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## Business Lawyers as Enterprise Architects

George W. Dent

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# Business Lawyers as Enterprise Architects

By George W. Dent, Jr.\*

*What do business lawyers do? To that seemingly simple question there has been no good answer. For twenty-five years, the most widely accepted explanation was that offered by Professor Ronald Gilson in his article, Value Creation by Business Lawyers: Legal Skills and Asset Pricing, in the Yale Law Journal. Examining the work of lawyers in large mergers and acquisitions, Professor Gilson concluded that business lawyers are transaction cost engineers. On that basis, he proposed sweeping changes for the training of business lawyers in law schools.*

*However, mergers and acquisitions are but one of many tasks handled by business lawyers, and their role in other contexts is quite different. Moreover, the work of business lawyers has changed considerably since 1984. This Article offers a broader and more current analysis of what business lawyers do and concludes that they are more accurately characterized as enterprise architects. The Article then discusses what skills business lawyers need and how law schools can best prepare them for this work.*

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In 1984 Ronald Gilson published *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*. It began: "What do business lawyers *really* do? Embarrassingly enough, at a time when lawyers are criticized with increasing frequency as nonproductive actors in the economy, there seems to be no coherent answer."<sup>1</sup> He dismissed lawyers' own answer that "they 'protect' their clients, that they get their clients the 'best' deal."<sup>2</sup> He also rejected the academic literature which offered a laundry list of roles the business lawyer plays: "a counselor, planner, drafter, negotiator, investigator, lobbyist, scapegoat, champion, and, most strikingly, even . . . a friend."<sup>3</sup>

While conceding that this list "rings true enough,"<sup>4</sup> he held it deficient because "[i]f what a business lawyer does has value, a transaction must be worth more, net

1. Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 *YALE L.J.* 239, 241 (1984) (emphasis in original) (footnote omitted).

2. *Id.* at 242.

3. *Id.*

4. *Id.* at 243.

of legal fees, as a result of the lawyer's participation."<sup>5</sup> That is, lawyers must not perform mere "distributive bargaining, in which the size of the pie is by definition fixed," but rather "joint problem solving in which, through cooperation, the size of the pie, *and hence the size of the piece received by each party*, can be increased."<sup>6</sup> He rejected prior analyses because they failed to explain "precisely *how* do the activities of business lawyers affect transaction value."<sup>7</sup> "[I]f all a business lawyer offers is skill in distributive bargaining, the clients' joint decision would be to hire *no* lawyers at all . . . ."<sup>8</sup>

Dissecting the corporate acquisition as his specimen,<sup>9</sup> Gilson concluded that lawyers add value as "transaction cost engineers."<sup>10</sup> In particular, lawyers bridge the parties' divergent expectations about returns on the asset to be transferred by drafting an earnout which makes the price contingent on its returns between the signing of the deal and the closing, and overcome lack of information (principally of the buyer) by arranging efficient production and verification of information.<sup>11</sup> From these findings, Gilson also recommended that legal education for business practice downgrade traditional subjects (like analysis of appellate cases and knowledge of relevant regulatory law) in favor of corporate finance and transaction cost economics.<sup>12</sup>

In the succeeding twenty-five years, Gilson and others refined his thesis, but no one fundamentally challenged it. This literature about what corporate lawyers do (the "received model") is too narrow. This Article takes a wider and deeper perspective. Part I describes the received model. Part II exposes several problems with that model. Part III offers a fuller vision showing that business lawyers perform a greater range of activities using a larger set of skills than in the received model. Although these activities and skills are extremely varied, it is less accurate to say that business lawyers are transaction cost engineers than that they are enterprise architects. Part IV discusses the implications of this revised model for legal education. It argues that, although a knowledge of corporate finance and transaction cost economics is useful for some business lawyers, it is more important that business lawyers understand the obstacles to optimizing the performance of business entities and the contractual mechanisms available to overcome these obstacles. They also need specific behavioral skills, including how to negotiate when all parties are trying to build mutual trust and confidence.

5. *Id.* (emphasis omitted).

6. *Id.* at 245 n.9 (emphasis added).

7. *Id.* at 243. Elaborating, Gilson adds that the question is not whether each party *separately* is better off with a lawyer. Rather, the transaction should be "viewed from the perspective of *both* clients . . . . [T]he appropriate perspective is not that of the client with the more talented lawyer, but the joint perspective of both clients." *Id.* at 245.

8. *Id.* at 245.

9. *Id.* at 256.

10. *Id.* at 255.

11. *See id.* at 262–93.

12. *Id.* at 305.

## I. THE RECEIVED MODEL

But for a few small errors Gilson's original article is accurate as far as it goes. Its main problem is that it focuses on lawyers in large acquisitions, a highly specialized practice involving one phase of one-shot, arm's-length transactions. This practice lies at one end of a continuum of business law practice that ranges across repeat transactions and relational contracts to internal transactions and non-transactional practice.<sup>13</sup> Large acquisitions are not at all typical of most business lawyers' practice. Like the blind men touching the elephant, Gilson mistook a small part for the whole.<sup>14</sup> Subsequent scholarship has improved only slightly on his original thesis.

### A. GILSON'S ORIGINAL THESIS

Again, Gilson claims business lawyers create value by reducing transaction costs. Government regulation is one source of transaction costs, but Gilson says "the regulatory justification for business lawyers . . . simply does not get us far enough."<sup>15</sup> Much that lawyers do in acquisitions does not concern regulation. Therefore, he analyzes the largely "standardized" corporate acquisition agreement, showing how lawyers lower costs.<sup>16</sup> For one, they bridge the parties' divergent expectations about the future risk and return of the asset to be transferred by drafting an earnout which makes the price contingent on the return from the asset over some period before the closing.<sup>17</sup> Since the seller will control the asset during that period, part of the lawyers' task here is "devising a transaction structure that constrains the seller's ability to maximize the value of the business over a period different from that relevant to the buyer."<sup>18</sup>

Gilson then considers the costs of information, which lawyers reduce by identifying the party best able to produce information and to what extent (if any) and by whom the accuracy of information should be warranted.<sup>19</sup> However, he finds a flaw in current practice:

What remains puzzling, however, is the apparent failure by both business lawyers and clients to recognize that the negotiation of representations and warranties, at least from the perspective of information acquisition costs, presents the occasion for cooperative rather than distributive bargaining. Reducing the cost of acquiring information needed by either party makes both better off. Yet practitioners report that the negotiation of representations and warranties is the most time-consuming aspect of the transaction . . . . Increased information costs needlessly result.<sup>20</sup>

13. Economists posit a continuum of exchanges ranging from the discrete transaction to relational contracts. See F. Robert Dwyer, Paul H. Schurr & Sejo Oh, *Developing Buyer-Seller Relationships*, J. MARKETING, Apr. 1987, at 11, 12; Gregory T. Gundlach & Patrick E. Murphy, *Ethical and Legal Foundations of Relational Marketing Exchanges*, J. MARKETING, Oct. 1993, at 35, 36-37.

14. In the Buddhist fable each of several blind men touched a different part of the elephant and reached a different conclusion about what it was. See JOHN GODFREY SAXE, *The Blind Men and the Elephant*, in THE POETICAL WORKS OF JOHN GODFREY SAXE 111, 111-12 (Houghton Mifflin 1882).

15. Gilson, *supra* note 1, at 247.

16. See *id.* at 257.

17. See *id.* at 262-67.

18. *Id.* at 266.

19. See *id.* at 267-93.

20. *Id.* at 272 (footnotes omitted).

In sum, lawyers expand the total pie by reducing the costs of regulation and information and by bridging differences of opinion about the future value of the asset being sold. Gilson notes that the last two require no knowledge of or license to practice law and that other professions (including investment bankers and accountants) covet this work, yearning to snatch it from lawyers.<sup>21</sup> To retain this interesting, challenging, lucrative work, Gilson exhorts lawyers to improve their performance.<sup>22</sup> To do so he touts drastic changes in legal education because "law schools [have] done so bad a job in training business lawyers."<sup>23</sup> He does not urge teaching practice skills.<sup>24</sup> Rather, law schools should use finance and transaction cost economics to teach students "a theory of private ordering and . . . how people order their relationships in the absence of regulatory interference."<sup>25</sup>

## B. LATER REVISIONS

In the last twenty-five years, Gilson and others embellished his original thesis but retained its core. In 1993 Robert Gordon still maintained that we lack "thorough, systematic descriptions and reflective analyses of what it is that corporate lawyers actually do."<sup>26</sup> Gilson acknowledged, albeit briefly, a broader concept of business lawyering encompassing reputation, expectations of repeated dealings, decision theory, and incentive structures in business transactions,<sup>27</sup> but he never wove these elements into a new theory.

Some works mention activity absent from Gilson's thesis. Venture capital lawyers, for example, added to the traditional functions of business lawyers the roles of matchmaking, helping to draft an entrepreneur's business plan, vouching for a client's honesty, and advising uninformed clients about industry practices and norms.<sup>28</sup> However, most accounts of business lawyers have been limited, even fragmentary. One recent essay even narrows Gilson's original portrait. Based on an empirical survey of business lawyers, Steven Schwarcz concludes that business lawyers add value primarily by reducing regulatory costs, not other transaction costs.<sup>29</sup>

Changes in business lawyering are well known. Reams of practice-oriented journal articles and treatises have been churned out and continuing legal educa-

21. *Id.* at 294–95.

22. *See id.* at 302.

23. *Id.* at 303.

24. *Id.* at 304.

25. *Id.* at 305.

26. Robert W. Gordon, *Lawyers, Scholars, and the "Middle Ground,"* 91 MICH. L. REV. 2075, 2088 (1993).

27. *See* Ronald J. Gilson & Robert H. Mnookin, *Foreword: Business Lawyers and Value Creation for Clients*, 74 OR. L. REV. 1, 7–9 (1995).

28. *See* Lisa Bernstein, *The Silicon Valley Lawyer as Transaction Cost Engineer?*, 74 OR. L. REV. 239, 245–51 (1995) [hereinafter "Bernstein, *Silicon Valley Lawyer*"]; Lawrence M. Friedman, Robert W. Gordon, Sophie Pirie & Edwin Whatley, *Laws, Lawyers, and Legal Practice in Silicon Valley: A Preliminary Report*, 64 IND. L.J. 555, 557–66 (1989).

29. Steven L. Schwarcz, *Explaining the Value of Transactional Lawyering*, 12 STAN. J.L. BUS. & FIN. 486, 506–07 (2007) [hereinafter "Schwarcz, *Transactional Lawyering*"].

tion is offered continually on tasks of business lawyers. However, these have not been integrated into a new description.

### C. IMPLICATIONS FOR LEGAL EDUCATION

As Gilson noted, "There is nothing traditionally 'legal' about the role I have described business lawyers as playing, nor are there any special requirements peculiar to lawyers [such as admission to the bar] necessary to play this role."<sup>30</sup> Not surprisingly, then, as he also recognized, there is growing "competition for transactional responsibility . . . with other professions."<sup>31</sup> He pointed out that an acquisition "is surrounded by substantial regulatory structures."<sup>32</sup> And, he stated, "Because the lawyer must play an important role in designing the structure of the transaction in order to assure the desired regulatory treatment, economies of scope should cause the nonregulatory aspects of transactional structuring to gravitate to the lawyer as well."<sup>33</sup> However, "the increasingly multidisciplinary character of the legal profession's most serious competitors threatens to overcome the economies of scope."<sup>34</sup>

To preserve lawyers' "central role in designing the structure of business transactions,"<sup>35</sup> Gilson advised major changes in legal education. He argued against a focus on practical skills like drafting and negotiation and familiarity with standard types of agreements because "most legal academics are not really competent to teach these skills" and "[l]aw firms and real practitioners, through some form of apprenticeship, are likely to do a far better job than any law school for a number of reasons."<sup>36</sup> He urged instead more stress on finance and transaction cost economics.<sup>37</sup>

In recent years corporate finance courses and a joint JD-MBA degree have become more popular,<sup>38</sup> but skills training of many kinds has also greatly expanded. Some of these skills are relevant to business law, including negotiation and contract drafting. Some courses teach these skills in general, including courses in interpersonal dynamics,<sup>39</sup> writing and drafting,<sup>40</sup> negotiation,<sup>41</sup> alternative dispute

30. Gilson, *supra* note 1, at 295.

31. *Id.* at 301.

32. *Id.* at 296.

33. *Id.* at 298 (footnote omitted).

34. *Id.* at 301.

35. *Id.* (footnote omitted).

36. *Id.* at 304.

37. *Id.* at 305.

38. Anthony J. Luppino, *Minding More than Our Own Business: Educating Entrepreneurial Lawyers Through Law School-Business School Collaborations*, 30 W. NEW ENG. L. REV. 151, 177 & n.91 (2007) (listing reports of proliferation of JD-MBA programs, reaching 82 percent of ABA-approved law schools in 2002).

39. See, e.g., Joshua D. Rosenberg, *Interpersonal Dynamics: Helping Lawyers Learn the Skills, and the Importance, of Human Relationships in the Practice of Law*, 58 U. MIAMI L. REV. 1225, 1258-69 (2004).

40. See, e.g., Jonathan C. Lipson, *Doing Deals in School*, BUS. L. TODAY, Sept./Oct. 2005, at 51, 55 (describing a course offered by the author).

41. See, e.g., *id.* at 55.

resolution,<sup>42</sup> and counseling.<sup>43</sup> Others are geared specifically to business law.<sup>44</sup> Some use simulation.<sup>45</sup> Traditional classroom courses also pay more attention now to practical lawyering skills.<sup>46</sup> Thus, Gilson's advice has been ignored by legal educators including, ironically, Gilson himself: he now offers "deals" courses that teach "professional skills."<sup>47</sup>

In later work Gilson conceded the value of knowledge, like the theory of agency and of negotiation, in order to "understand the complexity of transactions and institutions" or, more grandly, to acquire "practical wisdom" and judgment.<sup>48</sup> A more capacious concept of business lawyering is also embraced by others. In Jonathan Lipson's Transactional Skills Workshop

students . . . set about doing the four things I think most good business lawyers routinely do:

- help plan the deal,
- investigate the facts and the law as the deal develops,
- help negotiate it, and
- draft the paperwork, once there is agreement in principle.<sup>49</sup>

As examples of planning issues, Lipson mentions division of power through composition of the board, choice of the shareholder vote needed to amend the charter, and protection in future rounds of financing.<sup>50</sup>

Lipson's approach bears on Gilson in a few interesting ways. First, it tacitly acknowledges the importance of dividing the pie and not just of its total size. Second, Lipson does not require or expect any special knowledge of corporate finance or of transaction cost economics.<sup>51</sup> Third, he tacitly recognizes that much of the business lawyer's work occurs before parties reach an agreement in principle, a period Gilson ignored.

Roberta Romano considers these changes in legal education "thoroughly inadequate. . . . [T]hose newer courses combined with other courses in the typical law school curriculum do not provide the technical level of knowledge that business lawyers need to master to be at the forefront of their profession."<sup>52</sup> Echoing Gilson, she says "[l]aw schools are not well-positioned to provide that knowledge on their own."<sup>53</sup> She urges "actively encouraging students seeking a business law

42. See Rosenberg, *supra* note 39, at 1231 & n.21.

43. See *id.*

44. See, e.g., Tina Stark, *Thinking Like a Deal Lawyer*, 54 J. LEGAL EDUC. 223, 232 (2004) (describing a course called Business Essentials) [hereinafter "Stark, *Deal Lawyer*"].

45. See, e.g., Lipson, *supra* note 40, at 51.

46. See, e.g., Bridget McCormack, *Teaching Professionalism*, 75 TENN. L. REV. 251, 262–63 (2008).

47. See Gilson & Mnookin, *supra* note 27, at 7 n.21. The two courses—a "Deals" class and "Deals Workshop"—are described in Victor Fleischer, *Deals: Bringing Corporate Transactions into the Law School Classroom*, 2002 COLUM. BUS. L. REV. 475, 490–92.

48. *Id.* at 6–7.

49. Lipson, *supra* note 40, at 53.

50. *Id.* at 54–55.

51. See *id.* at 55.

52. Roberta Romano, *After the Revolution in Corporate Law*, 55 J. LEGAL EDUC. 342, 352 (2005).

53. *Id.* at 352.

career to enroll in joint degree programs.<sup>54</sup> She also recommends creating accelerated joint degree programs so that students could acquire the JD and MBA degrees in three rather than four years.<sup>55</sup>

Based on his own poll of business lawyers and clients, Steven Schwarcz parts with both Gilson and Romano by questioning

an increased focus on finance theory and transaction-cost economics. . . . [T]he findings suggest that budding transactional lawyers would be even better served by focusing on law and on applying legal concepts to solve real-world problems—goals that the case method has a long and distinguished record of helping students achieve. Similarly, law schools should introduce, if not emphasize, the importance of developing good working relationships between opposing lawyers in business transactions.<sup>56</sup>

## II. PROBLEMS IN THE RECEIVED MODEL

### A. TRANSACTION COSTS, OPPORTUNISM, AND RATIONAL BARGAINING

Again, Gilson posits that “if all a business lawyer offers is skill in distributive bargaining, the clients’ joint decision would be to hire *no* lawyers at all.”<sup>57</sup> Therefore, lawyers must engage in “joint problem solving in which, through cooperation, the size of the pie, *and hence the size of the piece received by each party*, can be increased.”<sup>58</sup> These claims are misleading and generate confusion and error in the ensuing analysis.

We should not exaggerate the novelty of the “value creation focus.” It is mere common sense that a person will hire a lawyer (or any agent) if she thinks the lawyer will increase the value of the transaction (net of the lawyer’s fee) *to her*.<sup>59</sup> Clients were “value creationists” *avant la lettre*. Gilson added analytical clarity and rigor, but the underlying insight is intuitive. Gilson is right that rational parties will agree to eschew lawyers (or any other agent or activity) if each expects to benefit from doing so. However, not all steps that expand the total pie also increase the slice of each party.

For example, Gilson highlights the role of lawyers in producing and verifying information.<sup>60</sup> This activity does not enlarge the total pie (i.e., the value of the asset exchanged). Nonetheless, clients rationally pay lawyers (and other agents, like accountants) big fees for this service. Without information, the buyer must either trust the seller or assume the worst. Considerable trust is warranted in some cases, but not all.<sup>61</sup> Consider, for example, the innumerable e-mail offers from Nigeria to share a windfall.

