Q&A

LEGAL MATTERS

LAW, INNOVATION, AND SILICON VALLEY

Larry Kramer in conversation with Craig Dauchy, Gordon Davidson, and Larry Sonsini

IDENTIFYING THE SPARK FOR WHAT IS NOW SILICON VALLEY IS SPORT FOR SOME, BUT FOR OTHERS IT'S THE FOCUS OF SERIOUS STUDY—WHOLE UNIVERSITY COURSES are designed to track the origins of this engine of innovation and entrepreneurship, perhaps hoping to capture it in a bottle. Was it Stanford University, particularly the financial struggles in the post-WWII period that led to patent partnerships and the Stanford Research Institute? Or California's employment laws that rendered "no compete" clauses irrelevant? Or was it the geography of the place, on the Pacific Rim, westward looking and warm? It was likely all that and more. One thing is for sure: It wouldn't have happened without the inventors and the dreamers—and the lawyers who shaped and were shaped by Silicon Valley, helping to launch some of the most transformative companies in the world. And the three "go to" law firms in "the Valley" for entrepreneurs starting companies were and still are Cooley, Fenwick & West, and Wilson Sonsini Goodrich & Rosati—each as essential to the history of this place as the inventors and dreamers.

Craig Dauchy, JD/MBA '75

CRAIG DAUCHY GOT SOME VALUABLE ADVICE AT THE START OF HIS CAREER. Jim Gaither, JD '64, recruited him to Cooley LLP as a summer associate, telling Dauchy, "Look, this is a wonderful career. You'll be able to provide counsel to growing companies and growing venture funds. They'll grow, you'll grow, and your career will prosper." Cooley was then a 35-lawyer firm with one office in San Francisco but it quickly became a leader in the still new practice area of emerging company representation and venture fund formation. Dauchy was soon sold on the idea. After graduation, when most of his classmates headed to big firms in Manhattan, Chicago, and Los Angeles, he joined the small band of lawyers at Cooley. "It was *the* opportunity as a newly minted grad to work with entrepreneurs and venture capitalists." And, he says, Jim was right. "It's been terrific. Working with lawyers like Jim and Brad Jeffries, JD '55 (BA '53), getting involved in those very early companies was for a young lawyer very exciting. We thought of it as cutting edge and it was. And really, apart from Cooley, Wilson, and Fenwick, there weren't that many firms doing it."

Now with 650 lawyers and 10 offices in key growth areas in the U.S., as well as in Shanghai, Cooley is one of the most respected firms in Silicon Valley. Its rise in venture capital law began in 1958 with the formation of Draper, Gaither & Anderson, the first West Coast venture capital partnership. And Cooley made its mark in Silicon Valley history with its representation of thousands of tech and healthcare companies such as Qualcomm, NVIDIA, Gilead Sciences, Zynga, and Yelp. Today, the prominence of Cooley in emerging company law extends far beyond California—its reach is global. And Dauchy has indeed grown with the firm and the Valley. As head of Cooley's venture capital practice group, he has participated in the formation of more than 200 venture capital and private equity funds and in hundreds of venture capital financings. Counsel to companies in diverse industries, including enterprise software, semiconductor, digital media, Web 2.0, medical devices, and computer hardware products, Dauchy shares his expertise by occasionally teaching at both Stanford Law and the GSB and through his book, *The Entrepreneur's Guide to Business Law*.

Gordon Davidson, JD '74 (BS '70, MS '71)

WHILE NAMES LIKE HEWLETT, PACKARD, JOBS, ELLISON, GROVE, AND OTHERS ARE ALREADY IN THE HISTORY BOOKS, few outside the Valley have heard of Gordy Davidson. But here, he is legend. Davidson graduated from Stanford University in 1970 with a BS in electrical engineering followed by an MS in electrical engineering in 1971. He worked at Stanford Research Institute as a computer systems engineer during the summer in between. He received his JD in 1974 and then clerked for Judge Benjamin C. Duniway, LLB '31, on the U.S. Court of Appeals for the Ninth Circuit. He'd also worked for a computer startup as an engineer before and during law school and knew he wanted to work with emerging technology companies. So in 1975 he joined a small firm with that focus, Fenwick & West.

Davidson describes himself as "boring," married to the same woman (a Stanford classmate) for 42 years and with the same firm for 36. But listen to him talk about what he does—from representing Apple in its early years to taking Oracle public in 1986 to representing Facebook today—and it's clear his life is anything but boring. The firm's client list is a who's who of Silicon Valley, and Davidson, its chairman since 1995, is one of the driving forces. He loves working with the engineers and dreamers, helping them create companies that will wrestle with what he calls "really big problems." And he shares that enthusiasm with students here at Stanford Law School when, in his spare time, he comes to campus to teach *Mergers & Acquisitions*. It's equally clear that Davidson is just hitting his stride.

Larry Sonsini

LARRY SONSINI HAD JUST GRADUATED FROM UC BERKELEY SCHOOL OF LAW IN 1966 when a favorite professor suggested that he bypass San Francisco and New York and instead look to start his career on the Peninsula where "something was happening." He found a position with McCloskey, Wilson and Mosher, a small Palo Alto firm that focused on technology companies. The salary was considerably lower than he might have earned at a big city firm, but Sonsini soon discovered that his professor was right—there was something happening in this place that in just a few more years would become known as Silicon Valley. The

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semiconductor business was growing up there, with tech companies blossoming around Stanford University. He stayed and put down roots in the area, choosing to grow with it. The firm was renamed Wilson Sonsini Goodrich & Rosati in 1978, and Sonsini became the chairman. "We could see that there was this niche of startup companies in the area and they required representation specific to their needs," says Sonsini. That insight gave rise to a new kind of law firm focused on emerging companies, with lawyers nurturing clients from startup to initial public offerings to M&A. Sonsini and his colleagues were among the first "startup lawyers," taking a chance on the creators, investing time and wisdom in the dreamers.

