positive if  $\gamma \leq \kappa + \epsilon$ . So the bidder chooses  $\gamma^* \in (\kappa + \epsilon, 1)$ . The success probability approaches 1 as  $N$  grows large, while  $\Delta \rightarrow 0$ . From Lemma 1, if the bidder offers  $p = \hat{v}_1$  then all shareholders tender with probability 1, and the bidder's per-shareholder payoff is  $(v_1 + \delta - p) = -(\alpha - \eta - \delta)\phi_1$ , which is a lower bound for the bidder's payoff. Hence the bidder's payoff approaches  $-(\alpha - \eta - \delta)\phi_1$  as  $N$  grows large (which also establishes that  $\gamma^* \rightarrow 1$ ).
- Subcase  $(\alpha - \eta - \delta)\phi_1 = 0$ : The bidder chooses  $\gamma^* = \kappa$ . Therefore,  $p^* = \mu(\kappa)$ . The

takeover success probability is bounded away from both 0 and 1. As  $N$  grows large the bidder's payoff  $\Pi^*$  approaches 0.

- Subcase  $(\alpha - \eta - \delta)\phi_1 > 0$ : There exists  $\epsilon > 0$  (independent of  $N$ ) such that (A-8) is strictly negative if  $\gamma \geq \kappa - \epsilon$ . So the bidder chooses  $\gamma^* < \kappa - \epsilon$ . The success probability approaches 0 as  $N$  grows large, and the bidder's payoff approaches 0.

■

**Proof of Proposition 2.** Let  $\phi_1^*$  be the externality level chosen by the bidder in equilibrium. If  $\eta + \delta = \alpha$  then by Corollary 1, if the bidder chooses  $\phi_1$  such that  $s(\phi_1) < 0$  then the bidder's payoff is 0. If instead the bidder chooses  $\phi_1$  such that  $s(\phi_1) > 0$  then the bidder's per-shareholder payoff is  $\kappa\Delta(\kappa)s(\phi_1)$ . Hence the bidder chooses  $\phi_1 = \phi_1^{**}$ . If  $s(\phi_1^{**}) < 0$  then choosing  $\phi_1^{**}$  is weakly optimal.

Next consider the case  $\eta + \delta < \alpha$  (the case  $\eta + \delta > \alpha$  follows from parallel arguments). From Theorem 1, if the bidder pledges  $\phi_1^{**}$  and  $s(\phi_1^{**}) > 0$  then it implies that shareholders tender with probability  $\gamma^{**} \in [0, 1)$ , and the bidder's per-shareholder payoff is (writing  $\Delta^{**} = \Delta(\gamma^{**})$  and  $q^{**} = q(\gamma^{**})$ )

$$\gamma^{**}\Delta^{**}s(\phi_1^{**}) + \gamma^{**}(q^{**} + \Delta^{**})(\eta + \delta - \alpha)\phi_1^{**}.$$

First note that there is a  $\phi_1^* < \phi_1^{**}$  yielding a higher payoff for the bidder. If  $\gamma^{**} > 0$  this follows by envelope arguments: because  $\frac{\partial s(\phi_1)}{\partial \phi_1}|_{\phi_1^{**}} = 0$ , one can find a  $\phi_1$  marginally below  $\phi_1^{**}$  such that, holding the acceptance probability unchanged at  $\gamma^{**}$  (by adjusting the offer  $p$ ), the bidder's payoff is strictly higher. If instead  $\gamma^{**} = 0$  then the bidder's payoff from  $\phi_1^{**}$  is zero; moreover, by (16) a necessary condition for this case is  $\phi_1^{**} > 0$ . If the bidder instead chooses  $\phi_1 < 0$ , then either  $s(\phi_1) > 0$  and from (16) the bidder's maximized payoff is strictly positive; or else  $s(\phi_1) < 0$ , and if the bidder offers  $p$  just above  $v_1 + (\alpha - \eta)\phi_1$  there is an equilibrium of the tendering subgame in which shareholders accept the offer with probability 1 and the bidder's payoff is strictly positive.

If  $s(\phi_1^{**}) < 0$  then, as noted above, the bidder can offer  $p$  just above  $v_1 + (\alpha - \eta)\phi_1$  and make a profit of  $(\delta + \eta - \alpha)\phi_1$ . Thus, choosing the smallest  $\phi_1 < 0$  in the choice set, and in particular  $\phi_1 < \phi_1^{**}$ , is optimal.