54. *Id.* at 353.

55. *Id.*

56. Schwarcz, *Transactional Lawyering*, *supra* note 29, at 507–08 (footnotes omitted).

57. Gilson, *supra* note 1, at 245.

58. *Id.* n.9 (emphasis added).

59. See David M. Driesen & Shubha Ghosh, *The Functions of Transaction Costs: Rethinking Transaction Cost Minimization in a World of Friction*, 47 *ARIZ. L. REV.* 61, 64 (2005) (noting “people and institutions paying lawyers’ fees or other transaction costs obtain something of value”).

60. See Gilson, *supra* note 1, at 267–93.

61. See George Dent, *Lawyers and Trust in Business Alliances*, 58 *BUS. LAW.* 45, 62–66 (2002) (discussing factors that enhance or erode trust) [hereinafter “Dent, *Lawyers and Trust*”].

The importance of information also torpedoes the idea of excluding lawyers (or other agents) altogether from a deal. In an acquisition the seller would happily urge it since lawyers' fees shrink the pie and the seller, who controls the asset, needs little information from the buyer. The buyer, though, needs full disclosure; it will not only reject the suggestion to forego lawyers but consider it so outrageous as to cast doubt on the seller's good faith.

Gilson's implication that expanding the pie guarantees each party a larger slice (and that shrinking the pie leaves each party a smaller slice) may explain his neglect of opportunism (i.e., self-interested behavior),<sup>62</sup> including agency costs: he mentions these only briefly as a transaction cost in earnouts.<sup>63</sup> This is a major omission.<sup>64</sup> Transaction costs

encompass the costs of deciding, planning, arranging, and negotiating the actions to be taken and the terms of exchange when two or more parties do business; the costs of changing plans, renegotiating terms, and resolving disputes as changing circumstances may require; and the costs of ensuring that parties perform as agreed.<sup>65</sup>

In business deals opportunism is a major issue.<sup>66</sup> Consider again the production and verification of information in an acquisition. This activity does not raise the value of the asset, but the buyer will insist upon it because the seller has an incentive to fabricate positive information and withhold negative information about that value.

Skillful structuring of an exchange can shrink transaction costs, but not to zero.<sup>67</sup> Some transaction costs are inherent in any exchange; often they are so high that it is inefficient to make an arm's-length exchange. This explains the existence of firms: "[I]n a world without transaction costs all activities would be carried out as exchanges between units, and it is due to the failure of markets, or arenas of exchange, to allow for many exchanges without prohibitively high governance costs that organizations come to exist."<sup>68</sup> Opportunism looms even larger as we move from discrete, arm's-length transactions (like acquisitions) to repeat and relational contracts.<sup>69</sup>

62. Oliver Williamson defines opportunism as "self-interest seeking with guile. This includes . . . lying, stealing, and cheating." OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING* 47 (1985). This definition seems to exclude the self-serving behavior that Gilson discusses, which involves no guile. This Article will understand "opportunism" to include all self-interested conduct.

63. See Gilson, *supra* note 1, at 266.

64. See Geoffrey Miller, *From Club to Market: The Evolving Role of Business Lawyers*, 74 *FORDHAM L. REV.* 1105, 1109 (2005) ("The simple version of Gilson's model of attorneys as transaction cost engineers also does not take account of the agency cost problem within firms.").

65. Paul Milgrom & John Roberts, *Bargaining Costs, Influence Costs, and the Organization of Economic Activity*, in *PERSPECTIVES ON POSITIVE POLITICAL ECONOMY* 57, 60 (James E. Alt & Kenneth A. Shepsle eds., 1990) (emphasis omitted).

66. See STEPHEN M. BAINBRIDGE, *CORPORATION LAW AND ECONOMICS* 27 (2002) (stating that in corporate law the largest transaction costs are "uncertainty, complexity, and opportunism").

67. See Driesen & Ghosh, *supra* note 59, at 64 (noting "transaction costs . . . often aid the realization of efficient transactions that would never occur without them").

68. Ranjay Gulati, *Does Familiarity Breed Trust? The Implication of Repeated Ties for Contractual Choices in Alliances*, 38 *ACAD. MGMT. J.* 85, 87 (1995) (citation omitted) [hereinafter "Gulati, Familiarity"].

69. See *infra* notes 173-77 and accompanying text for a discussion of these contracts.

*Value Creation* focuses on transaction costs but elides some of their complexities. Again, Gilson decries ubiquitous haggling over representations and warranties; parties should view this as “the occasion for cooperative rather than distributive bargaining.”<sup>70</sup> They should identify who can best provide information or assume the risk that some information or assumption is wrong and adjust the sale price by the cost of accepting that burden. However, in practice representations and warranties are negotiated only after the parties agree in principle on the price, which “does not usually change continuously as the lawyers negotiate other contractual provisions.”<sup>71</sup> Lawyers who try Gilson’s approach “may find themselves accused of renegotiating the deal.”<sup>72</sup>

Gilson also ignores the different exposures to liability on representations and warranties among the seller’s shareholders. Only those who sign on to the representations are liable if they prove false.<sup>73</sup> Unless the seller has only a few shareholders who all sign the representations, not all shareholders do sign. Enhanced representations may fetch a higher acquisition price for all shareholders, but the increased threat of liability given in exchange extends to just a few, who naturally resist that burden regardless of who is the least-cost guarantor of information.

## B. THE NARROW DEFINITION OF “ACQUISITION”

Gilson took a narrow view of what comprises the acquisition transaction. Basically, he analyzes only the activity after agreement in principle is reached. Thus, he excludes several terms, some of which are legally binding, some of which are not but are important nonetheless. He disregards agreement in principle on the price. Although this term is not legally binding, large companies enter into many transactions, and trust is important in business deals.<sup>74</sup> To be trusted, a company must earn a reputation for fair dealing. Repudiating a deal after agreement in principle is reached sullies that reputation, so firms are loathe to do it, even though they are not legally bound. This disinclination compels their lawyers to behave in ways that may otherwise seem illogical.<sup>75</sup>

Gilson ignores lock-up arrangements, like termination fees and bargain purchase options, that make it costly for either side to repudiate a deal. He also over-

70. Gilson, *supra* note 1, at 257.

71. Edward Bernstein, *Law & Economics and the Structure of Value Adding Contracts: A Contract Lawyer’s View of the Law & Economics Literature*, 74 *OR. L. REV.* 189, 195 (1995).

72. JAMES C. FREUND, *SMART NEGOTIATING: HOW TO MAKE GOOD DEALS IN THE REAL WORLD* 186 (1992). Proposing new terms may erode trust. “[B]y accepting the standard forms and not negotiating for unusual terms, parties signal that they will be cooperative after the closing.” Robert B. Thompson, *Value Creation by Lawyers Within Relational Contracts and in Noisy Environments*, 74 *OR. L. REV.* 315, 317 (1995).

73. See, e.g., *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 769–73 (2008) (rejecting secondary liability under Rule 10b-5); *In re DVI Inc. Sec. Litig.*, 249 F.R.D. 196, 216–18 (E.D. Pa. 2008) (rejecting liability under Rule 10b-5 of a law firm that helped to draft, but whose name did not appear on, a materially false corporate document).

74. See Dent, *Lawyers and Trust*, *supra* note 61, at 49–52 (discussing the importance of trust in strategic alliances).

75. See *supra* notes 71–72 and accompanying text.

looks no-shop agreements that hinder competing bids for the target. Both sorts of arrangements are legally binding and buttress the non-binding terms: although a party who walks away is not liable for breach of contract, it may incur substantial liability or lose large benefits under the binding terms.<sup>76</sup> Drafting these arrangements is an important function of the acquisition lawyer.

Lawyers involved in preliminary deliberations are likely to be the parties' house counsel. Outside law firms that serve as special counsel in acquisitions often do not appear until many key issues—whether to do the deal at all, its scope (i.e., a full or partial acquisition), lock-ups, termination fees, satisfaction of fiduciary duties, and price (probably including the basic terms of any earnout)—are already resolved. Only the esoteric issues on which Gilson dwells remain.

Gilson's narrow vision of the acquisition transaction also colors his thoughts about the allegiances of the lawyers. He argues they should maximize the size of the pie without regard to its division. However, a lawyer (like the other negotiating parties) is an agent with a fiduciary duty to maximize the benefits to her principal.<sup>77</sup> In addition to their legal duties, agents also care about their personal reputations. Some might praise an agent who prizes total deal value over the interests of his client, but few clients share that view. A lawyer (or any agent) negotiating a deal places the client's interests first if she cares about her own future. Concern about her reputation may cause outside counsel to be even more aggressive than the client wishes.

## C. THE NARROW VIEW OF "TRANSACTION"

### 1. Arm's-Length Transactions Other than Acquisitions: Relational Contracts

Gilson's focus on acquisitions distorts his conclusions because the role of lawyers in other business deals is quite different.<sup>78</sup> Even in the few acquisitions that include an earnout,<sup>79</sup> the parties' interaction after the closing is limited, confined mostly to enforcing their contract rights. Absent an earnout, the parties often have little contact after the closing. (An exception is litigation, in which case they are fighting, not cooperating.) Generally, they do not anticipate future dealings.

Many other deals entail a requirement or expectation of extensive future dealings. Even in a single sale of goods the parties must often collaborate on deliv-

76. See DALE A. OESTERLE, *MERGERS AND ACQUISITIONS IN A NUTSHELL* 233–34 (2d ed. 2006) (describing these "deal protection" devices).

77. See WILLIAM A. GREGORY, *THE LAW OF AGENCY AND PARTNERSHIP* 57–58 (3d ed. 2001) (stating that "[t]he law of Agency . . . pretty generally governs the relationship between the lawyer and his client. This means that, for the most part, the same rules which apply to other agencies govern." (footnotes omitted)).

78. To some extent he recognizes this. He acknowledges that an acquisition differs from "a complex real estate transaction or joint venture," Gilson, *supra* note 1, at 257, though he does not explain how.

79. See Srikant Datar, Richard Frankel & Mark Wolfson, *Earnouts: The Effects of Adverse Selection and Agency Costs on Acquisition Techniques*, 17 J.L. ECON. & ORG. 201, 216 (2001) ("The overall percentage of transactions involving reported earnouts is 4.1%."); ROBERT F. BRUNER, *APPLIED MERGERS AND ACQUISITIONS* 611 (2004) (reporting that from 1992 to 2000 only 1.2 percent of deals had earnouts).

ery, installation, operation, and maintenance after the closing. Further, the parties often envision future intercourse between themselves (sometimes formalized in a long-term or "relational" contract)<sup>80</sup> and with others, so they want to establish trust and cooperation and burnish their reputations.

In contracts for services (which now comprise most economic activity<sup>81</sup>), collaboration is even more important. The services rendered and the cooperation needed are often so complex that contract terms can only vaguely sketch the parties' duties. Proving a breach in court, then, may be impossible absent flagrant misconduct,<sup>82</sup> so that litigation is of little value in enforcing reasonable expectations. In many service and long-term sales contracts, the parties also expect to modify terms before the agreement expires. Given the impossibility of drafting and enforcing precise performance obligations, the parties often employ indirect solutions, like fair and efficient exit and termination arrangements.<sup>83</sup>

Financings also require extensive interaction after the closing. In a large loan the borrower not only promises periodic payments but also accepts restrictive covenants that limit the scope of its business and require it continually to meet specified financial tests and to disclose material information to the lender.<sup>84</sup> The parties also realize that these covenants, however well drafted, may later hinder the borrower in ways unnecessary to protect the lender. In that case, it is expected that the lender will sympathetically entertain a plea to revise a term or waive a right.

## 2. Strategic Alliances

In joint ventures and other strategic alliances (such as licenses, dealerships, and franchises), the parties' collaboration after the closing is the whole purpose of the deal.<sup>85</sup> Written terms, then, are even less useful than in service and long-term sales contracts. A writing can fix some measurable ancillary duties, such as how much money a party will contribute and what personnel it will second to the venture. The primary duty, however, cannot be precisely defined; it must often be described in such vague terms as "best efforts."<sup>86</sup>

80. See generally Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089 (1991).

81. See Coalition of Service Industries, <http://www.uscsi.org/Statistics/> (last visited Jan. 16, 2008) ("Services represent nearly 78% of US economic output and a similar proportion of employment.").

82. See Roland Kirstein & Dieter Schmidtchen, *Judicial Detection Skill and Contractual Compliance*, 17 INT'L REV. L. & ECON. 509, 512-14 (1997) (discussing the difficulties of contracting in situations where it may not be possible to prove breach to a court).

83. See *infra* notes 153-69 and accompanying text.

84. See Clifford Smith & Jerold Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117, 125-46 (1979).

85. "Strategic alliance" is a business term; it has no legal definition. It has been described as an arrangement "whereby two or more firms agree to pool their resources to pursue specific market opportunities." Gulati, *Familiarity*, *supra* note 68, at 85. Although there is no clear, precise line between relational contracts and strategic alliances, in the former each party typically performs a distinct, well-defined function in a chain of production (as in a long-term sales contract); in alliances, the parties' duties are generally vaguer and their relationship is more symbiotic, requiring closer cooperation.

86. See Josh Lerner & Robert P. Merges, *The Control of Technology Alliances: An Empirical Analysis of the Biotechnology Industry*, 46 J. INDUS. ECON. 125, 132 (1998) (asserting the impossibility of specifying exactly a requisite "level of effort" or "delivery of a specific innovation").

The limited utility of the writing does not mean, however, that drafting is easier or less important or that the lawyers' role is less significant—quite the contrary. First, many issues of little relevance in acquisitions are often crucial in strategic alliances. These include misuse of proprietary information and defining the scope of the venture. The very purpose of an alliance is to achieve synergy between firms in related businesses, often in advanced technology. To do this, one or both parties must reveal valuable information that could be appropriated by the other.<sup>87</sup>

Alliances often last for many years.<sup>88</sup> In setting the scope of the venture, the parties do not want a fixed plan but flexibility to handle unexpected contingencies.<sup>89</sup> If a venture is defined too broadly, it could include activity that a partner could pursue (more) profitably alone or with a third party. If it is too narrow, one party may appropriate the knowhow of its partner, hence denying the partner the fruits of its efforts. Vague contract terms may preserve flexibility but foster uncertainty about who owns opportunities that arise out of the venture or that come to one partner from an outsider.<sup>90</sup> Parties in an alliance often start small and see what happens; if the venture prospers, they expand it.<sup>91</sup> Lawyers must craft a structure to suit the alliance through various stages or, at least, not pose undue difficulties when modification of the venture is needed.

Given the difficulties of drafting precise contracts and proving a breach, indirect solutions are employed here, too. A party may, for instance, contract for a

87. See Joanne E. Oxley, *Appropriability Hazards and Governance in Strategic Alliances: A Transaction Cost Approach*, 13 J.L. ECON. & ORG. 387, 392 (1997). The problem often begins during negotiations before a final agreement is reached: "If the seller were to provide . . . information in order to educate the buyer on the value of know-how for sale, he would, by revealing the information, be transferring the know-how free of charge." Jean-Francois Hennart, *A Transaction Cost Theory of Equity Joint Ventures*, 9 STRATEGIC MGMT. J. 361, 365 (1988). "Hence, information is shared alongside sheaves of nondisclosure agreements, and, even then, there is selective hiding of critical components." Richard J. Zeckhauser, *The Challenge of Contracting for Technological Information*, 93 PROC. NAT'L ACAD. SCI. USA, Nov. 1996, at 12743, 12744.

88. See Lerner & Merges, *supra* note 86, at 131–32 (stating that it often takes biotechnology joint ventures a decade or more to obtain FDA approval for their products).

89. See Friedman, Gordon, Pirie & Whatley, *supra* note 28, at 563 (stating that a venture financing often "does not try to spell out contingency plans for every conceivable event that could go wrong, but assumes that the parties will be able to cooperate sufficiently to work out flexible adjustments to changing circumstances"); Ranjay Gulati & Harbir Singh, *The Architecture of Cooperation: Managing Coordination Costs and Appropriation Concerns in Strategic Alliances*, 43 ADMIN. SCI. Q. 781, 782 (1998) (referring to "an ongoing need for mutual adaptation and adjustment" in many alliances).

90. See Steven I. Glover, *Negotiating and Structuring Joint Ventures: Lessons from Management Consultants*, M&A LAW., Mar. 1998, at 1, 7 (noting "most high profile joint venture litigation turns on issues of scope"). See also David Ernst & Stephen I. Glover, *Strategic Alliances: Combining Legal and Business Practices to Create Successful Strategic Alliances*, INSIGHTS, Oct. 1997, at 6, 10–11 (discussing dangers of defining venture scope either too broadly or too narrowly).

91. See Rachel E. Kranton, *The Formation of Cooperative Relationships*, 12 J.L. ECON. & ORG. 214, 227 (1996) ("[I]ndividuals begin cooperative exchange relationships at low levels of exchange. As partners fulfill their exchange obligations, cooperation rises to higher levels."); Ranjay Gulati, *Alliances and Networks*, 19 STRATEGIC MGMT. J. 293, 299 (1998) (noting "many joint ventures occur as options to expand in the future and are interim mechanisms") [hereinafter "Gulati, *Alliances and Networks*"]. Some business analysts posit five phases in the evolution of an alliance: awareness, exploration, expansion, commitment, and dissolution. See Dwyer, Schurr & Oh, *supra* note 13, at 15–20.

right of easy exit in order to escape mistreatment. If exit is too attractive, though, it may be used to exploit the other party.

In many alliances one party is by law a fiduciary for the other. In some, including joint ventures, they are mutual fiduciaries.<sup>92</sup> Unless otherwise agreed, then, they owe duties with regard to many matters, including proprietary information, business opportunities, and termination of the venture. Often parties wish either to limit or to expand these default rules. Designing solutions to all these problems requires great skill and is typically the province of the lawyers.

### 3. "Internal" Transactions

Even further removed from acquisitions are what might be called internal transactions, including the organization and reorganization of a business, equity financings, voting agreements, buy-sell-agreements, and executive employment contracts. Unlike strategic alliances, these transactions involve only parties who are or will become co-owners of the firm. However, unlike "housekeeping" chores that also occupy business lawyers, in these activities the participants legitimately act, at least in part, in their own interests and not just as agents of the firm.

