NEW YORK UNIVERSITY
JOURNAL OF LAW & BUSINESS

VOLUME 20 FALL 2023 NUMBER 1

EXIT ENGINEERING

RACHEL LANDY*

How do business lawyers create value? For nearly forty years, scholars have conceptualized the business lawyer as a "transaction cost engineer" who helps contracting parties efficiently break negotiation stalemates to create more valuable deals. This theory provides meaningful insights about sophisticated corporate law practice, where outside lawyers parachute in to make one-off deals happen. However, it fails to explain the behavior of startup lawyers, who develop long-term relationships with their clients and counsel them on seemingly routine matters, well before a major transaction materializes. These lawyers are not just transaction cost engineers, they are exit engineers.

This Article offers a novel theory of startup lawyers as intertemporal transaction cost engineers who create value by anticipating issues that could arise in an exit transaction—an acquisition or an IPO—and helping their clients address those issues proactively. The exit engineering startup lawyer future-proofs clients against the long-term consequences of commercial transactions that they might otherwise neglect because of inexperience or short-term pressure to get deals done.

Startup lawyers minimize the costs of exit transactions and make deals happen that might otherwise fail, enabling more efficient use of the parties' resources. In turn, this facilitates reinvestment into the broader technology ecosystem; profitable liquidity events enable VCs to fund more enterprises and innovation. Successful exit transactions lead to more, new successful ventures.

* Visiting Assistant Professor of Law and Director of the Heyman Center for Corporate Governance, Benjamin N. Cardozo School of Law. I am grateful to Stewart Sterk, Matthew Wansley, and Samuel Weinstein for their valuable feedback on multiple drafts, and to Yifat Aran, Emmanuel Arnaud, Barath Chari, Amanda Ferber, Myriam Gilles, Luís Calderón Gómez, Mark Holloway, Cathy Hwang, Alma Magaña, Katy Miller, Lindsay Nash, Michael Pollack, Elizabeth Pollman, Alex Reinert, Naveen Thomas, Saurabh Vishnubhakat, and participants in the Richmond Junior Faculty Forum, the National Business Law Scholars Conference, and the Law & Entrepreneurship Association for helpful input.

Introduction 28
I. A Limited View of Value Creation 36
A. *The Value Creation Corpus* 36
B. *A Different World* 40
C. *Exit Transactions and Innovation* 44
II. Startup Psychology 46
A. *EmCo: A Mess of a Firm* 47
B. *Intertemporal Transaction Cost Engineering* 50
1. *Intellectual Property Assignments* 53
2. *Open-Source Software Licenses* 55
C. *Customer and Supplier Contract Provisions* 58
1. *Intellectual Property Licenses* 59
2. *Change of Control Provisions* 61
3. *Vertical Restraints* 63
4. *Binding Future Affiliates* 63
III. EmCo's Exits 65
A. *The Acquisition* 66
1. *Confirmatory Diligence and Search Costs* 69
2. *Definitive Documents and Bargaining Costs* 72
a. *Deal Restructure* 73
b. *Purchase Agreement* 74
i. Representations and Warranties . . . 74
ii. Indemnification and Insurance . . . 76
iii. Closing Provisions 79
3. *Closing and Enforcement Costs* 81
B. *The IPO* 84
1. *Due Diligence and Search Costs* 85
2. *Definitive Documents and Bargaining Costs* 87
3. *Effectiveness and Enforcement Costs* 90
Conclusion 92

Introduction

Do business lawyers add value to transactions? In an influential article nearly forty years ago, Ronald Gilson suggested they do, as "transaction cost engineers."[1] Under his theory,

1. Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 Yale L.J. 239, 253 (1984).

clients come to business attorneys for assistance with transactions, even when the advice sought is not strictly legal, because the lawyer helps contracting parties efficiently break negotiation stalemates in discrete transactions to create more valuable deals.[2] In doing so, the lawyer "engineers" the costs of the transaction for both parties.[3] Gilson's transaction cost engineer model has yielded decades of scholarship,[4] but it fails to explain how many business lawyers, and particularly, startup lawyers, operate.[5]

This Article re-contextualizes what it means to be a transaction cost engineer for venture-backed startups operating at a rapid pace to develop and commercialize their products en route to an M&A or initial public offering (IPO) exit transaction. For these companies, an exit is the most significant inflection point in its lifecycle; it reflects the end of the company's initial era as a privately-funded, independently-owned

---

2. *Id.* at 246.

3. *Id.* at 255.

4. *See, e.g.*, Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227 (2010) (showing how lawyers create value in transactions by minimizing associated regulatory costs); George W. Dent, Jr., *Business Lawyers as Enterprise Architects*, 64 BUS. L. 279 (2009) (showing how lawyers create value through structuring entities in joint ventures and other strategic alliances); Elisabeth de Fontenay, *Law Firm Selection and the Value of Transactional Lawyering*, 41 J. CORP. L. 393 (2015) (showing how law firms create value through their understanding of "market" terms for transactions); Lisa Bernstein, *Silicon Valley Lawyer as Transaction Cost Engineer?*, 74 OR. L. REV. 239 (1995) (showing how Silicon Valley lawyers create value by facilitating introductions between clients and investors); Karl S. Okamoto, *Reputation and the Value of Lawyers*, 74 OR. L. REV. 15, 23 (1995) (showing how lawyers create value as reputational intermediaries for transactions); Manuel Utset, *Producing Information: Initial Public Offerings, Production Costs, and the Producing Lawyer*, 74 OR. L. REV. 275 (1995) (showing how lawyers create value in designing IPO documents); Nestor M. Davidson, *Values and Value Creation in Public–Private Transactions*, 94 IOWA L. REV. 937 (2009) (showing how lawyers create value in negotiating and drafting public–private transactions); Omari Scott Simmons & James D. Dinnage, *Innkeepers: A Unifying Theory of the In-House Counsel Role*, 41 SETON HALL L. REV. 77 (2011) (showing how in-house lawyers create value by assisting with transactions, as well as designing and maintaining corporate governance practices and compliance policies and participating in other non-transaction sources of value); Cathy Hwang, *Value Creation by Transactional Associates*, 88 FORDHAM L. REV. 1649 (2020) (showing how transactional M&A associates (versus law firm partners) optimize deal value by structuring and modulating deal documents); Steven L. Schwarcz, *Explaining the Value of Transactional Lawyering*, 12 STAN. J.L. BUS. & FIN. 486 (2007) (showing, by way of an empirical study of corporate clients, how lawyers create value by reducing regulatory costs).

5. Gilson leaves "business lawyer" undefined, and instead generally refers to lawyers who seek to get clients the "'best' deal." Gilson, *supra* note 1, at 242.

entity. As such, these lawyers are more than just transaction cost engineers, they are exit engineers. Exit engineering lawyers create value not only in one-off transactions, but through long-term relationships and by providing counsel on seemingly routine day-to-day matters that ultimately affect the efficiency and value of an exit. Indeed, in the absence of such counsel throughout a startup's lifecycle, by the time it gets to the point in an exit where Gilson's transaction cost engineer may be useful, it is often too late to salvage an efficient deal (or even an inefficient deal[6]).

When Gilson's article, *Value Creation by Business Lawyers,* was published in 1984, the corporate sector was facing an onslaught of merger and acquisition (M&A) activity, and business law practice at major law firms was dominated by the structuring and negotiation of those single strategic enterprise transactions.[7] Back then, Silicon Valley was scarcely more than a hub for semiconductor companies whose names were known to few outside the region, and the now-ubiquitous platforms operated by Google, Amazon, Meta, Spotify, and Uber were almost inconceivable.

Since then, the technology sector has bubbled, burst, and boomed, and business law practice has taken on a much broader meaning, encompassing transactional work spanning general corporate, commercial, venture capital, M&A, capital

6. E.g., an acquisition for which the transaction costs are significantly higher than what would be justified by the purchase price of the company.

7. Over 29% of Fortune 500 companies received acquisition offers in the 1980s, during what is known as the "1980s merger wave." Gerald F. Davis & Suzanne K. Stout, *Organization Theory and the Market for Corporate Control: A Dynamic Analysis of the Characteristics of Large Takeover Targets, 1980–1990*, 37 ADMIN. SCI. Q. 605, 605 (1992). *See also* Roberta Romano, *After the Revolution in Corporate Law*, 55 J. LEGAL EDUC. 342, 348–51 (2005) (describing changes to corporate law in response to the 1980s merger wave); Linda Brewster Stearns & Kenneth D. Allan, *Economic Behavior in Institutional Environments: The Corporate Merger Wave of the 1980s*, 61 AM. SOCIO. REV. 699, 699–718 (1996) (describing the 1980s merger wave).

markets, and more.[8] The startup[9] market, in particular, has created a class of companies engaging in (and requiring counsel on) commercial technology matters germane to operating in an online economy, such as the licensing of intellectual property and the negotiation of agreements for online products and services. Each of these operational needs are well outside the bounds of the long-standing doctrinal linchpin of commercial law, the Uniform Commercial Code (UCC).[10] Yet, the growth of the modern, technology transactions law practice[11] and its role in the startup ecosystem remains underrepresented in legal scholarship. This Article fills that gap.

Technology transactions attorneys play a dual role for their clients. Like all business lawyers, they help companies navigate complex legal landscapes and negotiate agreements that are lawful and of low litigation risk.[12] But they also wear a second hat: that of the future-proofing transaction cost engineer for the startup's ultimate exit.[13] In helping to ensure the success of

---

8. One scholar describes a business lawyer's work as assisting with "business formation, securities and tax research, and contract review." Gordon U. Sanford, III, *An Intellectual Property Roadmap: The Business Lawyer's Role in the Realm of Intellectual Property*, 19 MISS. COLL. L. REV. 177, 177 (1998). *See, e.g.*, Stanford Law School's Law, Economics, & Business curriculum, including courses on "tax law and policy, statistics, mathematics, bankruptcy, contract and commercial law, corporation and securities law, corporate governance, health law and policy, antitrust, intellectual property, and employment law." *Law, Economics, and Business*, https://law.stanford.edu/areas_of_interest/law-economics-business (last visited Jan. 30, 2023).

9. I use "startup" to mean a "high-growth, high-risk, early-stage business[] that [is] backed by venture capital financing." Seth C. Oranburg, *Democratizing Startups*, 68 RUTGERS U. L. REV. 1013, 1028 (2016).

10. *See* Michael L. Rustad & Elif Kavusturan, *A Commercial Law for Software Contracting*, 76 WASH. & LEE L. REV. 775, 780 (2019) (discussing the UCC's inapplicability to technology products). *See also* Giuliano G. Castellano & Andrea Tosato, *Commercial Law Intersections*, 72 HASTINGS L.J. 999, 1002–03 (2021) (describing modern commercial law as a "fragmented bundle of subject-specific legal and regulatory regimes that govern transactions and corporate actions in the course of business").

11. Several "Big Law" firms have technology transaction practices. Many other technology transaction lawyers are employed as in-house commercial attorneys at technology companies all over the country.

12. This role of the attorney is becoming more nuanced, given the rise of businesses built to operate outside of relevant law, such as Airbnb and cannabis enterprises. *See* Charles M. Yablon, *The Lawyer as Accomplice: Cannabis, Uber, Airbnb, and the Ethics of Advising "Disruptive" Businesses*, 104 MINN. L. REV. 309 (2019).

13. An "exit" refers to an acquisition (by way of merger, asset purchase, stock purchase, or other change of control) or an IPO. D. Gordon Smith, *The*

these exits, the technology transactions lawyer not only enables transactions to occur that might not otherwise happen, but also helps to generate funds for venture capitalists (VCs) to back new enterprises and drive more innovation.

Since *Value Creation*, numerous scholars have debated how business lawyers create value for clients. While some have hewed close to Gilson's model, articulating how lawyers take on a "private ordering role"[14] in helping sophisticated parties efficiently structure and negotiate transactions, others have theorized that value is derived from softer skills (such as facilitating introductions between clients and investors[15]), knowledge or market terms,[16] or ability to manage regulatory consequences.[17] This earlier research has predominantly, and narrowly, focused on the lawyer's role in facilitating single transactions, rather than the ways that a lawyer's involvement in multiple transactions over time affects the trajectory of the business.[18] Startup lawyers, in contrast, engineer the costs and efficiency[19] of an exit transaction *before that transaction even materializes*, and in doing so, they engineer the value of a startup itself.[20] As this Article will show, the startup lawyer's value is best illustrated by considering

---

Exit Structure of Venture Capital, 53 UCLA L. Rev. 315, 317 (2005); *see also* Darian M. Ibrahim, *The New Exit in Venture Capital*, 65 Vand. L. Rev. 1, 2 (2012); Abraham J.B. Cable, *Time Enough for Counting: A Unicorn Retrospective*, 39 Yale J. on Regul. Bull. 23, 24 (2021). Where the term "M&A" is used in this article, it broadly refers to any acquisition form, *see infra,* note 23.

14. Gilson, *supra* note 1, at 255.

15. Bernstein, *supra* note 4, at 245–46.

16. de Fontenay, *supra* note 4.

17. Fleischer, *supra* note 4.

18. *Cf.* Simmons & Dinnage, *supra* note 4. Simmons & Dinnage agree that Gilson's theory is limited, but their focus is also narrow, confined to in-house lawyers and non-transactional contexts. This Article's arguments apply to all commercial lawyers (although it focuses on external counsel) and the long-term value they create by participating in routine matters.

19. I.e., whether and to what extent resources and money will be wasted in an exit transaction. *See Definition and Examples: Economic Efficiency*, Investopedia, https://www.investopedia.com/terms/e/economic_efficiency.asp (last updated Feb. 27, 2020).

20. While this Article focuses on successful startups who undergo exit transactions, the exit engineering practices of startup lawyers also apply to failed startups whose businesses or assets are sold-off in attempts to salvage some returns; those acquisitions also benefit from the lawyer's ex ante work. *See* Elizabeth Pollman, *Startup Failure*, Duke L.J. 20–22 (forthcoming 2023), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4535089 (discussing how founders and VCs may pursue buyers to recoup their investments in failed startups).

the commercial decisions (and the attendant consequences) a startup might make *without* the aid of counsel.

Imagine a recently-founded startup, EmCo, is developing a software-as-a-service (SaaS) platform.[21] It will enter into numerous commercial transactions arising out of its product development and third-party relationships, such as intellectual property assignments, open-source software licenses, customer contracts, and agreements with service providers. Each of these has the potential to increase the costs of EmCo's future exit and reduce the value of EmCo, forsaking EmCo's unspoken commitment to its founders, early employees, and investors to preserve an efficient and valuable path to liquidity. Such contracts include (i) intellectual property assignments that may be legally sufficient, but do not reflect the expectations of potential acquirers and IPO underwriters, (ii) terms associated with open-source software that inadvertently strip EmCo of value,[22] (iii) overly broad intellectual property licenses granted to third parties, (iv) boilerplate provisions that have no bearing on immediate performance obligations but directly implicate EmCo's future exit, such as clauses relating to a change of control,[23] (v) restraints that limit EmCo's ability to organically grow its revenue and customer base (e.g., "most-favored-nation"[24]

---

21. A SaaS platform delivers applications over the Internet—as a service. Instead of installing and maintaining software, users simply access it via the Internet. "SaaS applications are sometimes called Web-based software, on-demand software, or hosted software." *What is SAAS?*, SALESFORCE, https://www.salesforce.com/in/saas (last visited Jan. 30, 2023).

22. Open-source software, described in Section II.B.2, *infra*, is typically made available to users at no cost, but subject to license conditions of varying degree, ranging from attribution for the original author (*see, e.g.*, *Attribution 3.0 United States*, https://creativecommons.org/licenses/by/3.0/us/deed.en_US (last visited Jan. 30, 2023)) to requiring users make the underlying source code of their own products available for free (*see, e.g.*, *GNU Affero General Public License*, FREE SOFTWARE FOUNDATION, https://www.gnu.org/licenses/agpl-3.0.html (last visited Jan. 30, 2023)).

23. A change of control "arises when a firm is acquired by another firm or when an existing or new stockholder acquires majority or substantially large stockholding." *Change in Control Definition & Legal Meaning*, THE L. DICTIONARY, https://thelawdictionary.org/change-in-control (last visited Jan. 30, 2023).

24. A "most-favored-nations" provision would require EmCo to ensure the customer is getting the lowest price offered to any other customer. C. Scott Hemphill & Tim Wu, *Parallel Exclusion*, 122 YALE L.J. 1182, 1208 (2012); *see Most Favored Nations Provision (MFN)*, PRAC. L., http://us.practicallaw.com/8-382-3637 (defining a most-favored-nation clause in contracts as "[a] contractual provision . . . in which the seller promises the buyer that it will not offer

or non-competition clauses), and/or (vi) language that binds EmCo's future, unknown acquirer.

EmCo "moves fast and breaks things"[25] on a path to developing its products and generating revenues and, like many startups, has little more than a year's worth of cash on hand,[26] relies heavily on third parties, and is run by managers who are most likely inexperienced in exit transactions.[27] EmCo might conclude that involving a lawyer to review these ordinary course contracts would add unnecessary complexity and costs, decreasing the value of the deals for both EmCo and its counterparties.[28] EmCo might, therefore, agree to such provisions, so long as they do not stand in the way of the company's immediate, profit-maximizing goals, and reserve its legal budget for more sophisticated deals.

Yet, EmCo's routine commercial contracts will impact the value of EmCo and the costs associated with its most important transaction: its future exit. And so, increasingly, startups like EmCo turn to technology transactions attorneys for counsel on these day-to-day matters, each of which can be managed at low cost to EmCo. The lawyer acts as what scholars have referred to as a "credible commitment" device.[29] Credible commitment theory explores how economic actors can be held to the promises they make;[30] the technology transactions lawyer

another buyer better terms before offering those terms or better terms to the first buyer") (last visited Sept. 10, 2023).

25. Mark Zuckerberg, *quoted in* Henry Blodget, *Mark Zuckerberg on Innovation*, BUSINESS INSIDER (Oct. 1, 2009, 4:36 PM), https://www.businessinsider.com/mark-zuckerberg-innovation-2009-10?r=US&IR=T. The early Facebook motto has become a stand-in for the ethos of ambitious, high-growth startups.

26. *Does Your Startup Have Enough Runway?*, J.P. MORGAN & CO. (Sept. 14, 2020), https://www.jpmorgan.com/commercial-banking/insights/does-your-startup-have-enough-runway-to-survive.

27. Brian Broughman, *Investor Opportunism and Governance in Venture Capital, in* VENTURE CAPITAL: INVESTMENT STRATEGIES, STRUCTURES, AND POLICIES 352–53 (Douglas Cumming ed., 2010) (describing the inexperience of startup founders).

28. Joan Macleod Heminway, *Why Can't We Be Friends? A Business Finance Lawyer's Plaintive Plea to Entrepreneurs*, 95 N.C. L. REV. 1459, 1465–66 (2017) (explaining that startups hesitate to call lawyers because of added complexity and cost).

