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Merger Enforcement Considerations:
Implications for Venture Capital Markets and Innovation

Ravi Sinha, Brendan Rudolph, and Alex Vasaly

Firms backed by venture capital ("VC") play a crucial role in driving innovation in the U.S. economy. Firms that were once backed by VC accounted for more than 92 percent of R&D spending and patent value generated by U.S. public companies founded over the past 50 years.[1] Furthermore, VC-backed firms experience growth rates 50 percent higher than the rest of the private sector and employment growth eight times higher than the average private company.[2]

Mergers and acquisitions ("M&A") involving VC-backed firms, most notably in the tech industry, have increasingly been scrutinized by regulators in recent years. When the proposed acquiror is an established incumbent, concerns over "killer acquisitions" have sometimes led to regulatory skepticism. However, as we document below, M&A is a critically important exit option for venture capitalists ("VCs") and the innovative firms that they fund, especially in light of the current stressed capital markets environment.

Thus, any broad, implicit assumption that acquisitions of VC-backed startups by incumbent tech platform firms are per se anticompetitive could have a chilling effect on future innovation. The review of any contemplated transaction calls for, among other things, a deep, situation-specific analysis of the target firm's financial situation (with particular attention to details related to its VC funding and capital structure). Only then can regulators begin to understand feasible counterfactual scenarios.

VC Financing and Exit Options for Startups

VC firms raise funds from investors and use those funds to invest in startup companies, typically in exchange for equity in the companies.[3] This is a critical role in the business ecosystem: because startups often have little or no revenue, they require outside financing to cover their costs. However, traditional lenders generally do not finance companies with the substantial risk profiles that

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[1] Will Gornall & Ilya Strebulaev, *The Economic Impact of Venture Capital: Evidence from Public Companies* (Jul. 8, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2681841.

[2] Annaleena Parhankangas, *The Economic Impact of Venture Capital*, *in* 2 Handbook of Research on Venture Capital 124 (Hans Landström & Colin Mason ed., 2012).

[3] For the purposes of this discussion, VC funds are considered to be those private investment funds that invest in early-stage or startup firms. Traditional private equity funds have certain similarities with VC funds, but often invest in later-stage or mature companies. "Portfolio companies" herein refer to the individual operating companies owned by a VC or PE fund. Such private funds typically hold stakes in many different operating companies at the same time: a "portfolio" of companies. Venture capital firms also provide advice and diverse networks of experts to their portfolio companies. *See* Rebecca Baldridge, *Understanding Venture Capital*, Forbes (Sept. 6, 2022), https://www.forbes.com/advisor/investing/venture-capital.

startup companies often carry.[4] Instead, startups often turn to VCs to provide financing through the early stages of their development.

Investors who provide capital during the earliest stages are known as seed investors.[5] Because of the wide range of potential outcomes for early-stage companies, investors in these companies bear very high risks and therefore require very high expected rates of return on their investments. Vision, team, and product potential are often relatively more important to these early-stage VCs than existing monetization strategies or tangible financial metrics (e.g., demonstrated revenue growth profitability).

As a startup grows and develops scale, later-stage specialist VCs typically participate in the startup's financing by making relatively larger investments. These VCs often focus more on tangible financial metrics and monetization strategies. Later VC investment "rounds" (i.e., Series B, C, etc.) typically come with investor protections designed to mitigate some of the risk for later-stage investors. For example, later-stage VCs often negotiate liquidation preferences, whereby their investment typically must be at least fully paid back before earlier-stage investors or employee shareholders earn any return.[6]

Employees of VC-backed firms often receive common stock with none of these investor protections. In addition, employees may receive stock awards in the form of options or warrants, which allow employees to purchase shares at a predetermined price.[7] This equity would only have value if the company increases in value (relative to the value at which the stock awards were granted).

