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### How Do Start-ups Obtain Their Legal Services?

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# HOW DO START-UPS OBTAIN THEIR LEGAL SERVICES?

DARIAN M. IBRAHIM\*

This Essay is the first to examine, using responses to online surveys, the use of in-house versus outside counsel by rapid-growth start-up companies. It also explores, from the vantage point of the start-up's entrepreneur, some reasons for that choice. The Essay tests several hypotheses derived from the economic and entrepreneurship literatures about the benefits of in-house versus outside counsel in the unique context of start-up firms.

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## INTRODUCTION

The growing importance of in-house counsel has been the focus of academic study.<sup>1</sup> Yet most of that work focuses on in-house counsel at large corporations, and for understandable reasons: large corporations are where in-house counsel are most likely to be found. But the question remains whether in-house counsel are also gaining traction at start-up companies. This Essay is the first to examine, using responses to online surveys, whether start-ups also use in-house counsel. It also explores, from the vantage point of the start-up’s entrepreneur, some reasons for that choice. The Essay is limited in its scope of data collection and thus the conclusions that can be drawn; however, the survey responses allow me to test several hypotheses derived from the

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1. See *infra* note 4 and accompanying text.

economic and entrepreneurship literatures about the benefits of in-house versus outside counsel in the unique context of start-up firms.

The most salient results of my study are as follows. First, as expected, most entrepreneurs who responded to the online survey did not employ full-time in-house counsel. For those start-ups, the most common reason given was that an in-house attorney was not cost-justified at this stage in the company's development. The second most common reason was that outside counsel offer more coverage than in-house counsel. All other reasons for favoring outside counsel lagged behind these two reasons by a substantial margin.<sup>2</sup>

For the smaller number of entrepreneurs who did employ full-time in-house counsel, the top explanation was in-house counsel's perceived advantage over outside counsel in understanding the company's business. In economics parlance, in-house counsel were seen as having lower information asymmetries about the start-up's business than outside counsel. Other reasons given for hiring in-house counsel included their superior ability to monitor the inner workings of the company and their greater responsiveness to company demands.

Through its original empirical evidence, this Essay contributes to the economic literature on information asymmetries and agency costs, the burgeoning literature on law and entrepreneurship,<sup>3</sup> and the literature on the growing importance of in-house counsel generally. On the latter, this Essay is most similar to Steven Schwarcz's terrific empirical paper on value creation by in-house counsel at large corporations.<sup>4</sup>

Although this Essay is the first academic work exploring in-house counsel in the start-up context, it is admittedly only a limited start. Considering the timeline for completing the Essay,<sup>5</sup> online surveys were chosen as a means of soliciting data over face-to-face interviews or phone calls, which could have led to more participation and deeper questioning. To encourage busy entrepreneurs to respond to online surveys, I promised complete anonymity and confidentiality to respondents. However, these promises prevented me from knowing which entrepreneurs responded to the survey and which did not. The complete anonymity also prevented me from matching entrepreneurs to

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2. See *infra* Part III for a summary of the main empirical results of the survey.

3. See Darian M. Ibrahim & D. Gordon Smith, *Entrepreneurs on Horseback: Reflections on the Organization of Law*, 50 ARIZ. L. REV. 71, 82-83 n.65 (2008) (citing examples of academic work that fit within the "law and entrepreneurship" genre).

4. Steven L. Schwarcz, *To Make or to Buy: In-House Lawyering and Value Creation*, 33 J. CORP. L. 497 (2008).

5. This Essay is part of the 2011 *Wisconsin Law Review* Symposium.

responses, which meant I could not dig deeper into those companies' characteristics (e.g., age, industry, and revenue) to draw more nuanced conclusions about the types of start-ups using in-house counsel. Also, while a more minor point, for simplicity this Essay frames the choice between in-house and outside counsel as a binary choice (i.e., the start-up is presented as having only one or the other, when in reality even a start-up with in-house counsel may need outside counsel for some legal issues).<sup>6</sup>

With these caveats in mind, this Essay proceeds as follows. Part I sets forth some theory about in-house counsel as well as several hypotheses about an entrepreneur's choice between in-house and outside counsel. Part II discusses the collection of original survey data to test these hypotheses, including my methodology and its potential weaknesses. Part III presents the empirical results matched to the earlier hypotheses. Part IV discusses two attendant issues that were not the main focus of this Essay, but are nonetheless interesting and present opportunities for further study. Part V is an appendix presenting the original survey and raw data.

## I. THEORY AND HYPOTHESES

Start-up companies are unique firms. As Joseph Bankman and Ron Gilson describe it, "[i]n Silicon Valley, the defining myth takes as its stage David Packard's or Steve Jobs' garage. . . . [W]ith nothing but an idea and strength of character, [the entrepreneur] leaves his job with an established company, starts a firm that becomes an industry leader, and in the process becomes fabulously wealthy."<sup>7</sup> Start-ups start small but, should all go as planned, grow large. Their financing comes from increasingly sophisticated and well-funded sources—friends and family, then angel investors, venture capitalists, and finally the public should the start-up make an initial public offering.<sup>8</sup>

Companies, including start-ups, obtain their legal services in a variety of ways. Small firms such as a local restaurant may use local attorneys and family friends, while large corporations hire the largest, most prestigious law firms in the world. But large corporations have

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6. The data suggest that in-house counsel at start-ups are primarily used for transactional and regulatory work, while less so for litigation. This finding is consistent with prior academic work on the type of work performed by in-house counsel at large corporations. See Schwarcz, *supra* note 4, at 498.

