

Smart Buyers*

Mike Burkart[†] Samuel Lee[‡]

July 2011

Abstract

In many bilateral transactions, the seller fears to be underpaid because its outside option is better known to the buyer. We rationalize a variety of observed contracts as solutions to such smart buyer problems. The key to these solutions is to grant the seller upside participation. In contrast, the lemons problem calls for offering the buyer downside protection. Yet in either case, the seller (buyer) receives a convex (concave) claim. Thus, contracts commonly associated with the lemons problem can equally well be manifestations of the smart buyer problem. Nevertheless, the information asymmetries have opposite cross-sectional implications. To avoid underestimating the empirical relevance of adverse selection problems, it is therefore critical to properly identify the underlying information asymmetries in the data.

JEL: D82, D86

Keywords: Bilateral trade, asymmetric information, royalties, cash-equity offers, debt-equity swaps, earnouts, commissions, lemons problem

*We thank Patrick Bolton, Archishman Chakraborty, Christopher Hennessy, Holger Mueller, Georg Nöldeke, Uday Rajan, Vladimir Vladimirov, and seminar participants at the Duke-UNC Corporate Finance Conference, ESSFM (Gerzensee), Lancaster University, Norwegian Business School (BI Oslo), NYU Stern, SSE/SIFR (Stockholm), Universities of Basel, Frankfurt, St. Gallen and Zurich and WFA for helpful comments.

[†]Stockholm School of Economics, London School of Economics, CEPR, ECGI and FMG. E-mail: mike.burkart@hhs.se

[‡]Stern School of Business, New York University. E-mail: slee@stern.nyu.edu.

1 Introduction

The highly successful 2010 US reality documentary *American Pickers* follows antique hunters on expeditions through people's homes, barns, and sheds to purchase collectibles to supply antique dealers. The story line portrays the thrill of discovering items of value unbeknown to their current owners. In a similar spirit, the British television show *Bargain Hunt* challenges contestants to generate as much profit as possible by buying antiques at a fair and reselling them in an auction.

Buyers outsmart less informed sellers not only on television. In 1981, Seattle Computer sold its rights to QDOS, a microcomputer operating system, to Microsoft for a flat price of about \$50,000. After some modifications, Microsoft licensed its own version, called MS-DOS, to IBM for a per-copy royalty fee. MS-DOS became the standard for IBM's hugely successful personal computer (PC), turning Microsoft's founder, Bill Gates, into a billionaire by 1986. Presumably, if Seattle Computer had grasped the potential of QDOS, or Microsoft's intentions, it would have asked for more than \$50,000. Microsoft got a bargain precisely because it had a better idea of the value locked in QDOS. This is a dramatic but by no means isolated incident. Better informed buyers are present in many markets: a real estate developer buying land, a pharmaceutical company buying patents, a management team buying out its shareholders, a venture capital firm buying into start-ups, a producer buying the movie rights to a novel, and collectors of all sort, to name a few.

When facing a better informed buyer, sellers may suspect that the terms of trade are unfavorable. Such fear of being short-changed makes them reluctant to sell, and therefore engenders trade frictions that are the inverse of Akerlof (1970)'s famous lemons problem. In the lemons problem, the seller is privately informed about the quality of the good, which affects the buyer's payoff from *entering* the trade (inside option). The buyer hesitates because the seller may *overstate* the inside option to raise the price. In the reverse constellation, which we refer to as the "smart buyer problem," the buyer is privately informed about the value of the good, which affects the seller's payoff from *rejecting* the trade (outside option). Here, the seller hesitates because the buyer may *understate* the outside option to lower the price.

These differences can also be cast in terms of signaling incentives. Consider

Spence (1973)’s classic labor market example, in which workers sell human capital to firms, but are privately informed about the quality of that capital. Confronted with a lemons problem, the firm hesitates to commit to a high “price.” Conversely, to avoid selling their services below par, workers must credibly reveal high skill levels. In some labor market situations, the information asymmetry is arguably the reverse. A record producer signing up a new garage band, a movie company signing a promising actress, tenured faculty recruiting PhDs fresh out of graduate school, and other adept buyers of human capital are often in a better position to evaluate a candidate’s potential (during the hiring process) than the candidate itself. In such situations, the challenge for the buyer is not how to match a candidate’s outside option but rather how to signal that the latter is indeed matched.

The present paper analyzes contractual solutions to the smart buyer problem with three aims in mind: First, we seek to draw attention to the prevalence of this problem. To this end, we consider various bilateral trade examples, all plagued by the smart buyer problem. We demonstrate that the information asymmetry gets resolved by observed contractual arrangements, such as royalties, cash-equity bids, earn-out clauses, debt-equity swaps, “gross points” (for actors), and concessions. Second, we systematically explore how a smart buyer can signal its information to the seller, and compare these solutions to those of the lemons problem. The latter leads to downward-sloping demand and necessitates downside protection for the uninformed party. By contrast, the smart buyer problem creates upward-sloping supply and calls for granting the uninformed party upside participation. Third, and perhaps most importantly, we show that – despite these differences – contractual solutions to these two information asymmetries look intriguingly similar. Indeed, this deceptive similarity can lead to erroneous conclusions in empirical contract studies.

These points are best illustrated by an example. Consider a company that wants to purchase a patent from a scientist to develop a new product. Gallini and Wright (1990) show that, if the company is concerned about the quality of the patent, the scientist can signal high quality by accepting royalties. This signal is credible because a scientist with less confidence in the patent is less willing to participate in revenues. By taking on upside exposure, the scientist effectively provides the company with downside protection. It is equally plausible, however, that the company, rather than the scientist, can better assess the latent value of

(products based on) the patent. The scientist is then reluctant to enter into an outright sale for fear of giving up a gem. We show that the company can alleviate such concerns by conceding royalties. This signal is credible because a more optimistic company is not as willing to share revenues. By surrendering such gains, the company grants the scientist upside participation. So royalties can be a manifestation of (either) the smart buyer problem or the lemons problem.

Despite implying identical contract forms, the two information asymmetries yield opposite predictions in the cross-section. When the scientist uses royalties as a signal, a greater reliance on royalties implies a higher patent value. Conversely, when the company uses royalties as a signal, a greater reliance on royalties implies a lower patent value. Neglecting this subtlety – identical contract form but contrary cross-sectional predictions – can lead to false conclusions. For instance, imagine an empirical study that relates patent valuations or revenues to royalties and does not find a positive relation between patent value and royalties. While this would indeed contradict the existence of a lemons problem, such evidence need not rule out that information problems shape the contract choice (royalties). It may be that the patent sales under consideration are plagued by the smart buyer problem in which case lower patent values go together with more royalties. Alternatively, some transactions may be subject to the lemons problems but others to the smart buyer problem, and their countervailing effects attenuate the average effect in the data. The general point is that confounding the two problems can make asymmetric information appear less relevant for contract design than it is.

We derive these insights in an informed principal model (Maskin and Tirole, 1992). Our key assumption is that the buyer has superior information not only about its own valuation of the good, but also about the common value component. To trade, the buyer must convince the seller that the latter’s participation constraint is met. Our model captures the seller’s fear of being short-changed as well as the notion that certain sophisticated buyers are “cherry pickers” and have the upper hand in bargaining. While these features make the informed principal framework appealing, our main insights could also be established in a screening model.¹

¹Shifting bargaining power changes the allocation of rents between seller and buyer, rather than the shape of the optimal contracts or the distribution of rents among the different types of the informed party. Thus, the results that obtain from a comparison between the smart buyer problem and the lemons problem are, for all intents and purposes, orthogonal to the

Our simple bilateral trade model allows us to capture a wide variety of transactions involving indivisible and divisible goods, as well as assets that generate verifiable or non-verifiable returns. For each type of goods transaction, we explore whether the smart buyer can signal the common value of the good. In general, a fully revealing equilibrium exists, provided that the buyer’s information advantage is one-dimensional, or equivalently, provided that the common value of the good is a sufficient statistic for the buyer’s valuation of the good. In case of a two-dimensional type space, the information advantage reaches an extent that severely undermines the buyer’s ability to signal. We also study equilibrium selection, which allows us to address the choice between “standardized” (pooling) and “customized” (separating) purchase offers, and to identify additional differences to the lemons problem.

There exist, of course, numerous papers that examine bilateral trade under one-sided asymmetric information in a variety of economic contexts. In many of the cases, it is predominantly – if not exclusively – the lemons problem that is given consideration.² Our paper connects to this body of research in several ways. First, it argues that the smart buyer problem is prevalent in practice, in some markets even more salient than the lemons problem. Second, it proposes contract solutions that previous studies associate (solely) with the lemons problem. Prominent examples of such studies include Leland and Pyle (1977), Myers and Majluf (1985), Gallini and Wright (1990), Eckbo et al. (1991), and Duffie and DeMarzo (1999). Third, our analyses synthesizes and generalizes the results of existing, but isolated, applications of the smart buyer problem, such as Shleifer and Vishny (1986) or Hirshleifer and Titman (1990). Most closely related is the contemporaneous paper by Dari-Mattiacci et al. (2010) who also consider a bilateral trade setting with an informed buyer. Their analysis concentrates on the pooling equilibrium and shows that buyer information advantage leaves only

allocation of bargaining power. This is not true when private information only pertains to private value components, in which case giving the informed party all the bargaining power eliminates all trade frictions (see Bolton and Dewatripont, 2005).

²Riley (2001) and Horner (forthcoming) provide recent reviews of the signaling literature. Most applications cited in these surveys – in marketing, industrial organization, finance, labor markets, politics, and biology – involve lemons problems; firms want to signal high quality to customers, competitors, or investors, workers want to signal high skill levels, politicians want to signal that they are highly attractive to voters, and animals want to signal high levels of fitness. A notable exception is Banks (1990)’s (non-trade) model of a political agenda setter who wants to signal that rejecting a proposal, that is, reversion to the status quo is undesirable. Note that the agenda setter wants to signal a low outside option.

high quality goods on the market and pushes up the equilibrium price. They informally discuss contractual and legal remedies to the smart buyer problem such as buy-back options or duties to disclose. By contrast, we study both pooling and separating equilibria and examine in detail how (and when) the buyer can structure the purchase offer to credibly reveal its private information.

Another related strand of the literature is auction theory where buyers with private information are the norm. Since multiple bidders compete for the good, there are, from the seller's perspective, no latent opportunities; all "options" are present in the bidding contest. Consequently, the seller's concern is how to maximize the expected auction revenues rather than how to avoid the risk of being short-changed. In contrast, the smart buyer problem presupposes that seeking alternative buyers or organizing an auction is costly, and that the informed buyer knows more about the costs and benefits of pursuing these outside "options." Put differently, a buyer faces actual competition in auctions which it must defeat, whereas in the smart buyer problem a buyer must convince the seller that its offer surpasses any latent alternative.

DeMarzo et al. (2005) study auctions in which buyers compete for a good by bidding with securities. In their model, the seller prefers to receive bids in "steep" claims; it prefers, for example, equity over cash. Steeper claims intensify bidding competition, thereby enabling the seller to extract more revenues.³ By the same token, the buyers prefer to submit bids in "flat" claims lest they give up rents to the seller. Indeed, if the buyers design their offers, they choose to bid in cash. (This contrasts with the smart buyer problem where the buyer voluntarily offers steep claims to appease the seller with upside participation.) In a similar spirit, Axelson (2005) and Garmaise (2007) examine how a firm designs securities that it wants to sell in an auction to privately informed investors.