Because the shares of VC-backed firms are not traded on public exchanges, shareholders have limited options to sell, or "exit," their investment and realize returns. Such options include selling shares in an initial public offering ("IPO") or selling shares to an acquirer of the company (which often is another company in the same industry or a private equity firm).[8]

VCs tend to achieve the highest returns when their portfolio companies go public via an IPO and they will generally continue to fund additional rounds for later-stage companies that are perceived to have strong potential to ultimately go public.[9] However, IPO exits are rare (by deal count). Typically, VCs will quickly try to sell firms they perceive have little potential to go public and will not extend multiple additional funding rounds to such companies.[10]

On average, VC-backed firms raise between 1.60 and 3.89 rounds of venture financing.[11] According to data from Pitchbook, only ten percent of tech firms that raised initial VC funding

[4] Venture debt has grown in prominence in recent years, largely led by niche financial firms that had familiarity with the VC ecosystem. However, the recent failure of Silicon Valley Bank, one of the largest providers of venture debt, garnered substantial media attention, and industry commenters have discussed implications of its failure on the outlook for venture-funded startups. As the *Financial Times* noted, for example: "Founders and investors fear that the demise of the tech sector's favourite bank will ripple through to lower valuations and hasten company collapses amid an already tough funding environment, according to more than a dozen interviewed by the Financial Times." George Hammond & Tim Bradshaw, *'A Devastating Impact': SVB's Collapse Leaves Start-Ups with A Funding Hole*, Fin. Times (Mar. 26, 2023), https://www.ft.com/content/9f8c506f-f01a-448e-ab4b-6c7fcd060422.

[5] Geoff Ralston, *A Guide to Seed Fundraising*, Y Combinator (2023), https://www.ycombinator.com/library/4A-a-guide-to-seed-fundraising.

[6] *See, e.g.*, Will Gornall & Ilya A. Strebulaev, *The Contracting and Valuation of Venture Capital-Backed Companies*, *in* 1 Handbook Econ. Corp. Fin. (forthcoming) (manuscript at 24-26), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4038538.

[7] Swapnil Shinde, *Startup Employee Equity: What Every Founder Should Know,* Forbes (Aug. 5, 2021), https://www.forbes.com/sites/theyec/2021/08/05/startup-employee-equity-what-every-founder-should-know/?sh=693bc4de5af9.

[8] Patrick Vernon, Venture Capital Strategy (2nd ed. 2022). Private exchanges of shares between investors are relatively rare.

[9] Paul Gompers & Josh Lerner, The Venture Capital Cycle 196 (2nd ed. 2004) [hereinafter Gompers & Lerner (2004)].

[10] *Id.* at 172, 196.

[11] *Id.* at 184 (Table 8.4).

between 2011 and 2014 raised a fifth round of funding, and only two percent ultimately exited via an IPO or acquisition after the fourth round. Thus VCs should not be thought of as perpetual sources of capital for their portfolio companies.

VC investment is typically conducted via fund entities, usually limited partnerships that are sponsored and managed by VC firms. Most VC funds have ten-year lifecycles, meaning VC firms must exit their stake in a company in ten years or less, again highlighting that in many circumstances—particularly for later-stage VC-backed firms—institutional constraints on VC funds can limit the ability of VCs to provide additional financing, and indeed can put pressure on VCs to exit.[12]

In fact, as commentators Paul Gompers and Joshua Lerner note:

> [a]lmost all venture funds are designed to be self-liquidating, that is, they must dissolve after ten to twelve years. This scheduled termination imposes a healthy discipline on everyone involved in the fund. For one thing, it forces investors to take the necessary but painful step of "pulling the plug" on under-performing firms in their portfolios.[13]

VC investing is inherently risky, and VC-backed firms frequently fail even after successfully raising financing in early rounds.

