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Acqui-Hiring

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ACQUI-HIRING

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ABSTRACT

Facebook, Google, and other leading technology companies in Silicon Valley have been buying start-up companies at a brisk pace. In many of these transactions, the buyer has little interest in acquiring the startup's projects or assets. Instead, the buyer's primary motivation is to hire some or all of the startup's software engineers. These so-called "acqui-hires" represent a novel—and increasingly common—tool by which the largest and most successful technology companies in the world satisfy their intense demand for engineering talent.

To date, the acqui-hire has attracted no attention in the academic or professional legal literature. With this Article, we aspire to fill this gap. Drawing on interviews with Silicon Valley entrepreneurs, venture capitalists, buyer representatives, and transactional lawyers, we offer

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the first formal description of the acqui-hire. In so doing, we seek to enrich the understanding of those already acquainted with the acqui-hire while also providing a comprehensive account of this transaction structure to the uninitiated.

We also discuss an existential puzzle: Why do acqui-hires occur? If a large technology company wants to hire a team of software engineers, why does it go to all of the trouble and expense of acquiring the company that currently employs them? Why not simply hire away the individuals that it wants? We argue that the solution to the puzzle lies primarily in the way that social norms and the threat of informal sanctions shape the behavior of members of the Silicon Valley technology community. Although California law generally allows for easy employee mobility, social norms lead many companies to engage in acqui-hires. We buttress this norms-based explanation with insights from prospect theory and tax law to show that the unique structure of acqui-hires reduces their perceived and actual costs, which in turn also promotes these transactions.

We then consider the most significant negotiation issue in acqui-hires: how the buyer's aggregate purchase price will be allocated between the startup's software engineers and its outside investors. Although our interviews suggested that there is currently no established norm for making this allocation, we predict that a money-back-for-the-investors norm will eventually develop to drive allocation determinations. We then propose several contractual innovations that could be designed to try to augment the investors' share of acqui-hiring proceeds.

TABLE OF CONTENTS

> *"[A] lot of the acquisitions that we make at Facebook are, you know, we look at great entrepreneurs out there who are building things. And often, the acquisitions aren't even to really buy their company or what they're doing. It's to get the really talented people who are out there trying to build something cool and say, you know, if you joined Facebook, you could work on this completely different problem. Isn't this a more important problem? And for the people who answer that question yes, they join. And that's how we've had the most success so far."*[1]

INTRODUCTION

Facebook, Google, and other leading technology companies in Silicon Valley have been buying start-up companies at a brisk pace.[2] In many of these transactions, the buyer has little interest in acquiring the startup's projects or assets. Instead, the buyer's primary motivation is to hire some or all of the startup's software engineers. After the transaction, the buyer redeploys the newly hired talent onto

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1. Interview by Charlie Rose with Mark Zuckerberg, Founder, Facebook, and Sheryl Sandberg, COO, Facebook, in Palo Alto, Cal. (Nov. 7, 2011), *available at* http://techcrunch.com/2011/11/07/zuckerberg-talks-to-charlie-rose-about-war-ipos-and-googles-little-version-of-facebook.

2. *See* Google Inc., Annual Report (Form 10-K), at 75–76 (Jan. 29, 2013), *available at* https://investor.google.com/pdf/20121231_google_10K.pdf (noting fifty-three total acquisitions for the fiscal year that ended on December 31, 2012); PRIVCO MEDIA LLC, FACEBOOK, INC. PRIVATE COMPANY FINANCIAL REPORT 37–38 (2012) (noting eleven total acquisitions for the fiscal year that ended on December 31, 2011); *see also* Shayndi Raice, *New Tech Spenders in Feeding Frenzy*, WALL ST. J., May 14, 2012, at B1 (describing accelerating acquisition activity by Silicon Valley buyers in 2012).

its existing projects and jettisons the startup's projects.[3] These acquisitions are known in the tech world as "acqui-hires."[4]

Given the pervasiveness of acqui-hiring and the prominence of the companies that engage in it, it is not surprising that acqui-hiring is frequently discussed on blogs and other websites.[5] Nor is it surprising that it has recently come to the attention of the mainstream media.[6] What is surprising is that, to date, the acqui-hiring phenomenon has attracted no attention in the academic or professional legal literature.[7] This neglect is particularly striking because acqui-hiring represents a novel—and increasingly common—tool by which the most successful technology companies satisfy their intense demand for engineering talent. It is also noteworthy because acqui-hiring raises a host of interesting issues across a wide range of topics that are relevant to lawyers and legal academics, including employment law, corporate law, intellectual property law, tax law, social norms, and behavioral economics.

3. *See* Miguel Helft, *For Buyers of Web Start-Ups, Quest To Corral Young Talent*, N.Y. TIMES, May 18, 2011, at A1 ("Companies like Facebook, Google and Zynga are so hungry for the best talent that they are buying start-ups to get their founders and engineers—and then jettisoning their products.").

4. Some commentators refer to this phenomenon as an "acqhire" or a "talent acquisition." *Id.*

5. *See, e.g.*, Michael Arrington, *Some Investors May Request Protection from Acqui-hires*, UNCRUNCHED (Apr. 24, 2012), http://uncrunched.com/2012/04/24/some-investors-may-request-protection-from-aqui-hires; Nate C. Hindman, *The Top 15 Tech 'Acqui-Hires,'* HUFFPOST TECH (May 7, 2011, 11:29 AM), http://www.huffingtonpost.com/2011/05/29/acqui-hires_n_867865.html #s283726&title=Facebook__Dropio; Patricio Robles, *Is the Acquihire Really a Smart Strategy?*, ECONSULTANCY (Oct. 28, 2011, 3:00 PM), http://econsultancy.com/us/blog/8201-is-the-acquihire-really-a-smart-strategy.

6. *See, e.g.*, Dan Bobkoff, *Employee Shopping: 'Acqui-Hire' Is the New Normal in Silicon Valley*, NPR (Sept. 24, 2012, 3:23 AM), http://www.npr.org/blogs/alltechconsidered/2012/09/25/161573307/employee-shopping-acqui-hire-is-the-new-normal-in-silicon-valley ("Tech companies like Google, Facebook and Zynga are on a shopping spree. They're buying small startups with innovative products and apps. But, many times, the tech giants don't care about what the small companies were producing. They just want the engineers."); Sarah E. Needleman, *Start-Ups Get Snapped up for Their Talent*, WALL ST. J., Sept. 13, 2012, at B6 ("Established technology companies increasingly are buying—and then shutting down—early stage start-ups, mostly to acquire their software-engineering talent. Investors, attorneys and others involved have dubbed these transactions acqui-hires.").

7. A recent search for the term "acqui-hiring" (and several variations in spelling) in law reviews, bar journals, and other legal periodicals on Lexis and Westlaw generated only two hits. One was a reprint of the *New York Times* article cited above, which briefly described the phenomenon. *See supra* note 3. The other was an article coauthored by one of us, *see* Gregg D. Polsky & Brant J. Hellwig, Examining the Tax Advantage of Founders' Stock, 97 IOWA L. REV. 1085 (2012), which briefly and preliminarily addressed the tax implications of acqui-hiring, *see id.* at 1097–99. These tax implications are explored in greater depth in Part III.F.

With this Article, we aspire to fill this gap in the literature. Based on in-depth interviews with individuals who have firsthand knowledge of acqui-hires—including entrepreneurs, venture capitalists, angel investors, buyer representatives, and transactional lawyers—we describe the acqui-hire transaction structure in detail.[8] In so doing, we offer the first formal account of a novel transaction structure that is familiar to a relatively confined group of people in Silicon Valley but largely unknown to everyone else.

We also identify—and seek to solve—a puzzle regarding the acqui-hiring phenomenon. If a large technology company wants to hire a team of software engineers, why go to all of the trouble and expense of acquiring the company that currently employs them? Why not simply hire away the individuals it wants? The latter approach would be less costly because it would not require that any money be paid to the startup's outside investors. The question is all the more perplexing because legal rules do not explain why companies would prefer an acqui-hire over simply hiring the targeted employees. California law generally provides for easy employee mobility; for example, the ability to enforce covenants not to compete is strictly limited.[9] Given the pro-employee-mobility orientation of California law, the litigation risk stemming from poaching employees will often be minimal. The puzzle, therefore, is why a large technology company would engage in an acqui-hire to meet its hiring needs when there

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8. We interviewed seventeen individuals based in Silicon Valley during the spring of 2012. Each interviewee had firsthand knowledge of at least one acqui-hire, and many had been involved in multiple acqui-hires. Six interviews were conducted in person during a research trip to Silicon Valley in May 2012. Nine interviews were conducted over the phone. The remaining two interviews took place over e-mail, as the interviewees responded in writing to written questions and follow-up questions. We arranged the interviews by asking friends and colleagues to make introductions on our behalf. Accordingly, the responses that we received may reflect a bias stemming from this nonrandom sample. The answers that we received were, however, consistent with observations and sentiments voiced by bloggers and message-board commenters at websites that regularly discuss acqui-hiring. After a draft of this Article was posted to the Social Science Research Network in August 2012, it received significant positive attention from Silicon Valley insiders, which suggests that our sample of interviewees was representative. *See, e.g.*, Michael Arrington, *The Lawyers Look at the Aqui-hires*, UNCRUNCHED (Aug. 10, 2012), http://uncrunched.com/2012/08/10/the-lawyers-look-at-the-aqui-hires ("What's most interesting about the paper for me – these guys, outsiders, really get the whole psychology of Silicon Valley and the multi-stage game that's going on."); Dan Primack, *Attack of the Acqui-hires*, CNNMONEY (Aug. 10, 2012, 10:28 AM), http://finance.fortune.cnn.com/2012/08/10/attack-of-the-acqui-hires ("You've almost certainly heard of acqui-hires, and now UNC law professors John Coyle and Gregg Polsky have written what seems to be the first academic paper on the subject.").

9. *See infra* notes 80–81 and accompanying text.

would seem to be a ready alternative that is less expensive and less complicated. Or, more succinctly, why do acqui-hires ever occur?

The solution to this puzzle, we argue, lies primarily in the ability of social norms to influence the behavior of members of the Silicon Valley technology community.[10] Although California law allows for easy employee mobility,[11] our interviews suggest that software engineers will in many cases prefer an acqui-hire over a simple defection because they do not want to risk incurring informal sanctions.[12] In addition, an acqui-hire allows the engineers to claim that their venture resulted in a successful exit, which has significant cultural cachet in Silicon Valley. An acqui-hire may also generate modest reputational benefits for the buyer or its representatives and make it easier for the buyer to differentiate the pay packages of similarly situated engineers. Finally, acqui-hiring is supported by the nonadversarial culture of Silicon Valley and its legal community. We argue, in short, that the explanation for the acqui-hiring phenomenon is based on the unique social structure and community norms of Silicon Valley, resulting in a triumph of social norms over legal rights and duties.

In addition, to fully explain the acqui-hiring phenomenon, we believe it is necessary to supplement this norms-based account with two additional insights. First, we draw upon the behavioral-economic literature to argue that the structure of the acqui-hire reduces the *perceived* cost to the engineers of engaging in an acqui-hire in lieu of simply defecting. In an acqui-hire, a portion of the engineer's compensation is deflected, in effect, to other stakeholders in the startup. Behavioral-economic theory suggests that the perceived cost of this deflection will be less than if the engineer had actually received the compensation and then paid it over to these other stakeholders. Second, we believe that tax considerations often reduce the *actual*

10. In this Article, we use the terms "entrepreneur" or "founder" to refer to those individuals who founded a start-up company. We use the term "engineer" to refer to software engineers or programmers who design and develop computer programs. We use the term "employee" to refer to any individual who works at the startup at the time it is acqui-hired. In many cases, the terms overlap. For example, a founder is also an employee of the startup and is very often also an engineer. In discussing the dynamics of an acqui-hire, we sometimes use the terms "entrepreneur" and "engineer" interchangeably because, first, they often overlap, and, second, even when the terms do not overlap, both groups would generally need to consent to the acqui-hire for the deal to be consummated.

11. *See infra* Part II.A.

12. The arguments and conclusions developed in this Article are restricted to acqui-hires of start-up companies in Silicon Valley by technology companies based in California.

cost of engaging in an acqui-hire by transforming ordinary income into capital gains.

Having solved the puzzle of why acqui-hires occur, we then consider the most significant negotiation issue in acqui-hires: how the buyer's aggregate purchase price will be allocated between the startup's engineers and its outside investors. We predict that a money-back-for-the-investors norm is likely to develop and that this norm will drive allocation determinations in acqui-hire transactions. We then propose and analyze several contractual innovations that could be used to try to augment the investors' shares of acqui-hiring proceeds.

This Article is organized as follows. Part I describes the acqui-hire structure and identifies the puzzle that it presents. Part II considers—and then rejects—the argument that acqui-hiring is driven by a desire on the part of the participants to reduce litigation risk. Part III provides a comprehensive theory of acqui-hiring that emphasizes the impact of social norms on participants' decisionmaking. Part IV takes up the critical issue of how proceeds of acqui-hire transactions are shared between engineers and investors.

I. THE ACQUI-HIRING PHENOMENON

In this Part we describe the acqui-hiring transaction structure that has become commonplace in Silicon Valley in recent years. We first explain the typical investment structure of startups in Silicon Valley and then discuss the challenges that large technology companies currently face in satisfying their intense demand for engineering talent. In response to these challenges, technology companies have turned to acqui-hires, the mechanics of which are described in detail. We conclude this Part by identifying the existential puzzle presented by the acqui-hiring phenomenon.

A. Investment Structure in Silicon Valley Startups

To finance a start-up company, entrepreneurs typically sell equity in the company to outside investors. Most investment capital provided to new ventures comes from one of two sources: (1) venture-capital funds (VCs), which raise and pool money from investors to invest in early-stage companies;[13] and (2) wealthy individuals known as angel investors, who invest directly in early-stage companies.[14] In addition, business incubators sometimes provide wide-ranging advice and support to early-stage companies in exchange for a small equity stake.[15]

Investment in startups is typically made in a series of rounds. At the very early stages of a company's development, there will be a seed round in which the company raises capital to launch the enterprise. The amount of cash raised in a seed round involving a technology company can vary, though a typical seed round involving professional investors will raise in the vicinity of $1 million.[16] If the company shows promise, then it may raise additional funds from investors in subsequent rounds of financing. These subsequent rounds are known as Series A rounds, Series B rounds, Series C rounds, and so on.[17]

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13. *See generally* Manuel A. Utset, *Reciprocal Fairness, Strategic Behavior & Venture Survival: A Theory of Venture Capital-Financed Firms*, 2002 WIS. L. REV. 45, 48–54 (discussing venture-capital firms).

14. *See generally* Andrew Wong, *Angel Finance: The Other Venture Capital*, *in* VENTURE CAPITAL: INVESTMENT STRATEGIES, STRUCTURES, AND POLICIES 71 (Douglas J. Cumming ed., 2010) (discussing angel investors).

15. *See* Darek Klonowski, *Business Incubation and Its Connection to Venture Capital*, *in* VENTURE CAPITAL, *supra* note 14, at 111, 113 ("Business incubators are places where low-cost, real estate-based facilities are provided to nurture the development of new firms."). The best-known business incubator in Silicon Valley is Y Combinator, which began operations in 2005 and currently provides seed funding (in cash and services) to eighty-two startups each year in exchange for small stakes in the companies. Parmy Olson, *Who Needs Silicon Valley?*, FORBES, Aug. 22, 2011, at 64, 65. Although Y Combinator itself invests only a relatively small amount in each startup—the average is $18,000, *see* Austin Carr, *Paul Graham: Why Y Combinator Replaces the Traditional Corporation*, FAST CO. (Feb. 22, 2012, 12:25 AM), http://www.fastcompany.com/1818523/paul-graham-why-y-combinator-replaces-traditional-corporation—certain angel investors have pledged to invest $150,000 in any company that Y Combinator accepts into its program. *Id.* When companies funded by Y Combinator are sold, a significant number of these sales take the form of acqui-hires. *See* Miguel Helft, *Are Talent Acquisitions a Sign of a New Bubble?*, N.Y. TIMES BITS BLOG (May 18, 2011, 2:46 PM), bits.blogs.nytimes.com/2011/05/18/are-talent-acquisitions-a-sign-of-a-new-bubble ("Of the more than 310 start-ups that have passed through [Y Combinator], a mere 25 have been sold and about 18 of those were talent acquisitions.").

16. *See* Barry J. Kramer & Steven S. Levin, *2012 Seed Financing Survey: Internet/Digital Media and Software Industries*, FENWICK & WEST LLP 2, 7 (Mar. 25, 2013), http://www.fenwick.com/FenwickDocuments/2012_Seed_Survey_Report.pdf (finding median amounts raised in its sample of Internet or digital media and software companies to be $1.36 million for preferred-stock investments and $918,000 for convertible-note investments in 2012, with similar medians for 2010 and 2011).

17. *See* Joseph Bankman, *The Structure of Silicon Valley Start-Ups*, 41 UCLA L. REV. 1737, 1739–40 (1994) (discussing rounds of financing).

Founders and employees of a startup generally receive common stock (or options to purchase common stock) in the company in exchange for their contribution of services to the organization.[18] VC investors in a startup will, by contrast, typically receive convertible preferred stock in exchange for their cash investments.[19] This preferred stock gives the holder certain management and blocking rights, as well as the ability to convert the instrument into a specified number of common shares.[20] The preferred stock is also commonly granted a liquidation preference, so that, if the company is liquidated or sold prior to the preferred stock's conversion into common shares, the holder will receive the stated liquidation-preference amount before the common stockholders divide up any remaining funds.[21] The liquidation preference may equal the amount invested or, alternatively, a multiple of the amount invested; convertible preferred stock purchased for $1 million, for example, could have a liquidation preference of $1, $2, or $3 million.[22]

Angel investors, by comparison, often structure their seed investments in the form of convertible promissory notes.[23] Although

18. These shares or options typically vest over a specified period of time. Any unvested shares or options are forfeited if the founder or employee ceases to be employed by the company before they became fully vested. *See* Ryan J. Foreman, Comment, *Employee Stock Options in Personal Bankruptcy: Assets or Earnings?*, 72 U. CHI. L. REV. 1367, 1371 (2005) ("[T]he employee's right to a block of options is contingent upon her continued employment until the vesting date. If she leaves her job (or is fired), she forfeits all rights to unvested options.").

19. *See* William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891, 892 (2002) (observing that "[c]onvertible preferred stock is the dominant financial contract in the venture capital market"); *see also* Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874, 902–04 (2003) (explaining tax advantages of convertible preferred stock).

20. *See* Gilson & Schizer, *supra* note 19, at 885; Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 VAND. L. REV. 1405, 1413–15 (2008).

21. *See* D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 347–48 (2005) (discussing liquidation preferences in VC investment agreements).

22. *See* Barry J. Kramer & Michael J. Patrick, *Explanation of Certain Terms Used in Venture Financing Terms Survey*, FENWICK & WEST LLP (Jan. 1, 2010), http://www.fenwick.com/publications/pages/explanation-of-certain-terms-used-in-venture-financing-terms-survey.aspx (explaining that preferred-stock venture-capital investments may, but do not always, have a "multiple liquidation preference," typically 1.5 to 3 times the amount of the investment).

23. *See* Ibrahim, *supra* note 20, at 1430 n.119 (arguing that angels use convertible debt to avoid having to price their investments); Monica Mehta, *Raising Capital with Convertible Notes*, BLOOMBERG BUSINESSWEEK (Jan. 25, 2011), http://www.businessweek.com/smallbiz/content/jan2011/sb20110125_145583.htm ("Over the past few years [convertible promissory notes] have gained in popularity."). Irrespective of whether an investor acquires a convertible note or

these notes, as the name suggests, are convertible into common stock, they typically offer fewer protections to investors than convertible preferred stock.[24] The notes rarely provide for seats on the company's board, for example.[25] In the event the startup is liquidated before a note is converted, the noteholder traditionally was entitled to a return of his investment plus accrued interest. It is, however, becoming increasingly common for the noteholder to be entitled to an acquisition premium, which entitles the holder to a multiple of his investment (for example, double the amount of the initial investment) upon an acquisition of the company before a subsequent equity financing.[26] This liquidation premium received by angel investors is analogous to the liquidation preference afforded the convertible preferred stock received by VCs.

