european corporate governance institute

The Inefficiency of Hostile Takeovers as a Disciplinary Mechanism: A Theoretical Analysis

Law Working Paper N° 781/2024
June 2024

Sang Yop Kang
Peking University and ECGI

© Sang Yop Kang 2024. All rights reserved. Short sections of text, not to exceed two paragraphs, may be quoted without explicit permission provided that full credit, including © notice, is given to the source.

This paper can be downloaded without charge from:
https://doi.org/10.67929/ecgi-law-781-2024

european corporate governance institute

ECGI Working Paper Series in Law

The Inefficiency of Hostile Takeovers as a Disciplinary Mechanism: A Theoretical Analysis

Working Paper N° 781/2024

June 2024

Sang Yop Kang

© Sang Yop Kang 2024. All rights reserved. Short sections of text, not to exceed two paragraphs, may be quoted without explicit permission provided that full credit, including © notice, is given to the source.

Abstract

Traditionally, takeovers are seen as a mechanism to improve societal efficiency by acquiring low-value firms at low costs, thereby eliminating poorly managed companies. However, this article challenges this view, demonstrating that certain market infrastructure issues can cause pricing distortions in capital markets. These market infrastructure issues include information asymmetry, imperfect industrial organizations, subsidies and support by the government or other entities, and capital-market imperfections. Such capital-market pricing distortions from market infrastructure issues can keep the value of bad-quality companies high. Conversely, high-quality companies may be undervalued, making them unintended targets. In either case, the disciplinary role of takeovers is undermined. Therefore, countries with serious corporate governance problems should address market infrastructure issues before encouraging hostile takeovers and relaxing related rules that previously restrict bidders' activities. In addition, this article argues that in countries with certain market infrastructure issues, hostile takeovers are not necessarily effective in enhancing the general quality of management competitiveness, corporate efficiency, or improving corporate governance. It also contends that the efficiency of hostile takeovers depends on the soundness of market infrastructure, a factor often overlooked by academia and policymakers.

Keywords: Hostile takeover, market infrastructure issues, price distortions in the capital market, disciplinary role of hostile takeovers

Sang Yop Kang
Professor of Law
Peking University
University Town, Xili, Nanshan District
Shenzhen 518055, China
e-mail: sykang@stl.pku.edu.cn

THE INEFFICIENCY OF HOSTILE TAKEOVERS AS A DISCIPLINARY MECHANISM: A THEORETICAL ANALYSIS

*Sang Yop Kang**

ABSTRACT

Traditionally, takeovers are seen as a mechanism to improve societal efficiency by acquiring low-value firms at low costs, thereby eliminating poorly managed companies. However, this article challenges this view, demonstrating that certain market infrastructure issues can cause pricing distortions in capital markets. These market infrastructure issues include information asymmetry, imperfect industrial organizations, subsidies and support by the government or other entities, and capital-market imperfections. Such capital-market pricing distortions from market infrastructure issues can keep the value of bad-quality companies high. Conversely, high-quality companies may be undervalued, making them unintended targets. In either case, the disciplinary role of takeovers is undermined. Therefore, countries with serious corporate governance problems should address market infrastructure issues before encouraging hostile takeovers and relaxing related rules that previously restrict bidders' activities. In addition, this article argues that in countries with certain market infrastructure issues, hostile takeovers are not necessarily effective in enhancing the general quality of management competitiveness, corporate efficiency, or improving corporate governance. It also contends that the efficiency of hostile takeovers depends on the soundness of market infrastructure, a factor often overlooked by academia and policymakers.

KEY WORDS

Hostile takeover; market infrastructure issues; price distortions in the capital market; disciplinary role of hostile takeovers

I. INTRODUCTION

Hostile takeovers have been an important area of corporate governance scholarship. Many papers have been written and discussed regarding hostile takeovers in the fields of economics, business administration, and law. In the 1980s, the United States experienced the peak of hostile takeovers, often dubbed the "deal decade." This era set crucial legal precedents particularly in the state of Delaware such as *Unocal Corp. v. Mesa Petroleum Co*,[1] *Moran v. Household International*,[2] *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc*,[3] and *Blasius Industries, Inc. v. Atlas Corp*.[4] These cases[5] are old but have still served as classic and significant milestones in both academic and practical discussions of hostile takeovers. As such, they are consistently recognized, analyzed, and cited internationally as matters of policy.

The introduction of the poison pill dramatically changed the landscape of hostile takeovers, making them an infrequent phenomenon. However, this decline of hostile takeover activities does not mean the lack of significance of hostile takeovers, as many mergers and acquisitions that eventually become amicable often start off contentiously. The hostile origins

[1] 493 A.2d 946 (Del. 1985).

[2] 500 A.2d 1346 (Del. 1985).

[3] 506 A.2d 173, 66 (Del. 1986).

[4] 564 A.2d 651 (Del. 1988).

[5] To briefly explain these cases: *Unocal* established an intermediate standard for hostile takeover disputes; *Moran* addressed the legality of poison pills; *Revlon* mandated directors' role to maximize the price for shareholders under certain conditions; and *Blasius* delved into "compelling justification" for certain board actions, particularly those relating to interference with shareholder franchise.

of these deals are generally not reflected in statistics because only outcomes—mostly friendly deals—rather than the entire process, are usually observed.

Outside the United States, hostile takeovers are extremely rare. Until recently, Japan experienced minimal activity in this area.[6] In China, the frequency of hostile takeovers is also very low. A notable example is Baoneng's takeover attempt against Vanke, which ultimately failed.[7] In South Korea (hereinafter Korea), although hostile takeovers attempts do occur, they are typically linked with foreign investors and rarely succeed. At this juncture, this article raises a question: Are hostile takeovers beneficial for promoting societal efficiency, and should we relax rules that previously restricted bidders' activities? Countries grappling with significant corporate governance challenges might aim to vitalize their market for corporate control. This effort could include promoting policies favoring hostile takeovers, easing previously stringent rules that limited bidders' actions, and weakening defensive measures against takeovers. Considering these countries' policy selection, this article addresses the above question primarily by criticizing the notion of a takeover system as a disciplinary mechanism.

As will be discussed in Part II, the conventional view holds that the takeover system enhances societal efficiency by eliminating low-value firms through the market for corporate control: In other words, takeovers serve as a *disciplinary* mechanism, as bidders acquire low-value firms and replace inefficient management at a low cost by purchasing cheap shares.[8]

---

[6] For the further explanation of Japan's hostile takeover outlook, *see* Dan W. Puchniak & Masafumi Nakahigashi, *The Enigma of Hostile Takeovers in Japan: Bidder Beware*, 15 BERKELEY BUS. L. J. 4 (2018).

[7] Regarding the hostile takeover regime in China and the Vanke-Baoneng case, *see* Sang Yop Kang, *The Vanke-Baoneng Takeover Battle and Beyond: Hostile Takeover(s) and Corporate Governance in China*, SSRN (first version in April 2018).

[8] Regarding the takeover system as a disciplinary mechanism, *see infra* Part II.

This perspective assumes that bad-quality firms—characterized by poor managerial skills and severe agency problems—have low firm values, as reflected in their stock prices.

