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Manne, Mergers, and the Market for Corporate Control

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I went down to the sacred store
Where I'd heard the music years before.[1]

INTRODUCTION

Although increasing longevity may well bankrupt the Social Security fund before my contemporaries and I get there, one of longevity's admitted benefits is the increased ability of the truly wise, truly seminal thinkers in intellectual society to see the fruits of their labors, even to add to our understanding of them. And so, as he moves past his seventieth year, Henry Manne is not only able to participate in the celebration of his contributions, but to add his latter-day reflections on them. It goes without saying that the words "wise" and "seminal" accurately describe Henry's contributions, along many margins. Those several margins are discussed in detail throughout this Symposium.

At the outset, we are considering in particular the Manneian notion—indeed, his very creation of the concept—of the "market for corporate control."[2] In anticipation of receiving Professor Carney's lead article, I went back and read Manne's *Mergers and the Market for Corporate Control*.[3] I first read the article as a graduate student in economics in the mid-1970s, when it was already some ten years old. To students slavishly devoted to the scientific method—in hopeful anticipation of defending a dissertation some day—it was a deceptively easy piece to read. Indeed, it was practically devoid of orthodox economic methodology. Unlike everything else we were studying, the article had no math, no hypotheses, no tests, and no R-squareds.

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1 DON MCLEAN, *American Pie*, *on* AMERICAN PIE (Capitol Records 1980).

2 In conversations with me, Henry himself credits Armen Alchian for helping him think generally in terms of "the market for this," or "the market for that."

3 Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

So this assignment promised a light night, only eleven pages, easily read within an hour, even less. I think a common reaction among most of us graduate students was: What's the big deal? And what is this article doing in, of all places, the very prestigious *Journal of Political Economy*?

History has proven what a revolutionary paper *Mergers and the Market for Corporate Control* really was, as Professor Carney's excellent paper illustrates.[4] In demonstrating generally how path-breaking Henry Manne's work was, the Carney paper accomplishes several objectives. Not the least of them is simply the reminder that it was Henry Manne who first realized the importance of this thing called the "market for corporate control."[5] It is curious how often today the genesis of the idea is forgotten. A recent encyclopedia of law and economics included an entry for "market for corporate control," which covered four almost coffee-table sized pages, with double columns and small print, and appended a bibliography of over thirty entries.[6] The bibliography did not include the seminal Manne article, nor was the founder's contribution mentioned in the text.

That's the bad news. But the good news is that the notion of a market for corporate control is now so well established that its origins no longer need citation. Henry's contribution is thus like Alfred Marshall's graphical introduction of the downward-sloping demand curve, a price-theory concept now so fundamental and well accepted that no one cites Marshall for its derivation.[7] Professor Carney's

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[4] *See* William J. Carney, *The Legacy of "The Market for Corporate Control" and the Origins of the Theory of the Firm*, 50 CASE W. RES. L. REV. 215 (1999) [hereinafter *Manne Legacy*]. I second Bill Carney's opening personal remarks in his article. As Henry Manne did for Bill, so did Henry alter my life. Having left Columbia Law School after just two months, discouraged by a lack of theoretical and empirical rigor in statements being propounded as truths, I switched to studying economics at the University of Virginia. It was only through the different prism on law offered by Henry Manne's Law and Economics Center that, on returning to Law School at the University of Miami, I discovered what was truly interesting and important, to me at least, in legal study and scholarship.

[5] The Carney paper usefully recalls that Henry Manne initiated the phrase "the market for corporate control" a year before publication of "Mergers and the Market for Corporate Control." *See id.* at 234; Henry G. Manne, *Some Theoretical Aspects of Share Voting: An Essay in Honor of Adolf A. Berle*, 64 COLUM. L. REV. 1427, 1444 (1964). For economists, this publication would have been much less accessible than *Mergers and the Market for Corporate Control.*

[6] *See* R. Glenn Hubbard & Darius Palia, *Market for Corporate Control*, *in* 2 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, 611-15 (PETER NEWMAN ED., 1998). *But see* Henry N. Butler, *Board of Directors*, *in* 1 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 165 (PETER NEWMAN ED., 1998) ("Economists interested in the relation between shareholders and the senior management of large corporations have identified numerous market forces, including the market for corporate control (Manne 1965), that give managers the incentives to control agency costs.").