Conversely, suppose  $s(\phi_1^{**}) > 0$  and consider any pledge  $\tilde{\phi}_1 > \phi_1^{**}$ , with  $\tilde{v}_1 = v(\tilde{\phi}_1)$ . If this pledge yields a zero payoff for the bidder then it is dominated by  $\phi_1^*$  above. Otherwise, let  $\tilde{\gamma}, \tilde{\Delta}, \tilde{q}$  be the associated probabilities. From Lemma 1, a necessary condition for  $\tilde{\gamma} > 0$  is that the bidder's offer is at least  $\tilde{v}_1 + (\alpha - \eta)\tilde{\phi}_1$ . From (14) it follows that, regardless of whether

$\tilde{\gamma} \in (0, 1)$  or  $\tilde{\gamma} = 1$ , the bidder's per-shareholder payoff is bounded above by

$$\begin{aligned} & \tilde{\gamma} \tilde{\Delta} s(\tilde{\phi}_1) + \tilde{\gamma} (\tilde{q} + \tilde{\Delta}) (\eta + \delta - \alpha) \tilde{\phi}_1 \\ & < \tilde{\gamma} \tilde{\Delta} s(\phi_1^{**}) + \tilde{\gamma} (\tilde{q} + \tilde{\Delta}) (\eta + \delta - \alpha) \phi_1^{**} \\ & \leq \gamma^{**} \Delta^{**} s(\phi_1^{**}) + \gamma^{**} (q^{**} + \Delta^{**}) (\eta + \delta - \alpha) \phi_1^{**}, \end{aligned}$$

so that  $\tilde{\phi}_1$  is dominated by  $\phi_1^{**}$ , which is in turn dominated by  $\phi_1^*$  (the first inequality follows from the fact that  $\phi_1^{**}$  maximizes  $s(\phi_1)$  and  $\phi_1^{**} < \tilde{\phi}_1$ , while the second inequality follows because, by definition,  $\gamma^{**}$  maximizes the bidder's payoff given the choice  $\phi_1^{**}$ .) ■

**Proof of Proposition 3.** The proof repeatedly uses the equilibrium characterization of Theorem 1. Let  $u_{ss}$  denote the expected utility of a target shareholder with social preferences if all target shares are held by social investors. Let  $u_{sf}$  denote the expected utility of a target shareholder with social preferences if all target shares are held by financial investors. Let  $u_f$  denote the expected utility of a target shareholder who is a financial investor if all target shares are held by financial investors. We define  $u_{sf}$  and  $u_f$  so that they don't include any transfers associated with trade between social and financial investors. Let  $\Lambda_s$  and  $\Lambda_f$  be the takeover-success probabilities if shares are held by social and financial investors, respectively. Hence

$$\begin{aligned} u_{ss} &= v_0 + \alpha \phi_0 + \Lambda_s s \\ u_{sf} &= \eta \phi_0 + \Lambda_f \eta (\phi_1 - \phi_0) \\ u_f &= v_0 + \Lambda_f (v_1 - v_0). \end{aligned}$$

(Note that in writing  $u_{ss}$  we make use of the equilibrium condition that a target shareholder is indifferent between tendering and retention.) Trade surplus is

$$\begin{aligned} u_{sf} + u_f - u_{ss} &= \Lambda_f (v_1 - v_0 + \eta (\phi_1 - \phi_0)) + (\eta - \alpha) \phi_0 - \Lambda_s s \\ &= \Lambda_f s + \Lambda_f (\eta - \alpha) \phi_1 + (1 - \Lambda_f) (\eta - \alpha) \phi_0 - \Lambda_s s. \end{aligned}$$

Hence the trade surplus is positive if

$$(\Lambda_f - \Lambda_s) s > (\alpha - \eta) (\Lambda_f \phi_1 + (1 - \Lambda_f) \phi_0). \quad (\text{A-9})$$

As discussed in the main text, we characterize outcomes under the assumption that trade occurs if and only trade surplus  $u_{sf} + u_f - u_{ss}$  is strictly positive.

First, we show that no trade occurs if  $\eta = \alpha$ . Specifically, we show that the trade surplus

is weakly negative for all combinations of  $v_0, v_1, \phi_0$  and  $\phi_1$ .