Internal transactions pose further quandaries for lawyers. Just identifying the client may be difficult. In general, the client of the corporate lawyer is supposed to be the corporation.<sup>93</sup> However, in a proposal to create stock with superior voting rights, for example, what are the interests of the corporation? Many deem shareholders the owners of the business to whom the fiduciary duties of the firm's agents are owed, but of course corporate lawyers tend to serve those who can hire and fire them—i.e., usually the executive officers, especially the CEO.<sup>94</sup>

In internal transactions for non-public firms, a lawyer is often asked to work for more than one party. She may do so if the parties' interests are not too divergent.<sup>95</sup> However, she must continually monitor the situation to be sure that the parties'

92. A true joint venture is generally considered a general partnership. Every general partner of a partnership is an agent with authority to conduct the partnership's ordinary business. UNIF. P'SHIP ACT § 9(1) (1914), 6 U.L.A. 553 (2001); UNIF. P'SHIP ACT § 301(1) (1997), 6 U.L.A. 101 (2001); see 1 RICHARD D. HARROCH, PARTNERSHIP & JOINT VENTURE AGREEMENTS § 2.09(2), at 2-74 (1992) ("[E]ach joint venturer has the power and ability to bind the other joint venturer and to subject it to liability to third persons in matters which are within the scope of the enterprise."). Joint ventures are often incorporated, but the parties typically share control and thus are again mutual fiduciaries. See 1 HARROCH, *supra*, § 2.09(2), at 2-75.

93. See MODEL RULES OF PROF'L CONDUCT R. 1.13(a) (2003) ("A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.").

94. See Miller, *supra* note 64, at 1109 ("Because the basic executive decisions—including the decisions to hire and fire counsel—are usually made by corporate managers, the attorney will not necessarily abide by the admonition that his or her duties run to the organization rather than its officers."). The Model Rules seem to condone this by instructing attorneys to accept the decisions of the corporation's authorized officers even if "their utility or prudence is doubtful." MODEL RULES OF PROF'L CONDUCT R. 1.13(a) cmt. 3 (2003).

95. "Notwithstanding the existence of a concurrent conflict of interest . . . , a lawyer may represent a client if: (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client; . . . and (4) each affected client gives informed consent, confirmed in writing." MODEL RULES OF PROF'L CONDUCT R. 1.7(b) (2003).

interests have not come into conflict and must try to balance their interests fairly. Some internal transactions threaten serious conflicts of interest. In a strategic investment (or "equity link"), the investor has an interest in the company beyond the financial returns on its securities.<sup>96</sup> A start-up software company, for instance, might raise equity capital from a large computer company that is one of its customers and will therefore accept a smaller amount of stock than venture capitalists demand. However, the smaller firm's lawyers must fashion mechanisms to deter the large firm from stealing the smaller firm's technology or otherwise abusing its dual status as major stockholder and customer.<sup>97</sup>

A firm's lawyers must often weigh the effects of their work on shareholders as well as the entity. Decisions about the structure of the firm will determine the distribution of rights to profits, the risk of loss, and the power to control. They will also fix tax consequences and rights to employment, to transfer or redeem interests in the firm, to terminate its existence, and rights upon termination. Other decisions define the scope of the enterprise and of fiduciary duties.

In addition to tensions between managers and investors, there are often conflicts among investors.<sup>98</sup> If there are two or more investors at the outset, they may quarrel over, for example, board representation. If later financings bring in additional investors, the incumbents may clash with the newcomers over their respective privileges. Counsel for managers will be involved because the investors will be tempted to resolve their differences at the expense of the managers.

Gilson's M&A specialists are outside counsel, but many internal transactions are handled by inside counsel who face unique problems.<sup>99</sup> An in-house lawyer is subject to the CEO not just in one transaction but full time; his whole career is at stake. Some of the lawyer's work will touch his own interests, as when his firm makes an acquisition or disposition, erects takeover defenses, alters employee stock options and other compensation, or takes steps affecting firm risk or stock price. Such concerns cause some commentators to bewail lawyers' loss of

96. See Thomas Hellmann, *A Theory of Strategic Investing*, 64 J. FIN. ECON. 285, 287 (2002). For a general discussion of strategic investments, see ALAN S. GUTTERMAN, *CORPORATE COUNSEL'S GUIDE TO STRATEGIC ALLIANCES* §§ 1:1–1:25 (2006 & Supp. 2008).

97. See generally Ronald W. Masulis & Rajarishi Nahata, *Strategic Investing and Financial Contracting in Start-ups: Evidence from Corporate Venture Capital* (European Corporate Governance Inst., Working Paper No. 189/2007), available at <http://ssrn.com/abstract=891605> (describing special arrangements that are made to limit the influence of strategic investors in start-up firms).

98. See generally Robert P. Bartlett, III, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. REV. 37 (2006). Part of the problem is that "[a]lmost all venture and buyout funds are designed to be 'self-liquidating,' that is, to dissolve after ten or twelve years." PAUL A. GOMPERS & JOSH LERNER, *THE VENTURE CAPITAL CYCLE* 19 (2000). A fund nearing dissolution will have a different time frame than other investors.

99. Inside counsel "are not lawyers in the pure sense anymore. They are a unique hybrid that is part lawyer, part business leader and, in some cases, part entrepreneur." Irene E. Taylor, *The Top 40 Corporate Counsel: 40 and Under 40*, LEXPERT, Nov./Dec. 2005, at 60, 61 (quoting Jim Riley, senior corporate partner at Ogilvy Renault). See generally Deborah DeMott, *The Discrete Roles of General Counsel*, 74 FORDHAM L. REV. 955 (2005); Robert L. Nelson & Laura Beth Nielsen, *Cops, Counsel, and Entrepreneurs: Constructing the Role of Inside Counsel in Large Corporations*, 34 LAW & SOC'Y REV. 457 (2000); Carl D. Liggio, *The Changing Role of Corporate Counsel*, 46 EMORY L.J. 1201 (1997).

independence.<sup>100</sup> On the other hand, inside counsel has more opportunity to act as an entrepreneur, not just as an outside advisor, and may aspire to the firm's highest executive offices.

In internal transactions lawyers often perform services far beyond normal legal advice. Again, Gilson's model is a large acquisition in which business issues are decided before the lawyers enter, and the parties are aided by a large cast of sophisticated, specialized business experts; the lawyers are confined to a small niche. In non-public firms the lawyer is often present in the beginning, at the creation. Moreover, the parties, though skilled in their business, often know little of finance and have no investment bankers or other experts to advise them. They often want a lawyer who can handle financial and business problems as well as give legal advice. Performing these tasks requires skills unnecessary to M&A specialists.<sup>101</sup>

#### D. THE EXCLUSIVE FOCUS ON TRANSACTIONS

Gilson cannot be faulted for covering what he chose—transactions. However, his conclusions are misleading because the very title of his article implies a broader compass by referring to “business lawyers.” Much work of business lawyers does not entail “transactions.” Business lawyers advise corporate boards and officers in satisfying their fiduciary and other legal duties. They oversee the firm's compliance with regulations and contracts. This work demands skills different from those needed in transactions.

#### E. SCHWARCZ'S ALTERNATIVE VIEW

Steven Schwarcz polled business lawyers and their clients and found (contrary to Gilson) that lawyers add value primarily by reducing regulatory costs.<sup>102</sup> This finding may be flawed, however, because of the questions asked. The only question about opportunism asks: “To what extent are you responsible for anticipating, and drafting to protect your client against, possible future events that could change the business incentives of *other transaction parties*?”<sup>103</sup> Many respondents probably did not understand this question to address opportunism. Further, the question mentions only “possible future events that could change the business incentives.” This does not cover incentives created immediately by a transaction, as when a party in a new venture is free to engage in self-dealing. It may not even cover future events (like termination) that are not just “possible” but predictable.

100. See, e.g., Miller, *supra* note 64, at 1121–26. Professor Miller concludes that “changing economic conditions . . . significantly altered the cost-benefit calculation facing attorneys confronted with the question of whether to exercise independence.” *Id.* at 1121. See also Paul D. Paton, *Corporate Counsel as Corporate Conscience: Ethics and Integrity in the Post-Enron Era*, 84 CANADIAN BUS. REV. 533, 538 (2005) (stating that an in-house lawyer is particularly “vulnerable” in confronting ethical challenges).

101. See *infra* notes 125–28 and accompanying text.

102. Schwarcz, *Transactional Lawyering*, *supra* note 29, at 486, 500.

103. *Id.* at 512.

Another question asks: “[W]hen you represent an ordinary business [as opposed to ‘a bank or other regulated entity’] in a business transaction, [do] you need to provide expertise in the law and regulations that generally govern that type of transaction . . . ?”<sup>104</sup> Not surprisingly, over 93 percent of lawyers and 94 percent of clients answered “yes.” This hardly proves that business lawyers serve primarily to reduce regulatory costs. “Law” includes the mandatory and default rules of business entities, including fiduciary duties, and contract law. In this question the work of enterprise design is lumped together with U.S. Securities and Exchange Commission and Uniform Commercial Code filings.

The phrasing of his questions may have been shaped by the range of business activity on which he focuses. He says lawyers “usually concentrate in such transaction-regulatory intensive areas as securities law, M&A, bank lending, structured finance, and project finance.”<sup>105</sup> This disregards strategic alliances, internal transactions, and non-transactional work, which involve different activities and skills.

### III. A BROADER PERSPECTIVE

#### A. A BROADER RANGE OF PRACTICE

##### 1. Including Other Transactions and Strategic Alliances—The Virtual Corporation

Gilson ignores debt financings, relational contracts, and strategic alliances. The disregard of strategic alliances is understandable but crippling. He wrote in 1984, when alliances were rare; since then they have become much more prevalent<sup>106</sup> and are of rapidly growing importance to lawyers.<sup>107</sup> Many alliances involve high risk<sup>108</sup> and, “[i]n general, the more legal risk there is, the more necessary and valuable legal services are.”<sup>109</sup> A joint venture differs from a discrete exchange because the

104. *Id.* at 513 (emphasis added).

105. *Id.* at 535.

106. See Matthew Schifrin, *Partner or Perish*, FORBES, May 21, 2001, at 26 (reporting rapid growth of corporate partnerships and alliances); Blair H. Sheppard & Marla Tuchinsky, *Micro-OB and the Network Organization*, in TRUST IN ORGANIZATIONS: FRONTIERS OF THEORY AND RESEARCH 140, 140 (Roderick M. Kramer & Tom R. Tyler eds., 1996) (“Hierarchy and market are moving aside for the boundaryless firm, the virtual organization, and the network organization.” (internal citations omitted)); *id.* at 141 (noting “hierarchy and market are being replaced with more connected, lateral forms of organization”).

107. See Glover, *supra* note 90, at 4 (estimating that in 2000 alliances “account[ed] for more than 20% of the average large firm’s revenues” and noting a 20 percent annual increase in the value of strategic alliances involving Fortune 1000 companies in preceding years).

108. See David T. Robinson, *Strategic Alliances and the Boundaries of the Firm* i (June 14, 2006), available at <http://ssrn.com/abstract=293721> (finding that “alliances cluster in risky, high-growth, high-tech industries”).

109. Donald C. Langevoort & Robert K. Rasmussen, *Skewing the Results: The Role of Lawyers in Transmitting Legal Rules*, 5 S. CAL. INTERDISC. L.J. 375, 377 (1997).

parties need to cooperate to an extent that cannot be specified by contract.<sup>110</sup> The law recognizes this by treating the parties as partners and mutual fiduciaries.<sup>111</sup>

Even acquisitions are often more complicated than Gilson realized. In acquisitions by private equity firms, the parties “utilize norms, conventions and outside constraints to fill contractual gaps.”<sup>112</sup> The failure of lawyers “to properly assess risks and to innovate” may have led to the collapse of many recent acquisitions and to the ensuing lawsuits.<sup>113</sup> Since complete contracts are impossible, lawyers fashion indirect means to encourage collaboration and deter opportunism. They are also part of a team working to foster collegiality. The skills they need differ from those needed for discrete exchanges.<sup>114</sup>

Few firms that enter into a relational contract or alliance stop at one; most have several, which further complicates the lawyer’s task. Many alliances include three or more partners, which drastically increases complexity.<sup>115</sup> Sometimes several firms organize a more or less formal network.<sup>116</sup> Each relationship must be viewed not alone but as part of a web of agreements; each piece must fit into a complex puzzle. Both economists and lawyers often find it useful to envision the corporation as a nexus of contracts—i.e., “not as an entity, but as an aggregate of various inputs acting together to produce goods or services.”<sup>117</sup> The platonic ideal of this concept is the “virtual corporation,” a firm with no employees except a management team and no assets but what the managers need to function; the managers contract for all the firm’s other inputs.<sup>118</sup> Although this is only an ideal, a number of real firms approximate that ideal: “hierarchy and market are being replaced with more connected, lateral forms of organization.”<sup>119</sup>

110. See *supra* note 86 and accompanying text.

111. See *supra* note 92 and accompanying text. In alliances with foreign companies, however, American lawyers must be aware that foreign law often imposes fiduciary duties different from ours. See Susan Perkins, Randall Morck & Bernard Yin Yeung, *Innocents Abroad: The Hazards of International Joint Ventures with Pyramidal Group Firms* 18 & n.14 (Feb. 2008), available at <http://ssrn.com/abstract=1097265> (stating that for firms that are part of a business group, foreign law often imposes on the directors and officers fiduciary duties to the group, not to the individual unit).

112. Steven M. Davidoff, *The Failure of Private Equity*, 82 S. CAL. L. REV. (forthcoming 2008) (manuscript at 6, on file with *The Business Lawyer*).

113. *Id.* at 56.

114. See Sandra M. Huszagh & Frederick W. Huszagh, *Lawyers as Exchange Engineers in Commerce: An Empirical Overview*, 74 OR. L. REV. 147, 174 (1995).

115. “[R]unning a triparty joint venture was extremely difficult, especially with respect to . . . direction and control.” KATHRYN RUDIE HARRIGAN, *STRATEGIES FOR JOINT VENTURES* 368 (1985); see also Gulati, *Familiarity*, *supra* note 68, at 96 (“[M]ultilateral alliances pose larger organizational problems.”).

116. See Hans B. Thorelli, *Networks: Between Markets and Hierarchies*, 7 STRATEGIC MGMT. J. 37, 38 (1986); Sheppard & Tuchinsky, *supra* note 106, at 140.

117. See BAINBRIDGE, *supra* note 66, at 27.

118. See John A. Byrne, Richard Brandt & Otis Port, *The Virtual Corporation*, *BUS. WK.*, Feb. 8, 1993, at 98; Ann E. Conway Stilson, *The Agile Virtual Corporation*, 22 DEL. J. CORP. L. 497, 499–502 (1997).

119. Sheppard & Tuchinsky, *supra* note 106, at 141. See also Bengt Holmstrom & John Roberts, *The Boundaries of the Firm Revisited*, 12 J. ECON. PERSP. 73, 85 (1998) (discussing some examples of virtual corporations). Gilson himself has discussed some parallel trends in creating new devices to divide risk. See Ronald J. Gilson & Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 COLUM. L. REV. 231, 245–47 (2008).

## 2. Including Internal Transactions and Non-Transactional Business Practice

Lawyers in internal transactions and non-transactional practice generally handle matters more personal to the client firm's officers than do M&A specialists and often serve more than one master; as a consequence, strong interpersonal skills are desirable. Unlike M&A specialists, they join the action before the major business issues have been resolved, so they need greater sensitivity to business concerns than do M&A lawyers.

Much of the work of business lawyers does not involve transactions at all. This non-transactional work falls roughly into two categories. One comprises routine or repeating matters, sometimes called "housekeeping." These include advising the board of directors and ensuring that it meets its duty of care,<sup>120</sup> proceeds properly when some directors are interested in a matter before the board;<sup>121</sup> and complies with the law in the board's own regular activities, like electing corporate officers and fixing their powers and compensation, holding shareholder meetings, and declaring dividends.<sup>122</sup> Counsel also advises both the board and firm employees on legal questions arising in the firm's regular business operations, including issues of employment and agency law; contract formation, performance, and enforcement; and compliance with regulatory and tax laws. If the firm is a public company, it must also obey the proxy rules and periodic reporting requirements of the federal securities laws.<sup>123</sup> Generally such matters are handled by house counsel or a regular outside counsel.

The second category of non-transactional practice includes extraordinary matters. Many of these, such as an uncontested amendment of the charter to increase the number of authorized shares, are uncomplicated and are handled by the firm's regular counsel. Others are complex and require specialized outside counsel. Examples of such work are a reorganization of the company and its subsidiaries, construction of anti-takeover defenses, and orchestration of a proxy fight.

A thorough catalogue of non-transactional business practice is unnecessary, but listing a few of these activities is instructive. One growing area of business practice is preventive law; that is, "periodically evaluating a client's business situation to identify potential legal problems . . . and to develop and recommend appropriate action accordingly."<sup>124</sup> The range of legal problems that can be so addressed

120. See, e.g., *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 968–70 (Del. Ch. 1996) (suggesting in dicta that directors' duty of care may require creation of program to monitor company's compliance with law); MODEL BUS. CORP. ACT § 8.31(a)(2)(iv) (2005) (imposing liability on directors for a "sustained failure" to act in the face of a clear warning).

121. See DEL. GEN. ANN. tit. 8, § 144 (2001) (governing interested transactions).

122. See *id.* § 142(b) ("Officers shall be chosen in such manner . . . as [is] prescribed by the bylaws or determined by the board of directors or other governing body."); *id.* § 170(a) (governing declaration and payment of dividends); *id.* § 211(b) (requiring an annual shareholders' meeting).

123. See Securities Exchange Act of 1934 §§ 14, 15, 15 U.S.C. §§ 78n, 78o (2006), and the rules thereunder.

124. Peter J. Gardner, *A Role for the Business Attorney in the Twenty-First Century: Adding Value to the Client's Enterprise in the Knowledge Economy*, 7 MARQ. INTELL. PROP. L. REV. 17, 50 (2003).

is wide and includes employment issues (like employment discrimination and sexual harassment), protection of confidential information (including intellectual property), and compliance with environmental laws.