[7] For the record, the citation is ALFRED MARSHALL, PRINCIPLES OF ECONOMICS: AN INTRODUCTORY VOLUME 81 n.2 (8th ed. 1952). In fact, although the diagrammatic downward-sloping demand curve is typically attributed to Marshall, several other economists had presented equivalent diagrams generations before Marshall. *See* Thomas M Humphrey, *Precursors of the*

points here are very well taken. Even measured just by a citation count, *Mergers and the Market for Corporate Control* is in the all-time top-twenty for law review citations, a feat Carney rightfully celebrates all the more, given that the article was not published in a law review or even an interdisciplinary law and economics journal. The concept and the phrase, "the market for corporate control," have passed into common parlance, as evidenced by the fact that the phrase is used almost four times for every time it is actually cited to Henry Manne. Thus Henry Manne has become the latest winner of the "Alfred Marshall Prize" for uncited, unattributed ideas.

Overall, Professor Carney's paper is a wonderful summary of all the concepts, accepted without second thought today, that were unknown or only dimly perceived before Henry Manne began writing in the early 1960s. Take, for example, the idea that market-based economic theory held the key for understanding corporate firms, or division of labor and free-rider problems that define shareholder roles in large corporations. These and other ideas are central to legal and economic thinking about the corporation today, and as Professor Carney indicates, all are parts of the integrated Manne *oeuvre* on how to think about the corporation. Central to the Manne legacy, though, was his identification of the "market for corporate control."

The Carney paper does an excellent job spelling out what made recognition of the market for corporate control so important, and indeed, how that recognition revolutionized all of economic and legal thinking about corporate firms. Others writing on this subject also will have more to say about this notion of the "market for corporate control." In atonement for my blinkered vision as a graduate student, I would like to highlight three particular aspects of the article that I think are important, and, as one too callow at the time to appreciate how revolutionary Manne's work was, help to put into context what a really seminal piece this was.

I. THREE CONTRIBUTIONS

A. The Reasons for Corporate Mergers

First, as *Mergers and the Market for Corporate Control* makes clear in its first 3 pages (i.e., almost 30 percent of the article), mergers in 1965 were viewed as phenomena of interest strictly in terms of industrial organization (for economists) and antitrust law (for lawyers).

Marshallian Cross, THE MARGIN, Spring 1993, at 31. No one, however, claims to antedate Henry Manne in propounding the phrase and the concept of the "market for corporate control."

Further, mergers in the 1960s were coming to be treated as virtually per se illegal, at least when challenged by the government.[8] But Manne explained why both economics and law were missing the larger picture. First, he said, mergers should not be analyzed within the framework of the economics and law of competition, or at least not most of the time. Rather, mergers are to be understood within the framework of the emerging fields of financial economics and law.[9]

In approaching mergers within a finance framework, Henry Manne illustrated what lawyers so often bring to the table in the academic world of law and economics, something that economists typically are unable to provide. In 1965, economists were concerned about mergers within a competition framework because that was how economists had always treated mergers. They were to be viewed in a cost-benefit sense, with the costs in particular being registered in terms of diminished competition. So were they treated at the University of Chicago at the time *Mergers and the Market for Corporate Control* was written, with George Stigler particularly noteworthy for his skepticism as to the competitive benefits of mergers.[10]

As a lawyer, however, Manne was familiar with legal cases involving sales of controlling blocks of shares in contexts having nothing to do with putative problems of competition.[11] In the paper's first important contribution, *Mergers and the Market for Corporate Control* noted that, in effect, there were two ways that a merger might increase the wealth of the merging parties. True, if competition were diminished by a merger's creating market power, that might motivate the merger, while, of course, decreasing social wealth by raising prices. Manne noted, however, that there was another way that merger might increase merging parties' wealth, in a way that actually increased societal wealth as well. Manne writes:

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[8] The Celler-Kefauver Amendments to § 7 of the Clayton Act in 1950 had greatly tipped the scales in favor of the government in merger challenges. *See, e.g.*, United States v. Von's Grocery Co., 384 U.S. 270 (1966) (enjoining merger resulting in a 7 percent share of relevant market); United States v. Philadelphia Nat'l Bank, 374 U.S. 321 (1963) (finding *prima facie* illegal a merger of two banks resulting in a 30 percent share of the market) ; Brown Shoe Co. v. United States, 370 U.S. 294 (1962) (holding that merger of two firms with a resulting market share of 5 percent was illegal). In *Von's Grocery*, the virtual per se illegality of mergers challenged by the government sparked Justice Stewart's famous remark, "The sole consistency [in merger cases] that I can find is that in litigation under § 7, the Government always wins." *Von's Grocery*, 384 U.S. at 301.

[9] As explained further below, there really was no such field as "financial economics" at the time Manne wrote, at least not in the domains that Manne discussed.

[10] The Manne article noted this Chicago approach to mergers. *See* Manne, *supra* note 3, at 111 n.6 (citing George J. Stigler, *Mergers and Preventive Anti-Trust Policy*, 54 U. PA. L. REV. 176, 181 (1955) (claiming it to be "most uncommon" that a merger would increase competition).