- Case,  $v_1 < v_0$  and  $s < 0$ :  $\Lambda_s = \Lambda_f = 0$ .
- Case,  $v_1 > v_0$  and  $s < 0$ :  $\Lambda_s = 0 < \Lambda_f$ .
- Case,  $v_1 < v_0$  and  $s > 0$ :  $\Lambda_s > 0 = \Lambda_f$ .
- Case,  $v_1 > v_0$  and  $s > 0$ :  $\Lambda_s = \Lambda_f > 0$ .

In all cases, the LHS of (A-9) is either zero or negative, while the RHS of (A-9) is simply 0. Next, consider the case of warm-glow preferences,  $\eta < \alpha$ .

- Case,  $\phi_1 < 0$ ,  $v_1 < v_0$  and  $s > 0$ :  $\Lambda_s > \Lambda_f = 0$ . The trade condition holds for some parameters (e.g.,  $\phi_0$  sufficiently negative); and when trade occurs it harms social efficiency.
- Case,  $\phi_1 < 0$ ,  $v_1 > v_0$  and  $s > 0$ :  $\Lambda_s > \Lambda_f > 0$ . The trade condition holds for some parameters (e.g.,  $\phi_0$  sufficiently negative); and when trade occurs it harms social efficiency.
- Case,  $\phi_1 > 0$ ,  $v_1 < v_0$  and  $s > 0$ :  $\Lambda_s > \Lambda_f = 0$ . The trade condition holds for some parameters (e.g.,  $\phi_0$  sufficiently negative); and when trade occurs it harms social efficiency.
- Case,  $\phi_1 > 0$ ,  $v_1 > v_0$  and  $s > 0$ :  $\Lambda_s < \Lambda_f$ . The trade condition holds for some parameters (e.g.,  $\phi_0$  sufficiently negative); and when trade occurs it enhances social efficiency.
- Case,  $\phi_1 < 0$ ,  $v_1 < v_0$  and  $s < 0$ :  $\Lambda_f = 0$ .  $\Lambda_s = 1$  is an equilibrium; and  $\Lambda_s = 0$  is an equilibrium if  $s$  is sufficiently negative. If  $\Lambda_s = 0$  then trade (if it occurs) has no impact on social efficiency. If  $\Lambda_s = 1$  then the trade condition holds for some parameters (e.g.,  $\phi_0$  sufficiently negative); and when trade occurs it enhances social efficiency.
- Case,  $\phi_1 < 0$ ,  $v_1 > v_0$  and  $s < 0$ :  $\Lambda_f \in (0, 1)$ .  $\Lambda_s = 1$  is an equilibrium; and  $\Lambda_s = 0$  is an equilibrium if  $s$  is sufficiently negative. If  $\Lambda_s = 0$  then the trade condition holds for some parameters;<sup>27</sup> and when trade occurs it harms social efficiency. If  $\Lambda_s = 1$  then the trade condition holds for some parameters (e.g.,  $\phi_1$

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<sup>27</sup>Specifically: the trade condition is  $\Lambda_f s > (\alpha - \eta)(\Lambda_f \phi_1 + (1 - \Lambda_f)\phi_0)$ ; we know  $\phi_0 > \phi_1$ , and so trade occurs only if  $\Lambda_f s > (\alpha - \eta)\phi_1$ ; while the  $\Lambda_s = 0$  condition is  $s \leq (\alpha - \eta)\phi_1$ . Since  $s < 0$  it is possible to satisfy both inequalities.

- Case,  $\phi_1 > 0$ ,  $v_1 < v_0$  and  $s < 0$ :  $\Lambda_s = \Lambda_f = 0$ . Trade (if it occurs) has no impact on social efficiency.
- Case,  $\phi_1 > 0$ ,  $v_1 > v_0$  and  $s < 0$ :  $\Lambda_s = 0 < \Lambda_f$ . The trade condition holds for some parameters (e.g.,  $\phi_0$  sufficiently negative); and when trade occurs it harms social efficiency.

