

ARTICLE

How Venture Capital's "Exit Strategy" Drives Tech Industry Concentration

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American antitrust tolerates monopoly pricing in order to motivate innovation, believing incumbents' outsized profits will entice startups to enter, innovate, and overtake them.¹ But successive innovation depends on new firms getting funded so they can grow large enough to compete. And, as we explore in a recent paper,² the venture capital model that today funds startups pushes them not to compete with incumbents, but to be acquired by them.

It doesn't have to be this way. In our larger paper, we propose a series of carrots and sticks to refocus startups and funders on making money by innovating to become tomorrow's market leaders instead of by selling out to today's.

One Silicon Valley "godfather" and instructor to generations of entrepreneurs from Stanford and Berkeley describes today's reality this way: "*There are many reasons to found a startup. There are many reasons to work at a startup. But there's only one reason [to fund a startup] - liquidity.*"³ Venture capitalists (VCs) give money in exchange for an ownership share in the startup, and to reap their reward they must sell that share to someone else. That sale, or liquidity event, is called an exit. In the past, the paradigmatic exit was the public sale of the company's stock to new stockholders (an initial public offering, or IPO); that accounted for over 80% of exits in the 1980s. But today, the predominant exit is a private sale of the entire company to an existing firm (an acquisition), which now accounts for over 90% of exits.⁴ And those acquisitions are increasingly by dominant firms in the industry. While

¹ See *Verizon Commc'ns Inc. v. Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398, 407 (2004).

² Mark A. Lemley & Andrew McCreary, *Exit Strategy*, 101 B.U. L. Rev. __ (forthcoming 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3506919.

³ Steve Blank, *How to Build a Startup that Gets Acquired*, ThinkGrowth.Org (Aug. 7, 2017), <https://thinkgrowth.org/how-to-build-a-startup-that-gets-acquired-85ada592bfd7>.

⁴ Lemley & McCreary, *supra* note ii, at 16.

companies that go public keep competing, companies that get acquired often stop operating altogether. Even if they don’t, they no longer offer the prospect of displacing incumbents and disciplining the market through Schumpeterian competition.

Compared to IPOs, exits by acquisition occur one to two years faster.⁵ Differing regulations explain some of this gap. Today, every company that goes public faces a listing process that requires multiple years to prepare for and complete. Even after a company goes public, VCs are barred by regulation and contract from selling shares for six months or longer. (Exits by IPO weren’t always so slow; before Enron-related reforms, time to exit by IPO was one-to-two years faster than by acquisition, and IPOs were more common.) By contrast, only in exceptional cases today does a company that gets acquired go through time-intensive antitrust review in the United States. This is true even when the acquisition is by a dominant firm. For instance, only one of Alphabet’s (Google’s) 270 acquisitions has been challenged by U.S. antitrust authorities.⁶ And VCs cash out immediately upon an acquisition. For these reasons, VCs may reasonably be attracted to speedy acquisition exits.

Further, compared to other acquisitions, incumbent acquisitions may happen faster and for higher prices. That’s because incumbents have unique information and incentives. They often have data to see an emerging rival’s success before others. And they are the only firms willing to pay not just to gamble on a startup’s success, but even for its failure. Others at best gain a foothold in a more competitive marketplace. The incumbent at worst eliminates a chance of losing its monopoly.

Finally, it is likely that exits to incumbents are easier to predict and pull off – which may also prompt VCs to place more bets on companies positioned for incumbent acquisition. In short, VC-backed companies may find incumbent acquisitions not only more attractive than alternatives but also easier to prepare for and complete.

This focus on exit, especially exit by incumbent acquisition, has consequences. First, it may limit the innovations that get imagined. Entrepreneurs once dreamed of becoming Apple or Google, but today may dream just of “get[ting] a call from [them].”⁷ Founders are taught to “be planning [their] exit the day [they] get funded”; VCs must do this, and “the minute you take money from someone, *their business*

⁵ Id., at 29-30.

⁶ Tim Wu & Stuart A. Thompson, *Roots of Big Tech Run Disturbingly Deep*, N.Y. Times (Jun. 7, 2019), <https://www.nytimes.com/interactive/2019/06/07/opinion/google-facebook-mergers-acquisitions-antitrust.html>.

