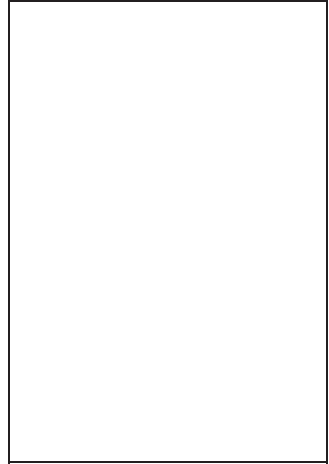


The Collected Works of Henry G. Manne

VOLUME 1 *The Economics of Corporations and Corporate Law*



Henry G. Manne

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of Henry G. Manne**

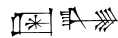
Fred S. McChesney

GENERAL EDITOR

VOLUME 1 The Economics of
Corporations and Corporate Law

With a General Introduction by Fred S. McChesney

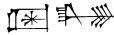
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**GENERAL INTRODUCTION TO THE
COLLECTED WORKS OF HENRY G. MANNE**

Fred S. McChesney

I was delighted when Liberty Fund asked me to help assemble the three volumes collecting several decades of Henry Manne's work. The writings of Manne have caused fundamental revisions ("paradigm shifts," Thomas Kuhn would call them) in several areas of legal and economic analysis. It was time for these seminal and diverse contributions to be organized and made easily available to the modern audience. Now, Liberty Fund has undertaken this long-overdue task.

As readers will discover, the scholarship offered here spans more than four decades, starting in the 1950s. The works were chosen to illustrate Manne's accomplishments in corporate law in particular. His work in this domain is found in volumes 1 and 2 of this collection. But as readers will also see, he hardly limits himself to any one area of inquiry. Much of his work in noncorporate areas, such as university governance, can be sampled in the collection's volume 3. The Manne scholarship presented in each volume is preceded by an introduction written by a leading academic (Henry Butler, Stephen Bainbridge, and Jonathan Macey, respectively) thoroughly familiar with the exceptional contributions Henry Manne has made.

Before embarking on reading (or rereading) the work in the three volumes, one might be interested in how Henry Manne came to understand the world about which he writes. Henry's maternal great-grandfather emigrated from Romania and opened a store in New Madrid, Missouri. But soon he moved to Memphis, where eventually Manne's father, an immigrant from South Africa, opened a dry-goods store. Henry grew up in Mem-

phis, working in the family store, and thereby came to see markets in action. “My whole life’s philosophy can be traced back to those early beginnings,” he relates. Henry then attended Vanderbilt, majoring in economics. There one of his professors, Roland McKean, urged him to continue his studies at the University of Chicago.

Manne was not a “Chicago school” acolyte when he arrived in Hyde Park. He was a supporter of Henry Wallace and aspired to be a labor lawyer. But while there, he took influential courses with Aaron Director and sat in on courses taught by Friedrich von Hayek and was thus led to read the fundamental works of Austrian economics, particularly Ludwig von Mises’s *Human Action*. That self-education continued when Manne, after finishing his law degree at the University of Chicago, went off to Yale for a year to get a doctorate in law.

At Yale Manne wrote his doctoral dissertation on insider trading in the stock market, a subject that was not especially controversial at the time.¹ The gist of that dissertation was not published for some ten years. But upon publication it provoked a storm of controversy over Manne’s principal point—that insider trading not only was not problematic but in fact could be and often was beneficial economically. Readers will find Manne’s scholarship on insider trading in volume 2 of this collection, *Insider Trading*.

Insider trading was not the first area in which Manne made an academic impact, however. In the late 1950s, after starting his academic career at St. Louis University School of Law, Manne had come to see how economics could inform the law and that lawyers had much to teach economists as well. Particularly because of Armen Alchian’s work, Manne saw how economics and law were not separate scholarly disciplines but in fact closely intertwined.² This insight—accepted as obvious today—was revolutionary at the time. Manne, in effect, began to distill thinking about the real world through dual prisms, rather than from just one perspective.

At this point (Manne had accepted a position at St. Louis University in

1. Henry Manne, “Insider Trading and the Stock Market” (S.J.D. dissertation, Yale University, 1956).

2. See, generally, Armen A. Alchian, *The Collected Works of Armen A. Alchian*, ed. Daniel K. Benjamin, 2 vols. (Indianapolis: Liberty Fund, 2006).