29. Lisa M. Fairfax, *Stakeholderism, Corporate Purpose, and Credible Commitment*, 108 VA. L. REV. 1163, 1186, 1188–89 (2022) (articulating how accountability mechanisms and long-term payoffs contribute to the challenge of keeping credible commitments).

30. *Id.* at 1186.

helps ensure that a startup's short-term decisions are consistent with its long-term commitment to a successful and efficient exit transaction.[31]

The value created by a technology transactions lawyer in structuring a startup's everyday transactions to facilitate an efficient exit clearly benefits the parties to that exit, who avoid wasting resources that could be spent on additional investments, such as research, product development, and operational improvements, in an acquirer's case, or by providing capital to other enterprises, in a bank's case. More critically, however, if a startup's exit is inefficient (or cannot occur at all) due to its earlier commercial missteps, then the entire venture capital ecosystem is harmed.[32] VCs use the exit proceeds from one startup to invest in new startups.[33] Successful exit transactions, therefore, enable more successful ventures. As a startup's prior contractual mistakes accumulate, the cost and inefficiency of an exit rise, and in some cases, negatively affect the startup's valuation. In other cases, the exit may not be able to happen at all and the startup may fold or be forced into bankruptcy. In either scenario, VCs' returns are impaired, jeopardizing the reinvestment cycle.

Part I of this Article revisits the value creation literature, describes the evolution of the technology transactions law practice, and shows why efficient exit transactions are critical to the venture capital and technology sector. Part II re-introduces EmCo, setting forth the characteristics that make startups more prone to failing to perceive the long-term exit-related consequences of ordinary course contracting decisions. It shows how lawyers are uniquely situated to add value to routine day-to-day matters, thereby optimizing the value of an exit transaction. Part III then engages with EmCo's hypothetical acquisition and IPO, demonstrating how EmCo's failure to use a startup attorney in its ordinary course commercial dealings diminishes the value of EmCo and its exit transaction.

---

31. This is particularly true as the startup's governance structure becomes more complex with each investment round. Elizabeth Pollman, *Startup Governance*, 168 U. PA. L. REV. 155, 161 (2019).

32. *See infra*, Section I.C.

33. Oranburg, *supra* note 9, at 1044.

I.
A Limited View of Value Creation

This Part reviews the "value creation" literature, beginning with Gilson's 1984 article, *Value Creation by Business Lawyers*.[34] It then introduces a type of lawyer that has been left largely unexamined by scholars: the technology transactions lawyer. These lawyers are the exit engineers who facilitate efficient acquisitions and IPOs. They will be examined in detail in Part II, but in advance, it is critical to understand why exits benefit from engineering. Section C of this Part illuminates the importance of efficient exits to the broader venture capital and innovation ecosystem.

A. *The Value Creation Corpus*

The last forty years have seen ample commentary articulating how business lawyers create value beyond providing basic legal advice, much of it emanating from *Value Creation by Business Lawyers*.[35] In that article, Gilson questioned why corporate clients engage lawyers to assist with transactions, even when the issues at hand are not *per se* rooted in the law.[36] In wondering how lawyers "create value even when use of their services is truly voluntary, when there is nothing that, in effect, artificially requires the use of a business lawyer,"[37] Gilson put forth a theory of transaction cost engineering.[38] Using the example of an asset acquisition, Gilson explained how a business lawyer helps the two contracting parties (both its client and the opposing side) devise solutions to negotiation issues in a single transaction that ultimately enlarge the pie for both parties, not just re-distribute it, thereby "engineering" the costs for the two sides.[39] He noted that when parties disagree as to the certainty of the future profitability of the seller's business, the lawyer can step in to help structure the purchase price payment to be issued in stages over an agreed-upon period of time in conjunction with hitting revenue milestones.[40] This transaction

34. Gilson, *supra* note 1.
35. *Id.*
36. *Id.* at 244.
37. *Id.*
38. *Id.* at 255.
39. *Id.* at 246.
40. *Id.* at 262–64.

mechanic, called an earnout, he observed, is a clever way of ensuring both parties' concerns are addressed in a manner that increases the deal value for both of them, while ensuring the final transaction does not deviate too far from the parties' original expectations.[41] As a result, neither party takes on an uncomfortable amount of risk that their assumptions might be wrong.[42] In the absence of the earnout, the buyer resists paying more up-front to the seller, the seller resists taking a discounted purchase price, and as a result of this impasse, the deal may not happen at all.[43]

Gilson's article characterizes all corporate lawyers as M&A practitioners, ignoring the particularities of startup and many other kinds of business lawyers. It has, however, spawned dozens of additional contributions to the literature. In the first decade or so following *Value Creation*, academics sought to fill the gaps left open by Gilson's narrow view of business lawyering. Karl Okamoto noted that lawyers can "rent" their reputations to clients, lending credibility in strategic transaction negotiations,[44] while Manuel Utset argued that business lawyers create value through their design of the IPO prospectus process.[45]

The early 2000s saw growing interest in the role lawyers play in helping clients navigate regulatory frameworks. Nestor Davidson examined lawyers who negotiate public-private deals for corporate clients, and how they engineer transaction costs by efficiently translating public policy goals into private contracts.[46] Victor Fleisher similarly engaged the regulatory landscape by arguing that lawyers generate value by exploiting gaps in regulatory schemes when negotiating transactions to minimize clients' regulatory costs.[47] Geoffrey Miller took a different perspective, arguing lawyers destroy value when failing to guide clients towards socially responsible decisions, particularly in the areas of corporate governance and regulation.[48]

41. *Id.* at 263–66.
42. *Id.* at 263–66.
43. *Id.* at 264.
44. Okamoto, *supra* note 4, at 23.
45. Utset, *supra* note 4, at 300–02.
46. Davidson, *supra* note 4, at 937, 956–57.
47. Fleischer, *supra* note 4, at 227; *see also* Schwarcz, *supra* note 4, at 506 (describing an empirical study of corporate clients that indicated lawyers create value by reducing regulatory costs).
48. Geoffrey Miller, *From Club to Market: The Evolving Role of Business Lawyers*, 74 FORDHAM L. REV. 1105, 1110, 1136 (2005).

In the past few decades, additional theories of value creation within the strategic transaction context have been developed.[49] Notably, Elisabeth de Fontenay explained how law firms, rather than lawyers, create value through their knowledge of market terms for strategic transactions.[50] Most saliently, she identified the relevance of being a repeat player across transaction types and having an understanding of non-obvious "value-increasing" terms that clients lack.[51]

Lisa Bernstein, Mark C. Suchman and Mia L. Cahill first applied Gilson's theory to Silicon Valley lawyering, describing how Valley lawyers help startup clients secure investors by facilitating introductions with VC funds[52] and shape informal norms within the technology sector that mitigate against uncertainty.[53] Other academics have explored whether the value startup lawyers create differs from value created by other corporate lawyers. John F. Coyle and Joseph M. Green found that startup lawyers help clients reduce costs by providing industry-standard form documents for use in fundraising transactions.[54] They also reinforced the value of reputation renting by emerging company lawyers, as clients have little reputation themselves to leverage.[55] Each of these contributions highlights a type of value that startup lawyers create for clients, but primarily for the sake of completing a discrete transaction, such as an investment round.

Gilson's original thesis has not gone unscathed, either. *Value Creation* has been openly critiqued as taking too limited a view of business lawyering by failing to fully consider the potential

---

49. *See, e.g.*, Dent, *supra* note 4 (arguing that lawyers create value by leveraging their expertise to efficiently structure and design entities for strategic alliances); Hwang, *supra* note 4 (offering a view of how transactional M&A associates (versus law firm partners) optimize deal value by structuring and modulating deal documents).

50. de Fontenay, *supra* note 4.

51. *Id.*

52. Marc C. Suchman & Mia L. Cahill, *The Hired Gun as Facilitator: Lawyers and the Suppression of Business Disputes in Silicon Valley*, 21 LAW & SOC. INQUIRY 679 (1996).

53. Bernstein, *supra* note 4.

54. John F. Coyle & Joseph M. Green, *Startup Lawyering 2.0*, 95 N.C. L. REV. 1403, 1411–12 (2017).

55. *Id.* at 1410, 1416–17. Abraham Cable has also written about the role startup lawyers play in Silicon Valley and beyond by promoting entrepreneurship through the promulgation of standard form contracts and reputation renting. Abraham J.B. Cable, *Startup Lawyers at the Outskirts*, 50 WILL. L. REV. 163 (2014).

costs of enforcing (or defending against) contractual terms[56] or the function of in-house business lawyers whose regular interactions and relationships with executives and employees deter compliance and litigation costs.[57] George Dent noted that Gilson over-simplified the issues that arise in an M&A transaction, and did not address how these issues differ across strategic acquisitions, while Miller criticized Gilson for ignoring the role that leverage plays in negotiations.[58] Jeffrey Lipshaw separately contended that the transaction cost engineer characterization is too sweeping of an abstraction, devoid of lawyers' subjective experiences.[59]

Several themes can be distilled from the existing scholarship on how business lawyers create value. First, academics remain focused on how a lawyer creates value in a single matter when representing sophisticated entities,[60] such as a joint venture,[61] large strategic transaction (e.g., public-private deal),[62] M&A deal,[63] or IPO.[64] Second, the literature over-generalizes business lawyers. Gilson and many of the scholars following in his path take the mature company, enterprise transaction (e.g., M&A) attorney as the archetypal business lawyer, failing to reflect the evolving specialization of law practice. The existing corpus, beginning with Gilson, speaks broadly of business or general corporate lawyers, who quarterback joint ventures, M&A transactions, and IPOs, but are by no means the only lawyers on any strategic deal team. Most relevantly, technology

56. Edward A. Bernstein, *Law & Economics and the Structure of Value Adding Contracts: A Contract Lawyer's View of the Law & Economics Literature*, 74 Or. L. Rev. 189, 198–200 (1995).

57. Simmons & Dinnage, *supra* note 4, at 117–118, 126.

58. Miller, *supra* note 48, at 1108.

59. Jeffrey M. Lipshaw, *What is it Like to be a Beetle? The Timelessness Problem in Gilson's Value Creation Thesis*, 15 U.C. Davis Bus. L.J. 23 (2014). Lipshaw previously offered another value creation theory, arguing that attorneys add value to transactions because their role takes on cultural significance that fosters client confidence and credibility. Jeffrey M. Lipshaw, *Beetles, Frogs, and Lawyers: The Scientific Demarcation Problem in the Gilson Theory of Value Creation*, 46 Willamette L. Rev. 139, 142–44 (2009).

60. *See* Praveen Kosuri, *Beyond Gilson: The Art of Business Lawyering*, 19 Lewis & Clark L. Rev. 463, 471 (2015) (criticizing Gilson for limiting "the work of business lawyers to structuring transactions to minimize leakage or drafting purchase agreements to eliminate inefficiencies").

61. Dent, *supra* note 4, at 290–292.

62. Davidson, *supra* note 4, at 937, 942–43.

63. Gilson, *supra* note 1.

64. Utset, *supra* note 4, at 299.

transactions lawyers, whose sphere of counsel encompasses the critical commercial operations of a client's business (such as the development and monetization of technology), do not appear in the value creation literature, until now.

Gilson believed that for business lawyers to have value, "a transaction must be worth more, net of legal fees, as a result of the lawyer's participation."[65] What continues to make Gilson's original thesis stand out is that he identified a theory of value that goes beyond simply leveraging legal expertise, experience, and reputation to get a better or less expensive deal for a client (at the expense of the counterparty). Rather, his focus was on how a lawyer benefits a transaction by increasing the overall value for both parties. While business lawyers still do just that, increased specialization of business law practice requires a more nuanced examination of how contemporary transactional specialists create value for clients. Gilson's theory still holds water, but business lawyering has evolved, and the different ways that business lawyers can optimize transaction costs have evolved, too. Creating value as a startup lawyer, in particular, is not just about engineering transaction costs for a deal, it is about engineering the efficiency of a company's exit.

B. *A Different World*

As Gilson was polishing the final draft of his article, the national economy was well on its way into the then-largest merger wave in American history (by volume of mergers),[66] with over $1.3 trillion in assets exchanged during the 1980s.[67] From 1984 to 1989, the average number of mergers per year neared 4,000.[68] These transactions largely involved public corporations going private, primarily by way of either a leveraged buy-out or a hostile takeover;[69] by the end of the decade, 28% of the Fortune 500 companies had left the public market.[70]

---

65. Gilson, *supra* note 1, at 243.

66. *See* Stearns & Allan, *supra* note 7, at 700.

67. Andrei Shleifer & Robert W. Vishny, *The Takeover Wave of the 1980s*, 249 AM. ASSN. FOR ADVANCEMENT SCI., 745, 745–49 (1990).

68. Stearns & Allan, *supra* note 7, at 710.

69. Bengt Holmstrom & Steven N. Kaplan, *Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s*, 15 J. OF ECON. PERSPS., 121, 124–25 (2001).

70. Shleifer & Vishny, *supra* note 67, at 745. Scholars have speculated on the causes of the merger wave, finding that mismanagement of excess cash

Insofar as the practice of business law generally reflects larger economic dynamics, it is safe to assume that many business lawyers in the 1980s advised clients on these transactions and the corporate governance mishaps[71] that led to so many hostile offers. Indeed, M&A receivables boomed, and law firms embraced the work, finding new ways to collaborate with investment banks on deal structure and defense of takeovers.[72] Forty years on, that work has not gone away: While the M&A market has waxed and waned, there are still hundreds, if not thousands, of lawyers working on acquisitions and other kinds of strategic corporate transactions described by prior *Value Creation* scholars. However, business law has also spawned specialized practices that did not exist in 1984.

As the merger wave began to fade, money poured into venture capital funds and startups.[73] Corporate practices at Silicon Valley law firms, such as Wilson Sonsini Goodrich & Rosati, Cooley, and Fenwick & West, reacted by fragmenting along the lines of their client needs, with groups dedicated to servicing the increasing number of technology startups in the region.[74] These fledgling companies needed outside counsel on VC fundraising, early-stage corporate governance matters, and, critically, how to develop and commercialize their technology-based products and services. The Silicon Valley (and eventually national) firms, already having seen how prior commercial transactions affected the cleanliness of M&A and IPO

---

flow, rising power of institutional investors, and the failure of conglomerates were all contributing factors. Holmstrom & Kaplan, *supra* note 69, at 129–31.

71. Academics have suggested public company boards too heavily deferred to management, rather than putting the shareholders' interests first, leading to mismanagement of internal resources. Following the 1980s merger wave, there was a boom in equity-based compensation for executives, which helped to re-align management and shareholder incentives. Holmstrom & Kaplan, *supra* note 69, at 123, 129–33.

72. James W. Jones, *The Challenge of Change: The Practice of Law in the Year 2000*, 41 Vand. L. Rev. 683, 685 (1988) ("Today [in 1988], mergers and acquisitions practice dominates the work of corporate lawyers"); Romano, *supra* note 7, at 348–49.

73. *See* Brian Kingsley Krumm, *Fostering Innovation and Entrepreneurship: Shark Tank Shouldn't Be the Model*, 70 Ark. L. Rev. 553, 559 (describing how regulatory changes in the late 1970s enabled pension funds to invest in riskier assets, including VC funds, leading to an investment boom in the technology sector).

74. *See* Amy Miller, *Market for Tech Transactions Lawyers Heating Up*, The Recorder (Oct. 29, 2012), (describing how Silicon Valley firms began developing more tech-specific practice groups in the late 1980s).

exits, began to develop practices focusing on the technology contracts underpinning day-to-day business operations, such as software and SaaS licenses, professional and technical services contracts, and user agreements.[75] Each of these contracts fell outside of the scope of the UCC, which had dominated commercial law practice for decades.[76]

Subsequently, numerous other national firms, including Morrison & Foerster, Goodwin Proctor, and Gunderson Dettmer, followed suit.[77] In later years, traditional New York law firms, such as Fried Frank and Wachtell Lipton, developed technology expertise from an M&A standpoint to assist their large clients in buy-side transactions.[78]

These attorneys, often engaged upon a company's founding, operate in an inherently inter-disciplinary world. From their first client matters, they develop fluency in at least two different legal regimes (intellectual property and contracts), the intersection of which form the basis of almost all technology companies' businesses, and become conversant in many others to help clients grow their businesses and protect against unforeseen future obstacles.[79] Early on, a client may need its

---

75. Telephone Interview with an early Silicon Valley technology transaction attorney (Aug. 11, 2022) (on file with author). Firms refer to these practices as "Technology Transactions," "Technology" or "Technology or IP Transactions." In this Article, I use the term "technology transactions" to generally refer to these practices.

76. The UCC applies to agreements for the sale and lease of physical goods, not intangible technology. *See* Rustad & Kavusturan, *supra* note 10, at 835 (noting the "widespread adoption of the UCC" led to "uniformity to American commercial law" for "seven decades").

77. *Technology Transactions*, THE LEGAL 500, https://www.legal500.com/c/united-states/media-technology-and-telecoms/technology-transactions (last visited Jan. 30, 2023); *Strategic Transactions & Licensing*, GUNDERSON DETTMER, https://www.gunder.com/strategic-transactions-licensing/ (last visited Oct. 16, 2023).

78. *See* Brian Baxter, *Wachtell Once Again Makes a Rare Lateral Hire*, LAW.COM (Apr. 4, 2018, 7:40 PM), https://www.law.com/2018/04/04/wachtell-once-again-makes-a-rare-lateral-hire/ (describing Wachtell's hire of a senior Wilson Sonsini commercial attorney to support the firm's M&A practice). These groups specialize in commercial technology issues that face startups, but from the perspective of acquirers purchasing such companies. In-house commercial counsel positions are also becoming more common, particularly for startups. As of December 2022, searching startup job postings in New York City on the local "Built in NYC" website (http://www.builtinnyc.com) yields several commercial counsel roles at early-stage companies.

79. *See, e.g.*, *Technology Transactions*, COOLEY LLP, https://www.cooley.com/services/practice/technology-transactions (last visited Jan. 30, 2023)

lawyer to grapple not only with how to properly construct a copyright license for a software product, but also bob and weave through issues arising in antitrust, consumer protection, tax, bankruptcy, free speech, employment, and any number of state laws that apply to the company's industry.[80] In advising on a company's day-to-day needs over time, moreover, the lawyer gains a deep understanding of the startup and how its contractual partnerships interrelate in a way that allows the lawyer's transactional support to be nuanced and tailored to the client's business preferences.[81]

The technology transactions law practice, now embraced by dozens of big law firms,[82] did not exist when Gilson wrote *Value Creation*. In the 1980s, business lawyers, even in Silicon Valley, were embroiled in M&A activity and other one-off strategic transactions, and the online industry was still nascent. There were no teams dedicated to counseling on routine commercial technology matters or thinking through how early-stage contracting issues affect future exit transactions.