⁷ John Boitnott, *5 Things You Must Do To Get Your Company Acquired*, Inc. (Apr. 19, 2018), . <https://www.inc.com/john-boitnott/how-to-boost-your-business-odds-of-an-acquisition.html>

*model now becomes yours.*⁸ Second, even for innovations that get funded, exiting to an acquirer may mean the innovation does not reach consumers. Many acquired technologies get shelved.⁹ This may be on purpose, because of shifting priorities at the larger company, or simply because of unanticipated difficulties (most merging companies overestimate the ease and value of integrating).¹⁰ Whatever the cause, critics lament that “another day” in Silicon Valley seems to bring “another acqui[red firm] shut down.”¹¹ And whatever innovations are not forestalled and not shelved may – in the hands of the dominant firm – reinforce the firm’s position, extending its ability to extract supracompetitive prices or non-price terms (e.g., bad privacy policies).

It doesn’t have to be this way. We can refocus VCs and entrepreneurs on building companies that compete for the long haul. In the longer paper, we suggest a combination of carrots and sticks. Carrots can make other exits more attractive – and even encourage ways of funding startups that don’t require exits at all. We should make IPOs easier, support pre-IPO secondary markets that allow VCs and founders to get paid while continuing the company as a going concern, and encourage alternatives to venture capital like venture debt.

But carrots alone will not be enough. We would combine them with sticks that internalize the cost acquisitions by dominant firms impose on competition. We should tax transactions to align private incentives with socially efficient outcomes, ending the preference for merger over IPO and imposing extra taxes on acquisitions by dominant firms. We could lock up the sale of shares after acquisition, just as we do with IPOs, further reducing the current disparity in favor of acquisitions.

Our most significant stick is antitrust law. We propose reversing the de facto presumption in modern U.S. antitrust enforcement that every acquisition is a good one unless shown otherwise. U.S. antitrust enforcement has grown more lax in recent decades, and the agencies regularly approve mergers they would have challenged in a different era. And the nature of high-tech markets makes traditional forms of merger analysis more difficult. The result of these trends is that even though the

⁸ Steve Blank, *How To Build a Startup that Gets Acquired*, ThinkGrowth.Org (Aug. 7, 2017), <https://thinkgrowth.org/how-to-build-a-startup-that-gets-acquired-85ada592bfd7>.

⁹ Tim Wu & Stuart A. Thompson, *Roots of Big Tech Run Disturbingly Deep*, N.Y. Times (Jun. 7, 2019), <https://www.nytimes.com/interactive/2019/06/07/opinion/google-facebook-mergers-acquisitions-antitrust.html>.

¹⁰ Alan Lewis & Dan McKone, *Many M&A Deals Fail Because Companies Overlook This Simple Strategy*, Harv. Bus. Rev. (May 10, 2016), <https://hbr.org/2016/05/so-many-ma-deals-fail-because-companies-overlook-this-simple-strategy> (analyzing 2,500 mergers to find over 60% “destroy value”).

¹¹ Ingrid Lunden, *After Facebook Acqui-Hired Branch Media In 2014, Founders Shutter Branch (And Potluck)*, TechCrunch (June 3, 2015 9:37 am PDT), <https://techcrunch.com/2015/06/03/bye-branch/>.

anticompetitive consequences of many tech mergers have been “obvious to industry participants, very few of these mergers [have been] investigated or challenged.”¹²

What complicates merger analysis in tech markets is that many startup acquisitions are not of firms that can be easily classified as horizontal direct competitors, vertically related, or even wholly unrelated. Today’s antitrust law depends on these descriptors. It is more skeptical of “horizontal” mergers between competitors than of “vertical mergers” (deals between buyers and sellers in a supply chain) or “conglomerate mergers” that link unrelated businesses. But how should we analyze two technologies that aren’t related but might become so? Things that interconnect and work together but do different things? Right now, antitrust law tends to treat any merger that doesn’t fit neatly into a horizontal bucket as unworthy of attention.

