

7-1-2000

## Comments on Contestability

Jack B. Jacobs

Follow this and additional works at: <https://repository.law.miami.edu/umlr>



Part of the [Business Organizations Law Commons](#)

---

### Recommended Citation

Jack B. Jacobs, *Comments on Contestability*, 54 U. Miami L. Rev. 847 (2000)

Available at: <https://repository.law.miami.edu/umlr/vol54/iss4/9>

This Article is brought to you for free and open access by the Journals at University of Miami School of Law Institutional Repository. It has been accepted for inclusion in University of Miami Law Review by an authorized editor of University of Miami School of Law Institutional Repository. For more information, please contact [library@law.miami.edu](mailto:library@law.miami.edu).

# Comments on Contestability

JACK B. JACOBS

## I. INTRODUCTION

To be asked to comment on a paper by this remarkable attorney and member of the Harvard Law School faculty is as daunting as it is an honor. Like most judges, I am not trained in econometrics and, in this highly specialized arena, have little to contribute to the substance of Professor Coates's paper, with whose conclusions I have no reason to disagree. What I, therefore, will do is share some modest reflections about broader issues implicated by that paper from the judicial perspective — a vantage point concededly more intuitive and anecdotal than scientific. I agree with Professor Coates that his critique of the “scientific evidence” on takeover defenses inevitably raises (in his words) “meta” questions<sup>1</sup> about the social sciences more generally and (from my perspective) the proper role of “scientific” empiric research in the adjudication process.

Professor Coates's thesis starts with the “fact” that the academic view, particularly after the Delaware Supreme Court validated the poison pill takeover defense in *Moran v. Household International, Inc.*,<sup>2</sup> was that the adoption by firms of the pill, alone or in combination with other antitakeover defenses, will reduce firm value. That view, which I will refer to as “conventional wisdoms,” stemmed from the concern that the pill would give target company boards, particularly boards that were entrenchment-motivated, *carte blanche* to obstruct value-creating hostile acquisition bids. From that premise, there developed the hypothesis that the market would react adversely to pill adoptions by lowering the adopting firm's stock market price.

This hypothesis became the subject of empirical research (“event studies”) that attempted to test it by measuring the impact of pill adoption upon the adopting firm's stock market price. That empirical research is the subject of Professor Coates's *Contestability* paper, which extensively surveys the prior studies and concludes that their results are wrong, or at least not supported by the evidence, because they suffer

---

1. John C. Coates IV, *The Contestability of Corporate Control: A Critique of the Scientific Evidence on Takeover Defenses*, 54 U. MIAMI L. REV. \_\_\_\_ (2000) [hereinafter *Contestability*]. This paper was the subject of a panel discussion at the Institute on Mergers and Acquisitions sponsored by the University of Miami Law School, held on February 12, 2000.

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

from design flaws. Professor Coates's hope is that exposing those flaws will improve future research on takeover defenses.

Neither I nor, I submit, the mergers and acquisitions practicing bar, should have reason to quarrel with Professor Coates's conclusions, because they are consistent with our own post-*Moran* experience. Fifteen years later, with the insight that only hindsight can provide, we now know that in most contested takeovers, target company boards have deployed the pill beneficently to achieve significant "control" premia — to increase firm value — for their shareholders. Similar results have been achieved in friendly acquisitions of firms that have adopted pills.

Given this nonscientific, anecdotal view of the effect of the pill, grounded upon fifteen years of evolved takeover jurisprudence and mergers and acquisitions experience, one would expect that the empiric studies based on target firm market prices would at first confirm the conventional wisdom beginning in 1985, and then, over the next ten years, increasingly reflect the opposite view because of the market's changing (i.e., positive) perception of the pill and its potential for increasing at target company's value. To the extent Professor Coates's paper does not validate this expectation — because it concludes that the empiric studies' conventional wisdom conclusions are not adequately supported — it comes as a surprise. One explanation may be that the market always knew that the conventional wisdom about pills was wrong. Another may be that the methodologies used in the event studies were flawed. Professor Coates appears to embrace the latter explanation.

These observations, informed by Professor Coates's study, prompt a few "meta" questions that we judges and practitioners who deal with mergers and acquisitions issues should seriously ponder. Those questions ultimately raise concerns about whether the factual perceptions of the effects of takeover defensive measures are accurate, or, to put it more formalistically, about the soundness of the factual and perceptual foundation upon which current mergers and acquisitions jurisprudence is based.