1956), he faced two problems. First, neither economists nor lawyers thought of the “other” discipline as contributing anything to their own. Differences in backgrounds, education, and professional standards, plus the organizational barriers of universities, meant that each group had been able to ignore the other with impunity. Manne realized that this was a mistake; each group would be better off by learning about what the other had to offer.

Manne’s own interests concerned business organizations, and especially the corporation. However, perhaps surprisingly to the current generation, which has learned at Manne’s knee, lawyers understood little if anything of the economics of the modern corporation. This is not to fault the lawyers alone. Economists were likewise ignorant of how the modern corporate firm functions in the real world, and in particular why it is organized as it is. Manne’s self-appointed task was the search for intellectual rapprochement. He sought to introduce to one another two groups nominally interested in the same things, each unable, on its own, to see the full picture.

But here Manne encountered a second challenge, a more personal one. The schism between economists and lawyers meant that his own work at the time went largely unappreciated, if not misunderstood. And so Manne’s first important intellectual work, his seminal pieces in corporate law (in volume 1 of this collection, *The Economics of Corporations and Corporate Law*), went largely undervalued, even ignored. This neglect in the legal academic profession was almost certainly due to Manne’s approaching the subject from the point of view of economics, one completely different from that of traditional doctrinal scholarship on corporate law. Indeed, this work was often scorned for its unorthodox blend of economics and law. Years later a corporate law professor from a prestigious law school said ruefully to me, “We may not have agreed with him, but we were wrong to dismiss him—he had a lot to say.” Or to quote Jonathan Macey,

The reaction to Professor Manne’s work, in particular, tells us as much about the culture of academia as it does about the law, economics, and policy of insider trading. Legal academia is a club, and to be ostracized by its elite can curtail or ruin a young academic’s career, even a career with Manne’s stellar credentials. I wonder how many people in academics today would have the courage to risk everything to write what they want to write, to reach the con-

clusions they think are justified, and then to stand by those conclusions in the midst of the unprecedented criticism that Dean Manne initially received for his work. I am sure that the number is not very large.³

Manne's most auspicious work in corporate law began with the two pieces from the *Columbia Law Review* that appear in volume 1. As Henry Butler summarizes in his introduction to this volume, "Henry Manne was an innovator challenging the very foundations of the current learning." "The 'Higher Criticism' of the Modern Corporation" was Manne's initial riposte to the then-accepted idea that the corporation was just a device by which managers fleeced shareholders, the lynchpin of the so-called Berle-Means view of the corporation.⁴ To Manne, this claim could not be squared with the basic economic assumption that individuals understand (or soon come to comprehend) the costs and benefits of the situations in which they find themselves and rationally respond according to their self-interest. If this was true throughout the rest of society, how could it not be true within corporations?

It then followed that shareholders did exert as much influence in their firms as they needed to. Manne next explained how shareholders actually ran the corporations they owned in "Some Theoretical Aspects of Share Voting." At that point, it was clear that Manne was an exceptionally original thinker in the area of corporate law and that he viewed the corporation in ways quite apart from those of other academicians.

Perhaps the best example of Manne's ability to see things from a completely different point of view is "Mergers and the Market for Corporate Control" (reprinted in volume 1).⁵ That it was published in an economics journal—perhaps the most prestigious of all economics journals—attests to the fact that he was writing in a different vein from that of all other corporate *law* scholars. And, to return to a point above, Manne was shifting

3. Jonathan R. Macey, "Securities Trading: A Contractual Perspective," *Case Western Reserve Law Review* 50 (1999): 270.

4. Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (New York: Macmillan, 1933).

5. Henry Manne, "Mergers and the Market for Corporate Control," *Journal of Political Economy* 73 (1965): 110.

the entire terrain of the debate over corporate takeovers.⁶ Previously they had been seen solely in terms of their antitrust consequences (i.e., creating market power by increasing industry concentration). Indeed, he began the article in antitrust terms because he knew that editors would be familiar with that subject, given the existing industrial organization literature on mergers. But then Manne told readers to think about mergers in a different way, to see takeovers as part of a different market, the market for corporate control.