That needs to change. Acquisitions by dominant incumbents are often bad for innovation and for competition, even or in some cases precisely because those acquisitions are *not* of direct competitors. Taking over a direct competitor is bad because it prevents that competitor from contesting the existing market. But taking over adjacent companies short-circuits the Schumpeterian competition that is more likely to displace the incumbent altogether. Seen narrowly, a direct competitor fights for a share of the market as defined today. But an adjacent firm fights to redefine the marketplace altogether, perhaps by solving the same problem for consumers in a way that prompts competitive entry and innovation. A digital smartphone didn’t look at first like a competitor to makers of paper maps, but it certainly disrupted their industry, replacing it with something much better. Autonomous vehicles, in turn, might displace some of the need for consumer-facing digital mapping. And virtual reality video conferencing may displace some of the need for moving around in cars. And even assuming for argument that only a minority of acquisitions by incumbents are anticompetitive, the cost of allowing even one anticompetitive merger to go forward may be more profound than antitrust appreciates. Despite the vaunted speed of innovation in Silicon Valley, today’s market leaders have succeeded in stopping the gale of creative destruction for decades.

We would reinvigorate merger enforcement in the tech industry. As a guiding principle, agencies should pay particular attention to acquisitions by incumbent monopolists, even if they don’t present as direct competitors. Acquisitions of adjacent firms are likely to increase concentration and prevent the development of fundamentally new sources of competition. And unlike mergers between small firms, which might help build a strong competitor to an incumbent, acquisitions of

¹² Mark Glick & Catherine Ruetschlin, Big Tech Acquisitions and the Potential Competition Doctrine: The Case of Facebook 3 (INET Working Paper No. 104, 2019).

adjacent startups by an incumbent often reinforce and extend its dominance, not only preventing a new competitor from arising but making it harder for other competitors to dislodge the incumbent. We propose applying this principle to create a strong rebuttable presumption against incumbent acquisitions of direct competitors, and a weak rebuttable presumption against incumbent acquisitions of other firms.

First, we think the antitrust agencies should presumptively block acquisitions of directly competitive startups by dominant firms. That presumption would extend to startups worth less than \$200 million (the current threshold for closer U.S. antitrust scrutiny of mergers). That presumption should be rebuttable if (1) the startup would not be viable as a freestanding entity and (2) there are no other plausible acquirers (a non-dominant company willing to pay a reasonable price, even if the price is lower than the incumbent would pay).

Second, we need a much greater focus on mergers that involve adjacent or potentially market-disrupting technologies – and a presumption against these mergers may also be appropriate, if a weaker one. True, whether society benefits from an acquisition gets complicated if the startup doesn't compete directly with the incumbent. Acquisition of a truly unrelated firm is unlikely to do much competitive harm (though it also won't offer any great benefits). And acquisitions of complementary firms can enhance efficiency. So we should treat these acquisitions differently than acquisitions of directly competitive firms. At the same time, much of the potential harm from acquisitions comes not in the form of suppression of direct competition but in accreting complementary technologies and shutting down potentially disruptive alternatives. Currently, the law pays little if any attention to non-competitive mergers involving startups. It should. A weaker presumption against those mergers may therefore also be appropriate. For these cases, we envision a presumption that could be rebutted by sufficient proof of efficiencies from the merger, or by strong evidence that the startup's technology is uniquely complementary to the incumbent's, so that it is unlikely to be profitably deployed by anyone else.

This month, the U.S. House of Representatives' competition policy subcommittee released a report that, among many other things, adopts our recommendation on restricting mergers by dominant firms.¹³ That makes us happy, and we hope to see the recommendation written into actual policy.

But we believe other suggestions of ours may be just as helpful. We should especially consider ways to achieve competition policy goals through tax and

¹³ Staff of S. Comm. on the Judiciary, 116th Cong., Rep. on Investigation of Competition in Digital Markets 388-90 (Comm. Print 2020), https://judiciary.house.gov/uploadedfiles/competition_in_digital_markets.pdf.

securities policies. Antitrust’s tools are blunt; there are error costs on both sides. Tax policy’s instruments, on the other hand, could be tailored to better shape decision-making on the margins to promote competition – and right now they are not shaped in that way at all.

Our carrots and sticks won’t break up today’s tech monopolies. But they will give tomorrow’s startups a better chance of making it to market. With Schumpeter’s “gale of destruction” blowing once more, monopolists will be compelled to innovate and compete, or else be overtaken by newer and better technologies.

Silicon Valley changed the world. It did so because founders and venture capitalists wanted to win tomorrow’s markets, not sell out to those who had already won yesterday’s. We should make sure founders and venture capitalists keep incumbents on their feet and don’t tire of the chase. And that means venture capitalists and tech companies must – as Steve Jobs urged Stanford’s graduating class in 2005 – “stay hungry.”

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