In this article, however, I criticize the conventional view's general application to countries outside the United States. I theoretically demonstrate that due to various issues in market infrastructure, pricing distortions may arise in the capital markets, causing the value of bad-quality companies to remain high. Under the stock price distortions, it is difficult for the takeover system to serve effectively as a disciplinary mechanism because sometimes bidders are not able to purchase a bad-quality company's shares at a low price. Also, it is possible that high-quality companies can sometimes be takeover target companies due to the price distortions: The firm value of high-quality companies may be distortedly depressed, ironically making them more attractive targets in the market for corporate control. In such cases, the disciplinary mechanism of a takeover system is flawed and even undesirable. This article's argument is depicted in Figure 1 below. Also, Table 1 briefly introduces the concept of "market infrastructure issues" that cause pricing distortions associated with shares.

Figure 1: Negative impact of market infrastructure issues on takeovers' disciplinary role

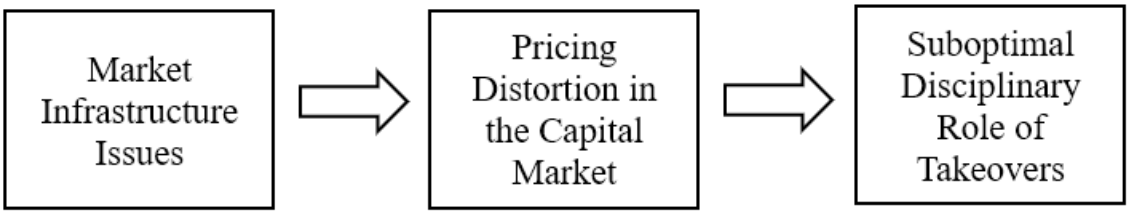


Table 1: Market infrastructure issues that negatively affect the efficiency of takeovers

	(1) Information asymmetry in the product and capital markets
	(2) Imperfect industrial organizations such as monopoly and oligopoly

Market Infrastructure Issues	(3) Subsidies and support from the government or other entities
	(4) Capital-market imperfections

The remainder of this article is structured as follows. Part II discusses the conventional view of a hostile takeover system as a disciplinary mechanism. Part III.A explains why hostile takeovers are so rare in controlling ownership structures. From Part III.B to III.E, this article demonstrates that certain market infrastructure issues can cause pricing distortions of shares. As introduced in Table 1, market infrastructure issues that this article discusses include (1) information asymmetry in the product and capital markets (Part III.B), imperfect industrial organizations such as monopoly and oligopoly (Part III.C), subsidies and support from the government or other entities (Part III.D), and capital-market imperfections (Part III.E). Part III.F provides a summary of market infrastructure issues and ownership structures in the context of hostile takeovers. Part IV summarizes and concludes the entire article.

The core argument of this article is that countries facing market infrastructure issues, as discussed in Parts III.B to III.E, will experience pricing distortions in the capital market, undermining the disciplinary role of takeovers. Additionally, this article contends that the efficiency of hostile takeovers depends on the soundness of market infrastructure, a factor often overlooked by academia and policymakers. Usually, countries with serious corporate governance problems often consider or are advised to revamp legal systems to encourage hostile takeover activities and relax restrictions that previously bidders encountered. However, this article suggests that these countries should focus on addressing market infrastructure issues before adopting policies directly in favor of hostile takeovers.

This article is a theory-oriented paper. Therefore, this article does not explore the takeover and general product/capital market situations in specific countries in detail. However, in addition to the United States, this article occasionally includes examples and explanations from specific countries such as China and Korea because they are large economies without active markets for corporate control. Also, in analyzing the disciplinary role of takeovers in jurisdictions where controlling shareholders predominate[9] and certain market infrastructure issues exist, China and Korea may provide important implications.

Globally, most countries typically have a controlling ownership structure and exhibit market infrastructure issues discussed in this article. Certainly, the impact of market infrastructure issues and corporate ownership differs from one country to another. This article does not suggest that the disciplinary function of takeovers is uniformly and consistently ineffective across the globe. Rather, it brings attention to market infrastructure issues that have been neglected in discussions about hostile takeovers and presents a pertinent analytical framework. This framework aids countries in developing policies that are customized to their unique situations.

II. TAKEOVER SYSTEM AS A DISCIPLINARY MECHANISM

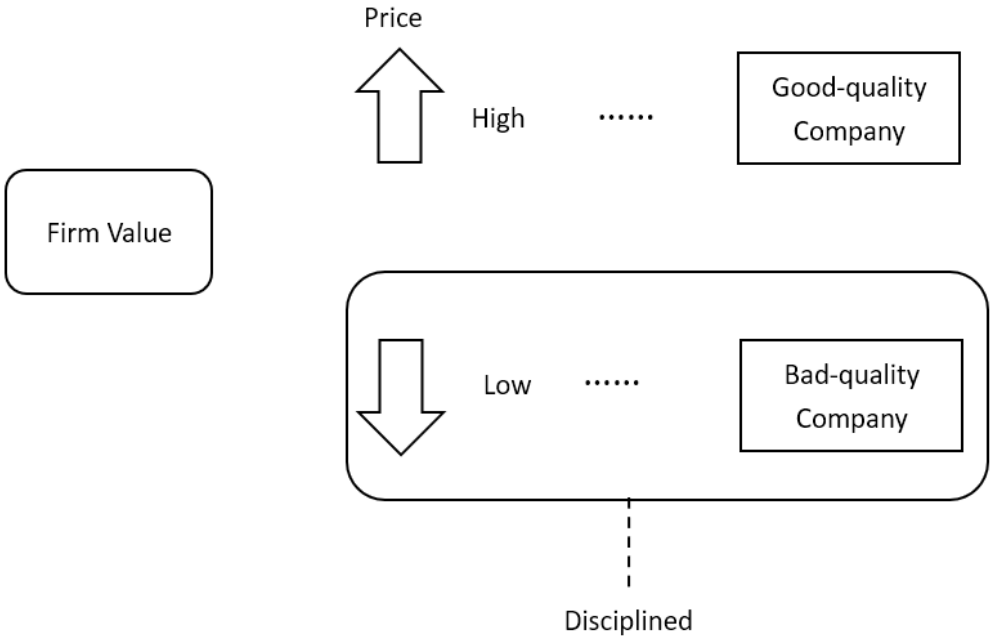
In the fields of economics and corporate law, it is often argued that hostile takeovers have the potential to significantly enhance corporate governance.[10] Figure 2 describes the

[9] Evidently, most corporations in China and Korea are based on the controlling ownership structure. *See infra* Part III.A.

[10] The role of corporate governance in contest for control was initially examined by Henry Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965). Another pivotal early academic contribution is Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to Hostile Takeovers*, 94 HARV. L. REV. 1161 (1981).

disciplinary role of hostile takeovers. Also, the conventional rationale can be encapsulated as follows.[11]

Figure 2: Disciplinary role of takeovers



Prior to hostile takeovers, potential target companies often have inefficient management, and agency problems,[12] including tunneling.[13] Consequently, the stock prices of these companies tend to be undervalued relative to their true worth. Let us present a simplified example. Suppose the intrinsic value of Company X is $20 billion in terms of market capitalization when the company operates with high management quality and corporate governance. If the total outstanding shares of Company X amount to 100 million, the *intrinsic value* per share would be $200. However, due to existing corporate governance issues such as

[11] *See, e.g.*, Henry Manne, *Bring Back the Hostile Takeover*, WSJ (June 26, 2002).

[12] For the classic explanation of "agency problem," *see, e.g.*, Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

[13] Tunneling is the practice in which controlling shareholders extract corporate value to the detriment of non-controlling shareholders or other stakeholders, such as creditors and employees. Regarding tunneling, *see generally* Simon Johnson et al., *Tunneling*, 90 AM. ECON. REV. 22 (2000).

lack of management skills, misjudgment on business matters, and fiduciary duty problems, let us suppose the current market capitalization, reflecting the firm's value, is only $10 billion. Consequently, the *current stock price* of Company X is $100 per share.