Additionally, VC firms typically do not "cross-invest" (i.e., multiple funds raised by the same VC firm will not typically invest in the same company).[14]

Nevertheless, a VC fund will typically allocate some of its capital for future investments into its portfolio companies or into new opportunities, which is called "dry powder" in the VC world. When considering whether a given startup might attract additional funding from current VC backers, assessing the relevant VC fund's levels of dry powder and remaining fund life is crucial.[15]

VC investing is inherently risky, and VC-backed firms frequently fail even after successfully raising financing in early rounds. Among a sample of over 1,100 technology companies that raised initial VC financing between 2008 and 2010, "nearly 67% of startups stall[ed] at some point in the VC process and fail[ed] to exit or raise follow-on funding."[16]

In light of these aspects of the VC-startup ecosystem, assessments of potential counterfactual (or "but-for") alternatives to a proposed merger involving a venture-backed startup should include a deep financial analysis of the specific circumstances of the target firm, such as the VC investor base, the number of funding rounds the target firm has raised, and the level of dry powder and remaining fund horizon of the investing VC firms.

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[12] The possibility of up to two, two-year extensions in investment horizon is a somewhat common feature of certain contracts. Broadly speaking, startup companies have also stayed private for longer in recent years. Additionally, major VC firm Sequoia Capital has recently been developing funds with a more "permanent" fund structure. As a result of these dynamics, the typical VC fund lifecycle may increase in the future.

[13] Paul Gompers & Josh Lerner, THE MONEY OF INVENTION: HOW VENTURE CAPITAL CREATES NEW WEALTH 99 (2001) [hereinafter Gompers & Lerner (2001)]. *See also*, *e.g.*, Paul Gompers, Will Gornall, Steven Kaplan & Ilya Strebulaev, *How Do Venture Capitalists Make Decisions?*, 135 J. FIN. ECON. 1, 169, 180, 185 (2020).

[14] Cross-fund investing (or "cross-investing") is the term of art for a subsequent fund run by a VC firm investing in a company that a sister fund had previously invested in. This is almost never done in the VC world.

[15] *See, e.g.*, Gornall & Strebulaev at 72. The authors also note: "For VC funds, which are constrained with respect to both time (because of a limited fund horizon imposed by limited partners) and capital (because of a limited fund size), the dry powder allocation decision is a critical consideration." *Id.*

[16] *Venture Capital Funnel Shows Odds of Becoming a Unicorn Are About 1%*, CB INSIGHTS (Sept. 6, 2018), https://www.cbinsights.com/research/venture-capital-funnel-2/#:~:text=Venture%20Capital%20Funnel%20Shows%20Odds%20Of%20Becoming%20A%20Unicorn%20Are%20About%201%25&text=The%20venture%20capital%20funnel%20highlights,in%20the%20venture%20capital%20process.

Legislative and Regulatory Focus on Merger Enforcement

Acquisitions of VC-backed startups—particularly by large, incumbent tech platform firms—have been a focus of recent debate among academics, regulators, and business commentators due to the possibility or threat of so-called "killer acquisitions" (defined for present purposes as acquisitions of a nascent or potential competitor by a large, incumbent firm).[17]

Ginger Zhe Jin, et al., provide a review of recent academic literature on this issue,[18] and we briefly summarize some of the relevant scholarship here. Salient considerations include (among others):

- Will the acquirer discontinue a product or forestall a nascent potential future competitor via a "killer acquisition"?
- Will incumbent acquisition activities create the broader perception of a "kill zone" that could stifle investor incentives to pursue future early-stage startups in a given space?[19]
- Will a vertical acquisition by one incumbent limit (or make more expensive) the ability of another large incumbent to use the target's product/service? Or similarly, will the transaction forestall a laggard incumbent's ability to "catch up" to a leader?

Legislation was introduced in the United States last year that would add new restrictions to M&A activity. Specifically, the Prohibiting Anticompetitive Mergers Act of 2022[20] would ostensibly simplify the merger review process, making it easier for the FTC and DOJ to block deals that: i) meet a certain size threshold, ii) result in the acquiring entity's exceeding specific market share thresholds, or iii) result in market concentrations exceeding specific thresholds. While such legislation might reduce the costs of the merger review process,[21] blanket rules would also preclude nuanced consideration of the actual competitive effects of a given merger. Such legislation might also fail to allow for consideration of the possible negative effects that blocking a specific merger might have on the target firm's ability to continue funding itself. More broadly, there could be downstream consequences for VCs' appetite to fund future innovative startups.