Since that early start, Sonsini has helped launch thousands of companies—from the 1980 IPO of Apple to Google's historic IPO in 2001 and Hewlett-Packard's merger with

Compaq Computer in 2002. The small law firm he took a chance on as a young lawyer is now a giant in startup law; it has represented more companies that receive venture financing than any other U.S. law firm and advised more U.S. companies in their public offerings than any other firm since 1998. Its business overall has scaled dramatically, with 11 offices in the United States, China, and Europe, a portfolio of clients that range from entrepreneurs to multibillion-dollar global corporations, and a buildup in powerhouse practices including antitrust, M&A, private equity, securities litigation, corporate governance and finance, and intellectual property. And today the name Larry Sonsini is synonymous with the Valley, as much a part of this place and its history as the storied dreamers and startup founders.

The conversation that follows was facilitated by Larry Kramer, Richard E. Lang Professor of Law and Dean.

KRAMER: What got Silicon Valley started? I think a lot of people ask this question, but your perspective would be unique. Why here and nowhere else?

DAVIDSON: It's something I've thought about a lot. I think the principle reason is Stanford University. I was an engineering undergraduate and graduate student here, and every single engineering class started with the story of the founding of Hewlett-Packard in a garage in Palo Alto and how the Walt Disney Company became its first customer when it ordered eight oscillators from HP to use in *Fantasia*. So, every engineering student for forty years, probably longer, was taught to think like an entrepreneur. Obviously, Frederick Terman encouraged that. And John Hennessy encourages that today. So Stanford has created a number of very bright engineer/entrepreneurs willing to take risks.

I come from Boston, and I keep wondering why it didn't happen there. The area has a lot of the same ingredients—great universities, strength in technology, and financing sources. But the culture is more risk averse and I think entrepreneurship is all about risk taking.

SONSINI: You know, I certainly think Stanford and the culture at Stanford contributed greatly. But it's a combination of many unique factors that led to Silicon Valley, and the absence of the symbiotic relationship of those factors elsewhere has been a problem for many other attempts to replicate it. When I came here out of Berkeley in 1966, it was just really beginning. But immediately you saw combinations of some unique things. First, you had the universities, you had Stanford, you had Cal. You also had some great enterprises that were technology based. Certainly, Hewlett-Packard but then Varian, Fairchild Semiconductor, and so on—it was the breeding ground.

You also had community support that is absent in many other areas: the ability to get building permits quickly, the relationship between education and entrepreneurialism—although we've got a long way to go there. And you also had, really, the focus of venture capital on technology here, with Art Rock and Tommy Davis in the early days and then Gene Kleiner and others who followed. It's a balance of all those factors, plus risk taking, as Gordy indicates—a culture of entrepreneurialism plus all those other factors needed to exist. And then you have to overlay it, I think, with the geography, the location, with the Pacific here, and the openness. So it's the unique balance of many factors found here. You try to see it in other areas—in Austin, Raleigh-Durham-Chapel Hill, Boulder, and Boston. However, I think it had a lot to do with not only risk taking but the commitment here. That was something special, and it still is.

DAUCHY: I think several factors are at play here. Certainly the ones mentioned by Larry and Gordy. In particular, the Bay Area's openness to new ideas and to bucking trends, with people willing to take chances here without fear of failure. It seems that in other parts of the country there is greater reluctance to take risks. Northern California just isn't like that—from the days of the Gold Rush forward, entrepreneurship has flourished. Add to that spirit the training at our great universities and you find something very special in this part of California.

I would also mention that employment issues have aided the Valley's development. Non-competes are not enforceable in California, so you cannot keep an employee from walking across the street and joining a competitor—which you can do in Massachusetts, for example. This freedom of movement adds to the culture of creativity in the Valley.

And, as Larry said, the culture of venture capital here has certainly made a difference. In fact, many of the early founders of venture capital came here from the East and were willing to forgo Wall Street careers, the traditional path for Harvard Business School graduates. Those early visionaries came out West and were willing to take chances on the new technology companies springing up here. The early success of firms like Sutter Hill Ventures, Kleiner Perkins, Institutional Venture Partners, and Asset Management helped create a funding engine that, in turn, encouraged entrepreneurs to leave their employers and start new companies.

KRAMER: So do you think this can be replicated? People have tried and failed.

DAVIDSON: Well, it is being replicated. Larry and Craig touched on a really important piece, which is the venture capital financing that funded the startup pioneers here. And the focal point for venture capital is still Sand Hill Road, with something like sixty percent of the venture capital nationally managed from there. But you see more venture capital being dispersed across the country to places like Austin and outside Washington, D.C., Boston, Seattle, and San Diego. So, it's gradually spreading to other areas and other countries.

SONSINI: I think though, what's been interesting to me is that these other areas where we saw a lot of activity have really slowed in the last decade and the expansion in many of these places has died back. We used to talk about the Research Triangle in North

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Carolina, we used to talk about Northern Virginia, we used to talk about Boulder, and Denver. Even Austin has pretty much kept a flat pace and it hasn't expanded into Dallas or Houston. And what's interesting is that if you look at Southern California, which has always intrigued me—in fact we have an office in San Diego—there is no real core there. For example, in the Great Basin, Los Angeles, you have the entertainment industry, with the creativity and financial structure needed for Hollywood and some great universities are there—Caltech, USC, UCLA, Harvey Mudd. It certainly should and will expand, but Southern California doesn't have what this place has, for whatever reason.