### 3. Serving Non-Public Firms

Again, lawyers for non-public firms handle many matters beyond mergers, get involved in matters earlier than M&A specialists do, and serve clients who have no flock of business advisors.<sup>125</sup> These firms want a lawyer who understands their business and can offer financial advice. In some cases—as when several parties create a new business—one lawyer may be asked to represent them all. In appropriate cases the lawyer may do so, but she must treat all parties fairly.<sup>126</sup> Alternatively, a lawyer may serve as a mediator helping parties to reach agreement.<sup>127</sup> In that case a lawyer needs not only the technical skills of enterprise design but also an understanding of the interests of each party as to risk of loss and sharing in the control and benefits (including profits, employment compensation, perquisites, buy-sell rights, rights in firm property, liquidation rights, and tax benefits) of the firm.

Two aspects of this work merit comment. First, knowledge of business is important here, but it has little to do with the transaction cost economics that Gilson deems crucial for business lawyers. A start-up company, for instance, may need help to draft a business plan and to get a hearing from venture capitalists.<sup>128</sup> Second, this work may be especially suited for lawyers. They enjoy substantial economies of scope (as Gilson calls it) because the work entails legal issues of fiduciary duties, default rules, property (including intellectual property) rights, and taxes. Further, in most cases no investment bankers or other sophisticated consultants are involved. Clients are more cost conscious here than in the large acquisitions on which Gilson dwells.

The role lawyers play here also raises questions about Gilson's critique of distributive bargaining versus joint problem solving. His view may make sense in a merger when both parties are sophisticated and advised by business experts before agreement in principle is reached and the M&A lawyers are called in. The parties are then committed, at least tentatively, to the deal. As Gilson himself partly recognizes, conditions are different earlier in the game. Parties do not reach agreement in principle unless each believes the deal will yield it profit net of transaction

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125. See *supra* notes 96–97 and accompanying text.

126. See *supra* note 95 and accompanying text.

127. MODEL RULES OF PROF'L CONDUCT R. 2.4(a) (2003) (permitting a lawyer to serve as "a mediator or in such other capacity as will enable the lawyer to assist the parties to resolve" a dispute if certain conditions are met).

128. See Bernstein, *Silicon Valley Lawyer*, *supra* note 28, at 245–46; Friedman, Gordon, Pirie & Whatley, *supra* note 28, at 562. Some firms hire non-lawyers to provide these services, but other Silicon Valley lawyers prefer to perform this task themselves. See Zusha Elinson, *Fenwick Hires Non-Lawyer to Introduce Clients to Venture Capital Funds*, THE RECORDER, Nov. 12, 2007, <http://www.law.com/jsp/article.jsp?id=1194602647347>.

costs. As Gilson puts it, absent that belief pies never get baked at all.<sup>129</sup> Lawyers must participate in the distributive bargaining needed to support that belief.

Gilson argues that if lawyers perform only pie-shrinking distributive bargaining, the parties will rationally agree to exclude them.<sup>130</sup> In many cases there are problems with that option, as when one party is sophisticated and the other is not. Consider an entrepreneur who has a valuable idea but is unsophisticated in business and finance and seeks funding from a venture capitalist. The latter is a sophisticated repeat player and would be happy to dispense with lawyers. The entrepreneur, though, cannot tell whether an offer is fair to her; she needs a lawyer's advice.

## B. TECHNICAL SKILLS: ENTERPRISE DESIGN

The business lawyer needs technical skills in what might be called "enterprise design"—that is, creating the best entity structure for each enterprise.<sup>131</sup> A brief overview gives an idea of the issues this entails.

### 1. Choice and Scope of Entity

The first question in designing an enterprise is whether it should be created at all. This is a business question, but even financially sophisticated clients may need lawyers to resolve it because legal issues may determine whether the venture can be profitable. Some legal issues are regulatory, such as what will be the tax treatment of the enterprise and its participants; whether proprietary information can be protected by patents or copyrights or already belongs to others; what licenses or regulatory approvals are needed; and the costs of complying with regulation, such as environmental and securities laws.

Lawyers may also help gauge the transaction and agency costs of the venture and whether it is possible to arrange the private ordering (or design the enterprise) so as to be profitable. This determination requires consideration of all the enterprise design issues discussed in this section, beginning with the choice of entity.<sup>132</sup> The lawyer must first see what options are available. The choices are

129. Gilson, *supra* note 1, at 312. He said:

[T]he manner in which the pie is carved can have enormous impact on the number of pies that are baked in the future. The decision to invest in the next pie's creation depends not just on the size of the pie in the abstract, but on the piece that the investor actually receives.

*Id.*

130. *Id.* at 245.

131. "The lawyers don't just solve problems facing a business venture. The lawyers help conceive the venture in the first place or, at an early stage, they're instrumental in funding and implementing the project." LARRY SMITH, *INSIDE/OUTSIDE: HOW BUSINESSES BUY LEGAL SERVICES* 137 (2001).

132. See generally Oxley, *supra* note 87. See also WILLIAMSON, *supra* note 62, at 18 ("Transaction costs are economized by assigning transactions (which differ in their attributes) to governance structures (the adaptive capacities and associated costs of which differ) in a discriminating way."); Charles R.T. O'Kelley, *Delaware Corporation Law and Transaction Cost Engineering*, 34 GA. L. REV. 929, 941 (2000) (stating "[t]he corporate lawyer . . . can increase the value of a prospective business association by selecting for it the optimal type of business organization").

multiplying.<sup>133</sup> Some ventures are ineligible for certain choices.<sup>134</sup> The choice of entity can influence or completely resolve such issues as the tax treatment of the entity and its participants, whether the participants are personally liable for the debts of the venture, and the fiduciary duties of the parties.<sup>135</sup>

Lawyers also help fix the scope of the enterprise, including its time frame, geographic scope, and range of business. Participants may not usurp business opportunities that belong to the entity, but the default rules about what opportunities belong to an entity are vague.<sup>136</sup> For example, some technology has several uses. If the technology will evolve during the life of the venture, it may be hard to predict what uses will emerge.<sup>137</sup> To avoid problems, parties often alter the default rules.<sup>138</sup> Although allotting opportunities is a business issue, mastery of property law and fiduciary duties is needed to achieve the desired results. The scope of the enterprise may also depend on what obligations the parties already have in other ventures,<sup>139</sup> a question which the lawyers may have to help answer. A company might have numerous alliances and must take care that a new one does not collide with an existing one or foreclose desirable alliances in the future.

To resolve these issues parties make extensive disclosures. Gilson recognizes disclosure as the central bailiwick of lawyers in acquisitions,<sup>140</sup> but disclosure is even more complex in relational contracts, alliances, and internal transactions. In an acquisition disclosure ends after the closing (except for purposes of an earnout, if there is one). Ongoing transactions require cooperation between the parties, which requires continual disclosure over the life of the venture.

133. See George S. Geis, *The Space Between Markets and Hierarchies*, 95 VA. L. REV. (forthcoming 2009) (stating "the possibility that we are moving toward an increasingly complete array of operational alternatives") (manuscript at 5, on file with *The Business Lawyer*).

134. For example, an S corporation cannot be used for an entity with a corporate shareholder. I.R.C. § 1361(b) (2006).

135. See, e.g., FRANKLIN A. GEVURTZ, *BUSINESS PLANNING* 58–112 (4th ed. 2008) (discussing choice of entity) [hereinafter "GEVURTZ, BUSINESS PLANNING"].

136. See FRANKLIN A. GEVURTZ, *CORPORATION LAW* § 4.2.7, at 362 (2000) (noting that "[u]nfortunately, courts have been unable to come up with any clear tests for resolving this issue" of what constitutes a business opportunity).

137. In research and development ventures, for example, "adequate specification of property rights will inevitably be problematic, since the contracted assets do not exist at the time the contract is written, and technological innovation is a highly uncertain process." Oxley, *supra* note 87, at 394. See also Hennart, *supra* note 87, at 366 (noting that, when knowledge is "embedded in the individual possessing it[,] . . . its exchange must rely on intimate human contact"). If the individual is made an employee, though, the individual is vulnerable to breach of implicit contracts. See Andrei Shleifer & Lawrence Summers, *Breach of Trust in Hostile Takeovers*, in *CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES* 33, 37–41 (Alan Auerbach ed., 1988).

138. See GEVURTZ, *BUSINESS PLANNING*, *supra* note 135, at 168 ("A well drafted provision expressing the parties' intent as to the extent of each owner's obligation to present to the firm any opportunities, inventions and the like, might avoid litigation if such events occur.").

139. "The opportunity set of each firm outside the particular alliance crucially affects its behavior within the alliance." Tarun Khanna, Ranjay Gulati & Nitin Nohria, *The Dynamics of Learning Alliances: Competition, Cooperation, and Relative Scope*, 19 STRATEGIC MGMT. J. 193, 205 (1998) (emphasis omitted).

140. See *supra* note 19 and accompanying text.

For like reasons, collaborative enterprises also pose thornier problems of protecting proprietary information than acquisitions do. In an acquisition the seller must beware that the buyer does not obtain valuable information and then repudiate the deal and exploit the information. At the closing, however, ownership of the information is transferred and the problem ends. In collaborative ventures the problem persists for the life of the venture. Moreover, since cooperation is essential (to develop some technology, for example), the other party's need to know certain information may go far beyond what is needed to establish its financial value.

To some extent lawyers can tackle these problems directly with confidentiality agreements, although these agreements will be more complicated than those in a routine acquisition. Proving a breach of a confidentiality agreement (which may not be an issue after the closing in an acquisition) is typically difficult, though, because breach is usually surreptitious. The lawyers must further protect confidential information indirectly. A party owning technology may, for example, contract for rights to do inspections of the other party so as to detect and prove any misuse of the technology. The parties may agree to some form of alternative dispute resolution before experts and with more liberal rules of evidence so that misappropriations of confidential information can be more easily proven. A party may also contract for easy exit in case it believes its partner is misusing proprietary information.<sup>141</sup>

## 2. Governance, Disputes, Profit Sharing, and Incentives

In public corporations the default rules for governance are generally followed. In non-public firms they are often altered, and relational contracts and alliances typically employ customized governance rules. An initial question is whether the parties will have equal voices. If so, neither can bully the other, but disagreement can mean deadlock. To prevent this they may provide for a neutral arbiter. Firms with venture capital, for example, often give a minority of board seats to both the managers and the investor and then have one or more neutral directors.<sup>142</sup> Neutral directors can fashion a board majority by voting with one side against the other, but they try not to let disagreements reach this point. Instead, realizing the importance of trust and cooperation between the two sides, they try to persuade one side of the reasonableness of the other's position or to hammer out a compromise. The parties may also provide for mandatory bargaining, mediation, or arbitration.<sup>143</sup>

141. See generally *infra* Part III.B.3.

142. See Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U.L. REV. 967, 988–89 (2006) (discussing use of neutral directors); Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281, 289–90 (2003) (reporting frequent use of neutral directors).

143. See Eric Rasmusen, *A Model of Negotiation, Not Bargaining: Explaining Incomplete Contracts* 45 (Apr. 27, 2001) (unpublished manuscript, on file with *The Business Lawyer*) (stating that mandatory bargaining "can raise welfare by overcoming pessimistic out-of-equilibrium beliefs"); Bernstein, *Silicon Valley Lawyer*, *supra* note 28, at 241 (stating that alternative dispute resolution is preferred by many firms); Thomas J. Stipanowich, *Contract and Conflict Management*, 2001 Wis. L. REV. 831, 847–51 (claiming benefits from terms requiring parties to negotiate requests for contract revisions).

If two parties will not share overall governance equally, each may be given control of some sphere of the venture. If one party gets general control, its power may be limited by giving the junior partner a veto over certain matters.<sup>144</sup> They may agree, for example, that one will run the daily operations but that both must approve major changes. If use of the veto could cause a debilitating impasse, they can provide for alternative dispute resolution.

If one party gets control, the other may need protection from oppression. Protection may be general. For instance, the junior partner may get a right to exit and have its interest bought out by the senior partner, either at the junior's discretion or if certain objective events occur. Alternatively, protection may be created for specific problems. To assure a party income, for example, she can be given either an employment contract at stipulated compensation or stock with features that encourage the payment of dividends.<sup>145</sup>

The parties must also agree on financial rights in the enterprise. It is generally wise to allocate these in the same proportions as the governance rights. Trouble brews when, as in public companies, those who control have a small equity interest. Their incentive then is to maximize their own compensation, to the detriment of the equity owners (i.e., the shareholders).<sup>146</sup> However, identical divisions of control and financial rights can cause problems. For example, if the managers and investors of a firm agree to divide profits equally, the investors may reasonably argue that profits begin only after they get back their initial contributions. To reach this result the parties may give the investors preferred stock with a liquidation preference.<sup>147</sup>

Governance terms largely reflect the bargaining power and prowess of the parties and their lawyers, but those terms may also depend in part on their ability to maximize the value of the venture. One example is executive compensation. Investors want managers to be rewarded only if they succeed. Even in a public company, designing efficient rewards is difficult. Stock and stock options are useful because stock price is the best measure of firm success.<sup>148</sup> However, the price may rise or fall because of trends in the firm's industry or in the economy gener-

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144. See D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 346 (2005) (reporting high incidence of veto rights of venture capitalists over various actions) [hereinafter "Smith, *Venture Capital*"].

145. See DWIGHT DRAKE, *BUSINESS PLANNING: CLOSELY HELD ENTERPRISES* 589, 595-97 (2006) (discussing situation in which those managing a close corporation get employment contracts and common stock and participants not involved in management get preferred stock with features that encourage payment of dividends).

146. Separation of ownership and control was first brought to light by Berle and Means. See ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 119-21 (1932). The problem persists. See, e.g., LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* 2 (2004).

147. See Bartlett, *supra* note 98, at 59-60, 76-77 (explaining reasons for, and illustrating use of, liquidation preferences); Kaplan & Strömberg, *supra* note 142, at 284 (reporting high frequency of use of convertible preferred stock in venture capital financings).

148. See ROBERT A.G. MONKS & NELL MINOW, *CORPORATE GOVERNANCE* 55 (1995) (stating that market share price has "unique value" and that other measures of value "are so highly flexible that they have limited significance").

ally rather than because of the performance of the individual firm. By definition, a non-public firm has no market price for its stock, so designing executive compensation to supply optimal incentives is even more problematic.<sup>149</sup>

Steps may also be needed to deter opportunism. If a party fails to perform as intended, the other may terminate the contract, sue for damages, or both, but litigation is slow and expensive, and proving a breach may be difficult or impossible.<sup>150</sup> One solution is for one or both parties to deliver a hostage—i.e., an asset or right that is worth more to the giver than to the receiver.<sup>151</sup> Because it values the hostage more, the giver is motivated to perform so as to get the hostage back; since the receiver values the hostage less, it is not motivated to keep the hostage unless the giver breaches the contract.

Such arrangements are particularly important if the parties to an alliance will incur costs or reap benefits at different times. If one party has contributed far more than it has received, the other may be tempted to grab the benefits of that contribution and leave.<sup>152</sup> For example, a distributor may spend heavily to cultivate a market for a supplier's product, expecting to recover its costs from commissions on future sales. The supplier might then switch to another distributor who will accept a lower commission because it has not incurred the development costs. The first distributor will want assurances against such opportunism, but the supplier will want freedom to terminate if the distributor performs poorly. Again, the lawyer must fashion an efficient solution, one that meets the legitimate concerns of both sides.

### 3. Exit and Termination

Another issue ignored by Gilson but central to strategic alliances is termination. In acquisitions each party contracts for a discrete performance. Except in the few deals with an earnout, there is little to do after the closing. By contrast, participants know that alliances do not last forever, even though they cannot know at the outset when their own venture will cease. The law provides default rules for withdrawal from an alliance,<sup>153</sup> but the parties often do not want the default rules, so they must fashion their own termination provisions.

Finding the ideal solution is not easy because termination may invite opportunism. For example, the default rule in joint ventures is that either party may terminate at any time and compel an auction of the venture's assets.<sup>154</sup> Often only

149. See DRAKE, *supra* note 145, at 262–64, 267–68 (discussing elements of an effective incentive compensation plan and dangers of specifying compensation).

150. See *supra* note 82 and accompanying text.

151. See Royce de R. Barondes, *The Business Lawyer as Terrorist Transaction Cost Engineer*, 69 *FORDHAM L. REV.* 31, 40–44 (2000) (discussing hostages in business transactions).

152. See Khanna, Gulati & Nohria, *supra* note 139, at 198.

153. See, e.g., *infra* note 154 and accompanying text.

154. UNIF. P'SHIP ACT § 38(1) (1914), 6 U.L.A. 487 (2001) (providing that on dissolution, unless otherwise agreed, any partner who has not wrongfully dissolved may demand that the surplus (if any) be distributed "in cash."). "In effect, this gives each partner the right to force a sale of the partnership assets . . ." J. DENNIS HYNES, *AGENCY, PARTNERSHIP, AND THE LLC IN A NUTSHELL* § 94, at 188 (1997)).

one party can afford to pay fair value for the assets. That party could terminate and then grab the assets at the auction for one dollar more than the inadequate amount the other party can bid. Courts sometimes construe fiduciary duties to prevent such behavior but, again, litigation is lengthy and expensive, proof of breach is often difficult, and the substantive tests are vague and do not deter all opportunism.<sup>155</sup> Even if both parties can afford to buy the assets, one or both parties may not know the value of the assets.

Lawyers employ various devices to deter opportunistic termination. One provides that if a party withdraws, the other party may buy the assets at a low price.<sup>156</sup> This deters exit except for compelling reasons. Another provides that if a party withdraws, the other recovers the property it contributed.<sup>157</sup> This prevents a party from grabbing assets contributed by the other at a low price. A third method is a Russian roulette buyout, in which the terminating party must name a price for the venture. The other party can then elect either to buy the terminating party's interest or to sell its own interest to the terminating party at that price.<sup>158</sup> This places more of the burden of uncertainty on the departing party.

An opposite problem is that an investor may get "locked-in" to an investment that is illiquid and gives no payouts. This can happen if the venture neither fails nor flourishes but lands in "limbo," healthy enough to pay its managers' compensation and other costs, but not so profitable as to go public or pay dividends. This fate may be worse than failure for an investor because in case of failure the investor can at least recognize a tax loss on its investment.<sup>159</sup> Even if the company prospers, most investors eventually want to cash in their stock. Although the managers generally share that desire, they may disagree about the manner or timing of obtaining liquidity.<sup>160</sup> Accordingly, investors need to arrange exit mechanisms at the outset.