Like these papers, we explore optimal contracts in the presence of informed buyers but focus on the buyer's design problem within bilateral trade settings. Inderst and Mueller (2006) take a similar perspective. In their model, a better-informed lender commits to a security design before screening loan applicants; the optimal design is a commitment to minimize inefficient lending decisions. In

³This insight builds on Hansen (1985) and Rhodes-Kropf and Viswanathan (2000). To the contrary, Che and Kim (2010) show that sellers may prefer flatter securities when bidders have private information about the investment cost. Similarly, Gorbenko and Malenko (forthcoming) show that competition among sellers may lead to auctions in flatter securities, as sellers must relinquish rents to attract bidders.

contrast, our model applies to situations in which the buyer is already informed and not yet committed to any particular contract.⁴

The paper proceeds as follows. Section 2 outlines the model and gives examples of smart buyer situations. Section 3 examines separating equilibria. Section 4 compares the smart buyer problem to the lemons problem. Section 5 introduces pooling offers and addresses the issue of equilibrium selection. Concluding remarks are set forth in Section 6, and the mathematical proofs are presented in the Appendix.

2 Framework

2.1 Model

A buyer approaches a seller, who possesses one unit of a tradable good. A transaction is characterized by a pair (x, t) where $x \in \mathfrak{X} \subset [0, 1]$ is the traded quantity and t is the total (net) cash transfer from the buyer to the seller. The buyer's and the seller's payoffs are $V(x; \cdot) = v(x; \cdot) - t$ and $U(x; \cdot) = u(1 - x; \cdot) + t$, respectively, where u and v are differentiable functions with $u(0; \cdot) = v(0; \cdot) = 0$, $u_x > 0$, and $v_x > 0$. To focus on the adverse effects of asymmetric information, we assume that the buyer has no wealth constraints, whereas the seller is penniless.

The buyer's valuation of the good can be written as the sum of two components, $v(x; \cdot) = [u(1; \cdot) - u(1 - x; \cdot)] + z(x; \cdot)$. The first term $u(1; \cdot) - u(1 - x; \cdot)$ represents the seller's loss from giving up x of the good, and the second term $z(x; \cdot)$ are the gains from trade. In other words, the function $v(x; \cdot)$ can be decomposed into a common value component $u(1; \cdot) - u(1 - x; \cdot)$ and a private benefit component $z(x; \cdot)$.

For tractability, we let the seller's valuation be constant per unit of the good, $u(x) = \theta_x x$ with $\theta_x \geq 0$. The coefficient θ_x reflects the seller's outside option. For example, θ_x could be the (expected) price a latent alternative buyer would pay, in which case $z(x; \cdot)$ would be the value-added by the present buyer relative

⁴In fact, the setting in Inderst and Mueller (2006) is more akin to the lemons problem, since the lender privately learns the firm's inside option (payoff from borrowing), while all outside options are commonly known. The lender de facto sells a loan product that may or may not be good for the borrower. Viewed in this light, we are the first to study security design by a smart buyer.

to the latent alternative buyer. The linearity simplifies the analysis but is not crucial for the qualitative insights.

Given the decomposition and the linearity, the preferences can be written as

$$\begin{aligned} U(x; \cdot) &= \theta_x(1 - x) + t && \text{(Seller)} \\ V(x; \cdot) &= \theta_x x + z(x; \cdot) - t. && \text{(Buyer)} \end{aligned}$$

We assume that $z = z(x; \theta_x, \theta_z)$. That is, the buyer's private benefits depend on the traded quantity x , factors determining the common value (captured by θ_x), and other factors (captured by θ_z). For example, θ_x is the objective quality of a car as the determinant of its market price, and θ_z is the buyer's idiosyncratic pleasure from driving.

Assumption 1 $z \geq 0$, $z_x \geq 0$, $z_{\theta_x} \geq 0$, $z_{\theta_z} \geq 0$, $z_{x\theta_x} \geq 0$, and $z_{x\theta_z} \geq 0$.

The buyer's private benefits are non-negative and increase in x , θ_x , and θ_z . Further, they increase marginally more in x when θ_x or θ_z are higher. Assumption 1 implies that the efficient outcome is full trade, $x = 1$.⁵

The parameters are continuously distributed on $\Theta_x \times \Theta_z = [\underline{\theta}_x, \bar{\theta}_x] \times [\underline{\theta}_z, \bar{\theta}_z]$ according to a commonly known distribution. The true parameters (θ_x, θ_z) are realized prior to the offer. We now introduce our central assumption.

Assumption 2 *Only the buyer observes θ_x .*

Put differently, the seller knows less about its outside option than the buyer. As a result, the seller is concerned that the buyer's offer might be too low. This in turn puts the burden on the buyer to convince the seller that the offer indeed matches, or exceeds, the latter's true outside option.⁶

With respect to θ_z , the bulk of our analysis presumes symmetric information, so that the buyer's type (information advantage) is one-dimensional and given

⁵This assumption is the opposite of, but also akin to, Assumption 5 in Riley (1979). On the one hand, it implies that increasing the level of the "signal" is cheaper for lower, rather than higher, common value types. On the other hand, both assumptions fulfil the same function, namely to allow separation.

⁶Unless the buyer's private information is about θ_x , there are no frictions in this model; the buyer would offer $t = E[\theta_x]$ for $x = 1$, which the seller would always accept. That is, being better informed does not matter to the buyer as long as she can guarantee to pay the seller's outside option. If the seller, rather than the buyer, had private information about θ_x , the buyer would face the lemons problem.

by $\theta_x \in \Theta_x$. For simplicity, we assume that θ_z is common knowledge. (Assuming instead that neither party observes θ_z does not change the qualitative results.) Only in Section 5.2, we assume that θ_z is known exclusively by the buyer, in which case the type (information advantage) is two-dimensional and given by $(\theta_x, \theta_z) \in \Theta_x \times \Theta_z$. In either case, the buyer has superior information both about its private benefits and about the seller’s outside option. The difference is that, in the one-dimensional case, θ_x is a sufficient statistic for both.

Contracting follows the informed principal model of Maskin and Tirole (1992). The informed buyer moves first and makes a take-it-or-leave-it offer to the seller. The offer consists of a menu of contracts. The seller decides whether to accept the menu or not. If the seller accepts the menu, the buyer chooses one contract from the menu, which is then implemented.

We introduce two conditions that render our model applicable to a wide range of bilateral trade situations, as the examples in Section 2.2 illustrate.

Condition V $v(x)$ is verifiable.

Condition V (for “verifiability”) is satisfied when a third party, such as a court, can verify the buyer’s valuation (only) after trade has taken place. If Condition V holds, the buyer can commit to monetary transfers that are contingent on the buyer’s valuation; otherwise, only fixed monetary transfers are feasible. Note that, under Condition V, the buyer’s valuation is verifiable as a whole, but not the individual components of the buyer’s valuation. Otherwise, payments could be made contingent on the common value θ_x , which would trivially resolve the smart buyer problem.

Condition D $\mathfrak{X} = [0, 1]$.

Condition D (for “divisibility”) states that the traded good is (perfectly) divisible. When Condition D is not satisfied, the parties can either trade the entire good or not at all. Unless otherwise stated, Conditions V and D are not satisfied.

2.2 Applications

We now present several examples of smart buyer constellations, including some of those mentioned earlier in the introduction.

A0: Art collector. A famous art collector wants to buy a work from a novice artist. The collector derives non-verifiable (hedonic) utility from complementing her own existing collection with the work, but also has more experience to assess the potential (future) value of the artist’s work. Here, θ_z captures the collector’s idiosyncratic component of its hedonic utility, while θ_x reflects the latent market value of the work. Neither Condition V nor Condition D is satisfied.

A1: Securities trading. A sophisticated investor wants to buy securities from a market maker. The investor gains from the trade partly because it hedges risk exposures that are specific to her current portfolio. These hedging gains are non-verifiable and cannot be transferred to the market maker. The investor also has private information about the fundamental value of the securities. Here, θ_z captures the investor’s idiosyncratic hedging demand, while θ_x reflects the securities’ fundamentals. Condition D is satisfied.

A2: Real estate. A well-known real estate developer wants to buy some property to build a hotel in lieu of the existing buildings. The future cash flow from operating the hotel can be shared. The current owner is unable to develop the land in the same way. She is also less informed about (valuations on) the real estate market. Here, θ_z captures the developer’s capabilities, while θ_x reflects the value of the “location.” Condition V is satisfied.

A3: Patent. A company wants to buy a patent from a scientist to improve its products. The scientist knows less about how valuable the patent is for improving such products. Here, θ_z captures the company’s product market share, while θ_x reflects the patent’s latent market value. Condition V is satisfied.

A4: Restructuring. The controlling shareholder of a firm under bankruptcy protection offers to inject new capital in exchange for partial debt forgiveness. While there is consensus that continuation is better, the controlling shareholder has superior information about the going concern value and the liquidation value. The creditors question the proposed terms. Here, θ_z captures the shareholder’s managerial ability, while θ_x reflects the firm’s liquidation value. Condition V is satisfied.

A5: Takeover. A small firm with promising ideas is approached by a large industry peer. The target management deems the buy-side valuations of their firm suspiciously low. Here, θ_z captures acquirer characteristics, while θ_x reflects target characteristics. Condition V is satisfied.

A6: Venture capital. A seasoned venture capitalist wants to invest in a

start-up firm, help develop its business, and finally take it public. The venture capitalist contributes useful experience to the start-up but also knows more about its potential market value. The firm founders fear conceding too large a stake. Here, θ_z captures the venture capitalist's experience, while θ_x reflects the potential of the firm. Condition V is satisfied.

A7: Movie rights. A Hollywood studio wants to buy the movie rights to a series of novels. Compared to the seller (writer and/or publishing company), the studio can better assess the box office potential of the novels and whether another studio may be interested. The seller is concerned about giving up a "hidden gem." Here, θ_z captures the studio's movie-making capacities, while θ_x reflects the novels' box office potential. Conditions V and D are satisfied.

A8: Hiring talent. A music producer wants to sign up a new band. The contract would confer exclusive rights to produce several records with the band. While the band is inexperienced, the producer has a track record of developing new talent. The band members have reservations about some of the contract terms and wonder whether they could get a better deal elsewhere or later. Here, θ_z captures the producer's capability, while θ_x reflects the potential of the band. Conditions V and D are satisfied.

A9: Legal counsel. A defendant (or plaintiff) considers hiring a specialist attorney, as opposed to seeking standard counsel. The specialist attorney claims that, without its help, the chances of winning the case are slim. The defendant is unsure about the validity of this claim, particularly given the high(er) legal fees. Here, θ_z reflects the quality of the specialist lawyer, while θ_x reflects the chances of winning the case with a run-of-the-mill attorney. Condition V is satisfied.

3 Persuasive purchase offers

An actual trade contract takes the form

$$\mathcal{C} = [x, t_0, \tau(v)]$$

where x is the quantity traded, t_0 is a fixed monetary transfer, and $\tau(v)$ is a monetary transfer contingent on the ex post realization of v . Thus, the total payment is $t = t_0 + \tau(v)$. When Condition V is violated, $\tau(v) = 0$, whereas $x = 1$ for any non-trivial buy offer when Condition D is violated. Let $\mathcal{C}_0 \equiv [0, 0, 0]$

denote the null contract. A buy offer consists of a set of contracts \mathfrak{C} , henceforth referred to as a contract *menu*.

In the absence of private benefits ($\bar{z} = 0$), the unique equilibrium outcome is the absence of trade. This result follows directly from the no-trade theorem (e.g., Milgrom and Stokey, 1982). Without gains from trade, any buy offer reveals that the buyer deems the common value of the asset (weakly) higher than the offered price. Hence, rejecting the buyer's offer is the dominant strategy for any offered contract (menu). In the presence of private benefits, trade is feasible in equilibrium.