[11] *See, e.g.*, Perlman v. Feldmann, 219 F.2d 173 (2d Cir. 1955), discussed in Manne, *supra* note 3, at 116 n.21.

> The basic proposition advanced in this paper is that the control of corporations may constitute a valuable asset; that this asset exists independent of any interest in either economies of scale or monopoly profits; that an active market for corporate control exists; and that a great many mergers are probably the result of the successful workings of this special market.[12]

It was not increases in market power nor decreases in production costs, economists' favorite explanations for merger gains, that necessarily explained mergers. At least equally possible as the rationale for mergers were improvements in management, made possible by transactions in corporate control.[13]

B. Corporate Control Transactions as Shareholder Protection Devices

From this initial—and revolutionary—perspective flows the article's second contribution, and Professor Carney's paper rightly gives this second insight central importance in the paradigm shift about corporate control changes that followed publication of the Manne article. The market for corporate control is really to be understood in consumer-protection terms, with "consumers" in that market being shareholders. In the pre-Manne era, the prevailing academic paradigm treated shareholders—that is, consumer-purchasers of corporate shares—as chumps. They were routinely, and so predictably, bamboozled by managers supposedly advancing shareholder welfare but really maximizing their own welfare.[14] Management operated seemingly without constraints in bilking shareholders.

But, Manne noted, the corporate control needed to undertake such machinations is subject to market forces. And if markets ordinarily operate reasonably competitively, would not shareholder sovereignty emerge in this market, just as consumer sovereignty emerges in competitive markets generally? So, Manne wrote, mergers "are of

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[12] Manne, *supra* note 3, at 112.

[13] It is interesting that Manne never specifies any particular way in which a change in corporate control, resulting in new management, will increase the value of the firm. He refers only generally to management being "more efficient," or of its "revitalization of a poorly run company." *Id.* at 113. In that sense, Manne's view of efficient management parallels Austrian economists' views of entrepreneurship. *See, e.g.*, ISRAEL M. KIRZNER, DISCOVERY AND THE CAPITALIST PROCESS 7 (1985) (stating that an entrepreneurial activity "reflects the decision maker's belief that he has discovered possibilities that both he and his actual or potential competitors had hitherto not seen. Such discoveries may reflect alertness to changed conditions or to overlooked possibilities. . . . The crucial element in behavior expressing entrepreneurial alertness is that it expresses the decision maker's ability spontaneously to transcend an existing framework of perceived opportunities").

[14] *See Manne Legacy*, *supra* note 4, at 220-25 (providing an excellent distillation of this view).

considerable importance for the protection of individual non-controlling shareholders . . . ."[15] Thus, as the Carney paper elucidates meticulously, for the first time the famous Berle-Means concern about the separation of ownership and control was seen for what it truly is: an undeniable fact but one that invites, and has elicited, a market solution because it offers manager-entrepreneurs individual gains while protecting other shareholders as well.[16] This was Henry Manne's central point. He writes:

> Basically this paper will constitute an introduction to a study of the market for corporation control . . . . Perhaps the most important implications are those for the alleged separation of ownership and control in large corporations. So long as we are unable to discern any control relationship between small shareholders and corporate management, the thrust of Berle and Means's famous phrase remains strong. But . . . the market for corporate control gives to these shareholders both power and protection commensurate with their interest in corporate affairs.[17]

In redefining mergers and the market for corporate control in consumer (shareholder) protection terms, the Manne approach anticipated future developments in parallel areas. When "Mergers and the Market for Corporate Control" appeared, things like advertising and product differentiation were—like mergers—typically analyzed according to their supposed impacts on competition. And viewed that way, they were—like mergers—typically treated with suspicion.[18] Advertising, for example, was viewed as a source of market power that would enable antitrust authorities to defeat an acquisition when the acquiring firm was a heavy advertiser.[19] That perception of advertising was just beginning to change in 1965, with the realization

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[15] Manne, *supra* note 3, at 119.

[16] *See id.* at 113. Manne wrote:

> The lower the stock price, relative to what it could be with more efficient management, the more attractive the take-over becomes to those who believe that they can manage the company more efficiently . . . . But the greatest benefits of the take-over scheme probably inure to those least conscious of it . . . . Only the take-over scheme provides some assurance of competitive efficiency among corporate managers and thereby affords strong protection to the interests of vast numbers of small, non-controlling shareholders. *Id.*

[17] *Id.* at 112.

[18] *See, e.g.*, WILLIAM S. COMANOR & THOMAS A. WILSON, ADVERTISING AND MARKET POWER (1974) (arguing that the advertising market favors big advertisers).