Manne's insights about corporate control were simple—or so they may seem forty years after he first set them out. Manne made two fundamental points. First, underperforming firms represented profit opportunities for others who could assume control of them and improve their performance. And second, there is a market of such people who would vie for the right to assume control of an underperforming firm.

Today, with the plethora of takeover specialists (be they individuals or venture capital firms), the working of that market for corporate control is a staple of newspapers' business sections and sophisticated academic research. In the mid 1960s, however, when Manne elaborated the notion of a corporate-control market, the idea was treated as an almost heretical perspective on corporate law. Fortunately Harry Johnson at the University of Chicago, editor of the *Journal of Political Economy*, recognized the importance of Manne's insights. This concept of a takeover market is now so well accepted that its origin has been forgotten by many. But it all goes back to Manne. As noted economist Harold Demsetz has written: "Few scholars can lay claim to a discovery of the workings of unsuspected economic forces. Even fewer have the words by which they identify their discovery become an indelible part of the language of a field of investigation. Manne's *Market for Corporate Control* is such a discovery."⁷

It is difficult to overstate the importance of this article. It remains one of the most cited pieces in economics, a remarkable feat for one writing in

6. This point is especially well explained in William J. Carney, "The Legacy of 'The Market for Corporate Control' and the Origins of the Theory of the Firm," *Case Western Reserve Law Review* 50 (1999): 215.

7. Harold Demsetz, "Henry Manne: Scholar, Academic Entrepreneur, and Friend," *Case Western Reserve Law Review* 50 (1999): 253.

a law school.⁸ At the same time, as so often happens, many younger scholars of the market for corporate control today seem to have forgotten its intellectual origins.⁹ This Liberty Fund collection can at least, one hopes, remind the current generation of its intellectual debt to Manne's germinal work.

The article is remarkable in other ways. It clearly adumbrates the now-familiar efficient market hypothesis concerning capital markets, although economists had not yet appreciated that phenomenon.¹⁰ And most important, it explains for the first time how shareholders typically were beneficiaries, not victims, of various management maneuvers in the market for corporate control.¹¹ As William Carney wrote:

Henry Manne's contribution to the theory of the firm and to a broader understanding of corporate law is both totally original and unmatched. He introduced both economists and lawyers to the role markets play in shaping firms. He first articulated the important features of the behavior of shareholders and the role markets play in protecting them. He explained the major features of the market for corporate control. Finally, he described the role of corporate law, and the forces that shape it. In all of this he was a pioneer.¹²

Iconoclastic thinking like this is evident as well in Manne's approach to insider trading, the subject of volume 2 of this trilogy. Insider trading in the early 1960s when Manne wrote the book (which had been accepted by Yale as his doctoral thesis) was not a major issue. But exogenous events were about to change that.

Legal decisions in the 1960s began to make insider trading an important part of securities law. Having thought about it for so long, Manne was ready to explain why insider trading was not the problem that the law increasingly

8. Carney, "The Legacy of 'The Market for Corporate Control,'" provides a count of citations.

9. *The New Palgrave Dictionary of Economics and the Law*, in its multipage entry "Market for Corporate Control," cites over thirty articles ([London: Macmillan Reference, 1998], 2: 611–14). There are no cites to Manne's seminal work.

10. This point is discussed in Fred S. McChesney, "Mergers, and the Market for Corporate Control," *Case Western Reserve Law Review* 50 (1999): 245.

11. Henry Manne himself credits Armen Alchian for starting him thinking about markets in areas where others would not see competition among rivals vying for a particular resource.

12. Carney, "The Legacy of 'The Market for Corporate Control,'" 244.

believed to exist—indeed, that the law had it all wrong. His book on the subject (*Insider Trading and the Stock Market*), in volume 2, was his analysis of the “problem.” And as Steven Bainbridge writes in his introduction to the volume, Manne’s views puzzled lawyers and, perhaps worse, evoked academic opprobrium. “One exaggerates only slightly to say that Manne stunned the corporate law academy by daring to propose the deregulation of insider trading. . . . The response by all too many traditionalist scholars was immediate and vitriolic. . . . Indeed, one might have thought Manne had insulted motherhood and apple pie.”