In this section, we focus on fully revealing Perfect Bayesian equilibria. A separating offer is a contract menu \mathfrak{C} such that, if the menu is accepted, the buyer's selection from the menu fully reveals her type unless the selected contract is \mathcal{C}_\emptyset . That is, a separating offer is a function $\mathcal{C} = \mathcal{C}(\theta_x)$ that attributes a particular contract to each buyer type. We focus on differentiable $\mathcal{C}(\theta_x)$ without loss of generality (Mailath and von Thadden, 2010).

3.1 Upward-sloping supply

Suppose Conditions V and D are violated; the good is indivisible, and transfers cannot be contingent. Thus, the buyer can only acquire the good through a contract of the form $\mathcal{C} = [1, t, 0]$. It is straightforward to see that such contracts rule out any separating offer, since all bidder types would select the contract with the lowest t from any given contract menu.

To construct separating equilibria, we need to allow for *stochastic* contracts. Under a stochastic contract $\tilde{\mathcal{C}}_g$, a deterministic contract \mathcal{C} is randomly implemented according to a probability distribution $g(\mathcal{C})$.

For a buyer of type θ_x , the expected payoff from a stochastic contract $\tilde{\mathcal{C}}_g$ is

$$\begin{aligned} \Pi(\tilde{\mathcal{C}}_g; \theta_x) &= p_g[\theta_x + z(1; \theta_x, \theta_z) - t_g^1] - (1 - p_g)t_g^0 \\ &= p_g[\theta_x + z(1; \theta_x, \theta_z)] - \bar{t}_g \end{aligned} \quad (1)$$

where $p_g \equiv \Pr_g(x = 1)$, $\bar{t}_g^1 \equiv E_g(t | x = 1)$, $\bar{t}_g^0 \equiv E_g(t | x = 0)$, and $\bar{t}_g \equiv E_g(t)$ under the probability distribution g . The payoff-relevant characteristics of $\tilde{\mathcal{C}}_g$ are thus summarized by p_g and \bar{t}_g , which allows us to express a stochastic contract in reduced form as $\tilde{\mathcal{C}}_g = [p_g, \bar{t}_g]$.

Proposition 1 (Trade failures) *Suppose Conditions V and D are violated. No deterministic fully revealing equilibrium exists. There exist stochastic fully revealing equilibria, in all of which buyer type $\theta_x \in \Theta_x$ trades with probability*

$$p_g(\theta_x, \theta_z) = \exp \left[- \int_{\theta_x}^{\bar{\theta}_x} [z(1; s, \theta_z)]^{-1} ds \right] \quad (2)$$

and the expected transfer to the seller is $\bar{t}_g(\theta_x, \theta_z) = p_g(\theta_x, \theta_z)\theta_x$.

Both success probability $p_g(\theta_x, \theta_z)$ and expected transfer $\bar{t}_g(\theta_x, \theta_z)$ are increasing in buyer type θ_x . A lower-valued buyer can credibly reveal its type by accepting a higher risk of trade failure. With less to gain, lower-valued types are less keen on trading and so bid less aggressively. Effectively, this implies a (stochastic) upward-sloping supply curve; the seller is more willing to supply the good, the higher the price.

The expected transfer equals the seller's true reservation price. So, in expectation, the buyer appropriates no part of the common value, which implies that the buyer does not signal its type by forgoing common value through its contract choice. Rather, it is through relinquishing expected *private benefits* that the buyer reveals its type when accepting a higher risk of trade failure.

A reduction in θ_z reduces the private benefits of all buyer types, and therefore decreases the trade probability of all but the highest type. That is, $\partial p_g(\theta_x, \theta_z) / \partial \theta_z > 0$. Intuitively, a lower θ_z means that the buyer — or, more precisely, its capacity to derive utility from the good — is less “special,” which increases the seller's suspicion that the buyer is merely after a good bargain.

Example 1 (Art). Consider the art collector setting (A0). A famous art collector approaches a young artist to buy a painting. The painting is indivisible, and the collector's hedonic pleasure from owning the painting is non-verifiable.

Under the stochastic contract

$$\tilde{\mathcal{C}}_g = \begin{cases} [1, \theta_x, 0] & \text{with probability } p_g(\theta_x, \theta_z) \\ \mathcal{C}_0 & \text{with probability } 1 - p_g(\theta_x, \theta_z) \end{cases}, \quad (3)$$

the collector commits to a mechanism that results in trade under the deterministic contract $[1, \theta_x, 0]$ with probability $p_g(\theta_x, \theta_z) \in [0, 1]$ and in no trade with probability $1 - p_g(\theta_x, \theta_z)$. By construction, $\bar{t}_g(\theta_x, \theta_z) = p_g(\theta_x, \theta_z)\theta_x$, and provided $p_g(\theta_x, \theta_z)$ satisfies (2), the stochastic contract $\tilde{\mathcal{C}}_g$ implements a stochastic

fully revealing equilibrium. The collector's personal interest in the work ($z > 0$) facilitates trade. If its intentions were predominantly commercial ($\theta_z \rightarrow \underline{\theta}_z$), the artist would be more prone to reject low bids.

Key to signaling is that private benefits can be forgone in a way that reveals information about the common value. Stochastic contracts allow the buyer to forgo private benefits by accepting failure with a self-selected probability. As we shall see, such randomization is no longer necessary for signaling when Condition V or Condition D holds. Save for a few remarks, we henceforth abstract from stochastic contracts.

Now suppose only Condition D holds; while the good can be divided, transfers still cannot be contingent. For a buyer of type θ_x , the payoff from a deterministic contract $\mathcal{C} = [x, t, 0]$ is

$$\Pi(\mathcal{C}; \theta_x) = x\theta_x + z(x; \theta_x, \theta_z) - t. \quad (4)$$

Proposition 2 (Trade rationing) *Suppose only Condition D is satisfied. There exists a unique deterministic fully revealing equilibrium in which buyer type $\theta_x \in \Theta_x$ acquires quantity $x(\theta_x, \theta_z)$ at price $t_0(\theta_x, \theta_z) = x(\theta_x, \theta_z)\theta_x$, where $x(\theta_x, \theta_z)$ satisfies the differential equation*

$$\frac{x'(\theta_x, \theta_z)}{x(\theta_x, \theta_z)} = [z_x(x(\theta_x, \theta_z); \theta_x, \theta_z)]^{-1} \quad (5)$$

and the boundary condition $x(\bar{\theta}_x, \theta_z) = 1$.

The trade quantity $x(\theta_x, \theta_z)$ and the unit price $t(\theta_x, \theta_z)/x(\theta_x, \theta_z)$ are increasing in the buyer type θ_x . The buyer signals a lower valuation by trading a smaller quantity. Quantity rationing is a means to relinquish private benefits, analogous to lowering trade probability in the stochastic separating equilibrium. The exact quantity schedule $x(\theta_x, \theta_z)$ depends on the private benefit function $z(x; \theta_x, \theta_z)$, which we illustrate using a linear example.

Again, trade is de facto characterized by an upward-sloping supply curve; the seller is willing to supply more of the good when the price is higher. In contrast, the lemons problem leads to a downward-sloping demand curve. In Duffie and DeMarzo (1999), for example, the securities market suffers illiquidity in the form of downward-sloping demand. This provides the backdrop for our next example.

Example 2 (Liquidity). Consider a simple two-period model of financial trade (A1). There are a buyer and a seller, both of whom are endowed with (zero-interest) cash to support trade. In addition, the seller is endowed with one unit of a security that yields an uncertain payoff $\tilde{\theta}_x \in \Theta_x$ later at date 1, where $\Theta_x = (1, \bar{\theta}_x]$.

The seller's and the buyer's consumption utilities are

$$u(c) = c_0 + c_1 \quad \text{and} \quad v(c) = c_0 + (1 + \theta_z)c_1,$$

respectively; c_t denotes date- t consumption, and $\tilde{\theta}_z \in \{-\theta_z, \theta_z\}$ is a consumption preference shock. If $\tilde{\theta}_z = -\theta_z$, the buyer is impatient and prefers consumption at date 0. If $\tilde{\theta}_z = \theta_z$, the buyer is patient and prefers consumption at date 1. By contrast, the seller is indifferent with respect to the timing of consumption.

When $\tilde{\theta}_z = -\theta_z$, the buyer uses her wealth to consume at date 0, and there is no demand for trading the security. However, when $\tilde{\theta}_z = \theta_z$, the buyer would like to invest some of its wealth in the security to increase date 1 consumption. If both knew the realization of θ_x at date 0, the buyer would simply offer $t = \theta_x$ and would enjoy additional benefits of $z(1; \theta_x, \theta_z) = \theta_z \theta_x$. When only the buyer learns the true return θ_x , there exists a unique deterministic fully revealing equilibrium characterized by Proposition 2.

To determine the equilibrium quantity schedule, note that (5) becomes

$$\frac{x'(\theta_x, \theta_z)}{x(\theta_x, \theta_z)} = [\theta_z \theta_x]^{-1}, \quad (6)$$

since $z(1; \theta_x, \theta_z) = \theta_z \theta_x x$ in this example. Integrating on both sides, and using $x(\bar{\theta}_x, \theta_z) = 1$ to determine the integration constant, yields

$$x(\theta_x, \theta_z) = (\theta_x / \bar{\theta}_x)^{1/\theta_z}. \quad (7)$$

Since the equilibrium per-unit price is θ_x , (7) also describes an upward-sloping supply curve. One can invert (7) to derive an equilibrium price function

$$P = \bar{\theta}_x x^{\theta_z}.$$

The slope of this function $\partial P / \partial x = \theta_z \bar{\theta}_x x^{\theta_z - 1}$ reflects the price impact of a given quantity order, similar to Kyle's (1985) λ , though not a constant.

As before, the traded quantity $x(\theta_x, \theta_z)$ is strictly increasing in θ_z for all $\theta_x \in \Theta_x \setminus \{\bar{\theta}_x\}$. (Recall that $x(\bar{\theta}_x, \theta_z) = 1$ irrespective of θ_z .) When non-informational trade motives become less important ($\theta_z \rightarrow 0$), the seller becomes more reluctant to trade which translates here into less liquidity: trade quantity decreases, and price impact increases.

3.2 Upside participation

Now suppose only Condition V holds; while the good cannot be divided, transfers can be made contingent on $v(\cdot)$. Feasible deterministic contracts now take the form $\mathcal{C} = [1, t_0, \tau(v)]$. We first consider a simple category of contingent transfers: linear sharing rules where $\tau(v) = (1 - \alpha)v$. Further below, we allow for more general contracts.

For a buyer of type θ_x , the payoff from a revenue sharing contract is

$$\Pi(\mathcal{C}; \theta_x) = \alpha[\theta_x + z(1; \theta_x, \theta_z)] - t_0. \quad (8)$$

It is straightforward to see that (8) is isomorphic to (1), and Proposition 1 therefore applies.

Proposition 3 (Revenue sharing) *Suppose only Condition V is satisfied and contingent transfers are restricted to linear sharing rules. There exists a unique deterministic fully revealing equilibrium in which buyer type $\theta_x \in \Theta_x$ acquires the good in exchange for a fixed transfer $t_0(\theta_x, \theta_z) = \alpha(\theta_x, \theta_z)\theta_x$ and a fraction $1 - \alpha(\theta_x, \theta_z)$ of the buyer's total revenues, where*

$$\alpha(\theta_x, \theta_z) = \exp \left[- \int_{\theta_x}^{\bar{\theta}_x} [z(1; s, \theta_z)]^{-1} ds \right]. \quad (9)$$

When the good has a low(er) common value, the buyer offers a large(r) fraction of revenues. The intuition behind the inverse relationship is that the buyer signals a low common value with granting the seller upside participation. Buyers do not want to mimic lower-valued types because the gains from paying a lower price are (more than) offset by the cost of conceding more revenues. Conversely, overstating the value of the good is not profitable since the gains from a larger share of revenues do not compensate for the higher cash price.

