



Optimal toeholds in takeover contests[☆]

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Abstract

We offer an explanation for why raiders do not acquire the maximum possible toehold prior to announcing a takeover bid. By endogenously modeling the target firm's value following an *unsuccessful* takeover we demonstrate that a raider may optimally acquire a small toehold even if the acquisition does not drive up the pre-tender target price. This occurs because although a larger toehold increases profits if the takeover succeeds it also conveys a higher level of managerial entrenchment and hence a lower firm value if the takeover fails. We derive new predictions regarding the optimal toehold and target value following a failed takeover. We also examine the impact of a rival bidder and dilution.

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1. Introduction

For the past several decades, takeover contests have attracted the interest of academics, practitioners, and regulators. This has led to an impressive array of both theoretical and empirical research that has greatly enhanced our understanding of the basic mechanisms behind the takeover process; Hirshlifer (1995) and Shleifer and Vishny (1997) offer surveys of this literature. However, some questions remain unanswered. In particular, there seems to be a gap between theory and empirical studies when it comes to the issue of toeholds. A toehold is defined as the raider's ownership stake in the target firm prior to announcing his tender offer. SEC regulation specifies that anyone who acquires 5% of a company's outstanding shares must file Schedule 13(D) within ten days to disclose their identity, the number of shares owned, and their purpose in acquiring the shares. In practice, a bidder can continue purchasing target shares anonymously after hitting the 5% threshold until the disclosure date.

While classic theory predicts that raiders should accumulate the maximum legally allowed toehold prior to making a public takeover bid, empirically we see that toehold size varies widely. For example, Bradley et al. (1988), Stulz et al. (1990), Jennings and Mazzeo (1993), and Betton and Eckbo (2000) all report that a significant fraction of raiders hold toeholds well *below* 5% when the takeover is announced, with some bidders having no toeholds at all. This is surprising since Jennings and Mazzeo (1993), Schwert (1996), and Betton and Eckbo (2000) all show that raiders pay a high premium over market value for target shares during the tender offer process.

In this paper we provide a theoretical explanation for this empirical anomaly. We accomplish this by expanding on previous work in two ways. First, we assume that the manager of the target firm can strategically decide whether to oppose the tender offer and reduce the likelihood of takeover success. Second, we explicitly model the value of the target firm following a *failed* takeover.¹ These two features allow us to demonstrate that while a larger toehold increases the raider's profits if the takeover succeeds, it can also reduce his profits if the takeover fails. This previously unmodeled cost of a larger toehold can result in an optimal toehold that is less than the 5% legal threshold. Furthermore, in some cases the raider will optimally bid for the target while acquiring a zero toehold.

Thus, we rationalize the existence of an interior solution to the optimal toehold problem as well as generate a new set of empirical predictions regarding the cross-sectional variation in toehold size and in firm value following a failed takeover. In addition, we provide testable implications regarding changes in the price of the target firm for different event windows during the takeover process.

The intuition for our findings is based on the observation that the target manager's incentive to block a takeover increases with the level of her private benefits of

¹Grossman and Hart (1980), Shleifer and Vishny (1986), Hirshleifer and Titman (1990), and Chowdhry and Jegadeesh (1994) all assume that firm value after a failed takeover is the same as that before the takeover is announced.

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