The disparity between Company X's intrinsic value and its current firm value—$20 billion versus $10 billion—creates a financial incentive for potential bidders to pursue takeovers. For instance, a bidder may offer to purchase the 60% of shares of Company X from its shareholders, equivalent to 60 million shares, at a 30% premium (i.e., $130 per share). If the bidder successfully acquires these 60 million shares at the premium price of $130 per share, the bidder's total cost for acquisition of these 60 million shares amounts to $7.8 billion.[14] As a result of acquiring 60% of the shares, the bidder successfully obtain control over Company X.

After the takeover, if management afflicted by inefficient management or agency problems is replaced by the bidder, the target company may undergo a transition to new management and improved corporate governance. For instance, suppose a scenario where Company X's firm value rises to $20 billion, aligning with its intrinsic value. Consequently, the company is expected to witness an increase in its stock price, reaching $200 per share.[15] With the bidder holding 60% of Company X's shares, the market capitalization controlled by the bidder would amount to $12 billion. Recalling that the bidder's expenditure to acquire 60% of Company X's shares was $7.8 billion, it follows that the bidder stands to gain $4.2 billion from the hostile takeover.

[14] $130 × 60 million shares = $7.8 billion.

[15] Indeed, there are instances where the acquiring entity might exploit the target company after the acquisition, potentially leading to a decline in the target company's stock price. However, due to space constraints, this article does not delve into this issue separately.

In summary, concerning the established hostile-takeover theories, several significant implications are noteworthy. First, the previous corporate insiders of Company X, associated with corporate governance problems, face the threat of being replaced by the takeover system. Second, due to the threat of replacement posed by takeovers, Company X's previous corporate insiders are motivated to enhance the quality of corporate governance to ensure their job security. Third, as illustrated in the numerical example, in the case where a hostile takeover succeeds, the bidder stands to achieve financial gains as the firm value of Company X, the target of the hostile takeover, rises. Fourth, stemming from the aforementioned three points, hostile takeovers can act as a mechanism to discipline management and enhance the quality of corporate governance throughout the economy (i.e., disciplinary function or mechanism).

III. MARKET INFRASTRUCTURE AND THE HOSTILE TAKEOVER SYSTEM

According to the conventional view discussed in Part II, hostile takeovers serve as a disciplinary measure for companies with poor management skills, market competitiveness, or corporate governance. However, the conventional view holds true only for markets deemed relatively complete. To the contrary, in many countries, due to inherent market infrastructure issues,[16] the disciplinary effect of hostile takeovers, may be limited. Part III mainly explores how market infrastructure issues—such as (1) information asymmetry in the product and capital markets (Part III.B), (2) imperfect industrial organizations such as monopoly and oligopoly (Part III.C), (3) subsidies and support from the government or other entities (Part

[16] Some of market infrastructure issues can also be associated with the microeconomics concept of "market failure." Regarding "market failure," *see Market Failure*, BRITANICA, available at https://www.britannica.com/money/topic/market-failure (last visited Aug. 9, 2023).

III.D), and (4) capital-market imperfections (Part III.E)—detrimentally impact the efficiency of the disciplinary role of takeovers.

A. Controlling Ownership and Takeovers

Before I explain the market infrastructure issues from Part III.B through III.E, let us review the takeover implications of corporate ownership structures. Based on the characteristics of corporations' ownership structures, the global economy can be categorized into countries with "dispersed ownership structure,"[17] where most companies lack a controlling shareholder, and countries with "controlling ownership structure," where most companies are controlled by controlling shareholders. The dispersed ownership structure is generally found in a few countries such as the United States, the United Kingdom, and Japan. In most other countries, companies usually have a controlling shareholder.[18]

In China, the state (either central or local government) still frequently acts as the controlling shareholder. The State-owned Assets Supervision and Administration Commission of the State Council (SASAC) is often referred to as the largest controlling shareholder in the world.[19] Since the economic reforms initiated in the era of Deng Xiaoping, there has been a continuous increase in cases where individuals or families become the controlling shareholders.

---

[17] For the further discussion of dispersed shareholding, *see* John C Coffee, *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L. J. 1 (2001).

[18] Controlling shareholders can be either a state (i.e., government), a family, an individual (or individuals), and an entity.

[19] *See* Li-Wen Lin & Curtis J. Milhaupt, *We Are the (National) Champions: Understanding the Mechanisms of State Capitalism in China*, 65 STANFORD LAW REVIEW 697 (2013).

In Korea, since the industrialization of the 1960s, the *chaebol* system based on family control has been firmly established and has persisted for several decades.

In the context of controlling ownership, it often serves as a defense mechanism against hostile takeovers. Specifically, when a controlling shareholder possesses more than 50% of the voting shares, it becomes significantly challenging. Controlling ownership can be extended at a corporate group level if a pyramidal ownership structure[20] or circular shareholding is used.[21] In general, a pyramidal structure provides greater control stability compared to circular shareholding.[22] This is because in circular shareholding, control over the entire corporate group can collapse when one of the numerous ownership chains among affiliated companies is cut by an external entity such as a takeover bidder. Nonetheless, takeover defense is more effective in controlling ownership with circular shareholding than in dispersed ownership. Accordingly, in any country, targets of hostile takeovers are often corporations with dispersed ownership.

Let me elaborate on the importance of ownership structures in the context of takeovers by discussing the Vanke-Baoneng case in China. The main reason why Vanke was the target in this case was not that its management performance or corporate governance was the worst among Chinese companies. Rather, it was because Vanke had a relatively dispersed ownership

---

[20] For a classic explanation of the pyramidal structure in China, *see, e.g.*, Joseph P.H. Fan, *The Emergence of Corporate Pyramids in China*, SSRN (Mar. 25, 2005), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=686582.

[21] Controlling shareholders use pyramidal ownership structures and circular shareholding as tools to leverage their voting rights. In this respect, these mechanisms can be referred to as "controlling minority structures (CMS)." For a more explanation of the CMS, *see* Lucian A. Bebchuk et al., *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, in CONCENTRATED CORPORATE OWNERSHIP, pp. 295-318 (University of Chicago Press, 2000).

[22] For the more explanation, *see generally* Nansulhun Choi & Sang Yop Kang, *Competition Law Meets Corporate Governance: Ownership Structure, Voting Leverage, and Investor Protection of Large Family Corporate Groups in Korea*, 2 PEKING U. TRANSNAT'L L. REV. 411 (2014).

structure.[23] Although Wang Shi was a charismatic business leader at Vanke, he was not a controlling shareholder.[24] Had Vanke been a company with a controlling shareholder holding the majority of shares, it would have been impossible for any company to take it over. Certainly, Vanke faced agency problems to some extent, but it seems that Vanke's agency problems were not considerably more severe than those of other companies in China.[25]

In this regard, the Vanke-Baoneng case suggests that the takeover's disciplinary mechanism does not work well in countries primarily with controlling ownership. In these countries, the pool of available targets, i.e., corporations with dispersed ownership, is quite limited, and thus, the potential target companies are not necessarily those with worst management performance or most serious agency problems.

B. Information Asymmetry and Takeovers

Information asymmetry, [26] traditionally considered a contributor to market imperfection, not only affects product markets but also significantly impacts the capital markets as well. In Part II.B, I elaborate on how information asymmetry in capital markets and product markets undermines the effectiveness of a takeover system as a disciplinary mechanism.