7. Joseph Bankman & Ronald J. Gilson, *Why Start-Ups?*, 51 STAN. L. REV. 289, 289–90 (1999).

8. See Darian M. Ibrahim, *Should Angel-Backed Start-ups Reject Venture Capital?* 101 (Univ. of Wis. Legal Studies, Research Paper No. 1170, 2011), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1919139](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1919139).

also increasingly internalized their legal services by employing one or sometimes even a small army of in-house counsel.<sup>9</sup> In-house counsel are perceived as having several advantages for large firms; further, the in-house attorney can play many roles inside a corporation.<sup>10</sup>

Many of these large corporations with an army of in-house counsel were once start-ups themselves. At some point in their development they decided to obtain at least some of their legal services from in-house counsel as opposed to outside law firms. When did that occur? And why? This Essay proposes some hypotheses for the use, or non-use, of in-house counsel at start-up companies that have received at least \$5 million of venture capital financing (typically one round).<sup>11</sup> What follows are hypotheses, derived from the economic and entrepreneurship literatures, about the use of in-house counsel at start-ups.

*A. General Hypothesis: Most Start-ups Will Not Have In-house Counsel*

My general hypothesis is that most start-ups, even those that have received venture capital financing, will not have full-time in-house counsel. For purposes of my survey, participants were told that in-house counsel did *not* include an employee with law training who might answer legal questions on an informal basis. The next set of hypotheses more specifically delve into reasons for the general hypothesis.

*B. Hypotheses for Start-ups without In-house Counsel*

1. HYPOTHESIS 2.1: IN-HOUSE COUNSEL ARE NOT COST-JUSTIFIED

Start-ups are notoriously cash-strapped. Expenses are heavily scrutinized and a start-up's main goal is to use its limited funds to

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9. See, e.g., Robert Eli Rosen, *The Inside Counsel Movement, Professional Judgment and Organizational Reputation*, 64 IND. L.J. 479, 481 (1989) ("Corporate leaders report their greater reliance on corporate legal departments and praise the departments' improving quality."); Schwarcz, *supra* note 4, at 498 ("There has been a substantial shift towards more in-house lawyer transactional work in the past decade . . .").

10. See generally Deborah A. DeMott, *The Discrete Roles of General Counsel*, 74 FORDHAM L. REV. 955 (2005).

11. See Darian M. Ibrahim, *Financing the Next Silicon Valley*, 87 WASH. U. L. REV. 717, 734 (2010) (typical round of venture capital financing "has spiked from \$2 million to upwards of \$5 million"). Venture capitalists stage their financing and provide several rounds should the start-up progress according to certain benchmarks and milestones. See Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1078–81 (2003).

develop or grow its product or service. As a result, legal and other needs may be seen as a luxury a start-up cannot afford. For example, in their important study of patenting among start-ups, Stuart Graham, Rob Merges, Pam Samuelson, and Ted Sichelman found that “the cost of getting a patent is the most common reason cited for not patenting a major technology.”<sup>12</sup> Similarly, some start-ups look to exchange stock for legal services to reduce cash outlays.<sup>13</sup>

Once start-ups are able to obtain venture capital, they have more funds at their disposal. Still, venture capitalists do not wish to have their money used in imprudent manners and employ various mechanisms to reduce the agency costs that may arise after funding.<sup>14</sup> Venture capitalists want their funds dedicated to immediately growing the company and may feel that full-time in-house counsel are not warranted. For these reasons, Hypotheses 2.1 predicts that most entrepreneurs who do not hire in-house counsel will cite cost as an important consideration.

## 2. HYPOTHESIS 2.2: OUTSIDE ATTORNEYS OFFER MORE COVERAGE

Outside law firms have multiple attorneys, each with their own areas of expertise and specialization.<sup>15</sup> Hiring a full-service law firm allows a client to tap into that varied expertise and cover more of its legal needs. In addition, corporate law firms bring to bear their past experience working with companies who have progressed through the life cycles the start-up will encounter.

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12. Stuart J.H. Graham et al., *High Technology Entrepreneurs and the Patent System: Results of the 2008 Berkeley Patent Survey*, 24 BERKELEY TECH. L.J. 1255, 1310 (2009).

13. See Casey W. Baker, *Incubating Golden Eggs: Why Attorney Ethics Rules May Stifle Small Business Development*, 2 ENTREPRENEURIAL BUS. L.J. 507, 521 (2007) (“More and more, attorneys and law firms are exchanging their services for equity positions in their business clients instead of cash.”); Gwyneth E. McAlpine, *Getting a Piece of the Action: Should Lawyers Be Allowed to Invest in Their Clients’ Stock?*, 47 UCLA L. REV. 549, 557 (1999) (“Many start-up companies cannot afford to pay high legal fees because they do not yet have a product with which to generate revenue. Instead of cash, they can offer their lawyers equity.”).

14. See Darian M. Ibrahim, *Debt as Venture Capital*, 2010 U. ILL. L. REV. 1169, 1206 (“[I]f [venture capitalists] can employ venture debt to force interest payments, lessen burn rates, and reduce financial slack on the margins, it helps them monitor entrepreneurs and reduces agency costs.”).

15. See Marc Galanter & William Henderson, *The Elastic Tournament: A Second Transformation of the Big Law Firm*, 60 STAN. L. REV. 1867, 1868–69 (2008) (“[As of 2000] large law firm lawyers comprised 10.5% of the U.S. legal profession.”); cf. Larry E. Ribstein, *The Death of Big Law*, 2010 WIS. L. REV. 749 (arguing that big law firms are a fundamentally flawed business model and predicting dire consequences for firms that fail to adapt to the changing corporate landscape).

This wide array of experience that outside counsel can offer a start-up is attractive to an entrepreneur. The needs of a growing company change quickly, and a start-up might require diverse services that only a large law firm can provide. Further, entrepreneurs might lack not only legal but also business experience, and value input from experienced corporate lawyers who have helped other start-ups grow. For these reasons, Hypothesis 2.2 predicts that entrepreneurs who prefer outside law firms will point to their perceived expertise and breadth of coverage as important considerations.

3. HYPOTHESIS 2.3: OUTSIDE ATTORNEYS ARE MORE INDEPENDENT/  
OBJECTIVE

Because outside law firms have multiple clients, their billings and livelihoods are less dependent on pleasing any one particular client. Conversely, in-house counsel have all their eggs in one basket, and therefore are at greater risk of telling management what they think they want to hear.<sup>16</sup> Entrepreneurs might prefer to hear both positive and negative aspects about their business and legal challenges from a neutral source in order to remain competitive. Thus, Hypothesis 2.3 predicts that entrepreneurs who rely on outside counsel could believe that these attorneys are more independent and objective.