Recent Activity and Trends in VC Financing Further Highlight the Importance of Strategic M&A Exits

The VC industry is not immune to changes in the broader capital markets, which have recently tightened in dramatic fashion. Following high inflation and low unemployment in recent years, the Federal Reserve increased the federal funds rate in 2023 at the highest pace since the 1980s.

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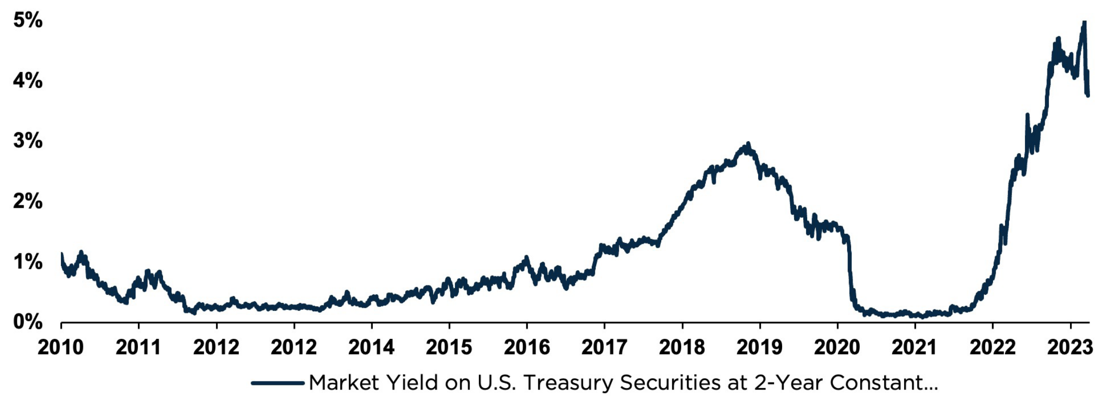
[17] *See*, *e.g.*, Colleen Cunningham, Florian Ederer & Song Ma, *Killer Acquisitions*, 129 J. POL. ECON. 3, 649-702 (2021); Axel Gautier & Joe Lamesch, *Mergers in the Digital Economy* 2 (CESIFO WORKING PAPER NO. 8056, Feb. 3, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3529012.

[18] Ginger Zhe Jin, Mario Leccese & Liad Wagman, *How Do Top Acquirers Compare in Technology Mergers? New Evidence from an S&P Taxonomy* 6-11 (NBER WORKING PAPER NO. 29642, Nov. 2022), https://www.nber.org/papers/w29642 [hereinafter Jin, et al. (2022)].

[19] Sai Krishna Kamepalli, Raghuram Rajan & Luigi Zingales, *Kill Zone* (NBER WORKING PAPER NO. 27146, May 2020), https://www.nber.org/papers/w27146.

[20] S.3847, 117th Cong. (2021-22).

[21] Notably, while such rules may superficially look simple, in practice they may not be. Any rule that relies on market share thresholds and market concentrations relies on market definition, which routinely is the most complex point of debate in merger reviews that proceed to trial. *See*, *e.g.*, Adam Di Vincenzo, Brian Ryoo & Joshua Wade, *Refining, Not Redefining, Market Definition: A Decade Under the 2010 Horizontal Merger Guidelines* 10, ANTITRUST SOURCE (Aug. 2020), https://www.americanbar.org/content/dam/aba/publishing/antitrust-magazine-online/2020/august-2020/aug20_divincenzo_8_18f.pdf.