Manne thought that insider trading was *not* a problem, that indeed it was actually beneficial. It was a form of executive compensation, one that did not cost shareholders as a group anything. In a large publicly held corporation, where shareholders are passive investors, they are not the ones who will get the information first and so be able to profit on it. If they are not the beneficiaries of new information, why would they care who else profits? Perhaps, as an even more fundamental benefit from insider trading, Manne pointed out, insider trading creates incentives to bring new information to the market earlier, making stock markets more efficient, that is, in evaluating new information correctly and in having it affect share prices more quickly.

For all his contributions in the economics and law of the modern corporation, Manne has constantly been interested in wider issues than just those arising in business law. Proof of Manne’s acumen beyond the confines of corporate law is apparent in volume 3. As Jonathan Macey’s introduction to that volume indicates, Manne was a “true philosopher” in areas beyond corporate law and governance. Trained at the University of Chicago and heavily influenced by Armen Alchian, Manne was ably equipped with the economist’s tool kit to analyze a range of problems, among them the governance of universities. His many shorter pieces in publications such as *Barron’s* explain clearly and convincingly why free markets are essential to maximizing social welfare and why so much of government regulation is pernicious.

Manne’s wider interests also led to a new phase in his career. Lawyers’ and law professors’ inability to understand how fundamental economics enhanced one’s understanding of the law (both corporate and other)

gnawed at him and ultimately caused him to begin thinking about teaching economics to lawyers. By the late 1960s Manne had been given a chaired professorship in the political science department at the University of Rochester. That department was the first to consider the application of economics to political institutions, a discipline known today as “public choice theory.” Finally, Manne was able to raise the money necessary to undertake his first seminar to teach economics to lawyers. The Summer Institute for Law Professors, held at Rochester in the summer of 1971, was dubbed “Pareto in the Pines.” And its impact was immediate.¹³ Manne then undertook the complementary tasks of teaching economics to judges and law to economics professors, with equal success.

After this organizational beginning at Rochester, Manne made an offer to establish a full-fledged Law and Economics Center at the University of Miami, which was accepted. Here the ambitious program that Manne had pioneered to teach economics combined with law began to soar. The Miami program had several parts. Olin Fellowships were awarded to young economists to study at the University of Miami’s law school.¹⁴ Dozens of conferences, moderated and attended by the leading lights in economics and law, were organized. (A list of those conferences is appended at the end of volume 3.) A new journal, the *Supreme Court Economic Review*, was established. The programs to teach law to economists spawned an important new literature that tied economic analysis to legal doctrine.

And perhaps most important, the center began a regular program of educating federal judges in economics, featuring classes taught by the best economists in the business, such as Armen Alchian, Harold Demsetz, Martin Feldstein, Milton Friedman, Paul MacAvoy, and Paul Samuelson. The

13. See Warren F. Schwartz, “What I Do for the Economists?” *Case Western Reserve Law Review* 50 (1999): 347. (“I was in Henry Manne’s very first ‘Pareto in the Pines’ summer camp for law professors. The effect of the experience, and my effort to gain a command of the economic theory that inspired, was profound. It is not an exaggeration to say that all of my teaching and research was revised to accommodate the centrality of the economic paradigm in my approach to legal problems.”)

14. Louis De Alessi, “The John M. Olin Fellowship Program in Law and Economics,” *Case Western Reserve Law Review* 50 (1999): 341, provides a detailed description of this three-year program.

judges' reaction to their new education was extraordinarily positive, and over the years the judges' program was perennially oversubscribed.

"By 1990 over 900 professors had received instruction in law (for economists) or in economics (for lawyers), and 350 judges (40 percent of the federal judiciary) had received instruction in law and economics."¹⁵ Manne's work as an intellectual entrepreneur is essential to understanding how economics and law found one another.

Manne introduced, popularized, and extended law and economics to thousands. Manne achieved this influence in three basic ways: first his instructional programs of law for economists and economics for lawyers; second, his programs on various law and economics topics for judges; third, and to my mind just as important, the academic conferences that he organized, many supported by the Liberty Fund.¹⁶

The courses presented to economists, lawyers, and judges revolved around the importance of freedom and private markets. This was hardly surprising, given Manne's interests. But they were always analytic, not doctrinaire, as participants in the courses emphasized time and again.¹⁷ Indeed,

15. Jonathan Macey, "Manne, Henry Girard," in *The New Palgrave Dictionary of Economics and the Law* (London: Macmillan Reference, 1998), 2:610.