Note that the buyer relinquishes exactly the same amount of (expected) private benefits as in the stochastic fully revealing equilibrium (Proposition 1), yet through revenue sharing rather than through trade failure. The above equilibrium is efficient (since trade always occurs), and Pareto-dominates the stochastic fully revealing equilibrium (since the seller is strictly better off).

Example 3 (Royalties). Consider the setting of a patent sale (A3). A company needs a scientist’s invention to develop a new product cycle. Let θ_z reflect the size of the company’s product market, whereas θ_x reflects the market valuation of (products based on) the patent. Concerned that the company is better informed about market valuations, the scientist is reluctant to enter into an outright sale. Aware of these concerns, the company offers a contract that combines a fixed payment of $t_0(\theta_x, \theta_z) = \alpha(\theta_x, \theta_z)\theta_x$ with royalties that give the scientist a share $1 - \alpha(\theta_x, \theta_z)$ of the revenues from the final product.

Intuitively, if the company were to offer only a low fixed price, the trade might fail (as Example 1). Implicitly, the scientist’s reluctance to sell is a request for a higher price. If the patent value — or, more precisely, θ_x — is, however, indeed low, the company is unwilling to increase the fixed price. Instead, it can concede a share of the revenues to placate the scientist’s fear of being short-changed. Like the lemons problem (cf. Gallini and Wright, 1990), the smart buyer problem thus provides a rationale for royalties; the difference being that, in the smart buyer problem, they are a means to reassure the seller, as opposed to the buyer.

Cash-equity offers in corporate control transfers are another example. Again, our explanation based on the seller’s fear of underpricing stands out against the extant literature (Hansen, 1987; Eckbo et al., 1990).⁷ An exception is Berkovitch and Narayanan (1990), where the seller’s outside option is to wait for a competing bid, the value of which depends on the initial buyer’s privately observed quality relative to potential competitors. Our smart buyer framework parsimoniously subsumes their setting (in reduced form). Further corporate finance examples include venture capital investments (cf. Garmaise, 2007), equity issues (discussed in Section 4), and our next example of bankruptcy restructuring.

⁷Burkart and Lee (2010) study tender offers, in which the bidder is better informed about the post-takeover share value improvement. In their setting, dispersed target shareholders free-ride and therefore appropriate the full share value improvement, thereby inducing a smart buyer problem.

Example 4 (Debt-equity swap). Consider an owner-managed firm in financial distress (A4). Everyone agrees that continuation is efficient, and the owner-manager is willing to inject fresh capital in exchange for partial debt forgiveness. Such a transaction amounts to “buying” back control from the creditors.

The problem is that the owner-manager is in a better position to assess both the firm’s liquidation value θ_x and its continuation value $v(1; \theta_x, \theta_z)$. This creates disagreement: On one hand, the creditors question the low liquidation value estimates. On the other hand, the owner-manager deems creditor demands too high. One solution is to “settle” the debt not only in cash but also in equity, whereby creditors benefit from a cash infusion $t_0(\theta_x, \theta_z)$ and receive a $1 - \alpha(\theta_x, \theta_z)$ equity stake in the restructured firm.

A standard explanation for the use of debt-equity-swaps in financial distress is debt overhang. The current example shows that smart buyer problems provide an alternative explanation for debt-equity-swaps. In fact, while debt overhang problems can be resolved by means of debt forgiveness for *cash only*, this is not true for smart buyer problems.⁸

We now relax the restriction of linear sharing rules and let the buyer choose the *form* of the contingent transfers $\tau(\cdot)$. Consequently, a buyer of type θ_x chooses $\mathcal{C} = [1, t_0, \tau(v)]$ to maximize

$$\Pi(\mathcal{C}; \theta_x) = \theta_x + z(x; \theta_x, \theta_z) - t_0 - E[\tau(v) | \theta_x]. \quad (10)$$

Given that θ_z is commonly known, the buyer knows exactly how large the contingent payment will be. In fact, $E[\tau(v) | \theta_x] = \tau[v(1; \theta_x, \theta_z)]$. This simplifies the optimal contracting problem greatly.

Proposition 4 (Security design) *Suppose Condition V is satisfied, and contingent transfers are unrestricted. There exists a deterministic fully revealing equilibrium in which buyer type θ_x acquires the good in exchange for a fixed*

⁸The restructuring of Marvel in the mid-1990s provides anecdotal evidence of smart buyer problems in bankruptcy (Harvard Business School Case No: N9-298-059). Ron Perelman, as debtor-in-possession, plays the role of a smart buyer. His attempt to regain control of the financially distressed Marvel company at too low a price is eventually thwarted by the appearance of another smart player, Carl Icahn.

transfer $t_0(\theta_x, \theta_z) = \theta_x$ and a contingent transfer

$$\tau(v) = \begin{cases} 0 & \text{if } v \leq v(1; \theta_x, \theta_z) \\ v - v(1; \theta_x, \theta_z) & \text{if } v > v(1; \theta_x, \theta_z) \end{cases}, \quad (11)$$

thereby retaining the entire trade surplus, as under symmetric information.

For $x = 1$ and a given θ_z , the buyer's total valuation v is a one-to-one mapping from Θ_x to $[v(1; \underline{\theta}_x, \theta_z), v(1; \bar{\theta}_x, \theta_z)]$. Moreover, v is strictly increasing in θ_x . Consequently, one can use a simple scheme to punish the buyer for understating θ_x : Let the buyer's reported type be $\hat{\theta}_x$. Then, the buyer incurs a penalty if and only if the realized v is larger than the announced $v(1; \hat{\theta}_x, \theta_z)$. The penalty specified in Proposition 4 satisfies limited liability ($\tau \leq v - t_0$); it requires the buyer to pay the seller the difference between actual total valuation and total valuation implied by $\hat{\theta}_x$. This amounts to a call option that allows the seller to extract more from the buyer when v is high. Thus, the penalty scheme grants the seller upside participation.⁹

Example 5 (Earnout). Consider a private equity buyout (A5). A well-known buyout firm wants to acquire a small private firm. The buyout managers present low current valuations for the target (low estimates of θ_x) and argue that post-takeover improvements will primarily result from their managerial skill (θ_z). The current owners take a hard bargaining stance, arguing that the buyout firm purposely undervalues the target. Yet, the buyout firm refuses to increase its cash bid $t = \theta_x$.

To persuade the current owners, the buyout firm includes a so-called “earnout” clause, whereby it must pay $v - v(1; \theta_x, \theta_z)$ (only) if the target's post-takeover market value v exceeds $v(1; \theta_x, \theta_z)$. In practice, earnout clauses specify supplementary payments when the target's operational or financial performance exceeds pre-determined threshold levels within a given time period after the acquisition. According to practitioners, earnout clauses allow the buyer “to pay a lesser guaranteed amount to the sellers of the target business on the closing

⁹The penalty need neither have this specific form nor be payable to the buyer to ensure incentive compatibility. Also, a similar penalty scheme is effective even when θ_z is unobserved by either party. Under Assumption 1, the support of v would differ across buyer types. In fact, the maximum of the support $\bar{v}(\theta_x, \theta_z)$ would be strictly increasing in θ_x . But even if the support of v were identical for all types, an incentive-compatible penalty scheme exists if the distributions $\{f_{\theta_x}(v)\}_{\theta_x \in \Theta_x}$ satisfy the monotone likelihood property (Burkart and Lee, 2010).

date” (Gallant and Ross, 2009).

Interestingly, earnouts can also be motivated on the grounds that the target owners have private information (Datar et al., 2001). Put differently, as in the case of royalties, it is a priori unclear whether a given earnout clause is a manifestation of the lemons or the smart buyer problem.

The next example applies the model to the “purchase” of human capital.

Example 6 (“20-against-20”). Consider an example of “hiring talent” (A8). A film studio wants an actress for a lead role in a new movie. The studio is better informed about industry factors that determine the actress’ latent outside options (θ_x), and it can better estimate the movie’s box office potential ($v(1; \theta_x, \theta_z)$). A producer and a director are already signed up, both well-known and experienced (high θ_z).

The actress bargains for a high salary (t'_0), otherwise reluctant to commit to the project in hopes of better options. Finding her demands too high ($t'_0 > \theta_x$), the studio pays the larger of a cash salary t_0 and a fraction of the revenues αv ; $\max\{t_0, \alpha v\}$. In essence, this compensation package amounts to a fixed salary supplemented by a fraction of revenues, *provided that the revenues exceed a certain threshold*.

Such convex salaries exist in the film industry. One better-known example is the so-called “20-against-20” contract, whereby a movie star effectively gets the larger of \$20 million and 20 percent of the movie’s gross revenues.¹⁰ This creates upside participation; the payoff is flat until the revenues reach \$100 million but thereafter increases linearly with further revenues. Weinstein (1998) argues that one explanation for such contracts is that the studio is better informed than the star, but acknowledges that such contracts are also consistent with the information asymmetry being the opposite.¹¹

Propositions 3 and 4 illustrate the two effects that the verifiability of v (Condition V) and the use of contingent transfers have on the solution to the smart

¹⁰For example, Tom Cruise signed a 20-against-20 contract for *Valkyrie*.

¹¹Goetzmann et al. (2007) study pricing and contracts in sales of screenplays. In our view, their evidence is consistent with the notion that film studios know more than inexperienced screenwriters. In particular, they show that experienced screenwriters more often receive fixed payments, and that studios forecast box office success well. Further, the motivating example on page 8 – studios offer contingent contracts when less optimistic – and the cross-sectional evidence – better scripts coincide with higher prices and less contingent payments – are indicative of the smart buyer problem (cf. Section 4.2 below).

buyer problem. First, trade becomes efficient, since revenue sharing replaces more wasteful means of relinquishing private benefits, such as rationing. Second, the buyer appropriates more of the trade surplus in the absence of restrictions on the contract form, since security design enhances the buyer's ability to commit to truthful behaviour.

A noteworthy proviso is that both results rely on the (implicit) assumption that contingent transfers do not affect the trade surplus. This may be debatable in some applications. Earnout clauses, for example, can dampen the acquirer's incentives to increase the target's post-takeover value, creating tension between signaling and incentive provision.

4 Fooled buyers or short-changed sellers?

4.1 Observationally equivalent contracts

The smart buyer problem presumes that the buyer knows more than the seller, and that this knowledge pertains to the seller's outside option. By contrast, the lemons problem presumes that the seller has superior knowledge of the buyer's inside option. These opposite points of departure become manifest in the signaling incentives. In the lemons problem, the informed party wants to convey a *high* value, whereas it wants to convey a *low* value in the smart buyer problem.

This difference also distinguishes the rationales behind the solutions. Signaling a high value calls for *downside protection*, whereby the uninformed party is recompensed if expectations are ex post not met. Signaling a low value calls for *upside participation*, whereby the uninformed party is recompensed if expectations are ex post surpassed. This is most evident in the security design solution with $\tau(v) = \max\{0, v - v(1; \theta_x, \theta_z)\}$ (Proposition 4). As v increases from zero, the payoff from this claim is flat until $v = v(1; \theta_x, \theta_z)$ and then increases linearly. The convexity is designed to give the uninformed seller upside participation. The buyer's payoff is accordingly concave, increasing linearly until $v = v(1; \theta_x, \theta_z)$ and flat thereafter.