■

**Proof of Proposition 4.** Let  $v_B \equiv \frac{V_B}{N_B}$  and  $v_B \equiv \frac{\Phi_B}{N_B}$ . As noted in the main text, we assume that all relevant valuations are positive even after accounting for externalities:

$$V_0 + \alpha\Phi_0 > 0 \quad (\text{A-10})$$

$$V_B + \alpha\Phi_B + \min\{0, \kappa(V_1 + \alpha\Phi_1), V_1 + \alpha\Phi_1\} > 0 \quad (\text{A-11})$$

$$V_1 + \alpha\Phi_1 > 0. \quad (\text{A-12})$$

That is, the target has a positive market value (inequality (A-10)) and the bidder has a positive market value both pre- and post-takeover (inequality (A-11)). Inequality (A-12) is marginally stronger, and is imposed only to avoid the degenerate case in which the bidder is indifferent between cash and equity offers because in both cases it acquires the target at zero cost.<sup>28</sup>

Also, let  $\Gamma_{j,N}(\gamma) \equiv \binom{N}{j} \gamma^j (1-\gamma)^{N-j}$ , with the convention that  $\Gamma_{j,N} \equiv 0$  if  $j > N$ . To ease exposition, we omit  $\gamma$  whenever possible. For use below note that

$$\Gamma_{j,N} = \gamma\Gamma_{j-1,N-1} + (1-\gamma)\Gamma_{j,N-1} \quad (\text{A-13})$$

$$(j+1)\Gamma_{j+1,N} = N\gamma\Gamma_{j,N-1}. \quad (\text{A-14})$$

Given exchange offer  $e$ , a shareholder's expected payoff from retaining is

$$\begin{aligned} & \sum_{j=0}^{K-1} \Gamma_{j,N-1} (v_0 + \alpha\phi_0) + \sum_{j=K}^{N-1} \Gamma_{j,N-1} (v_1 + \alpha\phi_1) \\ &= \sum_{j=0}^{K-2} \Gamma_{j,N-1} (v_0 + \alpha\phi_0) + \sum_{j=K-1}^{N-1} \Gamma_{j,N-1} (v_1 + \alpha\phi_1) - \Gamma_{K-1,N-1}s, \end{aligned}$$

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<sup>28</sup>The case  $V_1 + \alpha\Phi_1 \leq 0$  is relevant if  $V_1 + \delta\Phi_1 > 0$ . In this case, then for both cash and equity offers there is an equilibrium in which shareholders accept a coercive offer that is infinitesimally small, yielding the bidder the full payoff  $V_1 + \delta\Phi_1$  in both cases. (If instead  $V_1 + \delta\Phi_1 \leq 0$  then the takeover always fails, for the simple reason that the bidder loses from acquiring the target even at a price of zero.)

while the expected payoff from tendering is

$$\sum_{j=0}^{K-2} \Gamma_{j,N-1} (v_0 + \alpha\phi_0) + \sum_{j=K-1}^{N-1} \Gamma_{j,N-1} e \frac{N_B (v_B + \alpha\phi_B) + (j+1) (v_1 + \alpha\phi_1)}{N_B + e (j+1)}.$$

Hence, the net benefit from tendering is

$$\begin{aligned} \tau_{eq}(\gamma; e) &\equiv \Gamma_{K-1,N-1} s + \sum_{j=K-1}^{N-1} \Gamma_{j,N-1} \left( e \frac{N_B (v_B + \alpha\phi_B) + (j+1) (v_1 + \alpha\phi_1)}{N_B + e (j+1)} - (v_1 + \alpha\phi_1) \right) \\ &= \Gamma_{K-1,N-1} s + \sum_{j=K-1}^{N-1} \Gamma_{j,N-1} \frac{N_B (v_B + \alpha\phi_B)}{N_B + e (j+1)} \left( e - \frac{v_1 + \alpha\phi_1}{v_B + \alpha\phi_B} \right). \end{aligned} \quad (\text{A-15})$$

Observe that  $\tau_{eq}(\gamma; e)$  is strictly increasing in  $e$  for any  $\gamma > 0$ .

If  $s > 0$  then for any  $\gamma \in (0, 1)$  there exists an offer  $e < \frac{v_1 + \alpha\phi_1}{v_B + \alpha\phi_B}$  such that  $\tau_{eq}(\gamma; e) = 0$ ; this follows from the fact that  $\tau_{eq}(\gamma; 0) < 0 < \tau_{eq}\left(\gamma; \frac{v_1 + \alpha\phi_1}{v_B + \alpha\phi_B}\right)$ . Moreover, if  $e = \frac{v_1 + \alpha\phi_1}{v_B + \alpha\phi_B}$  then  $\tau_{eq}(1; e) = 0$  and  $\gamma = 1$  is the unique stable tendering probability in the subgame.