4. HYPOTHESIS 2.4: OUTSIDE ATTORNEYS WILL ENHANCE OUR  
REPUTATION

In his classic work on value creation by business lawyers, Ron Gilson notes that business lawyers “commonly play the role of reputational intermediary,”<sup>17</sup> renting their established reputations to clients who are less established. Karl Okamoto follows Gilson’s work with an empirical test of the reputation-intermediary theory, breaking business lawyers into two categories: in-house and outside counsel.<sup>18</sup> Like Gilson, Okamoto observes that “clients who are unable to effectively bond their own performance resort to high reputation intermediaries to rent the intermediary’s reputation as a bond.”<sup>19</sup> Okamoto then theorizes that, unlike other business lawyers, in-house

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16. See John S. Dzienkowski & Robert J. Peroni, *The Decline in Lawyer Independence: Lawyer Equity Investments in Clients*, 81 TEX. L. REV. 405, 517 (2002) (“The danger of impaired judgment of the in-house counsel may exist.”).

17. Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 290 (1984).

18. Karl S. Okamoto, *Reputation and the Value of Lawyers*, 74 OR. L. REV. 15 (1995).

19. *Id.* at 26.



counsel are *not* a good reputational intermediary because they have only one client, and thus “third parties will rationally discount [their] independence due to the risk of capture.”<sup>20</sup> Conversely, because outside counsel have multiple clients, they can play the role of reputational intermediary. Using a data set of corporations filing for public offerings of securities, Okamoto finds empirical support for these assertions.<sup>21</sup>

Start-up companies have sparse track records, and are thus in greater need of reputational intermediaries than the corporations Okamoto studied. Because the reputation of outside law firms is enhanced by their success with past clients and ability to attract top legal talent, Hypothesis 2.4 predicts that entrepreneurs who prefer outside counsel will perceive these attorneys as able to enhance their standing in the business community.

##### 5. HYPOTHESIS 2.5: OUTSIDE ATTORNEYS CAN CONNECT US TO ANGELS AND VENTURE CAPITALISTS

While the prior hypothesis is that outside counsel can enhance a start-up's reputation with *any* third party, one third party of particular importance to start-ups is the outside investor. Angel investors and venture capitalists are vital to the life of a start-up,<sup>22</sup> and entrepreneurs spend considerable time trying to find and sell these investors on their companies.

In his important work on Silicon Valley law firms, Mark Suchman suggests that in addition to their traditional functions, outside counsel play “matchmaker” between start-ups and venture capitalists.<sup>23</sup> In other words, outside counsel, as repeat players in the entrepreneurial finance game, “channel[] start-ups to ‘appropriate’ venture capital funds.”<sup>24</sup> Consequently, Hypothesis 2.5 is that entrepreneurs who prefer outside counsel will do so in part because these attorneys can connect them to investors.

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20. *Id.* at 28.

21. *Id.* at 38 (“The principal finding from the data is the existence of segmentation in the market for legal services based on the value of reputation. [Clients] who have relied on the technical competence of their corporate counsel in contexts where verification and reputational bonding are not needed turn to outside counsel when they are.”).

22. *See* Ibrahim, *supra* note 8, at 103–04.

23. Mark C. Suchman, *Dealmakers and Counselors: Law Firms as Intermediaries in the Development of Silicon Valley*, in UNDERSTANDING SILICON VALLEY: THE ANATOMY OF AN ENTREPRENEURIAL REGION 71, 89 (Martin Kenney ed., 2000).

24. *Id.*

*B. Hypotheses for Start-ups with In-house Counsel*

The preceding hypotheses all provide reasons that entrepreneurs may eschew in-house counsel at the start-up stage. However, there are good reasons why entrepreneurs may hire in-house counsel even before becoming large corporations. Those reasons form the hypotheses that follow.

1. HYPOTHESIS 3.1: IN-HOUSE COUNSEL WILL BETTER UNDERSTAND  
OUR BUSINESS

In his empirical paper on in-house counsel at large corporations, Schwarcz predicts that outside counsel will have steeper learning curves than in-house counsel when it comes to understanding the company's business.<sup>25</sup> In economic terms, in-house counsel have lower information asymmetries when it comes to understanding their clients' businesses and thus more effectively serve their legal needs.<sup>26</sup> Although the outside attorneys Schwarcz surveyed did not believe this was a significant issue,<sup>27</sup> their answers could be somewhat self-serving.

Due to their high-tech nature, start-ups may present even greater information asymmetries to outside counsel. These unique companies are often working in cutting-edge fields such as software, biotechnology, and clean energy. These fields require lawyers that know the intricate regulatory and competitive landscapes that are unique to each field. Having a competent lawyer who focuses solely on that start-up may prove to be a competitive advantage. For these reasons, Hypothesis 3.1 predicts that entrepreneurs who hire in-house counsel will perceive these attorneys as better positioned to understand their business.

2. HYPOTHESIS 3.2: IN-HOUSE COUNSEL WILL BE MORE  
RESPONSIVE/TIMELY

Schwarcz also predicts that in-house counsel "are generally more responsive to and can better communicate with the 'client' than outside counsel."<sup>28</sup> This may be because of the "physical proximity," with in-house counsel and company management "having offices in the same building if not on the same floor."<sup>29</sup> It may also be because

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25. Schwarcz, *supra* note 4, at 503–04.

26. *Id.* at 525.

27. *Id.* at 552.

28. *Id.* at 509.

29. *Id.*

management feels more comfortable communicating with in-house counsel due to their repeat interactions. Therefore, Hypothesis 3.2 predicts that entrepreneurs who hire in-house counsel will perceive those attorneys as being more responsive/timely than outside counsel.