Nevertheless, Gilson's original premise—that business lawyers optimize the transaction costs of a single deal—still applies, even to these modern attorneys. In fact, technology transactions lawyers regularly take on the role of Gilson's transaction cost engineer by helping parties efficiently find solutions to negotiation stalemates in their day-to-day deals. For example, if a startup's potential customer wants a right to terminate an agreement for convenience at any time, but the startup wants to lock in a revenue source for multiple years, the lawyer steps in and immediately offers up the "auto-renewal" option, through which the parties commit to a negotiated initial term (one or more years), but either party may opt out of the contract during subsequent annual renewal periods.[83] More significantly, as this

---

(describing the practice's transactional and strategic counseling services as including a broad array of contracts and legal regimes).

80. *Id.*

81. *See, e.g.*, *Technology Transactions*, Wilson Sonsini Goodrich & Rosati, https://www.wsgr.com/en/services/practice-areas/technology-transactions-group/index.html (last visited Jan. 30, 2023) ("We strive to build long-lasting relationships with our clients, serving as knowledgeable and trusted strategic partners").

82. *See* The Legal 500, *supra* note 77. Wilson Sonsini boasts over 70 lawyers in its group. *Technology Transactions, supra* note 81. Cooley has over 50. Cooley LLP, *supra* note 79.

83. *See* Jane Song & Ryan Enchelmayer, *Key Areas for Reviewing Software-as-a-Service Agreements*, Law360 (Dec. 1, 2017, 2:17 PM), https://www.law360.com/

Article will show in Part II, the technology transactions lawyer adds value and optimizes transaction costs in a much more purposeful way by anticipating risks in these day-to-day commercial agreements that may prove consequential at the time of exit, mitigating those risks at lower costs, and while doing so, increasing the value of startups and their exit transactions.

C. *Exit Transactions and Innovation*

Many startups (and almost all VC-backed startups) are formed with exit options in mind,[84] and either an acquisition or an IPO will be considered a win.[85] Successful and efficient exits are vital to the continued success of the venture capital market. Profitable M&A deals and IPOs are how VC investors generate cash to back more enterprises.[86] That cash is then infused into new startups to facilitate more research and innovation.[87] Outside of M&A deals and IPOs, VCs have limited (if any) other avenues to pursue liquidity.[88]

For the startup and its founders, an exit is the realization of the economic benefits of their own hard work and investment.[89] So when a technology transactions attorney begins working with a startup (often shortly after the company's founding), it is near-given that the investors, founders, and employees all have their eye on a future exit.

---

articles/990241/key-areas-for-reviewing-software-as-a-service-agreements (describing auto-renewal provisions in SaaS agreements).

84. Mark A. Lemley & Andrew McCreary, *Exit Strategy*, 101 B.U. L. Rev. 1, 1 (2021).

85. Smith, *supra* note 13, at 317.

86. Pollman, *supra* note 31, at 169; Oranburg, *supra* note 9, at 1044; *see* Darian M. Ibrahim, *Financing the Next Silicon Valley*, 87 Wash. U. L. Rev. 717, 733 (2010) (describing how exit proceeds are "recycle[d]" through reinvestment in new startups).

87. Ibrahim, *supra* note 86, at 733.

88. Ibrahim, *supra* note 13, at 2 (noting that a venture capital firm's success "depends" on future exits of portfolio companies); Paul A. Gompers & Josh Lerner, The Venture Capital Cycle 23 (1st paperback ed. 2002). Alternative (but rarer) avenues VCs pursue include selling off shares to other investors (known as "secondary sales") or pushing the company to liquidate assets. Lemley & McCreary, *supra* note 84, at 16.

89. Gary Dushnitsky & D. Daniel Sokol, *Mergers, Antitrust, and the Interplay of Entrepreneurial Activity and the Investments That Fund It*, 24 Vand. J. Ent. & Tech. L. 255, 262 (2022).

Acquisitions have been, and continue to be, the dominant form of startup exit.[90] In recent years, VCs have looked to acquisitions to net quicker, and increasingly, bigger, returns on investment than IPOs.[91] VCs get paid immediately after an acquisition closes, whereas they must wait out a months-long "lock-up period" following an IPO.[92] And, in efforts to quickly expand their business or reduce competition, buyers frequently overbid for startups,[93] so the exit may occur at a premium over the company's valuation. Exit timing is also critical for VC firms; the funds through which they invest have predetermined, limited lifetimes, and a sale or IPO must occur before the fund closes.[94] As a fund's end date appears on the horizon, the investor may steer a portfolio company towards an acquisition,[95] which can be completed more quickly than an IPO.[96] Moreover, acquisitions are the only path to an exit for

---

90. There were nearly four times as many acquisitions of VC-backed companies in 2021 (1,156) than IPOs (298). *See* PitchBook-NVCA Venture Monitor, Nat'l Venture Cap. Ass'ns (2022), https://nvca.org/research/pitchbook-nvca-venture-monitor/ (hereinafter NVCA Venture Monitor Data Pack) (click "Diving into the data pack" and then locate the "Exits x Type" tab at the bottom) (displaying the number of annual acquisitions of venture-backed companies dating back to 2006, and in each year outpacing IPOs by at least a factor of four).

91. Lemley & McCreary, *supra* note 84, at 36.

92. *Id.* at 33.

93. *Id.* at 8, 40.

94. Dushnitsky & Sokol, *supra* note 89, at 273–74; Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 Vand. L. Rev. 1405, 1415 (2008). Venture funds typically last for around 14 years. Diane Mulcahy, *The New Reality of the 14-Year Venture Capital Fund*, Institutional Inv. (Feb. 19, 2015), https://www.institutionalinvestor.com/article/b14z9vv7hjbt6y/the-new-reality-of-the-14-year-venture-capital-fund.

95. This may include offering carrots (e.g., bonuses) or sticks (threats to terminate or blacklist) to startup founders and executives who are uncooperative. Brian Broughman & Jesse M. Fried, *Carrots and Sticks: How VCs Induce Entrepreneurial Teams to Sell Startups*, 98 Cornell L. Rev. 1319, 1325 (2013).

96. Lemley & McCreary, *supra* note 84, at 33–37; Dushnitsky & Sokol, *supra* note 89, at 273–74. There are two other infrequent forms of acquisitions worth mentioning. First, for startups with strong revenues that have trouble ascending to IPO-readiness, private equity buyers are increasingly sweeping in to capitalize on the profit potential. Ajay Chopra, *Private Equity Buyouts Have Become Viable Exit Options Even for Early-stage Startups*, TechCrunch (Dec. 28, 2018, 10:06 AM), https://techcrunch.com/2018/12/28/private-equity-buyouts-have-become-viable-exit-options-even-for-early-stage-startups/; *see also* Julie Segal, *Start-Ups are Being Bought up by Private Equity*, Institutional Inv. (Feb. 24, 2020), https://www.institutionalinvestor.com/article/b1kh4y07671zbf/Start-Ups-Are-Being-Bought-Up-by-Private-Equity. Second, some companies undergo "acqui-hires," in which the startup is purchased,

startups whose revenues do not meet the thresholds required by IPO underwriters.[97] From 2004 to 2021, acquisitions accounted for an average of 92% of VC-backed exit activity.[98]

The startup lawyer's *ex ante*, value-increasing advice on routine, everyday matters is insurance against both an inefficient exit and an exit that may not happen at all. In the absence of such counsel, the avoidable costs of an exit transaction, described in Part III, increase for all parties and it becomes more difficult to complete the deal. As the exit's value slides, so does the value of the company because an exit transaction—as opposed to other enterprise transactions—is a direct reflection of what the relevant market thinks a company is worth, articulated as either the purchase price in a sale or the share price paid by an underwriter in an IPO. Whether the deal is ultimately completed at a lower valuation or dies altogether, the result is less money all around for future investments, particularly for the VCs who look to use their proceeds to fund more startups.

II.
Startup Psychology

This Part re-introduces EmCo and shows why it is, by design, more likely to make decisions, absent counsel, that lead to an inefficient exit and decrease in its valuation. It also illustrates how the technology transactions lawyer can avoid those results at low cost and at the same time, preserve the value of the company and its future exit.

---

but for the purpose of integrating the employee talent into the acquirer's existing operations. *See* John F. Coyle & Gregg D. Polsky, *Acqui-hiring*, 63 Duke L.J. 281 (2013).

97. *See* Nicole Irvin, *16 Things to Get IPO-ready (or Just Build a Really Strong Business)*, Vox (Dec. 2, 2016, 8:00 AM), https://www.vox.com/2016/12/2/13813792/checklist-16-things-ipo-ready-public-company-andreessen-horowitz-a16z.

98. Nat'l Venture Cap. Ass'n & PitchBook Data, Inc., 2022 National Venture Capital Association Yearbook 38 (2022).

A. *EmCo: A Mess of a Firm*

There are certain traits that can be expected of any firm[99] as it grows. Long-standing behavioral economics principles tell us that enterprises tend to be led by managers who discount the long-term consequences of short-term decisions,[100] and act on imperfect information, whether knowingly or not.[101] In these regards, startups are no different.[102] Account sales employees whose bonuses depend on meeting quotas may acquiesce to unfavorable contract terms to close customer deals, including provisions that limit the company's long-term growth potential.[103] Business people may choose not to call a lawyer because of the fear of adding complexity and cost to a seemingly straight-forward commercial arrangement.[104] Engineers under pressure to finish developing a product feature may quietly

---

99. The "firm," as it exists in economic theory, is an enterprise that is defined by a combination of internal resources, on the one hand, and contracts that serve to fill gaps where bringing production and the relevant know-how in-house is more costly, on the other hand. R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 394–96 (1937); Reza Dibadj, *Reconceiving the Firm*, 26 CARDOZO L. REV. 1459, 1504–05 (2005).

100. Stephanie Plamondon Bair, *Innovation Inc.*, 32 BERKELEY TECH. L.J. 713, 726–27 (2017).

101. Owen D. Jones, *Time-Shifted Rationality and the Law of Law's Leverage: Behavioral Economics Meets Behavioral Biology*, 95 NW. U. L. REV. 1141, 1151 (2001) (describing bounded rationality, a decision-making theory commonly applied to corporate actors, as the set of constraints that "limit human information-gathering and information-processing capacities in ways that can yield deviations from perfectly rational, optimal outcomes").

102. *But see* DANIEL F. SPULBER, THE INNOVATIVE ENTREPRENEUR 11–12, 19, 69 (2014) (stating that a startup is not actually a "firm" at all, and that it only becomes a firm once it is "no longer . . . subject to the entrepreneur's financial and liquidity constraints," and has sufficient, self-sustaining revenues or undergone an exit).

103. Joshua S. Gans & Scott Stern, *The Product Market and the Market for "Ideas": Commercialization Strategies for Technology Entrepreneurs*, 32 RSCH POL'Y 333, 346 (2003) ("Firms opportunistically take advantage of potential revenue opportunities as they present themselves, rather than choosing a strategy that focuses resources and attention towards activities most likely to yield the highest long-term return").

104. Heminway, *supra* note 28, at 1465–66 (listing reasons why startups hesitate to call lawyers, including added complexity and cost for transactions); *see also* Scott Edward Walker, *Top 10 Reasons Why Entrepreneurs Hate Lawyers*, VENTURE HACKS (Jan. 14, 2010), http://www.venturehacks.com/hate-lawyers.

slot in an open-source component without regard to its license terms to meet a launch deadline.[105]

Startups differ from more established firms in important ways, however. Startup founders and early employees often lack the sophistication of seasoned executives; they operate at a frenetic pace of innovation, have limited resources, likely lack exit experience, and must be constantly calibrating for the interests of new and existing venture capital backers.[106] These characteristics, when layered on top of standard enterprise behavioral tendencies, make a startup more prone to engaging in behaviors that ignore long-term consequences in favor of short-term gains.

Take EmCo, for example. Like most startups, it is "fragile,"[107] "over[ly] optimistic,"[108] "greedy, cunning, opportunistic, and self-interested,"[109] "risk-taking,"[110] and "scrappy."[111] Where more proven companies have money, time, and human capital to devote to any given decision, EmCo and other startups are unprofitable for significant periods of time,[112] possess sparse infrastructure,[113] and are shrouded in the anxiety of

105. *See* Linda Rosencrance, *Why Open Source Matters for Developers*, TECHBEACON, https://techbeacon.com/app-dev-testing/why-open-source-matters-developers (noting that speed is a top reason why developers use open-source software).

106. *See* F. Scott Kieff, *IP Transactions: On the Theory & Practice of Commercializing Innovation*, 42 HOUS. L. REV. 727, 743 (2005) (noting startups' size and resource constraints); Manuel A. Utset, *High-Powered (Mis)incentives and Venture-Capital Contracts*, 7 OHIO ST. ENTREPREN. BUS. L.J. 45, 80–81 (2012) (explaining entrepreneurs' lack of understanding of contractual issues); Pollman, *supra* note 31 (describing how each additional venture capital investment brings an increased chance of conflicts and tension as to long-term goals between founders, executives, investors, and/or Board members).

107. Manuel A. Utset, *Reciprocal Fairness, Strategic Behavior & Venture Survival: A Theory of Venture Capital-Financed Firms*, 2002 WIS. L. REV. 45, 52 (2002).

108. Mirit Eyal-Cohen, *Through the Lens of Innovation*, 43 FLA. ST. U. L. REV. 951, 975 (2016).

109. David E. Pozen, *We Are All Entrepreneurs Now*, 43 WAKE FOREST L. REV. 283, 286 (2008). This self-interest is complicated by the customary issuance of equity to employees, whose own financial gains then become intertwined with those of the company.

110. Eyal-Cohen, *supra* note 108, at 961.

111. Ranjay Gulati & Alicia DeSantola, *Start-Ups That Last*, HARV. BUS. REV., Mar. 2016, at 54, 61.

112. Pollman, *supra* note 31, at 161.

113. Paul Almeida, *Semiconductor Startups and the Exploration of New Technological Territory, in* ARE SMALL FIRMS IMPORTANT? THEIR ROLE AND IMPACT 39, 43–44 (Zoltan J. Acs ed., 1999).

uncertainty about future success. The length of EmCo's "runway" (i.e., the amount of time a startup can operate before it runs out of money, which is usually 12–18 months) and its ability to secure future investments depend on revenue growth, or at a minimum, revenue potential, through growing customer relationships.[114] Time is of the essence, and leverage is constrained. Almost by definition, startups like EmCo are chronically disadvantaged vis-à-vis more experienced contracting counterparties and have limited, if any, negotiation capital in early deals. High employee mobility associated with the startup community jeopardizes the retention of critical institutional knowledge when workers leave, risking a lack of continuity between transactions.[115] The more complex the knowledge (e.g., legal advice[116]), the harder it is to transfer that knowledge among workers. Thus, misrepresentatations and information loss are inevitable.[117] Lastly, while all firms engage in operational decisions to develop capacity internally or buy products or services from a third party (so-called "make-or-buy" decisions),[118] given its small team, EmCo must outsource at a

---

114. *See* Aaron Vick, *How Long Is My Startup Runway? A Guide to Calculating and Managing Monthly Burn Rate*, FORBES (July 31, 2019, 7:45 AM), https://www.forbes.com/sites/forbestechcouncil/2019/07/31/how-long-is-my-startup-runway-a-guide-to-calculating-and-managing-monthly-burn-rate/?sh=1e9c549b6caa; Ben McClure, *How Venture Capitalists Make Investment Choices*, INVESTOPEDIA (July 26, 2022), https://www.investopedia.com/articles/financial-theory/11/how-venture-capitalists-make-investment-choices.asp#:~:text=So%2C%20before%20putting%20money%20into,it%20takes%20to%20make%20money.

115. A 2018 survey of 25 large startups found that 25% of employees leave in a given year. *In the Front Door, out the Back: Attrition Challenges at High Growth Startups*, FOUNDERS CIRCLE CAP., https://www.founderscircle.com/high-startup-turnover-rate (last visited Jan. 30, 2023). *See also* June Carbone & Nancy Levit, *The Death of the Firm*, 101 MINN. L. REV. 963, 1025 (2017) (noting that "[h]ighly sought-after workers start with technical skills, get entry-level jobs that give them experience, move to the next firm as they mature"); Paul R. Tremblay, *The Ethics of Representing Founders*, 8 WM. & MARY BUS. L. REV. 267, 300 (2017) (describing a company's natural evolution to include departing founders). *See also* Yifat Aran, *Beyond Covenants Not to Compete: Equilibrium in High-Tech Startup Labor Markets*, 70 STAN. L. REV. 1235 (2018) (describing California's law against enforcing non-competes in employment agreements as contributing to high startup employee mobility, which has been partially counterbalanced by the granting of stock options that vest over a set period of time).

116. Heminway, *supra* note 28, at 1465–66.

117. Martin Ganco, *Cutting the Gordian Knot: The Effect of Knowledge Complexity on Employee Mobility and Entrepreneurship*, 34 STRATEGIC MGMT. J., 666, 669 (2013).

118. Coase, *supra* note 99, at 394–98.

higher level than larger companies.[119] With more contracts to be executed, there are, plainly, more opportunities for error.

When EmCo makes ordinary course decisions as it goes about building its business, it is almost always doing so in a frantic, fast-paced, pressure-cooker environment, with minimal operations and incomplete information. It is, in fact, the messiest embodiment of an enterprise engaging in day-to-day make-or-buy decisions to grow its operations.[120] As it matures, it may be compelled to prioritize immediate revenue generation and user growth over addressing remote, future issues.[121] These circumstances present a unique value creation opportunity for a startup attorney to ensure that EmCo's ordinary course contracts satisfy the company's immediate needs, but also optimize the costs of its future exit, and by extension, the value of EmCo itself.

B. *Intertemporal Transaction Cost Engineering*

Absent experienced counsel, a startup like EmCo is more likely to make a misstep and unknowingly generate additional transaction costs for its exit (and thereby affect its value) in the following three routine commercial matters:[122] obtaining

---

119. Neal Taparia, *How Outsourcing Key Functions Can Give Your Startup a Competitive Edge*, FORBES (Oct. 21, 2020, 2:49 PM), https://www.forbes.com/sites/nealtaparia/2020/10/21/how-outsourcing-key-functions-can-give-your-startup-a-competitive-edge/?sh=67bc45a22f19.

120. *But see* SPULBER, *supra* note 102, at 11–12, 19, 69.

121. "Few entrepreneurs spend adequate time planning their exit strategy," note Richard A. Mann et al. in *Starting from Scratch: A Lawyer's Guide to Representing a Start-Up Company*, 56 ARK. L. REV. 773, 839 (2004). *See also* Tanya M. Marcum & Eden S. Blair, *Entrepreneurial Decisions and Legal Issues in Early Venture Stages: Advice That Shouldn't Be Ignored*, 54 BUS. HORIZONS 143, 144 (2011) (stating that entrepreneurs are more likely to devote "time and energy toward more interesting and creative aspects" of their business, "rather than . . . dealing with decisions that will have long term legal implications"); Heminway, *supra* note 28, at 1465 (arguing that entrepreneurs are "focused on their innovation").