If instead  $s < 0$  then if  $e \leq \frac{v_1 + \alpha\phi_1}{v_B + \alpha\phi_B}$  the unique stable tendering probability is  $\gamma = 0$ ; while if  $e > \frac{v_1 + \alpha\phi_1}{v_B + \alpha\phi_B}$  then  $\gamma = 1$  is a stable tendering probability.

The bidder's payoff (net of status quo) is

$$\begin{aligned} \Pi_{eq}(\gamma; e) &\equiv \gamma \sum_{j=K-1}^{N-1} \Gamma_{j,N-1} \left( N_B \frac{N_B (v_B + \delta\phi_B) + (j+1) (v_1 + \delta\phi_1)}{N_B + e (j+1)} - N_B (v_B + \delta\phi_B) \right) \\ &+ (1 - \gamma) \sum_{j=K}^{N-1} \Gamma_{j,N-1} \left( N_B \frac{N_B (v_B + \delta\phi_B) + j (v_1 + \delta\phi_1)}{N_B + ej} - N_B (v_B + \delta\phi_B) \right) \end{aligned} \quad (\text{A-16})$$

$$\begin{aligned} &= \gamma \sum_{j=K-1}^{N-1} \Gamma_{j,N-1} \frac{N_B (j+1) (v_B + \delta\phi_B)}{N_B + e (j+1)} \left( \frac{v_1 + \delta\phi_1}{v_B + \delta\phi_B} - e \right) \\ &+ (1 - \gamma) \sum_{j=K-1}^{N-2} \Gamma_{j+1,N-1} \frac{N_B (j+1) (v_B + \delta\phi_B)}{N_B + e (j+1)} \left( \frac{v_1 + \delta\phi_1}{v_B + \delta\phi_B} - e \right). \end{aligned} \quad (\text{A-17})$$

For use below, we establish:

*Claim:* If  $\Pi_{eq}(\gamma; e) > 0$  then  $\frac{\partial}{\partial \gamma} \Pi_{eq}(\gamma; e) > 0$ .

*Proof of Claim:* The condition  $\Pi_{eq}(\gamma; e) > 0$  implies  $(v_B + \delta\phi_B) \left( \frac{v_1 + \delta\phi_1}{v_B + \delta\phi_B} - e \right) > 0$ ; this can



be seen from (A-17). It then further follows that

$$\frac{N_B(j+1)(v_B + \delta\phi_B)}{N_B + e(j+1)} \left( \frac{v_1 + \delta\phi_1}{v_B + \delta\phi_B} - e \right) > \frac{N_B j(v_B + \delta\phi_B)}{N_B + ej} \left( \frac{v_1 + \delta\phi_1}{v_B + \delta\phi_B} - e \right). \quad (\text{A-18})$$

Inequality (A-18) in turn implies that the first summation in (A-16) exceeds the second summation. Moreover, an increase in  $\gamma$  induces a first-order stochastic dominance shift in the distribution of  $j$ ; consequently, (A-18) also implies that each of the two summations in (A-16) is increasing in  $\gamma$ . The claim then follows from the combination of these two observations.

From (A-13) and (A-14),  $\gamma\Gamma_{j,N-1}(j+1) + (1-\gamma)\Gamma_{j+1,N-1}(j+1) = N\gamma\Gamma_{j,N-1}$ , and so

$$\Pi_{eq}(\gamma; e) = N\gamma \sum_{j=K-1}^{N-1} \Gamma_{j,N-1} \frac{N_B(j+1)(v_B + \delta\phi_B)}{N_B + e(j+1)} \left( \frac{v_1 + \delta\phi_1}{v_B + \delta\phi_B} - e \right).$$

If  $s > 0$  then in equilibrium  $\tau_{eq}(\gamma; e) = 0$ ; using (A-15) it follows that

$$\Pi_{eq}(\gamma; e) = N\gamma\Gamma_{K-1,N-1}s + (\delta - \alpha)N\gamma \sum_{j=K-1}^{N-1} \Gamma_{j,N-1} \frac{N_B}{N_B + e(j+1)} (\phi_1 - e\phi_B). \quad (\text{A-19})$$