---

[23] *See* Kang, *supra* note 7.

[24] *Id.* At the time of the control battle, the largest shareholder of Vanke was China Resources, a central government state-owned enterprise (SOE). However, its shareholder was approximately 15% or so.

[25] *See* Kang, *supra* note 7.

[26] For the further explanation of "information asymmetry," *see generally* George Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970).

1. Impact of Capital-Market Information Asymmetry on the Takeovers' Disciplinary Role

The problem of information asymmetry occurs when one party in a transaction has a superior position in terms of information compared to the other party. Although the classic analysis of information asymmetry takes an example of a used car market (i.e., a product market), information asymmetry also occurs in capital markets. For example, in the capital market, when a company (which is a seller) issues stocks, it possesses significantly more and accurate information about the company's management, financial status, and future development than the investors (who are buyers). The role of reducing this information gap is handled by the disclosure system and enforcement system.

Even in the U.S. capital market, the most advanced capital market in the world, information asymmetry remains an issue that cannot be completely overcome. However, the U.S. capital market relatively well manages information asymmetry through a well-established disclosure system, developed securities regulations, and efficient enforcement by the Securities Exchange Commission (SEC) and self-regulatory organizations (SROs). Outside the United States, capital markets in most countries experience more severe information asymmetry, primarily due to underdeveloped disclosure systems, less developed securities regulations, and less efficient enforcement mechanisms.

Let us consider the situation in these countries. Through a disclosure system, companies provide information about various aspects of their business, such as market share, and financial details, including revenue, earnings, and profit margins, to the capital market. Despite this, the accuracy of the disclosed information is often compromised due to severe information asymmetry. In other words, the role of filtering out inaccurately reported

information in the capital market is significantly limited. Based on this discussion so far, let us consider the next scenario.

Company A and Company B operate in the same industry, produce the same products, and have similar financial structures (such as debt-to-equity ratios) and company sizes.[27] Suppose the earnings per share of the two companies are $15 for Company A and $10 for Company B, and the price-earnings ratio (PER)[28] of the industry is 10. Thus, the stock price for Company A and Company B would be $150 and $100, respectively. Suppose Company A *accurately* discloses its earnings per share, whereas Company B *falsely* reports its earnings per share as $20, despite the actual figure being $10. If such tendencies are common and enforcement of the disclosure system is not effective in this capital market, investors will lose trust the capital market's integrity.[29]

The problem is that even with "true" information such as Company A's earnings per share of $15, ordinary investors in the capital market do not trust it as well. This is because in the case of information asymmetry, these investors cannot know which companies are providing correct or incorrect information to the capital market. Given the investors distrust caused by information asymmetry, the stock prices of Company A and Company B would not be observed at $150 and $100, respectively. Instead, the stock prices of companies within such a capital market may be distorted from their intrinsic values. As a result of the price distortions in both corporations' shares, it is possible that Company A's stock price is still higher than

[27] Although using a company's price per share for cross-company comparisons can present theoretical challenges, this article sometimes relies on cross-company comparison based on price per share for its convenience, simplicity, and intuitive appeal.

[28] For a further explanation of the PER, *see* John J. Pringle, *Price Earnings Ratios, Earnings-Per-Share, and Financial Management*, 2 FIN. MANAGEMENT 34, 34 (1973).

[29] In this respect, *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988) is noteworthy. Another important point is that the discussion presented in *Basic* cannot be well applied to the inefficient capital markets.

Company B's. However, there is no guarantee that the ratio of 3:2 (i.e., $150 v. $100) between the two corporations will be maintained after the price distortions. In other words, after price distortions, even if Company B's stock price is $90, Company A's stock price is not necessarily $120.

Since investors cannot know which company is better in terms of corporate quality, it is also possible that investors mistakenly believe that Company B is a better company than Company A in terms of earnings per share and its capability to generate future cash flows. In such cases, for example, in the capital market, the stock price of Company A could be evaluated at $120, while Company B's stock price could be evaluated at $150, a higher price.[30] Although the intrinsic values suggest that Company A's stock price should be higher than that of Company B, in a capital market afflicted by severe information asymmetry, it is possible for Company B's stock to be valued higher than Company A's. Table 2 summarizes the discussion.

Table 2: Example – information asymmetry and price distortions

	Company A	Company B
Earnings per share (true information)	$15	$10
Stock price per share (based on the true information)	$150	$100
Earnings per share (false information by Company B)	$15	$20
Stock price per share (based on the false information by Company B)	$120	$150

[30] In this scenario, two instances of stock-price distortion associated with information asymmetry occur: (i) distortion arises from the divergence between the stock prices of the two companies and their intrinsic values; (ii) another distortion occurs as the relative stock prices of the two companies are completely reversed, with Company A's stock being priced lower than Company B's.

Recall that, according to the conventional view explained in Part II, a low stock price indicates inefficient management, poor company performance, or low quality of corporate governance. Thus, continuing the rationale from the conventional view, hostile takeovers, which target companies with low stock prices, serve as a mechanism to discipline such companies. Under these circumstances, if a company is targeted in a hostile takeover, it should be Company B rather than Company A. However, under severe information asymmetry, Company A can become the target due to a distorted pricing system in the capital market. In other words, companies with relatively *higher* performance and corporate governance quality might become targets of hostile takeovers. If distinguishing between high-quality and low-quality corporations becomes confusing, the hostile takeover system's disciplinary function cannot operate effectively.

In summarizing this subsection, when exploring information asymmetry in the capital market in the context of takeovers, the concepts of "adverse selection" and Gresham's law[31] are also crucial. In terms of intrinsic values, Company A is a better corporation than Company B. However, due to information asymmetry, investors are unaware of this distinction about the two companies' intrinsic values. Instead, investors in the capital market may collectively mistakenly believe that Company B possesses superior management skills and corporate governance quality compared to Company A. Accordingly, this *reversed* preference of investors is associated with "adverse selection." Additionally, in cases where the disciplinary takeover mechanism erroneously functions such as cases of adverse selection, Company A becomes a takeover target while Company B survives in the capital market. In other words, in

[31] Recall that originally Gresham's law states that bad money drives out good money. As to Gresham's law, Richard Dutu et al., *The Tale of Gresham's Law,* Federal Reserve Bank of Cleveland (2005) ("bad money tends to drive good money out of circulation.").

the market for corporate control, Gresham's law applies: the bad (Company B) drives out the good (Company A).

2. Impact of Product-Market Information Asymmetry on the Takeovers' Disciplinary Role

The previous subsection (Part III.B.1) explained how information asymmetry in the *capital* market can damage the efficiency of the takeovers' disciplinary mechanism. In this subsection (Part III.A.2), I will examine how information asymmetry in the *product* market similarly impairs the efficiency of this mechanism.

Information asymmetry in the product market is well illustrated by George Akerlof's classic example of the used car market. When information asymmetry arises in a product market, consumers cannot differentiate between high and low-quality items to justify paying a premium for superior products or a reduced price for inferior ones. Thus, they attempt to purchase at an *average* price, believing it reflects the *overall* product quality. In response, sellers of *superior* quality products have little economic incentive to remain in the market, as they cannot command higher prices for their products. This situation leads to a classic "market for lemons"[32] predicament. In other words, a pricing mechanism is not functioning effectively.