As Figure 1 illustrates, the above claims represent standard securities, straight debt for the buyer and equity for the seller. This is compelling in that the same claim structure is optimal in security design models with better informed sellers (Duffie and DeMarzo, 1999). That is, optimal contracts in lemons problems and

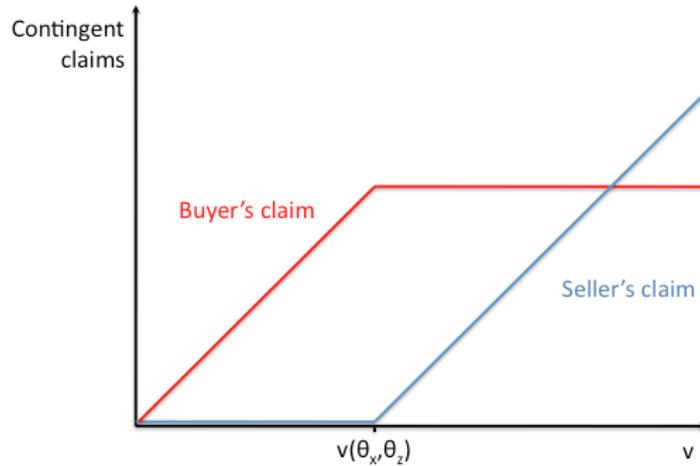


Figure 1: The graph illustrates the security design solution (Proposition 4) under limited liability. It plots the value of contingent claims granted to the buyer and the seller (vertical axis) as functions of total realized value v (horizontal axis). The seller receives equity (blue line), and the buyer receives debt (red line).

optimal contracts in smart buyer problems can be *observationally equivalent*. Starting with Myers and Majluf (1984), debt issuance is commonly linked to private information of the issuer: In the typical pecking order model, debt best protects less informed investors from buying overvalued securities. As our analysis shows, debt is also optimal when the issuer faces better informed investors. It best protects the issuer from selling undervalued securities. Thus, empirical tests built on the presumption that debt is more likely (only) when the issuer has better information than the market may capture only half the picture.¹²

The above also explains why other contractual provisions, such as royalties, earnouts, and “20-against-20,” can be ascribed to either of the two information asymmetries (see Examples 3, 5, and 6). The patent example provides a lucid illustration. If the company is concerned about the quality of the patent, the scientist can signal high quality by *accepting* royalties, that is, through its willingness to share low revenues in case the product is a flop (downside protection). Conversely, if the scientist is wary of the terms of trade, the company can alleviate such concerns by *conceding* royalties, that is, through its willingness to share high revenues in case of success (upside participation). In either case, the

¹²Chen et al. (2007) provide empirical evidence that investors may sometimes know more about a firm’s fundamentals than its managers. See fn. 16 for papers that formalize this idea in the context of primary capital markets.

scientist receives royalties. Analogously, cash-equity bids in takeovers can reflect the seller’s willingness to accept equity as a signal that the target is not a lemon or the buyer’s willingness to concede equity as a signal that the offer is adequate (we revisit this example further below).

The uniformity of contracts can be attributed to the fact that, as the mode of signaling switches between downside protection and upside participation, so does the identity of the informed principal. The eventual claim structure is the same regardless of whether the seller grants the buyer the downside protection or the buyer grants the seller the upside participation. The more fundamental reason is that both the lemons problem and the smart buyer problem can be reduced to asymmetric information about a common value component. Crucially, conditions for incentive compatibility and separation depend on neither the identity of the informed party nor whether it wants to overstate or understate the value. Conditional on separation, the informed principal’s identity affects only the surplus division (between buyer and seller and across common value types).

4.2 Opposite cross-sectional predictions

Because of identical contractual solutions, real-world contracts are unlikely to be sufficient to identify empirically the underlying information problem. One may have to look beyond the contract shape and take into account the division of surplus. For example, signaling costs are borne by the seller in the lemons problem, whereas they are borne by the buyer in the smart buyer problem. Hence, identifying the party who is willing to pay for third-party verification, such as due diligence or fairness opinions, can help to discriminate between the two information problems. However, in practice, it is difficult to attribute such expenses to one or the other party, because they may be laid out by one party but accounted for in the transaction price.

Alternatively, one can study how contracts relate to (revealed) common value, which reflects the distribution of rents across common value types. This relation changes with the identity of the informed party. Let us extend the financial trade application (Examples 2 and 5) by giving the informed party an endowment that it wants to *sell* in case of impatience, thereby introducing a lemons problem. Figure 2a depicts the relation between trade quantity x , which is the signaling instrument in this setting, and common value θ_x . It is positive when the informed

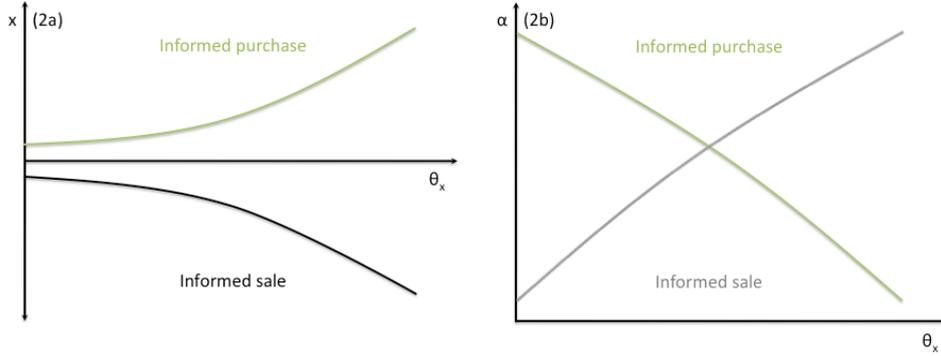


Figure 2: The two graphs illustrate that the smart buyer problem (informed purchase) and the lemon’s problem (informed sale) can make opposite predictions about the relationship between the underlying common value and the signaling instrument. The left graph shows this for trade rationing, while the right graph shows this for linear sharing rules.

party wants to buy (green line) but negative when it wants to sell (grey line). Identifying trade “direction” is therefore important, as commonly done in market microstructure research (e.g., Lee and Ready, 1991).

Accounting for trade direction also matters in other settings. Figure 2b illustrates this point for linear sharing rules, where the seller’s equity stake α is the signaling instrument. In smart buyer problems, α and θ_x are inversely related (green line); sellers *receive* more equity when common values are lower. In lemons problems, they are positively related (grey line); sellers *retain* more equity when common values are higher. For instance, consider a firm that wants to issue equity. Leland and Pyle (1977) presume that the issuer is better informed than the investors, who are therefore unwilling to pay a high(er) price unless the issuer retains a large(r) stake. However, it can also be that, for example, institutional investors know more than the issuer,¹³ who therefore wants to retain a large(r) stake if investors insist on a low(er) price. In the former case, the uninformed investors adapt price to quantity, paying less for more; in the latter case, the uninformed issuer adapts quantity to price, selling less for less. Thus, the relations between quantity and price are the opposite.

Analogously, consider a bidder that wants to acquire a target (firm). If cur-

¹³Indeed, Benveniste and Spindt (1989) argue that IPO bookbuilding processes are a way for underwriters to elicit information from sophisticated investors. Subrahmanyam and Titman (1999), Axelson (2007), Lyandres et al. (forthcoming) also presume primary equity markets in which managers want to extract information from the investors.

rent owners are better informed than the bidder, the latter is unwilling to pay a high(er) price unless the former are willing to accept a large(r) part of the consideration in post-takeover equity. Conversely, if current (dispersed) shareholders are less informed than the bidder, the latter must pay either a high(er) price or offer a large(r) part of the consideration in post-takeover equity. Similar to above, the correlations between equity consideration and (total) price are the opposite. Confounding, or incorrectly classifying, the lemons problem and the smart buyer problem can hence lead to erroneous conclusions. Suppose a takeover study searches for evidence of the lemons problem, but finds takeover premia (or post-takeover performance) not to be decreasing in the share of equity consideration. This does not warrant the conclusion that asymmetric information is negligible for the choice of consideration. In fact, the evidence could be consistent with the smart buyer problem; or the average effect could be weak because both information asymmetries with their countervailing effects are present in the data. Incidentally, the existing evidence on contractual signaling in external financing, or in mergers and acquisitions, is rather mixed. The above suggests one possible reason why past empirical studies may have been inconclusive.

4.3 Identification through intermediary contracts

In some markets information frictions are mitigated by expert intermediaries, which buy and resell the goods. The role of such intermediaries is not entirely obvious. In particular, how can the presence of another, say, smart buyer resolve an uninformed seller's fear of being short-changed?

We argue that this is indeed possible, and that intermediary contracts can help infer the underlying information problem. Suppose a person wants to sell an inherited antique but lacks expertise to assess its value (θ_x). To evade a bargain hunter, the seller enters into a contract with a specialized antiques dealer: The dealer buys the antique for θ_x and makes supplementary payments if the antique is resold for more than $\theta_x + \varepsilon$. Since the dealer is smart, the ultimate buyer will not be able to buy the antique for less than θ_x . The increment ε can be interpreted as a dealer commission. In fact, a similar deal can be implemented through a percentage commission.

This example illustrates that informed intermediation helps for two reasons. First, the intermediary does not buy the good for own consumption. Otherwise,

the seller is back to the original problem. Second, the resale generates *verifiable* information about θ_x . This allows for contracts that resemble the security design solution or revenue sharing, thereby obviating inefficient signaling through trade failures. In practice, such *informed* intermediation is provided by agents (for performing artists), galleries (for visual artists), market-makers (in stock exchanges), or underwriters (in capital markets).

Relevant for the identification of the underlying information problem is the fact that the intermediary enters into different contracts with the informed and the uninformed party. In a smart buyer problem, the intermediary enters into a contingent contract with the seller, such as a commission, while engaging in a simple cash transaction with the buyer. By contrast, in a lemons problem, the intermediary enters into a contingent contract with the buyer, such as a warranty, while engaging in a simple cash transaction with the seller. This asymmetry in the way the intermediary interacts with both sides of the market allows to infer the underlying information problem.

5 Pooling outcomes

5.1 Equilibrium multiplicity

Since the security design solution in Proposition 4 implements the first-best outcome, we must exclude it to create a role for pooling offers. In this subsection, we focus on trade rationing contracts; only Condition D is satisfied, and contracts take the form $\mathcal{C} = [x, t, 0]$. In this setting, an equilibrium is *efficient* if all buyer types trade the full quantity $x = 1$ and must therefore be uninformative.

To examine the possibility of equilibrium outcomes with pooling, we focus without loss of generality on binary contract menus that contain two elements; \mathcal{C}_θ and some contract $\mathcal{C}_P \neq \mathcal{C}_\theta$ such that, if the menu is accepted, the buyer selects either \mathcal{C}_θ or \mathcal{C}_P for all $\theta \in \Theta$. In an uninformative equilibrium, every type $\theta \in \Theta$ submits the same pooling offer $\mathfrak{C}_P = \{\mathcal{C}_P, \mathcal{C}_\theta\}$ and selects the same contract from this menu. In a partially revealing equilibrium, offers may but need not contain more than two elements. The defining feature is that not all buyer types choose the same contract although some contracts are chosen by more than one type. For example, an equilibrium in which all types submit the same offer $\mathfrak{C}_P = \{\mathcal{C}_P, \mathcal{C}_\theta\}$ and both contracts are sometimes chosen is partially

revealing.

A binary contract offer $\mathfrak{C}_P = \{\mathcal{C}_P, \mathcal{C}_\emptyset\}$ must meet both parties' participation constraints. Clearly, the element \mathcal{C}_\emptyset trivially satisfies this condition. By contrast, \mathcal{C}_P meets the buyer's participation constraint only when the latter's type $\theta \in \Theta$ satisfies

$$x_P \theta_x + z(x_P; \theta_x, \theta_z) \geq t_P. \quad (12)$$

For a given \mathcal{C}_P , let Θ^P denote the subset of buyer types for whom (12) holds.