16. George L. Priest, "Henry Manne and the Market Measure of Intellectual Influence," *Case Western Reserve Law Review* 50 (1999): 329.

17. See, for example, *ibid.*, 330. ("None of the many Manne conferences that I attended were ideological directly. There was no clear or, to my mind, subterranean agenda.") As one federal appellate judge from the Sixth Circuit wrote, "Dean Henry G. Manne has made a greater contribution to the continuing professional education of America's federal judges than any individual, foundation, institute or agency in the nation" (quoted in Henry N. Butler, "The Manne Programs in Economics for Federal Judges," *Case Western Reserve Law Review* 50 [1999]: 351). The Butler article provides much information (and similar accolades) from judges (including Ruth Bader Ginsburg, now a member of the Supreme Court) concerning their education by Henry Manne. Judge Jack Weinstein of the Eastern District of New York explained that judges were eager to have the education that Manne was providing: "Henry G. Manne set many judges to thinking on ways to learn more about the fundamental knowledge that supports much of our general law. . . . It is likely that the knowledge and perspective Professor Manne helped impart did affect my decisions and those of my colleagues in the judiciary. This is an advantage, not a disadvantage. We cannot rule well out of ignorance. . . . Not one of the instructors Professor Manne brought to our class rooms was less than balanced, and none sought to steer us to particular policy decisions" (421).

Manne himself has always been open to counterarguments and alternative points of view. Steven Bainbridge, in his introduction to volume 2, recounts how Manne has come to understand that some of his arguments concerning insider trading have required revision over the years. And Jonathan Macey observes in his introduction to volume 3 that, in his scholarship concerning the “social responsibility” of business firms, “Manne recognizes the empirical difficulty posed by his analysis. It is extraordinarily difficult to figure out when a particular act is a true act of corporate social responsibility and when that act is, in fact, being done out of enlightened self-interest.” Manne has always taken criticism, such as that leveled by Macey in volume 3 at Manne’s analysis of universities, with the utmost grace.

During his evolving career as a pedagogic trailblazer, Manne remained active as a scholar, a remarkable feat given his ongoing academic creativity. Again to quote Harold Demsetz, “Manne is a distinguished member of a rare breed, one part successful academic entrepreneur and a second part scholarly talent.”¹⁸ Much of his later scholarly work is reprinted herein, in volume 3.

By 1980 the Law and Economics Center had moved to Emory University, but not for long. Both Gordon Tullock and Nobel laureate James M. Buchanan called from George Mason University, urging Manne to consider the newly vacant deanship in the law school at George Mason. He accepted George Mason’s offer of the deanship, but only after the president of the university convinced him that he could in effect start the law school over from a clean slate. In a very short time, that law school became a nationally recognized institution, particularly noted for its economics and law curriculum. The faculty whom Manne recruited to build that new curriculum, and various innovative advances in legal education such as creating specialty “tracks” for students, akin to a master’s degree, made the law school unique.¹⁹ Almost all the programs that Manne had begun with the original Law and Economics Center in Miami followed him to George Mason and, upon his retirement, were continued by his successors.

18. Demsetz, “Henry Manne,” 255–56.

19. Peter Letsou describes how the system Manne created worked in “The Future of Legal Education: Some Reflections on Law School Specialty Tracks,” *Case Western Reserve Law Review* 50 (1999): 457.

The move to George Mason demonstrated what most observers had already perceived. Manne was not just a producer of intellectual insights but an educator adept at transmitting the insights of others. The combination of intellectual progenitor and pioneering educator is a powerful one. Asked to follow a course of study different from those of other, better-known, universities, students might wonder about the wisdom of following a road not yet taken. But Manne and the group he had assembled laid any doubts to rest. Indeed, the reactions of those being instructed at George Mason emphasized that they were receiving a more valuable kind of legal education, one that the market was not long in recognizing.