## II. SOME "META" QUESTIONS

The ultimate question lurking in the *Contestability* study is an old one presented in a new context: to what extent can "science" or the "scientific method" be validly employed to predict and understand human behavior and social arrangements? Can "facts" derived from scientific methods improve the development, whether by judges or legislators, of rules governing human behavior by more accurately reflecting reality and furthering the policies that underlie those rules?

Ever since the late-nineteenth century scholars and social reformers have sought to affix the label “science” to fields of scholarly endeavor that are essentially humanistic and nonquantitative, e.g., political science and social science. Classical science involves precisely accurate measurement and prediction. This accuracy is possible because the units of scientific measurement (a second, a minute, an erg, an ohm, a meter, a liter or an ounce) are the subjects of universally accepted conventions, and also because, in most cases, the models employed by science can be defined and expressed in mathematical terms. The field of human behavior, whether of individuals or entire societies, however, has by and large, not successfully lent itself to such precise models or to universally accepted and precise units of measurement. That is not due to lack of effort. Rather, it is *either* because the human condition does not lend itself to conventional scientific methods *or* because the current state of our science is too primitive to measure and predict phenomena as complex as human and social behavior.

I say this not to diminish Professor Coates’s paper but, rather, to create a broader context into which his scholarship fits and contributes. The context is the discipline of law which unites all of us professionally. Even that value-oriented discipline has been the object of efforts to employ methods claimed to be “scientific.” During the latter part of the nineteenth century, Christopher Langdell viewed the case study method as a “scientific” way to abstract general rules of law from highly particularized “data,” namely, judicial decisions. Langdell’s ambition and vision drove the development of the Socratic method, but that approach, despite Langdell’s claims, was not scientific except to the extent it required rigorous and careful inductive and deductive reasoning. During the twentieth century, the emergence of other counter-scientific legal movements, especially legal realism and critical legal studies, conveyed quite different views of the nature of law. Critical legal studies, in particular — premised on the view that “law is politics” — fell on the opposite end of the spectrum. One outcome of these movements was a wide recognition that law is no more “scientific,” in the classical sense, than social science or political science.

Although efforts to disconnect law and science persist, they have not banished science from the field, but only relocated its sphere of influence in that field. Rather than being a model or analytical framework for “discovering” or “developing” legal rules, science is currently used in a more limited, yet more realistic and helpful way: to determine more accurately social “facts” to serve as a basis for legal rules and for the social policies underlying those rules. The *Contestability* paper is a prime example of this use of science. Professor Coates does not deploy

science as a framework to deduce rules of law that govern the adoption and deployment of poison pills. Rather, he and other scholars invoke science to validate the accuracy of the perceived and disputed effects of the pill — specifically, whether the pill enhances, reduces, or has no effect upon, firm value. Ideally, and depending on the answer, the legal rule might (or should) change as an indirect consequence. By way of example, if it could be accurately determined by a proper application of the scientific method that pills reduce firm value, then, arguably, legal rules should be developed that would deter the adoption and use of pills. Conversely, if pills enhance firm value, legal rules should be developed that encourage, or at least not discourage, their use.

The potential benefits to courts of this use of the scientific method are readily apparent, at least to me. To make the point, I mention two takeover defense cases over which I recently presided.

In *Carmody v. Toll Brothers*,<sup>3</sup> I confronted the question of whether a dead hand poison pill<sup>4</sup> was properly a subject of legal attack on the basis that, in addition to violating Delaware's corporate statute, that form of pill was coercive or preclusive under *Unocal Corp. v. Mesa Petroleum Co.*<sup>5</sup> and that it constituted an intentional interference by target company directors with the shareholder franchise under *Blasius Indus., Inc. v. Atlas Corp.*<sup>6</sup> In *Toll Brothers* both questions were answered in the affirmative, but that ruling was completely theoretical, since it was made on a Rule 12 (b)(6) motion to dismiss.<sup>7</sup> That is, the motion was denied because it was possible that, in some future case, the dead hand pill might conceivably prove to be coercive, preclusive, and/or obstructive to a meaningful exercise of the shareholder franchise. The true test of those hypothetical possibilities would have to await a real case in which the pill was actually being deployed.