B. *The Insatiable Demand for Engineering Talent in Silicon Valley*

The history of Silicon Valley is a story of intense competition for engineering talent. In her classic historical account of the region, Professor AnnaLee Saxenian explained how companies began vigorously competing for such talent as early as the 1970s, when "firms began to offer incentives such as generous signing bonuses, stock options, high salaries, and interesting projects to attract top people."[27] These aggressive recruiting practices continued, more or less unabated, through the 1980s and into the 1990s.[28] Although the

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convertible preferred stock, founders and employees will typically own all of the outstanding common stock prior to conversion, although occasionally a business incubator or an early investor might also own a small percentage of the outstanding common stock. *See* Olson, *supra* note 15, at 64–65.

24. Upon conversion of the note or preferred stock, the holders will receive a specified amount of common stock, and their percentage equity interest (calculated on a postconversion basis) will be protected (before and after conversion) through antidilution and similar contractual protections. Smith, *supra* note 21, at 354.

25. For example, a 2011 study on seed financing by the law firm Fenwick & West LLP found that whereas preferred stockholders were granted board seats in 70 percent of financings, convertible noteholders were granted board seats in only 4 percent of financings. Kramer & Levin, *supra* note 16, at 6–7.

26. The Fenwick & West LLP study also found that 61 percent of convertible notes included an acquisition premium, up from 50 percent in 2010, and that the median premium in 2011 was equal to the original principal amount. *Id.* at 7. In acquisitions in which the convertible notes convert to common stock subject to a valuation cap, the return to the investors may be less than the acquisition premium.

27. ANNALEE SAXENIAN, REGIONAL ADVANTAGE: CULTURE AND COMPETITION IN SILICON VALLEY AND ROUTE 128, at 35 (9th prtg. 2000).

28. Robert A. Mamis, *Golden Handcuffs*, INC., Aug. 1983, at 59, 60 ("[T]he battleground is so keen for talent that [it] can make a company—or break it by its absence . . . ."); Miriam

demand for engineers waned in the years following the burst of the dot-com bubble, it picked up steam again less than a decade later. In 2011, a seasoned observer described the market for engineering talent in Silicon Valley as the most intensely competitive that he had ever seen.[29]

Large technology companies today are willing to offer extraordinary inducements to hire and retain good engineers.[30] These inducements include generous salaries, signing bonuses, restricted stock, stock options, game rooms, iPads, limo service, tickets to sporting events, and a host of other perks.[31] These inducements notwithstanding, there still are many engineers in Silicon Valley who would prefer to launch, or to participate in, a start-up venture rather than to work for a large technology company.[32] These individuals are willing to accept lower salaries and fewer perks in exchange for more control over the company's future, the possibility of an incredible fortune if the startup is successful, and the intangible benefits of participating in a startup in Silicon Valley, where entrepreneurship is cherished.[33]

Rozen, *Wanted: High-Tech Engineers*, DUN'S BUS. MONTH, Mar. 1, 1985, at 35, 36 (noting that Microsoft chose to locate in Washington rather than Silicon Valley in part "because employees wouldn't be as tempted by other companies' offers"); Kathy Rebello, *Wanted: Experienced Computer Programmers*, USA TODAY, July 19, 1989, at 7B ("Experienced computer programmers are in hot demand and short supply. And companies will do almost anything to get their hands on them."); Julie Schmit, *High-Tech Firms Roll out Red Carpet for Top Talent*, USA TODAY, Nov. 27, 1995, at 1B (listing benefits offered to attract engineers).

29. Jessica Guynn, *Boom Is Back in Silicon Valley*, L.A. TIMES, July 17, 2011, at A1.

30. In 2000, the CEO of Cisco famously expressed the view that "a world-class engineer with five peers can out-produce 200 regular engineers." John A. Byrne, *Visionary vs. Visionary*, BUS. WK., Aug. 28, 2000, at 210.

31. *See* Jon Swartz, *Tech Firms Go on a Hiring Binge Again*, USA TODAY, Apr. 21, 2011, at 1B ("Tech workers . . . are coveted commodities as the high-tech industry undergoes its biggest hiring binge in more than a decade. Not since the dot-com bubble of the early 2000s has competition been so fierce."); *infra* note 59 and accompanying text.

32. *See* Joseph Bankman & Ronald J. Gilson, *Why Start-Ups?*, 51 STAN. L. REV. 289, 305–07 (1999) (discussing reasons why employees leave employers to form startups despite the significant tax, informational, and scope advantages of an employer over a venture-capital-backed startup); Robles, *supra* note 5 ("For companies, it's worth considering that many entrepreneurs aren't going to be happy as 'employees[.'] It's simply not in their DNA, as they value the creative control and ownership that comes with entrepreneurship above just about everything else.").

33. Homa Bahrami & Stuart Evans, *Flexible Recycling and High-Technology Entrepreneurship*, *in* UNDERSTANDING SILICON VALLEY: THE ANATOMY OF AN ENTREPRENEURIAL REGION 180–81 (Martin Kenney ed., 2000) ("Motivated by the opportunities for personal growth, and the potential for significant financial gain . . . many technical professionals forego the relative security of a large entity for the turmoil and sense of adventure associated with a start-up."); *id.* at 181 ("Maturing firms may have difficulty matching

In recent years, this preference for participating in a technology startup over employment at a large technology company has been bolstered by three interrelated developments. First, the cost of launching a startup has fallen precipitously, as the rise of cloud computing has brought about a dramatic reduction in the cost of information technology infrastructure.[34] Second, new sources of seed funding from business incubators, angel investors, and angel "arms" of venture-capital firms have become available to startups in Silicon Valley.[35] Third, in part because of the cost savings of cloud computing and the abundance of seed funding, startups are now able to offer salaries and bonuses that are more competitive with those offered by

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the cultural intensity of a start-up, which is critical for building a team spirit and focusing emotional and creative energy on achieving the desired goal."); *see also* Interview by Jessica Livingston with James Hong, Cofounder, HOT or NOT, *in* JESSICA LIVINGSTON, FOUNDERS AT WORK: STORIES OF STARTUPS' EARLY DAYS 377, 384 (2008) ("If you're not in school and you're not an entrepreneur, you're not working on new ideas. You are just a cog in someone else's wheel, and you'll never make anything new.").

34. Joe McKendrick, *How Cloud Computing Is Fueling the Next Startup Boom*, FORBES (Nov. 11, 2011, 6:00 AM), http://www.forbes.com/sites/joemckendrick/2011/11/01/cloud-computing-is-fuel-for-the-next-entrepreneurial-boom ("Thanks to cloud computing . . . it now costs virtually pennies to secure and get the infrastructure needed up and running to get a new venture off the ground."). One study found that on-premises software and servers in a new business cost upwards of $40,000; the costs of a small server operation operating in the cloud, by contrast, were virtually zero. *Id.*

35. *See* Pui-Wing Tam & Spencer E. Ante, *'Super Angels' Fly in To Aid Start-Ups*, WALL ST. J., Aug. 16, 2010, at C1 ("As many conventional venture capitalists retreated after the technology bust last decade, super angels filled the gap, investing amounts from $25,000 to $1 million in dozens of start-up companies . . . . As these microcap venture capitalists now raise their own funds—giving them more ammunition to participate in later financing rounds of a start-up company—they are siphoning off more investment deals and fund-raising dollars from larger venture firms."). The funding for startups has also increased. *See* Peter Delevett, *Is Silicon Valley in Another Tech-Stock Bubble?*, SAN JOSE MERCURY NEWS (Aug. 12, 2011, 4:31 PM), http://www.mercurynews.com/business/ci_18671416 ("[The National Venture Capital Association's] latest MoneyTree report found that $2.3 billion spread among 275 Internet deals during the latest quarter marked a high last seen in 2001. The trend held true in Silicon Valley, where $1.51 billion went into online startups, a decade-long high."). Many of the new angels were early employees of hugely successful technology companies, like PayPal. Ari Levy, *'PayPal Mafia' Gets Richer*, BLOOMBERG BUSINESSWEEK (Feb. 21, 2012), http://www.businessweek.com/technology/paypal-mafia-gets-richer-02212012.html; *see The New Tech Bubble*, ECONOMIST, May 12, 2011, at 13, 13 ("The bubble is being pumped partly by wealthy 'angel' investors, some of whom made their fortunes in the late-1990s IPO boom. Their financial firepower has increased and they are battling one another for stakes in web start-ups. In some cases angels are skimping on due diligence to win deals."). In the wake of these developments, a number of VCs have established angel investment "arms" to remain active in seed-round financing. *See* Chris Dixon, *Revisited: Big VCs Investing in Seed Rounds*, CHRIS DIXON (Apr. 2, 2012), http://cdixon.org/2012/04/02/revisited-big-vcs-investing-in-seed-rounds ("A few years ago, the trend of companies raising smaller seed rounds combined with the emergence of new seed funds caused many big VCs to create seed investment programs.").

larger technology companies.[36] This reduction in pay differential means that the day-to-day standard of living enjoyed by start-up employees compares more favorably to the standard of living enjoyed by employees of large technology companies.

The cumulative effect of these developments is that it is easier than ever before to finance, launch, and staff a tech startup in Silicon Valley. These developments have led some engineers, who might otherwise have joined a large technology company, to launch or join a startup. In light of these circumstances, the problem faced by large technology companies in dire need of engineering talent is how to extricate these individuals from the startups that currently employ them.[37] Many companies have turned to acqui-hiring as a solution.

C. *The Acqui-hire*

In a typical acquisition, the principal purpose of the acquisition is to obtain ownership of the company's assets, whether tangible (e.g., property, plant, and equipment) or intangible (e.g., intellectual property, customer lists, and goodwill). In an acqui-hire transaction, by contrast, the acquiring company places little or no value on the assets owned by the target company.[38] Instead, the transaction occurs

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36. Pui-Wing Tam, *Start-Up Staff Getting More Cash*, WALL ST. J. (May 9, 2012, 5:50 PM), http://online.wsj.com/article/SB10001424052702304451104577390133148700046.html ("According to a new study . . . the salaries and cash bonuses that closely held Silicon Valley start-ups are offering their workers are now on par with what publicly traded tech companies are paying.").

37. These companies were, significantly, able to finance these acquisitions given the prevailing market conditions in Silicon Valley in 2011. *See* Brad Stone, *It's Always Sunny in Silicon Valley*, BLOOMBERG BUSINESSWEEK (Dec. 22, 2011), http://www.businessweek.com/magazine/its-always-sunny-in-silicon-valley-12222011.html ("It was never clearer than in 2011 that Silicon Valley exists in an alternate reality—a bubble of prosperity. Restaurants are booked, freeways are packed, and companies are flush with cash. The prosperity bubble isn't just a state of mind: Times are as good as they've been in recent memory.").

38. It is not always easy to distinguish an acquisition from an acqui-hire. *See* Interview with Attorney, AmLaw 100 Law Firm I, in Cal. (May 2012) ("It's a blurry line between the acquisition and the acqui-hire."). When the startup has some semivaluable intellectual property (IP), we were told that more and more buyers are taking it and then granting back to the startup a nonexclusive, perpetual royalty-free license to use it. Interview with Attorneys, Silicon Valley Law Firm I, in Cal. (May 2012). Another interviewee, however, suggested that many buyers do not really want the IP and are happy to let it revert to the investors. Interview with Acqui-hired Emp., NASDAQ 100 Co. I, in Cal. (May 2012). Still another interviewee noted that even when the buyer does not want the IP, per se, it does not want to leave that asset out there for someone else to use. Interview with Attorney, Silicon Valley Law Firm II, in Cal. (May 2012).

primarily because the acquirer wishes to hire some or all of the target company's at-will employees.[39]

One frequently cited rationale for acqui-hiring is that it allows a large technology company to obtain the services of several talented engineers and entrepreneurs in one fell swoop.[40] It also allows the buyer to hire an existing, well-functioning team of individuals who will often continue to work as a team with expertise in a certain field, as opposed to trying to assemble such a team from scratch.[41] When Apple was developing its cloud-based music service, for example, it acqui-hired a team of engineers from Lala that had extensive experience in streaming music online. That team stayed together at Apple to work on the cloud-based music service even after Apple terminated the Lala service six months after the acquisition.[42] An acqui-hire also enables the buyer to utilize the talents of its new, experienced employee team to enter into a new space quickly despite

39. In Silicon Valley, employment at startups is typically not governed by a fixed-term employment agreement; rather, employees are typically hired on an at-will basis. Interview with Attorneys, Silicon Valley Law Firm I, *supra* note 38. Accordingly, an acquisition of a startup does not, standing alone, give the acquirer any contractual right to employ any of the startup's employees. *See* Deborah A. Ballam, *Employment-at-Will: The Impending Death of a Doctrine*, 37 AM. BUS. L.J. 653, 653 (2000) (defining at-will employment as a relationship wherein the employer or employee may terminate the relationship without consequences of legal liability). If a fixed-term employment agreement did exist, and if it did not terminate on a change of control (or if it were assignable by the employer in the event of a sale of its assets), then an acquisition of the employer or its assets would give rise to a contractual right of the acquirer to employ the employees; in that case, the acquirer could be viewed as acquiring an asset—namely, the favorable employment contract.

40. *See* Interview with Attorney, Silicon Valley Law Firm III, in N.Y. (Apr. 2012) (observing that one benefit of an acqui-hire is that "you get a cohesive team rather than one to two individuals"); Interview with Partner, Venture Capital Fund, in Cal. (Apr. 2012) ("[A]gainst the backdrop of the most difficult hiring environment for strong engineers and product people, [acqui-hiring] can often be the only way to ensure continued top talent—especially among the risk-taking type."); Interview with Recruiter, NASDAQ 100 Co., in Cal. (Apr. 2012) ("The primary virtue of the acqui-hire is that it allows you to get group talent.").

41. Interview with Attorney, AmLaw 100 Law Firm I, *supra* note 38 ("[O]ne virtue of the acqui-hire is that it builds on a sense of purpose among the engineers."); Interview with Engineer, NASDAQ 100 Co., in Cal. (Apr. 2012) (noting that an acqui-hire "[a]llows you to get a complete team . . . that already know each other rather than assemble a team yourself").

42. *See* Bobbie Johnson, *Just How Much Did Apple Pay To Buy Lala.com – and Why?*, GUARDIAN, Dec. 10, 2009, at 2 (suggesting that Apple's acquisition of Lala was "a talent acquisition, in which Apple decided it wanted to hire a group of clever, seasoned and well respected engineers"); Brad Stone, *Apple Strikes Deal To Buy the Music Start-Up Lala*, N.Y. TIMES, Dec. 5, 2009, at B2 ("One person with knowledge of the deal . . . said Apple would primarily be buying Lala's engineers, including its energetic co-founder Bill Nguyen, and their experience with cloud-based music services.").

the buyer's inexperience in that space.[43] This is especially useful in Silicon Valley, where the pace of technological innovations creates a frenetic environment in which time is frequently of the essence and business plans rapidly shift and pivot.

Although an acqui-hire transaction can occur at any stage of a new venture's lifecycle, it is most common after a seed round and before a Series A round of financing, or between Series A and Series B rounds of financing.[44] In many cases, the transaction occurs because the startup was unable to develop a product and successfully bring it to market before it ran out of money.[45] This type of acqui-hire will occur after it becomes clear that another round of financing will not be forthcoming.[46] In these situations, the acqui-hire is the only alternative to simply liquidating the company. Our interviews suggested that this type of acqui-hire—as an alternative to a liquidation—was the most common and, accordingly, we treat this scenario as the prototypical acqui-hire in this Article. In a minority of acqui-hires, the transaction occurs in lieu of the next round of financing.[47] In these cases, the founders decide that an exit through an acqui-hire transaction is more attractive than continuing the startup under the terms of the next round of financing.[48]

43. Interview with Engineer, NASDAQ 100 Co., *supra* note 41.

44. Interview with Acqui-hired Emp., NASDAQ 100 Co., *supra* note 38; Interview with Attorney, AmLaw 100 Law Firm II, in Cal. (May 2012); Interview with Attorney, Silicon Valley Law Firm III, *supra* note 40; Interview with Former Corp. Dev. Officer, NASDAQ 100 Co., in Cal. (Aug. 2012). One interviewee offered the following explanation for why companies were more likely to be acqui-hired after a seed round than at any other time:

> A company that has raised a seed round but not a full Series A or later will (1) have less liquidation preference to worry about . . . and (2) have few enough employees that it might make sense to hire the whole team. Investors will be more likely to approve the deal if they can get more of their liquidation preference back, and companies are more likely to sign up a whole team if it's not huge and of consistently high quality.

Interview with Attorney, Silicon Valley Law Firm III, *supra* note 40.

45. Interview with Acqui-hired Emp., NASDAQ 100 Co. I, *supra* note 38; Interview with Founder, Start-Up Co., in Cal. (Apr. 2012); *see* Interview with Attorney, AmLaw 100 Law Firm I, *supra* note 38 ("Another upshot of the vast amounts of money sloshing around is that firms can survive long enough for a soft landing via an acqui-hire. In the old days, the startup would run out of money and go out of business. Everyone would send out résumés and that would be that.").

46. *See supra* note 45.

47. Interview with Attorney, Silicon Valley Law Firm II, *supra* note 38.

48. *Id.* For example, the next round's valuation of the company might be perceived to unduly dilute the interests of the founders, or the liquidation preference investors require might be perceived as too high. In either case, the precise terms of the next round of financing might

The terms and structure of an acqui-hire deal are highly variable.[49] In its most rudimentary form, a buyer may acqui-hire a two-person company for as little as a few hundred thousand dollars in cash.[50] In these cases, the transaction is typically structured as a simple cash payment in consideration for the startup's covenant not to sue the buyer for hiring its employees; the startup thereafter liquidates and distributes the cash and any other assets to its shareholders.[51] In larger deals, the acqui-hire is commonly structured as an asset sale.[52] Often, the only assets acquired by the purchaser are whatever intellectual property rights that the startup owns; other assets—such as property, plant, and equipment—are left behind.[53] The consideration paid by the buyer and any residual assets are then distributed to shareholders in the liquidation of the startup. In still larger deals, acqui-hires may be structured as stock purchases or as mergers.[54] In such a case, stock of the buyer may be included as part of the consideration, and the transaction sometimes will be structured as a tax-free reorganization.[55] Notwithstanding these generalizations, acqui-hiring transactions run the gamut, with transaction structures and deal terms varying to take account of the specific circumstances surrounding the given transaction. Key facts include the number of employees that the buyer wishes to hire, the value of those employees to the buyer, the value (if any) of the startup's intellectual property

reduce the founders' interests in the company to the point that the acqui-hire bird in the hand is more attractive than the possibility of the future two in the bush.

49. The factors affecting an acqui-hire's terms and structure include, but are not limited to, the following: (1) identity of the founders, (2) technology, (3) product, (4) channels, (5) relationships, (6) identity of the investors, and (7) terms of the initial investment. Attorney, Silicon Valley Law Firm II, *supra* note 38.

50. Interview with Acqui-hired Emp., NASDAQ 100 Co., *supra* note 38; Interview with Attorney, AmLaw 100 Law Firm II, *supra* note 44.

51. *See* Interview with Attorney, AmLaw 100 Law Firm II, *supra* note 44. This promise not to sue is known as a waiver and release or, alternatively, as a covenant not to sue. *Id.* In these deals, no assets are acquired and virtually no diligence is performed by the buyer. Interview with Attorney, Silicon Valley Law Firm II, *supra* note 38. Nevertheless, lawyers in Silicon Valley tend to view these deals as a form of acqui-hire because consideration flows to the company and the company thereafter liquidates. Interview with Attorney, AmLaw 100 Law Firm II, *supra* note 44.

52. Interview with Attorney, AmLaw 100 Law Firm I, *supra* note 38.

53. Interview with Acqui-hired Emp., NASDAQ 100 Co., *supra* note 38 ("[Non-IP] assets of the company revert to the investors. The buyer doesn't want them.").

54. Interview with Attorney, AmLaw 100 Law Firm II, *supra* note 44; Interview with Attorney, Silicon Valley Law Firm II, *supra* note 38.

55. *See* Interview with Attorney, AmLaw 100 Law Firm II, *supra* note 44. It is also possible for asset deals to be structured as tax-free reorganizations. *See* I.R.C. § 368(a)(1)(C) (2006).

and other assets to the buyer, and the customary practices of the corporate development team that initiates these deals on behalf of the buyer.