Source: *FRED*

The Federal Reserve's actions had follow-on effects in the broader debt and equity markets.[22] Importantly, in the startup world, the recent tightening in capital markets has impacted new investments into startups, which declined by 29 percent between 2021 ($346 billion) and 2022 ($246 billion).[23]

Exit activity similarly declined from 2021 to 2022. VC-backed companies created a total exit value of just $72.9 billion across 1,281 exits in 2022, compared to $768.2 billion across 1,951 exits in 2021, representing a 90 percent decline in total exit value.[24] As exit activity declined,[25] the share of exit value from M&A exits increased substantially (from 14 percent of total exit value in 2021 to forty-seven percent in 2022), while the share from IPOs declined (from 85 percent of exit value in 2021 to 48 percent in 2022).[26] Taken together, these data paint a picture that in weak markets, VC investment gets curtailed and M&A exits become even more important.

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[22] Jeanna Smialek, *Fed Chair Opens Door to Faster Rate Moves and a Higher Peak,* N.Y. Times (Mar. 7, 2023), https://www.nytimes.com/2023/03/07/business/economy/fed-powell-interest-rates.html. These market stresses were also reflected in the stock prices of publicly-traded companies. For example, the S&P 500 Index declined nineteen percent in 2022, and the tech-heavy Nasdaq Composite Index declined by 33 percent.

[23] John Gabbert, Nizar Tarhuni, and Dylan Cox, *Q1 2023 PitchBook-NVCA Venture Monitor First Look*, PITCHBOOK (Apr. 12, 2023), https://pitchbook.com/news/reports/q1-2023-pitchbook-nvca-venture-monitor.

[24] Gabbert, John, Nizar Tarhuni, and Dylan Cox, *Q1 2023 PitchBook-NVCA Venture Monitor First Look*, PITCHBOOK (Apr. 12, 2023), https://pitchbook.com/news/reports/q1-2023-pitchbook-nvca-venture-monitor.

[25] Exit activity has continued to decline in 2023. Total exit value of $5.8 billion in the first quarter of 2023 represents an 82 percent decline from the $32.2 billion of total exit value in the first quarter of 2022 and a 93 percent decline from the $86.8 billion of total exit value in the first quarter of 2021. In addition, U.S. fundraising activity has declined substantially—the $11.7 billion raised in the first quarter of 2023 is less than seven percent of the $170.8 billion raised in 2022. *See* John Gabbert, Nizar Tarhuni, and Dylan Cox, *Q1 2023 PitchBook-NVCA Venture Monitor First Look*, PITCHBOOK (Apr. 12, 2023), https://pitchbook.com/news/reports/q1-2023-pitchbook-nvca-venture-monitor.

[26] IPOs did remain a much more lucrative exit option on average; in 2022, the median IPO exit value was $214.0 million, more than three times larger than the median M&A exit value of $65.0 million in 2022. Pitchbook data also include a third category of exits in addition to M&A by an incumbent firm and IPO: sale to a private equity buyer. *See* John Gabbert, Nizar Tarhuni, and Dylan Cox, *Q4 2022 PitchBook-NVCA Venture Monitor*, PITCHBOOK (Jan. 11, 2023), https://pitchbook.com/news/reports/q4-2022-pitchbook-nvca-venture-monitor.

As a general matter of industry custom and practice, VCs will seek a corporate buyer for portfolio firms once they believe the firm has little potential to go public.[27] This is an even more salient consideration in currently stressed capital markets; all else equal, given the IPO pathway is challenged at the moment, VCs seeking to maximize the value of their investment will be looking more to corporate buyers—a trend already borne out in the 2022 data cited above.

In short, there are fewer IPO opportunities in the current capital markets environment, which means VCs must rely more on M&A as the means to exit their investments.

In short, there are fewer IPO opportunities in the current capital markets environment, which means VCs must rely more on M&A as the means to exit their investments. If regulators make such exits more difficult (e.g., by presuming that any acquisition of a startup by an incumbent is anticompetitive), VCs may invest less going forward, and more startups will either never get funded or will die on the vine at a higher rate. Given the important role VCs play in funding innovative startups, this could have a broader chilling effect on innovation in the economy.