DAUCHY: I agree that these other areas have not yet developed like Silicon Valley, but I also think we will see continued expansion beyond the Valley. After all, the Valley is a state of mind as much as it is a geography. Look at the trends in where venture dollars are being spent today; New York City, for example, has steadily moved up so it is number two or number three now, after Silicon Valley, in terms of companies attracting venture capital dollars. And L.A. has recently surpassed San Diego in venture capital financing dollars, as startups have started to congregate on the Westside.

KRAMER: Speaking about the connection between education and entrepreneurship, you said, "Although we have a long way to go." Can you elaborate on that a little—explore that connection and how central it is and whether others can or cannot pick up that piece of Silicon Valley?

SONSINI: A relationship between business, the private sector, and the disciplines at a university is very, very important for all constituencies. I think the work that Stanford is doing in particular demonstrates how that relationship benefits education and, at the same time, the business community. When I talk to people from China, from Russia, from the Eastern Bloc, I see that there's really a big gap between what's going on here and elsewhere. Licensing of technologies out of a university is unheard of in some foreign countries—yet look at what we do at Stanford.

DAUCHY: I've worked with three different universities in the U.S. to try to get venture funds formed around technology transfer and licensing opportunities and, in each case, the fund did not get off the ground. The resistance of the universities, their need to control technologies developed at their schools, and their concerns about not participating sufficiently in big successes all presented very real challenges. Stanford has a smarter approach—in essence saying "we'll take our cut, but let's be certain the technology gets a chance"—that approach really sets Stanford apart from the others. At other universities technology licensing can get caught up in the politics of the place, with professors and technology offices that want to make sure that they get their slice of the pie. And then you often see university administration hovering, wanting to control the sharing of technology. Stanford's technology licensing office has been more or less left alone to do its thing and look at what has happened—Stanford has benefited economically while an enormous number of big ideas developed here have flourished in the marketplace.

DAVIDSON: Stanford is, by far, the most highly advanced university in terms of licensing technology. And it's also the easiest to deal with, even among the other American institutions. But there are so many other first-rate institutions that are fostering entrepreneurship—Carnegie Mellon is a good example. Many of the leaders of Silicon Valley are Carnegie Mellon graduates and they are trying to foster more entrepreneurship in the Pittsburgh area.

SONSINI: And I certainly agree with that.

DAVIDSON: But what we find with companies that are started in other parts of the country is that they move here. The infrastructure here—the venture capital and all the other services, not the least of which are the lawyers who are ready to help companies get started, and the incubators, the support staff, the availability of software engineers—Silicon Valley has a critical mass of all these essential components, so there's a lot of talent right here.

And there are a lot of role models, people who have started successful companies whom you can reach out and talk to through connections of a degree or two of separation. They're iconic and they're inspirational to students. It's not hard to be introduced to an angel investor or a programmer—or somebody who can help you launch a company or get lab space for a life science company on a very economical basis. The infrastructure is here along with the role models and the connections. So companies move here for the talent pool, even though there's more competition for the talent and you have to pay more.

SONSINI: Infrastructure is an important point. You look at the accounting firms, the investment banking firms, the legal firms, the consulting firms, even the real estate brokerage firms—the commercial real estate development—and then you overlay the universities. Even the work you see at UCSF—it has started an incubator group to foster business plans for life sciences right there on campus. It's that tremendous flywheel effect of all of these elements and I think that for another place to replicate Silicon Valley, it's going to have to replicate infrastructure.

DAUCHY: The Valley model needs to be replicated. My disappointment with some efforts I've been involved with points to a larger concern. Our universities are this country's lifeblood, with innovations coming from them essential to maintaining our competitive advantage. I can't tell you the number of people I have spoken with around the country who say, "We developed this great technology in the university lab but we just couldn't work out a deal to get it into the marketplace." That's very troubling, and as a country we have to do a better job.

KRAMER: **So this all naturally segues into the next question, which is how safe is this unique environment? Could government regulation, for example, kill the goose?**

SONSINI: I think that the answer is no. Government regulation can definitely slow it down, can definitely change methodologies. But it depends on how far it goes. If we over-regulate our capital markets and curtail access to capital, that's a key piece. If we don't create tax incentives, that's a key piece. I don't see, certainly in this country, a risk of a shutdown of our basic principles, but certainly there's potential for a slowdown.

DAVIDSON: Government regulation in terms of capital formation for small businesses is actually becoming much more company-friendly with the JOBS Act, particularly for emerging growth companies.

DAUCHY: Well, I'm worried. For one thing, I am concerned that as Washington looks for additional sources of revenue, lawmakers may decide to tax carried interest as ordinary income—which would mean the entire venture capital industry might end up paying more taxes. That may mean that extraordinarily talented people end up choosing to go to other industries, staying away from venture and private equity. My other concern is regulation on the disclosure side. Congress' reaction to the Wall Street mess was to pass Dodd-Frank, with the consequence that venture firms are now regulated under the Investment Advisers Act. For the first time, venture firms have to make various public filings with the SEC and are subject to SEC examination of their records. The new law already has taken a toll with the expense of complying. Worse, it has distracted venture capitalists from what they should be doing, which is making smart investments in great companies. Instead, the VCs are worrying about how to comply with the newly applicable government regulations. For a long time, our country was very good about making capital formation easier, not harder. And notwithstanding the JOBS Act, I worry about what additional regulation might be coming.

KRAMER: **And how about intellectual property protection?**

DAVIDSON: IP protection is strong. And that's important. I don't think we're going to see any weakening of that.

DAUCHY: I think IP protection has to be looked at very carefully; we can't always protect all IP, all of the time. If protection is too strong it may hurt, not help, innovation, and if it is too weak there can be obvious problems. And from an international perspective, certainly, we have to figure out a way to ensure that our companies are protected overseas with respect to IP. Reciprocity of IP protection is critical.