The foregoing is written not just to recall Henry Manne's intellectual and academic importance but, in particular, to introduce the three-volume edition of Manne's writing compiled for Liberty Fund. In it one sees all aspects of Manne's career, both as a "pure" academician (teacher and scholar) and as an entrepreneur for economics, law, and liberty. Manne is one of those remarkable individuals who has used his academic prowess to forge new roads into thinking outside the conventional university realm. As Bainbridge puts it in his introduction to volume 2, "Unlike ivory tower academics content to watch their ideas collect dust on a library shelf, Manne long has played the dual role of serious academic and public intellectual. As the latter, he has used books, articles and newspaper op-ed columns to transmit his thesis to the public." Lawyers, economists, judges, and otherwise-interested readers have benefited from his ability to put his learning into action. For someone already accomplished in the more scholarly aspects of his university trade, this is highly unusual and most welcome.

To be a seminal thinker and writer, and at the same time an educator both within and outside one's chosen intellectual domains, is an art that few possess. Henry Manne possesses it and has made it work in ways that have benefited us all. The three volumes of this present collection make that abundantly clear. With thanks to Liberty Fund, I hope that readers enjoy and learn from these volumes and grow in appreciation for all that Henry Manne has done.

BIOGRAPHY OF HENRY G. MANNE

Jonathan R. Macey

MANNE, HENRY GIRARD (1928–). Henry Manne has made three distinct contributions to the field of law and economics which taken together constitute a unique and impressive legacy. The first contribution consists of Manne's foundational scholarship in the law and economics of corporate law and securities regulation. To this day his seminal work on takeovers, insider trading, corporate disclosure and the role of regulatory agencies provides a basic starting point for scholarship by lawyers and economists doing research in corporate finance and market micro-structure as well as corporate law and securities regulation.

The second stage of his career in law and economics began in 1974 when he founded the Law and Economics Center at the University of Miami Law School. The Law and Economics Center, which was moved briefly to Emory University en route to its current home at George Mason Law School, began innovative programmes supporting research and teaching in law and economics in a variety of forums.

The third contribution made by Manne to the field of law and economics is comprised of the decade between 1986 and 1996, when he served as the Dean of the George Mason Law School. During this period, he single-handedly transformed a sleepy backwater of American legal education into a major intellectual centre for the study of law and economics.

Reprinted from *The New Palgrave Dictionary of Economics and the Law*, edited by Peter Newman (London: Macmillan Reference Limited, 1998), 609–11. Reproduced with permission of Palgrave Macmillan.

Manne received his training in law and economics at the University of Chicago Law School where he studied with Aaron Director. Soon Manne, followed by Judge Richard Posner and Judge Guido Calabresi, was one of the pioneers in the use of economic analysis to provide insights into legal problems. In his words, the application of economic analysis to the law is “the only really high quality work systematically going on in law today” (Marx 1994: 1). After receiving his *juris doctor* (J.D.) at Chicago, Manne began teaching at a series of universities including St. Louis University, the George Washington University and the University of Rochester, where he was William R. Kenan Professor of Law and Political Science. Along the way, he also earned a doctorate in law (S.J.D.) from Yale.

Scholarly Contribution

For decades after its publication, the prevailing theory of American corporate governance was that of Adolf Berle and Gardiner Means (1932), who argued that the separation of ownership (shareholding) and control (management) in publicly traded corporations allows managers to run such corporations for their own benefit, to the exclusion of the interests of shareholders and society as a whole (Kaufman 1994: 52). Manne’s scholarship on mergers and the market for corporate control constituted a powerful refutation of this approach. In part, the power of Manne’s approach derives from the fact that he was the first person to use economic analysis in the corporate law area.

In his pathbreaking article, “Mergers and the Market for Corporate Control” (1965), Manne recognized that corporate control is a commodity, or good, which, like any other commodity, has a market. He established that the “agency cost” problems of separation of ownership and control in corporations with diffuse shareholders posited by Berle and Means were exaggerated since managers must keep share prices high in order to avoid being displaced in a hostile takeover. In other words, the best defence against a hostile takeover is to keep share prices sufficiently high that rival management teams cannot earn positive rates of return by purchasing control and ousting incumbent management. The market for corporate control thus provides incentives for managers to act in shareholders’ interests. As