A real-world instance of such an issue occurred with the melamine-contaminated milk powder crisis in China.[33] In this scandal, consumers (i.e., parents who purchase milk powder

[32] *See* Akerlof, *supra* note 26. Also, regarding information asymmetry, Gresham's Law, and adverse selection in the context of corporate governance, *see generally* Sang Yop Kang, *Re-envisioning the Controlling Shareholder Regime: Why Controlling Shareholders and Minority Shareholders Often Embrace*,16 U. PA. J. BUS. L. 843 (2013).

[33] Regarding the scandal, *see, e.g.*, Changbai Xiu & Kirt K. Klein, *Melamine in Milk Products in China: Examining the Factors that Led to Deliberate Use of the Contaminant*, 35 Food Policy 463 (2010).

for their babies) cannot differentiate between high and low-quality items, thereby causing the market to collapse. In Korea, there was an incident involving humidifier disinfectants, where many people died or suffered from various diseases due to the disinfectants contained in the humidifier additives.

Eventually, information asymmetry in a *product* market may distort the stock pricing system in a *capital* market. Suppose there are two corporations, Companies C and D, in the humidifier market. Company D's humidifiers and related products, such as disinfectants, are more popular than Company C's because they are cheaper and more convenient to use. However, suppose there is an information asymmetry issue because Company D conceals information about its products potentially having negative health effects. On the other hand, Company C's products are relatively more expensive and less convenient to use, but they do not cause health problems. In other words, in a situation of asymmetric information, Company D *appears* to offer *better* products, but in reality Company C is the one producing *superior* products. Before the health issues caused by Company D's products became apparent, consumers significantly preferred Company D's products over those of Company C.

For instance, given information asymmetry, let us say that Company D holds 80% of the market share, while Company C holds the remaining 20%. Under these circumstances, suppose the earnings per share for Company D reach $20, while those for Company C are $10. Assuming a PER of 10 in this product market, the stock price per share for Company D would be $200, and for Company C, it would be $100. This implies that Company C would become a target in the market for corporate control. However, if information about the health issues associated with Company D's products is properly conveyed to consumers in the product market, the situation might be reversed so that Company D holds 20% of the market share,

while Company C holds 80% of the market share. Then, the earnings per share for Company D would reach $10, while those for Company C would be $20. Under these circumstances, where information asymmetry is corrected, the stock price per share for Company D would be $100, and for Company C, it would be $200. Accordingly, in the absence of information asymmetry in the product market, Company D would become a target in the market for corporate control. Table 3 summarizes the discussion.

Table 3: Information asymmetry and a takeover target

	Companies	Market Share	Stock Price	Takeover
With Information Asymmetry	Company C	20%	$100	Target = **Company C** → Erroneously Disciplined
	Company D	80%	$200	
In the Absence of Information Asymmetry	Company C	80%	$200	Target = **Company D** → Well Disciplined
	Company D	20%	$100	

Also, several implications can be drawn from this scenario. First, Company D is able to achieve a dominant market position because it conceals a fatal flaw in its products, which directly relates to information asymmetry in the product market. Second, information asymmetry in the *product* market influences the market share between Company C and D, which in turn affects their financial performance. The performance of these companies impacts their stock prices through earnings per share and the PER, ultimately determining which company becomes a target for a takeover. Thus, eventually information asymmetry in the *product market* has a crucial impact on the *capital market* and the *market for corporate control*.

Fourth, in this scenario, there are no issues such as false disclosures in the capital market. In other words, in this scenario, information asymmetry in the *product* market *alone* gives rise to stock price distortion in Companies C and D. Consequently, given information asymmetry in the product market, the notion that a hostile takeover system acts as a disciplinary mechanism is significantly impaired. Company C, which should be treated as a more valuable corporation than Company D, is ironically and erroneously disciplined as a takeover target corporation. Indeed, the corporation that should be punished as a takeover target is Company D.

Fifth, and last but not least, as the concept of ESG gains prominence, information about health, environment, and social issues is becoming increasingly important. In this context, the issue of information asymmetry will grow more crucial, given that ESG information, while more abundant than before, remains limited to the public investing group.

C. (Quasi) Monopoly and Takeovers

In Part III.C, setting aside the issue of information asymmetry, I will discuss how a (quasi) monopoly distort stock prices and consequently render the hostile takeover system ineffective.

In many countries, various product markets face issues with (quasi) monopolies.[34] For instance, let's consider Company E, a (quasi) monopoly corporation, enjoying significant economic rents. Company E has considerably poor management skills and low corporate

[34] For a general explanation of product market imperfections such as monopoly and oligopoly, *see, e.g.*, Arnold S. Kling, *Competition and Market Structures (Industrial Organization)*, ECONLIB (last visited, Feb. 6, 2024), https://www.econlib.org/library/Topics/Details/competitionmarketstructures.html.

governance quality. However, the company's stock price reaches $200 per share due to the monopoly-induced economic rents. If the company had good management capability and high corporate governance quality, its stock price might have reached as high as, for example, $400 per share.

Nevertheless, the current stock price of $200 is considered sufficiently high in the stock market. Thus, Company E remains unaffected by the market for corporate control. However, the reason why Company E is not a target company is not because its management capability and the quality of its corporate governance are so good that it is not subject to the takeover system's disciplinary mechanism. Rather, it is because Company E enjoys a significant amount of economic rent from its already established monopoly position in the market. Accordingly, it can be argued that the effectiveness of the disciplinary system that hostile takeovers may generate is significantly weakened when product market distortions occur.

The phenomenon of monopolies or oligopolies is a pervasive feature of the global economy. This observation leads to the conclusion that the hostile takeover disciplinary mechanism is problematic in many countries. For instance, in numerous relevant product markets in China, SOEs[35] or some selected private companies frequently hold and exercise a dominant market position. In Korea, family-controlled corporate groups, commonly referred to as *chaebols*, have established and utilized monopolistic positions in a multitude of related markets. Furthermore, quasi-monopolistic behavior is observed in numerous industries in advanced Western economies, including those in the United States.

[35] Regarding SOEs, *see, e.g.*, Karen Jingrong Lin et al., *State-Owned Enterprises in China: A Review of 40 Years of Research and Practice*, 13 CHINA J. ACCOUNTING RES. 31 (2020).

The United States is the largest product import market in the world and has relatively low barriers to entry compared to other countries. Consequently, even if there are numerous monopolistic markets, competitive pressures potentially exist. Also, the Federal Trade Commission's (FTC's) antitrust enforcement power still appears to be relatively effective. On the other hand, following the advent of the Covid-19 pandemic, industrial policies such as reshoring and reorganizing the supply chain to prioritize domestic industries, as well as trade policies partially due to conflicts with China and other countries, have served to raise the barriers to entry in the U.S. market somewhat. Accordingly, the monopolies' monopoly power in the United States appears to be stronger than before.

The question of whether the overall situation in the United States is one in which the harms of monopoly are "extreme" or whether monopoly exists but is "sufficiently controllable" is beyond the scope of this article. It is evident, however, that under the prevailing product market conditions, monopolies are at least somewhat problematic even in the United States, which has been considered as one of a few countries with most competitive markets. Accordingly, it is possible for companies with a (quasi) monopoly position to enjoy monopoly rents, which are reflected positively in their stock prices.

In many other countries, industrial organization is characterized with (quasi) monopoly. In these countries, companies with a monopoly position to enjoy monopoly rents, which are reflected positively in their stock prices. In other words, due to high stock prices, these companies are insulated from the market forces that would otherwise make them vulnerable to hostile takeovers, even if their managers' abilities or the company's business and financial condition are suboptimal. In essence, with regard to (quasi) monopolies, the efficacy of a

takeover system as a disciplinary mechanism is also diminished to some extent, if not rendered meaningless.