If instead  $s < 0$  then an equity offer infinitesimally above  $e = \frac{v_1 + \alpha\phi_1}{v_B + \alpha\phi_B}$  leads all shareholders to tender, and delivers a bidder payoff infinitesimally below

$$\begin{aligned} N_B \frac{V_B + \delta\Phi_B + V_1 + \delta\Phi_1}{N_B + N \frac{v_1 + \alpha\phi_1}{v_B + \alpha\phi_B}} - (V_B + \delta\Phi_B) &= \frac{(V_B + \alpha\Phi_B)(V_1 + \delta\Phi_1) - (V_1 + \alpha\Phi_1)(V_B + \delta\Phi_B)}{V_B + \alpha\Phi_B + V_1 + \alpha\Phi_1} \\ &= (\delta - \alpha) \frac{V_B\Phi_1 - V_1\Phi_B}{V_B + \alpha\Phi_B + V_1 + \alpha\Phi_1}. \end{aligned} \quad (\text{A-20})$$

Recall that if  $s > 0$  then the bidder's payoff from a cash offer is (see (16), recalling the definitions of  $q$  and  $\Delta$  and using  $\eta = 0$ )

$$\Pi(\gamma) = N\gamma\Gamma_{K-1,N-1}s + (\delta - \alpha)N\gamma \sum_{j=K-1}^{N-1} \Gamma_{j,N-1}\phi_1. \quad (\text{A-21})$$

If instead  $s < 0$  then a cash offer infinitesimally above  $p = v_1 + \alpha\phi_1$  leads all shareholders to tender, and hence the bidder can approach the payoff

$$(\delta - \alpha)\Phi_1. \quad (\text{A-22})$$

*Part (a),  $\delta = \alpha$ :* If  $s \leq 0$  then from (A-20) and (A-22) the bidder's payoff is zero under both equity and cash offers. If instead  $s > 0$ , then recall that the bidder makes a cash offer that induces  $\gamma = \kappa$ . From (A-19) and (A-21), it is immediate that the bidder cannot do better with an equity offer than with a cash offer. It remains to establish that there is an equity offer that matches the bidder's payoff from the best cash offer. Let  $e_\kappa < \frac{v_1 + \alpha\phi_1}{v_B + \alpha\phi_B}$  be the equity offer such that  $\tau_{eq}(\kappa; e_\kappa) = 0$ . Observe that there cannot exist  $\gamma > \kappa$  such that  $\tau_{eq}(\gamma; e_\kappa) = 0$ , because by the Claim above, the bidder's payoff would be strictly higher at this  $\gamma$ , but by (A-19) and the fact that  $\gamma\Gamma_{K-1, N-1}$  is maximized at  $\kappa$  the bidder's payoff would be strictly lower, a contradiction. It then follows from  $\tau_{eq}(1; e_\kappa) < 0$  that  $\gamma = \kappa$  is the highest stable subgame equilibrium under offer  $e_\kappa$ , thereby establishing bidder indifference.

*Part (b),  $\delta < \alpha$ :* We first consider the case of  $s > 0$ . Since any tendering probability can be induced as a stable equilibrium under a cash offer, from (A-19) and (A-21) a sufficient condition for the bidder to strictly prefer cash to equity is that

$$\phi_1 < \frac{N_B}{N_B + e(j+1)} (\phi_1 - e\phi_B) \text{ for all } j = K-1, \dots, N-1$$

or equivalently,

$$\max\{\Phi_B + \kappa\Phi_1, \Phi_B + \Phi_1\} < 0.$$

Similarly, we next show that a sufficient condition for the bidder to strictly prefer equity to cash is

$$\min\{\Phi_B + \kappa\Phi_1, \Phi_B + \Phi_1\} > 0. \quad (\text{A-23})$$

To see this, let  $\gamma_{ca}$  be the tendering probability under the bidder's payoff-maximizing cash offer. Let  $e_{ca} \leq \frac{v_1 + \alpha\phi_1}{v_B + \alpha\phi_B}$  be the equity offer that induces tendering probability  $\gamma_{ca}$ . From (A-19), (A-21) and (A-23) it follows that  $\Pi_{eq}(\gamma_{ca}; e_{ca}) > \Pi(\gamma_{ca})$ . If  $\gamma_{ca}$  is the largest stable subgame equilibrium under offer  $e_{ca}$  then the result follows. If instead  $\gamma_{ca}$  is not the largest stable equilibrium or it is unstable then the fact that<sup>29</sup>  $e_{ca} < \frac{v_1 + \alpha\phi_1}{v_B + \alpha\phi_B}$  implies  $\tau_{eq}(1; e_{ca}) < 0$ , and hence there must exist a stable subgame equilibrium  $\tilde{\gamma} > \gamma_{ca}$ . By the Claim,  $\Pi_{eq}(\tilde{\gamma}; e_{ca}) > \Pi_{eq}(\gamma_{ca}; e_{ca})$ , and hence  $\Pi_{eq}(\tilde{\gamma}; e_{ca}) > \Pi(\gamma_{ca})$ , establishing the result for  $s > 0$ .