Several devices can meet this need.<sup>161</sup> One gives the investor working control or the power to require dissolution and liquidation in certain circumstances. If an

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155. See, e.g., *Page v. Page*, 359 P.2d 41, 44 (Cal. 1961) (holding that partner's proposed dissolution would be wrongful if he were "attempting to appropriate to his own use the new prosperity of the partnership without adequate compensation to his co-partner").

156. See *DRAKE*, *supra* note 145, at 180 (suggesting that a buy-sell agreement set a discount from the regular price for certain situations).

157. See Mark A. Medearis & Michael W. Hall, *Minority Equity Investments in Connection with Strategic Alliances*, in *STRUCTURING, NEGOTIATING & IMPLEMENTING STRATEGIC ALLIANCES: 2001*, at 93, 106 (PLI Corp. L. Practice Course, Handbook Series No. B-1260, 2001) (describing a "rubber band" clause providing for return to a party upon dissolution of property that it had contributed to the alliance).

158. See *HARRIGAN*, *supra* note 115, at 98-99 (describing this device).

159. See I.R.C. § 165(a) (2006) (permitting deduction for "any loss sustained").

160. See Michael Klausner & Kate Litvak, *What Economists Have Taught Us About Venture Capital Contracting*, in *BRIDGING THE ENTREPRENEURIAL FINANCING GAP* 54, 57 (Michael J. Whincop ed., 2001) (stating that managers may wish to delay termination in order to maintain "salary and other compensation, social status, and psychic benefits of managing a business").

161. See Kaplan & Strömberg, *supra* note 142, at 298, 305, 309 (reporting on frequent provision for increase in venture capitalists' board representation if company fails to meet stated goals); *id.* at 291 ("Optional redemption and put provisions also are commonly used to strengthen the liquidation rights of the [venture capitalist]'s investment.").

investor cannot have this at the outset, it may demand a “voting switch” or “event of election” right that allows it to dissolve if the company fails to meet specified performance targets.<sup>162</sup> Alternatively, the investor may obtain a “put” entitling it to sell its stock back to the company at a stated price in specified circumstances,<sup>163</sup> or “demand” registration rights that require the company to register the investor’s shares for a public offering when the investor so desires and stipulated conditions are met.<sup>164</sup>

Disputes can also arise over exit opportunities. If an offer is made to buy the company, one party may want to take it but the other party vetoes the offer; or one party agrees to sell its interest (usually the controlling interest) in response to a third-party offer that is not made to the other partner. In the former case a party can avoid being “frozen in” by an “unlocking clause,” which requires a party that vetoes a bid to offer to buy out its partner at the same price it rejected.<sup>165</sup> The latter plight may be prevented by a “tag-along” or “take-me-along” clause forbidding sales to third parties unless all partners are invited to sell on the same terms.<sup>166</sup> If the company makes a public offering of its stock, an investor may be assured a chance to participate in that offering by “piggy back” registration rights.<sup>167</sup>

Despite a desire for eventual liquidity, the parties may initially want to restrict the sale of shares.<sup>168</sup> With respect to the managers, the motive for restrictions is obvious; equity ownership increases their stake in the firm’s success and, thus, of their incentive to work for that success. Both the managers and investors may wish also to restrict transfers by an investor. Investors participate in control, have access to confidential information, and can ask a court to command or forbid the company to take certain steps. Managers and investors must trust each other and cooperate. They restrict share transfers so as to exclude investors who might upset the apple cart because they have a conflicting interest (like a stake in a competitor, customer, or supplier), or different investment goals (like a desire for dividends), or are simply hard to get along with.

Many public companies have a simple equity structure: one class of common stock.<sup>169</sup> As the foregoing shows, many private companies have several classes of common and preferred stock and debt convertible to equity, each with different

162. See ROBERT J. HAFT, 2 VENTURE CAPITAL AND SMALL BUSINESS FINANCINGS § 1:14, at 1–12 (1994) (describing such provisions).

163. See Kaplan & Strömberg, *supra* note 142, at 291.

164. See 2B HAFT, *supra* note 162, at F8-1 (describing “demand” registration rights).

165. See DAVID J. GLADSTONE, VENTURE CAPITAL HANDBOOK 148–49 (1988) (describing such a clause).

166. See J. Howard Clowes, *Equity Structures for Strategic Alliances*, in STRUCTURING, NEGOTIATING, AND IMPLEMENTING STRATEGIC ALLIANCES: 2001, at 69, 142–43 (PLI Corp. L. Practice Course, Handbook Series No. B4-7156, 1996) (sample clause, here called “right of co-sale”).

167. See 2B HAFT, *supra* note 162, at F8-1 (describing “piggyback” registration rights).

168. See ROBERT CHARLES CLARK, CORPORATE LAW 763 (1986) (“As time passes, the personal relationships among the major participants in a close corporation always change in important ways. . . . Shareholders who look ahead to these possibilities will usually want to restrict the transferability of their shares.”).

169. See JEFFREY J. HAAS, CORPORATE FINANCE IN A NUTSHELL 332 (2004) (“Most corporations typically have only one class of common stock outstanding.”).

rights and restrictions. The firm's success may depend on whether the lawyers create the right capital structure at the outset and revise it wisely as the company moves through each stage of development.

#### 4. The Significance of Regulation

Gilson notes the importance of regulation and the edge this gives lawyers in handling tasks entwined with regulation.<sup>170</sup> He finds this does not explain the lawyers' role, however, because "business lawyers frequently function in a world in which regulation has made few inroads."<sup>171</sup> This assertion is questionable. Regulation is not diminishing now and is unlikely to do so in the future. Expanding environmental regulation is probably the biggest new influence on business,<sup>172</sup> but nondiscrimination and privacy laws and land use regulation are also playing an increasing role. Changes in business are also adding to legal complexity. One example is the growing importance of intellectual property in the knowledge economy. What was once an obscure field that most lawyers safely ignored is now central to much of the economy. Globalization also requires more firms to juggle simultaneously laws of several jurisdictions, many of which differ fundamentally from our own.

None of this contradicts Gilson's call to expand the skills of business lawyers, but it does call for a different focus than he suggests. For the M&A specialist concentrating primarily on information issues and, occasionally, an earnout, the growing importance of regulation is of little relevance. For most business lawyers, though, it is central.

#### 5. Agency Costs and Opportunism

Because Gilson's specimen is the acquisition, a one-time arm's-length deal, it is unsurprising that he sees business lawyers as transaction cost engineers and stresses the costs of producing and verifying information. Relational contracts, alliances, and internal transactions need a broader concept. These relationships entail agency and agency costs—i.e., "the sum of the monitoring and bonding costs, plus any residual loss, incurred to prevent shirking by agents."<sup>173</sup> "Shirking" (or rent-seeking or opportunism) "include[s] any action by a member of a production team that diverges from the interests of the team as a whole."<sup>174</sup> "Norms of cooperation and mutual trust," which are crucial to the success of these rela-

170. See Gilson, *supra* note 1, at 296–98.

171. *Id.* at 247.

172. Ralph Lindeman, *Small Businesses Face Highest Burden of Regulatory Costs, New Study Says*, DAILY REP. FOR EXECUTIVES (BNA), No. 181, at DER-A26 (Sept. 20, 2005).

173. BAINBRIDGE, *supra* note 66, at 35–36. See generally *id.* at 35–38. All relational contracts and alliances entail agency in the economic sense that one party relies on the exercise of discretion by another, although they do not always entail agency in the legal sense of one party (the agent) having authority to act on behalf of another.

174. *Id.* at 36.

tionships, "create openings for opportunists . . . to abuse them."<sup>175</sup> Thus, deterring opportunism is a principal concern of corporate law<sup>176</sup> and of lawyers who structure these relationships.<sup>177</sup>

## 6. Looking Ahead (and Further Ahead)

The time frame of M&A specialists generally ends at the closing. Earnouts are an exception, but they are relatively uncommon and require only limited planning. By contrast, many other areas of business practice require extensive planning for future dealings. Again, a relational contract, strategic alliance, or (re)organization of a firm requires careful planning to promote cooperation and trust in order to maximize gains to all.

To foster trust a lawyer may include some purely aspirational contract declarations about "the centrality of trust in the relationship" and "that success will depend on continuing cooperation."<sup>178</sup> Although not legally enforceable, such terms are useful because the people involved in the alliance change over time. Those who create the alliance may move on; their successors should understand the intentions of the parties when they formed the venture.<sup>179</sup> Trust and cooperation are also nurtured by provisions for frequent meetings and exchanges of information.<sup>180</sup>

Partners begin a venture with certain expectations. In venture financings, for example, control and financial rights are allotted on the basis of agreed projections that usually begin with a business plan prepared by the entrepreneurs.<sup>181</sup> Since the enterprise and the projections are created by the entrepreneurs, venture capitalists often argue that, if the projections are not met, the entrepreneurs should surrender some of their control and financial rights to the investors. This can be arranged through a "voting switch" or "event of election" clause.<sup>182</sup>

175. Robert W. Gordon, *Why Lawyers Can't Just Be Hired Guns*, in *ETHICS IN PRACTICE: LAWYERS' ROLES, RESPONSIBILITIES, AND REGULATION* 42, 44 (Deborah L. Rhode ed., 2000).

176. See BAINBRIDGE, *supra* note 166, at 27.

177. See Rasmusen, *supra* note 143, at 44 ("The purpose of the legal staff is to deter the other side from trying to be sly or dishonest . . .").

178. JORDAN D. LEWIS, *TRUSTED PARTNERS: HOW COMPANIES BUILD MUTUAL TRUST AND WIN TOGETHER* 265 (1999) (recommending such provisions).

179. See George G. Triantis, *The Efficiency of Vague Contract Terms: A Response to the Schwartz-Scott Theory of U.C.C. Article 2*, 62 *LA. L. REV.* 1065, 1072-73 (2002) (stating that "[t]he parties may use a vague term to communicate intentions and expectations to each other or even to their own co-workers or agents").

180. See Jörg Sydow, *Understanding the Constitution of Interorganizational Trust*, in *TRUST WITHIN AND BETWEEN ORGANIZATIONS: CONCEPTUAL ISSUES AND EMPIRICAL APPLICATIONS* 38, 48 (Christel Lane & Reinhard Bachmann eds., 1998) (noting that "frequent, repeated and multifaceted contacts among organizations and an open exchange of information increase the possibility of trust building"); Gulati, *Alliances and Networks*, *supra* note 91, at 306 (stating that "regular information exchange with the partners" is associated with success in alliances); Edward H. Lorenz, *Neither Friends nor Strangers: Informal Networks of Subcontracting in French Industry*, in *TRUST: MAKING AND BREAKING COOPERATIVE RELATIONS* 194, 207 (Diego Gambetta ed., 1988) (stating that members of business networks invariably "stressed the need for personal contact").

181. See Bernstein, *Silicon Valley Lawyer*, *supra* note 28, at 245 ("The lawyer . . . assists the entrepreneur in developing a business plan . . .").

182. See *supra* note 162.

Further, additional financing is often contemplated.<sup>183</sup> Planning then is more complicated. The lawyers must create a structure that is suitable both for the present and for the changes that will be needed for later financing. To some extent the lawyers can let the parties cross that bridge when they come to it, but some advance planning is required. Consider a firm that begins with two parties—the managers and one investor. If more money is needed later and the initial investor can veto the entry of a new participant, the managers must then either watch the firm fail or let the initial investor provide the additional capital on whatever terms it dictates. If the initial investor has no veto, however, a new investor could obtain rights that drastically dilute the initial investor's financial and control rights.<sup>184</sup> The lawyers must arrange matters so that no party can block a future financing that would enlarge the pie (i.e., increase the value of the firm), and so that no future financing will seriously injure any incumbent party.

There are several ways to tackle this problem. If the initial board of directors has neutral directors who hold the balance of power between the managers and the investor, the future financing decision will not be self-interested, but it may still be unfair to another party or unwise for the firm. The initial investor may also obtain at the start anti-dilution clauses that entitle it to receive additional stock if a second issue of stock is made at a price lower than the initial investor paid.<sup>185</sup> However, such clauses mean that the decline in the stock's value must be borne disproportionately (or entirely) by the managers, which they may not consider fair.

Obviously, there is no one right answer to this problem. The minimum need is for *some* arrangement acceptable to all sides. The ideal solution is one that causes no friction when future financing is sought. The skill of counsel may determine whether the ideal is realized or, at the other extreme, no solution is found and the deal collapses. And this is but one of many issues that must be resolved when a firm is created. Other issues concern the future possibility of going public, such as what happens to the rights of investors that are unsuitable in a public company.

Handling these problems requires distinct skills. Counsel must be able to anticipate future problems and fashion solutions to them. In so doing they must decide what issues can be left open until later and which should be resolved at the outset, which in turn raises questions of how important various questions are to the parties. Thus, counsel needs an understanding of what problems can arise for a particular firm as it grows and the special needs of its particular parties.

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183. See Bartlett, *supra* note 98, at 52 (stating that "a venture capitalist will typically stage its investment in a start-up company by incrementally investing capital over time"). Joint ventures and other alliances also frequently need additional capital after a time, and this need can cause friction between the parties. See George W. Dent, Jr., *Gap Fillers and Fiduciary Duties in Strategic Alliances*, 57 *BUS. LAW.* 55, 93 (2001) [hereinafter "Dent, *Gap Fillers*"].

184. See Bartlett, *supra* note 98, at 53–54 (stating that a venture capital investor "typically obtains special stockholder voting rights (or 'protective provisions') allowing the investor to veto important corporate actions").

185. See Bartlett, *supra* note 98, at 79–80 (describing anti-dilution clauses).

## 7. Conclusion

The range of enterprise designs is vast and solutions are often complex. Part of the complexity is that the solution to one problem often gives birth to another. If counsel is skillful, however, the new problem will be smaller than the old, and the new problem can also be solved. Although that solution, too, may spawn new difficulties, eventually problems may be whittled down to acceptable proportions.<sup>186</sup>

### C. PRACTICAL SKILLS

In addition to enterprise design, most business lawyers need a variety of practical skills that are largely irrelevant to the M&A specialist. Although many of these skills are also needed in other fields of legal practice, the demands on business lawyers are in many ways distinctive.

#### 1. Spotting and Solving Problems and Counseling

Gilson's M&A specialists may spot a problem of which the clients were unaware—that is the whole purpose of having lawyers produce and verify information. However, their clients are sophisticated and have sophisticated advisors in several fields; the lawyers enter the lists late in the contest, after most significant issues have been resolved. As a result, the scope of the lawyers' work is quite limited.

In many other matters business lawyers arrive much sooner, not only before major issues are settled but often before many of them are identified. Indeed, business people often leave the discovery and negotiation of problems to the lawyers. In deals where parties must cooperate after the closing or anticipate future dealings, they cultivate amicability and trust in their direct contacts. To harp on differences would sabotage this effort.<sup>187</sup> Thus, "businessmen when bargaining often talk only in pleasant glittering generalities, think they have a contract, but fail to reach agreement on any of the hard, unpleasant questions until forced to do so by a lawyer."<sup>188</sup>

As Gilson says, the form of acquisition agreements is pretty well settled,<sup>189</sup> but the structure of many other transactions is highly negotiable. In strategic alliances, for example, the parties may at first be undecided whether to create a joint

186. A less sanguine view is offered by Robert Bartlett: "[T]he very attempt to manage one form of agency problems may itself result in a second, equally troublesome dimension of agency problem among other corporate constituents." Bartlett, *supra* note 98, at 47.

187. See David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104 HARV. L. REV. 373, 405 (1990) ("Negotiation may also create or intensify an adversarial atmosphere by raising the specter of litigation for transactors who wish to view themselves as friends or partners.").

188. Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55, 76 (1963). See also HARRIGAN, *supra* note 115, at 363 (stating that a common reason for the collapse of joint venture negotiations is "that partners did not think through their arrangements adequately before they reached the altar. The probing questions the lawyers asked exposed these shortfalls in partners' agreements, and the venture fell apart.").

189. Gilson, *supra* note 1, at 257 (noting "the general contents of the [acquisition agreement] have by now become pretty much standardized").

venture, franchise, license, or dealership.<sup>190</sup> They may also be unsure what products, territory, and time period to cover. If dealing with advanced technology, they may not even be sure what the product is. Even at closing their attitude may be a cheerfully optimistic "let's hope it works."

Because the parties often duck known sore points and are unaware of lurking problems, lawyers play a crucial role in ferreting out difficulties and finding solutions.<sup>191</sup> This task is rendered trickier because spotting problems may cause a deal to collapse, whereupon the lawyers may be blamed for "queering" the deal.<sup>192</sup> In many cases this accusation is not warranted, but in some it is. Law schools teach students adversarial activity (i.e., litigation) and probing analysis to detect errors of fact and logic,<sup>193</sup> so problem spotting comes more naturally to lawyers than problem solving. "[I]n many cases lawyers are satisfied when they say you can't do what you propose to do . . . . [C]lients expect you to take the next step and solve the problems."<sup>194</sup> And, for self-preservation, a lawyer can be expected to behave so that, if a deal does collapse, she will not be blamed.

More generally, to detect and solve problems a lawyer must understand the business context in which the client operates. This is something of which many lawyers are ignorant—often, it seems, willfully so. The biggest complaint of many corporate general counsel about their outside lawyers is their "not understanding [the client's] business pressures."<sup>195</sup>

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190. See Dent, *Lawyers and Trust*, *supra* note 61, at 67–70 (discussing choice of entity in alliances). See also Gulati, *Alliances and Networks*, *supra* note 91, at 302 (stating that there is "considerable variation in the formal structures of alliances"); Glover, *supra* note 90, at 9 (referring to a lack of standard-form contracts for joint ventures).

191. See Thomas Disare, *A Lawyer's Education*, 7 MD. J. CONTEMP. LEGAL ISSUES 359, 370 (1996) ("The ability to accumulate relevant facts and to identify actual or possible legal issues which those facts raise is also key").

192. "The most frequent answer explaining why announced joint ventures never went beyond the discussion stage was that ventures were sunk by lawyers." HARRIGAN, *supra* note 115, at 363. See also ROBERT A. WENKE, *THE ART OF NEGOTIATION FOR LAWYERS* 86 (1985) ("[M]any business people view attorneys as deal killers."); SMITH, *supra* note 131, at 136 (referring to the "historical dread" of corporate clients who have "just cooked up a whale of a business deal" that "it will take the lawyers three months to 'clear' . . . and they're bound to sabotage the whole thing anyway").