KRAMER: **When you think about SOPAs and PIPAs, you're not worried about any of that?**

DAVIDSON: I think there's some over-swing there in some of the legislation, but basically support for protecting IP will foster innovation and protect the investment that you make in innovation. That's what slows down some foreign countries—the uncertainty about IP protection.

SONSINI: What I fear is that government regulation could adversely affect our competitive position in the world, vis-à-vis innovation and commercializing technology. What we do—everything from patent protection to access to capital, to transparency. What's interesting is that although the venture capital model, the Silicon Valley model, is not easily replicated, the capital markets and the access to cash are being replicated. If you look at the decline of foreign listings in the United States, if you look at the decline of our IPOs, versus other geographies, you see a shift. And that is what could hurt all of us. Now, that being said, we've got a long way to go because the quality of some of the IPOs, in say China, is turning out to not be the quality of what we have here. But China, for example, is very interested in duplicating our securities and exchange commission and our capital markets because the Chinese see that that's an important ingredient to our innovation. So, government regulation certainly can get in the way and over time can erode our position.

DAUCHY: I agree with that. Regulation is a big concern.

KRAMER: **What about global competition from China and India—can they replicate Silicon Valley?**

DAUCHY: Well, they are certainly trying. We represent 25 different venture capital firms in China right now, and another 15 venture firms in India. We helped set up an incubator in Beijing, and we're working on one right now in India. Each country has its own unique social and regulatory issues, without question. But having said that, parts of China are looking a lot like Silicon Valley. For example, there is a Starbucks out in the west side of Beijing, right by Tsinghua University, near several new office buildings that house venture capital funds. There's tremendous innovation happening there. You can visit a floor of one of these buildings and you will see hundreds of programmers working to create companies—a new online travel company here, a new online social company there, the new eBay over there—literally being created as you stand there. And when you walk into that Starbucks, it feels just like Silicon Valley—except that Chinese is being spoken. The aspirations of those Chinese entrepreneurs with whom I speak are global; they want to compete on a global basis.

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It's not just about being the biggest Chinese travel website; they want to be the biggest travel site in the world. So there is a spirit and drive there that is absolutely exciting. China has more Internet users than we do—but whether these companies can monetize that usage in a way that will drive value to the companies and to their investors remains to be seen. And, how will the Chinese government ultimately deal with all that? That is a significant qualifier to the opportunity. But at least for now, what I've seen makes me think that some of Silicon Valley is already happening in China and in India.

DAVIDSON: Certainly, both of those countries have had an enormous impact already and will continue to do so. When you take 1.3 billion people and multiply anything you've got by that number, then you've got a powerful force. But, so far, it appears that the creativity and the real innovation still are centered here, even with the manufacturing and manpower advantages that other countries have. And other countries are developing manpower advantages over India and China, with cost advantages. I don't think that will detract from the fundamental opportunity for innovation in the United States. But here's something to think about: I just got back from a trip to China. It seems that everyone there is an entrepreneur and everyone is connected to the Internet. And the generation of twenty- to thirty-year-olds that you meet are as vibrant and as interested in starting companies as those you meet on campus here.

SONSINI: I would agree with that. I do fear global competition in that sense. To me, it begins with education. And I believe that those nations are educating their people to a high end—much better—and with great volume. They are adopting, in one form or another, capitalistic principles that foster innovation. They have access to capital and they are starting to get governmental support. So I see less replication of Silicon Valley in the United States and more replication of Silicon Valley in places like China and India and Israel. And eventually probably Russia.

KRAMER: When you think of the legal practice in Silicon Valley, you think of Wilson Sonsini and Fenwick and Cooley. So what makes you guys different?

SONSINI: You know, I think a lot about this. One thing that makes us different is that we bought in very early to the Silicon Valley, or technology, model. In other words, our firms are focused on representing entrepreneurs and growth businesses. And we've built our disciplines, our training, our mentoring, our systems, so that they are primarily focused on that model, whereas a New York firm is built on what I call a horizontal model—one that is transaction-driven. There are disciplines, whether antitrust or tax, different types of litigation, different types of regulation, that are all fit to attach on to service a particular problem.

In the Valley, we think less of the problem and more about the entity and the solutions it needs to advance and grow. And that really is a very different model economically. It's a different model in the way you train or react to the client. I think that's why it's very hard for many firms that come from the East, that don't work with that model, to come here and try to replicate what we're doing. So, it's the focus, what drives our business plan—how we think about growth. It's much different.

DAVIDSON: I agree. We've all bought into the model and part of that is having the entrepreneurial mindset that we partner with clients when they start a company. We like to see ourselves as extensions of the management team and we're partnering with them to build a company from scratch. That means an investment of time; it means an investment of money. You can't be paid your lofty hourly rates for every little bit of work you do at the beginning. But you invest in these companies because they can grow one day into some of the leading companies in the world and they're solving some of the important problems that the world faces. So we don't need to make our hourly rates on every little thing we do in the early stages. And, you know every nail doesn't necessarily need a hammer here. You can be pragmatic in addressing some of the legal issues.

DAUCHY: To be a successful counselor in the Valley, you can't charge for every phone call. You have to invest your time and expertise in companies. Outside firms that come into the Valley seem to have a hard time with this. As for being a small local firm, our experience shows that size does matter. Your firm needs to be large enough—with lawyers in all the significant disciplines who understand the issues within the entrepreneurial and venture community, who understand tech and venture and "speak the speak" if you will. The other element of note for our three firms is that we're all dedicated to this practice. This is what we do, almost exclusively. We do it day in, day out. In the case of Cooley, and I think at Wilson and Fenwick as well, that dedication and focus create a buzz and excitement for our lawyers across practice groups and across offices. It is very special.