Second, we consider the case of  $s < 0$ . From (A-20) and (A-22) cash offers dominate equity offers if and only if

$$\Phi_1(V_B + \alpha\Phi_B + V_1 + \alpha\Phi_1) - (V_B\Phi_1 - V_1\Phi_B) = (\Phi_1 + \Phi_B)(V_1 + \alpha\Phi_1) < 0,$$

thereby establishing the result for the case  $\delta < \alpha$ .

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<sup>29</sup>If  $e_{ca} = \frac{v_1 + \alpha\phi_1}{v_B + \alpha\phi_B}$  then  $\gamma_{ca} = 1$ , and is stable.

Part (b),  $\delta > \alpha$ : The analysis parallels the case  $\delta < \alpha$ , completing the proof. ■

**Proof of Proposition 5.** Special case of the equilibrium analysis of Online Appendix B. ■

**Proof of Corollary 4.** Straightforward adaption of the equilibrium analysis of Online Appendix B. ■

**Proof of Proposition 6.** If the bidder offers  $p$  then the gain from tendering is

$$\begin{aligned} & (q + \Delta)(p + \eta\phi_1 - v_0 - \alpha\phi_0) - q(s + \sigma(v_0 + \eta\phi_1 - v_1 - \alpha\phi_1)) \\ &= \Delta s - (q + \Delta)(v_1 + (\alpha - \eta)\phi_1 - p) - \sigma q(v_0 + \eta\phi_1 - v_1 - \alpha\phi_1). \end{aligned} \quad (\text{A-24})$$

The bidder's per-shareholder payoff is

$$\gamma(q + \Delta)(v_1 + \delta\phi_1 - p) - (1 - \gamma)\sigma q(v_0 - v_1 - \delta\phi_1), \quad (\text{A-25})$$

where the second term reflects the bidder's litigation-induced acquisition of a share it values at  $v_1 + \delta\phi_1$  for a price  $v_0$ .

Note first that there is no equilibrium with  $\gamma = 1$ , since from (A-24) such an equilibrium would require (using (23))

$$v_1 + (\alpha - \eta)\phi_1 - p \leq -\sigma(v_0 + \eta\phi_1 - v_1 - \alpha\phi_1) < 0,$$

which by balanced preferences implies that the bidder's payoff is strictly negative.

Hence the only possibility of  $\gamma^* > 0$  is if the tendering probability in the tendering subgame is interior. In this case, balanced preferences imply that the bidder's payoff is

$$\gamma\Delta s - \sigma q(v_0 + \eta\phi_1 - v_1 - \alpha\phi_1). \quad (\text{A-26})$$

Recall that  $\gamma\Delta$  is single-peaked in  $\gamma$ , obtaining its maximum at  $\gamma = \kappa$ .<sup>30</sup> By condition (23), it follows that (A-26) obtains its maximum at  $\gamma < \kappa$ . Since the optimizing value is independent of  $N$  the result follows, completing the proof.

Finally: In footnote 25 we state that an analogous version of Proposition 6 holds if non-tendering shareholders litigate for cash compensation  $v_1 - v_0$  while retaining their shares. In this case, the litigation condition (23) becomes  $v_0 > v_1$ ; the gain from tendering (A-24)

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<sup>30</sup>Formally: By the same arguments as in the proof of Lemma 1, the gain from tendering (A-24) is either monotone, single-peaked, or single-troughed in  $\gamma$ . Suppose that, contrary to the claimed result, the bidder's optimal offer  $p$  induces an equilibrium  $\gamma \geq \kappa$ . Then the bidder would strictly increase its profits by marginally reducing  $p$ , leading to a marginally lower  $\gamma$  in the tendering subgame.

becomes  $\Delta s - (q + \Delta) (v_1 + (\alpha - \eta) \phi_1 - p) - \sigma q (v_0 - v_1)$ ; the bidder's payoff (A-25) becomes  $\gamma (q + \Delta) (v_1 + \delta \phi_1 - p) - (1 - \gamma) \sigma q (v_0 - v_1)$  and (A-26) becomes  $\gamma \Delta s - \sigma q (v_0 - v_1)$ ; and all steps in the argument are unchanged. ■