SCHOOL OF LAW
CASE WESTERN RESERVE UNIVERSITY

Case Western Reserve Law Review

Volume 50 | Issue 2

1999

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SOME OBSERVATIONS ON HENRY MANNE'S CONTRIBUTIONS TO FINANCIAL ECONOMICS

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INTRODUCTION

Like almost everyone else at the Symposium, Henry Manne's work has had an enormous influence on my career. My first exposure to Manne's work was in my second year of graduate school at Washington University, in an industrial organization course taught by Lee Benham. I went to graduate school thinking that I wanted to be a macroeconomist. After a full year of Keynesian style macro, I was feeling that the emperor had no clothes and wondered what I was going to do. Then Lee introduced my classmates and me to papers by Ronald Coase, Armen Alchian, Harold Demsetz, and Henry Manne. These papers gave us a whole new way of thinking about problems and convinced me that I wanted to be an economist. In reading Manne's papers in advance of this conference, it was, as Yogi Berra would say, "déjà vu all over again"—I experienced the same sense of insight and excitement that I did in graduate school.

I. SOME OBSERVATIONS ON *MERGERS AND THE MARKET FOR CORPORATE CONTROL*

I begin by making a few observations on Manne's classic 1965 paper, *Mergers and the Market for Corporate Control.*[1]

First, it is fascinating to reread this paper today with the hindsight of several hundred papers, mostly empirical, that have been published in the economics literature on the market for corporate control since 1965. At the time Manne wrote the paper, there was virtually no literature in economics on the workings of this market. As evidence, Manne cited only four articles in economics journals, but fifteen in law journals. His article may hold the all-time *Journal of Political Economy* ("*JPE*") record for the ratio of legal to econom-

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[1] Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. Pol. Econ. 110 (1965).

ics cites. In any event, Manne clearly broke new ground in the economics literature with the publication of this paper.

Second, Manne's paper anticipated numerous issues that have been addressed by financial economists during the past two decades. Perhaps most prominently, much research in this area has examined whether the market for corporate control plays the disciplinary role described in Manne's paper. Although many questions still remain on this topic, there is plenty of evidence that it does. Targets of hostile takeovers generally have low market to book ratios and often have squandered free cash flow on negative NPV projects. Leveraged buyouts and proxy contests create substantial shareholder value and result in significant improvements in the operating performance of target companies.

In addition to this insight, Manne's paper anticipated research on several other topics related to the market for corporate control. At the end of his paper, Manne suggests the merit of examining how the stock prices of target and acquiring firms react to takeover announcements. In 1974, Gershon Mandelker, my colleague at the University of Pittsburgh, published the first paper on this topic.[2] Since then, the analysis of stock returns around mergers has grown into a cottage industry.

Manne's discussion of the relation between the market for corporate control and the "alleged separation of ownership and control"[3] hinted at some substitutability between an active takeover market and concentrated corporate ownership structures. In a clever study of state laws governing takeovers of banks, Mary Schranz finds that the ownership structure of banks becomes more concentrated after restrictive takeover laws are passed, suggesting that such substitutability does indeed exist.[4]

Manne's article also explicitly recognized other topics that have spawned numerous papers in the financial economics literature. He discussed how the structure of bids might mitigate the now familiar "hold-out" problem.[5] In a brilliant discussion of how the SEC's proxy solicitation rules favor insiders, Manne described how outsiders have to "'guess' why the company is doing as well as it should,"[6] whereas insiders are fully informed about the firm's performance. This is an example of a problem that today we would refer to as one of "asymmetric information," about which much has been written in

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[2] *See* Gershon Mandelker, *Risk and Return: The Case of Merging Firms*, 1 J. Fin. Econ. 303 (1974).

[3] *Manne, supra* note 1, at 112.

[4] *See* Mary S. Schranz, *Takeovers Improve Firm Performance: Evidence from the Banking Industry*, 101 J. Pol. Econ. 299, 320-323 (1993).

[5] *See Manne, supra* note 1, at 116.

[6] *Id.* at n.18.

the corporate control literature and more generally in the finance literature. Manne also discusses how the shareholdings of management affect their incentives to approve merger proposals, a topic that has been the focus of much empirical research. Manne also discusses how "side payments" to management can strengthen their incentives to approve value-increasing mergers. The modern name for these side payments is "golden parachutes," and a great deal of research has been devoted to this topic.