Despite this variability, there is one critical feature that is common to every acqui-hire transaction: existence of two distinct pools of consideration paid by the buyer.[56] The first pool of consideration—which we call the "deal consideration"—is used to acquire the startup. The deal consideration usually consists of cash or buyer stock and is used, depending on the specific deal structure, to pay for the covenant not to sue, to buy all or some of the startup's assets, to acquire the start-up company's stock, or to serve as the merger consideration.[57] When the transaction closes, the cash and stock that constitute the deal consideration will eventually end up in the hands of the startup's outside investors and its employee shareholders.[58]

The second pool of consideration—which we call the "compensation pool"—is used to compensate the startup's founders and employees for their future services in favor of the buyer. Most of the compensation pool consists of options, restricted stock, or restricted-stock units in the buyer that vest over specified periods of employment.[59] Occasionally the consideration may be performance vested, meaning that it vests upon the attainment of identified benchmarks.[60] Most commonly, the consideration in the compensation pool is simply time vested and will completely vest after three or four years of employment.[61] Significantly, neither

56. Interview with Attorney, AmLaw 100 Law Firm II, *supra* note 44; Interview with Attorneys, Silicon Valley Law Firm I, *supra* note 38.

57. Interview with Attorney, AmLaw 100 Law Firm II, *supra* note 44.

58. In practice, this means that the distribution is likely to occur in accordance with the company's liquidating distribution waterfall. *Cf.* Heather M. Field, *Experiential Learning in a Lecture Class: Exposing Students to the Skill of Giving Useful Tax Advice*, 9 PITTSBURGH TAX REV. 43, 78 n.123 (2012) (describing the operation of such a waterfall). In cases in which the investment was made in the form of a convertible note, these notes will sometimes be paid a predetermined multiple of their face value. In other cases, the holder of the note will convert it to common stock and be paid as a common stockholder.

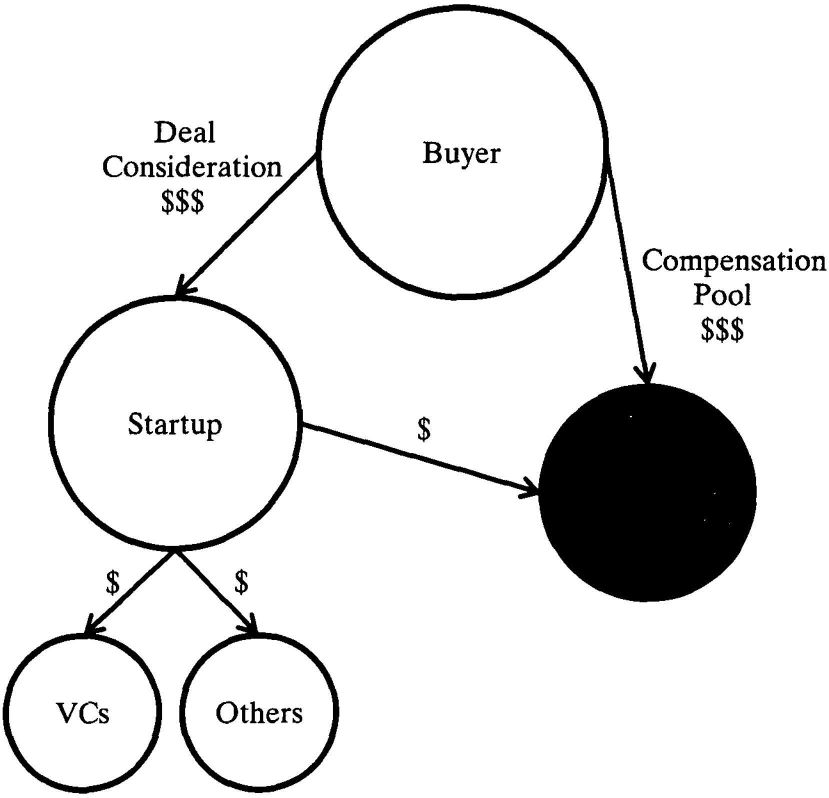
59. Interview with Attorney, AmLaw 100 Law Firm I, *supra* note 38.

60. *Id.*

61. *See* Interview with Former Corp. Dev. Officer, NASDAQ 100 Co., *supra* note 44 ("[A]lmost all companies have moved away from product based milestone payments to calendar based milestones (tenure) . . . ."); Interview with Founder, Start-Up Co., *supra* note 45 (three years of employment); Interview with Attorney, AmLaw 100 Law Firm II, *supra* note 44 (four years of employment). One interviewee reported that the buyer will enter into offer letters and compensation deals with the engineers and that they will be offered equity in the buyer, ranging

outside investors nor employee shareholders who are not hired by the acquirer will receive anything from the compensation pool; the compensation pool goes only to those employees hired by the buyer. In practice, this means that the cash and restricted stock in the compensation pool will wind up in the hands of the startup's software engineers, as the buyer in an acqui-hire transaction is rarely interested in hiring the other employees. The diagram below illustrates the two distinct pools of consideration paid in an acqui-hire:

Figure 1. Two Distinct Pools of Consideration Paid by the Buyer in an Acqui-hire Transaction



from slightly better than market to much better than market. Interview with Attorney, AmLaw 100 Law Firm II, *supra* note 44. The equity will usually vest ratably on a monthly basis over three or four years, but often with a one-year cliff—meaning that the first year's shares will not vest at all until one full year has passed. Interview with Acqui-hired Emp., NASDAQ 100 Co. II, in Cal. (May 2012); Interview with Attorneys, Silicon Valley Law Firm I, *supra* note 38.

Because of these two separate pools, a key economic issue is how the aggregate consideration paid by the buyer will be allocated between the two pools.[62] Outside investors in the startup, as well as employee shareholders who are not hired by the buyer, would prefer to allocate more to the deal consideration, so as to maximize their share of the proceeds. On the other hand, engineers who are to be hired by the buyer would prefer to allocate more to the compensation pool, because they do not have to share that pool with investors or other employees.[63] The buyer likewise would generally prefer to allocate more to the compensation pool.[64] In an acqui-hire, the buyer is mostly, if not exclusively, interested in hiring and retaining the engineers. Whereas the entirety of the compensation pool will go to these desired employees, a substantial portion of the deal consideration will end up going to other parties. Paying deal consideration therefore is a wasteful transaction cost from the buyer's perspective. Furthermore, only the compensation pool will provide beneficial incentives to its employees, which means that the buyer, all else being equal, would prefer to fund that pool over the deal-consideration pool.[65]

In allocating the buyer's aggregate purchase price between the two pools, the interests of the buyer and the engineers are thus aligned against the interests of the investors and other shareholders of the startup. In fact, a number of our interviewees claimed that there often was some degree of collusion between the buyer and the engineers to structure the terms of the transaction to maximize the compensation pool at the expense of the deal-consideration pool.[66] Lawyers representing investors, in particular, felt that acqui-hiring

62. Interview with Attorney, AmLaw 100 Law Firm I, *supra* note 38; Interview with Attorney, AmLaw 100 Law Firm III, in Cal. (May 2012); Interview with Attorneys, Silicon Valley Law Firm I, *supra* note 38.

63. Interview with Acqui-hired Emp., NASDAQ 100 Co. II, *supra* note 61.

64. Interview with Attorneys, Silicon Valley Law Firm I, *supra* note 38.

65. Interview with Attorney, AmLaw 100 Law Firm III, *supra* note 62; Interview with Attorneys, Silicon Valley Law Firm I, *supra* note 38. The compensation pool is composed largely of restricted stock and other time- or performance-vested consideration, which encourages the engineers to remain employed by the buyer or to achieve certain performance benchmarks. Interview with Attorneys, Silicon Valley Law Firm I, *supra* note 38. The deal consideration, which consists usually of cash or unrestricted stock, typically provides no such incentive effect. *Id.* Furthermore, portions of the deal consideration end up in the hands of people who will not work for the buyer; therefore, there will be no incentive benefits resulting from that consideration regardless of its form.

66. *E.g.*, Interview with Attorney, AmLaw 100 Law Firm V, in Cal. (May 2012); Interview with Attorneys, Silicon Valley Law Firm I, *supra* note 38.

deals with terms that allocated very large proportions of the total consideration to the compensation pool were unfair.[67] If the investors had not put up the seed and other funding in the first place, they argued, the desired team of engineers would never have been assembled, the team would never have had the opportunity to showcase its talents, and it would consequently never have been offered such a rich compensation package by the buyer.

Other interviewees contended, however, that because the most valuable or only valuable "asset" of the acqui-hired companies is their at-will human capital, to which the startup had no legally cognizable claim, the engineers should receive the vast majority, if not all, of the consideration paid by the buyer.[68] Furthermore, the alternative to an acqui-hire in many cases is for the company to liquidate,[69] in which case the investors would receive, at best, pennies on the dollar.[70] Thus, some argued, investors should be satisfied with any allocation to the deal consideration that results in a larger recovery than liquidation.[71]

Turning to pricing, the overall size of an acqui-hire is, in many cases, driven by the number of engineers at the startup who will be employed by the buyer. It has been reported that a general rule of thumb in Silicon Valley acqui-hires is $1 million per engineer.[72] Despite this general rule of thumb, participants reported that the total prices for acqui-hires they had seen ranged from a few hundred thousand dollars to $50 million or more.[73] One interviewee estimated

67. Interview with Attorney, AmLaw 100 Law Firm V, *supra* note 66.

68. Interview with Acqui-hired Emp., NASDAQ 100 Co. II, *supra* note 61; Interview with Attorneys, Silicon Valley Law Firm I, *supra* note 38.

69. *See supra* notes 45–46 and accompanying text.

70. When a company is wound down, any remaining value in the business would usually be remitted to the outside investors, whether by virtue of the liquidation preference guaranteed by the terms of their preferred stock or by virtue of their status as creditors by the terms of their convertible notes. *See supra* note 58.

71. Interview with Acqui-hired Emp., NASDAQ 100 Co. II, *supra* note 61; Interview with Attorney, AmLaw 100 Law Firm II, *supra* note 44; Interview with Attorneys, Silicon Valley Law Firm I, *supra* note 38. In some cases, the entrepreneurs will shop themselves to the buyer. Interview with Acqui-hired Emp., NASDAQ 100 Co. I, *supra* note 38. In others, the investors will shop the entrepreneurs. *Id.* In still others, the buyer's business development team will recommend that the corporate development team take a look. *See* Interview with Attorneys, Silicon Valley Law Firm I, *supra* note 38.

72. *See* Helft, *supra* note 3.

73. Interview with Acqui-hired Emp., NASDAQ 100 Co. I, *supra* note 38; Interview with Attorney, Silicon Valley Law Firm II, *supra* note 38.

that the total consideration paid in the median acqui-hire transaction was in the $3 to $6 million range.[74]

D. The Existential Puzzle: Why Acqui-hire?

The popularity of the acqui-hire presents an existential puzzle. In an acqui-hire, the buyer's exclusive or primary objective is to gain access to the startup's at-will employees. Given this objective, why does the buyer go to all of the trouble and expense of acquiring the company? Simply hiring these individuals away from the startup would be cheaper because no money would need to be paid to the startup's investors or to those employees that the buyer does not wish to hire.[75] Why then do acqui-hires even exist?

Throughout this Article, we refer to simply hiring employees away from a startup through the normal channels as a "defection" (from the employee's perspective) or a "poach" (from the buyer's perspective) to distinguish it from an "acqui-hire." Poaching is, of course, the way that most group hiring occurs in the United States. It is extremely unusual—indeed, it is almost unheard of outside of Silicon Valley—for one company to buy another company solely or primarily for the purpose of obtaining the future services of its at-will employees. The mystery, therefore, is why Facebook, Google, and other companies have engaged in so many acqui-hiring transactions in recent years when there exists a viable alternative to achieve their hiring goals at lower cost and with fewer complications.

74. Interview with Attorney, AmLaw 100 Law Firm I, *supra* note 38. Although the level of acqui-hiring appears to have increased in recent years, it still represents only a portion of the hiring that occurs in Silicon Valley. One entrepreneur whose team was ultimately acqui-hired by a large technology company told us that he had been individually recruited by a number of other technology companies. Interview with Acqui-hired Emp., NASDAQ 100 Co. II, *supra* note 61. Acqui-hiring is therefore only one of the many ways by which large technology companies in Silicon Valley satisfy their need for engineering talent.

75. This course of action could be cheaper because the engineers who accept positions with the buyer would continue to receive the same amounts, with the buyer keeping the rest. Alternatively, the total consideration paid by the buyer could remain constant, but all of the deal-consideration pool would be shifted into the compensation pool. In that case, the engineers are obviously better off. Such a buyer's position is likewise improved because the compensation pool can be used to provide the engineers with even more attractive incentives to stay with the buyer or to meet specified performance goals. Finally, the buyer and the desired employees could achieve some middle ground where the buyer pays less and receives more positive incentive effects and the desired employees receive more value. In any of these situations, a defection would cut investors and the undesired employees out of the deal, leaving more for the buyer and the desired employees to share as they wish.

At first glance, one might think that acqui-hiring is sometimes preferred over poaching in Silicon Valley because acqui-hires facilitate the hiring of *teams* as opposed to *individuals*. A moment's reflection, however, reveals the flaw in this argument. There is no apparent reason why the hiring company could not recruit and hire a team of at-will employees away from another company through the normal hiring channels. Groups of law firm partners and associates, for example, routinely leave one firm to join another.[76] Furthermore, in any acqui-hire transaction, the desired employees and the buyer will have to negotiate the individual compensation packages on a person-by-person basis, meaning that there will be no negotiation efficiencies that result from acqui-hiring. Thus, the notion that acqui-hires are necessary in the recruitment of teams of employees away from their current employer is unconvincing. These teams could just as easily be poached away.

Part II considers and rejects one rationale—that acqui-hiring is a defensive response to the threat of litigation—that may at first glance appear to explain the acqui-hiring phenomenon. Part III then explains our theory of acqui-hiring.

II. ACQUI-HIRING AS A MECHANISM TO REDUCE LITIGATION RISK?

One reason why parties to an acqui-hire might choose to engage in the acqui-hire rather than an employee defection is to eliminate or reduce litigation risk. If a buyer were to simply hire away all or a subset of a startup's engineering team, the outside investors may be tempted to cause the startup to sue both the buyer and the departing engineers. To forestall this possibility, the buyer may structure the transaction as an acqui-hire.[77] On this account, the payments made to

76. *See, e.g.*, *Team of Intellectual Property Litigators Joins Kasowitz in Atlanta and New York*, KASOWITZ BENSON TORRES & FRIEDMAN LLP (May 10, 2011), http://www.kasowitz.com/team-of-intellectual-property-litigators-joins-kasowitz-in-atlanta-and-new-york-05-10-2011 (reporting that six partners from Sutherland Asbill & Brennan LLP had departed to join Kasowitz, Benson, Torres & Friedman LLP).

77. In contrast to the defection, the acqui-hire typically requires the approval of the outside investors in the start-up company. When the acqui-hire is structured as a sale of all or substantially all of the company's assets, a sale of the company's stock, or a merger, the investors will either have to affirmatively take part in the transaction (for example, agree to sell their stock) or will possess contractual rights to prevent the transaction from occurring. In cases in which the acqui-hire is consummated through the startup's execution of a covenant not to sue, the buyer and the desired employees could insist that the investors (and any other

investors in connection with the acqui-hire through the deal consideration would be, in effect, payments to obtain the release of legal claims stemming from the buyer's poaching of the company's engineering talent.[78]

Whether this account actually explains the existential puzzle of acqui-hiring depends on whether the investors have valid legal claims against the buyer or departed employees and, if so, whether the investors could credibly threaten to pursue these claims in court.[79] If either one of these two conditions—the existence of valid legal claims and a credible threat to sue—is not present, then litigation-risk reduction cannot explain acqui-hiring.

A. *Validity of Legal Claims*

There are a number of legal claims that, though actionable in other jurisdictions, would not be viable in California if employees were poached in lieu of an acqui-hire. The most obvious of these claims would be for a breach of a covenant not to compete executed by the departing employee. In most jurisdictions, these covenants are enforceable to the extent they are reasonable in scope and duration.[80] California employment law, however, is famous for its refusal to enforce covenants not to compete, regardless of their scope and duration, except in certain limited contexts.[81] In fact, scholars have

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shareholders, such as employees that are not desired by the buyer) also consent to the transaction. In each case, the investors must consent to the transaction or it will not take place.

78. There are many examples in which one company paid a sum of money to another company in connection with the hiring away of an employee. *See, e.g.*, Robert McMillan, *Nortel Appoints Ex-Motorola Exec as Operations Chief*, NETWORK WORLD (Jan. 19, 2006, 8:57 PM), http://www.networkworld.com/edge/news/2006/011906-nortel-motorola.html?rl (reporting that Nortel paid Motorola $11.5 million to release its COO from his noncompete agreement).

79. Technically, any claims would be owned by the startup, but following the departure of the employees via a defection the startup would presumably be controlled by the investors. Thus, the decision about whether or not to sue would be made by the investors, and the benefits of a successful suit would inure mostly to them. For simplicity purposes, therefore, we refer to the investors as owning the claim.

80. *See, e.g.*, 1 BRIAN M. MALSBERGER, COVENANTS NOT TO COMPETE, A STATE-BY-STATE SURVEY 1565, 1875 (6th ed. 2008).

81. CAL. BUS. & PROF. CODE § 16600 (West 2008) ("Except as provided in this chapter, every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void."). To be sure, one of the few exceptions to this general rule provides that noncompetes *are* enforceable in connection with the sale of a business. *Id.* § 16601. This exception, however, is not relevant to a defection scenario because, if a departing engineer had executed a noncompete, it would not have been executed in connection with the sale of any business. Rather, the noncompete would have been executed in connection with the investor's investment in an ongoing business or, alternatively, in connection

argued that this unique California law and its liberating effect on employee mobility are partly responsible for the strength of the technology sector in Silicon Valley.[82] Thus, under California law, even if the departing employees had executed a covenant not to compete with the startup, which would be highly unusual, it would not be enforceable.[83]

Trade-secret law, at least in theory, could offer an alternative means of achieving the same effect as a covenant not to compete. A number of jurisdictions have adopted the doctrine of "inevitable disclosure" in the area of trade-secret litigation.[84] This doctrine permits an employer to obtain an injunction to prevent even an at-will employee from going to work for a competitor if the court concludes that the employee will "inevitably disclose" trade secrets that were obtained in the course of working for the former employer.[85] California courts have, however, explicitly declined to follow the doctrine of inevitable disclosure, which means that this particular legal avenue is likewise unavailable to a startup when employees are poached away.[86]

Finally, if the employee had entered into a fixed-term employment contract with the startup, her defection could potentially create valid claims against the employee and the hiring company. The employee would be in breach of the employment agreement, whereas the hiring company could (depending on the nature of its recruitment activities) be liable for tortious interference with a contractual

with the hiring of the engineer by the startup. Nevertheless, the exception is potentially relevant to the buyer in an acqui-hire because the *buyer* could impose an enforceable noncompete on acqui-hired employees. *See infra* note 173 and accompanying text.

82. *See e.g.*, ALAN HYDE, WORKING IN SILICON VALLEY: ECONOMIC AND LEGAL ANALYSIS OF A HIGH-VELOCITY LABOR MARKET 27–40 (2003) (discussing the role played by this legal framework in promoting employee turnover in Silicon Valley); Ronald J. Gilson, *The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants Not To Compete*, 74 N.Y.U. L. REV. 575, 607–09 (1999) (same).

83. Under California law, the mere inclusion of such a clause in an employment agreement may give rise to a claim of unfair competition against the employer. *See* Application Grp., Inc. v. Hunter Grp., Inc., 72 Cal. Rptr. 2d 73, 89–90 (Ct. App. 1998).

84. *See, e.g.*, PepsiCo, Inc. v. Redmond, 54 F.3d 1262, 1269 (7th Cir. 1995).

85. *See* Gilson, *supra* note 82, at 622–26.