122. I do not mean to suggest that these examples are the only commercial matters that affect an exit's efficiency. Companies do many things in the ordinary course that will be scrutinized and questioned (and therefore lead to additional transaction costs) in an exit and other specialized startup lawyers provide early-stage counsel with exits in mind. Corporate lawyers almost uniformly advise startups to be formed as corporations, which are easier vehicles for investment and exits, notwithstanding that other entities may be more advantageous in the short term for tax and other reasons. *See, e.g.*, Victor Fleischer, *The Rational Exuberance of Structuring Venture Capital Start-ups,* 57 TAX

written intellectual property assignments from employees,[123] using open-source software,[124] and agreeing to various commercial contract provisions.[125] Recalling Gilson's original premise, the use of a lawyer for these matters may appear optional;[126] after all, much of the advice the lawyer gives is not *per se* legal, nor is it terribly complex. It does not affect the enforceability of the contract (with limited exception[127]) and EmCo may not be overly concerned about the litigation risk, given it would be nearly judgment proof if sued.[128] Lawyering these issues in the short term could merely add expense and unnecessary intricacy, decreasing the value of the instant transaction and delaying critical business operations for all parties. So why would a cash-strapped startup engage the services of a lawyer in these circumstances? And why is the lawyer the best situated advisor to engineer the future transaction costs of EmCo's exit?

From EmCo's perspective, the lawyer has the benefit of being a repeat player in daily commercial deals and the exit transactions themselves.[129] EmCo may not be able to anticipate

L. Rev. 137 (2003). *See also* de Fontenay, *supra* note 4, at 407–08 (recognizing that "value-increasing" terms of a contract may be non-obvious).

123. *See* Sara Rona, *Protecting Intellectual Property: What Every Startup Founder Needs to Know*, Silicon Valley Bank, https://www.svb.com/startup-insights/startup-strategy/protecting-intellectual-property-startups (last visited Jan. 30, 2023) (noting how startup founders frequently overlook obtaining employee invention assignment agreements); *see also* Richard Harroch et al., *15 Big Legal Mistakes Made By Startups*, Forbes (Feb. 1, 2020, 7:00 AM), https://www.forbes.com/sites/allbusiness/2020/02/01/legal-mistakes-made-by-startups/?sh=54f95d22a6b1 (noting the significance of written intellectual property assignments in M&A transactions).

124. *See* Heather Meeker, *9 Open Source License Management Rules for Startups*, Opensource.com (Sept. 28, 2017), https://opensource.com/article/17/9/9-open-source-software-rules-startups (describing open-source licensing considerations for startups that affect exit opportunities).

125. *See* John Greathouse, *Kiss of Death – Contract Provisions Entrepreneurs Should Avoid at All Costs*, socalTECH, https://www.socaltech.com/articles/kiss-of-death-contract-provisions-entrepreneurs-should-avoid-at-all-costs/a-00041.html (last visited Jan. 30, 2023) (describing commercial contract provisions that startups should avoid to preserve efficient paths to financing and exits).

126. *See supra* text accompanying notes 35–43.

127. *See infra* note 148 and accompanying text.

128. *See* Marcum & Blair, *supra* note 121 (noting that entrepreneurs are unlikely to be concerned with "decisions that will have long-term legal implications").

129. *See* de Fontenay, *supra* note 4, at 405 (describing how clients perceive law firms to have value as repeat players who have "[k]nowledge of the

how these issues materially increase the company's long-term value and its future exit transaction, given the constraints it operates under,[130] but it recognizes that the lawyer has seen the likely blunders startups make that hold-up exit transactions and is able to address them in the near term. The lawyer can propose compromises that EmCo may not realize are possible, such as the auto-renewal option described above.[131] These compromise positions are simple and straightforward to negotiate, so they are also unlikely to result in significant legal fees.[132] EmCo also knows that when the exit transaction does arise, lawyers will be "drafters and keepers of the [associated definitive] deal documentation,"[133] and intimately involved with the negotiation of risk allocation and remedies, including those related to commercial matters. EmCo's lawyer will already have the necessary background and understanding of those matters, given their involvement in the day-to-day transactions themselves.

Gilson, comparing the lawyer's role to that of accountants and investment bankers, similarly posited that lawyers were the best situated to engineer transaction costs because they are also tasked with designing the broader transactional structure in a way that minimizes related legal and regulatory issues.[134] Moreover, unlike EmCo's managers and investors, the lawyer is not personally invested in EmCo's balance sheet; she does not stand to profit any more or less if the company's valuation is higher

ever-changing and ever-expanding set of value-increasing terms" for transactions); Broughman, *supra* note 27, at 353.

130. de Fontenay, *supra* note 4, at 424 ("[u]nsophisticated clients may not adequately appreciate their bargaining disadvantage"); *see supra* discussion accompanying notes 106–121.

131. *See supra* discussion in text following note 82. *See* Royce de R. Barondes, *The Business Lawyer as Terrorist Transaction Cost Engineer*, 69 FORDHAM L. REV. 31, 56 (2000) (describing how finding a "counterclaim" to a hostage right can lead to a more cooperative outcome for contracting parties).

132. In the author's experience, the issues described in this Article are routinely handled by junior law firm associates who have lower hourly rates. Additionally, several Silicon Valley law firms offer fee deferrals for startups in exchange for equity to offset legal costs for routine early-stage matters. *See* John S. Dzienkowski & Robert J. Peroni, *The Decline in Lawyer Independence: Lawyer Equity Investments in Clients*, 81 TEX. L. REV. 405, 417–18, 433 (2002).

133. de Fontenay, *supra* note 4, at 412; Gilson, *supra* note 1, at 257 ("negotiation and preparation of the acquisition agreement is the lawyer's principal charge in the [acquisition] transaction").

134. Gilson, *supra* note 1, at 297–99.

or lower.[135] In contrast, both startup managers and VCs benefit from increased margins that boost their own investment positions and help market the company for an exit.[136] Even seasoned startup managers who have been through an exit before or have been otherwise exposed to exit-related issues do not have the breadth of experience that lawyers do, nor are they able to analyze and understand them in a disinterested, uninvested, unemotional way.[137] To think otherwise would be akin to considering a divorcee to be an expert on preparing for a divorce.

The lawyer lends long-term credibility and experience to EmCo's short-term decisions, which strengthens EmCo's commitment to its investors to deliver a high return on investment[138] and yields positive efficiency gains for the firm by planting the seeds of value early for EmCo and its future exit counterparty.[139] In the following sections, this Article explores the inefficient commercial decisions EmCo might make if not counseled by a lawyer.

1. *Intellectual Property Assignments*

The genesis of all startups is an idea.[140] For technology startups, that idea derives value (and the ability to generate revenues) from intellectual property.[141] In EmCo's case, like many

---

135. This is not to say that the lawyer is wholly disinterested. Lawyers rely on referrals to build their own businesses, for example, and are incentivized to provide efficient and effective services to clients who will, in turn, refer other clients.

136. *See* Villi Iltchev, *Why Gross Margins Matter*, TWO SIGMA VENTURES BLOG (Nov. 21, 2019), https://twosigmaventures.com/blog/article/why-gross-margins-matter/ (stating that gross margins (i.e., net sales less the cost of goods sold) "meaningful[ly] impact" valuation").

137. *See* Utset, *supra* note 107, at 104 (regarding entrepreneurs' ability to understand contractual matters, says startup managers "may not know what type of information to acquire or what questions to ask—in short, they may be ignorant about the parameter of the problem they are trying to solve").

138. *See* Fairfax, *supra* note 29, at 1188–89. Additionally, the presence of a lawyer early-on in a company's operations can send a seriousness signal that attracts potential investors.

139. *See* D. Gordon Smith & Brayden G. King, *Contracts as Organizations*, 51 ARIZ. L. REV. 1, 29 (2009) (describing lawyers as "an important conduit of experience and knowledge").

140. Michael J. Burstein, *The Entrepreneurial Commons: Reframing the Relationship Between Intellectual Property and Entrepreneurship*, 2016 UTAH L. REV. 611, 613 (2016).

141. Mann et al., *supra* note 121, at 775, 815, 852–53.

startups, the idea is embodied in computer source code, which is the foundation of its platform; for other companies, that code might form a downloadable mobile or software application or an artificial intelligence algorithm. Whatever the product, the startup must secure ownership and grant value-protecting licenses to the intellectual property embodied in the underlying bits and bytes to be viable for investment, and ultimately, an exit.[142]

The primary form of protection for computer code is copyright.[143] Under the Copyright Act, the default rule is that works created by employees in the scope of employment are automatically owned by the employer, even if that arrangement is not memorialized in writing.[144] It costs EmCo nothing to take advantage of this rule, and EmCo believes it will secure ownership of the rights in its most important asset without having to manage any friction caused by paperwork, interrupt its engineers' momentum, or incur the cost of a lawyer when it has not yet earned any revenues. However, unbeknownst to EmCo, relying on the law's default rule is not an exit-friendly approach. Acquirers and IPO underwriters almost uniformly require written assignments from all employees (as well as consultants, for which the default rule would not apply).[145] A signed writing from an employee confirms the parties' agreement as to what technology is created within the scope of employment; in the absence thereof, the company exposes itself to litigation from an employee who contests what code was actually created as part of that employee's role at EmCo.[146] Additionally, the

142. *See* Shubha Ghosh, *The Transactional Turn in Intellectual Property*, 35 Dayton L. Rev. 329, 339 (2010) (describing intellectual property as a source of value for a company); Eran Kahana, *Protecting Intellectual Capital in Startups: A Guide for the Entrepreneurial Attorney in the New Economy*, 28 Wm. Mitchell L. Rev. 1187, 1190 (2002) (same).

143. Trade secret protection is also critical for technology companies, as can be patents (although less so for software companies following the Supreme Court's decision in Alice Corp. Pty. Ltd. v. CLS Bank Int'l., 573 U.S. 208 (2014), which limited patent eligibility for software products) and trademarks, as the company seeks to establish its brand. *Copyright Registration of Computer Programs*, U.S. Copyright Office, https://www.copyright.gov/circs/circ61.pdf (last visited Oct. 16, 2023).

144. 17 U.S.C. § 101.

145. *See* Harroch et al., *supra* note 123 (noting the significance of written intellectual property assignments in M&A transactions).

146. *See* Deborah E. Bouchoux, Protecting Your Company's Intellectual Property: A Practical Guide to Trademarks, Copyrights, Patents & Trade Secrets 108 (2001).

default rule does not apply to trade secrets, trademarks, and patents.[147] Upon the company's formation, the technology transactions lawyer, foreseeing the issues that arise in exit transactions from missing written intellectual property assignments, would simply provide EmCo with a standard form of contract to secure EmCo's ownership of all intellectual property rights.[148]

2. *Open-Source Software Licenses*

Technology companies frequently use open-source software code.[149] This software is marked by certain liberal characteristics, including the right for users to use, modify, and create derivative works of its source code.[150] Because of these traits, open-source software is widely believed to promote collaboration and creativity,[151] and has underpinned the development of popular products such as Google's Android operating system[152] and Mozilla's Firefox browser.[153]

As the saying goes, however, open-source software is "free as in free speech, not free as in free beer."[154] Open-source software

---

147. In the biotechnology and hardware sectors, patents are crucial and an important role for any startup lawyer is pursuing appropriate protection.

148. It is worth noting that the lawyer should provide EmCo with assignments that sufficiently cover all intellectual property, not just copyright, to competently represent EmCo's interests. The language used in an intellectual property assignment must be consistent with Bd. of Trs. of the Leland Stanford Junior Univ. v. Roche Molecular Sys., 563 U.S. 776, 786–87 (2011) to ensure enforceability.

149. Synopsys, Open Source Security and Risk Analysis Report 6 (2022). The Synopsys report examined the code bases of 2,409 software products and found that 97% contained some open-source software.

150. There are two common definitions of open-source software. One is promulgated by the Free Software Foundation, What is Free Software?, Free Software Foundation, www.gnu.org/philosophy/free-sw.html (last visited Jan. 30, 2023), and the other is offered by the Open Source Initiative, *The Open Source Definition*, Open Source Initiative, http://opensource.org/docs/definition.php (last visited Jan. 30, 2023).

151. Clark D. Asay, *A Case for the Public Domain*, 74 Ohio St. L.J. 753, 755 (2013).

152. *About the Android Open Source Project*, Android Open Source Project, https://source.android.com (last visited Jan. 30, 2023).

153. *About Your Rights*, Mozilla, https://www.mozilla.org/en-US/about/legal/terms/firefox/# (last visited Jan. 30, 2023).

154. This oft-cited quote is attributed to open-source pioneer Richard Stallman, who also writes "that free software is a matter of liberty, not price." Richard Stallman, *What is Free Software?*, The Free Software Found., https://www.gnu.org/philosophy/free-sw.html (last visited Jan. 30, 2023); *see also* David McGowan, *Legal Implications of Open-Source Software*, 2001 U. Ill. L. Rev. 241,

components are accompanied by license terms that restrict distribution of the licensed code, including instances where it is incorporated by a user into its own products and services.[155] These licenses typically fall in one of two camps: "permissive" or "copyleft."[156] Permissive licenses generally require only that the user provide attribution to the author of the open-source component in the product or feature in which the component is used.[157] Many companies comply by simply having an "open-source license" document on a website or included in a mobile app.[158] Copyleft licenses, on the other hand, can have dramatic consequences. First, they require that the licensed component continue to be made available to downstream users on the same license terms.[159] Second, some copyleft licenses also apply to derivative works of the licensed component, such as the feature or product that incorporates a modified version of the component, and in doing so, attach the open-source terms to that product or feature.[160] In plain English, this means that a developer (EmCo) who modifies and uses copyleft components in its own product may be required to offer that product to users on the same copyleft terms (including for free).[161]

Open-source software is also usually free (as in free beer). Most open-source licenses implicitly or explicitly prohibit charging users,[162] therefore providing an inexpensive means of engineering a particular feature or functionality. When EmCo needs to finalize bespoke product features prior to launch, its engineers might search for an open-source component that will do the trick and save them the time and cost of building the functionality themselves. They have heard that prior engineers at the company (who have since left) regularly used open-source software and wrote down some complicated guidelines from their lawyer, but those guidelines cannot be located.

---

245 (2001) (noting that "'[o]pen-source' or 'free' software refers to a type of license and not to the economic characteristics of particular projects").

155. McGowan, *supra* note 154, at 254.

156. Asay, *supra* note 151, at 759–60.

157. *See id.* at 760–61 (describing different open-source licenses).

158. *See, e.g.*, *Licenses*, GMAIL, (located in the Gmail iPhone app by selecting "Settings" in the main menu, and then "About Gmail").

159. HEATHER J. MEEKER, THE OPEN SOURCE ALTERNATIVE 23 (2008).

160. *Id.*

161. *Id.*

162. *See id.* at 13; David Ferrance, *Economic Interests and Jacobsen v. Katzer: Why Open Source Software Deserves Protection Under Copyright Law*, 39 N.M. L. REV. 549, 567 (2009).

Moreover, many of EmCo's engineers come straight from academic environments where open-source code is widely used.[163]

Assume EmCo was not counseled by lawyers. Its engineers, facing a deadline, choose an open-source component licensed under the copyleft GNU Affero license, which they subsequently modify and incorporate into their product. In doing so, they've put the company at risk of having to offer its own source code to the world for free.[164] As a condition (among many others) of using the Affero component, users who modify that component and then include the modified code in their own proprietary product (including in a SaaS offering) must subsequently license the modified code under Affero terms, and make the associated source code available.[165] Depending on the extent of the usage of the modified code, this requirement could extend broadly to EmCo's main product.[166] The engineers have a rudimentary understanding of the license terms, but decide they will simply not comply. Being nonlawyers, litigation risk for breach of the license is not top of mind; no one will ever know that they used that particular component. However, an exit will not proceed without detailed diligence of the company's open-source software practices, and the use of that component licensed under those terms may render EmCo worthless on paper,[167] and generate litigation risk for a buyer. Public companies as sophisticated as Cisco Systems and Vizio have found themselves defending lawsuits that allege non-compliance with copyleft licenses and demand release of the affected source code.[168] Further, having to make source code available would

---

163. Mark A. Lemley & Ziv Shafir, *Who Chooses Open-Source Software?*, 78 U. Chi. L. Rev. 139, 145 (2011).

164. The GNU Affero General Public License is the only copyleft open-source license that is expressly intended to apply to SaaS platforms; others are generally understood to only apply to downloadable software. *Why the Affero GPL*, GNU Operating Sys., https://www.gnu.org/licenses/why-affero-gpl.html (last visited Jan. 30, 2023).

165. *Id.*

166. *Id.*

167. *See* discussion *infra* notes 231–36.

168. *See* Complaint, Free Software Found., Inc. v. Cisco Sys., Inc., No. 1:08-cv-10764 (S.D.N.Y. Dec. 11, 2008); Complaint, Software Freedom Conservancy, Inc. v. Vizio, Inc., No. 30-2020-01226723-CU-BC-CJC (Cal. Super. Ct., Oct. 19, 2021). The Cisco litigation settled, and Cisco agreed to make the relevant source code available to users. *See* Brett Smith, *FSF Settles Suit Against Cisco*, Free Software Found. (May 20, 2009, 10:00 AM), https://www.fsf.org/news/2009-05-cisco-settlement.html.

affect EmCo's competitive advantage in the marketplace; other companies would be able to copy EmCo's product's features and functionality without risk.[169] A technology transactions lawyer would help EmCo avoid these problems by providing basic guidelines to the company early on that advise EmCo to limit its use of open-source software to components licensed under permissive licenses or engineer the code themselves. These licenses (and therefore, the guidelines) change infrequently, so the lawyer can provide this turnkey advice at minimal cost to EmCo.

C. *Customer and Supplier Contract Provisions*

As EmCo's business and product develops, it enters contracts with customers and third-party service providers to build out its operations. Commercial contracts are routinely the vehicle by which sophisticated companies impose terms on startups that will generate additional costs, and in some cases, act as hold-up mechanisms, in an exit.[170] EmCo has little leverage in these relationships, and its more established customers and suppliers are likely to insist on using their own long-standing template agreements.[171] Often, the "business" terms (e.g., price and duration of the deal) are set forth in a separate order form or cover sheet,[172] deterring review of the associated terms, where these questionable provisions lurk. Knowing it has few bargaining chips to put on the table (if any), desperate to get these deals done, and unaware of how seemingly routine provisions may affect the value of the enterprise,[173] EmCo, if not counseled by a lawyer, might agree to some (or all) of the following terms: inaccurate intellectual property licenses, vertical

169. *See* Instructure Holdings, Inc., Registration Statement (Form S-1) 37–38 (June 28, 2021) [hereinafter Instructure S-1].

170. *See* Barondes, *supra* note 131, at 62 (noting that "hidden contractual rights" may be a reflection of exploitation of a party's leverage in drafting the agreement).

171. This assertion is based on the author's personal experience. *See* RACHEL LANDY, BEYOND THE WORK PRODUCT: A GUIDE TO RELATIONSHIP-DRIVEN TRANSACTIONAL LAWYERING 75 (2021).