Footnote 10 of Manne's article also contained the essence of the efficient markets hypothesis, one of the major intellectual breakthroughs in finance during the past thirty years. The note elaborates on Manne's statement in the text 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."[7] In the note, Manne acknowledged that "[t]he contention is often made that stock market prices are not accurate gauges, since far more trades take place without reliable information than with it."[8] He goes on to argue that "there is reason to believe that intelligence rather than ignorance ultimately determines the course of individual share prices."[9] Although the theory posited in this footnote is a bit loose, the basic intuition of market efficiency, which has since been validated, lies in footnote 10 of Manne's paper.

Finally, Manne's paper also anticipated various "real world" phenomena that became common during the hostile takeover boom of the 1980s. His argument that "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"[10] seemed to presage the rash of hostile takeover bids in the 1980s. This argument became the rallying cry for those trying to stave off takeover regulations in the 1980s, including takeover artists such as Boone Pickens, Carl Icahn, and James Goldsmith.

As Bill Carney points out, Manne effectively described how leveraged buyouts might work,[11] but pointed out that "American commercial banks are generally forbidden to lend money for this purpose."[12] Many argue that these banking restrictions in part created an incentive for Michael Milken and Drexel Burnham to develop junk

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[7] *Id.* at 112.

[8] *Id.* at n.10.

[9] *Id.*

[10] *Id.* at 113.

[11] *See* William J. Carney, *The Legacy of "The Market of Corporate Control" and the Origins of the Theory of the Firm*, 50 CASE W. RES. L. REV. 215, 235 (1999).

[12] *Manne, supra* note 1, at 113.

bond financing for the dozens of leveraged buyouts that occurred in the 1980s.

II. MANNE'S INFLUENCE ON RESEARCH IN FINANCIAL ECONOMICS

To gauge the impact of Manne's work on research in financial economics, I examined the number of times his work was cited in corporate control papers published in the *Journal of Financial Economics* ("*JFE*") from 1974 (the first year of the *JFE*) through February 1999. The *JFE* is the predominant finance journal in which papers on corporate control have been published during the past 25 years. The attached table contains data showing the results of this analysis.[13]

The data shows that only four corporate control papers were published in the *JFE* from 1974 through 1982. In 1983 the JFE published 16 corporate control papers, including 12 in a special issue containing proceedings from a symposium on corporate control. Since 1983, the JFE has published 114 papers on corporate control, or roughly 8 per year.

The table also shows the number of times Manne's work is cited in these papers. From 1974-1983, Manne's work was cited 19 times in the 20 corporate control papers published in the *JFE*, or an average of 0.95 times per paper. From 1984 to present, Manne's work has been cited only 17 times in 114 papers, or an average of only 0.15 times per paper. The attached table shows the ratio of cites to Manne to the number of corporate control papers published in the *JFE* for each year, 1974-present. It shows a steady decline in the frequency with which Manne is cited in the financial economics literature on corporate control. The obvious question is why?

I offer two explanations for these data. First, Mike Jensen and Rick Ruback published a survey article in the symposium issue of the *JFE* in 1983.[14] In the article, they refer to Manne and state that "Manne's (1965) seminal article initiated an interest in how the market for control influences large corporations . . . ."[15] Since 1983, Jensen and Ruback's survey article has undoubtedly attracted some citations that otherwise would have gone to Manne. Second, the ideas initially espoused by Manne in 1965 are now so commonly accepted by financial economists that perhaps they do not even find it necessary to cite him. Perhaps this is the ultimate compliment that a scholar can receive from his profession.

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[13] *See* Appendix A.

[14] *See* Michael C. Jensen and Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. Fin. Econ. 5 (1983).

[15] *Id.* at 7.

APPENDIX A

Table 1

The number of *Journal of Financial Economics* ("*JFE*") papers on corporate control, number of cites to Manne in these papers, and the ratio of the number of cites to Manne to the number of *JFE* papers on corporate control, 1974-1999.

Year	**Number of JFE papers on corporate control**	**Number of cites to Manne**	**Ratio of number of cites to Manne to number of JFE papers on corporate control**
1974	1	2	2
1975	0	0	0
1976	1	4	4
1977	1	1	1
1978	0	0	0
1979	0	0	0
1980	1	1	1
1981	0	0	0
1982	0	0	0
1983	16	11	0.69
1984	0	0	0
1985	2	0	0
1986	2	2	1
1987	6	0	0
1988	19	7	0.37
1989	16	3	0.19
1990	10	1	0.1
1991	7	0	0
1992	6	1	0.17
1993	3	0	0
1994	7	0	0
1995	7	0	0
1996	6	1	0.17
1997	9	0	0
1998	11	2	0.18

Table 1, cont.

1999	3	0	0
Total	**134**	**36**	**0.27**
1974-1983	**20**	**19**	**0.95**
1984-1999	**114**	**17**	**0.15**