### 3. HYPOTHESIS 3.3: IN-HOUSE COUNSEL CAN BETTER MONITOR THE INNER WORKINGS OF OUR COMPANY

Economic theory would suggest that full-time employees of a company are better able to monitor the company's inner workings than an outsider hired on an intermittent basis. And greater monitoring can reduce agency costs. Translating these general theories to the choice between in-house and outside counsel, Schwarcz notes that there are two kinds of agency costs that in-house counsel can potentially mitigate—the first is misbehavior by company managers, while the second is conflicts with outside counsel.<sup>30</sup> Because start-ups may not have significant need for outside counsel if in-house counsel are employed, the most relevant agency cost for my purposes is misbehavior by company managers.

As Schwarcz observes, “[i]n-house counsel’s informal day-to-day interactions with other corporate employees give them access to information through back channels that would rarely, if ever, be available to outside counsel.”<sup>31</sup> As a result, in-house counsel may be able to identify and head-off legal and other problems at an earlier stage than outside counsel. For these reasons, Hypothesis 3.3 predicts that entrepreneurs who hire in-house counsel will consider it important that these attorneys are better able to monitor the inner workings of the company than outside counsel.

## II. METHODOLOGY

### *A. Data Gathering*

To test the hypotheses set forth in Part I, original data were gathered through online surveys. The first step was to determine a sample population. I chose venture capital-backed start-ups because they are important drivers of economic growth and job creation in the U.S. economy.<sup>32</sup> Further, their use of in-house counsel has been

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30. *Id.* at 505.

31. *Id.*

32. See Press Release, Nat’l Venture Capital Ass’n, National Venture Capital Association Releases Recommendations to Restore Liquidity in the U.S. Venture Capital Industry (Apr. 29, 2009), *available at* <http://www.dcm.com/dnld/news/>

unexplored in the academic literature. The VentureXpert database provided by Thomson Financial was used to identify these companies. To limit the sample size, I included only companies formed between 2006 and 2008 that received at least \$5 million in venture capital funding since their formation. After reviewing the list, I noticed a number of venture capital firms themselves were included in the sample. Because operating firms and not their financiers were the target population, I removed all venture capital firms from the sample. This led to an original total of 1,678 start-ups to attempt to survey.

The next step was to distribute online surveys to these start-ups. The website SurveyMonkey ([www.surveymonkey.com](http://www.surveymonkey.com)) was selected to distribute the surveys and collect the data.<sup>33</sup> SurveyMonkey enables easy preparation and distribution of surveys, allows survey participants to quickly submit information, and offers tools to neatly analyze and report data. As mentioned earlier, online surveying, and SurveyMonkey in particular, was chosen as a means of collecting data for reasons of time and expediency. The survey was kept short, with an estimated response time of approximately 5-10 minutes, to maximize the breadth of participation even though this sacrificed depth.

The survey was e-mailed to the chief executive officer or someone in a similar position at each start-up. In short, a high-ranking officer was selected as the crude approximation of the start-up's "entrepreneur." The e-mail addresses that we received for each start-up from VentureXpert varied. For some, the CEO's name and e-mail address were listed, in which case the CEO received the survey. In many cases the CEO was not listed, however, and the next highest-ranking titled officer (e.g., CFO, COO) was chosen, followed by a board member if no officers were listed. If no one from the board of directors was listed, the survey went to the highest-ranking employee listed (e.g., a vice president).

The surveys were originally distributed on June 13, 2011. Three reminder e-mails were sent over the following month in an attempt to obtain more responses. Several e-mails bounced back, which is to be expected as many start-ups fail or are acquired by larger companies. We ultimately received seventy one responses out of 1,460 surveys sent (excluding bounced e-mails), resulting in a response rate of 4.86%. The

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NVCARRecommendations042909.pdf ("[I]n 2008 public companies that were once venture-backed accounted for more than 12 million U.S. jobs and \$2.9 trillion in revenues, which equates to 21 percent of U.S. GDP.").

33. Web-based surveys are now commonly used for data collection. See, e.g., D. Daniel Sokol, *Antitrust, Institutions, and Merger Control*, 17 GEO. MASON L. REV. 1055, 1120 (2010) ("The data for this study comes from an online survey, which was launched at [www.surveymonkey.com](http://www.surveymonkey.com).").

response rate seems to be low compared to other surveys of this type.<sup>34</sup> Online surveys often wind up in recipients' spam folders and may not be treated that seriously, especially if distributed through a commonly available site such as SurveyMonkey. The recipients were too numerous to follow up with phone calls or attempts for face-to-face interviews, as others have done to encourage participation.<sup>35</sup> It is also important to keep in mind that these are CEOs or the like at high-pressured start-ups, not the type of people likely to have free time for survey requests.

### *B. Selection Issues*

There were several issues with the survey methodology that could have introduced selection bias to the results. As a general matter, "[s]urvey methodology is potentially subject to flaws. . . . [and is] dependent on the precise wording, format, and context of the survey questions."<sup>36</sup> Further, survey responses come only from those who voluntarily respond to the survey request. There could be systematic differences between start-ups whose entrepreneurs responded to my survey and those whose entrepreneurs did not. The surveys were only sent to entrepreneurs, while many questions would have been better answered by lawyers. Interviewing only entrepreneurs also raised the possibility of biased responses where indicators of creativity and innovation were concerned. Finally, entrepreneurs may have refrained from providing information that they felt would reflect negatively on themselves, their start-up, or the industry they work in. Thus, there is a possibility that they provided responses they believed were socially desirable, even if less accurate.

Although VentureXpert is my preferred database for collecting information about venture capital-backed start-ups, there are other

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34. Graham et al., *supra* note 12, at 1272 (conducting large-scale patent survey with response rates of 10.6% from Dun & Bradstreet database and 17.9% from VentureXpert database); Lawrence P. McLellan, *Expanding the Use of Collaborative Law: Consideration of Its Use in a Legal Aid Program for Resolving Family Law Disputes*, 2008 J. DISP. RESOL. 465, 474 (noting response rate of 7.5% using SurveyMonkey); Tse-Hua Shih & Xitao Fan, *Comparing Response Rates from Web and Mail Surveys: A Meta-Analysis*, 20 FIELD METHODS 249, 257 (2008) (finding the mean response rate for web-based surveys is 34%); Sokol, *supra* note 32, at 1120 (noting response rate of 19% using SurveyMonkey).