172. *See, e.g.*, *Main Services Agreement*, SALESFORCE, https://www.salesforce.com/content/dam/web/en_us/www/documents/legal/salesforce_MSA.pdf (last visited Jan. 30, 2023) (referencing an "Order Form" that sets forth the specifics of the services Salesforce provides each customer).

173. *See* de Fontaney, *supra* note 4, at 424. *See* Part III.

restraints or other business restrictions, change of control provisions, and terms that bind a company's future affiliates. Each of these provisions reflects how mature companies strong-arm smaller firms, resulting in hidden hostage-taking of EmCo that may not be revealed until EmCo's acquisition or IPO.[174] EmCo's technology transactions lawyer, however, would recognize that it may be worth spending EmCo's one or two bargaining chips on these issues to find a compromise that is consistent with what is reasonable in the market;[175] these provisions will have an outsized effect in the structure and execution of an exit.[176]

1. *Intellectual Property Licenses*

Often, large enterprise customers serve up agreements to startups with SaaS platforms that are not fit for purpose and instead, are designed for traditional software companies.[177] Software (such as a mobile or desktop application) is downloadable onto a device,[178] whereas SaaS products are accessed through the Internet.[179] This distinction in use carries through to the license granted to users. A properly drafted SaaS license grants users the right to access and use the product,[180] whereas software comes with a right to reproduce the product on the user's device,[181] and in business-to-business cases, often includes

174. *See infra* Section III.A.3; *see, e.g.*, Jim Edwards, *Internal Apple Documents Show How Strict and Punitive its Contracts Can Be*, INSIDER (Oct. 17, 2014), https://www.businessinsider.com/apple-supplier-contracts-and-confidentiality-documents-2014-10 (describing draconian provisions in Apple's form manufacturing and supply contract).

175. *See* de Fontaney, *supra* note 4, at 405–06 (proposing that law firms who see a high volume of transactions add value as repeat players with an understanding of a contract's "market" terms).

176. *See infra* Part III.

177. *See* David Tollen, *Don't Use License Agreements for Software-as-a-Service*, TECH CONTRACTS (June 1, 2018), https://www.techcontracts.com/2018/06/01/dont-use-licenses-saas-contracts/ (highlighting issues associated with accepting software license language to grant access to a SaaS platform).

178. *See* 1 Computer Contracts § 2.05 (2021).

179. Michael P. Widmer, *Application Service Providing, Copyright, and Licensing*, 25 J. MARSHALL J. COMPUT. & INFO. L. 79, 80–81 (2007).

180. 1 Computer Contracts § 2.05 (2021).

181. *See, e.g.*, *Software License Agreement (Pro-Licensor, Long Form)*, PRAC. L. (Oct. 11, 2022), http://us.practicallaw.com/7-505-1335 (including a right for a licensee to "install, use, and run" a copy of the licensed software in the license grant).

rights to modify or create derivative works of the licensed product.[182] Software licenses are also more likely to be perpetual (i.e., they cannot be terminated),[183] because once the software is on the user's device, it is difficult for the licensor to remove it. SaaS providers, on the other hand, can shut off access to the product at any time. Customers of software startups also often require the startup to deposit its source code in escrow for the customer's benefit, to be released if the startup folds or ceases to provide the product.[184] It is impractical for a customer to ask a SaaS company to escrow its product because the customer does not host the software internally, and therefore lacks any ancillary infrastructure needed to run the program if it were to gain access.[185]

EmCo is served up an agreement from a large prospective customer that includes the software rights described above. For EmCo, there is no risk that any of these rights will ever be invoked because the customer will not be able to, technologically speaking, download EmCo's platform onto its own computers. Although the contract may not accurately reflect the rights granted, there is no practical issue in EmCo's view, so it wishes to sign the form as-is to get the money flowing. Yet, the mere existence of such broad software rights and implication that a customer may be able to tinker with EmCo's platform, however remote the risk, will be problematic in an exit.[186] Buyers, for example, do not want to take a chance that customers will come out of the woodwork, demanding rights that were not priced into the original offering or that would enable them to

182. Jay Dratler, Jr., *Licensing Agreements*, in START-UP & EMERGING COMPANIES § 16.05 (2023) (describing common provisions in software licenses to include rights to modify and create derivative works); *Software License Agreements Practice Note*, PRAC. L. (Oct. 11, 2022), http://us.practicallaw.com/W-015-8354 (noting that software licensors should decide whether to make license grants perpetual in term or allow modifications or improvements to the software).

183. MICHAEL L. RUSTAD, SOFTWARE LICENSING, CLOUD COMPUTING AGREEMENTS, OPEN SOURCE, AND INTERNET TERMS OF USE §1.01 (Matthew Bender, 2016) (noting that many "mass-market licenses are perpetual").

184. *See* Dratler, *supra* note 182 (noting that sophisticated licensees often request startups escrow their source code); *Software License Agreements Practice Note*, PRAC. L. (Oct. 11, 2022), http://us.practicallaw.com/W-015-8354 (noting that software licensors should decide whether to agree to put their code in escrow).

185. 1-9 Software Licensing Chap. 8 (2016).

186. *See infra* Part III.

modify EmCo's products without further permission.[187] EmCo's lawyer would quickly spot the inaccurate terminology and propose a common sense, non-controversial compromise to reflect the rights actually granted.

2. *Change of Control Provisions*

Nearly all commercial contracts include an "Assignment" (or "Anti-Assignment") clause in the "miscellaneous" provisions at the back of the document.[188] These clauses have historically prohibited a party from unilaterally offloading its rights or obligations to an unknown third party.[189] However, these provisions are also used by parties to "prevent a future acquiring entity [of a party] from becoming a party to the contract."[190] Some forms of enterprise acquisitions constitute assignments by operation of law (such as an asset purchase, where certain contracts and assets—but not the corporate entity—are assigned to a purchaser), so any prohibition on assigning a contract applies to those types of exits. Others, such as reverse triangular mergers[191] and stock purchases are not de facto assignments and must be more explicitly referenced in order to be subject to a prohibition.[192] Alternatively, some parties simply ensure that

187. *See, e.g.*, Fleet Lease Exch. Co. v. Itneo, Inc., No. 1:21-CV-665-LY, 2021 U.S. Dist. LEXIS 155458, at *10–11 (W.D. Tex. Aug. 18, 2021) (finding for the defendant provider of a SaaS platform after the plaintiff brought suit alleging it had rights akin to a software license that enabled it to, among other things, access the platform's source code).

188. *See General Contract Clauses: Assignment and Delegation*, PRAC. L., http://us.practicallaw.com/8-508-2992 (identifying anti-assignment provisions as "standard clause[s]"); Shannon D. Kung, *The Reverse Triangular Merger Loophole and Enforcing Anti-Assignment Clauses*, 103 NW. U.L. REV. 1037, 1039 (2009) ("many business contracts contain a clause (an "anti-assignment clause") prohibiting free transfer of contractual rights and property without consent from all contracting parties").

189. *See* TINA STARK, NEGOTIATING AND DRAFTING CONTRACT BOILERPLATE 3.01 (2003) (describing contracting parties' use of the assignment provision "to control with whom each does business").

190. Kung, *supra* note 188, at 1039.

191. Elaine D. Ziff, *The Effect of Corporate Acquisitions on the Target Company's License Rights*, 57 BUS. LAW. 767, 783 (2002). In a reverse triangular merger, the seller merges into an empty subsidiary of the acquiror, and that subsidiary disappears so the seller remains as the surviving corporation.

192. H. Justin Pace, *Anti-Assignment Provisions, Copyright Licenses, and Intra-Group Mergers: The Effect of Cincom v. Novelis*, 9 NW. J. TECH. & INTELL. PROP. 263, 265 (2010); *but see* SQL Sols., Inc. v. Oracle Corp., No. C–91–1079 MHP, 1991 WL 626458 (N.D. Cal. Dec. 19, 1991) (holding that a reverse triangular merger of a licensee of intellectual property rights constitutes an assignment).

any restriction on assigning the agreement without the other party's consent extends broadly to any "change of control" of a party, encompassing all acquisition structures (but usually not an IPO[193]). When a ban on assigning the contract, however drafted, can be interpreted to apply to the relevant acquisition structure, then that acquisition cannot proceed without the counterparty's permission.[194] Otherwise, at a minimum, the party undergoing a change of control is in breach of the agreement by virtue of the acquisition—a risk that acquirers do not want to absorb as it may lead to termination of the relationship or litigation.

A commercial counterparty is also able to exert authority over the acquisition of the other party via a termination provision, where it may reserve for itself the right to cancel the agreement in the event the other party is acquired. In that case, an acquisition will not necessarily trigger a breach of the agreement, but there is no contractual obligation for the counterparty to remain in the relationship post-change of control. This becomes an issue for a party undergoing an acquisition if the counterparty is a significant source of revenue or a material supplier, as there is a potential for a significant hold-up problem when the acquisition materializes.

These provisions are, by design, usually sandwiched between non-controversial, customary provisions (frequently referred to as "boilerplate"). If EmCo fails to use a lawyer, in a rush to get deals done, and perhaps not even aware that boilerplate is negotiable, it will easily miss the relevant language, and enter numerous contracts with change of control consent and termination clauses. However, EmCo's attorney, knowing these clauses will be scrutinized in an M&A exit, would negotiate the language to ensure its startup client has sufficient flexibility to proceed with an acquisition without having to seek consent or a waiver of a termination right.[195]

Other courts have rebuked *SQL*'s approach. *See, e.g.*, Meso Scale Diagnostics, LLC v. Roche Diagnostics GMBH, 62 A.3d 62 (Del. Ch. 2013).

193. *See infra* note 302.

194. This counterparty could be a customer or a supplier.

195. *See infra* Part III. For example, the attorney may propose simply providing notice of an acquisition to the counterparty.

3. *Vertical Restraints*

Mature companies also use commercial contracts to gain competitive advantages by imposing vertical restraints on a startup, which limits its business growth.[196] A large customer insists on a most-favored-nation clause that restricts EmCo's ability to charge that customer higher prices than some of EmCo's smaller customers.[197] Another party demands EmCo stay out of particular geographic markets and industries through the use of a non-compete. A supplier requires EmCo to agree to use that supplier exclusively for particular products and services. Each of these restrictions limit EmCo's ability to organically grow its business and operations in the most profitable and cost-conscious way possible, and each reflects a sophisticated company's leverage in a negotiation. Framed as "deal breakers" for the counterparty, EmCo will agree to these terms, to avoid losing out completely. Yet, its lawyer would seek to strike these provisions or, at worst, pare them back to apply as narrowly as possible. In an exit, these clauses will be scrutinized to determine if they affect EmCo's revenue opportunities and flexibility in choosing suppliers.

4. *Binding Future Affiliates*

Lastly, the form agreements provided by larger companies often reflect the complex nature of sophisticated organizations with numerous affiliated companies that contribute to the contracting party's products and services. Subsidiaries and sister companies may be created and brought within the fold on a regular basis. As a result, frequently buried within the easily glazed over preamble or definitions section of an agreement with a customer is language indicating that the contract binds both EmCo and its current and future affiliates.[198] EmCo has

---

196. Herbert Hovenkamp, *Antitrust and Platform Monopoly*, 130 YALE L.J. 1952, 1960, 2003–04 (2021) (describing large technology firms' use of vertical restraints, such as most-favored-nation and exclusivity provisions, against "suppliers or other business partners"); *see* Dratler, *supra* note 182, at § 16.03[2] (describing tendency of licensees of startups' technology to ask for exclusivity); Hina Ahmad & Edward L. Turner III, *Contracts*, in START-UP & EMERGING COMPANIES § 18.02[5][a] (2023) (noting that startup customers exert leverage by asking for most-favored-nations guarantees).

197. *See supra* note 24.

198. This is an intentional over-simplification. For example, an agreement may include in the preamble that it is binding upon a party and its "Affiliates," with "Affiliate" subsequently defined in the contract's body as "any other

no affiliates at the time of contracting and does not envision needing to create one in the course of the agreement, so in reading the plain language of a customer agreement, sees no issue. With the other terms of the deal reasonable and acceptable to EmCo, it is ready to execute the agreement. By doing so, however, the company will inadvertently (arguably) bind its future acquiror (a "future affiliate") to the same terms.[199] These provisions are particularly problematic when intellectual property is licensed or business restrictions are implicated, and an acquirer's own intellectual property portfolio or business growth is put at risk.[200] EmCo's lawyer would request the language be removed entirely, to reflect EmCo's then-current corporate structure.

* * *

In each of the above cases, the technology transactions lawyer's work is routine, and straightforward, but embedded within its counsel is a credible commitment device that increases the chances EmCo will uphold its promise to its early investors of a future successful liquidity event.[201] While EmCo operates under pressure to show progress on commercial agreements and get revenues flowing, the lawyer, when given the opportunity, is able to step in and remind EmCo of its longer term interests and need to complete an exit to deliver the maximum possible return to its investors, founders, and employees.[202] As a result of the lawyer's advice, the subsequent exit transactions, described in Part III, are more likely to be concluded efficiently.

[person or entity] that directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with, such [person or entity] at any time during the term of this Agreement."

199. *See* Medtronic Ave, Inc. v. Cordis Corp., 2003 U.S. Dist. LEXIS 23580 (D. Del. 2003), *rev'd,* 367 F.3d 147 (3rd Cir. 2004) (deciding whether a license agreement requires arbitration for a dispute over whether Cordis had a license to patents owned by an affiliate of Medtronic, where Medtronic acquired the affiliate after the date of the license, given that the agreement expressly binds Medtronic's affiliates, including those acquired after the license's effective date).

200. *See infra* Part III.

201. Anecdotally, the author also believes that engaging counsel early on also sends a strong signaling device to prospective VC investors about a company's seriousness and dedication to long-term growth.

202. *See generally* Douglass C. North, *Institutions and Credible Commitment*, 149 J. INSTITUTIONAL & THEORETICAL ECON. 11, 15 (1993) (noting that credible commitments are "realized over a very long period of time.").

Imagine, then, that just a few years into the future, EmCo is valued at half a billion dollars. It engaged a technology transactions lawyer early on, and as a result, can prove it owns all the intellectual property it purports to, does not use open-source software licensed under copyleft terms, has no customers with consent or termination rights in connection with a change of control, and has negotiated away any provisions that would limit its business growth or bind its future parent company. EmCo's lawyer, already familiar with EmCo's commercial practices, will draft and negotiate the relevant provisions of the operative documents with ease.[203] Whichever exit route EmCo pursues (an acquisition or an IPO) will proceed efficiently, without either party wasting resources or incurring needless costs. Its VCs will fund more enterprises, which facilitates additional research and development that, in turn, generates societal and economic benefits.

But what would have happened if EmCo had not used an attorney? The next Part shows how the efficiency of EmCo's exit transactions is jeopardized because a lawyer did not have an opportunity to engineer the transaction costs and create sustainable value in the enterprise in advance.

III.
EmCo's Exits

This Part begins with a big technology company, TechCo, pursuing a hypothetical acquisition of EmCo, followed by EmCo's hypothetical IPO (underwritten by a Wall Street firm, Big Bank). In both transactions, EmCo's earlier failure to use the technology transactions attorney increases the transaction costs for both parties, far beyond what it would have cost to engage a lawyer to solve the issues when they arose in the ordinary course of business.[204] The efficiency of the deal is jeopardized as a result; the parties must divert resources away from their intended beneficial uses to address EmCo's deficiencies. The lawyer's inability to deflect and anticipate hold-up issues arising from EmCo's everyday commercial transactions

203. *See* Abraham J. B. Cable, *Comment on Griffith's Deal Insurance: The Continuing Scramble Among Professionals*, 104 Minn. L. Rev. 75, 81 (2020) (describing how lawyers gain institutional knowledge about clients over the course of representation).
204. *See supra* note 132.

reveals itself as the value of EmCo decreases (measured by the purchase price paid by TechCo and its share price vis-à-vis Big Bank). In some cases, the exit may not happen at all.

This Part breaks both the acquisition and IPO into three parts, each correlating to a type of transaction cost. In *Value Creation,* Gilson did not articulate what kind of transaction costs the business lawyer engineers; rather, he referred to transaction costs only in a general sense. However, those costs are divided into three categories.[205] Search and information costs ("search costs") are the expenses associated with parties identifying each other and the proposed terms of a deal.[206] Bargaining and decision costs ("bargaining costs") are the costs associated with negotiating an agreement.[207] Finally, policing and enforcement costs ("enforcement costs") are the costs incurred by each party in observing each other's behavior and taking actions to ensure the agreement is carried out.[208] It is safe to assume that because Gilson's transaction cost engineer only steps into the spotlight when there is a negotiation stalemate,[209] it has the most meaningful effect on bargaining costs for a given transaction.[210] That is not the case for the technology transactions lawyer, whose *ex ante* counseling affects all forms of transaction costs incurred in the exit.

A. *The Acquisition*

Acquisitions are the most common form of exit for startups[211] and will provide EmCo's VCs with a quicker and potentially bigger return on investment than an IPO.[212] Strategic acquisitions

205. *See* R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 15 (1960); *see also* Carl Dahlman, *The Problem of Externality*, 22 J.L. & ECON. 141, 148 (1979) (noting the three forms of transaction costs, but concluding all boil down to the costs of obtaining information).

206. Dahlman, *supra* note 205, at 147.

207. *Id.* at 147–48.

208. *Id.* at 148.

209. Gilson, *supra* note 1. However, in facilitating efficient negotiation, the Gilson transaction cost engineer may also optimize information exchange and affect the potential costs of enforcement, thereby indirectly reducing other forms of transaction costs.

210. *Cf.* Victor Fleischer, *Brand New Deal: The Branding Effect of Corporate Deal Structures*, 104 MICH. L. REV. 1581, 1587 (2006) (recognizing that the negotiation issues addressed by Gilson's transaction cost engineer affect monitoring (i.e., policing) costs).

211. *See supra* note 90, at 36.

212. Lemley & McCreary, *supra* note 84, at 36.

in which a buyer buys one of its suppliers are pervasive in the technology industry.[213] In those transactions, buyers often pay a premium for a company because they are purchasing more than the additional business line or elimination of a cost.[214] In some cases, both parties to an acquisition are able to take advantage of efficiencies generated through complementary products and services, cost savings and sharing, and customer bases that allow the businesses to grow at a pace not available individually.[215] In other cases, companies buy when acquiring a firm is cheaper than it would be to generate the same output internally.[216] Lastly, some companies prefer to use acquisitions simply to reduce competition.[217] By purchasing smaller competitors, bigger companies secure a greater market share for themselves, either by integrating the startup's products and services (and its customers) into their own business divisions, or by killing the startup's operations altogether.[218] The buyer's

---

213. *See id.* at 8.

214. *See id.* at 8, 45.