D. Subsidies/Support and Takeovers

1. Government's Industrial Policy and Takeovers

In many countries, corporations' business and financial conditions are often influenced by the government's industrial policies, regulations, permissions, and discretionary actions in the product markets. For instance, local or central governments often provide subsidies or implement policy financing to nurture companies in certain markets. As a result, these companies are placed in advantageous positions. On the other hand, other companies that lack government support find themselves in disadvantageous positions. In this way, a company's profitability is often influenced by the government's decision to confer what I refer to as "government-generated rent" in markets with less competition pressure.

In this regard, companies that have obtained (quasi) monopolistic market power, as well as those that have received subsidies and other forms of support from the government, may potentially experience *abnormal* profits without necessarily having to engage in additional managerial efforts, enhance their caliber or attempt to improve the quality of corporate governance. Therefore, even if the overall quality of management's management skills, vision, and corporate governance is *low*, companies that effectively engage in such "rent-seeking" can still maintain *high* stock prices. In such circumstances, corporate earnings and stock prices may not accurately reflect the overall quality of corporate-governance factors, including the corporation's agency problems and management skill.

Consequently, a company that would otherwise be a target of a hostile takeover due to its low stock price of $100 per share could become a company with a higher stock price of $200 per share, thus circumventing the disciplinary mechanism of a hostile takeover. In other words, it is unlikely that the takeover system will effectively function as a disciplinary mechanism to punish corporations for poor management performance or agency problems.

Also, conversely, even if a corporation's stock price is lower than its intrinsic value, it does not necessarily imply that the company generally has poor management skill or inadequate corporate governance in the product markets. For instance, a *low* stock price might simply result from a lack of support from the government[36] or from missed monopoly opportunities due to companies not having connections with local or central governments. In other words, even *best* corporations in terms of the overall quality of corporate governance may experience relatively *low* stock prices and become targets for hostile takeovers. Under these circumstances, ironically an active hostile takeover regime could even be harmful to market efficiency because corporations actively engaged in "rent-seeking" could survive in the market for corporate control and innovative corporations without such rents could be targets of hostile takeovers.

2. Other Entities' Subsidies and Takeovers

Other entities such as corporate groups also support or subsidize a corporation. For instance, a corporate group may subsidize an affiliated company through another affiliated

[36] Frank Tang, *China's Industrial Subsidies: What Are They and Why Are They a Source of Tension with the West?*, SOUTH CHINA MORNING POST (Feb. 20, 2022), https://www.scmp.com/economy/china-economy/article/3167588/chinas-industrial-subsidies-what-are-they-and-why-are-they.

company. In this case, a subsidized affiliated company has cost advantages, and thus, its firm value is enhanced.

Consider a scenario where five companies compete in a market, with four being affiliates of four different corporate groups and receiving their direct support or benefits from related party transactions (RPTs). The remaining company, not part of these corporate groups, may exhibit the lowest operational performance and, consequently, the lowest valuation. This makes it a likely target for a hostile takeover. Also, the other four companies receiving support from their corporate groups are alleviated from the pressures of a hostile takeover. Consequently, the disciplinary role of takeovers may diminish.

E. Capital-Market Imperfections and Takeovers

Part III.E explores how imperfections in the capital market can reduce the efficiency of the disciplinary mechanism of takeovers. Essentially, these imperfections lead to distorted stock prices. Such price distortions prevent stock prices from serving as a basis for the disciplinary mechanism, where a low-quality company with a diminished corporate value would typically be targeted for takeover.

1. (Un)Availability of Material Information in the Capital Market

According to the efficient (capital) market hypothesis, a company's stock price already reflects *all available* information in the (capital) market.[37] Efficient capital markets[38] play a vital role in facilitating the proper pricing of stocks.

The ability of a company's directors and executives, the company's business strategies in relation to generating future cash flows, and the quality of its corporate governance are considered to be "material information" that affects the price of a company's stock. Legally speaking, "material information" is defined as information if "there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision or voting. This definition of material information, along with the substantial likelihood test, was suggested in *TSC Industries, Inc. v. Northway, Inc*.[39] In an efficient capital market, a company's material information is reflected in the stock's price as soon as it becomes available to the investing public. In this respect, providing material information through media and company disclosures is a fundamental aspect of an efficient capital market. Accordingly, a responsible, independent, and capable media and a well-functioning and effectively enforced disclosure system constitute the bedrock of an efficient capital market.

In an efficient capital market, the quality of management, the severity of the company's agency problems, and the overall quality of corporate governance serve as material information that is reflected in the value of the company's stock. In other words, if information is freely and

---

[37] Efficient market hypothesis has three forms: the weak form, the semi-strong form, and the strong form. For the further analysis of these three forms of efficient market hypothesis, *see* STEPHEN A. ROSS ET AL., CORPORATE FINANCE (9th ed. 2009), at 433~36. Eugene F. Fama, *Efficient Capital Markets: II,* 46 J. FIN. 1575, 1575 (1991).

[38] As to "efficient market," *see generally* Burton G Malkiel, *The Efficient Market Hypothesis and Its Critics*, 17 J. ECON. PERSP. 59 (2003).

[39] 426 U.S. 438 (1976).

effectively transmitted to investors, in general a company with lower ratings in these aspects will have a lower stock price compared to one with higher ratings.

In the U.S. capital market, by generating a great deal of material information about companies, a variety of media entities provide expert and independent opinions on companies' overall issues. In addition, public companies in the United States are required to provide material information to investors through an efficient disclosure system and the SEC's enforcement. In this respect, the U.S. capital market, while not perfect, is considered to be close to the concept of "efficient market."

However, in many other countries, there is a paucity of specialized, independent, and diverse media outlets. Furthermore, in these countries, disclosure regimes are often weak, and enforcement is ineffective. This constrains the avenues through which material information about a company can be disseminated to investors in the capital markets.

Under these circumstances, material information such as the management's management capabilities or the severity of the agency problems within the company may not be properly reflected in the company's stock price. In other words, a company's stock price may be high even if the level of these indicators is low, and conversely, a company's stock price may be low even if the level of these indicators is high. Crucial elements of the company's quality may not be conveyed to the capital market, resulting in an inaccurate representation of the company's value. In such a scenario, the disciplinary mechanism may be operating incorrectly in the event of a hostile takeover system being triggered.

2. Factors Aggravating Capital Market Imperfections

The presence of capital market imperfections, depending on their severity, can interfere with the pathway by which such material information is properly reflected in the price of a company's stock. In this subsection, I explain some factors contributing to the imperfections in capital markets.

First, as discussed in Part III.B.1, information asymmetry within the capital market gives rise to systematic and structural issues in terms of capital market imperfections. Second, in certain instances, the imposition of excessive regulatory constraints may impede the stock market's capacity to ascertain the intrinsic value of stocks. For instance, more restrictive short-selling rules imposed and enforced by the Securities Law, government agencies, and stock exchanges in China may hinder the price-discovery function in China's capital market.[40] In Korea, short-selling is also widely restricted. This is mainly due to the government's fear of short-selling causing the stock market to decline and the resentment of the general investing public, who make up a significant portion of electorate.