Similarly, \mathcal{C}_P satisfies the seller's participation constraint if and only if

$$t_P \geq x_P E[\theta_x | \mathfrak{C}]. \quad (13)$$

In words, the seller must deem the fixed transfer larger than the forgone common value, given beliefs that are conditional on the observed offer.

Two considerations determine how the expectations in (13) are formed. First, the seller must conjecture what subset of Θ would make such an offer $\mathfrak{C}_P = \{\mathcal{C}_P, \mathcal{C}_\emptyset\}$. Let Θ_1^P denote this subset. Second, the seller must infer what subset of Θ_1^P prefers \mathcal{C}_P over \mathcal{C}_\emptyset . Let Θ_2^P denote this subset. Suppose the seller conjectures $\Theta_1^P = \Theta$, that is, it believes that all types $\theta \in \Theta$ make the observed offer (as must be true in an uninformative equilibrium). Then, $\Theta_2^P = \Theta^P$ and (13) can be written as

$$t_P \geq x_P E[\theta_x | \theta \in \Theta^P]. \quad (14)$$

An uninformative equilibrium offer \mathfrak{C}_P must satisfy (14) and further requires out-of-equilibrium beliefs that prevent deviations from \mathfrak{C}_P .

Lemma 1 *Suppose only Condition D is satisfied. In the absence of restrictions on the offer form,*

- *There always exists one fully revealing equilibrium.*
- *There is a unique threshold value $\underline{\mu}_x \in (\underline{\theta}_x, \bar{\theta}_x)$ such that an uninformative equilibrium exists if and only if $E(\theta_x) \leq \underline{\mu}_x$.*
- *A partially revealing equilibrium exists if and only if there exists a pooling offer $\mathcal{C}_P = [x_P, t_P, 0]$ such that $t_P \geq x_P E[\theta_x | \theta_x \in \Theta_x^+(\mathcal{C}_P)]$.*

As is common in signaling games, the equilibrium can but need not be unique. The separating outcome of Proposition 2 always exists. Hence, any unique equilibrium is fully revealing. Since the seller's participation constraint is *binding*

for every type in this outcome, any alternative offer that some types find more attractive, if attributed to the highest of those types, is unacceptable to the seller.

By contrast, uninformative equilibria do not exist, unless *every* buyer type weakly prefers some uninformative offer over the separating offer. This is only the case when the seller's average outside option, $E(\theta_x)$, is so low as to warrant a sufficiently low pooling price. Indeed, skewing the probability distribution toward type $\underline{\theta}_x$ raises every type's pooling payoff but leaves their separating payoff unchanged.

Finally, there can be partially revealing equilibria. For example, given some offer \mathcal{C}_P , let $\Theta_x^+(\mathcal{C}_P) \subset \Theta_x^+$ denote the subset of buyer types that prefers \mathcal{C}_P over the separating outcome. If \mathcal{C}_P is acceptable to the seller under the premise that it is made by all types in $\Theta_x^+(\mathcal{C}_P)$, there is an equilibrium in which all types in $\Theta_x^+(\mathcal{C}_P)$ submit \mathcal{C}_P and all other types submit the separating offer schedule.

The proclivity for pooling increases as the seller's average outside option decreases, that is, as pooling becomes more lucrative (less expensive) for high (low) types. Indeed, all buyer types are weakly better off in partially revealing or uninformative equilibria than in the separating equilibrium; else, some type would deviate to the separating offer, which invariably succeeds. In the limit, as $E(\theta_x) \rightarrow \underline{\theta}_x$, every buyer type prefers the efficient (uninformative) equilibrium over any other equilibrium. An appealing conjecture is that, under such conditions, standard refinement criteria select the efficient uninformative equilibrium. Yet, this is not the case. On the contrary, Cho and Kreps (1987)'s intuitive criterion uniquely selects the fully revealing equilibrium, even though it is every type's least preferred.

Proposition 5 *Only the fully revealing equilibrium survives the intuitive criterion.*

Under the intuitive criterion, there is always some, however small, deviation that causes pooling offers to collapse.

5.2 Inscrutable private information

We now turn to the case of two-dimensional private information, in which the buyer observes both θ_x and θ_z but the seller observes neither. First, we note that

the proof of Lemma ?? is still valid, except that the condition for the existence of efficient uninformative equilibria becomes $\underline{\theta}_x + z(1; \underline{\theta}_x, \underline{\theta}_z) \geq E(\theta_x)$. At the same time, one expects the additional private information about θ_z to make separating offers more difficult. The reason is that all aforementioned signaling devices — stochastic offers, trade rationing, revenue sharing, and security design — exploit the relation between θ_x and z . Being less informed about θ_z , and therefore about this relation, impairs the seller’s ability to infer the common value from the private benefits.

To illustrate this point in a stark way, we demonstrate how two-dimensional private information affects the security design solution with linear sharing rules.

Proposition 6 *Suppose only Condition V is satisfied and contingent transfers are unrestricted. If the buyer has private information about both θ_x and θ_z , there exists no equilibrium in which θ_x is fully revealed to the seller.*

It is instructive to consider why the specific signaling mechanisms in Propositions 3 and 4 collapse. Linear sharing rules enable the buyer to signal its type by relinquishing a particular fraction of $v = \theta_x + z$. The willingness to do so is informative because there is symmetric information about $\partial z / \partial \theta_z$. Private information about $\partial z / \partial \theta_z$ on part of the buyer obstructs the seller’s inference: It is unclear to what extent the relinquished part of v is private benefits or common value.¹⁴

The collapse of the security design solution illustrates the problem even more starkly. With θ_z known, there is a one-to-one mapping from common value θ_x to total value $v(1; \theta_x, \theta_z)$. This allows the buyer to signal θ_x , and to offer $t = \theta_x$, by accepting a commensurate penalty in the event of $v > v(1; \theta_x, \theta_z)$. When less informed about θ_z , the seller must be wary of another type (θ'_x, θ'_z) with larger common value $\theta'_x > \theta_x$ but identical total value $v(1; \theta'_x, \theta'_z) = v(1; \theta_x, \theta_z)$. Under the above contract, type (θ'_x, θ'_z) would earn (precisely $\theta'_x - \theta_x$) more than under full information, and hence more than under a fully revealing contract. In fact, since these types are ex post indistinguishable, there is no penalty scheme that

¹⁴While the same problem undermines signaling via stochastic offers, signaling via trade rationing can remain feasible. Unlike the other signaling devices, rationing quantity need not reduce common value and private benefits in the same proportions for all types since $\partial z / \partial x$ can vary across types. Due to this variation, trade rationing retains discriminatory power under two-dimensional private information. Still, full revelation can break down as for instance when $\partial v(x; \theta_x, \theta_z) / \partial x > \partial v(x; \theta'_x, \theta'_z) / \partial x$ for some $\theta_x < \theta'_x$ and $\theta_z > \theta'_z$.

can discriminate between them based on ex post information.¹⁵

Intuitively, Proposition 6 can be explained as follows. The smart buyer problem arises because the seller is less informed about the common value. The buyer can overcome this problem contractually by sharing trade surplus, provided that the seller knows how trade surplus relates to common value. Yet, this signaling mechanism breaks down when the informational disadvantage is so severe that the seller, for any given common value, cannot fathom the buyer’s ability to add value; that is, communicating private information becomes more difficult for the buyer when the seller does not “understand the business.”

Example 8 (Merger). Consider a takeover of a small firm by a larger industry peer (A5). The acquirer paints a bleak picture of the target’s stand-alone future (low estimates of θ_x) but a rosy one of the potential merger synergies (high estimates of z). With the target being wary of low cash offers, the acquirer considers an offer that includes an equity stake in the merged firm.

The problem is that the post-merger value (v) also depends on the quality of the acquirer’s assets (θ_z), about which the target is not well-informed. Suspicious again, the target demands a large stake to be on the safe side. This demand in turn makes equity payments less attractive to the acquirer. The acquirer is caught in a dilemma: It needs to concede equity to overcome the smart buyer problem (private information about θ_x), but issuing equity suffers from the lemons problem (private information about θ_z).

6 Concluding remarks

Our analysis of bilateral trade frictions, and their contractual resolution, premises that the buyer is better informed about the seller’s outside option. This outside option, which we posit in *reduced form*, could be the seller’s (counterfactual) payoff either when retaining the good indefinitely or when seeking out alternative buyers to eventually sell the good. In the latter case, our implicit assumption

¹⁵When v is a random variable drawn from a conditional distribution $h(v|\theta_x, \theta_v)$, differences in $h(v|\theta_x, \theta_v)$ across types with identical $E(v|\theta_x, \theta_z)$ may facilitate separation. Still, if (a subset of) different types have identical $h(v|\theta_x, \theta_v)$, the above result holds. For example, this is the case when v is normal, and θ_x and θ_z only affect the conditional mean. If $h(v|\theta_x, \theta_v)$ is different for each type, types can be described by a single parameter. Though this need not ensure full revelation; within the “redefined” type space, separation may still be infeasible because the single-crossing property need not hold.

is that searching for alternative buyers is costly, and that the initial buyer has private information about the costs and benefits of doing so. Clearly, a natural extension is to embed the current model into a search market, in which participants on one side of the market are informed about each other's valuations, whereas participants on the other side of the market only know their individual valuations. In such a setting, every meeting between potential trading partners results in a smart buyer problem, since one has private information about the other's *outside* option. What contracts would arise in equilibrium, and how would they depend on the (severity of the) search frictions?

Another promising avenue, touched upon in Section 4, is to explore the role of intermediaries in brokering trade. In practice, laypeople frequently employ experts as agents to negotiate trades with the other (better informed) side of the market, often motivated by the fear of otherwise being short-changed. Conversely, better informed parties sometimes use "front men" to trade on their behalf in order to avoid suspicion. This use of third parties by both buyers and sellers has possibly interesting implications for market structure, intermediary contracts, and firm boundaries. These issues as well as more specific applications of the smart buyer framework are left for future research.

Appendix

6.1 Proof of Proposition 1

The inexistence of a deterministic separating equilibrium is explained in the text. It remains to be shown that a stochastic separating equilibrium must satisfy the properties stated in the proposition.¹⁶

Given the buyer's expected payoff function satisfies the single-crossing property, a fully revealing equilibrium is the solution to the maximization problem

$$\begin{aligned} \max_{\hat{\theta}_x} & p(\hat{\theta}_x)[\theta_x + z(1; \theta_x, \theta_z)] - \bar{t}(\hat{\theta}_x) \\ \text{s.t.} & \bar{t}(\hat{\theta}_x) \geq p(\hat{\theta}_x)\theta_x & \text{(PC)} \\ & p'(\theta_x)[\theta_x + z(1; \theta_x, \theta_z)] = \bar{t}'(\theta_x) & \text{(FOC)} \\ & p'(\theta_x) \geq 0 & \text{(M)} \end{aligned}$$

where $\hat{\theta}_x$ is the buyer's self-reported type (Baron and Myerson, 1982).

The first-order condition (FOC) and the monotonicity condition (M) are necessary and sufficient for incentive compatibility.