Prohibiting Certain Mergers Would Worsen Expected Exit Outcomes

Devising a plausible "but for" scenario in the absence of a proposed merger is a particularly nuanced exercise when the target is a VC-backed startup. Absent a strategic merger, a VC-backed startup can: i) continue operating as an independent company, ii) go public via an IPO, iii) be acquired by a private equity firm,[28] or iv) fail. Predicting which of these paths a company will take, let alone estimating a company's counterfactual exit value, is exceedingly difficult.[29] However, removing the M&A option will only decrease expected exit values in our view.

In light of the industry customs and practices discussed in the first section above, it would be inappropriate to assume that, as a general matter, VC investors would continue to extend additional funding to a VC-backed startup if an M&A exit is blocked. There are a number of VC customs and practices that weigh on the likelihood and viability for a VC-backed startup to continue operating as a standalone entity. Specifically:

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[27] For example, as Gompers and Lerner note:

> Firms that go public receive more total financing and a greater number of rounds than other firms (those that go bankrupt or are acquired). . . . If venture capitalists receive favorable information about the firm and it has the potential to go public, the venture capitalist continues to fund the project. ***If the project is viable but has little potential to go public, the venture capitalist quickly searches for a corporate buyer***. Firms that have little potential are liquidated.

Gompers & Lerner (2004) at 172, 196 (emphasis added).

[28] Acquisitions by private equity firms differ from acquisitions by competitors in several respects. For example, acquisitions by private equity firms generally do not raise antitrust concerns (unless the company were subsequently merged with a competing portfolio company in a "roll up" deal). Additionally, private equity firms, like venture capital firms, do not hold portfolio companies indefinitely and typically exit their investment at some point, which is not the case for acquisitions by competitors.

[29] The focus of this article is on VC customs and practices and not transaction price. Although financial analysis of plausible alternative transactions also has an important place in assessing mergers involving a startup, that issue is beyond the scope of this article. Nevertheless, it is worth noting that—as a matter of financial economics—when an M&A transaction occurs following an open and competitive merger process, the agreed-upon price typically provides a reasonable estimate of firm value. A purportedly high transaction price is in itself insufficient evidence that a transaction is a "killer acquisition." The degree to which an observed transaction price reflects firm valuation can be nuanced and complex. An assessment of whether a transaction price is reasonable should consider that, for example, a certain buyer may have a unique ability to monetize a product that the standalone startup company or other bidders do not, or there may be significant cost synergies or efficiency gains from a combination with a certain buyer. When dealing with a product that might be complementary to the buyer's other offerings, in the but-for world the buyer could attempt to make such a product from scratch. However, it may be that it is cheaper to buy the product (via M&A) than to make a similar product from scratch, and thus such make-vs.-buy considerations should also be robustly assessed. As with monetization potential, not all potential buyers are necessarily situated similarly. For example, expertise in a certain area or a pre-existing set of complementary products could render certain firms better suited than others to integrate a complementary product into their existing offerings and/or monetize that product.

- VC investment time horizons are limited, and VC firms are not perpetual investors by design. As discussed above, they typically need to exit within ten years or less. Further, few venture-backed startups receive more than four rounds of funding, and it is rare to ultimately exit successfully after a fourth round.
- Early-stage VC firms are looking to hit "home runs," and their business model does not typically entail extending startup firms a long leash of multiple rounds of financing, nor does it typically entail getting intimately involved with running the business or trying to devise new monetization strategies.
- As noted above, it is rare for VC firms to cross-invest (i.e., if a specific VC fund that backs a startup has exhausted all its dry powder, the fund's parent firm would be unlikely to make further investments in the startup).
- The different structural preference terms typically associated with late-stage investments have important implications for hypothetical *additional* funding round(s). For example, liquidation preferences that would likely be associated with such additional investment might imply that the investors would need an *even higher* exit value down the road to earn positive returns.