86. *See, e.g.*, Whyte v. Schlage Lock Co., 125 Cal. Rptr. 2d 277, 293 (Ct. App. 2002) ("Schlage and Whyte did not agree upon a covenant not to compete. We decline to impose one, however restricted in scope, by adopting the inevitable disclosure doctrine.").

relationship.[87] But start-up employees in Silicon Valley do not sign fixed-term employment agreements.[88] Rather, they are at-will employees. Their departures therefore do not breach any employment agreement. Furthermore, under California law, the act of inducing an at-will employee to leave his current employer to accept a position with a competitor is not, by itself, actionable.[89]

Although claims based on covenants not to compete, inevitable disclosure of trade secrets, and breaches of employment agreements would not be available, there are other legal claims that an aggrieved investor might bring against the poaching company and the defecting employees.[90] Investors could, for example, allege a breach of the departing employee's fiduciary duty of loyalty to the startup, if that employee actively recruited other individuals to join him in going to work for a competitor prior to his departure.[91] Likewise, depending

87. CRST Van Expedited, Inc. v. Werner Enters., Inc., 479 F.3d 1099, 1105–07 (9th Cir. 2007) (discussing elements of a claim for intentional interference with contractual relations under California law).

88. Interview with Attorneys, Silicon Valley Law Firm I, *supra* note 38. Although employees at Silicon Valley startups do not sign fixed-term employment agreements, virtually all startups require their employees to enter into nondisclosure agreements, invention assignment agreements, and nonsolicitation agreements as a condition of their employment. It is conceivable that a departing employee could be sued for breach of a nonsolicitation agreement if that individual provided names of his former coworkers to his new employer and the new employer subsequently hired those individuals. *See* Loral Corp. v. Moyes, 219 Cal. Rptr. 836, 841 (Ct. App. 1985) (concluding that nonsolicitation agreements, in contrast to covenants not to compete, are valid in California). Suits alleging breaches of nonsolicitation agreements are, however, vanishingly rare. Interview with Attorney, AmLaw 100 Law Firm IV, in Cal. (May 2012).

89. *See* Reeves v. Hanlon, 95 P.3d 513, 515 (Cal. 2004) ("[O]ne commits no actionable wrong by merely soliciting or hiring the at-will employee of another."); *see also* Diodes, Inc. v. Franzen, 67 Cal. Rptr. 19, 25-26 (Ct. App. 1968) ("Even though the relationship between an employer and his employee is an advantageous one, no actionable wrong is committed by a competitor who solicits his competitor's employees or who hires away one or more of his competitor's employees who are not under contract, so long as the inducement to leave is not accompanied by unlawful action."); RESTATEMENT OF TORTS (SECOND) § 768 cmt. i ("The competitor is . . . free, for his own competitive advantage, to . . . offer better contract terms, as by offering an employee of the plaintiff more money to work for him . . . all without liability.").

90. *See* Jeffrey W. Kramer, *The Risks of Recruiting At-Will Employees*, L.A. LAW., Feb. 2006, at 19, 21 (2005) ("Employers may still be liable for interference with economic relations when recruiting at-will employees if the recruiting involves breaches of fiduciary duty, misappropriation of trade secrets, defamation, or any conduct constituting unfair competition.").

91. The viability of this claim would depend on whether the departing employee was a corporate officer or director who owed fiduciary duties to the startup. *See* Bancroft-Whitney Co. v. Glen, 411 P.2d 921, 934–36 (Cal. 1966) (describing fiduciary duties owed by corporate officers and concluding that these duties were breached when the company president provided information to a competitor to facilitate his own recruitment as well as that of sixteen other

on the precise facts—in particular, whether the project that the defecting engineer works on while employed by the poaching company is sufficiently similar to the startup's projects—investors could allege that the poaching company and the defecting engineer colluded to misappropriate the startup's trade secrets.[92] Although investors could conceivably bring other claims against the hiring company—such as a cause of action for unfair competition[93] or for intentional interference with prospective economic advantage[94]—

employees); GAB Bus. Servs., Inc. v. Lindsey & Newsom Claim Servs., 99 Cal. Rptr. 2d 665, 674–75 (Cal. Ct. App. 2000) (concluding that there was a breach of a fiduciary duty as a matter of law when an officer used insider knowledge to recruit seventeen employees into jobs with a competitor), *overruled on other grounds by Reeves*, 95 P.3d at 521; RESTATEMENT (SECOND) OF AGENCY § 393 cmt. e ("[A] court may find that it is a breach of duty for a number of the key officers or employees to agree to leave their employment simultaneously and without giving the employer an opportunity to hire and train replacements."). As explained below, however, investors have only brought suit against start-up founders in cases involving fraud or outright theft. *See infra* note 98 and accompanying text.

92. *See* UNIF. TRADE SECRETS ACT §§ 1–11 (amended 1985), *adopted by* CAL. CIV. CODE §§ 3426–3426.11 (West 1997 & Supp. 2013); *see also* Therapeutic Research Faculty v. NBTY, Inc., 488 F. Supp. 2d 991, 999 (E.D. Cal. 2007) (identifying elements of a misappropriation of trade-secrets claim in California); Tait Graves, *Nonpublic Information and California Tort Law: A Proposal for Harmonizing California's Employee Mobility and Intellectual Property Regimes Under the Uniform Trade Secrets Act*, UCLA J.L. & TECH., Spring 2006, at 1, 3–5 (arguing that the California version of the Uniform Trade Secrets Act preempts alternative common-law claims). California trade-secrets law is generally regarded as very pro-defendant. *Cf.* CAL. CIV. CODE § 3426.4 ("If a claim of misappropriation is made in bad faith . . . the court may award reasonable attorney's fees and costs to the prevailing party."); Whyte v. Schlage Lock Co., 125 Cal. Rptr. 2d 277, 293 (Cal. Ct. App. 2002) (concluding that California does not follow the doctrine of inevitable disclosure).

93. *See* CAL. BUS. & PROF. CODE § 17200 (West 2008) (defining unfair competition to constitute "any unlawful, unfair or fraudulent business act"); Korea Supply Co. v. Lockheed Martin Corp., 63 P.3d 937, 943 (Cal. 2003) (observing that the California Unfair Competition Law is a statute that "'borrows' violations from other laws by making them independently actionable as unfair competitive practices"); *Bancroft-Whitney Co.*, 411 P.2d at 926 (concluding that a hiring company was liable for unfair competition because it had benefitted from the breach of a fiduciary duty of a corporate officer at the target company in recruiting other employees).

94. *See* CRST Van Expedited, Inc. v. Werner Enters., Inc., 479 F.3d 1099, 1109–10 (9th Cir. 2007) (concluding that acts violating California's Unfair Competition Law qualify as "wrongful" for purposes of establishing liability under a claim for intentional interference with prospective economic advantage); *Reeves*, 95 P.3d at 514 (explaining that a hiring company may be liable under an intentional interference theory for inducing an at-will employee to leave the original company if the plaintiff can "plead and prove that the defendant engaged in an independently wrongful act—i.e., an act 'proscribed by some constitutional, statutory, regulatory, common law, or other determinable legal standard'" (quoting *Korea Supply Co.*, 63 P.3d at 954)); Am. Mortg. Network v. Loancity.com, No. D044550, 2006 WL 3199291, at *17 (Cal. Ct. App. Nov. 7, 2006) (describing "breach or conspiracy to breach a fiduciary duty" as "independently wrongful" conduct for purposes of this claim); Gemini Aluminum Corp. v. Cal. Custom Shapes, Inc., 116 Cal. Rptr. 2d 358, 1258–59 (Cal. Ct. App. 2002) (discussing what conduct qualifies as

these claims are likely to succeed only when the investors are also able to show an underlying breach of a fiduciary duty or the misappropriation of a trade secret.[95]

B. Credibility of an Investor's Threat To Sue

The foregoing discussion explained that, depending on the precise circumstances, investors could in some cases have viable claims stemming from a defection of a group of employees from a startup to a large technology company in California. However, the mere existence of valid legal claims does not compel the conclusion that the purpose of acqui-hiring is to mitigate legal risk. First, valid legal claims likely exist only in a fairly narrow subset of all acqui-hiring transactions. Second, and more importantly, investors in Silicon Valley are extremely reluctant to pursue legal claims against their former entrepreneurs. As a result, it would be extremely difficult for investors to credibly threaten a lawsuit, even in cases in which the lawsuit might be meritorious. In our interviews with acqui-hiring participants, we were told repeatedly that no investor in Silicon Valley would ever sue its entrepreneurs.[96]

A comprehensive search of reported state and federal cases in California confirms this conventional wisdom.[97] Excepting cases

"wrongful"); *see also* BRIAN M. MALSBERGER, TORTIOUS INTERFERENCE IN THE EMPLOYMENT CONTEXT: A STATE-BY-STATE SURVEY 298 (3d ed. 2010).

95. Whether the investors are likely to prevail on either of these claims will, moreover, depend heavily on the facts and circumstances surrounding the defection. One treatise states that liability will generally be imposed on any of these theories only when the hiring company has "acted maliciously, or wholly without justification, or with the primary objective of driving the plaintiff out of business." *Liability for Inducing Employee Not Engaged for Definite Term To Move to Competitor*, 24 A.L.R. 3d 821 (1969 & Supp. 2013); *see also* Silicon Knights, Inc. v. Crystal Dynamics, Inc., 983 F. Supp. 1303, 1305, 1309–10 (N.D. Cal. 1997) (discussing claims that a California-based video-game designer raided the employees of a Canadian company). Another treatise notes that these claims will typically turn on "how disloyal and generally evil the [defendants] have been, how badly the [original company] has been damaged as a result, and the adequacy of the proof of those charges." JAMES POOLEY, TRADE SECRETS: HOW TO PROTECT YOUR IDEAS AND ASSETS 83 (1982). In cases in which the startup was foundering and on the verge of liquidation before the defection, it may be difficult to prove that the plaintiff company had suffered any actual damages.

96. *See* Interview with Attorney, AmLaw 100 Law Firm I, *supra* note 38 ("Most entrepreneurs are not worried about litigation. The odds are slim that investors will sue."); Interview with Attorney, AmLaw 100 Law Firm II, *supra* note 44 ("I have never heard of an investor who sued a founder.").

97. We searched the California State and Federal Cases databases in Westlaw, examining cases and trial documents returned by search terms including "angel," "dilution," "entrepreneur," "founder," "fraud," "freeze out," "incubator," "investor," "non compete,"

involving allegations of fraud or outright theft,[98] our search of Westlaw databases did not turn up a single reported case in which an investor in a Silicon Valley technology startup had sued its entrepreneurs. This result is consistent with the only published empirical study of litigation in the venture-capital industry which concluded that "[w]hen founders are involved in litigation, they are almost always plaintiffs."[99] Although there are many possible reasons for this dearth of lawsuits (including California law's pro-employee-mobility orientation), the one that our interviewees repeatedly cited was the critical importance of investor reputation in Silicon Valley. As one investor explained, "I'm not aware of any cases of VC-initiated litigation.... We just wouldn't do it—and we'd lose if we tried. And the reputational damage of suing your entrepreneurs would be almost irreparable."[100]

To appreciate the key role played by investor reputation in Silicon Valley, it is necessary to understand that entrepreneurs soliciting investment capital place an extremely high value on investor reputation in deciding with whom to partner. One study found that "a financing offer from a high-reputation VC is approximately three times more likely to be accepted by an entrepreneur" and that "highly reputable VCs acquire start-up equity at a 10–14%

"series," "silicon valley," "startup," "trade secret," "venture capital," and various combinations of these terms.

98. *See* WPP Lux. Gamma Three Sarl v. Spot Runner, Inc., 655 F.3d 1039, 1044–46 (9th Cir. 2011) (investor sued founders for fraud); Admiral Capital Venture, I, Ltd. v. Pelczarski, Nos. 88-2639, 88-15594, 1989 WL 150583, at *1 (9th Cir. Dec. 11, 1989) (same); *see also* Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 571 (1991) ("The sophisticated investors in such private placements (usually venture capitalists or established companies) do not generally sue if things turn out badly, in the absence of strong evidence of common-law fraud.").

99. *See* Vladimir Atanasov, Vladimir Ivanov & Kate Litvak, *The Effect of Litigation on Venture Capitalist Reputation* 18 (Nat'l Bureau of Econ. Research, Working Paper No. 13,641, 2007).

100. Interview with Partner, Venture Capital Fund, *supra* note 40. This insight is generally consistent with the views of legal scholars. *See, e.g.*, HYDE, *supra* note 82, at 40 ("[C]ompanies [in Silicon Valley] that sue departing employees will suffer harm to their reputation."); Ibrahim, *supra* note 20, at 1435 ("The conventional wisdom is that the tight-knit nature of communities such as Silicon Valley creates a reputation market among venture capitalists and entrepreneurs, which explains the lack of litigation between them."). The Internet has facilitated the transmittal of reputational information within the venture-capital community. *See* D. Gordon Smith, *Venture Capital Contracting in the Information Age*, 2 J. SMALL & EMERGING BUS. L. 133, 162–70 (1998) (discussing the potential for the Internet to be used as a means of disseminating information relating to venture-capital reputation).

discount."[101] This premium on reputation is reasonable because, as others have explained in great detail, the formal contracts between investors and entrepreneurs are notoriously incomplete, leaving investors with the ability to act opportunistically.[102] An investor's good reputation ameliorates an entrepreneur's rightful concerns about opportunistic behavior.[103] Investors, in turn, trade on their good reputation, citing it as a major reason to choose them over other investors. In an intensely competitive environment for venture-capital investment opportunities, a damaged reputation could dry up investment opportunities or otherwise make those opportunities significantly more expensive.[104]

To investigate the reputations of various venture-capital firms, angel investors, and business incubators, entrepreneurs consult a variety of informal sources, including their friends and lawyers,[105] as well as websites such as TechCrunch or Hacker News.[106] Although these networks are not perfect, they function well in transmitting highly salient information to entrepreneurs in Silicon Valley.[107] A

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101. David H. Hsu, *What Do Entrepreneurs Pay for Venture Capital Affiliation?*, 59 J. FIN. 1805, 1807 (2004).

102. *See* Utset, *supra* note 13, at 114–16 ("Written venture capital contracts are incomplete, . . . [which] leaves open the possibility that one or more of the parties will engage in costly ex post bargaining. . . . [T]he high-powered incentives in the contracts[] effectively grant[] the venture capitalist the great majority of ex post bargaining power."). *But see* Michael Klausner & Kate Litvak, *What Economists Have Taught Us About Venture Capital Contracting*, *in* BRIDGING THE ENTREPRENEURIAL FINANCING GAP: LINKING GOVERNANCE WITH REGULATORY POLICY 54, 68 (Michael J. Wincop ed., 2001) (questioning the effectiveness of reputational constraints on VC opportunism).

103. *See* Brian Broughman, *Investor Opportunism, and Governance in Venture Capital*, *in* VENTURE CAPITAL, *supra* note 14, at 347, 376–78 (surveying the literature on reputational constraints on VC opportunism).

104. *See* Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1092 (2003) ("Because the [venture-capital firm] needs to raise successor funds, it will have to make investments in new portfolio companies run by other entrepreneurs. If a [venture-capital firm] behaves opportunistically toward entrepreneurs in connection with previous portfolio company investments, it will lose access to the best new investments. This, in turn, will make raising successor funds more difficult."); Hsu, *supra* note 101, at 1807 ("The empirical results suggest that entrepreneurs are willing to forego offers with higher valuations in order to affiliate with more reputable VCs.").

105. *See* Mark C. Suchman, *Dealmakers and Counselors: Law Firms as Intermediaries in the Development of Silicon Valley*, *in* UNDERSTANDING SILICON VALLEY, *supra* note 33, at 71, 89 (discussing the advising role played by lawyers).

106. *See* Smith, *supra* note 100, at 162–70 (discussing the potential for the Internet to be used as a means of disseminating information relating to venture-capital reputation).

107. *Cf.* HYDE, *supra* note 82, at 39 (noting that "chat groups lit up all over the Valley" after Intel sued two former employees for theft of trade secrets).

lawsuit filed against a founder would be extremely salient. Interviewees were emphatic that, if an investor were to sue its entrepreneurs, the story would immediately be posted to TechCrunch and would quickly become the talk of the Valley.[108] Regardless of the merits of the suit, that investor would thereafter find it much more difficult to invest in startups at competitive prices.[109]

The fact that investors in Silicon Valley will not bring suits against entrepreneurs does not mean that they lack the ability to sanction bad behavior by entrepreneurs. As one attorney explained, "VCs don't sue their founders. They keep a list. And they tell their friends."[110] The implications of these informal sanctioning regimes are explored in the next Part. For now, it is sufficient to conclude that mitigation of litigation risk does not appear to explain the prevalence of the acqui-hire. This conclusion was repeatedly confirmed over the course of our numerous conversations with entrepreneurs, venture capitalists, and attorneys in Silicon Valley. In every interview, we specifically asked whether litigation risk was a significant factor behind the popularity of acqui-hiring. The answer that we consistently received was that it was not.[111]

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108. *E.g.* Interview with Founder, Start-Up Co., *supra* note 45.

109. *See supra* note 104. Although investors could, in theory, file a suit against the hiring company without naming the departing employees as defendants, this course of action will often not be attractive. Consider, for example, the investor's potential claims of unfair competition and intentional interference with prospective economic advantage. The clearest way to prevail on such claims would be to prove that a departing employee, who was also a corporate officer, breached a fiduciary duty to the original company and that the hiring company benefitted from the breach. *See supra* note 91. In fact, all of the investor's potentially viable legal claims against the hiring company will necessarily involve allegations of wrongful conduct by the former employees. For a description of potential legal claims resulting from an employee defection from a startup, see *supra* Part II.A. Thus, even if the former employee is not actually a defendant, she would still be deposed aggressively by the investor's lawyer. In these circumstances, it is highly unlikely that the entrepreneurial community will appreciate the fact that the investor, despite assailing the former entrepreneur's conduct and character, has not technically sued the entrepreneur. Certainly, investors would not rely on word of mouth and other informal reputational scorecards to maintain such a fine distinction.

110. Interview with Attorney, AmLaw 100 Law Firm V, *supra* note 66.

111. This statement is subject to two minor qualifications. In one conversation with a Silicon Valley lawyer, we were told that the acqui-hire was driven in part by a "pathological avoidance of legal risk." Interview with Attorneys, Silicon Valley Law Firm I, *supra* note 38. In another, we asked a lawyer about the reasons why companies would pursue an acqui-hire as opposed to a defection, and he stated immediately that it was to protect against a lawsuit. Interview with Attorney, AmLaw 100 Law Firm V, *supra* note 66. When we then asked if he had ever heard of an investor suing its founders, however, the attorney acknowledged that he had not. *Id.*

III. A THEORY OF ACQUI-HIRING

If acqui-hiring is not a defensive response to the threat of litigation, then we are back to the existential puzzle. If what the buyer really wants is the engineers, why not just hire them away? Or, to put it another way, why does a buyer principally or exclusively interested in hiring a team of software engineers agree, in effect, to make wasteful side payments to investors and other employees of the startup?

In this Part, we seek to answer this question by providing a comprehensive theory of acqui-hiring. Drawing on interviews with acqui-hiring participants, as well as on academic literature across a range of areas, we argue that there is no single factor that drives the buyer and the engineers to adopt this transaction structure. Rather, the decision to engage in an acqui-hire appears to be the product of a host of factors, some of which are interrelated.

We argue that a number of nonlegal mechanisms—including reputational concern, self-image, and a desire to avoid social sanctions—serve to constrain the desire of entrepreneurs to pursue short-term financial gains through defection.[112] Acqui-hires are also preferred because entrepreneurs derive significantly more prestige in Silicon Valley by "selling" their startup to a leading technology company than by quitting the startup to join that same company. In addition, the culture of Silicon Valley and its legal community encourages entrepreneurs to take a cooperative—rather than an adversarial—view of venture-capital transactions, which encourages acqui-hiring. From the buyer's perspective, moreover, the acqui-hire structure may result in modest reputational benefits, make it easier for the buyer to differentiate the pay packages of similarly situated engineers, and facilitate the buyer's ability to retain engineering talent.

In addition, the mechanics of acqui-hiring also promote the technique by reducing the perceived and actual costs of acqui-hiring to the entrepreneurs. Well-documented cognitive biases may lead the

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112. The concern in this context about entrepreneurial opportunism is ironic because much of the venture-capital literature focuses on the opportunities for the *investors* to act opportunistically at the expense of the entrepreneurs. *See, e.g.*, Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243, 261–63 (1998) (discussing reputational constraints on venture-capitalist opportunism). *But see* Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 990 (2006) (discussing entrepreneurial opportunism).

entrepreneurs to undervalue the costs they incur when funds are deflected to investors and other shareholders in an acqui-hire. In addition, tax considerations reduce the actual costs incurred by the entrepreneurs because acqui-hires convert ordinary income into capital gains. Our theory of acqui-hiring, therefore, is that acqui-hires occur because the aggregate of the benefits to the parties described in the previous paragraph exceed the costs to the entrepreneurs, after those costs have been adjusted to take account of cognitive biases and tax effects.