SONSINI: One of the major challenges that we face as our companies become global, multibillion-dollar enterprises, is that they need a lot of expertise in key areas. So the goal for us is to maintain that entrepreneurial, startup business model for the growth enterprise. But at the same time if you want to scale, and that's a fundamental question for any law firm, then bring in the disciplines to serve those clients that are growing so big. For example, we invest a lot in our antitrust department in Washington, D.C. We've got sixty lawyers there very focused on regulation and they compete with many of the big New York firms, and have to service at that so-called horizontal level. So you've got to strike a balance. You want to maintain what I call the vertical model growing with a client and not billing to the hilt—but at the same time be able to transition into the horizontal.

KRAMER: But how do you do that? It sounds like less of a problem structurally than culturally, right?

SONSINI: Well, it's doable. I think we've proved we can do it, but it requires a buy in and a philosophy and a culture. I think the law firms here are doing that, I think Fenwick is, I think Cooley is, and I think that makes us incredibly unique and very sustainable.

DAUCHY: Yes, you need to be large enough to service these companies as they grow. You need to have the expertise required for both startup and post-IPO clients. So growing with the client is important.

DAVIDSON: To scale with the clients that do become the really significant companies—the Apples, the Ciscos, and so on—you need to have the expertise in tax and regulatory matters and intellectual property. And one of the great things about Silicon Valley is that you're able to attract high-caliber lawyers.

SONSINI: Here's a classic example: You take the work that we do for a giant like Google—it's doable, and we've proved it. But it requires a unique culture and leadership and buying in early, growing with them. I've always said it's easier for us to scale up into the horizontal world than it is for a New York firm on a horizontal model to scale down. Because, as Gordy pointed out in his example, the economics are a major shift: How you bill, how you relate, how you mentor is a bigger sea change than what we face going the other direction.

KRAMER: You've got a lot of competition trying to come in and that's been true for a while. How have you kept your advantage?

DAUCHY: The lawyers at our firms live and breathe Silicon Valley. They know the ecosystem; they've seen the issues hundreds of times before. Our three firms are known throughout the Valley as the go-to firms for this kind of specialized law. I don't think you can be as successful at our kind of law with a small group of lawyers who are operating inside a larger firm that mostly focuses on labor law or bond offerings. Their specialties are elsewhere—our specialty *is* serving the companies and investors in this community.

DAVIDSON: Well, part of it is the ecosystem. It is, in the early stages, driven by venture capital and the networks of contacts in the venture capital funds you've built. They have developed confidence in a small number of firms that have demonstrated that they're able to do something cost-effectively and to give the right advice, practical advice—and clients are steered toward these indigenous firms.

DAUCHY: Also, we're growing with our clients beyond the Valley. In the case of Cooley, we've been doing formations for China-based funds for twenty years. We decided to open an office there in December for three reasons. First, our clients based here wanted to do more in China and wanted us to help. A large public chip company, for example, was a big supporter of that. Second, our clients on the ground in China, both companies and venture capital and private equity firms, said, "You should come here because there aren't lawyers who do what you do." The third reason was that those same clients on the ground told us that they knew lots of companies in China that want to do business in the U.S., that want to make acquisitions, that need to either prosecute or defend intellectual property cases, that have trade regulation issues, and so on. And they thought that with our tech focus we would be very good at helping them. In China, it's all about trust and relationships and these clients don't introduce lawyers lightly to their friends and colleagues. So those are very warm introductions. That's why we went to Shanghai.

KRAMER: What about lateral losses?

DAVIDSON: Say you're a thousand- or a two-thousand-lawyer firm, and you think you really ought to have an office in Silicon Valley because there's obviously something happening there. You don't really understand what it is, but there's Apple, there's Facebook, there's Google. So these firms hire a couple of partners laterally and they tell them, "Go get Google." "Go get Apple." "Go get Facebook." What they don't understand is that you start with a portfolio of a hundred seedling companies and three of them grow up to be Google, Apple, Facebook—you can't just cherry-pick the great ones. You've got to cast a broad net, invest in them all, and with that portfolio some of them will grow to be these magnificent companies that everybody would like to represent.

SONSINI: It's a very relationship-driven business, but as you move, so to speak, upscale, it becomes less relationship-driven and more discipline-driven. So, for example, we have seen the growth of private equity in Silicon Valley—growth that has really outpaced, in my judgment, the growth of venture capital. That business is still primarily served by out- of-town firms because it is a unique financial engineering type of model. But as those firms decide to parachute into the technology industry, they have to differentiate themselves, not just on finance and engineering but on content. And they turn more and more to our type of firm because we've done one other thing—we've built disciplines to deal with IP, patents, technology transactions, employee benefits. There's a lot of infrastructure that a Fenwick or a Wilson Sonsini or a Cooley can do and we have found a way to deliver that service economically. So it's a big challenge to parachute in here, just as it would be a big challenge for us to try to break into the M&A market in New York City.

DAUCHY: All three of our firms have lost a few partners over the years to out-of-town firms that have tried to create a splash with expensive hires. But many times they have set up what amounted to outposts for firms that are primarily focused on other kinds of law and clients. Emerging technology companies are our focus—it is what we do. That dedicated model is the one that has been most successful here in the Valley.