193. See Daniel D. Bradlow & Jay Gary Finkelstein, *Training Law Students to Be International Transactional Lawyers—Using an Extended Simulation to Educate Law Students About Business Transactions*, 1 J. BUS. ENTREPRENEURSHIP & L. 67, 68 (2007) ("Law schools . . . have historically focused on litigation-based instruction . . ."); J. Edwin Dietel, *Exceptional Lawyer Leadership: Trust and Trustworthiness*, LAW PRACTICE Q., June 2002, [www.abanet.org/lpm/newsletter/articles/newsarticle0502\\_p3\\_front.shtml](http://www.abanet.org/lpm/newsletter/articles/newsarticle0502_p3_front.shtml) (stating that law students "are trained to question, doubt, to be adversarial, to be independent, to be competitive, and to think win-lose. At or near their extremes, each and all of these concepts can and often do work at cross purposes to earning, building, and maintaining trusting relationships.").

194. Friedman, Gordon, Pirie & Whatley, *supra* note 28, at 563 (quoting a Silicon Valley lawyer). See also *id.* at 562 (stating that in Silicon Valley the lawyers' "job is to solve problems: to take a principle, a task and 'engineer' it legally, showing how it can be done, or be done best. It is not his job to say something can't be done, but to show how it *can* be done." (emphasis in original)); SMITH, *supra* note 131, at 136 (stating that clients want lawyers to "find . . . ways to help businesses stay within the law and still get their deals done").

195. Kathryn Hayes Tucker, *What's GC's Biggest Beef with Outside Counsel?*, FULTON COUNTY DAILY REP., Sept. 14, 2007, <http://www.law.com/jsp/ihc/PubArticleFriendlyIHC.jsp?id=1189674162049>. See SMITH, *supra* note 131, at 173, 249 (referring to the need for lawyers to develop a "closer identification" with the client's "corporate goals, corporate interests, corporate culture" and to "understand the

## 2. The Lawyer's Role in Promoting or Questioning Transactions

Unlike mergers, transactions contemplating long-term interaction require that the parties develop trust and cooperation. Clients often feel that lawyers hinder this effort. "[M]any businesspeople are more at ease without lawyers in the room, more confident about getting things accomplished while preserving the goodwill between the parties. They rail at the negative attitudes lawyers exhibit, seeing a problem behind every bush, overcompensating to avoid risk, generating conflict."<sup>196</sup> As a result, they often exclude lawyers until late in the game.<sup>197</sup> To be helpful the lawyer must promote the client's other interests without shattering trust and cooperation with the other party.

One way to preserve trust is to avoid unusual and complex terms. The effects of novel terms are hard to predict; business people feel more comfortable with customary terms.<sup>198</sup> They also prefer to rely on trust and cooperation rather than on contract terms.<sup>199</sup> Proposing novel or complex terms may signal that a party intends to "rely on his legal rights" in case of a dispute rather than trying to resolve it amicably.<sup>200</sup> "[P]arties propose simple contracts . . . in order to signal that they are trustworthy."<sup>201</sup> The need for trust and cooperation should influence the

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[clients] business objectives"). The need to "educate new firms about their operations" is one reason for corporate clients to eschew outside lawyers in favor of in-house counsel. Steven L. Schwarcz, *To Make or to Buy: In-House Lawyering and Value Creation*, 33 J. CORP. L. 497, 504 (2008) [hereinafter "Schwarcz, *In-House Lawyering*"]; see also *id.* at 514. They consider inside lawyers to have a "better understanding of their problems." *Id.* at 509. Inside lawyers are often preferred for handling matters like "preventive law" because they are "closer to the business of the client than outside counsel." SMITH, *supra* note 131, at 221. See *supra* note 124 and accompanying text for a definition of preventive law.

196. FREUND, *supra* note 72, at 186; see Ernst & Glover, *supra* note 90, at 6 (stating that lawyers' inclinations may clash with the parties' desire to establish a long-term cooperative relationship).

197. See FREUND, *supra* note 72, at 186 ("[M]any businesspeople avoid introducing lawyers into the early stages of a deal when, in their view, what's needed is nurturing—not disaster scenarios."). It is telling that "in-house counsel seem to get involved at earlier stages of transactions than outside counsel, often helping (more than outside counsel could) to actually structure transactions." Schwarcz, *In-House Lawyering*, *supra* note 195, at 509; see also Abram Chayes & Antonia H. Chayes, *Corporate Counsel and the Elite Law Firm*, 37 STAN. L. REV. 277, 281 (1985) (noting that "the very existence of a properly established inside counsel pushes back the involvement of lawyers to an earlier phase of a transaction and shifts the mode from reactive to proactive"). See also Gulati, *Familiarity*, *supra* note 68, at 95 (quoting one senior business executive as saying "[s]ometimes we give our lawyers only a few days to write up the contract, and that too after the project may already have begun").

198. See Bernstein, *Silicon Valley Lawyer*, *supra* note 28, at 248–50 (stating that using standard terms bolsters trust because the parties are familiar with them and their effects). See also *id.* at 230 n.107 (stating that the biggest factor affecting trust "is whether the proposal departs from custom"). Of course, innovation is proper, even necessary, when the client has new technology or a new problem. See *infra* note 233 and accompanying text.

199. See Macaulay, *supra* note 188, at 58 ("Business people often prefer to rely on a man's word . . .").

200. Lisa Bernstein, *Social Norms and Default Rules Analysis*, 3 S. CAL. INTERDISC. L.J. 59, 70–71 (1993).

201. Karen Eggleston, Eric A. Posner & Richard Zeckhauser, *The Design and Interpretation of Contracts: Why Complexity Matters*, 95 Nw. U. L. REV. 91, 117 (2000). See also *id.* at 115 (noting "trust and nonlegal sanctions encourage the formation of simple contracts"); Macaulay, *supra* note 188, at 64 ("Some businessmen object that in . . . a carefully worked out relationship, one gets performance only to the letter of the contract . . . whereas performing to the spirit of the contract would offer mutual expected gains.").

lawyer's demeanor as well as her substantive positions. One veteran practitioner says "the attorney on the other side and I see each other as partners facilitating a mutually beneficial business arrangement."<sup>202</sup> This is achieved by the "signaling of shared assumptions and understandings at the very beginning. Competence, benevolence, and integrity [are] important antecedents of trustworthiness."<sup>203</sup>

On occasion, however, clients want a lawyer to play the heavy in a good-cop bad-cop game.<sup>204</sup> Although seeking trust and cooperation, clients also realize that tough issues must be tackled, so they assign lawyers the dirty work. The business people on both sides take the resulting benefits while disowning the lawyers' hardball tactics. However, some business people may not know this game. The lawyer must navigate cautiously to placate varied sensibilities. Playing the bad cop should be easier for outside counsel, and may be one reason for the continuing use of outside counsel to handle contentious issues.

A lawyer who represents a client frequently cares more about pleasing the client and less about his own reputation than a lawyer in a one-time representation. Even in the former case, though, the lawyer often expects that he will again face those with whom he is dealing in the future. Lawyers in a venture capital financing may deal with the same people repeatedly. Lawyers who create a strategic alliance may meet again later to cope with new problems or to revise the venture. Lawyers who get a reputation for being unreasonable may find others hesitant to deal with them and, thus, with their clients, and that word spreads that clients should not hire them.

Concern for her reputation can affect not only a lawyer's behavior toward third parties but also her advice to her client. Again, many deals rely on trust as well as contract. If a client violates a partner's trust, the lawyer may fear damage not only to the client but also to her own reputation.<sup>205</sup> More generally, the lawyer will seek to prove himself not as a one-time hired hit man but as a valuable member of an ongoing team. To do so he must understand the company's business plan, strategy, and culture, matters of no interest to the M&A specialist. And to understand the business a lawyer must ask questions, something many lawyers hesitate to do.<sup>206</sup>

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202. Lewis, *supra* note 178, at 262 (quoting an unnamed lawyer). See also *id.* at 220 ("Candor is our style; bluffing and deception are unacceptable[] . . . We will use only logic, not politics or pressure, to find the best solutions.").

203. Sydow, *supra* note 180, at 38.

204. See Barondes, *supra* note 151, at 53 (discussing situations where a client "imput[es] responsibility to its counsel. . . Counsel, by taking responsibility[,] . . . can deflect the negative reputation that otherwise would accrue to the client . . .").

205. This would be especially likely in a tight-knit business community, which could comprise either a geographic area or an industry. See Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243, 252-53 (1998) (discussing reputational constraints on parties in the venture capital industry in Silicon Valley).

206. See Robert Eli Rosen, *The Inside Counsel Movement, Professional Judgment and Organizational Representation*, 64 IND. L.J. 479, 505-06 (1989) (noting that "elite law practitioners do not adequately and efficiently determine the client's objectives for the representation"). One in-house lawyer complained, "You'd be amazed at how many law firms will make a pitch [for the company's work] and never ask a question about our business." Tucker, *supra* note 195 (quoting Teri Plummer McClure, General Counsel of UPS).

A lawyer whose client is a repeat customer will also care about the client's reputation and about his own impact on that reputation. M&A specialists often do not worry that aggressive tactics will alienate opposing parties and, since they are one-time agents, their behavior is not likely to be ascribed to the client anyway. A repeat player, though, needs a reputation for being fair, reasonable, trustworthy, and cooperative, and its regular lawyer will be viewed as one of its general representatives; the client cannot disclaim responsibility if its lawyer acts improperly. Because of the ongoing relationship, the lawyer will also be more careful to keep her fees reasonable. These concerns are heightened if the lawyer has only one client; i.e., when the lawyer is house counsel. The lawyer's entire career then depends on satisfying that one client, which calls for behavior different from that of the M&A specialist.

### 3. Cost Consciousness

Thoroughness is ingrained in the legal profession. New law students learn that a good lawyer dots all "i's" and crosses all "t's"; failure to do so courts malpractice liability. M&A specialists can be thorough, billing the client for long hours spent poring over every detail. Acquisitions have huge sums at stake and armies of expensive advisors; excruciating care may be cost-justified, and the lawyers' fees are small compared to those of the investment bankers.<sup>207</sup> Mistakes can be expensive. A corporate officer (especially of the buyer) who curbs the lawyers could be blamed if a major defect is overlooked. Further, if the client is a public company, the lawyers' fees are borne by the public shareholders. The self-interest of the officer, then, is to instruct the lawyers to spare no expense.

In most other areas of business practice clients are more sensitive to legal fees.<sup>208</sup> Hourly billing is often limited or eliminated altogether because it rewards lawyers for "running the meter."<sup>209</sup> Lawyers who spend too much time on matters will lose money or lose their clients. "Simply put, clients want 'good enough' legal services, and outside lawyers frequently strive to deliver work worthy of an A+

207. See J. Peter Williamson, *Mergers and Acquisitions*, in *THE INVESTMENT BANKING HANDBOOK* 219, 245 (J. Peter Williamson ed., 1988) ("Generally, the investment banker's fee in a major M&A transaction is based on the size of the transaction, often running into the millions of dollars. Lawyers' fees have been much lower, although they have risen in recent years.").

208. See Disare, *supra* note 191, at 385 ("Clients have become overly conscious that 'the clock is running.' Contact with lawyers is generally kept at a minimum to avoid excessive legal bills."); Debra H. Snider, *Enough Is Just Enough*, *CORP. COUNSEL*, Oct. 17, 2001, [http://www.debrasnider.com/site/files/639/43356/175619/242742/Enough\\_Is\\_Just\\_Enough\\_w-o\\_bio.pdf](http://www.debrasnider.com/site/files/639/43356/175619/242742/Enough_Is_Just_Enough_w-o_bio.pdf) (stating that business people believe that lawyers engage in "overlawyering" and should pay more attention to cost efficiency and the client's "business objectives").

209. See Langevoort & Rasmussen, *supra* note 109, at 389–93 (showing how hourly billing encourages overlawyering). See also Julie Kay, *Billing Gets Creative in Souring Economy*, *NAT'L L.J.*, Nov. 10, 2008, at 1, 1 ("What has been a slow and steady call by many corporations, in-house counsel and legal think tanks to law firms to abandon the billable hour in favor of alternative fee arrangements has turned into a loud drumbeat in the past year . . ."); Zusha Elinson, *Are Big Firms Warming Up to Alternative Fee Deals?*, *THE RECORDER*, July 11, 2007, [www.law.com/jsp/law/LawArticleFriendly.jsp?id=1184058401567](http://www.law.com/jsp/law/LawArticleFriendly.jsp?id=1184058401567) ("With hourly rates continuing to skyrocket at big firms, clients are pushing alternative fees as a way to control costs . . . While the billable hour is still the most common

on a law school exam."<sup>210</sup> To succeed, lawyers first need the skill to distinguish what's important and cost-effective for the client, and what's not. In negotiations, for example, the lawyer must determine whether the cost of negotiating and drafting a provision will exceed the present value of its benefits.<sup>211</sup> Lawyers must also explain to the client what work is needed and why. Many clients complain that lawyers do not do this well.<sup>212</sup>

The lawyer and client also need a fee structure that works for both. Clients will not pay by the hour for a lawyer who quibbles endlessly over trivia. If a lawyer works for a fixed fee, unnecessary or inefficient work earns no reward; it just wastes her own time. Lawyers may fear fixed fees, though, because the client may demand extra service for which the lawyer will not be paid. Clear communication and cooperation between lawyer and client are needed to reach a mutually satisfactory arrangement.

Some clients ask their lawyers to take part of their fee in stock in the client.<sup>213</sup> Handling this request requires another distinct skill of the lawyer. First, the lawyer needs to gauge whether the client will succeed so that its stock will be valuable. The law firm must also be sure it can pay its own costs (rent, utilities, compensation of staff and associates) when it is not being paid in cash. The law firm must ascertain the tax consequences of the arrangement and decide how it fits into its own profit-sharing agreement. In particular, to what extent (if at all) should the risks of stock ownership in a client be shared by firm partners who have not served that client?

Share ownership alters a lawyer's relationship with the client. The lawyer's time horizons and risk preferences may differ from those of other shareholders, thus influencing the lawyer's advice about dividends and other payouts, capital structure, and what projects the firm should undertake. The lawyer then is also a rival

calculation, fixed fees for larger volumes of work or success-based arrangements . . . are getting more attention . . ."); David Gialanella, *The Skinny on Flat Fees*, ABA J., July 2008, at 26 (discussing a firm that is using flat fees); SMITH, *supra* note 131, at 233 (referring to the wide variety of billing structures used by various corporate clients). See generally RICHARD C. REED, BILLING INNOVATIONS: NEW WIN-WIN WAYS TO END HOURLY BILLING (1996); Stephen W. Jones & Melissa Beard Glover, *The Attack on Traditional Billing Practices*, 20 U. ARK. LITTLE ROCK L. REV. 293 (1998). The lack of this incentive is one reason for the growth of in-house counsel. See Schwarcz, *In-House Lawyering*, *supra* note 195, at 505-06.

210. Snider, *supra* note 208, at 57.

211. This is the basic tenet of costly contracting theory. See Alan Schwartz & Joel Watson, *The Law and Economics of Costly Contracting*, 20 J.L. ECON. & ORG. 2, 2-6 (2004).

212. See Zusha Elinson & Douglas Malan, *Corporations Increasingly Unhappy with Their Outside Counsel*, CONN. L. TRIB., July 9, 2007, at 1 (reporting study finding that most corporate clients were not satisfied with their outside counsel and that poor communication was a major complaint).

213. Rules of professional responsibility now permit lawyers in proper circumstances to accept stock as payment. MODEL RULES OF PROF'L CONDUCT R. 1.8(a) (2003) (permitting a lawyer to "enter into a business transaction with a client" if "the transaction and terms . . . are fair and reasonable," the client receives written advice "to seek the advice of independent counsel," and "the client gives informed consent, in a writing"). The practice became common. See Christine Hurt, *Counselor, Gatekeeper, Shareholder, Thief: Why Attorneys Who Invest in Their Clients in a Post-Enron World Are "Selling Out," Not "Buying In,"* 64 OHIO ST. L.J. 897, 918 (2003) ("In 1999, law firms in Silicon Valley midwived 173 clients in IPOs and owned equity in ninety-nine of those clients."). It is unclear whether the bursting of the dot.com bubble or the more recent turmoil in the financial markets has reduced this practice.

when other shareholders have or seek separate rights, like the liquidation preference and board representation that venture capitalists often have.<sup>214</sup>

The competition for a company's legal work often includes both law firms and inside counsel. There is a trend toward bringing more legal work in-house.<sup>215</sup> This is not surprising; as employees, in-house lawyers are subject to closer control by the company's officers, they have a better knowledge of the company's business and goals, and their physical presence in the company obviates some travel and other costs. At the same time, though, large corporations realize that house counsel is not always the most cost-effective provider, particularly for specialized legal work.<sup>216</sup>

#### 4. Business Aspects of Business Law Practice

It is now commonplace that the practice of law has become less a profession and more a business.<sup>217</sup> Many lawyers could once just do their work as they thought best and bill clients for the hours they spent. Nothing more was required to achieve prosperity. That has changed. Law firms now compete more for business. Clients no longer hire one firm for all their legal work; they retain different firms for different matters, and often look for a particular lawyer, not a whole firm.<sup>218</sup> Lawyers are more mobile. It was once rare for partners to switch firms; now it happens every day. As a result, firms can no longer divide income on some stair-step basis like the partner's year of law school graduation.<sup>219</sup> A lawyer who brings more income to the firm than she is allowed to take out will go elsewhere. Because

214. See 2 HAFT, *supra* note 162, § 1.01, at 1–4 (describing conflicting interests when lawyer is also a shareholder).

215. See ANTHONY T. KRONMAN, *THE LOST LAWYER—FAILING IDEALS OF THE LEGAL PROFESSION* 284 (1993) (stating that “many corporations today do more of their own routine legal work than they did before, and increasingly rely on outside firms only for those unusual matters requiring special intellectual or other resources that it would be uneconomical for these companies to acquire on their own”); Mary C. Daly, *The Cultural, Ethical, and Legal Challenges in Lawyering for a Global Organization: The Role of General Counsel*, 46 EMORY L.J. 1057, 1059 (1997) (reporting that between 1961 and 1982 the number of in-house lawyers quadrupled, and that from 1980 to 1991 the number rose by 33 percent); Rosen, *supra* note 206, at 488; D. Daniel Sokol, *Globalization of Law Firms: A Survey of the Literature and a Research Agenda for Further Study*, 14 IND. J. GLOBAL LEGAL STUD. 5, 24–25 (2007) (referring to the growing “importance of the in-house counsel to the corporation” and the “increasingly large number of roles” played by in-house counsel); Niraj Chokshi, *Survey: GCs Cutting Back on Outside Firms*, THE RECORDER, June 25, 2008 (on file with *The Business Lawyer*) (stating that “more chief legal officers are planning to decrease their reliance on outside counsel and increase their in-house staffs in the coming year”); Smith, *Venture Capital*, *supra* note 144, at 227 (stating that between 1990 and 2000 General Electric increased the portion of legal work done in-house from 40 percent to 60 percent).