A. *Informal Sanctions and Reputational Harm*

Because the enforceability of covenants not to compete is strictly limited by California law, it is difficult to negotiate adequate ex ante protections against defections by at-will employees. The contracts negotiated between Silicon Valley start-up investors and entrepreneurs are thus incomplete in that they do not address this contingency.[113] In the absence of any contractual provisions that inhibit defections, investors have no formal legal protections apart from those identified in Part II, which they are generally loath to pursue.[114] Nevertheless, acqui-hiring transactions are now commonplace in Silicon Valley. To explain this anomaly, we argue that it is necessary to look past the formal means of enforcing contractual obligations and look, instead, to informal mechanisms.[115]

113. *See* Mark P. Gergen, *The Use of Open Terms in Contract*, 92 COLUM. L. REV. 997, 999 (1992) (describing an incomplete contract as "any contract short of the ideal of a complete contingent contract, which has been drafted with all contingencies in mind and provides for optimal performance on every contingency"). We discuss in Part IV.B some possible contractual protections that may benefit investors. As discussed above, it is rare for individuals who go to work for startups to be required to sign fixed-term employment agreements; instead they are merely at-will employees. Consequently, it is unclear whether the investors would be adequately protected even if California courts enforced noncompetes. *See* Darian M. Ibrahim & D. Gordon Smith, *Entrepreneurs on Horseback: Reflections on the Organization of Law*, 50 ARIZ. L. REV. 71, 82–83 (2008) (explaining that although some scholars "attribute[] Silicon Valley's advantage to . . . California refus[ing] to enforce non-competition agreements[,] . . . much more remains to be learned about entrepreneurship when viewed through the lens of law").

114. *See supra* Part II. This does not mean that investors do not have other, nonlegal mechanisms to encourage employees to stay with a start-up company. Incentive compensation, such as restricted stock and unvested stock options, provide carrots to encourage loyalty. But in cases in which the startup is failing or "going sideways," the typical fact pattern in which an acqui-hire occurs, the incentive to stay provided by such compensation is drastically weakened.

115. We make no claim that these dynamics are unique to Silicon Valley or to the technology industry. There are doubtless other industries in which informal sanctions may play a similar role in determining the manner in which an employee chooses to leave one firm for another.

In developing this argument, we draw upon a rich literature that explains the relationship between formal legal rules and institutions, on the one hand, and social norms and informal sanctioning regimes, on the other. Professor Robert Ellickson famously argued, for example, that ranchers and farmers in Shasta County, California, rely on informal social norms—as opposed to formal legal rules—to resolve disputes arising out of the construction of boundary fences.[116] Professor Lisa Bernstein likewise concluded that social norms play a critical role in resolving disputes between merchants in the diamond[117] and cotton trades.[118] And Professor Stewart Macaulay found in his classic account that businessmen in Wisconsin in the early 1960s virtually never turned to litigation to resolve their disputes, preferring to rely instead on informal sanctioning regimes.[119] These and other case studies provide rich accounts of the role played by social norms in shaping behavior across a number of different communities.

Other scholars have, in turn, drawn upon these and other studies to advance theoretical frameworks to explain when parties choose to rely on informal sanctions instead of formal legal ones. Professor David Charny, for example, has argued that the decision to enforce an agreement via formal or informal means will depend on "the costs of gathering information and of drafting and enforcing agreements."[120] Professors Ronald Gilson, Charles Sabel, and Robert Scott have shown how parties sometimes "braid" together formal and informal mechanisms for enforcing contractual commitments.[121] Amid this widespread interest in social norms, the focus has generally been on

116. *See generally* ROBERT C. ELLICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES (1991).

117. Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115, 115 (1992).

118. Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions*, 99 MICH. L. REV. 1724, 1745–46 (2001); *see also* Eric A. Feldman, *The Tuna Court: Laws and Norms in the World's Premier Fish Market*, 94 CALIF. L. REV. 313, 316 (2006) (examining "whether, when, [and] why informal norms rather than state-created law prevail in certain settings").

119. Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55, 61 (1963).

120. David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104 HARV. L. REV. 373, 392 (1990).

121. *See generally* Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine*, 110 COLUM. L. REV. 1377 (2010); *see also* Robert E. Scott, *A Theory of Self-Enforcing Indefinite Agreements*, 103 COLUM. L. REV. 1641, 1675–92 (2003) (discussing the relationship between formal and informal enforcement of deliberately indefinite agreements).

the role played by these norms in resolving disputes without resort to litigation.[122] In this Section, we advance the novel claim that these norms can lead, and have led, to parties utilizing a unique transaction structure to prevent a dispute from arising in the first place.

There are, broadly speaking, three types of informal sanctions that may be imposed by one party (here, the investors) upon another (the entrepreneurs), if the latter were to defect en masse to another company.[123] First, investors could threaten to refuse to finance the entrepreneur's subsequent endeavors.[124] This threat is amplified by the likelihood that other investors will learn about the entrepreneur's defection and similarly refuse to invest.[125] Second, investors may appeal to the entrepreneur's sense of moral obligation toward those who have backed her venture.[126] Third, investors may threaten to ostracize the defecting entrepreneur from the social community.[127] In our interviews, we found that each of these three informal sanctioning methods plays a role in promoting the acqui-hire in Silicon Valley.

1. *Future Dealings.* One potential constraint on the willingness of an entrepreneur to act opportunistically is the threat that the investor will refuse to deal with him in the future.[128] When an engineer

122. *See, e.g.*, Macaulay, *supra* note 119, at 61 (explaining that many product manufacturers routinely accept cancellation of orders rather than pursuing litigation for breach of contract because, as one salesman explained, "You can't ask a man to eat paper [the firm's product] when he has no use for it").

123. Gilson et al., *supra* note 121, at 1392–94 (2010); *see also* ELLICKSON, *supra* note 116, at 131 (offering a typology of nonlegal sanctions); Charny, *supra* note 120, at 392–97 (same).

124. *See* Gilson et al., *supra* note 121, at 1392 ("One type of informal enforcement is the threat that one party to an informal contract will respond to its counterparty's breach by reducing or terminating future dealings.").

125. *See id.* at 1392–93 ("Even where the particular parties do not expect to deal with each other in the future, the tit-for-tat informal enforcement structure will still work if a misbehaving party expects to trade with others in the future—i.e., if trade will be multilateral rather than bilateral—so long as that party's reputation—i.e., the collective experience of others who have previously dealt with that person—becomes known to future counterparties.").

126. *See id.* at 1393 ("A second type of informal enforcement is normative or dispositional.... [E]xperimental evidence . . . indicates a widespread, but not universal, taste for reciprocity—an inclination to reward cooperators and punish opportunists even when the subjects derive no direct and particular benefits from doing so.").

127. *See id.* at 1393–94 ("Third, normative or dispositional informal sanctions can operate at the level of social groups rather than among individuals. In compact and homogenous communities, for instance, the community as a whole can sanction the breach of one member's obligation to another by ostracizing the malefactor . . . .").

128. *Id.* at 1392; *see also* Charny, *supra* note 120, at 393 ("[Another] type of nonlegal sanction is loss of reputation among market participants. . . . If the promisor improperly

at a startup chooses to accept a position at a large technology company, both parties recognize that it may not be a lengthy employment relationship. The standard employee retention package in Silicon Valley contains equity incentives that vest over a period of three or four years.[129] Interviewees explained that it would not be unusual for an acqui-hired entrepreneur to leave the buyer at the end of the vesting period, if not sooner, to launch another startup.[130] In fact, several former founders mentioned that they viewed their current employment at large technology companies as a way station between start-up ventures.[131]

Whether an entrepreneur will be able to raise funds for a new venture will depend, at least in part, on his relationship with the investors who had funded his last venture. When you start a company, we were told, the first place you look is to the people who funded you the last time.[132] Even if these previous investors decline to invest, their opinions will still impact the ability of the new venture to obtain funding. In Silicon Valley, previous investors often vouch for an entrepreneur and also provide leads and recommendations for funding when they are unwilling or unable to invest themselves.[133]

Entrepreneurs who aspire to start another venture someday will therefore desire to remain on good terms with their previous investors. In game-theoretic terms, the relationship between the entrepreneur and the investing community in Silicon Valley is a multistage game in which the optimal strategy often may not be to

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breaches his commitments, he damages his reputation and thereby loses valuable opportunities for future trade.").

129. *See* Interview with Attorney, AmLaw 100 Law Firm II, *supra* note 44; Interview with Former Corp. Dev. Officer, NASDAQ 100 Co., *supra* note 44.

130. Whether this will in fact occur in the majority of cases is open to debate. *See* Ibrahim, *supra* note 20, at 1436 n.155 ("[T]here is some question as to whether the typical entrepreneur is a 'serial' entrepreneur . . . ."). Nevertheless, the culture of Silicon Valley lionizes the serial entrepreneur, and this perception tends to inform the expectations of both the buyer and the entrepreneur. Interview with Acqui-hired Emp., NASDAQ 100 Co. I, *supra* note 38; Interview with Partner, Venture Capital Fund, *supra* note 40.

131. *E.g.*, Interview with Acqui-hired Emp., NASDAQ 100 Co. I, *supra* note 38; *see also* Interview with Attorney, AmLaw 100 Law Firm I, *supra* note 38.

132. Interview with Attorneys, Silicon Valley Law Firm I, *supra* note 38.

133. Interview with Attorney, AmLaw 100 Law Firm I, *supra* note 38; Interview with Founder, Start-up Co., *supra* note 45; *see also* WPP Lux. Gamma Three Sarl v. Spot Runner, Inc., 655 F.3d 1039, 1045 (9th Cir. 2011) (noting the claim that an entrepreneur concealed potentially fraudulent activities from his investors because he wanted to use the good reputation of the investors to attract additional investors).

maximize one's winnings in the first stage of the game.[134] The entrepreneur's desire to maintain his reputation, we were told repeatedly, can and does serve to check his incentive to extract everything he can from the current venture.[135] This may explain the prevalence of the acqui-hire structure, in which part of a portion of the entrepreneur's compensation package is effectively deflected to the investors, as contrasted with the defection model, in which the entrepreneur gets to keep everything.

The prospect of future dealings as a check on entrepreneurial opportunism appears to vary with the prominence of the investor in the original venture. If the investor is Sequoia Capital—perhaps the

134. Several interviewees noted that the entrepreneur's perspective shifts when his individual payout hits about $10 million. Interview with Acqui-hired Emp., NASDAQ 100 Co. I, *supra* note 38; Interview with Acqui-hired Emp., NASDAQ 100 Co. II, *supra* note 61. At this point, there is enough money at play that the entrepreneur will start to view the negotiations as a single-play game. As discussed above, however, it is rare for an acqui-hiring deal to generate an individual payout that is this large. *See supra* notes 72–74 and accompanying text.

135. It is possible, though unlikely, that the acqui-hire will diminish in importance because reputation becomes less important as a constraint on entrepreneurial opportunism in Silicon Valley. As communities grow larger, information about potential business partners often becomes more costly both to obtain and to verify. *See* Barak D. Richman, Essay, *Firms, Courts, and Reputation Mechanisms: Towards a Positive Theory of Private Ordering*, 104 COLUM. L. REV. 2328, 2340 n.36 (2004) ("[R]eputation mechanisms may weaken when relied upon beyond small communities . . . ."). *But see* Lior Jacob Strahilevitz, *Social Norms from Close-Knit Groups to Loose-Knit Groups*, 70 U. CHI. L. REV. 359, 365 n.31 (2003) ("[T]he salient theoretical issue is not the size of the relevant community per se. Rather, it is the community members' ability to monitor instances of noncooperation and communicate with fellow members about each member's reputation . . . ."). If those reputational constraints that currently exist in Silicon Valley were to grow weaker as a result of an increase in the size of this community, then one might expect to see fewer acqui-hires and more defections, as well as more litigation over defections. This reputational argument must account, however, for the fact that Silicon Valley has already undergone tremendous growth over the past few decades. Between 1975 and 2010, for example, the number of venture-capital firms in Silicon Valley increased from approximately 38 to 718, based on data from Thomson Reuters' VentureXpert database. Between 1975 and 2008, the number of lawyers in Palo Alto—considered by many to be the heart of the Silicon Valley legal community—listed in the Martindale-Hubbell directory of lawyers grew from approximately 489 to 2,156. Data from both databases are on file with the *Duke Law Journal*. This growth notwithstanding, reputation still appears to matter a great deal in Silicon Valley. The key to understanding this apparent incongruity is to recognize the role played by technology in facilitating the transmission of information. *Cf.* Charny, *supra* note 120, at 419 ("[M]ass markets based on reputational bonds are feasible only with technology that conveys information cheaply to a large group of transactors, such as computers used to monitor creditworthiness or mass media used in advertising."). The fact that not all members of a community personally interact with one another on a regular basis matters little if these same individuals have access to and regularly internalize the same information. So long as information about past behavior is reliably conveyed to all or a significant portion of the community, then it is irrelevant whether it is conveyed over a backyard fence or via a blog like TechCrunch.

best-known venture-capital firm in Silicon Valley—we were told that the entrepreneur will go to great lengths to end the current venture on good terms.[136] In the acqui-hiring context, this would mean making sure that Sequoia—or any other well-regarded VC—received a payout from the buyer large enough for it to feel as though it had been treated fairly. If, on the other hand, the investor is a smaller angel investor who is not well connected, then the entrepreneur will be less concerned about leaving on good terms.[137] Such an angel investor might be unable to finance any future ventures and, moreover, would be a small-enough player that any negative assessment would not generate traction in the Silicon Valley investor community.[138] Between these two extremes—Sequoia and the novice angel—there is obviously a wide range. In all cases, however, it seems that entrepreneurs try to figure out, as one interviewee put it, "the lowest amount [that must be paid] to investors so that [they] don't squawk."[139]

2. *Loyalty*. Another informal constraint on the willingness of an entrepreneur to act opportunistically is the person's sense of loyalty to her investors.[140] In many cases, the investor is much more than a source of capital. The investor is also a trusted counselor, a valued source of industry contacts, and a partner in a shared undertaking.[141] If a large technology company were to contact the founders with job offers, it would not be an easy decision simply to abandon the investor and move elsewhere with their team, even if nothing in any of the investment agreements expressly forbade it. Indeed, many entrepreneurs would view a decision to defect to another company when there exists at least the possibility of recovering a portion of the

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136. Interview with Acqui-hired Emp., NASDAQ 100 Co. I, *supra* note 38.

137. If the angel investor were well connected or were a so-called "super angel," however, this conclusion would not necessarily follow. *See* Tam & Ante, *supra* note 35 ("What elevates super angels into an unofficial upper class generally is the magnetic effect their participation in a deal has on other investors . . . .").

138. *See* Ibrahim, *supra* note 20, at 1435–36 (discussing other constraints on the abilities of angel investors to utilize reputational sanctions against opportunistic entrepreneurs).

139. Interview with Attorney, AmLaw 100 Law Firm I, *supra* note 38.

140. Gilson et al., *supra* note 121, at 1393; *see* Charny, *supra* note 120, at 393–94 ("[Another] type of nonlegal sanction is the sacrifice of psychic and social goods. The breaching promisor may suffer . . . loss of self-esteem, feelings of guilt, or an unfulfilled desire to think of himself as trustworthy and competent." (emphasis omitted)).

141. *See* Fried & Ganor, *supra* note 112, at 968–69 ("VCs also provide valuable management and strategic advice to these startups, many of which are founded by entrepreneurs with little business experience.").

investor's investment as supremely disloyal. As one entrepreneur explained, "A founder wants to do right by anyone who has invested in him. He would like to at least get the money back for his investors."[142]

Although there are likely to be some entrepreneurs who feel little sense of loyalty to their investors, there are many others who would prefer an acqui-hire transaction to a defection precisely because it allows the investor to recoup some or all of her investment or perhaps even make a profit.[143] One entrepreneur whose company was acqui-hired told us that he had fought to make sure that his investors got their money back, not because he was looking ahead to his next venture, but simply because it was "the right thing to do."[144] According to a venture capitalist who has been involved in a number of acqui-hiring transactions, "Often the [entrepreneurs] do feel loyalties to their investors to not abandon them unless [the investors] can get their money back (or some portion thereof), so they hold the acquirer 'hostage' to doing that if it wants them to work there."[145] Whether one labels this impulse "loyalty," "fairness" or simply a desire to "do the right thing," there is little question that it can and does serve as a check on profit maximization by entrepreneurs in some cases.

In addition to the desire to do right by the investors, founders may also feel a moral obligation to those employees at the startup who will not be hired by the buyer. These employees will frequently own small equity stakes in the startup. In an acqui-hire transaction, they may receive some portion of the deal consideration, though they will receive none of the compensation pool. On the other hand, in a defection these employees would receive nothing. Like the investors, these employees believed in the founders, and they also probably sacrificed pay and other opportunities to join the startup. To repay

142. Interview with Founder, Start-Up Co., *supra* note 45.

143. The degree of loyalty that an entrepreneur feels toward an investor will depend on any number of factors, including the length of the relationship and the extent to which the investor has devoted her time and energy to the startup. When a startup is acqui-hired six months after its founding, and when the investor has gone to only six board meetings and has not been meaningfully involved with the company, the entrepreneurs are likely to feel less loyal than when the relationship has been longer and more meaningful. Interview with Corp. Dev. Officer, NASDAQ 100 Co., in Cal. (June 2012).

144. Interview with Acqui-hired Emp., NASDAQ 100 Co. II, *supra* note 61.

145. Interview with Partner, Venture Capital Fund, *supra* 40.

this loyalty, some founders may prefer acqui-hiring over a defection even though it reduces their own personal gains.[146]

3. *Social Sanctions.* A third constraint on short-term profit maximization by entrepreneurs is the threat of social sanctions.[147] Social sanctions bring about compliance with a community norm by shaming noncompliant individuals and excluding them from the social benefits of belonging to a group.[148] This particular constraint is perhaps most relevant in the context of smaller angel investors, precisely the type of investors who may find it quite difficult to impose meaningful future dealings sanctions. The academic literature suggests that angel investors tend to invest in people and businesses that are geographically proximate to their homes.[149] This makes it easier for angel investors to monitor the companies in which they invest and also to impose social sanctions on those entrepreneurs who they view as acting opportunistically.

One angel investor, for example, told us that he invests with people only if he knows where they live. If a startup fails notwithstanding the entrepreneur's best efforts, then there will be no hard feelings.[150] If, however, the startup fails because the entrepreneur shirked or because he defected to a large technology company with the engineering team without making any effort to ensure that the investor is "taken care of," then social sanctions could be imposed. Although the social sanctions that could be levied in a relatively large community such as Silicon Valley pale in comparison to those that can be leveled by more homogenous and close-knit communities, there is little doubt that the threat of social sanctions may, in some cases, encourage entrepreneurs to pursue an acqui-hire over a defection.[151]

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146. Interview with Acqui-hired Emp., NASDAQ 100 Co. II, *supra* note 61.

147. Gilson et al., *supra* note 121, at 1393–94.

148. *Id.* at 1393–94; *see also* Bernstein, *supra* note 118, at 1749 ("[A] transactor's . . . position in the community[] and his social connections were intertwined with his business reputation, making breach of contract something that would hurt not only his business prospects but also his standing in his social community.").

149. Wong, *supra* note 14, at 75.

150. *See* Bahrami & Evans, *supra* note 33, at 177 ("In Silicon Valley there is no stigma attached to honest failure, although there is for resting on one's laurels or not playing the game.").