In addition to these considerations, stagnant growth can deter investors. If a later-stage target firm has not received funding for many years, it suggests the VC firms that invested in it may not perceive the firm to be relatively successful or likely to go public.[30] For example, if a later-stage target firm has not been able to demonstrate a viable monetization strategy, it may not be a natural candidate for additional investment.

Highlighting the impact of stagnant growth, "down rounds" (rounds of financing in which a startup's implied valuation is lower than it was as of the prior funding round) have severe implications and consequences. Common stock could potentially be wiped-out with extreme down rounds, and even if not, down rounds raise issues of employee morale and retention, and send negative signals to the market.[31]

In sum, there are several salient considerations regarding VC-backed target firms and the existing VC investment(s) in target firms when assessing what could feasibly happen absent a merger. Depending on the circumstances, it is entirely conceivable that a firm's VC backers would simply not extend any additional funding.

Absent the opportunity to continue operating as an independent company, VC-backed startups need to successfully exit in order to avoid failing. When assessing an M&A deal with a VC-backed target, one is already dealing with a conditional subset of all VC-backed firms—those that are *not* perceived to have strong potential to go public. Thus, assertions that an IPO is a possible

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[30] The time between funding rounds generally decreases as the company matures, dropping from an average of 1.63 years between rounds for the earliest-stage firms to less than one year between rounds for later-stage firms. *See* Gompers & Lerner (2004) at 186 (Table 8.5).

[31] For example, Steven Davidoff Solomon notes:

> [a] down round hits employees and founders hard, evaporating the worth of their hard-won shares. . . . Employees aren't going to stick around long if they see their equity stake wiped out. They will move on to the next start-up and take their chances there. The down round is a "lemon" signal to the market that the company's business plan is not working out. And one of the thorniest issues in dealing with down rounds is how a former unicorn keeps its employees after destroying the value of their shares.

Steven Davidoff Solomon, *Expect Some Unicorns to Lose Their Horns, and It Won't Be Pretty*, N.Y. Times (Jan. 19, 2016), https://www.nytimes.com/2016/01/20/business/dealbook/expect-some-unicorns-to-lose-their-horns-and-it-wont-be-pretty.html.

counterfactual alternative to the proposed merger should be carefully scrutinized.[32] Such concerns are even more salient when capital markets are stressed.

The most plausible counterfactual alternative may be a transaction rather than additional investment from existing investors or an IPO. Of course, every circumstance is unique, but some considerations to bear in mind with alternative transaction counterfactuals include:

- If a viable alternative offer exists, it would likely be at a lower valuation. VCs are interested in maximizing returns for their investors; if it were possible to achieve higher value via an alternative transaction, then profit-maximizing VCs would have taken it.
- Exit options—and the valuation at which exit can be achieved—are dictated by the market. Not all exits are "successful" (e.g., an investment can be sold at a loss or below the investor's *ex ante* expected return). There is no guarantee that if a deal falls through, an alternative deal would be able to generate a positive return to the target's investors/employees.
- A firm may not have other viable exit options and consequently might go out of business absent a challenged merger.

Foreclosing or reducing the likelihood of certain M&A exits, all else equal, would disincentivize VCs and other early-stage investors from backing future startups.

The Importance of VC-Backed Startups to Future Innovation

Foreclosing or reducing the likelihood of certain M&A exits, all else equal, would disincentivize VCs and other early-stage investors from backing future startups. This would make it more difficult for future startups to gain necessary early-stage funding, which in turn could lower employment at (and the number of) startup firms, thereby generally stifling future innovation. Insofar as a downstream effect of such a posture is an increase in "down round" financings for later-stage startups, this too would make working at a startup less attractive to skilled employees, and thereby chill future innovation. In fact, Tiago Prado and Johannes Bauer find empirical evidence of a positive relationship between acquisitions by "Big Tech" companies and VC activity.[33]

The reason for this is basic supply and demand dynamics and the associated incentives that actors in the market face. VCs supply the capital for firms to innovative and their willingness to supply future capital is inextricably tied to the returns they expect to receive upon exit. Supply necessarily varies with expected returns and limiting exit options will reduce expected future returns, thereby reducing the supply of VC capital *ex ante*.