215. *See* D. Daniel Sokol, *Vertical Mergers and Entrepreneurial Exit*, 70 FLA. L. REV. 1357, 1372 (2018) ("Many large firms acquire smaller firms . . . with the belief that the acquisition will allow the acquirer to create efficiencies that are not possible" otherwise); Douglas J. Cumming & Jeffrey G. MacIntosh, *Venture-Capital Exits in Canada and the United States*, 53 U. TORONTO L.J. 101, 105 (2003) ("one of the great advantages of the sale of a firm . . . over an IPO . . . is that it is the most likely to result in the realization of transaction synergies"). Additionally, in the patent space, buyers operating in similar fields may seek to eliminate potential plaintiffs in infringement lawsuits. Peter Lee, *Innovation Consolidation*, 54 U.C. DAVIS L. REV. 967, 1006–07 (2020); *see also* Clark D. Asay, *Artificial Stupidity*, 61 WM. & MARY L. REV. 1187, 1243–44 (2020) (describing how large companies buy small ones in order to build out intellectual property portfolios and eliminate litigation risk).

216. Coase, *supra* note 99, at 395.

217. Colleen Cunningham et al., *Killer Acquisitions*, 129 J. POL. ECON. 649 (2021).

218. Lemley & McCreary, *supra* note 84, at 20–21; Lee, *supra* note 215, at 1006–07; Cunningham et al., *supra* note 217; OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING 128 (1985); MAJORITY STAFF REP. & RECOMMENDATIONS, SUBCOMM. ON ANTITRUST, COM. & ADMIN. L. OF THE COMM. ON THE JUDICIARY, 116TH CONG., INVESTIGATION OF COMPETITION IN DIGITAL MARKETS 143. As of 2020, Amazon had purchased over 100 companies in the prior twenty years, spending billions of dollars on other dominant online retailers, such as Diapers.com and Zappos. *Id.* at 261–262. Many small competitor acquisitions go unnoticed for lack of meeting the minimum purchase price to trigger a regulatory filing, currently $101 million. Federal Trade Commission, *HSR threshold adjustments and reportability for 2022* (Feb. 11, 2022), https://www.ftc.gov/enforcement/competition-matters/2022/02/hsr-threshold-adjustments-reportability-2022.

motives for purchasing the company affect how it approaches the deal.

The M&A process can be divided into two phases. In the first phase, the acquirer conducts initial due diligence and delivers a term sheet to the seller. EmCo makes available confidential information for TechCo to review relating to the company's finances (TechCo also reviews pertinent public data).[219] Then, the parties negotiate a term sheet that reflects key elements of the deal based on TechCo's initial diligence, including, most importantly, the amount it believes EmCo is worth, i.e., the purchase price.[220] The term sheet also includes a description of what is being sold (e.g., the nature of EmCo's business or assets)[221] and the deal structure.[222]

After TechCo and EmCo complete preliminary diligence, the parties agree that TechCo will buy EmCo for $500 million by way of a reverse triangular merger (the most common structural mechanism for vertical mergers[223]). The parties also agree to purchase representations and warranties insurance, consistent with market practice (and discussed further below). These material terms are intended to delineate the boundaries of the parties' subsequent negotiation of the definitive documents, so long as there are no surprises in the next phase of the process.[224]

The second phase is where the technology transactions lawyer's (if used) earlier transaction cost engineering would materialize, as the parties engage in confirmatory diligence, negotiate, execute the definitive acquisition documents, manage any conditions to closing the transaction, and finally, close (at which time TechCo pays the purchase price).[225]

---

219. Cathy Hwang, *Deal Momentum*, 65 UCLA L. Rev. 376, 385–386, 402 (2018).

220. *Id.* at 385; Lou R. Kling et al., *Summary of Acquisition Agreements*, 51 U. Miami L. Rev. 779, 780 (1997).

221. Kling et al., *supra* note 220, at 780.

222. Hwang, *supra* note 219, at 385; E. Thom Rumberger Jr., The Acquisition and Sale of Emerging Growth Companies: The M&A Exit § 3:5 (2d ed. 2021).

223. *Selling Your Company: Merger vs. Stock Sale vs. Asset Sale*, CooleyGo, https://www.cooleygo.com/selling-your-company-merger-vs-stock-sale-vs-asset-sale (last visited Jan. 30, 2023).

224. Rumberger, *supra* note 222, § 3:5.

225. *See* Hwang, *supra* note 219, at 385 (describing stages of the M&A process, beginning with the term sheet and ending with closing).

1. *Confirmatory Diligence and Search Costs*

After signing the term sheet, TechCo undertakes confirmatory diligence to verify the assumptions TechCo made based on EmCo's financial records in determining the purchase price and other key terms. Confirmatory diligence reveals the information asymmetry between the parties as it relates to EmCo's business, and is used by TechCo to validate its expectations, address unforeseen issues,[226] and get comfortable with the risk it is taking on in absorbing EmCo and its business.[227]

Diligence of any company is expansive, and EmCo's acquisition is no different. Both parties involve legal, business, accounting, and technical experts to produce and review information. In addition to a detailed review of all EmCo's internal practices and records relating to corporate governance, employment, tax, and regulatory compliance, TechCo scrutinizes EmCo's commercial operations to confirm its revenue expectations, as well as its ability to integrate the business and products into its own operations with maximum flexibility and little disruption. Therefore, some search costs are guaranteed in this stage. If EmCo had heeded its lawyer's advice on intellectual property, open-source software, and commercial contract provisions, then those costs would be optimized for both parties and the value created by the lawyer through its day-to-day counseling would finally bear fruit. Instead, however, once TechCo looks under EmCo's hood, the process takes them in another direction.

TechCo's commercial diligence begins with requesting EmCo's employee intellectual property assignments. TechCo must verify that EmCo can prove it owns those rights and that it has valued EmCo properly because of that ownership.[228] EmCo has no such agreements. This is a significant issue for TechCo. At best, EmCo does in fact own the copyrights in its platform, but there is no written evidence to rely on, nor any documentation regarding trade secrets, trademarks, or patents.[229] If ownership of the intellectual property was ever challenged, TechCo would

---

226. *See id.* at 393, 403.
227. Hwang, *supra* note 219, at 403; Rumberger, *supra* note 222, § 4:2.
228. Martin B. Robins, *Intellectual Property and Information Technology Due Diligence in Mergers and Acquisitions: A More Substantive Approach Needed*, 2008 U. Ill. J.L. Tech. & Pol'y 321, 324 (2008).
229. *See supra* Section II.B.1.

have no paperwork to definitively point to, inviting litigation;[230] unlike EmCo, TechCo will not be viewed as judgment proof by potential plaintiffs.

Next, TechCo seeks to understand EmCo's open-source software usage, which affects the value of the product, integration plans, and litigation risk (arising from non-compliance with license terms).[231] TechCo's legal and technical teams review EmCo's use of open-source software in detail. This is intense and time-consuming, as TechCo requests a list of every open-source component EmCo has used, the license it was provided under, and a description of how it was used.[232] TechCo reviews this list through two lenses: first to understand whether any copyleft components were used, and second to determine whether EmCo is in compliance with the relevant licenses.[233] It will also scan EmCo's code base by engaging a third-party auditing company to identify open-source components and their governing licenses to confirm EmCo's list. [234]

TechCo's engineers quickly spot EmCo's non-compliant use of several modified copyleft open-source components in its proprietary platform, governed by the GNU Affero license. If EmCo were to comply with the applicable license provisions, it would need to make much of the source code underlying the platform available to the public for free.[235] To TechCo, on paper, this renders the product worthless; it cannot exploit the platform without being in knowing breach of the license or, as a result, potentially infringing the copyright embodied by the open-source code.[236] TechCo must determine how much of the platform will need to be re-engineered to eliminate the copyleft components prior to closing, and how much litigation risk it wishes to take on due to EmCo's non-compliance with the licenses to-date. This is a particularly onerous task if the original engineer has left the company.

---

230. *See* BOUCHOUX, *supra* note 146, at 109.

231. Phil Odence, *Overlooked Due Diligence Considerations in Tech M&A*, LAW360 (Oct. 28, 2019, 4:07 PM), https://www.law360.com/articles/1194484/overlooked-due-diligence-considerations-in-tech-m-a.

232. Asay, *supra* note 151, at 771.

233. *Id.* at 771; *see also* Robins, *supra* note 228, at 328 (noting due diligence typically includes a buyer determining whether a seller complies with open-source licenses).

234. Asay, *supra* note 151, at 773.

235. *See supra* text accompanying notes 164–69.

236. Jacobsen v. Katzer, 535 F. 3d 1373 (Fed. Cir. 2008).

Lastly, TechCo undertakes a comprehensive review of EmCo's contracts with customers and suppliers.[237] Unlike commercial contracts governed by the UCC, there are few standard provisions TechCo can assume are present, so it reviews these agreements in detail, noting all problematic provisions.

TechCo reads the "Assignment" provisions in each contract to analyze whether the acquisition, as currently structured, results in a commercial counterparty having to consent to the transaction. As noted above, some forms of transactions, like asset purchases, constitute assignments, while others (such as reverse triangular mergers) are not assignments, but may still trigger a consent by virtue of the language used in the agreement.[238] EmCo has numerous contracts with assignment and termination provisions that require the counterparty's consent to any change of control. TechCo must determine which of those contracts are critical to maintaining EmCo's operations such that consent (or a waiver of termination rights) must be obtained before closing. For EmCo, seeking those consents may make it vulnerable to a hold-up scenario, by which third parties can leverage hostage rights to extract additional gains from EmCo.[239]

A customer contract that purports to license software (not a SaaS platform) from EmCo, and which also binds EmCo's future affiliates, is identified next. TechCo does not want to take on this contract and worry that a customer may demand to exercise its expansive rights, nor does it want to risk devaluing its own pre-existing software products that could be brought into the license (at no additional cost).

EmCo also agreed to several vertical restraints with its counterparties, including a most-favored-nation provision and a non-compete (prohibiting EmCo from entering a particular line of business), thus limiting the business' organic growth potential. The assumptions TechCo made about potential revenue opportunities when it entered into the term sheet must be revisited as a result. Additionally, EmCo agreed to use a third-party supplier exclusively for several years. TechCo's integration plans had included leveraging its existing third-party

---

237. *See* RUMBERGER, *supra* note 222, § 4:33 (describing a buyer's diligence of a seller's material commercial contracts).

238. *See supra* discussion in Section II.B.3.b.

239. *See* Barondes, *supra* note 131, at 44 (describing how parties secure hidden hostage rights to "extract gains" in future transactions).

suppliers for EmCo to minimize redundancies. Now, it must maintain a separate arrangement for those services until the end of the contract, reducing the operational synergies it had planned to gain.

The deal process allows TechCo to ferret out and appropriately address any commercial issues that impact the deal structure, integration plans, the risk it is assuming, and its ability to efficiently close the transaction.[240] Once identified in diligence, however, these issues have a cascading effect on the efficiency (or existence) of the deal and the value of EmCo.

TechCo, having completed diligence, has come to a fork in the road. Its review of EmCo has revealed that there was severe information asymmetry at the time the term sheet was executed, and so the term sheet no longer reflects the business it seeks to buy. Some buyers might, at this stage, walk away from the deal, having determined that the company is too impaired to take on or that issues will simply take too long to fix for the deal to be worthwhile. In that case, both parties lose all the resources already sunk into the deal (as well as the opportunities to develop cost-saving synergies through business integration),[241] and EmCo's VC investors yield nothing in the short term. EmCo may find it difficult to raise additional funds or sell itself at the same valuation because of any adverse inference that potential investors or acquirers draw from the aborted deal. For our purposes here, however, let's assume TechCo decides to continue with the deal and proceeds to the next phase.

2. *Definitive Documents and Bargaining Costs*

As with search costs, certain bargaining costs involved with an M&A transaction cannot be avoided, and these costs are related primarily to the drafting and negotiation of the purchase agreement and its schedules.[242] However, EmCo's and

---

240. RUMBERGER, *supra* note 222, § 4:4.

241. *See* Sean J. Griffith, *Deal Protection Provisions in the Last Period of Play*, 71 FORDHAM L. REV. 1899, 1900 (2003) ("[m]ost obviously, the acquiror will have significant sunk costs in the initial transaction, including the fees of legal and financial advisors, loan commitments, research and diligence costs, and perhaps most significantly, management time and foregone business opportunities," if a deal dies)*; see also* Sokol, *supra* note 215, at 1367 (describing such benefits of vertical mergers).

242. There are also several ancillary agreements, including executive employment agreements and voting agreements. *See* Cathy Hwang, *Unbundled*

TechCo's bargaining costs will increase significantly given the commercial issues identified in diligence.[243]

a. *Deal Restructure*

The parties first incur costs in renegotiating the term sheet in light of two material diligence issues. First, TechCo has determined it cannot take on the software license that purports to bind EmCo's future acquiror. This is not uncommon; in certain instances, when a seller has entered a commercial contract that is so detrimental to its future growth, or the buyer's business or plans, the parties restructure the deal to leave behind that contract and any associated assets, liabilities, and potentially employees.[244] The other option (terminating the contract without cause) risks litigation, so TechCo would rather exile that contract to a separate company. It then insists that the deal be restructured as an asset purchase, rather than a reverse triangular merger, which allows it to cherry-pick the parts of EmCo's business it will absorb.

Second, the purchase price of the transaction, which was determined (in part) by revenue forecasts, is also affected.[245] EmCo is worth less than assumed because it cannot generate the revenues originally predicted. For one, TechCo is leaving behind the receivables associated with the toxic customer agreement. Two, TechCo's accountants have determined that the vertical restraints EmCo previously agreed to materially impact EmCo's revenue potential: EmCo is limited in its ability to raise prices for a large customer, and it has agreed to stay out of a particular line of business entirely. Before the

---

Bargains: Multi-Agreement Dealmaking in Complex Mergers and Acquisitions, 164 U. Pa. L. Rev. 1403 (2016) (describing the ancillary agreements that accompany a purchase agreement).

243. *See* R. Tyler Hand, *Managing Risk and Liabilities in Today's M&A Market*, M&A Deal Strategies: Leading Lawyers on Conducting Due Diligence, Negotiating Representations and Warranties, and Succeeding in a Post-Recession Market at 1, 2015 WL 1802924 (2015) (noting due diligence "directly impact[s]" the rest of a transaction).

244. *See* Byron F. Egan et al., *Asset Acquisitions: A Colloquy*, 10 U. Miami Bus. L. Rev. 145, 150–52 (2002) (describing asset purchases as appropriate when the buyer wants to exclude certain assets and/or liabilities from the transaction).

245. *See* Albert Choi & George Triantis, *The Effect of Bargaining on Contract Design*, 98 Va. L. Rev. 1665, 1690 (2012) (noting that parties may revisit the purchase price if post-term sheet negotiations produce results outside of expectations).

parties even begin to negotiate the nuts and bolts of the purchase agreement, the value of the deal, and EmCo itself, has already declined in the most apparent way, with a reduced sticker price.

The exercise of re-negotiating the term sheet also generates new search costs, as the parties must review their diligence findings in terms of the new transaction format. Every "Assignment" provision in every commercial contract is re-read to understand what additional consents from counterparties are required, for example, due to the new asset purchase structure (which constitutes an assignment of those contracts).

b. *Purchase Agreement*

Once the parties have settled on a deal structure and updated term sheet, they turn to the purchase agreement[246] and its schedules. Purchase agreements are lengthy (often over 100 pages[247]) and include provisions relating to tax, employment, dispute resolution, and closing mechanics.[248] From a commercial standpoint, the most relevant provisions are the representations and warranties (and the associated disclosure schedule), indemnification, and closing conditions. Because of the problems identified in diligence, the negotiation of each of these terms will result in expenses well beyond what it would have cost EmCo to use a lawyer when entering its commercial deals.

i. *Representations and Warranties*

The parties negotiate EmCo's representations and warranties (the "reps") in the purchase agreement; these provisions reflect the state of EmCo's business at the time the agreement is signed[249] and are another method TechCo uses to confirm the assumptions it made in the term sheet stage and address issues

246. Depending on the deal structure, this agreement may be a merger agreement, stock purchase agreement, or asset purchase agreement. I use the term "purchase agreement" to refer to any agreement memorializing the purchase of a company.

247. Matthew Jennejohn, *The Architecture of Contract Innovation*, 59 B.C. L. Rev. 71, 85 (2018).

248. *See generally* Kling et al., *supra* note 220, at 782–92 (outlining the parts of a purchase agreement).

249. *Id.* at 781.

with EmCo.[250] TechCo gleans information by asking EmCo to attest to certain expected (or the lack of unexpected) characteristics of a company of its size and maturity.[251] In particular, EmCo is asked to confirm (among many other things) that (i) it owns (or has sufficiently licensed) all of the intellectual property assets required to run the business and the business does not infringe on any third party's intellectual property rights, (ii) it has written intellectual property assignments from all employees and contractors, (iii) it complies with all licenses that govern any open-source code incorporated into its products, and all such licenses are listed on a schedule, (iv) it has not used any copyleft open-source software in a way that would require it to make its products available to the public, (v) it has no contracts that require a third party to consent to the acquisition, (vi) it is able to list all contracts with vertical restraints, and (vii) it has no contracts that will impose obligations on TechCo directly following closing.[252] As we now know, EmCo cannot make all of those reps (either because they are untrue or the relevant records do not exist), and the parties must determine the extent to which EmCo is excused from liability should a third-party claim arise relating to those reps. Any unforeseen increase in the amount of risk TechCo takes on in the deal decreases the value of EmCo.

The allocation of risk due to non-compliance with reps is accomplished via a disclosure schedule.[253] On the disclosure schedule, EmCo lists any circumstances or contracts that render a rep untrue.[254] This allows TechCo to identify with specificity

---

250. RUMBERGER, *supra* note 222, § 9:14.

251. Ronald J. Gilson et al., *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice,* and Doctrine, 110 COLUM. L. REV. 1377, 1432 (2010).

252. *See, e.g.*, Adobe Inc., Current Report (Form 8-K), at Exhibit 2-1 (Sept. 15, 2022) (Agreement and Plan of Merger by and among Figma, Inc., Adobe Inc., Saratoga Merger Sub I, Inc., Saratoga Merger Sub II, LLC and Fortis Advisors LLC, as the Representative, dated Sept. 15, 2022) [hereinafter Figma Agreement]; Meta Platforms, Inc., Quarterly Report (Form 10-Q), at Exhibit 2-1 (Apr. 25, 2014) (Agreement and Plan of Merger and Reorganization by and among Facebook, Inc., Rhodium Acquisition Sub II, Inc., Rhodium Merger Sub, Inc., WhatsApp Inc. and Fortis Advisors LLC, dated Feb. 19, 2014) [hereinafter WhatsApp Agreement] (each including all such reps).

253. Sean J. Griffith, *Deal Insurance: Representation and Warranty Insurance in Mergers and Acquisitions*, 104 MINN. L. REV. 1839, 1854 (2020).