151. Interview with Attorney, AmLaw 100 Law Firm V, *supra* note 66; *see also* John Seely-Brown, *Foreward* to UNDERSTANDING SILICON VALLEY, *supra* note 33, at xii ("Even at a more informal level, however—at parties, at restaurants, at sports events, at your kid's school—you

B. *Optics and Reputational Benefits*

In addition to enabling entrepreneurs to avoid reputational harm, the sale of a company pursuant to an acqui-hire may also play a role in improving the reputation of those entrepreneurs in Silicon Valley. There is undoubtedly a cultural cachet that comes with selling one's startup to a leading company, particularly in Silicon Valley.[152] In fact, one lawyer suggested that the social status that entrepreneurs derive from being able to claim that they sold their company could be the primary factor behind the acqui-hiring phenomenon.[153]

Certainly an acqui-hire is a more positive story than the one that would accompany a defection. As one investor put it, "[I]t's a lot cooler to say you 'sold' your company even if everyone [that is, all the investors] lost money than to say your company was an utter failure and you put it into liquidation proceedings and grabbed a nice offer from Google."[154] Or as another interviewee explained, "The talent wants the mystique of having been bought out."[155] Or as still another interviewee observed:

> [S]ome of these 'acqui-hires' are cosmetic things. It's not really much of an acquisition at all but just an assuming of employees with some modest signing bonuses and retention payments. Then you add all of this stuff up and send out a press release that says you were acquired for $8 million when in reality that's the value of the stock those employees would have gotten anyway for joining.[156]

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discover whom you need to meet [in Silicon Valley], who is worth working with, whom you should avoid, etc."); *cf.* Bernstein, *supra* note 118, at 1749 ("Deeply rooted social forces, such as the culture of honor in the Old South and the close-knit nature of many small town mill communities, helped to ensure that a transactor's sense of self-esteem, his position in the community, and his social connections were intertwined with his business reputation, making breach of contract something that would hurt not only his business prospects but also his standing in his social community.").

152. Interview with Attorney, AmLaw 100 Law Firm V, *supra* note 66 ("After you tell someone that you sold your company, it is rare that you get to the next level of conversation. Nobody ever asks how much you sold it for or whether you screwed your investors.").

153. Interview with Attorney, AmLaw 100 Law Firm II, *supra* note 44. Indeed, sometimes people stretch the definition of acqui-hire to the point that it is used to cover even transactions in which no acquisition of the corporate entity or the assets thereof actually occurs. *See supra* note 51 and accompanying text.

154. Interview with Partner, Venture Capital Fund, *supra* note 40.

155. Interview with Recruiter, NASDAQ 100 Co., *supra* note 40.

156. Interview with Partner, Venture Capital Fund, *supra* note 40; *see also* Paul Graham, *Hiring Is Obsolete*, PAULGRAHAM.COM (May 2005), http://www.paulgraham.com/hiring.html ("Often big companies buy startups before they're profitable. . . . What they want is the

The optics can also affect the ability of the entrepreneur to receive financing for a future project.[157] "You're more likely to be backed the next time you have a startup if you have an 'exit' under your belt," one interviewee explained.[158] "Most good investors can tell the difference [between a bona fide acquisition and a mere acqui-hire] but many don't bother to do the research—especially at the angel-investor stage."[159]

The optics of an acqui-hire can also be beneficial to investors, albeit to a lesser extent. Individuals and firms who invest in early-stage companies expect the overwhelming majority of these companies ultimately to fail. They continue to make investments, however, in the hopes of hitting a few "home runs," which can return as much as thirty times their initial investment or more.[160] Against this backdrop, these investors tend to view companies that are acqui-hired as not meaningfully different from those companies that fail. When the measure of success is a thirtyfold return, then the difference between a portfolio company that is a complete loss and one that "goes sideways" is immaterial. Nevertheless, there are some nonfinancial benefits that flow to investors as a result of acqui-hires.[161] From the perspective of an angel investor or a VC trying to convince an entrepreneur to partner with him over other investors, or of a VC

development team and the software they've built so far. When a startup gets bought for 2 or 3 million six months in, it's really more of a hiring bonus than an acquisition.").

157. The optical benefits from acqui-hiring may diminish over time as the phenomenon receives greater attention and scrutiny. If acqui-hires become known as simply dressed-up defections, rather than real "exits," the cultural cachet of doing an acqui-hire will likely diminish. In fact, the popular press now sometimes explicitly distinguishes between acqui-hires and real acquisitions in reporting on Silicon Valley merger-and-acquisition activity. *See, e.g.*, Laurie Segall, *Facebook Acquires Facial Recognition Startup Face.com*, CNNMONEY (June 18, 2012, 1:55 PM), http://money.cnn.com/2012/06/18/technology/startups/facebook-acquires-face/index.htm (noting, in reporting that Facebook acquired Face.com, that "Facebook is famous for doing 'acqui-hires,' scooping up talented staff and then shutting down their services, but a source close to Facebook emphasized that Face.com's technology will remain intact").

158. Interview with Partner, Venture Capital Fund, *supra* note 40.

159. *Id.*

160. *See* EWING MARION KAUFFMAN FOUNDATION, VALUING PRE-REVENUE COMPANIES 19 (2007), *available at* http://www.angelcapitalassociation.org/data/Documents/Resources/AngelCapitalEducation/ACEF_-_Valuing_Pre-revenue_Companies.pdf (noting a target return on investment for angels of 30 percent); Paul Graham, *Black Swan Farming*, PAULGRAHAM.COM (Sept. 2012), http://www.paulgraham.com/swan.html ("[I]n purely financial terms, there is probably at most one company in each YC batch that will have a significant effect on our returns, and the rest are just a cost of doing business.").

161. Interview with Attorney, AmLaw 100 Law Firm II, *supra* note 44; Interview with Attorneys, Silicon Valley Law Firm I, *supra* note 38.

raising capital for a new fund, it is better to be able to say that a portfolio company was acquired by Google than to say that it failed, even if the economics between the two outcomes are not materially different. As one interviewee explained, "[T]he exit is worth something. Particularly for [venture-capital] funds in progress, the scorecard may ignore the money and say that four [portfolio companies] are dead, three are exited . . . , and seven are alive. The exits matter."[162]

Because investors would always prefer an acqui-hire (in which they receive at least some of the buyer's payments) over a defection (in which they receive nothing), the investors' preference for the optics of acqui-hires is not directly relevant to the puzzle we are exploring. Recall, however, that reputational concerns can cause entrepreneurs to prefer acqui-hires at the margin. Because investors place some value on the optics of acqui-hires, the amount that must be paid to investors to keep them from squawking is reduced. In some cases, the optics premium that investors receive might bridge the gap between the amount that the entrepreneurs are willing to deflect to investors and the amount that investors would view as minimally acceptable.

C. *The Buyer's Perspective*

The foregoing discussion focused on the entrepreneurs' preferences for acqui-hires over defections. The question arises, however, whether buyers have the same preference or whether they are indifferent between the two methods of acquiring talent. On this question, our interviewees expressed contrasting views.

One stated, for example, that buyers did strive to maintain good relations with prominent angel investors and VCs and would, therefore, prefer an acqui-hire transaction structure.[163] Another indicated that buyers might prefer acqui-hiring so as to "preserve the start-up ecosystem [in Silicon Valley]."[164] One interviewee suggested that individuals working in buyers' corporate-development groups often aspire to eventually work for VCs.[165] These buyer

162. Interview with Attorney, Silicon Valley Law Firm III, *supra* note 40.

163. Interview with Acqui-hired Emp., NASDAQ 100 Co. I, *supra* note 38.

164. Interview with Attorney, Silicon Valley Law Firm II, *supra* note 38. Acqui-hiring would preserve the start-up ecosystem by paying investors for failed or failing startups, which effectively subsidizes venture-capital investment.

165. Interview with Former Corp. Dev. Officer, NASDAQ 100 Co., *supra* note 44.

representatives would therefore tend to promote transaction structures—such as acqui-hires—that would keep them in the good graces of those firms; on this account, acqui-hiring is the product of an agency problem between the buyer and its agents.[166] However, all of our interviewees agreed that whatever buyer reputational concerns exist, they pale in comparison to the reputational concerns of the entrepreneurs.

Other interviewees were skeptical that buyers or their representatives might be at all concerned about their reputation in the VC community, emphasizing that the buyers have billions of dollars of purchasing power, which allows them not to worry much about their reputations among start-up investors. One interviewee familiar with the workings of the corporate-development group at a leading technology company demurred when asked about whether buyers are concerned about their reputation among start-up investors, stating simply that "[a]t the end of the day the job is to figure out the right value for everything" and that there are "[v]ery few deals where everyone is happy."[167] This individual suggested that large technology companies are far more concerned about getting the best value for their money than about their reputation among VCs.[168]

There are, however, two factors unrelated to reputation that may encourage a buyer to engage in acqui-hiring.[169] First, the acqui-hire structure allows buyers to differentiate the pay packages of similarly situated engineers.[170] When new engineers are simply hired, any such differentiation would have to be made within the engineer's compensation package, which could disrupt the buyer's existing salary structure, leading potentially to resentment among existing employees. In an acqui-hire, differentiation could be accomplished via the deal consideration and, therefore, would not (at least superficially) disrupt the salary structure. Acqui-hiring, therefore, allows buyers to provide a de facto signing bonus to desired engineers.

Second, we were told that it is not uncommon for buyers to require acqui-hired engineers to sign a covenant not to compete. One

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166. *Id.*

167. Interview with Corp. Dev. Officer., NASDAQ 100 Co., *supra* note 143.

168. *Id.*

169. Our interviewees emphasized that these two factors, though supporting acqui-hiring at the margin, were much less important than the reputational factors discussed above.

170. Interview with Acqui-hired Emp., NASDAQ 100 Co. I, *supra* note 38.

leading acqui-hirer, for example, routinely requires acqui-hired employees to promise not to compete for one to two years after their departure.[171] Although covenants not to compete are generally unenforceable in California, these covenants may be enforced when they are executed in connection with the sale of a business.[172] An acqui-hire is a sale of a business and, therefore, it would trigger an enforceable covenant not to compete.[173] One additional virtue of an acqui-hire from the perspective of the buyer, therefore, is that it allows for these enforceable covenants, which would not be possible if the engineer had simply been poached.

D. The Unique Culture of Silicon Valley and Its Legal Community

In addition to the various considerations discussed above, the prevalence of acqui-hiring may also be attributable to cultural norms that are unique to Silicon Valley. The culture of Silicon Valley has been described as one that generally "depicts venture capital transactions as being natural and desirable rather than as being 'evil' . . . and oppositional."[174] In such a culture, one would expect transaction structures that promote cooperation between investors and entrepreneurs to evolve as a means of discouraging "an

171. Interview with Former Corp. Dev. Officer, NASDAQ 100 Co., *supra* note 44.

172. See *supra* note 81 and accompanying text.

173. This assertion is consistent with our earlier analysis discounting the importance of covenants not to compete. In that analysis, we considered whether the existence of a covenant not to compete between the *startup* and the engineer could be a factor driving the use of the acqui-hire transaction structure. *See supra* notes 80–83 and accompanying text. We argue here that the ability of a *buyer* to require a talented engineer to execute a covenant not to compete in connection with an acqui-hire may play a minor role in encouraging buyers to utilize this particular transaction structure.

174. Mark 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, 700 (1996); *see also id.* (quoting a Silicon Valley attorney as stating that venture financing "is not an adversarial process" and that "[p]eople who view it properly . . . realize that they are creating a very long-term partnership between the venture capitalists on the one hand and the entrepreneurs on the other"); *cf.* Craig W. Johnson, *Advising the New Economy: The Role of Lawyers*, *in* THE SILICON VALLEY EDGE: A HABITAT FOR INNOVATION AND ENTREPRENEURSHIP 325, 334 (Chong-Moon Lee et al. eds., 2000) ("[I]n environments like Silicon Valley . . . lawyers are prized for their 'win/win' attitude and an ability to keep everyone focused on common goals and make things happen smoothly. Contentiousness, formality, an emphasis on status, and unpleasantness are all qualities that will drive clients away."); Suchman, *supra* note 105, at 87 (quoting a California attorney as stating that "I felt like our office in Newport Beach had a sort of missionary mode—to at least encourage the entrepreneurs to consider that venture capital could be an alternative, because some of the other options are really awful").

antagonistic style where you fight for every nickel on the table."[175] The acqui-hire, on this account, serves to reinforce prevailing community norms by making it possible for the investors to receive some return on their investment even if the startup's founders choose to leave and accept lucrative employment at large technology companies.

How are these nonadversarial norms maintained and transmitted to new arrivals in the community?[176] A study by Professor Mark Suchman and Mia Cahill argues that this task is achieved in significant part through the efforts of Silicon Valley lawyers.[177] In their words:

> Silicon Valley lawyers work to "civilize" their clienteles, indoctrinating new entrants into the routines and vocabularies of the local business community. In a setting where the rapid influx of companies and technologies threatens to undermine social coherence, law firms help to define and communicate the socially constructed boundaries of "reasonable" behavior.... *[S]uch ministrations increase the likelihood that financial transactions will reflect the cultural norms of the community rather than the individual interests of the client.*[178]

Specifically, Suchman and Cahill argue that Silicon Valley attorneys further nonadversarial community norms by assessing the litigiousness of their clients before agreeing to make introductions to investors they know,[179] advising their clients as to whether certain deal

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175. Suchman & Cahill, *supra* note 174, at 700 (quoting a Silicon Valley lawyer).

176. For a discussion of the ways in which norms are transmitted, see John McMillan & Christopher Woodruff, *Private Order Under Dysfunctional Public Order*, 98 MICH. L. REV. 2421, 2432–35 (2000).

177. Suchman & Cahill, *supra* note 174, at 699–702; *see also* Broughman, *supra* note 103, at 353 ("[E]ven though entrepreneurs may not be repeat players, they are typically represented by repeat player law firms that are actively engaged in VC. Such law firms may bolster the effectiveness of entrepreneurial business norms."); Smith, *supra* note 100, at 154 n.82 ("It is far from obvious that the reputational constraints on venture capitalists and entrepreneurs are much greater than other potential litigants in American society. Perhaps the relatively modest appeal to litigation results from the moderating role of venture capital lawyers.").

178. Suchman & Cahill, *supra* note 174, at 701 (emphasis added). Suchman and Cahill acknowledge that attorneys who adopt this ethos "tread[] near the boundaries of conventional legal ethics" and yet argue that "such social regulation may be the price for a viable market." *Id.*

179. *Id.* at 698–99. As one lawyer who represents entrepreneurs told Suchman and Cahill,

> [I]f a client comes in, we want to know whether they're litigious. Frequently, the lawyer carries the ball for the client, in terms of opening up connections and introducing the client to the business world. We want to make sure that we're not making an introduction that will ultimately backfire on us.

Id. at 699.

terms and valuations are reasonable,[180] and encouraging the use of certain types of transaction structures.[181] In sum, Suchman and Cahill argue that Silicon Valley lawyers are "key players in an informal apparatus of socialization, coordination, and normalization that serves to avert potential disputes between members of the local business community."[182]

Although Suchman and Cahill conducted their interviews and published their study well before the recent wave of acqui-hires began, their claim that Silicon Valley lawyers encourage the use of transaction structures that reflect the nonadversarial norms of the local community helps to explain the widespread use of the acqui-hire, a transaction structure whose primary purpose appears to be to preserve good relations between investors and entrepreneurs. Although none of our interviewees specifically endorsed the sociological account offered by Suchman and Cahill, several of the interviewed lawyers referenced the unique "culture" of Silicon Valley as an important factor in promoting the use of the acqui-hire.[183] If Suchman and Cahill are correct that community norms support a nonadversarial approach toward venture finance, then the widespread use of the acqui-hire may also be attributable, at least in part, to these norms.

* * *

The norms-based account outlined above, we believe, goes a long way toward explaining the acqui-hiring puzzle. The threat of various nonlegal sanctions serves to deter opportunistic defection on the part of the entrepreneurs. At the same time, these entrepreneurs derive social status when they sell a company, which encourages the use of the acqui-hire transaction structure. These entrepreneurs are, finally, steeped in a culture that promotes cooperative, rather than adversarial, relationships with investors. These various effects, significantly, operate outside the formal legal system, which means

180. *Id.* at 700–01.

181. *Id.* at 699–700; *cf. id.* at 701 ("More generally, Silicon Valley lawyers facilitate smoothly functioning capital markets by socializing entrepreneurs in the conventions of the local investor community . . . .").

182. *Id.* at 683.

183. *E.g.*, Interview with Attorney, AmLaw 100 Law Firm V, *supra* note 66; Interview with Attorneys, Silicon Valley Law Firm I, *supra* note 38.

that the story of acqui-hiring is, at least in part, a story about the triumph of social norms over legal rules.

To fully explain the acqui-hiring phenomenon, however, we believe it is necessary to supplement this norms-based account with two additional points. First, we draw upon prospect theory to suggest that the formal structure of acqui-hiring—which diverts funds from the engineers before they receive those funds—may reduce the *perceived* cost of acqui-hiring. Second, we argue that tax considerations often reduce the *actual* cost of engaging in an acqui-hire because they convert ordinary income into capital gains. Although neither of these two factors, standing alone, is likely to lead engineers to prefer an acqui-hire to a defection, each functions to make the acqui-hire more palatable to engineers weighing the costs and benefits of engaging in an acqui-hire.

E. Prospect Theory

In a defection, all of the buyer's purchase price goes to the engineers in the form of salary, bonuses, restricted stock, and other compensation. By contrast, in an acqui-hire, a portion of this purchase price paid by the buyer for the engineers' services is effectively diverted from the engineers to the investors and other shareholder employees.[184] The diverted portion of the buyer's purchase price is not, however, first received by the engineers and then paid over by them.[185] Instead, the diverted portion goes straight from the buyer to the investors and other shareholders.

Because the diverted portion of the purchase price is never actually received by the engineers, the engineers are unlikely to mentally code that consideration as ever having "belonged" to them. Therefore, they will not perceive those funds as having been lost. Prospect theory, a behavioral-economic theory first developed by Nobel Prize winners Daniel Kahneman and Amos Tversky,[186] suggests that, for most people, "[f]oregone gains are less painful than perceived losses."[187] Engineers will thus tend to undervalue the costs

184. *See supra* Part I.C.

185. *See supra* Part I.C.

186. Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263 (1979); *see* DANIEL KAHNEMAN, THINKING, FAST AND SLOW 278–88 (2011) (discussing prospect theory).

187. Daniel Kahneman, Jack L. Knetsch & Richard H. Thaler, *Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias*, J. ECON. PERSP., Winter 1991, at 193, 203; *see also* Lee Anne Fennell, *Death, Taxes, and Cognition*, 81 N.C. L. REV. 567, 643 (2003) ("Because

that they incur from acqui-hiring, as compared to an equivalent transaction in which they first received the buyer's entire purchase price and then paid investors and other shareholders out of their own pockets. Thus, the cognitive biases underlying prospect theory promote acqui-hiring.

It is at least theoretically possible that engineers could be able to mentally reframe a proposed acqui-hiring transaction to better appreciate the associated cost. Legal counsel might, for example, help to focus engineers on the fact that foregoing compensation in an acqui-hire is economically the same as receiving compensation and then paying it over.[188] Yet, the engineers in an acqui-hire are often not independently represented by counsel.[189] Particularly in smaller deals, the engineers tend to rely instead on the startup's company counsel to represent their personal interests in the acqui-hire negotiations.[190] Company counsel would not, however, usually be helpful to the engineers in assessing the true cost of acqui-hiring because the counsel's client is the start-up company itself, and the startup would always prefer an acqui-hire to a defection. A lawyer tasked solely with representing the engineers, by contrast, would be under no obligation to be loyal to the startup and would, presumably, encourage the entrepreneurs to at least consider the possibility of a defection. Because of the absence of such an independent lawyer in many acqui-hire transactions, the engineers might not be fully aware of the defection alternative to the acqui-hire, although one suspects that representatives of the buyer might sometimes take it upon themselves to raise this possibility. Nevertheless, even if the engineers are aware of the defection alternative, the lack of independent counsel could make it more difficult for the engineers to mentally reframe an acqui-hire transaction to overcome cognitive bias.

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people tend to find a loss more painful than a failure to secure an equivalent gain, a frame that presents the tax as reducing a gain rather than generating a loss might be expected to make the tax more palatable." (citation omitted)).

188. *Cf.* Jonathan R. Macey, *Packaged Preferences and the Institutional Transformation of Interests*, 61 U. CHI. L. REV. 1443, 1443 (1994) (suggesting that institutional agents can help the principal overcome cognitive biases); Jeffrey J. Rachlinski, *Gains, Losses, and the Psychology of Litigation*, 70 S. CAL. L. REV. 113, 171–73 (1996) (explaining that litigators can help their clients overcome cognitive biases by reframing settlement offers that have been offered to them).