Necessity: Consider two arbitrary buyer types, θ_x^h and $\theta_x^l < \theta_x^h$. The downstream incentive compatibility constraint is

$$p(\theta_x^h)[\theta_x^h + z(1; \theta_x^h, \theta_z)] - \bar{t}(\theta_x^h) \geq p(\theta_x^l)[\theta_x^h + z(1; \theta_x^h, \theta_z)] - \bar{t}(\theta_x^l).$$

Similarly, the upstream incentive compatibility constraint is

$$p(\theta_x^l)[\theta_x^l + z(1; \theta_x^l, \theta_z)] - \bar{t}(\theta_x^l) \geq p(\theta_x^h)[\theta_x^l + z(1; \theta_x^l, \theta_z)] - \bar{t}(\theta_x^h).$$

Rearranging and combining these constraints yield

$$[p(\theta_x^h) - p(\theta_x^l)] [\theta_x^h + z(1; \theta_x^h, \theta_z)] \geq \bar{t}(\theta_x^h) - \bar{t}(\theta_x^l) \geq [p(\theta_x^h) - p(\theta_x^l)] [\theta_x^l + z(1; \theta_x^l, \theta_z)]. \quad (15)$$

By Assumption 1, $\theta_x + z(1; \theta_x, \theta_z)$ is increasing in θ_x . Hence, (15) can hold only if $p(\theta_x)$ is non-decreasing in θ_x . Dividing by $(\theta_x^h - \theta_x^l)$ and taking the limit $(\theta_x^h - \theta_x^l) \rightarrow 0$ implies (FOC) and (M).

Sufficiency: Using (FOC) to substitute for $\bar{t}'(\hat{\theta}_x)$ in the first derivative of the

¹⁶We thank Vladimir Vladimirov for comments that helped us to greatly shorten this proof.

objective function and rearranging yields

$$p'(\hat{\theta}_x)[\theta_x - \hat{\theta}_x + z(1; \theta_x, \theta_z) - z(1; \hat{\theta}_x, \theta_z)] \quad (16)$$

Since $z_{\theta_x}(x; \theta_x, \theta_z) \geq 0$ (Assumption 1), condition (M) implies that (16) is positive for all $\hat{\theta}_x \leq \theta_x$ but negative for all $\hat{\theta}_x \geq \theta_x$. That is, the buyer's objective function is quasi-concave.

To construct the cheapest mechanism for the buyer, we impose that the seller's participation constraint (PC) binds for every buyer type. Differentiating on both sides with respect to θ_x and substituting in (FOC) yields the differential equation $p'(\theta_x) = p(\theta_x)[z(1; \theta_x, \theta_z)]^{-1}$, which implies

$$p(\theta_x) = p(\bar{\theta}_x) \exp \left[- \int_{\bar{\theta}_x}^{\theta_x} [z(1; s, \theta_z)]^{-1} ds \right].$$

Since the buyer's expected payoff, $p(\theta_x)z(1; \theta_x, \theta_z)$, increases in $p(\theta_x)$, it is immediate that $p(\bar{\theta}_x) = 1$. Note that $p(\theta_x)$ is differentiable, meets the properties of a probability, $p(\theta_x) \in [0, 1]$, and satisfies (M). ■

6.2 Proof of Proposition 2

Parallel to Proposition 1, a fully revealing equilibrium is the solution to the maximization problem

$$\begin{aligned} \max_{\hat{\theta}_x} & x(\hat{\theta}_x)\theta_x + z(x(\hat{\theta}_x); \theta_x, \theta_z) - t(\hat{\theta}_x) \\ \text{s.t.} & \quad t(\hat{\theta}_x) \geq x(\hat{\theta}_x)\theta_x \quad (\text{PC}) \\ & \quad x'(\theta_x)\theta_x + z(x; \theta_x, \theta_z) = t'(\theta_x) \quad (\text{FOC}) \\ & \quad x'(\theta_x) \geq 0 \quad (\text{M}) \end{aligned}$$

where $\hat{\theta}_x$ is the buyer's self-reported type. As before, (FOC) and (M) are necessary and sufficient for incentive compatibility.

To construct the cheapest mechanism for the buyer, we impose that the seller's participation constraint (PC) binds for every buyer type. Differentiating on both sides with respect to θ_x and substituting in (FOC) yields the differential equation $x'(\theta_x) = x(\theta_x)[z_x(x(\theta_x); \theta_x, \theta_z)]^{-1}$. Note that (M) is satisfied. Since the principal's expected payoff increases in $x(\theta_x)$, it is immediate that $x(\bar{\theta}_x) = 1$. ■

6.3 Proof of Proposition 3

It is straightforward to see that (8) is isomorphic to (1), and Proposition 1 therefore applies.

6.4 Proof of Proposition 4

A buyer of type θ_x receives the payoff $z(1; \theta_x, \theta_z)$ when making a truthful offer with the fixed transfer θ_x . Now consider its payoff when mimicking a lower valued type $\theta'_x < \theta_x$. By Assumption 1, $v(1; \theta'_x, \theta_z) < v(1; \theta_x, \theta_z)$. Hence, when mimicking type θ'_x , type θ_x would incur a penalty $\tau > \theta_x - \theta'_x$ and its payoff would be less than $z(1; \theta_x, \theta_z)$. Now consider the payoff from mimicking any type $\theta''_x > \theta_x$. By Assumption 1, $v(1; \theta''_x, \theta_z) > v(1; \theta_x, \theta_z)$. Hence, mimicking would not trigger a penalty, but type θ_x would pay a fixed transfer of θ''_x , which is higher than the fixed transfer θ_x under its truthful offer. ■

6.5 Proof of Lemma 1

Existence of single fully revealing equilibrium: Consider the fully revealing equilibrium in Proposition 2. We show that there exist seller beliefs such that any deviation to another (not fully revealing) contract (menu) is rejected.

Denote the preferred contract of type θ'_x in the fully revealing equilibrium by $\mathcal{C}' = [x', t', 0]$. Suppose that the deviation offer contains a contract $\mathcal{C}_1^d = [x_1^d, t_1^d, 0]$ that type θ'_x strictly prefers to \mathcal{C}' where $x_1^d \leq x'$. Given $z_x \geq 0$ (Assumption 1), the total surplus is weakly smaller under \mathcal{C}_1^d than under \mathcal{C}' . Since type θ'_x strictly prefers \mathcal{C}_1^d over \mathcal{C}' , the seller's payoff must be smaller under \mathcal{C}_1^d than under \mathcal{C}' if chosen by type θ'_x . Given the seller breaks even under \mathcal{C}' , beliefs that assign the deviation offer to type θ'_x cause the seller to reject it.

Now suppose that the deviation offer contains a contract $\mathcal{C}_2^d = [x_2^d, t_2^d, 0]$ that type θ'_x strictly prefers to \mathcal{C}' where $x_2^d > x'$. In this case, x^d must be equal to the quantity that some higher type $\theta''_x \in (\theta'_x, \bar{\theta}_x]$ trades in the fully revealing outcome. Denote the preferred contract of type θ''_x in the fully revealing equilibrium by $\mathcal{C}'' = [x'', t'', 0]$ where $x'' = x_2^d$. Since type θ'_x prefers \mathcal{C}' over \mathcal{C}'' (by incentive compatibility), it also prefers \mathcal{C}_2^d over \mathcal{C}'' (by transitivity). Because $x'' = x_2^d$, this implies $t'' > t^d$ so that type θ''_x also prefers \mathcal{C}_2^d over \mathcal{C}'' . This in turn implies that the seller's payoff is smaller under \mathcal{C}_2^d than under \mathcal{C}'' if chosen by type θ''_x . Given

the seller breaks even under \mathcal{C}'' , beliefs that assign the deviation offer to type θ'_x cause the seller to reject it.

Defining off-equilibrium beliefs in this manner, one can deter all potential deviations of every buyer type to support the unique fully revealing equilibrium of Proposition 2.

Existence of an uninformative equilibrium: An uninformative equilibrium exists when a binary offer $\mathfrak{C}_P = \{\mathcal{C}_P, \mathcal{C}_\emptyset\}$ (a) satisfies the seller's participation constraint and (b) yields a higher payoff for every type than in the fully revealing equilibrium. Therefore, all buyer types must participate in an uninformative equilibrium, and the lowest acceptable price is $P_P = E(\theta_x) \equiv \mu_x$. The payoff of type θ'_x in such an equilibrium is

$$\Pi_P(\theta'_x) = x_P \theta'_x + z(x_P; \theta'_x, \theta_z) - \mu_x.$$

Unlike the buyer's payoff in the fully revealing equilibrium, $\Pi_P(\theta'_x)$ depends on the probability distribution of θ_x over Θ_x , in particular $\partial \Pi_P(\theta'_x) / \partial \mu_x < 0$ for all $\theta'_x \in \Theta_x$. Hence, for sufficiently large x_P , condition (b) can always be satisfied by letting $\mu_x \rightarrow \underline{\theta}_x$.

For example, consider the limit $\lim_{\mu_x \rightarrow \underline{\theta}_x} \Pi_P(\theta'_x)$ for $x_P = 1$:

$$\lim_{\mu_x \rightarrow \underline{\theta}_x} \Pi_P(\theta'_x) = \theta'_x + z(1; \theta'_x, \theta_z) - \underline{\theta}_x.$$

For every $\theta'_x \in \Theta_x$, this limit is weakly larger than the buyer's payoff under full information, and hence also larger than in the fully revealing equilibrium. Thus, there exist some threshold $\underline{\mu}_x \in (\underline{\theta}_x, \bar{\theta}_x]$ such that, for $\mu_x < \underline{\mu}_x$, some binary offer makes every type better off than in the fully revealing equilibrium.

Finally, we show that there exist seller beliefs such that any deviation from such a binary offer is rejected. Deviations to any other contract menu that contains some contract with $P < \bar{\theta}_x$ can be deterred by beliefs attributing this offer to type $\bar{\theta}_x$. Offers that contain only contracts with $P \geq \bar{\theta}_x$ yield lower payoffs than the payoffs in the fully revealing equilibrium, which by construction are lower than those under the binary offer.

Existence of partially revealing equilibrium: A partially revealing equilibrium can only exist if there is a binary offer that is (a) satisfies the seller's participation constraint and (b') yields a higher payoff than in the fully revealing equilibrium for a subset of buyer types. For any binary offer $\mathfrak{C}_P = \{\mathcal{C}_P, \mathcal{C}_\emptyset\}$,

define a subset $\Theta_x(\mathcal{C}_P) \subset \Theta_x$ that contains all buyer types whose payoff is larger under $\mathcal{C}_P = [x_P, t_P, 0]$ than in the fully revealing equilibrium. There always exist some \mathcal{C}_P such that $\Theta_x(\mathcal{C}_P)$ is non-empty, and hence satisfy condition (b'). Such an offer also satisfies condition (a) if and only if

$$t_P \geq x_P E[\theta_x | \theta_x \in \Theta_x(\mathcal{C}_P)]. \quad (17)$$

Whenever there exists a binary offer with non-empty $\Theta_x(\mathcal{C}_P)$ that satisfies (17), there exists a partially revealing offer of the following kind: All types $\theta_x \in \Theta_x(\mathcal{C}_P)$ make the binary offer, whereas all other types make some other offer. Beliefs associated with any deviation are chosen as in the proof of the uninformative equilibrium. ■

6.6 Proof of Proposition 5

In any equilibrium other than the fully revealing one, there is a subset Θ^P with at least two types that choose the same contract $\mathcal{C}_P = [x_P, x_P P_P, 0]$. To satisfy the seller's participation constraint, $P_P \geq E(\theta_x | \theta_x \in \Theta^P)$. Denote the lowest type in that subset by $\underline{\theta}^P \equiv \min \Theta^P$. Clearly, $P_P > \underline{\theta}^P$.