216. See Michael J. Powell, *Professional Innovation: Corporate Lawyers and Private Lawmaking*, 18 LAW & SOC. INQUIRY 423, 450 (1993) (stating that corporations “remain dependent on outside counsel for specialized advice and representation in critical high-risk areas”).

217. See Miller, *supra* note 64, at 1111–21. Professor Miller concludes that changing economic conditions of corporate practice have produced “a far-reaching change in the economic organization of the legal profession from a ‘club’ system to a competitive one.” *Id.* at 1106.

218. See SMITH, *supra* note 131, at 255–60.

219. See Miller, *supra* note 64, at 1118 (“The ‘Cravath’ strategy of lockstep partner compensation has given way nearly everywhere to ‘performance-based’ pay.”).

clients are more cost conscious and no longer hire a firm to handle all the client's legal work, each firm department—indeed, each lawyer—must be treated as a “cost center.” Those that do not pull their weight must be retooled or removed.

#### D. ETHICAL ISSUES

The range of ethical issues confronting the M&A specialist is narrow. She must be honest and may face questions about shading the truth. Otherwise, her main concern is to represent her client zealously, which usually does not pose any serious quandaries. Deciding whether to enter into a merger and with whom, and negotiating the price and other basic terms, often do raise difficult ethical issues, but these are usually decided before the M&A specialist arrives.

Lawyers in other areas of business practice, though, face a host of ethical issues, often on a daily basis. Sometimes the correct path is unclear, and doing the right thing may be costly. In organizing a business the lawyer is often asked to represent several parties, and may do so with their consent if she can represent them all fairly.<sup>220</sup> Deciding whether the multiple representations can begin and continue and balancing the interests of the various clients can pose tough ethical questions. In reorganizing a business the interests of various participants in the firm may differ. The lawyer is supposed to represent the entity,<sup>221</sup> but the entity is a fictitious person. Again, balancing the conflicting interests of the participants may be difficult. When the lawyer owns stock in the firm,<sup>222</sup> she must also try not to favor her own interests unfairly.

In strategic alliances the parties often owe each other fiduciary duties<sup>223</sup> with which the lawyers as well as the business people must comply. House counsel are employees as well as legal advisors. As lawyers with a single client, their own interests are entwined with the actions of that one client to an extent that outside counsel almost never are. This situation may compromise the lawyer's independence.<sup>224</sup> It may also sway the lawyer's advice about questions like whether to allot some legal work to in-house or outside counsel.

The Sarbanes-Oxley Act and amendments to the rules of professional responsibility have also added to the ethical duties of lawyers.<sup>225</sup> The lawyer who learns of illegal conduct within a client firm now may not be able to remain silent while continuing the representation. She may be obliged to report the illegality to higher officers and the board of directors and, if they fail to make appropriate corrections, to resign as counsel and perhaps to notify outsiders.<sup>226</sup>

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220. See *supra* note 95 and accompanying text.

221. See *supra* note 93.

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

223. See *supra* note 92 and accompanying text.

224. See *supra* note 100.

225. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 745, 784 (codified at 15 U.S.C. § 7245 (2006)) (authorizing SEC to adopt rules requiring corporate attorneys to report certain incidents of illegality); MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (2003) (requiring company lawyer to report certain known incidents of illegality).

226. See *supra* note 225.

In sum, the wide range of activities performed by business lawyers now pose far more and more complicated ethical issues than those faced by M&A specialists.

## E. CONCLUSIONS: THE DISTINCTIVE ROLE OF LAWYERS

The work of M&A specialists is narrow, esoteric, and not distinctively “legal.” It is not surprising, then, that Gilson considered their status tenuous and urged lawyers to re-create themselves as quasi-corporate finance experts.<sup>227</sup> A wider view of business law practice suggests quite a different diagnosis. The role of business lawyers, especially in enterprise design, is broad. And although much of this work can be done legally without admission to the bar, knowledge of the law is so essential to it that it would be foolish to try.

Changes in business are increasing the need for lawyers’ skills.<sup>228</sup> Transactions like strategic alliances and venture capital financing have proliferated.<sup>229</sup> They often require complex planning,<sup>230</sup> and enterprise design for these transactions is evolving rapidly. Innovation comes from many sources, but lawyers certainly play a key role in the process. As Gilson acknowledged, acquisition agreements have become standardized.<sup>231</sup> In other areas, however, there is, and probably will long continue to be, ample room for lawyers to be creative. For some types of transactions, such as angel investments, there are no standardized terms yet.<sup>232</sup> And creativity is indispensable “where a client comes in with a new technology or a new problem and there is no form book to go to and change the dates and names.”<sup>233</sup>

Business lawyers are not retreating into a shrinking domain, but expanding their realm and prestige. In Silicon Valley, the great incubator of new enterprises, lawyers now not only pursue a broad practice of business law but also engage in matchmaking, helping to draft an entrepreneur’s business plan, vouching for a client’s honesty, and instructing untutored clients about the ven-

227. Gilson, *supra* note 1, at 305.

228. See Huszagh & Huszagh, *supra* note 114, at 147 (“As a result of competition, innovation and information handling technologies, the need to execute [transactional] arrangements efficiently and effectively has increased, making lawyers critical participants in these transactions.”).

229. See Dent, *Gap Fillers*, *supra* note 183, at 62–65 (describing growth of strategic alliances).

230. See Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 *STAN. L. REV.* 1067, 1076 (2003) (“The special character of venture capital contracting is shaped by the fact that investing in early stage, high technology companies presents [problems of uncertainty, information asymmetry, and opportunism] in an extreme form.”).

231. Gilson, *supra* note 1, at 257.

232. See *cf.* Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 *VAND. L. REV.* 1405, 1419 n.57, 1424–25 (2008) (stating that the angel investment market is characterized by informality).

233. Friedman, Gordon, Pirie & Whatley, *supra* note 28, at 562 (quoting a Silicon Valley lawyer). See also Powell, *supra* note 216, at 428 (discussing lawyers’ “development of new legal practices and devices . . . and even new forms of corporate organization”). By contrast, proposing novel terms may be counterproductive when new technology or problems are absent. See *supra* notes 198–203 and accompanying text.

ture capital industry's practices and norms.<sup>234</sup> This is not to say that business lawyers should be complacent. Much business law practice is routine and can be mechanized. Business lawyers who lack advanced skills must compete not only among themselves for a limited amount of uninteresting work but also with paralegals, a growing number of whom are foreigners willing to work for low pay.<sup>235</sup>

#### IV. IMPLICATIONS FOR LEGAL EDUCATION

##### A. IS THERE A PROBLEM? THE DOG THAT'S NOT BARKING

Gilson and others have discussed legal education for business lawyers. They vary in their prescriptions, but all agree there is a crisis.<sup>236</sup> We may demur if, like Sherlock Holmes, we note the dog that's not barking.<sup>237</sup> If business law training were deficient, we would expect employers of new business lawyers to be barking loudly to complain. In fact, they are not. Sad to say, their silence may not mean that law schools are doing a great job but that employers do not care what students learn in law school. Most employers seem to stress two hiring criteria: what law school the applicant attended, and what her grades were.<sup>238</sup> They likely do not even care whether a student took many business courses, much less about the content of any business courses she did take.

Legal educators could take comfort from this indifference of employers: it suggests we can run our schools however we please without hurting our students' career prospects. (Of course, law school applicants, alumni, and employers care about a school's prestige, so we compete like crazy for *U.S. News & World Report* rankings, but that has nothing to do with the curriculum.) However, most people like to think that what they do is important and not irrelevant to the outside world. So consider two possible explanations of employers' indifference about

234. See Bernstein, *Silicon Valley Lawyer*, *supra* note 28, at 245–51; Friedman, Gordon, Pirie & Whatley, *supra* note 28, at 557–66; Karl S. Okamoto, *Reputation and the Value of Lawyers*, 74 OR. L. REV. 15, 28 (1995) (stating that if the business client's reputation is insufficient, the lawyer's reputation may be accepted as a substitute); 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, 699–700 (1996) (discussing the role of lawyers in educating entrepreneurs who seek venture capital financing); SMITH, *supra* note 131, at 137 (stating that, "if you had a great business idea," some Silicon Valley law firms "could help get you the venture bucks to make it happen").

235. See Miller, *supra* note 64, at 1115 ("Non-attorneys are performing tasks previously monopolized by lawyers, and even computers can do some of the work").

236. See *supra* Part I.C.

237. In *Silver Blaze* Holmes solves a crime in part by noting that dog that didn't bark. The dog's silence at the time of the crime showed that it had been committed by an insider, someone familiar to the dog. ARTHUR CONAN DOYLE, *Silver Blaze*, in *THE COMPLETE SHERLOCK HOLMES* 335, 347 (Doubleday & Co. 1930).

238. See Richard H. Sander, *A Systemic Analysis of Affirmative Action in American Law Schools*, 57 STAN. L. REV. 367, 458–59 (2004) (reporting that within each geographic region the most powerful predictors of earnings were law school grades and school prestige); Ursula Furi-Perry, *Do Law Firms Love Your Law School?*, NAT'L JURIST, Sept. 2007, at 30, 31 (noting that "more than 50 percent of all on-campus interviews take place at only 25 schools—or 13 percent").

curriculum. First, perhaps the right changes to the business curriculum would matter to employers, but the steps taken so far are not the right ones. Second, perhaps some law schools have made significant improvements but have not verified the improvements to employers. I will consider both possibilities.

## B. POSSIBLE IMPROVEMENTS

Gilson urged a focus on finance and transaction cost economics, not on mundane skills like drafting, negotiation, and familiarity with standard forms of agreements.<sup>239</sup> Business law curricula have changed,<sup>240</sup> but in 2005 Roberta Romano declared these changes “thoroughly inadequate.”<sup>241</sup> She would “actively encourag[e] students seeking a business law career to enroll in joint degree programs” which should be “streamlined” so that students could earn a JD and MBA in three rather than four years.<sup>242</sup> There is something to be said for both proposals, but they strike me as insufficient and somewhat misguided. First, they deal with the upper-class curriculum, but the problem begins in the first year. Most first-year law courses—torts, civil procedure, criminal law—deal explicitly with litigation. Those that do not—contracts and property—traditionally stress learning doctrine by reading appellate decisions. Thus they, too, emphasize litigation, not transactions.<sup>243</sup>

This is odd since many more lawyers work at negotiating and drafting contracts than at litigating over the doctrinal niceties of consideration, impossibility, unconscionability, and the parol evidence rule, which preoccupy most contracts courses. Contracts courses should not focus on enterprise design because much knowledge of the substantive law of business entities is needed for that. However, many contracts courses emphasize sales of goods, so the drafting and negotiation of a major sales contract would fit well and also initiate students in skills (including spotting and solving problems in transactions) useful in later courses in business associations.

After the first year, earning an MBA can help a prospective business lawyer.<sup>244</sup> Romano is right that this option “is currently not feasible because the student

239. See *supra* note 37 and accompanying text.

240. See *supra* notes 38–46 and accompanying text.

241. Romano, *supra* note 52, at 352.

242. *Id.* at 353.

243. See Edward Rubin, *Why Law Schools Do Not Teach Contracts and What Socioeconomics Can Do About It*, 41 SAN DIEGO L. REV. 55, 56 (2004) (noting that in most contracts courses students “never read even a single contract” and “are never given any instruction about the way to negotiate a contract”). See also Tina L. Stark, *My Fantasy Curriculum and Other Almost Random Points 3–8* (Emory Law and Econ. Research Paper No. 08-29, 2008), available at <http://ssrn.com/abstract=1158506> (recommending a contracts course with greater attention to transactional issues) [hereinafter “Stark, *Fantasy Curriculum*”].

244. There does not seem to be any good empirical evidence on the value of the JD-MBA, but some anecdotal evidence suggests that it does have some value. A few years ago Columbia’s Dual Degree Student Association did a survey which found that several law firms reward associates who hold the JD-MBA. See <http://www0.gsb.columbia.edu/students/organizations/ddsa/jdmbasur.htm> (last visited Dec. 18, 2008).

must forgo a year of employment and incur an additional year of tuition in the existing joint degree program framework, a costly impediment to most individuals' enrollment."<sup>245</sup> One practical problem with her proposal is that it would cost a law school money since it would have to share tuition with the business school. Most law school deans and faculties will not accept that. Romano mentions that one school (Northwestern) has already done so,<sup>246</sup> but that does not mean that many schools will follow suit. One program is an experiment that may fail, or may be financially feasible only because of gifts. Further, one or a few schools may attract some better students than their usual with a novel program. If many schools ape them, however, they will not all get that boost.

More important, reducing the JD-MBA program to three years means the MBA comes in lieu of, not in addition to, law courses. Many consider the third year of law school superfluous, at least for top students. If so, students would not lose much by spending one of their three years in business school. However, it also follows then that they would not lose much by ending school altogether and entering practice after two years. If, as Gilson and Romano agree, law schools are not well suited to teach skills for business lawyers,<sup>247</sup> eliminating the third year would be an improvement on the current program; at least it would save students a lot of money. Again, however, it would be opposed by law deans and teachers because it would cut tuition revenue by one-third and force cancellation of advanced courses, which faculty most enjoy teaching.

I am unpersuaded, though, that the third year of law school is superfluous and that the MBA is as valuable as Gilson and Romano believe. In the first two years of law school, students take basic courses that they remember throughout their careers. Specialized courses taken in the third year may seem less crucial, especially since most students cannot know what kind of practice they will eventually pursue. It does not follow, however, that little would be lost if third-year students decamped for business school. Although they may not realize it then or later, in the third year students hone general skills of research, writing, and analysis. Additional substantive courses also help to connect and integrate the discrete bodies of knowledge that they acquired in the first two years.

Further, few lawyers spend their entire careers practicing exactly what they planned to do in law school. Despite the inexorable trend toward specialization, flexibility is still essential. Young lawyers often wind up in unexpected fields. Even if they do not realize it, they may then profit from a broad legal education. An MBA may be helpful, but it is hardly indispensable; few lawyers who enter corporate law now have one. And, although I have no statistics, I believe it is rare for a business lawyer who lacks an MBA to decide that she needs one and to return to school to earn it.

245. Romano, *supra* note 52, at 353.

246. *Id.* The University of Pennsylvania also recently created a three-year JD-MBA program. See Press Release, Penn Law, Penn Law and Wharton Create 3-Year JD-MBA Program (Sept. 10, 2008), [http://www.law.upenn.edu/blogs/news/archives/2008/09/penn\\_law\\_and\\_wharton\\_create\\_3-.html](http://www.law.upenn.edu/blogs/news/archives/2008/09/penn_law_and_wharton_create_3-.html).

247. See Gilson, *supra* note 1, at 304; Romano, *supra* note 52, at 352.

This does not mean that some specialization in legal education is undesirable; the question is whether a year in business school is the right prescription. Law students can take a few courses in a business school, or a business course offered by the law school.<sup>248</sup> A longer tour of duty may be not only unnecessary but counterproductive. The knowledge of finance, transaction cost economics, and accounting that Gilson and Romano extol is only a tiny part of the skills the lawyer needs in most areas of business practice.<sup>249</sup>

Gilson questions whether law schools can teach practical skills like drafting and negotiation. He says “[l]aw firms and real practitioners, through some form of apprenticeship, are likely to do a far better job than any law school for a number of reasons.”<sup>250</sup> However, law school training in these general skills has improved greatly since Gilson wrote in 1984. Law schools now give more emphasis to skills training.<sup>251</sup> Upper-level courses are offered in these subjects; indeed, they are often required, and are often taught by specialists in these fields.<sup>252</sup>

It makes no economic sense for small and medium law firms and corporate law departments to give systematic skills training. Even large law firms now provide little training in these skills.<sup>253</sup> One reason is that in law, as in sports, the best performers are rarely the best pedagogues. Few top partners want to organize or conduct training for associates. Given their high billing rates, that would not be a cost-effective use of their time. Trapped between the Scylla of rising associate salaries and the Charybdis of growing cost consciousness of clients, it seems more likely that large firms will reduce rather than expand skills training in the future.<sup>254</sup>

Further, although general skills like drafting and negotiation are useful to all lawyers, Part III shows that business lawyers need many skills unique to their field, especially skills in what I call enterprise design. These are not skills taught in business school or by even large law firms. Whatever the shortcomings of law

248. See Stark, *Deal Lawyer*, *supra* note 44, at 232 (describing a two-credit course called Business Essentials offered at Fordham Law School). One professor who co-teaches a Deals course with Gilson says that the course includes a component that teaches “somewhat simplified versions of some of the financial concepts taught in business school.” He calls this part of the course “B-School Lite.” Fleischer, *supra* note 47, at 495.

249. See *supra* Part III.

250. Gilson, *supra* note 1, at 304 (footnote omitted).

251. See, e.g., Scott Jaschik, *Overhauling Law School’s Third Year*, INSIDE HIGHER ED, Mar. 12, 2008, <http://insidighighered.com/news/2008/03/12/thirdyear> (describing plan of Washington and Lee Law School to “completely replac[e] all academic courses in the third year of its program with ‘experiential’ courses in which students will perform work equivalent to that done by lawyers”). See also *supra* notes 39–47 and accompanying text.

252. See Disare, *supra* note 191, at 377, and authorities cited therein (noting “clinicians focus on such topics as interviewing and counseling, mediation, and fact gathering” (footnotes omitted)).

253. See Disare, *supra* note 191, at 360 (“Law firms and corporate clients are no longer willing to complete a law school graduate’s education.”); *id.* at 384 (noting “young associates no longer get the same education they used to in law firms[,] that which is not billable does not get done at law firms”).