189. Interview with Attorney, AmLaw 100 Law Firm I, *supra* note 38. Although company counsel typically recommends that the entrepreneurs obtain their own counsel, this recommendation is frequently not followed in smaller deals. *Id.*

190. *Id.*

F. Tax Considerations

Although prospect theory suggests that the engineer's perceived cost of acqui-hiring will often be lower than the actual cost, tax considerations may serve to reduce the actual cost.[191] In a defection, all of the consideration received by a Silicon Valley engineer via signing bonuses or participation in a buyer's equity-compensation plan is generally taxed as compensation income, which has in recent history generally been subject to a combined federal and Californian maximum effective marginal tax rate of approximately 46 percent.[192] On the other hand, in an acqui-hire, the portion of the deal consideration that ultimately flows to the engineer (that is, as payment for her stock in the startup) is characterized as capital gains, which has in recent history been subject to a combined federal and state effective rate of approximately 23 percent.[193] Thus, by engaging in an acqui-hire and by shifting part of the buyer's purchase price to the deal-consideration pool, the engineer cuts her tax rate approximately in half on the amounts that come back to her as payment for her equity interest in the startup.[194]

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191. Several acqui-hire participants confirmed that tax considerations played a role, but only after we brought up the subject of taxes. Interview with Attorney, AmLaw 100 Law Firm II, *supra* note 44; Interview with Attorneys, Silicon Valley Law Firm I, *supra* note 38. Only one participant spontaneously mentioned tax considerations as a significant factor that promotes acqui-hiring. Interview with Attorney, Silicon Valley Law Firm II, *supra* note 38.

192. *See* Gerald Prante & Austin John, Top Marginal Effective Rates by State and by Source of Income, 2012 Tax Law vs. 2013 Tax Law (as Enacted in ATRA), at 10 tbl.3 (Feb. 3, 2012) (unpublished manuscript), *available at* http://ssrn.com/abstract=2176526 (calculating the maximum effective marginal tax rate on wages earned by California residents to be 45.9 percent in 2012). In 2013, this rate went up to 51.9 percent due to legislative tax rate increases at both the federal and state level. *See id.* at 3 (explaining that the increase from 2012 to 2013 is attributable to the new federal top rate of 39.6 percent and the new California top rate of 13.3 percent).

The discussion in the text uses the tax rates that applied before 2013 because that is the period when acqui-hiring first became prominent. Nevertheless, the tax changes that became effective in 2013, *see* American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, 126 Stat. 2313, Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 9015, 124 Stat. 119, 870 (2010), continue to provide a significant differential between the tax rates that apply to compensation income and those that apply to capital gains, so the overall conclusion that tax considerations promote acqui-hiring is not affected, though the precise mathematical calculations would be different in 2013. *See* Prante & John, *supra*, 5–6 & tbl.1 (calculating a 2013 top rate of 51.9 percent on wages and 33.0 percent on capital gains for California residents).

193. *See* Prante & John, *supra* note 192, at 6 tbl. 1 (calculating maximum effective marginal tax rate on capital gains earned by California residents to be 23.6 percent in 2012). In 2013, this rate went up to 33.0 percent due to legislated tax rate increases. *See id.*

194. *Cf.* Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 3–4, 14 (2008) (explaining how private-equity fund managers

For example, assume that an engineer could receive $1,000,000 of compensation income by engaging in a defection. Alternatively, the engineer could participate in an acqui-hire, in which case $300,000 of the buyer's price that would have gone directly to her is shifted to the deal consideration. Assume further that the engineer, in her capacity as a shareholder of the startup, has a $100,000 share of the $300,000 of deal consideration.

Under these facts, and assuming a 46 percent tax rate on compensation and a 23 percent rate on capital gains, a defection would net the engineer approximately $540,000 after taxes.[195] In the acqui-hire, the engineer would receive a net amount of $455,000.[196] Thus, even though the engineer's pre-tax cost from engaging in the acqui-hire was $200,000,[197] the after-tax cost was only $85,000.[198] The discrepancy is due to the fact that the $200,000 that she left on the table would have been taxed at 46 percent, leaving her with only $110,000 after tax. She also shifted the character of $100,000 of her proceeds from compensation to capital gains, which saved her $23,000 in taxes.[199]

In this example, the tax benefit reduces the after-tax cost to the engineer of engaging in the acqui-hire.[200] In other cases, it is possible

likewise cut their effective tax rates on compensation approximately in half by receiving their incentive compensation as a share of the fund's profits). As noted above, in 2013 the top effective rates increased to 51.9 percent (from 45.9 percent) and 33.0 percent (from 23.6 percent) on compensation and capital gains, respectively. *See supra* note 192–193. While both rates increased, the capital gains rate increased to a greater extent (both nominally and on a percentage basis), which means that the conversion of compensation into capital gains would cut the tax rate by approximately one-third (from 51.9 percent to 33.0 percent) instead of approximately one-half (from 45.9 percent to 23.6 percent).

195. $1,000,000 of compensation less 46 percent of $1,000,000 is $540,000.

196. $700,000 of compensation less 46 percent of $700,000, and $100,000 of capital gains less 23 percent of $100,000, equals $455,000.

197. Pre-tax, the engineer received $1,000,000 from the defection and $800,000—that is, $700,000 as compensation and $100,000 as payment for her shares—from the acqui-hire.

198. Her net after-tax recovery from the defection was $540,000, whereas it was $455,000 from the acqui-hire.

199. At the assumed tax rates, $100,000 of compensation would result in $46,000 in tax liability, whereas $100,000 in capital gains would result in $23,000 in tax liability. It is worth noting that to calculate the net after-tax cost of an acqui-hire, the acqui-hire would have to be compared to a defection and that this comparison would involve a reframing of the transaction that might solve the cognitive-bias problem identified in the previous section. Thus, the engineers who are most afflicted by cognitive bias are not likely to be motivated by tax considerations and vice versa.

200. In addition to reducing the after-tax cost to the engineers, it might appear that tax considerations promote acqui-hiring by allowing the buyer to inherit the benefits of the start-up company's net operating losses (NOLs). However, preservation of these NOLs is unlikely to be

that the acqui-hire could actually result in an after-tax gain to the engineer. If the engineer in the example received back $250,000 of her compensation deflected to the deal consideration, rather than $100,000, then she would end up with after-tax gain of approximately $30,000.[201] Whether the engineer ends up with an after-tax gain or loss depends on how much of the deflected compensation gets returned to her as payment for her equity interest in the startup, which depends on the investor's preference rights and the engineer's percentage common-stock interest.

In any event, at a minimum, tax considerations often reduce the actual cost of engaging in an acqui-hire, although they do not affect the reputational benefits of doing so. Tax considerations, therefore, promote acqui-hiring, subject only to some technical caveats set forth in the Appendix.

IV. ALLOCATION AND INNOVATION

In the previous Parts, we identified the existential puzzle presented by the acqui-hiring phenomenon and provided our theory of acqui-hiring as the solution. In this Part, we address the most significant economic issue in acqui-hiring transactions: how the aggregate purchase price paid by the buyer is allocated between the deal-consideration and the compensation pool. This issue is important because it determines how much of the buyer's purchase price is ultimately received by the engineers and how much is received by the investors and other employees of the startup.

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a significant factor in structuring acqui-hiring transactions. First, the startup's NOLs will be inherited by the buyer only if the acqui-hire is structured as a stock deal or as a tax-free reorganization, *see* BORRIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL INCOME TAXATION OF INCOME, ESTATES AND GIFTS ¶ 95.3 (3d ed. 2003), and acqui-hires are typically not structured in those ways, *see* Interview with Attorney, AmLaw 100 Law Firm I, *supra* note 38. Second, even if structured as a stock deal or a tax-free reorganization, the start-up company will have undergone an ownership change, which triggers substantial limitations on the ability of the buyer to utilize these NOLs going forward. *See* I.R.C. § 382 (2006 & Supp. V 2011) (limiting the annual use of inherited NOLs following an ownership change of the acquired corporation to the product of the acquired corporation's value on the date of the ownership change and the long-term tax-exempt rate). These limitations were designed precisely to ensure that acquisitive transactions do not occur merely for the purpose of utilizing the target's NOLs. *See* BITTKER & LOKKEN, *supra* ¶ 95.5.1 ("Congress sought a limitation that would make NOL carryovers a relatively neutral factor in acquisitions.").

201. In the defection scenario, she would end up with $540,000 after tax. *See supra* note 195 and accompanying text. In the acqui-hire under the revised facts, she ends up with $570,500 after tax: $700,000 compensation less 46 percent tax on the $700,000, plus $250,000 of capital gains less 23 percent tax on the $250,000, equals $570,500.

A. Allocation of Consideration

The critical economic issue in an acqui-hire is the allocation of the buyer's purchase price between the deal-consideration pool and the compensation pool. In a bona fide acquisition, the amount of deal consideration would equal the value of the startup's assets (less any liabilities assumed by the buyer). But in an acqui-hire, by definition, the assets of the startup other than the talented workforce have relatively little, if any, value to the buyer.[202] Thus, the main function of the deal consideration paid to the company is simply to pay off the investors so the entrepreneurs can obtain the reputational benefits described in Part III. Because the deal consideration mostly buys these intangible benefits instead of actual assets, pricing is a difficult exercise. Furthermore, the fact that the engineers could simply defect without risk of legal sanction makes negotiations over allocations unique.[203] After all, if the investors push too hard, the engineers could conclude that the reputational benefits from an acqui-hire are no longer worth the cost.

In essence, the question is the size of the investors' "acqui-hiring premium"—the amount that they are paid above and beyond their share of whatever valuable assets the startup owns at the time of the acqui-hire. To preserve the reputation of the engineers, and to get the cooperation necessary to achieve the desired optics of an acquisition, the investors need to get paid an acqui-hiring premium amount close to the amount to which the investors believe they are entitled. But how much of an acqui-hiring premium should investors believe they are entitled? The situation is analogous to tipping of service providers. Social norms tell us that certain service providers should be tipped—even though tippers are not legally responsible for leaving a tip—and that the amount of the tip is calculated based on what service providers expect to get tipped.[204] Absent knowledge of the "typical" tip, however, how does one know when one has been left a tip that is exceedingly generous or insultingly low or just right?

Theoretical arguments about the investor's "proper" recovery do not help resolve the issue. On the one hand, the startup has no legally

202. *See supra* Part I.C.

203. *See supra* Part II.A.

204. *See* Yoram Margalioth, *The Case Against Tipping*, 9 U. PA. J. LAB. & EMP. L. 117, 118 (2006) ("People typically tip fifteen to twenty percent of the bill (or double the sales tax plus change in places where the sales tax is around seven to eight percent), as long as the service is reasonable.").

cognizable claim to the future at-will employment of the engineers, and therefore the investors are entitled to little or no acqui-hiring premium. On the other hand, without the investors' cash investment, the team of engineers would not have been built and that team would not have had the opportunity to showcase their abilities to the buyer. Under this view, the investors should receive a not-insignificant acqui-hiring premium. Both sides have good fairness arguments, and there is no real guidance about how to resolve the conflict.

Two problems stem from the current state of ambiguity. First, it would seem to make negotiations over allocations unduly expensive and time consuming. Second, by increasing the variance of possible outcomes, the ambiguity exposes the parties to additional, unwanted risk. One possible response to these inefficiencies would be the development of a rule of thumb, like the 15- to 20-percent norm for tipping in restaurants.[205] If a standard norm were to develop in the acqui-hiring context, the buyer and the engineers would have a much better sense for how much of an acqui-hiring premium that they would need to pay to the investors, thereby reducing their negotiating costs and risk.[206] Because of the increased efficiency, we predict that such a norm will eventually develop in acqui-hiring.

Nevertheless, a rule of thumb does not appear to exist currently, or if it does exist, it is not yet very salient. Acqui-hiring participants with whom we spoke were emphatic that the negotiating dynamics of acqui-hire transactions were impossible to generalize and that pricing was always determined on a case-by-case basis.[207] When we specifically asked about a rule of thumb, they universally denied that one existed.

Although participants initially declined to make generalizations about pricing, when pushed a number agreed that in several acqui-hires they had seen, the investors expected to get back their investment.[208] This evidence suggests that a norm of investors getting their money back in acqui-hires might eventually develop. Under this norm, the allocation between the deal-consideration and the compensation pool would be reverse engineered to ensure that the

205. *Id.*

206. *See generally* William J. Baumol & Richard E. Quandt, *Rules of Thumb and Optimally Imperfect Decisions*, 54 AM. ECON. REV. 23 (1964) (discussing the efficiency of rules of thumb and the design of effective rules of thumb in the pricing context).

207. *E.g.*, Interview with Attorney, AmLaw 100 Law Firm II, *supra* note 44.

208. *Id.*; Interview with Attorney, Silicon Valley Law Firm II, *supra* note 38.

investors got roughly their money back. An alternative would be for a norm to develop regarding the percentage of the buyer's overall purchase price that should be allocated to the deal-consideration pool. For example, the norm could be that 20 percent of the buyer's aggregate purchase price should be allocated to the deal-consideration pool.

We believe that, should a rule of thumb develop, it will be the money-back-for-the-investors norm, for four reasons. First, in our discussions with acqui-hire participants, it seemed natural for them to use the amount of the investor's investment as the key point of reference. Conversely, interviewees rarely talked about the relative consideration between the two pools, and usually only after being specifically prompted to discuss that ratio. Several interviewees mentioned, for example, that they had firsthand knowledge of a deal in which the investor "got his money back" or "got a substantial fraction of his money back" or "negotiated to get back double his initial investment."[209] However, interviewees did not refer to percentages of total consideration. This suggests that acqui-hire participants tend to think of the investor's "rightful" share of acqui-hiring proceeds by reference to the amount of the investor's investment.

Second, there would be significant practical problems in implementing a percentage-allocation norm. Because the startup and its investors do not participate in the compensation pool, they are not necessarily privy to the amount in this pool and its particulars.[210] Our interviewees disagreed about whether investors typically knew the terms of the compensation pool.[211] But even if some investors are aware of the size of the compensation pool, valuation of that pool for purposes of making a percentage allocation would be difficult.[212] As

209. *See supra* note 208.

210. However, they do participate in the deal-consideration pool. In an asset deal, the startup receives the deal consideration, which is subsequently distributed to the investors in liquidation. In a stock deal, the investors directly receive their share of the deal consideration.

211. *Compare* Interview with Acqui-hired Emp., NASDAQ 100 Co. I, *supra* note 38 (noting that investors generally know the precise terms of compensation pool), *and* Interview with Attorney, Silicon Valley Law Firm II, *supra* note 38 (noting that investors know the terms of compensation pool as a result of disclosures in the approval process), *with* Interview with Acqui-hired Emp., NASDAQ 100 Co. II, *supra* note 61 (noting that investors do not know the terms of compensation pool).

212. The deal consideration is usually fully vested, so there is no issue in valuing that pool. But, with regard to unvested property, some of the value of the property is surely attributable to the future effort of the defecting engineers that is necessary to cause the property to vest. *Cf.*

discussed above, the compensation pool consists mostly of equity compensation that vests over time.[213] A percentage-allocation norm would require discounting unvested consideration to take into account the risk of nonvesting and also the fact that the engineers effectively earn some of that consideration through their future work effort, to which the investors have no reasonable claim.[214] Furthermore, even if the valuation issue were not overly difficult, there would be nothing to stop the buyer and the engineers from supplementing the compensation pool with grants of incentive compensation that are awarded shortly after the acqui-hire deal closed.

Third, considering that one of the primary purposes of the deal consideration is to "do right" by the investors,[215] using the investors' initial investment as the point of reference leads to more rational and predictable results. If a percentage-allocation rule were used, the amount that the investor ultimately recovers would depend on matters like liquidation preferences and percentage stock ownership, which can vary substantially from deal to deal. Yet the vast majority of acqui-hires involve the same basic fact pattern: the startup was not successful, though a promising team of engineers was assembled.[216] If a percentage-allocation rule were used, investors in different acqui-hires could receive drastically different returns on investment, even though all of their investments suffered the same fate.

Finally, behavioral-economic research indicates that people tend to have a particularly intense focus on the amount of their sunk-cost investments in making financial decisions, even if the sunk costs are not at all relevant to the decision at hand.[217] In other words, people will make efforts to avoid "booking" a loss. Thus, for example, in evaluating the price at which they would be willing to sell their homes, people appear to place a significant amount of weight on how

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Interview with Attorney, AmLaw 100 Law Firm V, *supra* note 66. That value is effectively additional compensation and should not be considered part of the overall consideration that would be divided according to a rule-of-thumb percentage allocation.

213. *See supra* note 61 and accompanying text.

214. For a discussion of pro rata allocations of each type of consideration paid by the buyer, see *supra* Part I.C.

215. *See supra* note 142 and accompanying text.

216. *See supra* notes 44–48 and accompanying text.

217. *See, e.g.*, Richard Thaler, *Toward a Positive Theory of Consumer Choice*, 1 J. ECON. BEHAV. & ORG. 39, 47–50 (1980) (modeling the sunk-cost effect). *See generally* Hal R. Arkes & Catherine Blumer, *The Psychology of Sunk Cost*, 35 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 124 (1985) (discussing this effect).

much they paid for the home.[218] This phenomenon, known as the sunk-cost or break-even effect, suggests that in acqui-hiring situations, in which the "proper" allocation to the deal-consideration pool is highly uncertain, investors will tend to focus on the amount of their initial investment in evaluating the fairness of an acqui-hire deal.[219]

In summary, we predict that a money-back-for-the-investors norm will develop, which will help determine the ultimate allocation between the deal-consideration and compensation pools. Although this norm will be a starting point for negotiating the allocation, many of the factors discussed in Part III will influence the final allocation.[220] For example, all else being equal, particularly prominent VCs will likely receive greater allocations to the deal-consideration pool (because of reputational concerns), as will investors who have had more significant face-to-face contact with their entrepreneurs (because of loyalty effects).

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218. *See* Lee Anne Fennell, *Homeownership 2.0*, 102 NW. U. L. REV. 1047, 1110 n.257 (2008) ("Turning down offers below the purchase-price benchmark may be understood as risk-seeking behavior consistent with the 'trying to break even' phenomenon." (quoting Richard H. Thaler & Eric J. Johnson, *Gambling with the House Money and Trying To Break Even: The Effects of Prior Outcomes on Risky Choice*, 36 MGMT. SCI. 643, 657–58 (1990))); David Genesove & Christopher Mayer, *Loss Aversion and Seller Behavior: Evidence from the Housing Market*, 116 Q.J. ECON. 1233, 1238 (2001) (suggesting that individuals facing the prospect of selling their home for less than they paid for it chose higher asking prices and held out for longer before selling); Thaler & Johnson, *supra*, at 644 (discussing the break-even effect and suggesting that "when decision makers have prior losses, outcomes which offer the opportunity to 'break even' are especially attractive").

219. For a discussion of this phenomenon in other contexts, see *supra* note 217. It should be noted that the behavioral-economic research behind these theories involves the general population, not start-up investors. There is reason to suspect that start-up investors might not evaluate financial matters in the same way that the general population does. Start-up investors are willing to finance large numbers of failures for the chance at a home-run investment. *See supra* Part III.B.; *see also* Fred Wilson, *When Things Don't Work Out*, AVC (Mar. 28, 2013), http://www.avc.com/a_vc/2013/03/when-things-dont-work-out.html ("[E]arly stage VC is a lot like baseball, if you get a hit one out of every three times, you are headed to the hall of fame."). They therefore may not mentally frame financial matters in the same way as ordinary people, who do not make such risky investments.

220. The salience of this norm will vary depending on the amount of money invested in the startup by the investors in the first instance. If the investors have put $100,000 into the business, then a money-back norm is probably viable. If the investors have invested $10 million into the business, then it is probably not.