DAVIDSON: Intellectual property is the key to this, because it's something that we do every day. We all have deep experts, many with PhDs, in various technology fields, like life sciences—and open-source software, software-as–a-service, and cloud services. And when private equity funds invest in technology, they may have firms that are very creative in terms of the financial structuring, but they don't really have the resources to understand what the companies do. When you buy a technology company, you're buying the people and the technology—you're not buying hard assets to which you can attach some financial value. So, the fundamental due diligence of any investment or any merger is focused on the intellectual property, and that's something that the local firms all do well. You need a critical mass, you need a certain amount of deal flow to develop the expertise to know what you're looking for. And we can all find the two or three really critical points in an investment or in an M&A deal when it would take somebody else a lot longer to sift through the data.

KRAMER: So, putting aside substantive knowledge, what are the special qualities that lead to being a successful Silicon Valley lawyer?

DAUCHY: I tell young lawyers that to succeed in the Valley you have to enjoy solving problems. And you have to be a good listener. You need to listen to the client's issues and then put yourself in the client's shoes to figure out what the client needs. And you have to be willing to express an opinion. The client often wants to hear what you think he or she should do, and the law is often only a small part of that advice.

DAVIDSON: I give the following advice to our young lawyers. You've got to be pragmatic, and you've got to understand not just what the client's question is, but also what the business objective is. Don't be confused by the way the client has framed the question. Sometimes clients will try to frame a question in a legal or quasi-legal way. If you answer that question, you're probably going to run up a big legal bill and not solve the client's problem. You need to go behind what the client asks you, figure out what the business objective is, and then help find a legal solution to the problem for the client.

SONSINI: Yes, I would agree. I think that the practice that we're talking about is the ultimate service practice. The mindset is really service—responsiveness, understanding, patience, and toughness. You have to have the ability to deal with volatility—not only of personality but of problem. And, by and large, the "Silicon Valley practice" is a heavily relationship-driven practice. You really have to be, at the beginning, a very good generalist. You have to understand everything from how to put together a stock option plan to deal with trade secret issues, to an employee benefit matter, to a financing issue. And to say that "I'm an expert in this and let me bring in three partners that can do each of those" and all of a sudden you have a room full of lawyers—that's not service. And that's where the tension is. So, approach it by teaching lawyers very early on that, on the surface, it's a very broad menu and service-focused.

DAVIDSON: One thing that is unique about Silicon Valley, and it's the one thing that students should think about, is that we form very strong bonds with our clients. Our clients become our friends. Our clients are also young, so as a young lawyer, you can have a client who is a contemporary of yours. In fact they prefer a lawyer their own age. It's getting harder every year for some of us! And we live among our clients. And our kids go to school with our clients' kids. You can be in line at the Safeway or at a dance class or swim meet and you will see clients there. You live among your clients and they become your friends. And I don't think that's true of other legal practices. Or not as true.

KRAMER: And, any particular advice for law students if this is where they want to come practice?

SONSINI: I think we've said it: Have an open mind, be committed to learn and understand. Be willing to engage and embrace the uniqueness of all the disciplines.

DAVIDSON: I would add, be intellectually curious about what the clients do. Because they do very neat things and you don't need to be an engineering major to understand it. Certainly some of the social networking is intuitive, but even some of that hard science you can learn what you need to know pretty quickly just from talking to the clients or from doing a little background reading. Understanding their business really matters.

DAUCHY: When I meet with law students on campus I tell them that this practice is not a predictable world. It's fast-moving; it's exciting, but it is 24/7 and you have to be prepared to take that 1 a.m. phone call from the entrepreneur who needs your advice to try to solve an urgent problem. It's very exhilarating to be that kind of counselor, but it's also very disruptive. So to be successful, you really have to live and breathe the practice, all day, every day.

KRAMER: Now let's talk a little about the startup business. Gordy, you mentioned that part of the business model is to take out a portfolio of companies of which a small number will make it big. How do you decide which small startups to choose, given the risk?

DAVIDSON: You have to be somewhat discriminating and over the years you develop an ability to find the ones that you think are going to make it. And also, I think we rely heavily on the judgments of the venture capital community—the ones that get funded are the ones that are going to be good clients.

KRAMER: How and when do you decide which clients to take on?

DAVIDSON: We all take on clients at the earliest stages, but the question is how much work will we do before they get funded. We help them get started, help them do it economically, help them help themselves. For example, we've developed open-source seed financing documents, where clients can essentially do their own seed financing with documents they can download from the Internet. Because if you are raising only $200,000-$300,000, you can't afford to involve law firms and negotiate representations, warranties and the rest. So there are ways to get companies launched cheaply in Silicon Valley; there are lots of technologies available and lots of services from banks and employers and accountants and so on. Then you see whether they get funded. And typically, we all, as firms, do extend them some credit, take some risk on some amount of fees. But not an enormous amount and not forever.

SONSINI: A lot depends where they came from, what they've done, and with whom they've associated themselves. And usually, that's about the only filter I need at that point. Because, as Gordy pointed out, you have a bunch of other filters before you really invest in them. But if you have young people that you know worked at Hewlett-Packard or at Cisco and they want to start a business with a discipline that they've been engaged with for a while—maybe they've had contact with an angel investor—that's almost good enough. Then, ask them to describe the concept. And then you have to be very careful to wean them into the firm, to be sure that they're for real, and see if they'll stick. It's amazing how quickly you can tell if they have a shot at it. You can't tell whether they'll be successful—I never have very much success with that.

DAUCHY: I agree with Larry. If their plan is of a certain quality and the character of the entrepreneur checks out, we are likely to take them on.

DAVIDSON: The easy ones are the ones that have done it before and come highly recommended. The hard ones are the ones like Steve Jobs, Steve Wozniak, Sergey Brin (MS '95), Larry Page, Mark Zuckerberg. They haven't done it before. They're very young and hard to assess. And that's when you stare deep into their eyes and try to see their commitment, their character, and their creativity and you say, "This kid is crazy, but he's gonna do something and I'm gonna back him."