35. Brian Broughman & Jesse Fried, *Renegotiation of Cash Flow Rights in the Sale of VC-Backed Firms*, 95 J. FIN. ECON. 384, 387–88 (2010), available at <http://ssrn.com/abstract=956243> (detailing the authors' multi-pronged approach to obtain responses that led to a roughly 40% response rate).

36. Schwarcz, *supra* note 4, at 502.

databases that might offer different advantages.<sup>37</sup> Keeping answers anonymous made it impossible to match entrepreneurs and responses; this prevented me from going back into VentureXpert and matching responses with specific firm types. It could be that in-house counsel usage is a function of age, revenue vs. pre-revenue, or industry. Yet I was unable to answer these questions in this limited survey. Finally, choosing only start-ups formed between 2006 and 2008 with at least five million dollars in venture capital funding was somewhat arbitrary. The choice to survey these companies and not others might affect the results because start-ups thrive or fail more prevalently with cyclical macroeconomic conditions.

### III. EMPIRICAL RESULTS

Keeping in mind the low response rate and selection effects discussed in the previous Part, the Essay will now highlight the main empirical results of my survey. It will also analyze those results against the hypotheses set forth in Part I.

#### *A. General Hypothesis: Most Start-ups Will Not Have In-house Counsel: Comparison with Empirical Results*

The data were consistent with the hypothesis that most entrepreneurs will not hire full-time in-house counsel. Almost 72% of respondents did not have in-house counsel, while only 28% did. Even entrepreneurs who reported having in-house counsel used them primarily for transactional and regulatory work. Over 63% of respondents estimated that the primary focus of their in-house attorney was transactional work,<sup>38</sup> over 31% said regulatory matters,<sup>39</sup> and only 6% litigation.<sup>40</sup> Likewise, the in-house counsel in Schwarcz's study did

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37. See Graham et al., *supra* note 12, at 1269–71 (combining databases from VentureXpert and Dun & Bradstreet for the authors' patent survey of 15,000 firms).

38. Transactional work was defined by the survey to include "contracts, employment agreements, and corporate governance matters such as fund-raising documents and stock option plans." See *infra* Part V.

39. Regulatory matters were defined by the survey to include "regulatory compliance, and working with governmental bodies including the Patent and Trademark Office (PTO), Securities and Exchange Commission (SEC), [and] Food and Drug Administration (FDA)." See *infra* Part V.

40. Litigation was defined by the survey to include "mediation, arbitration, and courtroom representation." See *infra* Part V.

“not address such non-transactional lawyering roles as litigation, lobbying, or compliance work.”<sup>41</sup>

For purposes of my survey, participants were told that in-house counsel did *not* include an employee with law training who might answer legal questions on an informal basis. It should be noted that 28.3% of respondents without in-house counsel gave as one reason for that choice that they “have an employee with legal training that plays the role of in-house attorney when needed.” Only one respondent, or 2.2% of the sample, listed that as their most important reason for eschewing in-house counsel.

*B. Hypotheses for Start-ups without In-house Counsel: Comparison with Empirical Results*

Start-ups without in-house counsel were asked to answer a series of questions to probe their decision to rely solely on outside counsel. The results are reported below.

1. HYPOTHESIS 2.1: IN-HOUSE COUNSEL ARE NOT COST-JUSTIFIED

When asked to indicate all of their reasons for not having in-house counsel from a series of choices, almost 83% of entrepreneurs responded that it was not cost-justified, making it the most common reason given by far. In the next question, entrepreneurs were asked to *rank* their reasons for not having in-house counsel. Again, “not cost-justified” topped the list, garnering over 61% of the total first-place votes. Therefore, the perceived cost of compensating in-house counsel appears to be a significant factor to entrepreneurs who eschew them. Hypothesis 2.1, that in-house counsel are not cost-justified, is consistent with the data.

Interestingly, entrepreneurs who eschewed in-house counsel were also polled on the extent of their legal needs. Over 82% claimed their start-up has “significant legal needs.” Further, when asked how much they spent on legal services in 2010, more than 67% claimed that it was

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41. Schwarcz, *supra* note 4, at 499. My results suggest in-house counsel in start-ups might focus more on “compliance” work than the in-house counsel in Schwarcz’s study. Over 30% of my respondents listed regulatory matters as the *primary* focus for their in-house counsel. It is important to note that my results could differ from Schwarcz’s if a large percentage of my sample were biotechnology or clean technology companies with significant regulatory issues. In addition, my results might reflect the greater tendency of start-ups to file for patent protection as opposed to non-high-tech companies. *See* Graham et al., *supra* note 12, at 1302 (comparing the average number of patents/applications held by start-ups across several industries).

over \$70,000. While salaries for in-house counsel can vary significantly, in today's economy at a young start-up, it would seem that \$70,000 could make an attractive salary, especially if combined with stock options.<sup>42</sup> However, to offer the experience and coverage a start-up might need would require a more seasoned attorney, who would likely charge well over \$70,000 as a base salary, especially in Silicon Valley.

## 2. HYPOTHESIS 2.2: OUTSIDE ATTORNEYS OFFER MORE COVERAGE

When asked to check all of the reasons for relying on outside counsel, over 60% of respondents checked that outside counsel offers more coverage, making it the second most common reason given for preferring outside counsel. In the next question, when respondents ranked their reasons for relying on outside counsel, "more coverage" garnered second place. Over 28% of respondents listed coverage as their most important reason. Therefore, the data are consistent with the hypothesis that the perceived depth of specialization and coverage offered by outside counsel is an important factor to entrepreneurs. The data support the view that start-ups require diversified legal services that only a large law firm can provide.