254. RUMBERGER, *supra* note 222, § 9:17; *see* Jeffrey Manns & Robert Anderson IV, *The Merger Agreement Myth*, 98 CORNELL L. REV. 1143, 1152 (2013)

issues that deviate from the norm. However, the scope and drafting of these exceptions are themselves subject to robust negotiation, as they directly reflect risk allocation between EmCo and TechCo. Once an exception is listed on the schedule, the associated risk is transferred to TechCo. If TechCo declines to take on certain liabilities, it will then refuse to allow the disclosure, limit the applicable language so EmCo clearly still bears the risk, or seek indemnification for losses arising out of that specific issue.[255] Therefore, the existence and drafting of each exception added to the disclosure schedule causes the parties to expend additional, unanticipated bargaining costs.

ii. *Indemnification and Insurance*

The parties must negotiate the recourse available to TechCo in the event a rep is untrue (and especially if a third party brings a claim against EmCo or TechCo related to that untrue rep). Historically, this recourse has been managed through an indemnification provision.[256] Parties would negotiate heavily to determine how a seller will make a buyer whole through an indemnity process if a rep is breached (and the seller had not transferred risk via the disclosure schedule).[257] As part of that negotiation, the buyer requires that a portion of the purchase price be diverted to an escrow account with a bank (or simply holds back the funds) to ensure available funds in the event of an indemnifiable third-party claim.[258] Roughly 10% of the purchase price is considered market in these situations,

---

(acknowledging the relationship between the reps, diligence, and the disclosure schedule).

255. For instance, the parties may allow a disclosure for "fraud purposes only," to ensure EmCo is not liable to TechCo for fraud, but that no other risk is shifted between the parties.

256. Hand, *supra* note 243; RUMBERGER, *supra* note 222, § 9:20; Abraham J. B. Cable, *Comment on Griffith's Deal Insurance: The Continuing Scramble Among Professionals*, 104 MINN. L. REV. 75, 79 (2020); *see* Kling et al., *supra* note 220, at 782. This is in contrast to ordinary commercial agreements, where a party can sue the other for breach of contract if a rep is untrue. Once two parties become part of the same family after an M&A deal, breach claims are rare; a parent company is hesitant to sue its own affiliate.

257. Hand, *supra* note 243.

258. *See* RUMBERGER, *supra* note 222, § 9:25 (describing escrow as "collateral for the collection of indemnification claims").

but this amount and the length of the escrow are subject to negotiation.[259]

EmCo and TechCo, however, agreed to purchase representations and warranties insurance to replace much of the contractual indemnity,[260] including for reps related to commercial and intellectual property matters. This is an increasingly common practice; close to half of all private company acquisitions now include an insurance component.[261] The parties determined they would purchase insurance at the term sheet stage, following preliminary diligence, but before confirmatory diligence.

The insurance is designed to replace contractual indemnification as TechCo's recourse for a breach of the covered reps;[262] in the event of a claim, TechCo looks to the insurer instead of EmCo. The policy allows EmCo to walk away with a larger share of the purchase price at closing than it would absent insurance. EmCo, theoretically, receives up to 100% of the purchase price at closing instead of having 10% (or more) held back as security for contractual indemnification obligations. TechCo also benefits from purchasing insurance because it is assumed to expedite the deal process (indemnification need not be negotiated[263]) and provide greater certainty as to the ability to recover for breaches.[264]

As part of the underwriting process, the insurer does its own review of EmCo and its business practices.[265] It also meets with TechCo's counsel to get comfortable with the amount of diligence undertaken and the results.[266] If the insurer is

---

259. *Id.* § 9:26. Abraham J. B. Cable, *Comment on Griffith's Deal Insurance: The Continuing Scramble Among Professionals*, 104 MINN. L. REV. 75, 88 (2020).

260. Griffith, *supra* note 253, at 1842–43; *see* PTC Inc., Current Report (Form 8-K), at Exhibit 1-1 (Nov. 17, 2022) (Share Purchase Agreement by and among PTC Inc., ServiceMax JV, LP and ServiceMax, Inc., dated Nov. 17, 2022) (providing for insurance to replace contractual indemnity).

261. Griffith, *supra* note 253, at 1843.

262. *Id.* at 1866.

263. *See* Hand, *supra* note 243 ("[B]ecause indemnification provisions are the primary means by which parties in M&A transactions allocate risks, they are typically the most heavily negotiated aspect of any M&A agreement.").

264. Griffith, *supra* note 253, at 1887; Matthew J. Moussiaux & Matthew R. VanWasshnova, *Representation and Warranty Insurance for M&A Transactions*, PRAC. L. (Oct. 11, 2022), http://us.practicallaw.com/W-000-4767.

265. Griffith, *supra* note 253, at 1893–94.

266. *Id.* at 1893.

uncomfortable with EmCo's positions or practices such that it cannot price the risk of a claim, then it proposes an exclusion from the policy.[267]

It is axiomatic that when the parties agree to purchase insurance, they do so under the assumption that there will be no nonstandard exclusions. Nevertheless, commercial items that are often the topic of exclusion discussions are similar to those that end up on the disclosure schedule, such as severe non-compliance with open-source licenses.[268] This is the case with EmCo, where an insurer will insist on an exclusion because of EmCo's offending use of copyleft code. For TechCo, the policy exclusion is particularly problematic because the insurance policy price remains the same, but TechCo has no remedy for a breach of the open-source reps due to foregoing contractual indemnification in favor of the insurance policy. Therefore, a bespoke, "special" indemnification provision must be negotiated to fill the gap, resulting once again in increased, unanticipated costs for both parties.

Once the need for a special indemnity is identified, EmCo and TechCo both spend significant resources negotiating the provision (including how long it will survive beyond the agreement,[269] its scope, and the aggregate amount recoverable). Additionally, EmCo must likely cede an additional portion of its purchase price to an escrow or holdback account,[270] representing yet another cost for the company and its investors that could have been avoided had it earlier sought out the advice of

267. *See* Moussiaux & VanWasshnova, *supra* note 264 (stating that policies typically do not cover losses for "matters disclosed on schedules to the acquisition agreement and all matters discovered in due diligence").

268. *See* Jeffrey Chapman et al., *Representations and Warranties Insurance in M&A Transactions*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Dec. 11, 2017), https://corpgov.law.harvard.edu/2017/12/11/representations-and-warranties-insurance-in-ma-transactions; *See* Moussiaux & VanWasshnova, *supra* note 264.

269. Abraham J. B. Cable, *Comment on Griffith's Deal Insurance: The Continuing Scramble Among Professionals*, 104 MINN. L. REV. 75, 89 (2020) (noting that parties may negotiate bespoke risk allocation provisions for items excluded from the insurance policy). This period could be months or years. James P. Dvorak & Erin E. Segreti, *What to Expect When You're Selling Your Company—Indemnification*, VENABLE LLP (August 2012), https://www.venable.com/insights/publications/2012/08/what-to-expect-when-youre-selling-your-company-in.

270. *See* Gilson, *supra* note 1, at 282 (noting that indemnification obligations are routinely backed by the "retention of a portion of the consideration").

counsel. Any delayed payments fall victim to a time-value-of-money problem; the value of the transaction decreases even if the purchase price is unchanged because EmCo and its investors cannot immediately access the escrowed amount to make new investments.[271]

Moreover, due to the exclusion, the parties must once again revisit their confirmatory diligence. In deals with insurance, the parties structure their diligence in a way that conforms to the insurer's expectations, as opposed to what TechCo would have required to manage risk allocation under a contractual indemnity.[272] Now that a special indemnification clause is needed, the parties must review their original findings, and then re-negotiate the relevant disclosures.

iii. *Closing Provisions*

There is often a delay between the signing of the purchase agreement and the transaction closing.[273] For any diligence issue that the buyer requires be fixed in order to close, this interim period allows the seller to undertake remedial actions. The completion of those actions becomes a condition to the buyer's obligation to close the deal (and pay the seller the purchase price, less its portion of the insurance policy premium and any amounts held back as security for its bespoke indemnification obligations).[274] If the seller does not meet its obligations, then the buyer can either waive the closing condition and proceed with closing or walk away from the deal.[275]

Where diligence, negotiation of the reps, and drafting of the disclosure schedule help to identify issues, the closing conditions provide TechCo with its last opportunity to force

---

271. Shauna Carther Heyford, *Understanding the Time Value of Money*, INVESTOPEDIA (May 23, 2022), https://www.investopedia.com/articles/03/082703.asp.

272. *See* Eric B. Oxley et al., *Representations and Warranties Insurance: Seven Practical Considerations*, THE NEBRASKA LAWYER, Sept.–Oct. 2017, at 14–15 https://www.koleyjessen.com/media/publication/20_Representations%20and%20Warranties%20Insurance%20Seven%20Practical%20Considerations.pdf (noting that an insurance policy affects how the parties structure diligence).

273. Kling et al., *supra* note 220, at 781. Depending on the size of the deal, this time period may be affected by regulatory approvals.

274. Manns & Anderson, *supra* note 254, at 1152–53.

275. *Id.* TechCo may also be able to terminate the acquisition if the reps are untrue at closing. Kling et al., *supra* note 220, at 783.

a remedy of any of those issues, thus ensuring the version of EmCo it is buying substantially resembles the one it negotiated for at the term sheet stage.[276]

Issues associated with deficient intellectual property rights, misuse of open-source software, and requirements to obtain consents to a change of control are frequently subject to closing conditions.[277] In EmCo's case, TechCo requires EmCo to address all three. Negotiating the scope of each of these conditions reflects an additional tranche of unexpected bargaining costs borne by the parties.

First, because EmCo failed to get written intellectual property assignments from its employees, EmCo must secure "confirmatory assignments . . . from any of [its] past employees . . . that have contributed to material [i]intellectual [p]roperty of" EmCo.[278] Second, TechCo has a strict open-source policy that prohibits copyleft open-source code in its code base, and because it plans to integrate EmCo's platform into its own, it cannot proceed with integration until EmCo's copyleft code is removed.[279] Therefore, EmCo must re-engineer the relevant part of its code base to eliminate the copyleft open-source components. Lastly, TechCo does not want to purchase a company only to lose all of the seller's revenues and suppliers because those parties had a right to withhold their consent or terminate their respective agreements in connection with EmCo's acquisition. TechCo identifies a dozen material contracts that include such clauses for which EmCo

276. Depending on the materiality of the issue, the seller may be able to negotiate for an "efforts" standard. RUMBERGER, *supra* note 222, § 9:34. As discussed in Section III.A.3, *infra*, some issues are not able to be remediated, and are managed differently.

277. *See, e.g.*, WhatsApp Agreement, *supra* note 252 (requiring WhatsApp to secure certain confirmatory intellectual property assignments prior to closing its acquisition by Facebook), Figma Agreement, *supra* note 252 (requiring Figma to use "commercially reasonable efforts" to secure certain third-party consents to its purchase by Adobe). *See* Zachary Turke & Edward Xia, *What To Know About Software Co. M&A As Deal Volume Rises*, LAW360 (Oct. 22, 2020, 5:01 PM), https://www.law360.com/articles/1321768/what-to-know-about-software-co-m-a-as-deal-volume-rises (suggesting that buyers consider having sellers remedy open-source issues prior to closing).

278. WhatsApp Agreement, *supra* note 252.

279. *See, e.g.*, Yahoo Open Source Developer Guide, https://yahoo.github.io/oss-guide (last visited Jan. 30, 2023) (requiring consent for use of any copyleft code and explicitly prohibiting the use of Affero components).

must "use reasonable best efforts . . . to obtain" written permission or waivers of termination rights before the parties close.[280]

Had EmCo used a technology transactions lawyer in its initial dealings on these issues, the disclosure schedule would include minimal exceptions to the reps, and there would be no additional exclusions from the insurance policy. EmCo would not be subject to conditions to closing the transaction, and TechCo would not be concerned about issues with integrating EmCo's technology into its platform or taking on an unreasonable amount of contractual risk. Instead, the parties have incurred significant additional bargaining costs in managing TechCo's unanticipated exposure and determining what EmCo must do to remedy its errors prior to closing, thus decreasing the overall value and efficiency of the transaction. Additionally, each closing condition offers TechCo an opportunity to find pretext to walk away from the deal, increasing the risk it does not happen at all.

3. *Closing and Enforcement Costs*

The last category of costs that arise in acquisitions are enforcement costs. In this context, enforcement costs are primarily derived from complying with, and monitoring, the closing conditions so that the transaction can close.[281] TechCo's costs are straight-forward. It will expend resources to verify the sufficiency of the intellectual property assignments and commercial consents, as well as examine EmCo's code base to ensure the copyleft open-source components are removed. EmCo's enforcement costs, however, are more complex. Embedded within its additional expenditures are more search and bargaining costs arising from the hold-up risk presented by unaffiliated third parties.

First, EmCo must locate former employees to execute intellectual property assignments, which can be a lengthy and cumbersome process for departed colleagues. Frequently a

280. Bakkt Holdings, Inc., Current Report (Form 8-K), at Exhibit 2-1 (Nov. 2, 2022) (Membership Interest Purchase Agreement by and among Bakkt Marketplace, LLC, Bakkt Holdings, Inc., Apex Fintech Solutions Inc., and Apex Crypto LLC, dated Nov. 2, 2022); *see* RUMBERGER, *supra* note 222, § 4:4 ("if necessary, acquirer may include a closing condition requiring [the counterparty's] consent to the assignment of the contract").

281. *See* Gilson et al., *supra* note 251, at 1438 (characterizing verification of closing conditions as "enforcement").

surprise to sellers, post-hoc intellectual property assignments are expensive. Contract law mandates the assignments be supported by consideration,[282] and while only a mere "peppercorn" is legally sufficient, [283] buyers demand more. They do not want to take the risk of a counterparty subsequently arguing the assignment is unenforceable and therefore require a heftier amount, often hundreds of dollars. That figure can rise if former employees recognize an opportunity to hold up the acquisition and demand more money to finalize the paperwork. This expense comes out of EmCo's pocket.

Second, commercial partners must be identified and contacted to execute consents to the transaction under their change of control provisions. Once these counterparties are found, EmCo must negotiate to secure their signature on the applicable documents, and there is nothing stopping a commercial partner from holding EmCo hostage in exchange for its signature (particularly when the closing of an acquisition is on the line). Counterparties could extract additional concessions on price or other non-economic terms in exchange for permission. EmCo bears those costs, as well.

Lastly, EmCo must re-engineer its code base to remove the portions infected by or including copyleft code. This once again affects EmCo's costs, as it must re-allocate resources and employees from other projects and determine whether to have its own software engineers develop new code internally or commercially license non-open-source code from a third party.[284] TechCo will also have to re-configure its integration plans.

The costs of fulfilling closing conditions do not end with compliance, however. Notably, EmCo's value (and that of the deal) declines with every additional obligation because closing conditions delay closing. Closing can take weeks or months longer with these additional obligations, particularly because third parties are involved. Once again, based on the time value

---

282. Hamer v. Sidway, 124 N.Y. 538, 544–546 (1891); RESTATEMENT (SECOND) OF CONTRACTS § 71 REQUIREMENT OF EXCHANGE; TYPES OF EXCHANGE (1981).

283. *See* Whitney v. Stearns, 16 Me. 394, 397 (1839) (requiring consideration of at least a "peppercorn" for an enforceable contract).

284. *See, e.g.*, Vizio Holding Corp., Registration Statement (Form S-1), at 55 (Mar. 1, 2021) (hereinafter Vizio S-1) (describing the costs associated with engineering open-source components out of its products).

of money, EmCo (and its investors) lose out every day that payment of the purchase price is delayed because the opportunity to invest that money and generate more income is put on hold.[285] At the same time, the value of the deal decreases for TechCo, which must wait longer to integrate EmCo into its platform, missing out on the gained revenues and efficiencies that motivated the acquisition in the first place during the delay.[286] Moreover, EmCo's cash on hand decreases with every dollar it spends to comply with closing conditions, sticking TechCo with a company that has fewer assets than anticipated.

* * *

Each stage of an M&A transaction and its associated costs are related. Preliminary diligence findings are reflected in the term sheet, which broadly dictates how the deal negotiations will proceed. Issues that are revealed in confirmatory diligence necessitate bargaining costs associated with drafting the reps and the disclosure schedule, as well as any necessary renegotiation of the term sheet.[287] For any significant disclosure that triggers an exclusion from a representation and warranty policy, the parties must engage in a bespoke negotiation over indemnification, which likely results in EmCo having to post a portion of the purchase price as security for the indemnity. When issues can be fixed, both parties expend enforcement costs associated with closing conditions. All these additional costs, however, would be avoided if EmCo had engaged a lawyer to structure its day-to-day deals and create value over the course of its lifecycle such that EmCo can exit efficiently. In the absence of that counsel, EmCo is no longer worth $500 million to TechCo, and while the parties completed the deal, they did so at a much higher cost than necessary. Both parties squandered resources that could have been spent on maximizing their business potential and, in the process, generated less money for reinvestment in the ecosystem.

285. Heyford, *supra* note 271.

286. Matteo Gatti, *Reconsidering the Merger Process: Approval Patterns, Timeline, and Shareholders' Role*, 69 HASTINGS L.J. 835, 882–83 (2018).

287. Manns & Anderson, *supra* note 254, at 1152.

B. *The IPO*[288]

Hundreds of companies pursue IPOs each year to raise capital. IPOs historically occurred at higher valuations than are available through an acquisition, but this is no longer always the case,[289] and in any event, they are more time-intensive (and expensive) than M&A exits.[290] However, an IPO allows a company to maintain its independence, as opposed to sacrificing culture and control through M&A—a critical factor for many startups. There are numerous participants in the IPO process, including lawyers, accountants, and bankers, but the operative documents (including the registration statement) are negotiated predominantly between the issuing company (EmCo) and the lead underwriter (Big Bank), which is responsible for developing the public market for the shares, purchasing the shares, and then selling them.[291]

The IPO process, like M&A, is broken into components that correspond with the three categories of transaction costs, beginning with diligence, then proceeding to the negotiation of the registration statement, and concluding with sign-off from the U.S. Securities & Exchange Commission (SEC),[292] although the parties' motives and the resulting costs differ slightly from the acquisition scenario. For EmCo, if we once again assume that it did not use an attorney, each of these phases will result in unnecessary and avoidable costs arising out of that failure.

---

288. This Part presents a traditional underwritten IPO. Recently, variations on IPO structures have proliferated, including the use of a special purpose acquisition corporation (SPAC). Special Purpose Acquisition Companies, SEC CF Disclosure Guidance: Topic No. 11 (Dec. 22, 2020) https://www.sec.gov/corpfin/disclosure-special-purpose-acquisition-companies. A company going public via a SPAC does so by merging into an (empty) public holding company. In that case, the company will incur many of the costs described in Section III.A regarding acquisitions (such as the requirement to obtain consents from third parties pursuant to change of control provisions).

289. *See* Lemley & McCreary, *supra* note 84, at 35–37 (describing how companies can command higher prices from incumbents looking to acquire competitors than would be available from the public market).

290. Dushnitsky & Sokol, *supra* note 89, at 273–74.

291. Carl W. Schneider et al., *Going Public: Practice, Procedure, and Consequences*, 27 Vill. L. Rev. 1, 8 (1981).

292. Jeremy R. McClane, *The Sum of Its Parts: The Lawyer-Client Relationship in Initial Public Offerings*, 84 Fordham L. Rev. 131, 141–42 (2015).