Consider the contract $\mathcal{C}^d = [x^d, x^d P^d, 0]$, with $x^d = x_P - \delta$. A given type θ_x prefers \mathcal{C}^d over \mathcal{C}_P if and only if

$$x_P P_P - x^d P^d > v(x_P; \theta_x, \theta_z) - v(x^d; \theta_x, \theta_z).$$

Since the right-hand side of the inequality increases in θ_x (Assumption 1), if the inequality holds for some type θ_x , then it also holds for all lower types. Hence, we can adjust P^d such that the inequality only holds for $\theta_x \leq \underline{\theta}^P$. For very small δ , this requires a small change in P^d such that $P^d \geq \underline{\theta}^P$. Under the intuitive criterion, the seller assigns the deviation \mathcal{C}^d to types $\theta_x \leq \underline{\theta}^P$. Given $P^d \geq \underline{\theta}^P$, the seller therefore never rejects the contract. Thus, any equilibrium other than the fully revealing equilibrium does not survive the intuitive criterion. ■

6.7 Proof of Proposition 6

For the proof, it is convenient to define buyer types in the θ_x - z -space. We proceed as follows: (I) We characterize necessary conditions for separating types with different θ_x but the same total valuation v . (II) We then characterize

necessary conditions for separating types with different v . (III) We demonstrate that the conditions in (I) and (II) cannot be reconciled with each other.

(I) Define $\Theta_v \equiv \{(\theta_x, z) : \theta_x + z = v_i\}$, which contains some type $(\bar{\theta}_x, \hat{z})$. Using $z = v - \theta_x$, we can express any type in Θ_v in terms of θ_x only, namely $(\theta_x, v - \theta_x)$. Let $\mathfrak{C}_v(\theta_x) = \{[1, t_v(\theta_x), [1 - \alpha_v(v; \theta_x)]v]\}$ denote an offer that separates all types in Θ_v , where $\alpha_v(v; \theta_x)v$ is a claim contingent on the realized v . For a given contract in this offer, type θ_x 's payoff is

$$\Pi(\theta_x) = E[\alpha_v(v; \theta_x)v | v] - t_v(\theta_x) = \alpha_v(v; \theta_x)v - t_v(\theta_x), \quad (18)$$

which is deterministic because the buyer knows its v . To achieve separation in Θ_v , the payoff must satisfy the invariance condition

$$\Pi(\theta_x) = \bar{\Pi} \quad \text{for all } \theta \in \Theta_v. \quad (19)$$

Otherwise, some types in Θ_v would be mimicked by other types in the set. Furthermore, note that $\bar{\Pi} = \hat{z}$. Otherwise, type $(\bar{\theta}_x, \hat{z})$ would deviate to the contract $[1, \bar{\theta}_x, 0]$. Using this, merging (18) and (19), and simplifying yields

$$t_v(\theta_x) = \bar{\theta}_x - \beta_v(v; \theta_x)v \quad (20)$$

where $\beta_v(v; \theta_x)v \equiv [1 - \alpha_v(v; \theta_x)]v$ denotes the contingent claim paid to the seller. For $\partial\beta_v(v; \theta_x)/\partial\theta_x \neq 0$, (20) characterizes all offers $\mathfrak{C}_v(\theta_x)$ that achieve separation within Θ_v , that is, separation of all types that generate the same total value v .

The invariance condition pins down a buyer's payoff as a function of total valuation. This function is given by, with slight abuse of notation, $\Pi(v) = \hat{z} = v - \bar{\theta}_x$. That buyer profits follow this function *across* Θ_v s is a necessary condition for separation *within* Θ_v s. Importantly, note that the function is *linear* in v , that is,

$$\partial\Pi/\partial v = 1. \quad (21)$$

(II) We now consider separation across different v , which is a necessary condition for achieving separation across all $\theta_x \in \Theta_x$. (If marginally different v are not separated, some θ_x -types are pooled.) A direct mechanism that separates different v must yield $\arg \max_{\hat{v}} \{E[\alpha(v; \hat{v})v | v] - t(\hat{v})\} = v$ for all v . The

corresponding first-order condition is

$$\frac{\partial \alpha(v; v)}{\partial v} v = \frac{\partial t(v)}{\partial v}. \quad (22)$$

By the envelope theorem, separation across v requires that equilibrium payoffs must vary across v according to

$$\partial \Pi / \partial v = \alpha(v; v). \quad (23)$$

(III) Conditions (21) and (23) can only hold simultaneously if $\alpha(v; v) = 1$. This already shows that separation cannot simultaneously hold within each Θ_v and across v . Indeed, substituting $\alpha(v; v) = 1$ — more precisely, $\partial \alpha(v; v) / \partial v = 0$ — into (22) yields $\partial t(v) / \partial v = 0$, which in turn implies that $t(v) = K$ where K is some constant. It is obvious that $\alpha(v; v) = 1$ and $t(v) = K$ cannot achieve separation across v .

References

- Akerlof, George, 1970, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism," *Quarterly Journal of Economics*, 84: 488–500.
- Axelson, Ulf, 2007, "Security Design With Investor Private Information," *Journal of Finance* 62(6), 2587-2632.
- Banks, Jeffrey S., 1990, "Monopoly Agenda Control and Asymmetric Information," *Quarterly Journal of Economics*, 105 (2), 445-464.
- Benveniste, L. and P. Spindt, 1989, "How investment bankers determine the offer price and allocation of new issues," *Journal of Financial Economics* 24, 343-361.
- Berkovitch, Elazar and M. P. Narayanan, 1990, "Competition and the Medium of Exchange," *Review of Financial Studies*, 3(2), 153-174
- Bolton, Patrick and Mathias Dewatripont, 2005, *Contract Theory*, MIT Press Cambridge Ma.
- Burkart, Mike and Samuel Lee, 2010, "Signaling in Tender Offer Games," FMG Discussion Paper No. 655.
- Che, Yeon-Koo and Jinwoo Kim, 2010, "Bidding with Securities: Comment," forthcoming, *American Economic Review*
- Chen, Qi, Itay Goldstein, and Wei Jiang, 2007, "Price Informativeness and Investment Sensitivity to Stock Prices," *Review of Financial Studies*, 20(3), 619-650.
- Cho, In-Koo and David M. Kreps, 1987, "Signaling games and stable equilibria," *Quarterly Journal of Economics* 102:179-221.
- Dari-Mattiacci, Giuseppe, Sander Onderstal and Francesco Parisi, 2010, "Inverse Adverse Selection: The Market for Gems," *Amsterdam Center for Law & Economics Working Paper No. 2010-04*
- Datar, S., R. Frankel, and M. Wolfson, 2001, "Earnouts: The Effects of Adverse Selection and Agency Costs on Acquisition Techniques," *Journal of Law, Economics, and Organization* 17, 201–37.

- DeMarzo, Peter and Darrell Duffie, 1999, "A Liquidity-Based Model of Security Design," *Econometrica*, 67(1), 65-99.
- DeMarzo, Peter, Kremer, Ilan and Skrzypacz, Andrzej. "Bidding with Securities: Auctions and Security Design," *American Economic Review*, 2005, 95, 936-959.
- Eckbo, B. Espen, Ronald M. Giammarino and Robert L. Heinkel, 1990, "Asymmetric Information and the Medium of Exchange in Takeover: Theory and Tests," *Review of Financial Studies*, 3(4), 651-675.
- Gallini, Nancy T. and Brian D. Wright, 1990, "Technology Transfer under Asymmetric Information," *RAND Journal of Economics*, 21(1), 147-160.
- Gallant, Jeffrey M. and Brian L. Ross, 2009, "SPACs And The Business Combination Agreement," accessed online on 09/12/2010 at www.graubard.com/FinancierWorldwide012009%5B1%5D.pdf.
- Garmaise, Mark, 2007, "Informed Investors and the Financing of Entrepreneurial Projects," UCLA.
- Gaughan, P. 2002, *Mergers, Acquisitions and Corporate Restructuring*, 3rd edition John Wiley & Sons.
- Gorbenko, Alexander S. and Andrei Malenko, 2010, "Competition among Sellers in Securities Auctions," forthcoming *American Economic Review*
- Goetzmann, William N., S. Abraham Ravid, Ronald Sverdlove, and Vicente Pascual Pons-Sanz, 2007, "The Role of Soft and Hard Information in the Pricing of Assets and Contract Design - Evidence from Screenplay Sales," EFA 2008 Athens Meetings Paper.
- Grossman, Sanford J. and Oliver D. Hart, 1981, "The Allocational Role of Takeover Bids in Situations of Asymmetric Information," *Journal of Finance*, 36(2), 253-270.
- Hansen, Robert, 1985, "Auctions with Contingent Payments," *American Economic Review*, Papers and Proceedings, 75(4), 862-865.
- Hansen, Robert G., 1987, "A Theory for the Choice of Exchange Medium in Mergers and Acquisitions," *Journal of Business*, 60(1), 75-95.

- Hirshleifer, David and Sheridan Titman, 1990, "Share Tendering Strategies and the Success of Hostile Takeover Bids," *Journal of Political Economy*, 98(2), 295-324.
- Hietala, Pekka et al., 2003, "What is the Price of Hubris? Using Takeover Battles to Infer Overinvestments and Synergies," *Financial Management*, Autumn 2003, 5-31.
- Horner, Johannes, forthcoming, "Signaling," *New Palgrave Dictionary of Economics*, 2nd edition.
- Grossman, Sanford J. and Motty Perry, 1986, "Perfect Sequential Equilibria," *Journal of Economic Theory*, 39, 97-119.
- Kyle, Albert S., 1985, "Continuous Auctions and Insider Trading," *Econometrica* 53(6), 1315-1335.
- Lee, Charles M. C. and Mark J. Ready, 1991, "Inferring Trade Direction from Intraday Data," *Journal of Finance*, 46, 733-46.
- Lyandres, Evgeny, Alexei Zhdanov, and Jim Hsieh, 2010, "A Theory of Merger-Driven IPOs," *Journal of Financial and Quantitative Analysis*, forthcoming.
- Mailath, George J. and Von Thadden, Ernst-Ludwig, 2010, "Incentive Compatibility and Differentiability: New Results and Classic Applications," *PIER Working Paper No. 10-32*.
- Maskin, Eric and Jean Tirole, 1992, "The Principal-Agent Relationship with an Informed Principal, II: Common Values," *Econometrica*, 60(1), 1-42.
- Milgrom, Paul and Nancy Stokey, 1982, "Information, trade and common knowledge," *Journal of Economic Theory* 26 (1), 17-27.
- Mueller, Holger and Roman Inderst, 2006, "Informed Lending and Security Design," *Journal of Finance*, 61, 2137-2162.
- Myers, Stewart and Nicholas S. Majluf, 1984, "Corporate Financing and Investment Decisions when Firms have Information that Investors do not have," *Journal of Financial Economics*, 13, 187-221.

Officer, M., “Collars in Merger Negotiations,” *Journal of Finance* 59 (2004), 2719–43.

Rhodes-Kropf, M. and S. Viswanathan, 2000, “Corporate Re-organizations and Non-Cash Auctions,” *Journal of Finance* 55, 1807-1854

Riley, 1979, “Informational Equilibrium,” *Econometrica*, 47(2), 331–59.

Riley 2001, “Silver Signals: Twenty-Five Years of Screening and Signaling,” *Journal of Economic Literature*, 39, 432-478.

Rochet, Jean-Charles and Lars Stole, 2003, “The Economics of Multidimensional Screening,” in *Advances in Economics and Econometrics: Theory and Applications - Eight World Congress*, M. Dewatripont, L. P. Hansen and S. J. Turnovsky (eds.), series “Econometric Society Monographs”, n. 36, Cambridge University Press.

Shleifer, Andrei and Robert W. Vishny, 1986, “Large Shareholders and Corporate Control,” *Journal of Political Economy*, 94(3), 461-488.

Spence, Michael, 1973, “Job Market Signaling,” *Quarterly Journal of Economics*, 87(3), 355–374.

Subrahmanyam, Avanidhar and Sheridan Titman, 1999, The Going-Public Decision and the Development of Financial Markets, *Journal of Finance* 54, 1045-1082.

Weinstein, Mark, 1998, “Profit-sharing contracts in Hollywood: Evolution and Analysis,” *Journal of Legal Studies*, 27, 67-112.