## 3. HYPOTHESIS 2.3: OUTSIDE COUNSEL ARE MORE INDEPENDENT/OBJECTIVE.

When asked to check all of their reasons for relying on outside counsel, only 13% of respondents included "more independent/objective" in their responses. Further, only 4% of respondents believed that the greater independence/objectivity of outside counsel was the primary reason to hire outside counsel over in-house counsel. Therefore, this hypothesis was not supported by the data and can be rejected.

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42. Interestingly, only 6.3% of start-ups with in-house counsel used stock options as the primary means of compensating them, and only 12.5% used an approximately equal combination of stock options and salary. Conversely, 81.3% of entrepreneurs reported that their in-house counsel's compensation came primarily in the form of salary. Unfortunately I did not ask those entrepreneurs whether stock options were still a component of the attorney's compensation, even if salary was its primary component. See DeMott, *supra* note 10, at 963 ("[A] general counsel's compensation package often includes components not otherwise available, such as stock options and other forms of compensation based on an employer's equity securities."); Steven L. Schwarcz, *Explaining the Value of Transactional Lawyering*, 12 STAN. J.L. BUS. & FIN. 486, 502 (2007) (finding that transactional lawyers add value by acting as reputational intermediaries); Suchman, *supra* note 23, at 89.



#### 4. HYPOTHESIS 2.4: OUTSIDE COUNSEL WILL ENHANCE OUR REPUTATION

When asked to check all of their reasons for relying on outside counsel, only 8.7% of respondents perceived outside counsel as enhancing their reputations with third parties. Further, in terms of rank, only 2% of respondents saw reputational enhancement as the primary reason to choose outside counsel over in-house counsel. Therefore, the reputational intermediary hypothesis was not supported by the data. In his empirical work on in-house counsel at large corporations, Schwarcz also found little support for the reputational intermediary hypothesis.<sup>43</sup>

#### 5. HYPOTHESIS 2.5: OUTSIDE COUNSEL CAN CONNECT US TO ANGELS AND VENTURE CAPITALISTS

When asked to check all of their reasons for relying on outside counsel, only 4% included among their reasons that outside counsel could connect them to angel investors and venture capitalists. Further, *no* respondents listed this as the primary reason to hire outside counsel. It should be noted that all of the surveyed firms had attracted at least one round of venture capital funding, which could make them non-ideal respondents on this question. Still, based on the results of my survey, the “matchmaking” hypothesis was not supported by the data and can be rejected. This calls into question Suchman’s findings on Silicon Valley law firms as matchmakers to entrepreneurs and venture capitalists.<sup>44</sup> However, there could be a time lag explanation here (i.e., lawyers could have served as important matchmakers in the past, but given technological advances and the like, they have more competition for that role today).

#### *B. Hypotheses for Start-ups with In-house Counsel: Comparison to Empirical Results*

Even though the survey data indicated that most start-ups do not have in-house counsel, we also collected data from several start-ups that did. Start-ups with full-time in-house counsel were asked to answer a series of questions probing the reasons for that choice.

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43. Steven L. Schwarcz, *Explaining the Value of Transactional Lawyering*, 12 STAN. J.L. BUS. & FIN. 486, 502 (2007) (finding that transactional lawyers add value by acting as reputational intermediaries).

44. See Suchman, *supra* note 23, at 89.

1. HYPOTHESIS 3.1: IN-HOUSE COUNSEL WILL BETTER UNDERSTAND  
OUR BUSINESS

When asked to check all of their reasons for employing in-house counsel, 93.8% of respondents included that in-house counsel can better understand the company's business and therefore work more efficiently and cost-effectively. This made it the most common choice by far. When entrepreneurs were then asked to rank their reasons for hiring in-house counsel, better understanding the company's business again topped the list, garnering over 75% of the "most important" reason votes.<sup>45</sup> Therefore, the data are consistent with the hypothesis that in-house counsel have lower information asymmetries about a start-up's business than outside counsel.

2. HYPOTHESIS 3.2: IN-HOUSE COUNSEL WILL BE MORE  
RESPONSIVE/TIMELY

Out of all their reasons for hiring in-house counsel, 56.3% of respondents included that an in-house attorney would be more timely and responsive than outside counsel. When asked to rank their reasons preferring in-house counsel, "more timely/responsive" garnered over 13% of the "most important" reason votes. The data therefore appear to provide weak support for the hypothesis that entrepreneurs perceive in-house counsel as more responsive to the start-up's needs than outside counsel.

3. HYPOTHESIS 3.3: IN-HOUSE COUNSEL CAN BETTER MONITOR THE  
INNER WORKINGS OF OUR COMPANY

When asked to include all of their reasons for hiring in-house counsel, 68.8% of respondents checked that in-house counsel would be better able to monitor the inner workings of the start-up than outside counsel. When asked to rank their reasons for hiring in-house counsel, the monitoring explanation garnered 12.5% of the "most important" reason votes. Therefore, the hypothesis that in-house counsel reduce

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45. Unfortunately, I included two choices to this survey question that were substantially the same. The first choice read "Because an in-house attorney can better understand our business and therefore work more efficiently and cost effectively," while the second read "Because an in-house attorney better understands our business than an outside attorney." See *infra* Part V. For purposes of reporting the ranked results, the "most important" votes given on both of these questions were combined.

agency costs through superior monitoring was a hypothesis that had moderate support in the data.

#### IV. ATTENDANT ISSUES FOR FURTHER STUDY

The foregoing Part revealed the main results of my study and how they matched up with the hypotheses presented earlier. The Essay will now conclude by briefly discussing two attendant issues on which entrepreneurs were also surveyed that warrant further study.