1. *Due Diligence and Search Costs*

Similar to TechCo, Big Bank first undertakes significant diligence efforts to understand EmCo's business. In an acquisition, diligence is performed to confirm the buyer's initial valuation and expectations of the company.[293] When issues are uncovered, generally either the parties allocate the associated risk contractually or the buyer requires the seller to take actions to remediate the issues in order to close.[294] In contrast, IPO diligence is undertaken to inform the drafting of a registration statement and to create a record to support a due diligence defense for the underwriter in the event of litigation after the IPO.[295] If, following the offering, a shareholder successfully sues EmCo and Big Bank alleging material inaccuracies in (or omissions from) the registration statement, EmCo will be strictly liable, but Big Bank can mount a defense and escape or reduce its liability by establishing that the inaccuracy or omission was not reflected in its diligence.[296]

Big Bank reviews EmCo's intellectual property assignment practices, open-source software usage, and supplier and customer contracts.[297] EmCo's failure to secure written intellectual property assignments is revealed[298] and ear-marked as an issue for disclosure in the registration statement; future stock owners of the company will need to be warned of the chances of a former employee suing EmCo for intellectual property infringement.[299] Similarly, the risks of litigation and having to

---

293. Hwang, *supra* note 219, at 403.

294. *See* Section III.A, *supra*.

295. William K. Sjostrom, Jr., *The Due Diligence Defense Under Section 11 of the Securities Act of 1933*, 44 Brandeis L.J. 549, 554–558, 572 (2006).

296. 15 U.S.C. § 77k(a)–(c) (establishing strict liability for issuers and the due diligence defense for underwriters); *see* Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 697 (S.D.N.Y. 1968) (interpreting Section 11 of the 1933 Securities Act to require an underwriter make a "reasonable attempt to verify" the statements made by the issuer).

297. Sjostrom, *supra* note 295, at 557; McClane, *supra* note 292, at 140.

298. *See* Sjostrom, *supra* note 295, at 557 (listing intellectual property as an area for which the underwriter will engage counsel for diligence).

299. Mobileye Global Inc., Registration Statement (Form S-1), at 38 (Sept. 30, 2020) (hereinafter Mobileye S-1) ("we may fail to enter into the necessary agreements, and even if entered into, these agreements may be breached or may otherwise fail to prevent disclosure, third-party infringement, or misappropriation of our proprietary information, may be limited as to their term, and may not provide an adequate remedy in the event of unauthorized disclosure or use of proprietary information"). Unlike in M&A, insurance is not an option in an IPO to protect Big Bank, or the eventual investing public.

comply with copyleft open-source licenses must be disclosed to the public.[300]

With respect to commercial contracts, Big Bank looks for items that affect EmCo's ability to run the business as envisioned, add customers, and maximize revenues,[301] and is less concerned with provisions for which the issues primarily matter to an acquirer (such as those related to affiliates, changes of control, [302] or overly broad licenses). Big Bank will note, however, terms that limit EmCo's freedom to run its operations in a cost-efficient and flexible manner. EmCo's agreement to use a third-party supplier for a key service on an exclusive basis, for example, puts the company at risk of significant business disruption if that third party's services go down and EmCo cannot secure a suitable replacement in a timely manner.[303] The non-compete and most-favored-nation provisions that EmCo previously agreed to are also flagged for disclosure. The former restricts EmCo's ability to grow its lines of business, and the latter affects EmCo's ability to freely price its products to meet the unique needs of different customers.

Fortunately, unlike an M&A transaction, an IPO is unlikely to die or face significant restructuring because of commercial issues.[304] Banks do, on occasion, decline to proceed with

300. *See, e.g.*, Mobileye S-1, *supra* note 299, at 38; Instructure S-1, *supra* note 169, at 37–38; Vizio S-1, *supra* note 284, at 55; MongoDB, Inc., Registration Statement (Form S-1), at 19–20 (Sept. 21, 2017); Palantir Technologies Inc., Registration Statement (Form S-1), at 52–53 (Aug. 25, 2020) (each including robust disclosures around the issuer's use of open-source software).

301. *See* Schneider et al., *supra* note 291, at 6 (1981) (describing the underwriter's diligence efforts to include an understanding of the issuer's financial health and "growth potential of its business").

302. Change of control provisions are rarely invoked in an IPO because the shares issued in an IPO usually constitute a fraction of the total outstanding stock (i.e., less than 50%), or are issued as a class of stock that has insufficient voting power. *See, e.g.*, Vizio S-1, *supra* note 284, at the Forepart of the Registration Statement and Outside Front Cover Page of Prospectus (describing the issuance of Class A common stock, which has 1/10th the voting rights of Class B common stock).

303. *See, e.g.*, Squarespace, Inc., Registration Statement (Form S-1), at 17 (Apr. 16, 2021) (hereinafter Squarespace S-1) (describing Squarespace's "primary rel[iance] on a single supplier" for a core product functionality).

304. This is in large part because the goal of the IPO process is disclosure, rather than clean-up. Will Kenton, *Securities Act of 1933: Significance and History*, INVESTOPEDIA (Oct. 20, 2020), https://www.investopedia.com/terms/s/securitiesact1933.asp#:~:text=The%20Securities%20Act%20of%201933%20was%20the%20first%20federal%20law,of%20the%20security%20being%20sold.

an IPO, but that is typically because the issuer's revenues and financial health are not ready for the public market; it cannot show verifiable business growth that allows a bank to determine a valuation.[305] WeWork's IPO fell apart in grand fashion because pervasive conflicts of interest among its management had allowed for reckless spending.[306] When the bankers looked under the hood with an eye towards public disclosure, they simply found an utter lack of a meaningful business.[307] That is not the case with EmCo. However, its failure to obtain written intellectual property assignments, non-compliant use of copyleft open-source software, and vertical restraint arrangements all necessitate additional diligence so that Big Bank can understand the associated risks in detail in preparation for drafting the registration statement.

2. *Definitive Documents and Bargaining Costs*

In collaboration, EmCo and Big Bank draft the registration statement, the form that must be filed with, and approved by, the SEC in order for shares to begin trading in the public market.[308] The registration statement (also referred to as "Form S-1" for US-based companies) consists of several sections mandated by law that are meant to inform, in detail, potential purchasers of EmCo's stock about its business, management, capitalization, and governance structure, and any risks associated with any of the foregoing.[309] Those risks are described in a section called "Risk Factors," which is where issues found in diligence are generally reflected.[310]

As noted earlier, Big Bank and EmCo are on the hook for material statements made in (or omissions from) the registration statement, [311] although a due diligence defense is available

---

305. James J. Park, *Investor Protection in an Age of Entrepreneurship*, 12 HARV. BUS. L. REV. 107, 120 (2022).

306. Donald C. Langevoort & Hillary A. Sale, *Corporate Adolescence: Why Did "We" Not Work?*, 99 TEX. L. REV. 1347, 1357 (2021).

307. *Id.* at 1354.

308. Sjostrom, *supra* note 295, at 558. Simultaneously, the parties negotiate an underwriting agreement under which Big Bank agrees to underwrite the offering, subject to EmCo's meeting certain obligations and making reps as to the state of its business and corporate records. *See id.*

309. 17 C.F.R. § 229 (2022).

310. *Id.* at § 229.105 (2022).

311. 15 U.S.C. §§ 77k(b)(3), 77l(b).

to Big Bank if the parties are found liable.[312] In theory, then, the parties need only disclose items of "material" concern. However, the materiality standard is largely disregarded when it comes to drafting the registration statement, as both parties gain an articulable benefit from erring heavily on the side of disclosure to mitigate the chances of litigation and liability.[313] Disclosure, in this context, is viewed as the cheapest insurance the parties can buy.[314] As a result, any marginally significant issue is likely to be included as a risk factor.

Therefore, for each issue arising from Big Bank's commercial diligence findings, the parties expend additional bargaining costs as they settle on the applicable language. They incur costs by reviewing multiple versions of similar risk factors put forth by other companies in their own registration statements to gain an understanding of what has passed SEC muster and avoided litigation in the past. They will then craft language that is tailored to the risk associated with EmCo.[315] The parties must strike an artful balance here: specificity offers the parties a better defense against a lawsuit, but too much nuance hazards creating an overly narrow disclosure.[316]

For example, with respect to the lack of intellectual property assignments, the parties may begin with language acknowledging that the issuer "may fail to enter into the necessary agreements [to secure intellectual property rights]"[317] before settling on a level of detail that reflects EmCo's failure to obtain any of those written assignments. Similarly, EmCo and Big Bank expend resources to review numerous open-source disclosures pertaining to the use of copyleft components before proposing changes unique to EmCo. They will negotiate whether the use of the Affero component must be specifically disclosed as potentially impacting the value of the business

312. 15 U.S.C. § 77k.

313. *See* Schneider et al., *supra* note 291, at 14 (noting the parties' incentives to "make things look "as bleak as possible").

314. *Id.*

315. Jeremy McClane, *Boilerplate and the Impact of Disclosure in Securities Dealmaking*, 72 VAND. L. REV. 191, 200, 217 (2019).

316. *Id.* at 259–60; *see* Jeremy R. McClane, *Regulating Substance Through Form, Lessons from the SEC's Plain English Initiative*, 55 HARV. J. ON LEGIS 265, 272 (2018) (describing "lengthy negotiations over issues such as the specific wording of certain disclosures (whether vague or detailed)").

317. Mobileye S-1, *supra* note 299, at 38.

and EmCo's competitive advantage,[318] as well as any risks associated with an uncertain need to re-engineer the code base, which would require expending additional resources without any guarantee the product will function the same or better afterwards.[319] Instructure Holdings, Inc. did just this with the following statement in its S-1:

> In addition, certain open source licenses, like the GNU Affero General Public License (the "AGPL"), may require us to offer for no cost the components of our software that incorporate the open source software, to make available source code for modifications or derivative works we create based upon incorporating or using the open source software, or to license our modifications or derivative works under the terms of the particular open source license. If we are required, under the terms of an open source license, to release the source code of our proprietary software to the public, our competitors could create similar applications with lower development effort and time, which ultimately could result in a loss of sales for us.[320]

Big Bank also insists that EmCo's exclusivity agreement with a third-party supplier and non-competition and most-favored-nation guarantees to customers be addressed in the risk factors. All indicate that EmCo has limited its growth potential in material ways. It cannot use other (cheaper or better) third parties for key services, expand its product offerings into certain business lines, or price its products with maximum flexibility. Each of these relationships may necessitate their own risk factors so that potential investors can more accurately contextualize the issue and Big Bank can price EmCo's shares properly.[321] For example, financial technology company Affirm, Inc.'s S-1 included a risk factor relating solely to the company's reliance on one third-party partner, Peloton, for a majority of its revenues.[322] Online game developer Snail, Inc. added a significant

318. Instructure S-1, *supra* note 169, at 37.
319. Vizio S-1, *supra* note 284, at 55.
320. Instructure S-1, *supra* note 169, at 37.
321. *See, e.g.*, Squarespace S-1, *supra* note 303, at 17, Snail, Inc., Registration Statement (Form S-1), at 14–15 (Sept. 16, 2022) (hereinafter Snail S-1) (each including a risk factor describing the issuer's agreements with specific, material third parties).
322. Affirm, Inc., Registration Statement (Form S-1), at 26 (Nov. 18, 2020).

disclosure about the risks arising out of its exclusive in-bound license arrangement with SDE, the parent company of video game developer Studio Wildcard.[323]

While the commercial issues at play in an IPO are typically fewer in number than those in an M&A deal, each one still results in additional bargaining expenditures for each party as they negotiate the boundaries and details of each risk factor in the registration statement. Had these issues not been present, there would be no need to address EmCo's past commercial practices and policies with such specificity, and as a corollary, there would be no additional associated costs.

3. *Effectiveness and Enforcement Costs*

Enforcement costs in an IPO transaction arise as the parties seek regulatory approval from the SEC to complete the exit.[324] As with TechCo's sign-off on EmCo's actions vis-à-vis closing conditions in the acquisition, the IPO cannot get over the finish line without the SEC's approval of the registration statement.[325]

EmCo and Big Bank send drafts of the registration statement to the SEC for review throughout the drafting process as they iterate on the document.[326] The SEC returns "comments and requests for clarifications, additions, or alterations to the disclosure, each of which must be addressed" in a subsequent draft.[327] When the SEC no longer has any feedback, it deems the registration statement effective, the parties finalize the share price, and the offering opens to the public.[328]

Each exchange with the SEC generates more costs for EmCo and Big Bank. Both sides must digest and propose a response to the SEC's concerns and negotiate with the other party to agree upon language. The more bespoke risk factors and disclosures presented by EmCo, the more feedback and

323. Snail S-1, *supra* note 321, at 14–15.

324. Some characterize post-IPO shareholder litigation as enforcement. *See, e.g.*, James Bohn & Stephen Choi, *Fraud in the New Issues Market: Empirical Evidence on Securities Class Actions*, 144 U. PA. L. REV. 903 (1996). Shareholder litigation challenging the accuracy of an SEC filing or the completion of a strategic transaction (such as an acquisition) is indeed a risk for a public company. However, any such litigation is beyond the scope of this Article, which focuses on the exit process that culminates with the IPO.

325. Sjostrom, *supra* note 295, at 559.

326. *Id.* at 558.

327. McClane, *supra* note 292, at 141.

328. Sjostrom, *supra* note 295, at 559–60.

questions the SEC is likely to have,[329] reflecting yet more avoidable enforcement costs arising out of EmCo's diligence issues.

* * *

EmCo's day-to-day commercial practices and decisions, in the absence of a lawyer, generate additional transaction costs for both EmCo and Big Bank throughout the IPO process. Additionally, the value of EmCo declines, although by what amount is not known until the last minute, in contrast to its acquisition, where a purchase price reduction is agreed upon partway through the process.

The price of a share of EmCo's stock is finalized the night before the company is listed on the stock exchange.[330] That figure, which is the price that Big Bank pays for the shares before selling them to the public, fluctuates throughout the diligence process, as issues are uncovered, and the registration statement is drafted.[331]

It is a long-held belief that underwriters intentionally seek to underprice IPOs so that, among other reasons, they can buy low and sell high.[332] Any increase in price following Big Bank's purchase of shares is a benefit that inures only to Big Bank as the seller of those shares.[333] In recent years, scholars have confirmed an inverse relationship between risk factor disclosure and share price: As the parties go through the drafting process and disclose more risk, there is a correlative downward adjustment to the proposed share price.[334] As such, increased disclosure not only limits Big Bank's legal exposure,[335] it also maximizes Big Bank's potential profits while lowering EmCo's.[336] The more diligence issues a company presents, the more likely

---

329. *See id.* at 558 (describing the SEC review process as iterative as the parties add disclosures); McClane, *supra* note 292, at 141 (same).

330. Sjostrom, *supra* note 295, at 559.

331. McClane, *supra* note 316, at 298–300. Performance across the public securities market also plays a part in last-minute changes to the price. Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 Va. L. Rev. 549, 617 (1984).

332. Janet Cooper Alexander, *The Lawsuit Avoidance Theory of Why Initial Public Offerings are Underpriced*, 41 UCLA L. Rev. 17, 18 (1993).

333. *See* Fleischer, *supra* note 210, at 1594–95 (noting that Wall Street insiders benefit from underpricing).

334. McClane, *supra* note 292, at 143–44.

335. Alexander, *supra* note 332, at 19.

336. McClane, *supra* note 292, at 169; *see* Joseph K. Leahy, *The Irrepressible Myths of BarChris*, 37 Del. J. Corp. L. 411, 474 (2012) (recognizing that dis-

it discloses more risk, and the greater chance the underwriter insists on a lower share price, ultimately decreasing the value of the issuer,[337] while maximizing the underwriter's potential profits. A company like EmCo that began the process with a target share price of $15–$17 might be forced to accept a price closer to $12 instead, resulting in a lower valuation for the company. Moreover, there are fewer funds available for investment in new research and product development on both sides of the ledger: more costs have been incurred in the IPO process on diligence and disclosure, and fewer proceeds have been raised through the public offering. The VCs are also likely to lose out. In traditional IPOs, large shareholders are customarily restricted from selling shares after an IPO for 90–180 days,[338] during which time the share price is volatile and ultimately more likely to fall than rise.[339]

The IPO was intended to give EmCo a significant infusion of cash to invest in its business without sacrificing control over its operations. While it did just that, both EmCo and Big Bank incurred more transaction costs than necessary and EmCo's valuation slid at the last minute. Had EmCo used an attorney throughout its pre-IPO lifecycle, that attorney would have created value in EmCo by ensuring the IPO proceeds efficiently, preventing these additional costs at little expense, and maintaining the company's worth.

Conclusion

Venture-backed startups drive innovation across industries,[340] but they are not infallible. With tight deadlines,

---

closures ensure investors do not "overpay[] for securities or buy[] worthless ones").

337. Leahy, *supra* note 336, at 474; Anita Indira Anand, *The Efficiency of Direct Public Offerings*, 7 J. Small & Emerging Bus. L. 433, 458 (2003). Underpricing also affects the underwriter's damages exposure. Under the Securities Act, damages may be calculated by subtracting the share price at the time of the lawsuit from the public offering price. 15 U.S.C. § 77k(e).

338. Christine Hurt, *Moral Hazard and the Initial Public Offering*, 26 Cardozo L. Rev. 711, 754 (2005).

339. Panos N. Patatoukas et al., *Valuation Uncertainty and Short-Sales Constraints: Evidence from the IPO Aftermarket* (27th Annual Conference on Fin. Econ. & Acct. Paper, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2789879; *see* Lemley & McCreary, *supra* note 84, at 44–45.

340. *See* Sabrina T. Howell et al., *How Resilient is Venture-Backed Innovation? Evidence from Four Decades of U.S. Patenting* 2–3 (Nat'l Bureau of Econ. Rsch.,

constrained resources, and inexperienced managers, startups are prone to making choices that will jeopardize their prospects for an efficient exit. Technology transactions lawyers step in early in a startup's lifecycle to help make decisions on issues that arise in the ordinary course of business that are consistent with the company's long-term goals of a successful exit. In doing so, those lawyers create value for the parties to exit transactions by optimizing the associated transaction costs and making deals happen that might otherwise not, so resources and funds can be used most efficiently for research, development, and other business improvements. They do more than that, though: they facilitate reinvestment back into the broader technology ecosystem; profitable liquidity events enable VCs to back more enterprises and innovation. More startups succeed because of the funds generated through efficient exits.

Forty years ago, Gilson posited that "if what a business lawyer does has value, a transaction must be worth more, net of legal fees, as a result of the lawyer's participation."[341] Indeed, business lawyers *do* create more valuable transactions, but not just on a one-off basis, as Gilson and others have articulated. Startup lawyers create value intertemporally, engineering the costs of an exit transaction *ex ante* and creating value that accrues not only to their client and its counterparty, but also to the wider market.

Working Paper 27150, 2020) (finding that early-stage VC-backed startups obtain higher quality patents than other enterprises).

341. Gilson, *supra* note 1, at 243.