KRAMER: Let's talk a bit now about the business of law. Do you think that the legal profession is going through a dramatic transformation or a short-term response to a severe economic downturn?

SONSINI: I think we are going through a transformation with many things coming into play. One of course is the old law firm model of billing for time, and that's under siege and it has been for a long time. So the economics of the profession are being looked at and changing. I don't think the law firms enjoy the position that they held for so many years—saying, "We're an hourly system, we change our hourly rate every year, and that's who we are." The buyer of legal services, particularly in the enterprise space, is asking questions. "Do you go for fixed-fee arrangements or discount arrangements? Do you go for long-term arrangements?"

I also think that the old model of leverage in the industry is changing. You used to have five-to-one leverage of associates to partners, then four-to-one. That model is shrinking. The smart buyer of legal services wants expertise early and doesn't want to be billed for lots of associates.

I think the third thing that's changing is that a lot of the metrics that the law firms judge themselves on—like profits per partner—have eroded, almost gamed by the system with equity and non-equity partners. And I think more revenue per lawyer is a constant that's creeping in. So a lot of the financial metrics are changing in the industry.

Then there's the globalization of the profession. Many firms believe that they have to scale globally and we've seen some major mergers. And a lot of lawyers think that their business plans are solved just by volume. So you have a lot of lateral movement within the industry. You have a lot more merger activity in the industry, and that's put a lot of firms on notice that things are changing.

So, yes, I think there's a lot of change. I think it's going to require a lot of adaptability and we're going to see a lot more moves.

DAVIDSON: I think the industry has been evolving over the past ten years, especially for our three firms, since the Internet bubble burst of 2001. While events like the post-Lehman recession or the more recent Dewey loss might cause some to say "Wow, everything has changed," I think it has been much more gradual than that.

KRAMER: Have you guys changed substantially already?

DAUCHY: This is a business. The profession has evolved to the point where partners at law firms know they cannot just sit back and wait for other partners to bring them work. We know that to be successful, the partners have to pull together as a group and care about revenue production and expenses. And the business is much more transparent today; thanks to the legal press, we can all see how the other U.S. and international firms are performing. So of course, yes, there's an emphasis on financial performance that didn't exist when I joined the industry.

SONSINI: We're trying to be prudent about it. But we're watching our loads—what's coming down. And we're not so quick on our billing rates. We're staffing differently. There's nothing unique here. But you've got to be consciously aware of what you want to be and what you want to become. Many firms, I think, have grown beyond their business plans. And we all know what's happening to Dewey and it's tragic. The business requires more business management—it's more of a business, it's less of a monopoly, it's a tougher business, and it requires a lot more professionalism.

KRAMER: The Dewey issue was driven very much by the internal compensation model, right?

DAVIDSON: I think it's driven by the unfunded pension plan obligation, mainly. And that's been the demise of other firms. But it's also part of the broad global business model evolution that Larry and Craig have been sketching. Law firms have to operate as businesses. It was very simple to have a law firm in the old days where you paid an associate x, you billed the associate out at 3x, you sent a bill to the client, and the client paid it. You had to be pretty incompetent not to make money with that business model. And now we have to be a real business. Clients want to pay for value, not time and effort. And we have to provide value and bill accordingly.

Ten years ago we [at Fenwick] embarked on a very deliberate effort to move away from the billable hour—and we would do it actually faster than our clients would. We think it has a lot of advantages. But not all clients have the ability to know what something should cost, so many would rather negotiate for a discount than for a fixed fee. Then they can report to their superiors that they got a 15 or 20 percent discount, and the CFO is happy. If they say, "I got the firm to agree to a fixed rate of $300,000 for this acquisition," the CFO doesn't know if that's a good price or a bad price. We know because we have the data, but it's hard to convince the clients.

Right now, we have something like twenty-seven ongoing "business model initiatives" focused on changing the basic processes for what we do. For instance, we require all of our partners to do a budget for every project that we think is going to be more than $250,000. And we provide a dashboard to the partners every day showing how they're doing against budget and why. We have data on the last 300 mergers we've done, the last 300 patent litigations we've done, what they cost by week, by function, by the number of parties, number of patents, the structure of the deal. So we've built up a great deal of instrumentation on what things should cost and how clients can do some of the work themselves in order to save money if that's what they want. And we're all looking at how we evaluate and compensate associates. We have non-lawyers to do some of the tasks, we have different categories of lawyers to do document review and some of the patent searches and those sorts of things that don't necessarily require the high-priced legal talent that we've been throwing at some problems. But we all have to be subject to the rules of business—be smart about how we train people, what we spend money on, how we charge for people, how we charge for the services we provide, and how we synchronize with our clients' objectives. So that's creating a lot of strain on law firms, ours included, because the traditional law firm model is somewhat anachronistic in today's world.

DAUCHY: We certainly have different billing arrangements that we can employ, depending on the needs of a particular client. Sometimes hourly rates make sense, sometimes they absolutely do not. On the expense side, law firms are taking a very hard look. Orrick has established its administrative complex in West Virginia to save money. Other firms have dramatically reduced their office size per lawyer. The ratio of lawyers per secretary continues to increase. All of those things are being looked at by well-managed firms. The key, though, is to not put so much pressure on expenses that you hurt the culture.

KRAMER: In some sense, firms as businesses are getting pulled by two really difficult things at the same time. One of them is customers saying you have to bring prices down and the other is the demand of your most productive partners to be more highly compensated. Part of that traditional model was a lockstep compensation scheme.