##### *A. Attorney-Client Privilege and Board Seats*

As Schwarcz observes, “[a]lthough in-house counsel are theoretically afforded the same privilege as outside counsel, the privilege only applies to communications that constitute ‘legal’ rather than ‘business’ advice.”<sup>46</sup> In-house counsel, especially at nascent start-ups, may be asked to provide business advice as well as legal advice as a full-time member of the “team.” The issue of attorney-client privilege is further complicated if in-house counsel serve on the company’s board of directors, where business advice is what is called for.<sup>47</sup> In-house counsel, it seems, would be more likely to sit on a start-up’s board than would outside counsel. Therefore, while it may be low on the list of considerations for a young company, start-ups may prefer outside counsel to in-house counsel to preserve attorney-client confidentiality.

My survey asked entrepreneurs with in-house counsel whether they worried about in-house counsel compromising attorney-client privilege relative to outside counsel. Almost 94% of respondents said that they did *not* have this concern. In addition, the same percentage reported that their in-house counsel did *not* serve on the start-up’s board of directors. It stands to reason that if in-house counsel were more prevalent on start-up boards, attorney-client privilege could be a greater concern. But from my data, at least, preserving attorney-client privilege does not appear to give entrepreneurs a reason to favor outside counsel.

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46. Schwarcz, *supra* note 4, at 512.

47. Janet J. Higley et al., *Confidentiality of Communications by In-House Counsel for Financial Institutions*, 6 N.C. BANKING INST. 265, 287 (2002) (noting problems when in-house counsel also serves as a member of the board of directors of the corporation client); Susanna M. Kim, *Dual Identities and Dueling Obligations: Preserving Independence in Corporate Representation*, 68 TENN. L. REV. 179, 182 (2001) (“One of the most controversial issues arising out of the context of corporate representation involves the corporate lawyer’s relationship vis-a-vis the board of directors.”).

*B. "Rent-a-General Counsel" Law Firms.*

To this point the Essay has presented only two means by which start-ups may obtain their legal services: in-house counsel or traditional outside law firms. But a third hybrid option is sprouting up as well. This option is a hybrid situated between the in-house counsel and traditional outside counsel. It is an outside law firm, but composed mostly of former in-house counsel. Sometimes referred to as "rent-a-general counsel" or "legal outsourcing,"<sup>48</sup> these innovative firms are as entrepreneurial as the start-ups they serve.

Rent-a-GC firms recognize that start-ups (and other companies) may have legal needs that are too few to justify full-time in-house counsel, but also do not justify a traditional law firm's steep hourly rates and learning curve. Rent-a-GC firms charge less than large law firms<sup>49</sup> and are quicker to hit the ground running due to their attorneys' prior in-house experience. Leading this entrepreneurial charge are firms such as Outside GC of Boston, The General Counsel, LLC of Southern California, and The General Counsel, Ltd. of Minneapolis, among others.<sup>50</sup>

In order to investigate the rise of Rent-a-GC firms further, the survey asked all entrepreneurs whether they had ever used this type of firm. Over 87% of respondents reported that they had not. Of the almost 13% of respondents that had used such a firm, over half were "satisfied" with the firm's performance, and another third were "somewhat" satisfied. Over 11% reported that they were "not satisfied" with their experience. Because so few respondents had used such a firm, these percentages are highly driven by a few responses and should be discounted accordingly. Further study should be done in this

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48. This type of legal outsourcing is not to be confused with the legal outsourcing to other countries that Larry Ribstein discusses in his recent article on the decline of large law firms. Ribstein, *supra* note 15, at 766–67.

49. See Terry Carter, *Outsiders Inside*, 96 A.B.A. J., Feb. 2010, at 31 (discussing that fees for rent-a-GC firms "typically run about a third of the going rate" of traditional law firms); Tonyia Sullivan, *Small Businesses Save Money by Hiring Outsourced Counsel*, AUSTIN BUS. J. (Feb. 12, 2006, 11:00 PM), <http://www.bizjournals.com/Austin/stories/2006/02/13/focus3.html> (noting that one Austin-based outsourcing firm "provides legal services to clients at 30 percent to 40 percent less than what it would cost to employ a full-time general counsel"); Chad Eric Watt, *General Counsel, Anyone? Outsourcing Is an Option*, ORLANDO BUS. J. (May 13, 2002, 12:00 AM), <http://www.bizjournals.com/orlando/stories/2002/05/13/focus1.html> ("General Counsel Advisors typically charges 50-75 percent less than big law firms . . .").

50. See John Wallbillich, *Rent-A-GC*, WIREDGC (Dec. 12, 2005), <http://www.wiredgc.com/205/12/12/rent-a-gc>.

area, as Rent-a-GC firms could present a promising middle ground by which start-ups obtain their legal services.

## V. APPENDIX: SURVEY QUESTION AND ANSWERS

**Introductory Question**

Do you have an “in-house attorney,” meaning an attorney who works full time at your company? (NOTE: If you have an employee with law training that answers legal questions on an informal basis, but you do NOT have a formally designated in-house attorney, please answer “No.”)

Answer Options	Response Percent	Response Count
Yes	28.2%	20
No	71.8%	51

**Questions for Companies With In-house Attorneys:**

**Question #1:** For the following question, please select the answer that best describes the primary focus of your in-house attorney.

Answer Options	Response Percent	Response Count
Transactional work (e.g., contracts, employment agreements, and corporate governance matters such as fund-raising documents and stock option plans)	62.5%	10
Litigation (including mediation, arbitration, and courtroom representation)	6.3%	1
Regulatory matters (e.g., regulatory compliance, and working with governmental bodies including the Patent and Trademark Office (PTO), Securities and Exchange Commission (SEC), Food & Drug Administration (FDA))	31.3%	5

**Question # 2:** Why did you hire an in-house attorney instead of relying on outside law firms? Choose all options that apply.