254. See Bradlow & Finkelstein, *supra* note 193, at 70 & n.5 (“It is expensive for law firms to provide [transactional] training . . . . Indeed, . . . the cost of such training has become nearly prohibitive.”).

schools in teaching these skills, they seem better suited for it than anyone else. Moreover, materials for teaching these skills, which were unknown in 1984, now exist. These include materials in mergers and acquisitions (including a casebook co-edited by Gilson) and in business planning.<sup>255</sup> To facilitate specialization, some law schools now offer concentrations in various fields, including business organizations.<sup>256</sup>

Some skills common to other areas of the law have distinctive features in business law. Negotiation, for example, is ubiquitous in legal practice. However, lawyers negotiating in litigation rarely need to foster collaboration between the parties they represent. Business lawyers often do, and that need should influence their demeanor in negotiations.<sup>257</sup> The ethical problems of business lawyers also differ from those in other areas of practice. For instance, business lawyers are more likely than other lawyers to have to deal with representing multiple clients with divergent interests or to act after learning of illegal activity within a client firm.

One gauge of the quality of law schools' skills training may again be the dogs that are not barking. Despite the growing demand for JD-MBA graduates, they remain a small minority of the associates hired for corporate work even at the top law firms. The JD-MBA seems to be a moderately valuable credential, particularly for students in the middle of the pack, but unnecessary for top students.<sup>258</sup>

Another dog that's not barking is the practice-oriented literature for business lawyers. Treatises, journals and magazines (like *The Business Lawyer* and *Business Law Today*), and continuing education courses pay some attention to economic concepts and to non-technical skills (like negotiation). However, the main emphasis is on technical skills (like the drafting of anti-dilution clauses) and digesting and analyzing legal developments.<sup>259</sup> There is little discussion of lofty finance theory and no suggestions that business lawyers need an advanced course

255. See RONALD J. GILSON & BERNARD S. BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* (2d ed. 1995). See also GEVURTZ, *BUSINESS PLANNING*, *supra* note 135.

256. For example, my own law school—Case Western Reserve—offers concentrations in litigation; criminal law; health law; international law; law, technology, and the arts; and public law, as well as business organizations. See Case Western Reserve University School of Law, Concentration Information, <http://law.case.edu/concentrations/> (last visited Jan. 17, 2009).

257. See *supra* notes 202–03 and accompanying text.

258. This is not surprising. Employers care first about the general cognitive skills of associates, not about what courses they took. See *supra* note 238 and accompanying text.

259. I reviewed the tables of contents of *The Business Lawyer* for 1997–2007. Although references to negotiation and scattered economic insights are common, only one article dealt directly with negotiation skills: James C. Freund, *Calling All Deal Lawyers—Try Your Hand at Resolving Disputes*, 62 *BUS. LAW.* 37 (2006). Ten paid heavy attention to economic issues and analysis: Linda Allen, *Meeting Daubert Standards in Calculating Damages for Shareholder Class Action Litigation*, 62 *BUS. LAW.* 955 (2007); Robert A. Fumerton, *Market Overreaction and Loss Causation*, 62 *BUS. LAW.* 89 (2006); Henry T. C. Hu & Bernard Black, *Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms*, 61 *BUS. LAW.* 1011 (2006); Henry T. C. Hu, *The New Portfolio Society, SEC Mutual Fund Disclosure, and the Public Corporation Model*, 60 *BUS. LAW.* 1303 (2005); Jay W. Eisenhofer, Gregory C. Jarvis & James R. Banko, *Securities Fraud, Stock Price Valuation, and Loss Causation: Toward a Corporate Finance-Based Theory of Loss Causation*, 59 *BUS. LAW.* 1419 (2004); Christian J. Henrich, *Game Theory and Gonsalves: A Recommendation for Reforming Stockholder Appraisal Actions*, 56 *BUS. LAW.* 697 (2001); G. Eric Brunstad, Jr. & Milke Sigal, *Competitive Choice Theory and the Unresolved Doctrines of Classification and Unfair*

in finance theory, much less an MBA.<sup>260</sup> Law school business and skills-training courses (including transactional clinics)<sup>261</sup> may have more practical value than most of the courses taken in an MBA program.<sup>262</sup>

It is also unlikely that the benefits now realized by earning an MBA and a three-year JD would accrue to students earning a joint degree in three years. Even if these students still took all the advanced law school business courses (some of which are offered only to third-year students), they would still lack the breadth of legal education now obtained in a JD program. Employers might fear that these students would lack the flexibility to work outside a narrow corporate area if the firm needed them to do so.

Again, it is hard to show directly the utility of the third year of law school; we can only speculate. In doing so, it may help to think more broadly about the education of all professionals. In most countries law is an undergraduate degree.<sup>263</sup> Before a law graduate can practice independently, she must complete a clerkship under an experienced attorney.<sup>264</sup> Despite the obvious cost advantages of this

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*Discrimination in Business Reorganizations Under the Bankruptcy Code*, 55 *BUS. LAW.* 1 (1999); Sanjai Bhagat, Dennis C. Carey & Charles Ellison, *Director Ownership, Corporate Performance, and Management Turnover*, 54 *BUS. LAW.* 885 (1999); G. Eric Brunstad, Jr. & Mike Sigal, *Competitive Choice Theory and the Broader Implications of the Supreme Court's Analysis in Bank of America v. 203 North LaSalle Street Partnership*, 54 *BUS. LAW.* 1475 (1999); Steven M.H. Wallman, *Competition, Innovation, and Regulation in the Securities Markets*, 53 *BUS. LAW.* 341 (1997); E. Norman Veasey, *An Economic Rationale for Judicial Decisionmaking in Corporate Law*, 53 *BUS. LAW.* 681 (1997). The vast majority of entries offer surveys and analyses of case law and legislation and discussions of planning and drafting problems.

260. This is a negative assertion and therefore hard to document; one could cite many authorities that support the claim, but that would not disprove the existence of authorities that belie the claim. Among those that support it are DANIEL LEE & MATT SWARTZ, *THE CORPORATE, SECURITIES, AND M&A LAWYER'S JOB: A SURVIVAL GUIDE* (2007) (a guide for new lawyers, published in conjunction with the American Bar Association, that pays almost no attention to sophisticated corporate finance doctrine); Disare, *supra* note 191, at 370–72 (a description of what it means to think like a deal lawyer that also ignores sophisticated corporate finance doctrine); Stark, *Deal Lawyer*, *supra* note 44, at 364–72 (description of author's development as a business lawyer that also ignores sophisticated corporate finance doctrine).

261. See, e.g., Susan R. Jones, *Promoting Social and Economic Justice Through Interdisciplinary Work in Transactional Law*, 14 *WASH. U. J.L. & POL'Y* 249, 267–84 (2004) (describing a small business clinic offered at George Washington University Law School); Dina Schlossberg, *An Examination of Transactional Law Clinics and Interdisciplinary Education*, 11 *WASH. U. J.L. & POL'Y* 195, 195–96 (2003) (describing a small business clinic offered at the University of Pennsylvania Law School). Although transactional law clinics offer certain benefits, they are restricted to a limited range of transactions because “[n]o client would entrust a multi-million dollar transaction to law students.” Fleischer, *supra* note 47, at 485–86.

262. Of course, by earning an MBA a student shows further evidence of strong cognitive skills, and also a commitment to corporate practice that may be lacking in a JD-only graduate who may just be looking for a high paying job for a couple of years before moving on to something he really wants to do. Also, most JD-MBA students will also have taken the business courses offered in their law school, so it may be hard to determine how heavily their employers weighed the MBA alone.

263. See James E. Moliterno, *Exporting American Legal Education*, 58 *J. LEGAL EDUC.* 274, 276 (2008) (“In most of the world, legal education is an undergraduate program of study.”).

264. See James H. Backman, *Where Do Externships Fit? A New Paradigm Is Needed: Marshaling Law School Resources to Provide an Externship for Every Student*, 56 *J. LEGAL EDUC.* 615, 619 (2008). Gilson recommends apprenticeships, although apparently as an addition to rather than a substitute for the graduate degree in law. See Gilson, *supra* note 1, at 304.

program over our own, there is little demand to adopt it here. Perhaps this is simply a result of coinciding interests of the bar and academia. Academia benefits from having future lawyers for seven, rather than four, years of higher schooling. The bar benefits from the lower supply of lawyers than there would be if only an undergraduate degree were required to enter the guild: a higher supply means lower prices.<sup>265</sup>

However, the public may also benefit from our current system. It is intuitively plausible that lawyers profit from developing general skills of reasoning and analysis (or “critical thinking”) and writing as undergraduates before starting law school. Even harder to prove, but no less plausible, is that four years of college before law school help to develop prudence, or practical wisdom, which has long been considered the quintessential quality for lawyers, and which is critical for much of the work of business lawyers.<sup>266</sup> Likewise, the third year of law school may help to cultivate these general qualities (including high ethical standards) that are hard to measure but undeniably important.

Transactional clinics with live clients and workshops (or laboratories) with simulated transactions offer clear pedagogical benefits. Their big drawback is that they are expensive for the school and time-consuming for instructors who, if they are traditional tenure-track faculty, must also teach other courses and produce scholarship. I believe that much of the benefit of these courses can be achieved with something like the traditional Socratic method in a large class. Problem cases can be assigned and students called upon to state how the issues therein should be handled. To simulate negotiation, students can be divided into groups to represent the different parties in a problem.<sup>267</sup> Skills training in large classes is artificial but has lower costs and time demands on staff than small clinics.

In addition to improving individual course offerings in business law, law schools should better integrate these courses. Many law students choose their curriculum without much thought about their careers.<sup>268</sup> Students who do think about their careers often find little guidance in planning their schedules. Most law schools offer only a list of courses in various fields, with no advice about which are most

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265. I do not defend the monopolistic practices of the bar. There are two separate issues here. One is who should be allowed to practice law. The other is what is the desirable education and training for lawyers, particularly business lawyers. I address only the second question.

266. See *supra* note 48 and accompanying text.

267. See Myron Moskowitz, *Beyond the Case Method: It's Time to Teach with Problems*, 42 J. LEGAL EDUC. 241, 249 (1992) (listing the virtues of the problem method); William J. Carney, *Teaching Problems in Corporate Law: Making It Real*, 34 GA. L. REV. 823, 828–32 (2000) (same); Cynthia G. Hawkins-Leon, *The Socratic Method—Problem Method Dichotomy: The Debate Over Teaching Method Continues*, 1998 BYU EDUC. & L.J. 1, 8–9 (same). See also Stark, *Fantasy Curriculum*, *supra* note 243, at 8–9 (advocating a “Deal Skills” course that would include many of these features).

268. This is not necessarily undesirable; there is nothing inherently wrong with the student taking courses that she finds the most interesting or that have the best instructors, even if they do not open up any particular career path. However, many third-year students start to worry that a lack of academic direction may limit their job opportunities or their ability to perform well in practice.

useful for particular purposes or in what order they should be taken. Offering a concentration in business law is a step forward since the program usually lists required and elective courses.<sup>269</sup>

That still falls short of prescribing an integrated plan of study. Tax professor Erik Jensen and I have for many years taught a course in Business Planning each spring. Its only prerequisites are Business Associations and Individual Income Tax, yet each year we have third-year students who want to take our course without having one of the prerequisites. Some other students, though, have taken several business and tax courses. The wide disparities in the prior courses taken by different students make it impossible to teach at a level of sophistication appropriate to all of them—what is just right for one group is too advanced for a second and too elementary for a third.

If we required (or at least suggested) a sequence, students would know how to proceed and their courses would be more useful to them. For instance, one problem in teaching advanced business courses is how to treat business and finance. All students have taken the basic Business Associations course, but their levels of knowledge vary greatly. Some have undergraduate majors in business and finance and have taken several business and corporate courses in law school; others have done neither. To avoid confusing the latter, the instructor must cover concepts already familiar to the former. If the advanced courses were sequenced, the differences would be smaller and instructors could reduce duplication in coverage among the advanced courses.

Courses in a business law sequence should focus on the role of enterprise architect—i.e., on transactions and internal planning—beginning with the basic Business Associations course. The basic course should cover both corporations and unincorporated entities because choice of entity is often a crucial issue for business lawyers.<sup>270</sup> It should treat legal principles in the business context in which they arise, including the financial issues that arise in structuring a business or transaction.

This approach discomforts some students who have no background in business or economics and who are accustomed to the litigation orientation of most law school courses. This is not surprising—learning in a new field is always difficult. Uneasy students should know that many principles they learn will be useful even if they do not practice in the business area. First, business issues often arise in other fields. For example, domestic relations lawyers often handle divorces in

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269. See Case Western Reserve University School of Law, Concentration Information, <http://law.case.edu/concentrations/> (last visited Jan. 17, 2009) (listing required courses and electives for each of several concentrations).

270. Treating both necessitates a course with many credit hours; at the law school where I teach the basic course gets five credits. This creates scheduling difficulties but seems unavoidable if the subject matter is to be handled properly. It is sometimes suggested that there be two introductory courses—one for those who want to specialize in business law and one for those who want just the basic course. This strikes me as a bad idea because students often change their plans after taking the introductory course in a field.

which a major marital asset is an interest in a closely held business and a key issue is how to value that interest. Further, law firms themselves are businesses. An understanding of business principles may be necessary for a lawyer to avoid trouble in her own career.

Would a focus on transactions and planning slight litigation? In general it should not. In the business field litigation almost always stems from poor planning; lawsuits are lessons in what not to do. I often ask students what mistakes led to the suit and how matters could have been handled to avoid it. If attention to litigation issues does fall somewhat, though, that is acceptable. Litigators usually need to bone up on the fine points of law in their suits anyway; they can do this after the suit begins. In transactions and planning, however, the lawyer does not know what legal doctrine to delve into unless she first spots the relevant issues; acquiring the knowledge to be able to do this cannot wait until the transaction is under way. The litigator is a soldier in battle while the transactional lawyer is a castle architect. The soldier cannot plan much in advance: no plan of battle survives the first shot.<sup>271</sup> Not so the architect. She can construct the castle (or enterprise) any way she likes, but once invaders appear on the horizon it is too late to say, "Oops! I forgot to ensure a secure water supply."

The first problem in planning an advanced curriculum in business is to get adequate faculty staffing. Since talented lawyers have better opportunities in practice in business (including antitrust, tax, financial, and commercial law) than in jurisprudence, constitutional law, and many other academic fields, it is harder to recruit good teachers and scholars in business fields. Neither offering higher pay nor lowering hiring (and tenuring) standards for business faculty alone is an attractive solution. As a result, many schools are understaffed in business areas. It would be unwise to dragoon a generalist into teaching even the basic Business Associations course. It is often said that any professor should be able to teach any first-year course, but Business Associations is not a first-year course and it requires much specialized knowledge if it is to be taught well. Nonetheless, if law schools are to meet the growing demands for skills training, they must somehow find good people to teach business courses.

In addition to the securities regulation and business planning courses that are now standard for most law schools, courses should be offered in mergers and acquisitions and in private financing, including venture capital and private debt financings. In general, although an MBA or just a theoretical knowledge of financial economics is helpful to aspiring business lawyers, the broader skill they need is problem solving, especially in relation to the legal problems of business firms.<sup>272</sup>

271. This is an old adage attributed to, *inter alia*, Napoleon. See JOHN C. MULCHER, *THE AMERICAN DIRECTORY OF WRITER'S GUIDELINES: A COMPILATION OF INFORMATION* 183 (2005).

272. See James C. Freund, *Teaching Problem Solving: New Business Lawyers Need to Know How to Find the Deal*, *BUS. L. TODAY*, July-Aug. 1999, at 32. See also *supra* Part III.C; Karl S. Okamoto, *Learning and Learning-to-Learn: Simulating Corporate Practice in Law School*, 45 J. LEGAL EDUC. 498, 505 (1995) (arguing that "[s]tarting with theoretical explanations . . . is for most people not a good method of learning"; theory should be integrated into the handling of realistic problems).

### C. CERTIFYING THE QUALITY OF OUR PRODUCT

As suggested earlier, many employers of lawyers do not pay much attention to what courses lawyers took in law school.<sup>273</sup> Maybe they do not think it makes any difference, but another possibility is that law schools fail to certify the quality of their product. A hiring partner can see from a student's transcript that she has taken some advanced business courses, but the hiring partner may not know whether the student acquired any knowledge or skills of practical value. Things might be different if law schools offered a systematic program in business law. Again, some schools have moved in that direction by offering concentrations in business organizations and other fields.<sup>274</sup> So far concentrations do not seem to improve a student's employment prospects much. One reason for this may be that a concentration indicates only that a student has taken several courses in the field; those courses are not integrated into a structured program with a logical sequence.

Another reason may be that law schools do not adequately certify the quality of their product. This may stem in part from the novelty of concentrations. As employers become familiar with them, concentrations may earn greater respect. But to gain that respect, law schools should better explain to employers the benefits of concentrations. Consider a hiring partner who needs one or a few associates for the corporate department and faces a mountain of resumes. She can winnow out students with low grades or from lesser law schools, but that step probably still leaves a daunting pile. Her job would be easier if she focused on students with a concentration in business law. Better yet, she could have law schools send her resumes that meet criteria she lays down. In addition to criteria like GPA, she could limit her search to students with the concentration.

### CONCLUSION

Ronald Gilson performed a signal service in publishing *Value Creation by Business Lawyers*—he made public the little known work of lawyers who handle large mergers and acquisitions after the parties reach agreement in principle until the deal closes. Unfortunately, Gilson took this highly specialized practice to represent the work of all business lawyers. It was not typical then, and is even less so now after twenty-five years of change in business activity and in the legal work it needs. Mistaking a small niche for the whole also led Gilson to erroneous conclusions about the legal education that future business lawyers need. Later commentators embellished but did not fundamentally alter Gilson's analysis and recommendations.

This Article offers a broader view of business practice, revealing the wide range of work that business lawyers do and the diverse skills that various functions require. Based on this broader view, it urges changes in legal education quite different from

273. See *supra* note 238 and accompanying text.

274. See *supra* note 256 and accompanying text.

those advanced by Gilson and others. The descriptive and prescriptive differences are important, and not just to business lawyers, their clients, and law schools. The ability of the American economy to innovate is the key to its success. Innovation requires the development and deployment of technology and imaginative ideas by business firms. Business lawyers play a crucial role in this work. A better understanding of what business lawyers do and, accordingly, of how they should be trained, is essential if maximum innovation and economic growth are to be achieved.