That case arose only three months later in *Mentor Graphics v. Quickturn Design Systems, Inc.*<sup>8</sup> There, the *Unocal* and *Blasius* issues were found to be too fact-laden and uncertain to be resolved on a motion for summary judgment. Accordingly, it became necessary to hold a trial, which involved expert testimony about the likely deterrent effect of

---

3. 723 A.2d 1180 (Del. Ch. 1998).

4. A "dead hand" poison pill is one that can be redeemed only by a majority of the directors in office at the time the pill is adopted. The purpose and effect of a dead hand pill is to discourage a hostile bidder from waging a proxy contest to remove the incumbent board, since the bidders' director-nominees would be unable to redeem the pill.

5. 493 A.2d 946 (Del. 1985).

6. 564 A.2d 651 (Del. Ch. 1988).

7. See *Toll Brothers*, 723 A.2d at 1182.

8. 728 A.2d 25 (Del. Ch. 1998), *aff'd sub.nom.*, *Quickturn Design Systems, Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998).

a no hand (delayed redemption) poison pill<sup>9</sup> upon the target company's public shareholders' reaction to a hostile takeover bid that offered a modest premium. How useful it would have been if that cause and effect relationship — the deterrent force of the pill — could be determined with scientific, incontestable accuracy, thereby avoiding the uncertainties of conventional fact-finding in a specialized field where most judges have no specific expertise. If such scientific knowledge were reliable and readily available, it would influence how new kinds of takeover defenses could be shaped, and would better enable their creators to predict to target company clients how those defenses would fare under the applicable system of legal rules. If the answers to such perplexing question could be determined scientifically, it should be inappropriate for those answers to be determined by the vagaries of the adjudication process that rests upon fortuities such as witness credibility. An eternal verity is an eternal verity regardless of the courtroom demeanor of the witness who utters it. A "counter scientific" finding of fact based on human perceptions should have no more validity because it is made by a court than should an edict of the church about the shape of the solar system during the time of Galileo.

But the foregoing is all prologue to a basic "meta" question: is there a reliable scientific method by which such cause and effect relationships can be measured? Although Professor Coates faults the methodologies used in the prior studies as flawed in their design, he does not, at least in his *Contestability* paper, propose a methodology to avoid those flaws. One can only hope that he is in the process of crafting that methodology and will report its successful use in a future article. In the meantime, the academic debate should center on whether it is possible to design a metric whose accuracy will be universally acknowledged.

If such a metric can be created, the next question is, by what process can it rapidly achieve judicial acceptance? Must there be a test case, employing methodologies such as those prescribed in *Daubert v. Merrill-Dow Pharmaceuticals, Inc.*,<sup>10</sup> where a non-scientist judge must determine, in an arena involving conflicting expert testimony, whether the new methodology is scientifically sound and generally accepted in that professional community? Alternatively, would it be possible to develop a scientific "certifying" board whose imprimatur would be

---

9. The dead hand poison pill in *Mentor Graphics* prohibited any board of directors — the incumbents or a new board elected by a proxy contest mounted by a hostile bidder — from redeeming the pill for six months after a change of control.

10. 509 U.S. 579, 589 (1993) (holding that the trial court has a special obligation to "ensure that any and all scientific testimony . . . is not only relevant, but [also] reliable."); see also, *Kumho Tire Co., v. Carmichael*, 526 U.S. 137 (1999); *M.G. Bancorporation, Inc. v. Le Beau*, 737 A.2d 513, 521 (Del. 1999).

regarded as so definitive that its mere placement would entitle the new methodology to judicial acceptance?

A related question to ponder is: at what point will the new methodology generate results fit to be a subject of judicial notice? The present state of the law of judicial notice makes it unlikely that that will happen at any time soon. But, if a scientifically reliable method of assessing the impact of antitakeover defenses (or, for that matter, any social phenomenon) can be developed, should there not be a doctrine of judicial notice that enables courts, in specific cases, to access studies employing that methodology without undergoing the costs and hazards of a live trial?

Being a non-academic, I have the luxury of asking these questions without having to struggle to develop answers. My point is that Professor Coates's paper is a noble endeavor that, if successful, could represent an important step in reaching a goal about which social scientists have long dreamed but have yet to achieve. If science can be deployed, accurately and reliably, to measure the effects of social or economic arrangements upon human behavior, our profession stands to benefit greatly.