Answer Options	Response Percent	Response Count
Because it's generally cheaper to pay an in-house attorney greater than outside firms, which charge too much	50.0%	8
Because it's cheaper to compensate an in-house attorney, as they can be paid with stock options	18.8%	3
Because an in-house attorney can better understand my business and therefore work more efficiently and cost-	93.8%	15

effectively		
Because outside attorneys are not transparent in the fees they charge	0.0%	0
Because an in-house attorney understands my business better than an outside attorney	62.5%	10
Because an in-house attorney would only have my company as a client and therefore be a stronger advocate for us	31.3%	5
Because an in-house attorney would be more responsive and timely	56.3%	9
Because an in-house attorney would better be able to monitor the inner workings of my company	68.8%	11

Answered Question: 16

**Question # 3:** Rank the reasons why you hired an in-house attorney by order of importance. However, ONLY rank the answers that you had checked in Question 2 above.

Answered Question: 15

Answer Options	1 Most Important	2	3	4	5	6	7	8 Least Important
Because it's generally cheaper to pay an in-house attorney than outside counsel, which charge too much	13%	13%	13%	7%	7%	0	0	7%
Because it's cheaper to compensate an in-house attorney, as they can be paid with stock options	13%	7%	0	7%	0	0	7%	7%
Because an in-house attorney can better understand my business and therefore work more efficiently and cost-effectively	53%	27%	0	0	0	0	0	0
Because outside attorneys are not transparent in the fees they charge	0	0	0	7%	0	7%	13%	0
Because an in-house attorney understands my business better than an outside attorney	40%	27%	7%	7%	0	0	0	0
Because an in-house attorney would only have my company as a client and therefore be a stronger advocate	0	0	20%	0	7%	0	7%	7%
Because an in-house attorney would be more responsive and timely	20%	33%	7%	7%	0	0	7%	0

Because an in-house attorney would better be able to monitor the inner workings of my company	20%	27%	33%	0	0	7%	0	0
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**Question #4:** What method of compensation makes up the majority of your in-house attorney's salary package?

Answer Options	Response Percent	Response Count
Salary	81.3%	13
Stock Options	6.3%	1
Approximately 50/50 combination of Salary and Stock Options	12.5%	2

**Question #5:** Is your in-house attorney also on the company's board of directors?

Answer Options	Response Percent	Response Count
Yes	6.3%	1
No	93.8%	15

**Question #6:** Do you worry about an in-house attorney compromising attorney-client privilege relative to an outside attorney?

Answer Options	Response Percent	Response Count
Yes	6.3%	1
No	93.8%	15

### **Questions for Companies Without In-House Counsel**

**Question #1:** Does your company have significant legal needs?

Answer Options	Response Percent	Response Count
Yes	82.6%	38
No	17.4%	8

**Question #2:** How much did your company spend on legal services in 2010?

Answer Options	Response Percent	Response Count
< \$10,000	2.2%	1
\$10,000-\$30,000	8.7%	4
\$30,000-\$50,000	15.2%	7
\$50,000-\$70,000	6.5%	3



> \$70,000	67.4%	31
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**Question #3:** What are your legal needs? Check all that apply.

Answer Options	Response Percent	Response Count
Transactional work (e.g., contracts, employment agreements, and corporate governance matters such as fund-raising documents and stock option plans)	97.8%	45
Litigation (including mediation, arbitration, and courtroom representation)	21.7%	10
Regulatory matters (e.g., regulatory compliance, and working with governmental bodies including the Patent and Trademark Office (PTO), Securities and Exchange Commission (SEC), Food & Drug Administration (FDA))	76.1%	35

**Question #4:** Why have you not hired an in-house attorney? Check all that apply.

Answer Options	Response Percent	Response Count
An in-house attorney is not cost-justified at this stage in our company's development	82.6%	38
We have an employee with legal training that plays the role of in-house attorney when needed	28.3%	13
Outside attorneys do a better job because they have multiple attorneys who specialize in different areas of law	60.9%	28
Outside attorneys are more responsive/timely	8.7%	4
Outside attorneys are more independent/objective	13.0%	6
Outside attorneys are better equipped to connect me to angel investors, venture capitalists, and others who can help further my company's development	4.3%	2
Outside attorneys enhance our company's reputation with outside parties	8.7%	4

**Question #5:** Rank the choices of your decision not to hire an in-house attorney and instead use outside counsel, in order of importance. However, ONLY rank the answers you selected in Question 4 above.

Answer Options	1 Most Important	2	3	4	5	6	7	8 Least Important
An in-house attorney not cost-justified at this stage in our company's development	61%	15%	4%	4%	0	2%	0	4%

We have an employee with legal training that plays the role of in-house attorney when needed	2%	22%	6.5%	0	0	4%	4%	6
Outside attorneys do a better job because they have multiple attorneys who specialize in different areas of law	28%	24%	22%	2%	0	0	2%	0
Outside attorneys are more responsive/timely	4%	9%	2%	6.5%	4%	4%	2%	6.5%
Outside attorneys are more independent/objective	4%	4%	4%	4%	13%	0	4%	4%
Outside attorneys are better equipped to connect me to angel investors, venture capitalists, and others who can help further my company's development	0	4%	2%	0	4%	11%	4%	13%
Outside attorneys enhance our company's reputation with outside parties	2%	2%	6.5%	6.5%	2%	9%	4%	11%

**Question #6:** Do you plan to hire an in-house attorney at some point in the company's development?

Answer Options	Response Percent	Response Count
Yes	26.7%	12
No	26.7%	12
It depends on how large we grow	46.7%	21

### **General Questions**

**Question #1:** Have you ever used a specialty "rent a general counsel" type law firm comprised of former general counsel as opposed to traditional law firm partners and associates?

Answer Options	Response Percent	Response Count
Yes	12.9%	8
No	87.1%	54

**Question #2:** If you answered "Yes" to the question above, were you satisfied?

Answer Options	Response Percent	Response Count
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Yes	55.6%	5
No	11.1%	1
Somewhat	33.3%	3

**Question #3:** In what order would you hire the following for future legal needs:

Answer Options	First-Most Likely to Hire	Second	Least Likely to Hire	Response Count
Outside law firm	80%	15%	5%	61
In-house attorney	13%	46%	41%	61
Rent a general counsel firm	7%	31%	62%	58

Answered Question: 62