This issue has been raised by scholars who have studied the VC industry. Gompers and Lerner succinctly summarize the point:

> [w]hile exiting is the last phase of the venture capital cycle … it is extremely important to the health of the other parts of the cycle. The need to ultimately exit investments shapes every aspect of the venture capital cycle, from the ability to raise capital to the types of investments that are made.[34]

The authors similarly note:

> [t]he long-run demand for venture capital is shaped by forces such as the pace of technological innovation and regulatory change, the presence of liquid and competitive markets (whether for stock offerings

[32] Furthermore, the IPO market itself can be cyclical, with down periods in public listings associated with recessions or capital markets turmoil. Thus, the possibility of exit via IPO is also partially conditional on the broader health of public equity markets and level of IPO activity generally. A similar principle also applies to M&A deals—market conditions will, in part, dictate the appetite for M&A generally, given the tenor of the prevailing capital markets environment.

[33] Tiago Prado & Johannes Bauer, *Big Tech Platform Acquisitions of Start-Ups And Venture Capital Funding For Innovation*, 59 Info. Econ. & Pol'y. 100973 (2022).

[34] Gompers & Lerner (2004) at 345.

> or acquisitions) through which investors can exit their investments, and the willingness of highly skilled managers and engineers to work in entrepreneurial environments.[35]

Limiting exit options (or the perceived value of future exits) would also make employment at a VC-backed startup relatively less attractive for skilled employees and innovators. Innovation at tech startups is driven by talent and startups rely heavily on equity compensation (i.e., shares of ownership and stock options in the firm) to attract and retain skilled workers. "Cashing out" such equity requires an exit (e.g., selling shares in the stock market following an IPO or having shares acquired by another firm in an M&A transaction). Limiting future exit options, or increasing the uncertainty about future exit options, would reduce the expected value of equity compensation, which in turn would make it less attractive for skilled employees to join future startups and, all else equal, have a chilling effect on innovation.

In addition, positive efficiency and innovation impacts from a potential acquisition should be robustly assessed. Contrary to the "kill zone" argument advanced by certain commentators, the prospect of an acquisition by an incumbent firm could *increase* future startup activity, thereby fostering innovation (and potentially increasing competition).[36] For example, the acquisition of a startup by an incumbent firm could increase growth and development of the startup's product due to the new owner's greater ability to fund and finance rapid development or greater experience/expertise in a given space. Such an acquisition could also increase the startup's efficiency and potential profitability via synergies. Consumers could also potentially benefit from greater network effects. For example, while Massimo Motta and Martin Peitz find certain scenarios where acquisitions of startups by tech incumbents could be anticompetitive, the authors also document many scenarios where there are welfare-positive network effects from such acquisitions.[37]

Conclusions

In light of the media attention and regulatory scrutiny on acquisitions of startups, it is important to remember that not all acquisitions, even those by large incumbent firms, are necessarily anticompetitive. Implicitly (or explicitly) presuming otherwise would have adverse consequences for future innovation, as VC-backed firms have accounted for the vast majority of new U.S. public company R&D spending in recent decades, and M&A transactions are a critically important exit option for such firms.

Consequently, when focusing on a specific proposed transaction, deep financial analysis of the target firm and the capital structure of the various rounds of investment by its VC backers, as well as the relevant VC customs and practices and how they would impact purported counterfactual worlds absent a merger, is crucial to understanding all the implications of blocking the transaction. ●

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[35] Gompers & Lerner (2001) at 139.

[36] Jin, et al. (2022) at 9.

[37] Massimo Motta & Martin Peitz, *Big Tech Mergers*, 54 INFO. ECON. & POL'Y 100868 (Mar. 2021).