[19] *See, e.g.*, Federal Trade Comm'n v. Procter & Gamble Co., 386 U.S. 568 (1967) (holding that § 7 of the Clayton Act prohibits the acquisition of a smaller, but dominant, firm by a powerful firm that advertised heavily because such a merger would substantially reduce the competitive structure of the industry).

that advertising should really be viewed as a way of enhancing consumer sovereignty by increasing consumer information.[20] The congruence with the paradigm shift urged by Manne concerning mergers—away from a focus on competitive problems and towards the benefits in protecting shareholder-consumers—is striking.

C. Managerial Efficiency and Share Prices

From the perspective of economists, this shift in thinking about mergers and the role of the market control in protecting consumers was not just a challenge to traditional economic theorizing. It was also a challenge to economists' practical quantitative skills. Measuring changes in market power or in production costs were empirical exercises that economists performed routinely in analyzing mergers. It would seemingly be more difficult to undertake the quantitative measurement that Manne was suggesting, increased efficiency in management.[21]

But here, Manne made a third important contribution. Having shifted the thinking about mergers from external market competition to internal firm management, he pointed out how gains from increased managerial efficiency should be measured: by changes in share prices. Manne stated that "[a] fundamental premise underlying the market for corporate control is the existence of a high positive correlation between corporate managerial efficiency and the market price of shares of that company."[22] Here, clearly, Manne was adumbrating what is now called the "efficient market hypothesis," generally acknowledged as one of the most important ideas in modern finance.[23] Today, analysts ordinarily accept (at the level of both theory and empirics) at least the semi-strong form of the efficient market hypothesis as applicable in most situations.[24]

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[20] Perhaps the most important catalyst that ultimately changed the thinking about advertising was Lester G. Telser, *Advertising and Competition*, 72 J. POL. ECON. 537 (1964). For a good summary of the debate and the changing perceptions, see Yale Brozen, *Advertising as an Impediment to Competition, in* INDUSTRIAL CONCENTRATION: THE NEW LEARNING (Harvey J. Goldschmid, et al. eds., 1974).

[21] Measurement of increased efficiency would seem all the more difficult, given that Manne did not specify in exactly what way (planning? production? marketing?) efficiency would increase.

[22] Manne, *supra* note 3, at 112.

[23] *See* RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 989-90 (5th ed. 1996).

[24] *See generally id.* at 323-36 (explaining the weak, semi-strong, and strong forms of the efficient market hypothesis); Steven L. Jones & Jeffry M. Netter, *Efficient Capital Markets*, in *The Fortune Encyclopedia of Economics* 569-73 (David R. Henderson ed., 1993) (providing a general discussion of the fundamental concept of the efficient market theory).

To modern readers, then, Manne's statement about managerial efficiency and share prices seems self-evident. But in 1965, no such efficient-market hypothesis was generally accepted or had even been widely propounded.[25] The full theoretical development of the efficient market hypothesis was still some years away.[26] Empirically, likewise, the now mundane stock-market event study had yet to appear.[27] Thus, Manne's insistence that the stock market was the appropriate barometer of the gains from managerial efficiency was a clairvoyant, even bold, aspect of his model.[28]

I would not overstress this last point. A great deal of theoretical and empirical work remained to be done in 1965 on the strengths and weaknesses of the efficient-capital-market hypothesis. But Henry Manne, the economist, understood that if the market for corporate control worked to protect consumers as he claimed, the effect of greater managerial efficiency must be registered in market prices. That in turn took him to the edge of one of the most important developments in modern finance, the ability of stock markets to accurately price information about, *inter alia*, managerial performance. Subsequent developments have largely validated what Manne instinctively knew must be true.

II. CONCLUSION

Of course, the contributions of Henry Manne are much more extensive than just his most cited article. The remaining papers in this Symposium cover his other contributions, both as scholar and educator. But one can only be impressed by how much erudition Henry Manne packed into the relatively few pages of *Mergers and the Market for Corporate Control*. While many (including myself) could not see as far into the future as Manne could, subsequent developments in economics and law have amply demonstrated how accurate and penetrating his vision was.

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[25] This is clear from Manne's footnote justification for the statement quoted *supra*, text accompanying note 22. He notes that the link between information and market pricing is in one sense an empirical proposition, but that no empirical information exists. He then explains why, theoretically, information and stock prices would be related, but is unable to cite anyone for the various propositions he discusses. *See* Manne, *supra* note 3, at 112 n.10.

[26] BREALEY & MYERS, *supra* note 23, at 329 (citing theoretical developments from the late 1960s and early 1970s); Jones & Netter, *supra* note 24, at 571 (dating the theoretical development of efficient capital markets as beginning in 1970).

[27] The first important empirical event study was Eugene Fama et al., *The Adjustment of Stock Prices to New Information*, 10 INT. ECON. REV. 1 (1969).

[28] Manne boldly stated: "Apart from the stock market, we have no objective standard of managerial efficiency." Manne, *supra* note 3, at 113.