However, a broad ban on short-selling may undermine the price discovery function. In such circumstances, the intrinsic value of the company is likely to be inadequately reflected in the stock market price. This phenomenon can be associated with price distortions in the stock market, whereby the stock price of a company with robust management, a robust ability to generate cash flows, and robust corporate governance may be undervalued, while the stock price of a company with suboptimal management, a suboptimal ability to generate cash flows, and suboptimal corporate governance is overvalued. Consequently, the disciplinary function of the takeover system is undermined.

[40] Regarding short-selling in China, *see, e.g.*, Xiaohu Deng & Lei Gao, *The Monitoring of Short Selling: Evidence from China*, 43 RESEARCH IN INT'L BUS. & FIN. 68 (2018).

Third, in many countries, retail investors without expertise play a significant role in terms of stock ownership and trading volume.[41] In China, so-called "mom and pop" traders are so influential that their trading activities often determine the ups and downs of a particular company and the capital market in general. In Korea, during the pandemic, the diversification and activation of non-face-to-face investment methods, coupled with the rebound of the stock market, has led to a substantial increase in the interest of retail investors in the stock market. This has resulted in a corresponding increase in the share and influence of their investments in the capital market.

On the one hand, the growing number and proportion of retail investors is positive in terms of expanding opportunities for people to grow their wealth and diversify their assets. On the other hand, if retail investors account for a substantial proportion in the capital market,[42] it is likely to lead to extensive noise trading[43] and behavioral finance issues[44] like herding.[45] Furthermore, retail investors are inclined to trade based on rumors rather than analysis, and they engage in frequent trading, which can elevate the risk and volatility of the stock market. Such behavior can contribute to the distortion of the price of a particular company or the stock market as a whole. Distortions in the price regime can undermine the disciplinary effect that a takeover system is designed to have.

---

[41] For the more explanation of retail investors in China, *see, e.g.*, Sang Yop Kang, *The Independent Director System in China: Weaknesses, Dilemmas, and Potential Silver Linings*, 9 TSINGHUA CHINA L. REV. 151 (2016) at 179-80 (fn. 139).

[42] *See, e.g.*, Sang Yop Kang, *The Independent Director System in China: Weaknesses, Dilemmas, and Potential Silver Linings*, 9 TSINGHUA CHINA L. REV. 151 (2016) at 179-80 (fn. 139).

[43] Regarding noise trading, *see generally* Andrei Shleifer & Lawrence Summers, *The Noise Trader Approach to Finance*, 4 J. ECON. PERSP. 19 (1990).

[44] As to behavioral finance, *see generally* Nicholas Barberis & Richard Thaler, *A Survey of Behavioral Finance*, HANDBOOK OF THE ECONOMICS OF FINANCE 1 (2003) at 1053-1128.

[45] Regarding herding, *see, e.g.*, Shu-Fan Hsieh et al., *Retail Investor Attention and Herding Behavior*, 59 J. EMP. FIN. 109 (2020).

Of course, institutional investors are not perfect either. They are also susceptible to behavioral finance problems, such as herding, which contribute to market price distortions. The failures of institutional investors in the U.S. and other developed financial markets particularly during the global financial crisis of 2007-8 reflect the imperfections of institutional investors. However, compared to retail investors in general, institutional investors *on average* are more rational since they are more likely to trade with macroeconomic, industry, and company-specific analysis and are generally less exposed to behavioral finance issues. In this respect, it is generally true that countries with a higher proportion of institutional investors in terms of shareholding and trading volume are less susceptible to price distortions in their capital markets.

Another point to discuss regarding institutional investors is that in certain countries, a considerable percentage of institutional investors are under the influence of the government, individuals, or other private entities. For instance, in China, the institutional investors owned or influenced by the government play the critical role.[46] Some of these institutional investors act as the government's macroeconomic policy tools. For instance, during the stock market crash in 2015, the Chinese government rallied institutional investors, including pension funds, to support the faltering market.[47] In Korea, particularly around one or two decades ago, the government has employed a variety of strategies to influence the stock market, including the use of private institutional investors. Over time, calls for market autonomy have grown stronger, and it has become increasingly difficult for the Korean government to overtly dictate the trading activities of domestic institutional investors. Nevertheless, the largest institutional investor in

[46] For the further explanation of the Chinese institutional investors, *see generally* Lin Lin & Dan W. Puchniak, *Institutional Investors in China: Corporate Governance and Policy Channeling in the Market within the State*, 35 COLUM. J. ASIAN L. 74 (2022).

[47] *See* Sang Yop Kang, *Analyzing Investor Protection in Chinese State-Owned Enterprises: Law and Economics Approach*, 40 REV. BANKING & FIN. L. 821 (2020).

Korea is the National Pension Service (NPS), a quasi-governmental organization under the Ministry of Health and Welfare.[48] While there is currently no clear evidence to suggest that the government, through the NPS and other pension funds, is deliberately manipulate the price of a particular company, there is a prevailing perception that the government, through the NPS and other pension funds, may attempt to prop up the entire Korean stock market when the stock market is depressed and unstable.

Certainly, from one perspective, this kind of policies can be interpreted as a proactive governmental intervention aimed at stabilizing the financial market in the face of its failure. However, from critical perspective, it can also be seen as the government intervening a significant part of the market's price discovery function. When the government mandates institutional investors to prop the stock market through direct order of "buy stocks," these investors cease to operate as "information traders."[49] Consequently, stock prices artificially inflate, disrupting the inherent price discovery mechanism within the capital market that is traditionally governed by the "invisible hand."[50]

This phenomenon serves a similar function to the short-selling ban, as it aims to prevent the stock market from falling. Another notable point is that even if the objective of the government propping through institutional investors is to stimulate the entire stock market, it is almost impossible for government-influenced institutional investors to invest in precisely the

[48] The NPS holds approximately 7-8% of the total market capitalization of the Korean capital market and is a major shareholder in almost all publicly traded companies in Korea. For the more explanation of the NPS, *see* Sang Yop Kang & Kyung-Hoon Chun, Korea's Stewardship Code and the Rise of Shareholder Activism: Agency Problems and Government Stewardship Revealed, in GLOBAL SHAREHOLDER STEWARDSHIP 239 (Dionysia Katelouzou & Dan W. Puchniak eds., 2022).

[49] For the further explanation of information traders, *see, e.g.*, Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L. J. 711 (2005).

[50] As to "invisible hand," *see generally* Emma Rothschild, *Adam Smith and the Invisible Hand*, 84 AM. ECON. REV. 319 (1994).

same proportion of all investee companies. Consequently, the stock price increase resulting from the stimulus will differ for each investee company. Therefore, government stimulus through government-influenced institutional investors will eventually distort the pricing system of the stock market. Consequently, the disciplinary effect of a hostile takeover is weakened.

F. Summary

Part III primarily explored how certain market infrastructure issues ultimately undermine the disciplinary role of takeovers.[51] These market infrastructure issues include information asymmetry (Part III.B), imperfect industrial organizations such as monopoly and oligopoly (Part III.C), subsidies and support by the government or other entities (Part III.D), and capital-market imperfections (Part III.E).