B. Legal Innovation To Protect Investor Interests

We previously discussed why it is difficult for investors in Silicon Valley to make credible threats to sue their entrepreneurs.[221] As a consequence, investors generally lack leverage to protect their interests in acqui-hire transactions.[222] Prominent entrepreneur and tech blogger Michael Arrington suggests that, in response to this situation, counsel for investors will develop legal innovations to address this deficiency. Specifically, he suggests that investors' counsel develop new contractual provisions that deal specifically with the prospect of a future acqui-hire.[223] In this Section, we discuss several possible innovations along these lines.[224]

First, investors could try to increase the liquidation preference they receive on their preferred stock or the liquidation premium they receive on their convertible notes. Liquidation preferences or premiums typically stipulate that upon the occurrence of a liquidity event—such as the sale or liquidation of the company—the investors will receive back their initial investment or a multiple thereof, as well as any accrued-yet-unpaid dividends or interest. In response to the acqui-hire phenomenon, investors could negotiate for a liquidation preference or premium with a higher multiple. In theory, this would increase the investor's recovery in an acqui-hire because it would increase the investor's share of the deal-consideration pool. However, a significant problem with this approach is that it does not ensure that a minimum amount of consideration will even flow into the deal-consideration pool. If there are insufficient funds to pay the investor

221. *See supra* Part II.B.

222. Interview with Corp. Dev. Officer, NASDAQ 100 Co., *supra* note 143 ("If . . . all the . . . employees want out, then the investors don't have much leverage.").

223. *See* Arrington, *supra* note 5 ("[W]hat I do believe we'll start to see are clauses being added to investment contracts that are designed to change these [acqui-hire] deals. Specifically these clauses would force all deal consideration around a deal—including stock options and stock grants to employees—to be pooled and distributed pro rata among all shareholders.").

224. The most obvious and straightforward contractual innovation that would increase the leverage of the investors in an acqui-hire transaction would be to require, as a condition to get funding, all start-up employees to sign enforceable covenants not to compete that would cover employment with the technology companies that engage in acqui-hiring. This would require the buyer and defecting engineers to negotiate with the investors for a release and would, consequently, give the investors the bargaining leverage that they currently lack. The problem, of course, is that California refuses to enforce covenants not to compete as a matter of public policy save in a few limited instances not relevant here. This innovation would therefore be ineffective in Silicon Valley.

its full preference or premium, then the investor bears the shortfall.[225] Put differently, the key economic issue in acqui-hires is not the amount of liquidation preference or premium but, rather, the allocation of the buyer's payments between the deal-consideration and the compensation pools.

In addition, an overly generous liquidation preference could actually backfire by encouraging the engineers to simply defect to the buyer in lieu of doing an acqui-hire. As discussed above, there are a number of reasons why these individuals would be reluctant to defect, including concern for their reputation, a sense of loyalty to their investors, fear of social sanctions, the positive optics of being acquired by a larger company, and tax considerations.[226] If the liquidation preference eats too much into the engineers' ultimate take-home recovery, the magnitude of these factors may be less than the marginal cost of doing an acqui-hire, which would cause the engineers to defect.[227] In that case, the investors would receive little or no recovery when the startup thereafter liquidates.

Alternatively, investment contracts could specify that all of the consideration, whether in the deal-consideration or compensation pool, go into the deal-consideration pool for distribution pursuant to the waterfall-distribution rules (for example, first to creditors, then to preferred stockholders, then to common stockholders).[228] The problem with this approach is that, as previously mentioned, the compensation pool typically consists of restricted stock and other unvested consideration that must, from the buyer's perspective, go to the engineers for incentive purposes.[229] To throw everything into the deal-consideration pool would usually result in much of this incentive compensation ending up in the investor's hands, which would make the transaction undesirable to the buyer. Furthermore, as with an

225. Another problem with this approach is that it could change the economics in transactions that are true acquisitions, not acqui-hires.

226. *See supra* Part III.

227. One interviewee told us that he had been involved in an acqui-hire transaction in which an angel investor had negotiated a fivefold liquidation preference. Interview with Corp. Dev. Officer, NASDAQ 100 Co., *supra* note 143. This preference, if honored, would have ensured that the investor received the entirety of the deal consideration. The buyer informed the investor that it would not do the deal unless he waived his preference and accepted a smaller payout. The investor eventually agreed to accept a smaller payout, in part because the startup was teetering on the brink of insolvency and there was a real prospect that he would receive nothing if the deal did not occur.

228. *Cf. supra* note 58.

229. Interview with Attorney, AmLaw 100 Law Firm I, *supra* note 38.

overly generous liquidation preference or premium, if the engineers determine that they would get too little under the waterfall after pooling all of the buyer's consideration together, they could simply defect, leaving the investor with little or nothing.

The most promising potential innovation would be for investment contracts to specify, instead, that a minimum percentage amount of the buyer's aggregate payments be allocated to the deal-consideration pool. For example, 30 percent of the buyer's total consideration would have to be allocated to the deal-consideration pool. Although more promising than the innovations previously discussed, this approach also has its problems.

First, there is the issue of valuation. The compensation pool paid by the buyer will typically not be paid out all at once but, rather, will consist of restricted stock and other inducements that vest over time and, in some cases, are performance based.[230] It will therefore be difficult to determine the present value of the aggregate consideration paid by the buyer, which is a necessary first step in determining what percentage of this consideration must be allocated to the deal-consideration pool. One way to solve this valuation problem would be to make the allocations to each pool consist of pro rata portions of each type of consideration. So, if the required allocation is 30/70, then 30 percent of the restricted stock and other incentive compensation would go into the deal consideration, as would 30 percent of any cash or unrestricted stock paid by the buyer. But this is deeply problematic from the perspective of the buyer, who wants the incentive compensation to go to its newly hired engineers to get the desired incentive effects. Furthermore, the investors would generally prefer not to have their economic fortunes depend on whether their former employees continued their employment with the buyer for the full three or four years or whether they went on to hit their performance incentives.[231]

Closely related to the valuation problem is the fact that, when equity compensation vests over time, part of the economic value going to the recipient engineer is attributable to her work effort after the acqui-hire closes. In that sense, restricted stock is akin to future salary. Presumably, in valuing unvested compensation for purposes of making the minimum allocation to the deal consideration, the

230. *Id.*

231. Interview with Attorney, Silicon Valley Law Firm II, *supra* note 38.

compensation must be discounted to reflect the fact that future work effort by the engineers will be necessary to receive it.

Another problem with this approach is that there are relatively easy ways for the buyer and the engineers to circumvent it. Although unvested compensation will presumably be included in the calculation of the buyer's aggregate consideration, future salary earned by the engineers presumably will not. Buyers and engineers could therefore swap unvested equity compensation for greater salary and thereby reduce the investor's recovery. Even though this strategy would not be optimal for the buyer and the engineers—who, all else being equal, would have structured for unvested equity compensation rather than salary—the benefit of cutting the investors out may be enough to justify the cost. Similarly, new incentive packages granted by the buyer after the acqui-hire would presumably not be included in the total consideration paid by the buyer, though there would probably be a representation at closing that there are no side deals. Buyers and the engineers could have an informal understanding, one that is not legally enforceable, that the buyers will review the engineers' incentive packages six months after closing to determine whether they are properly incentivized. Though not ideal from the engineers' perspective, due to the added uncertainty, the benefit of not having to share the newly granted incentive compensation might be worth the risk.[232]

Finally, as with the other potential innovations, if the engineers determine that the investors' share is too large, they could simply defect. A minimum-percentage-allocation rule could try to cover defections, though it would not be easy to distinguish between defections that are in lieu of acqui-hires (which would trigger the rule) and garden variety departures (which would not). But even if a defection were covered, to make a recovery investors would ultimately have to, at a minimum, credibly threaten that they would enforce their contractual rights in court. Given the received wisdom

232. Another problem with this approach is the definitional issue of whether a defection would trigger the minimum-percentage-allocation rule. If the transaction is structured as an acqui-hire, then it is clear that the rule would apply. But what if there is simply a defection? In that case, there is formally no deal-consideration pool. If defections did not trigger the minimum-percentage-allocation rule, then that would again create an incentive at the margin to defect rather than do an acqui-hire. And if certain defections did trigger the rule, then the contractual provision would have to distinguish between the ones that do and the ones that do not. If the entire group of founders and engineers left in one fell swoop, that would be an easy case. But what if only one of the founders and three engineers left?

in Silicon Valley that investors never sue their founders, and the dearth of any such litigation, it is likely that any such threat would be perceived as empty.

In summary, it is doubtful that legal innovations could, standing alone, adequately protect investors in acqui-hire situations. When combined with the factors discussed in Part III, however, legal innovations could serve to increase the investor's recovery. If, for example, the documents specify the amount that investors are to receive, reputational and loyalty effects may encourage the engineers to pay out the specified amount or an amount reasonably close to it. The ever-present danger, however, is that if investors push too hard, whether in the legal documents or in negotiations, the engineers will simply defect, leaving the investors empty handed.

CONCLUSION

In this Article, we provided the first formal description of the acqui-hire transaction structure. We also proposed a solution to the existential puzzle of acqui-hiring. Drawing upon state law, social norms, informal sanctions, tax considerations, and cognitive biases, we showed how the social norms of Silicon Valley lead engineers in some cases to prefer acqui-hires over defections, even though acqui-hires leave money on the table. Finally, we analyzed the critical issue of how acqui-hiring proceeds are allocated between investors and entrepreneurs and discussed several contractual innovations that have the potential to better protect investors in acqui-hire situations.

APPENDIX

In Part III.F, we explained that tax considerations promote acqui-hiring by converting ordinary income into capital gains. A few technical caveats to the tax analysis are necessary, though they do not alter the conclusion that tax considerations generally support acqui-hiring.

First, acqui-hires are sometimes structured as tax-free reorganizations.[233] In those situations—which are not common[234]—the tax benefit to the engineers from receiving a portion of the deal consideration in lieu of compensation is even greater. This is because, in addition to the favorable conversion of ordinary income into capital gain, the employees also get to defer the capital-gains tax until they liquidate the buyer stock that they receive in the reorganization.[235]

Second, in analyzing the tax advantageousness of a particular transaction structure, the tax consequences to all parties to the transaction must be considered.[236] If one side of a transaction receives a tax benefit and the other side receives an equal, offsetting tax detriment, the transaction is not tax advantaged, and we would expect the parties to take these offsetting tax consequences into account in setting their nominal (that is, pre-tax) prices.[237] Therefore, it is not a complete analysis to simply say that the engineers are better off tax-wise receiving a certain amount of deal consideration in lieu of the same amount from the compensation pool, because the buyer may

233. *See supra* note 55 and accompanying text.

234. *See supra* note 199.

235. *See* I.R.C. §§ 354(a)(1), 356(a)(1) (2006) (providing for nonrecognition of gain when stock is exchanged in a reorganization).

236. *See* Michael S. Knoll, *The Tax Efficiency of Stock-Based Compensation*, 103 TAX NOTES 203, 208 (2004) ("Whether a compensation mechanism is tax efficient or not should be determined from a joint contracting perspective rather than the employer's or employee's perspective alone."); David I. Walker, *Is Equity Compensation Tax Advantaged?*, 84 B.U. L. REV. 695, 699–700 (2004) (focusing attention upon the tax consequences for employers and employees).

237. *See* JONATHAN GRUBER, PUBLIC FINANCE AND PUBLIC POLICY 561–62 (3d ed. 2011) ("[T]he side of the market on which the tax is imposed is irrelevant to the distribution of the tax burdens."); Ethan Yale & Gregg D. Polsky, *Reforming the Taxation of Deferred Compensation*, 85 N.C. L. REV. 571, 580 (2007) (noting that the "side of the compensation arrangement on which a tax burden is imposed or a tax benefit is conferred is irrelevant . . . since the parties can adjust the nominal pretax compensation to shift the tax benefits and burdens between themselves").

suffer a tax detriment when it pays more deal-consideration and less into the compensation pool.[238]

However, in most acqui-hire cases, the buyer will not suffer a significant tax detriment. If the buyer, in lieu of an acqui-hire, had simply hired away the engineers, the buyer would have generally received immediate, ordinary deductions when it made compensation payments to the engineers.[239] If the acqui-hire is structured as the buyer's purchase of a covenant not to sue, then that payment would also result in an ordinary deduction.[240] Thus, there would be no tax detriment to the buyer.

However, if the acqui-hire is structured as an asset deal or stock purchase, then the buyer's deductions would be deferred. If the buyer purchases the startup's assets, the purchase price of those assets would generally be amortized ratably over fifteen years,[241] and those amortization deductions would be characterized as ordinary deductions. However, if all of the startup's intangible assets, including workplace in force, were abandoned or became worthless before the end of that fifteen-year period, then the unamortized cost of those assets could be immediately deducted at that time.[242] Finally, if the acqui-hire is structured as a stock purchase, the buyer would not be entitled to any immediate deduction, but it would be entitled to an ordinary deduction once the stock was abandoned or deemed to be worthless.[243] Thus, in cases in which the acqui-hire is structured as an asset or stock deal, the buyer's deduction will be delayed somewhat,

238. *See* Polsky & Hellwig, *supra* note 7, at 1088 (arguing that a unilateral tax perspective is flawed).

239. *See* I.R.C. § 162(a) (2006 & Supp. V 2011) (authorizing deduction for compensation). This is generally true regardless of the form in which the compensation is paid. If the compensation is paid in the form of stock options or restricted stock, then the ordinary deduction would often be delayed until the options are exercised or the restricted stock vests. *See id.* § 83(h) (2006) ("Such deduction shall be allowed for the taxable year of such person in which or with which ends the taxable year in which such amount is included in the gross income of the person who performed such services.").

240. *See* Treas. Reg. § 1.263(a)-4 (2013) (allowing immediate deductions when intangible value is acquired except in certain specified instances not relevant to the purchase of a covenant not to sue).

241. *See* I.R.C. § 197 (2006) (providing that business intangibles are generally amortized ratably over fifteen years).

242. *Id.* § 165(a). *But see id.* § 197(f)(1)(A) (disallowing the loss deduction if the taxpayer retains any § 197 intangibles).

243. *See id.* § 165 (authorizing a deduction for losses incurred in a trade or business). Even if the acqui-hire is structured as a stock deal, then the buyer would still be entitled to an ordinary deduction once the startup's stock is abandoned or deemed worthless. *Id.* § 165(g).

which is generally disadvantageous. However, this tax cost is likely not significant for two reasons. First, because the startup's projects can be expected to be jettisoned quickly after the acqui-hire is completed, the buyer will typically not have to wait very long to get all of its deductions.[244] Second, many of the buyers in acqui-hire transactions are subject to low effective marginal tax rates—because of the existence of net operating losses[245] or due to international tax planning relating to intangibles.[246] These low tax rates mean that whatever delay occurs with respect to deduction utilization would often result in a low tax cost to the buyer.

However, if an acqui-hire is accomplished via a tax-free reorganization, then the acqui-hire could be significantly detrimental tax-wise to the buyer. In a tax-free reorganization, the buyer will generally receive a carryover basis in the startup's assets (in an asset deal) or in the employee's stock (in a stock deal).[247] In either case, that basis will usually be very low and, when the stock or assets are thereafter jettisoned or deemed worthless, the buyer's loss will be limited to the amount of that basis;[248] on the other hand, in a poach/defection, the buyer would typically get a deduction equal to the full value of the consideration paid by the buyer.[249]

In summary, the buyer will generally not suffer significant adverse tax consequences from the acqui-hire structure, except perhaps if the transaction is structured as a tax-free reorganization,

244. It is possible that the buyer might not be able to recover the entire purchase price until all of the acqui-hired engineers depart. *See* Treas. Reg. § 1.197-2(b)(3) (defining "workforce in place," which is an intangible subject to the amortization rules in § 197, as including "any portion of the purchase price of an acquired trade or business attributable to the existence of a highly-skilled workforce"). On the other hand, the expected employment term for an acqui-hired engineer is likely relatively short compared to the full fifteen-year amortization period.

245. *See, e.g.*, Stacy Cowley, *Facebook's Zuckerberg May Face $2 Billion Tax Bill*, CNNMONEY (Feb. 7, 2012, 5:59 PM), http://money.cnn.com/2012/02/07/technology/zuckerberg_tax_bill/index.htm (noting that Facebook expects to realize a net operating loss in 2012).

246. *See, e.g.*, Jesse Drucker, *Google 2.4% Rate Shows How $60 Billion Lost to Tax Loopholes*, BLOOMBERG (Oct. 21, 2010, 3:00 AM), http://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html (noting Google's 2.4 percent effective tax rate); *see also* Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699, 707–13 (2011) (describing in detail Google's use of the "Double Irish Dutch Sandwich" structure that results in Google's exceptionally low effective tax rate).

247. I.R.C. § 362(b).

248. *See id.* § 165(b) (limiting loss deductions to the amount of basis in the property that suffers the loss).

249. *See id.* § 162 (2006 & Supp. V 2011) (allowing a deduction for reasonable compensation paid in connection with a trade or business).

which is unusual.[250] However, even in tax-free reorganizations, if the buyer is subject to very low effective marginal tax rates, the tax cost will be minimal.

Third, and finally, the tax discussion in Part III.F assumes that the parties' characterization of the acqui-hire transaction will be respected by the Internal Revenue Service (IRS). Yet, the form of an acqui-hire does not truly reflect its substance. When a buyer in an acqui-hire pays for a covenant not to sue, it really is not worried about getting sued.[251] Likewise, when the buyer purchases the assets or stock of the startup, it actually does not place significant value on these items.[252] In substance, the deal consideration in acqui-hires is additional compensation paid to the engineers who pay it over to investors and other shareholders for the purpose of preserving their reputation.[253] The IRS is able to recharacterize transactions when the form of the transaction is inconsistent with its substance.[254] In an acqui-hire situation, that would mean treating the engineers as first receiving the entire purchase price (that is, the aggregate of the deal-consideration and the compensation pool) and then transferring the appropriate portion of it over to the investors and others. In the example in Part III.F, when the engineer deflected $300,000 of her would-be $1,000,000 compensation into the deal-consideration pool and received back $100,000 in respect of her equity interest in the startup, the IRS would treat the engineer as first receiving the full $1,000,000 as compensation and then transferring $200,000 to the investors. The full $1,000,000 would be ordinary compensation income and the employee would likely be able to claim a $200,000 ordinary deduction[255] for net ordinary income of $800,000.[256] If the

250. *See supra* note 199.

251. Part II concluded that acqui-hires are not explained by litigation risk.

252. For a description of acqui-hires as transactions that buyers undertake merely to hire the startup's at-will employees, see *supra* Part I.

253. For the argument that reputation enhancement is the best explanation for the acqui-hiring phenomenon, see *supra* Part III.A–C.

254. *See* United States v. Phellis, 257 U.S. 156, 168 (1921) (recognizing "the importance of regarding matters of substance and disregarding forms in applying the . . . income tax laws"); Estate of Weinert v. Comm'r of Internal Revenue, 294 F.2d 750, 755 (5th Cir. 1961) (referring to the substance-over-form principle as "the cornerstone of sound taxation").

255. *See* I.R.C. § 162 (2006 & Supp. V 2011) (allowing a deduction for ordinary and necessary business expenses). Historically, courts have sometimes disallowed deductions for when an individual makes voluntary reputation-enhancing payments, even when they are intended to bolster the individual's future earning capacity. *See, e.g.*, Welch v. Helvering, 290 U.S. 111, 112, 115–16 (1933) (denying such a deduction). *But see* Jenkins v. Comm'r, 47 T.C.M. (CCH) 238, 247 (1983) (allowing such a deduction based on the specific facts and circumstances

acqui-hire were respected, she would have realized \$700,000 of ordinary income and \$100,000 of capital gain. Thus, the recast by the IRS would take away the tax benefit that the engineer received by effectively recharacterizing \$100,000 of capital gain as ordinary income. Whether the IRS would be able to make this type of recharacterization in acqui-hire transactions depends on whether the IRS would be able to distinguish a bona fide acquisition, in which the buyer really wants the items it buys, from a mere acqui-hire, in which the buyer really only wants the at-will human capital.

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of the case). However, recently promulgated regulations appear to overrule the *Welch* case and allow a deduction for reputation-enhancing expenditures that are related to the taxpayer's trade or business in all cases. *See* Treas. Reg. § 1.263(a)-4 (2013). However, for the acqui-hired engineer, the deduction would be considered an unreimbursed employee business expense, I.R.C. § 62(a)(1), *amended by* American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 201, 126 Stat. 2313, 2323, and therefore it would be subject to limitation under § 67, *see id.* §§ 67(a), (b) (2006), and under the alternative minimum tax, *see id.* § 56(b)(1)(A)(i) (2006 & Supp. V 2011).

256. As discussed in the preceding footnote, the deduction would be limited under § 67 and the alternative minimum tax, so the net ordinary income would effectively be higher than \$800,000 and, depending on the taxpayer's adjusted gross-income level and other deductions, could approach \$1,000,000.