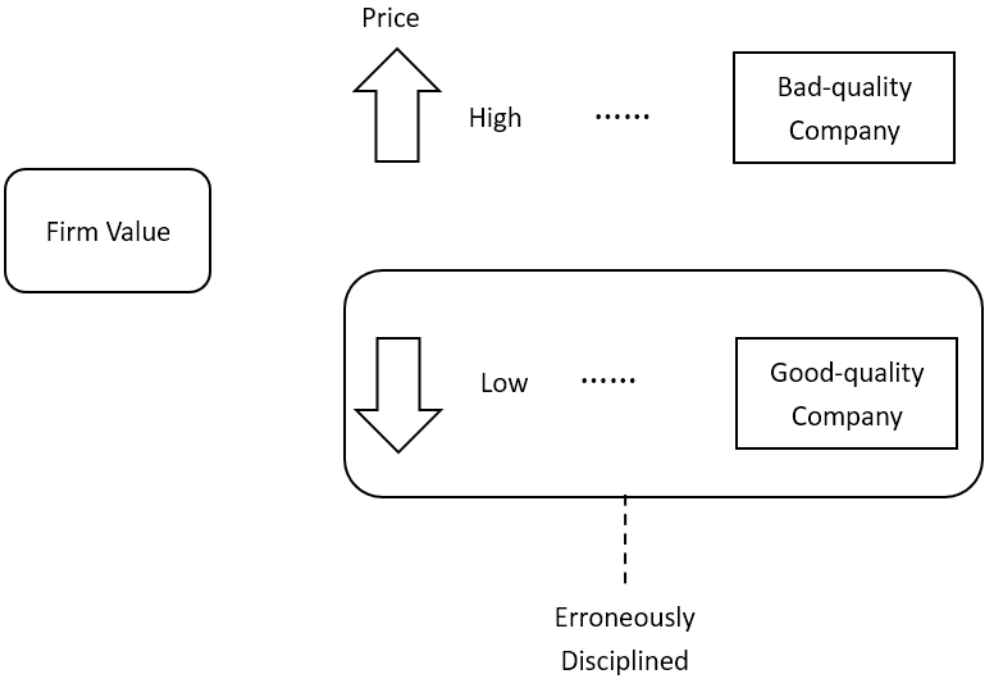
According to the conventional view of takeovers' disciplinary role, a low-quality company will become a takeover target in the market for corporate control, leading to the replacement of its management. Part II and Figure 2 explains this story. This disciplinary mechanism assumes that the poor quality of the target company is reflected in the capital markets by a lower corporate value and stock price.[52] However, severe market infrastructure issues can lead to price distortions affecting company value and stock price. In such cases, even a high-quality company may appear undervalued in the capital market and become a takeover target, potentially providing financial profits for a bidder. In essence, when market

[51] Also, *see supra* Figure 1 and Table 1.

[52] *See supra* Part II.

infrastructure issues are severe, the takeover system becomes inefficient, and takeovers may *erroneously discipline* high-quality corporations. The inefficiency of the takeover system in fulfilling its disciplinary role varies across countries, as each is exposed to varying extents of market infrastructure issues. This is an issue for empirical research to address. Figure 3 illustrates this discussion, in contrast to Figure 2.

Figure 3: Inefficiency of takeovers' disciplinary role



Market infrastructure issues and pricing distortions in share prices can occur in countries with predominantly dispersed ownership structures. However, these issues may have a more significant impact in countries where companies have a predominantly controlling ownership structure. In such countries, the control exerted by controlling shareholders serves as a takeover defense, shielding most controlled corporations from becoming takeover targets.[53] This means that if a market for corporate control is activated in these jurisdictions, only a few companies with dispersed ownership may become available targets. Therefore, in these countries, when a high-quality corporation experiences a price distortion (i.e., a low firm value in the stock market), it would attract attention from potential bidders. This is because these bidders can gain financial benefits by acquiring a high-quality corporation at a low cost,

[53] However, note that controlled corporations are not perfectly protected from hostile takeover threats. As discussed, control based on circular shareholding is weaker than control based on a pyramidal ownership structure.

and there are only few other potential targets in the market for corporate control in these countries.

As the last point of this section, it is worth noting that beyond market infrastructure issues, the disciplinary role of takeovers in the United State has been limited by the advent of poison pills, which protect the management of low-quality firms from takeover market pressures. However, the takeovers' "disciplinary role" in the United States has been somewhat revitalized through advances in executive compensation, including the golden parachute. This mechanism allows for the replacement of poor-quality firm management relatively smoothly. Certainly, golden parachute and other compensation packages for replaced executives in the United States cause significant costs. Compared to the severe inefficiency costs that such inefficient executives may bring to the corporation and its shareholders, shareholders may find these packages worthwhile (i.e., relatively cheaper) to remove inefficient executives. This raises an interesting question of whether executives, paid handsomely to depart, are truly "disciplined" by this "disciplinary mechanism" of the market for corporate control. Conversely, in many countries outside the United States, such golden parachutes may not be as substantial. In countries like China and Korea, compared to the U.S. situation, these packages are often too small to effectively serve as an incentive for executives or controlling shareholders to leave a company. In this respect, I refer to these modest packages in these countries as "bronze parachutes" rather than golden ones.

IV. CONCLUSION

According to the conventional view, takeovers are seen as a mechanism to eliminate poor-quality corporations, thereby improving the general quality of corporate governance in a

jurisdiction.[54] However, this article challenges that perspective, demonstrating how market infrastructure issues—such as information asymmetry, imperfect industrial organizations, government subsidies and support, and capital market imperfections—can lead to pricing distortions in corporate shares.[55] These distortions may inflate the value of low-quality companies or undervalue high-quality ones, making them unintended takeover targets. In both scenarios, the disciplinary role of takeovers is compromised.[56]

Countries facing serious corporate governance issues may seek to revitalize their market for corporate control. This could involve encouraging hostile takeovers, relaxing regulations that previously restricted bidders' activities, and reducing the effectiveness of takeover defense measures. However, through the analytical framework of market infrastructure issues, price distortions in corporate shares, and the inefficiency of the disciplinary role of takeovers, this article suggests that these countries should address market infrastructure issues before directly adopting takeover-friendly policies. This article posits that in countries grappling with specific market infrastructure challenges, hostile takeovers may not effectively boost overall management competitiveness, corporate efficiency, or enhance corporate governance.

Of course, the severity of market infrastructure issues varies from country to country. This article does not claim that the disciplinary role of takeovers is uniformly ineffective worldwide. Instead, it highlights previously overlooked market infrastructure issues within the hostile takeover debate and offers a relevant analytical framework. This analytical framework

[54] *Supra* Part II.

[55] *Supra* Part III.

[56] *Id*.

guides countries in tailoring their policies to their specific circumstances. Finally, I conclude this article hoping it will prompt country-specific empirical studies on the impact of market infrastructure issues on hostile takeover regimes across diverse legal and economic environments.

european corporate governance institute

about ECGI

The European Corporate Governance Institute has been established to improve *corporate governance through fostering independent scientific research and related activities.*

The ECGI will produce and disseminate high quality research while remaining close to the concerns and interests of corporate, financial and public policy makers. It will draw on the expertise of scholars from numerous countries and bring together a critical mass of expertise and interest to bear on this important subject.

The views expressed in this working paper are those of the authors, not those of the ECGI or its members.

www.ecgi.global

european corporate governance institute

ECGI Working Paper Series in Law

Editorial Board

Editor	Amir Licht, Professor of Law, Radzyner Law School, Interdisciplinary Center Herzliya
Consulting Editors	Hse-Yu Iris Chiu, Professor of Corporate Law and Financial Regulation, University College London
	Martin Gelter, Professor of Law, Fordham University School of Law
	Geneviève Helleringer, Professor of Law, ESSEC Business School and Oxford Law Faculty
	Kathryn Judge, Professor of Law, Coumbia Law School
	Wolf-Georg Ringe, Professor of Law & Finance, University of Hamburg
Editorial Assistant	Asif Malik, ECGI Working Paper Series Manager

https://ecgi.global/content/working-papers