DAVIDSON: Part of it was that your worth was measured by your compensation and it wasn't necessarily your job satisfaction. What we do is hard and the hours are long and it's a little bit like watching a baseball game—90 percent of the time it's routine and 10 percent of the time it's exhilarating. You have to prepare for the exhilarating part. So, job satisfaction matters as much as money does. If you're in a collegial environment where you're doing exciting things, do you really need to make $4 million a year? Or is $3 million enough? I think realistically, lawyers make a lot of money and there's going to be pressure on what lawyers can make. You mentioned Dewey and the compensation—certain partners there were guaranteed amounts that weren't sustainable by the practice. And that isn't going to work.

SONSINI: I think it's a major issue. If you try to manage or build a firm, based solely on the economics, you are going to find that it's a very difficult model because you find yourself growing by paying a price. And you're not thinking about culture, integration, synergy. To get into this world of guaranteed salaries and to try to match salaries just to grow is dangerous. I think that you have to focus on a merit system without guarantees. And you have to have people buy into what you're trying to do. If you enjoy working on growth enterprises and if you want to be a part of technology and if you want to be a part of what's driving world economies, then think of this practice. And the economics will be good. So that is a major tension in firm space today because the lateral market is really pricey right now and you've seen it in many examples. But the problem here is that the success rate in terms of sustainability with the lateral model is not very good. If you look out five years, it's less than 50 percent, according to some of the national averages. Now, that's a pretty expensive model to run. I think it's a major challenge, so I echo what Gordy's saying—we try to run this like a business, we step back and say, "Forget about the old metrics of the legal business; instead think what is the business we're running? What is our business model? How is it integrated? How are the feedback systems? What are the dashboards we're using?" And then try to get people to buy into the long-term, as opposed to a short-term, contract. It is one of the toughest businesses in America today.

DAUCHY: Frankly, there is a heavy subjective element to our compensation system and that subjective element is based on how much a partner contributes to the firm's success. Part of that contribution is measurable by billable hours and revenue production. But much of it is not measurable in these terms—for example, contributions to the culture, to firm administration, and to pro bono work. There are a wide variety of factors that help make a firm "successful" and all those factors need to be recognized. Critically important is that your partners trust that compensation is structured to take those factors into account fairly.

DAVIDSON: We strongly believe that teamwork and collegiality and collaboration are the keys to managing a law firm—not buying the talent. People do derive more job satisfaction by accomplishing something as a team—you can do more miraculous things as a team than you can as an individual. And if you have internal competition for dollars, that's just an unhealthy environment to operate in. I think every single partner in our firm could make more money on the lateral market. But we haven't lost many partners to other firms. Some of them retire, some have become judges, and that sort of thing. There's a glue—a culture that has to be something other than money. Money's important at a certain level but so long as it's within a range, it doesn't have to be the most amount of money.

KRAMER: So before we wrap up I want to ask you what you see as the sort of exciting frontiers of the modern legal profession, looking at, not just what's happening now, but going ahead ten years?

DAVIDSON: That's a good question. I've always thought that the answer for me and for us is technology. Technology is going to continue to change and continue to provide new social challenges, new advances to the way we live and interact, and present new legal challenges. And those are fascinating to me. When I was a law student, a lot of my colleagues were going to law firms that represented banks and I thought to myself "please, don't let me go there." So technology and the kinds of companies we work with will continue to generate novel problems with big impacts on the world, which don't have legal solutions that you can look up in a textbook or a case. You're going to have to fashion the solution from scratch and that's what makes a practice renewably enjoyable and rewarding for us. I don't know in what field that will occur, but I do think it'll be connected in some way to technology.

SONSINI: I agree. When I think back on the forty-five years I've been doing this, the legal challenges have really been driven a lot by what's come out of technology. And if you see the globalization of technology and innovation today, and if you see the impact of technology on the consumer, we're really entering a world where technology is now at home, at your desk, it's on your kitchen table. And that is ballooning the issues.

Issues of privacy, issues of protecting intellectual property, the monetization of data—we are just in the first inning of all of that. And that's going to grow—it's going to move economies, it's going to build boom industries, it's going to affect the way we raise our children, how we educate our children. And all of that is going to come with social problems that lead to legal problems.

History teaches us that the law comes out of the social mix, and the social mix is greater than ever. Look at just the last decade—with social media, Internet searching, social networking—and look what it has fostered. We're just beginning to understand the legal problems. And you can see it in the way that the government is dealing with it and how other nations are dealing with it. I think that's the big thing, technology, and that's where our businesses are focused.

DAUCHY: I would add international legal issues to the list—cross-border deals, international arbitration, protection of intellectual property across international borders. There is absolutely no doubt that the world is shrinking and shrinking rapidly. Most all of our clients in ten years will need help on international issues. And I think that will produce some very exciting legal opportunities for lawyers, whether they are housed here in the Valley or overseas.

KRAMER: Okay—last question. If you ask me, law students today are coming out of law school much better prepared to practice than we were. But legal practice is much different today. So are you satisfied with the quality of lawyers you're getting? And what should law schools do to better prepare them?

SONSINI: I would say that the quality of young lawyers is tremendously high compared with the past. When I taught here at Stanford, last fall, I was just so impressed with the quality and diversity and depth of the backgrounds and the level of inquiry. Same thing when I taught over in Berkeley. I think the quality's great. As to the second part of the question, to me it's to bring the private sector more into the classroom—the pragmatics of what the law is all about. Because all of these law students are incredibly bright and they're learning the law, but the law is really learned in practice. To be a great lawyer, you really need experience and you need depth of judgment—you need to fail.

And frankly, Larry, what you're doing is great—you're bringing in people from the private sector, you're opening up technology into the classroom. You've introduced more joint degrees, more combination business school/law school degrees—and ethics centers, integrity centers, and governance centers. To me, it's all about broadening the menu. When I was in law school, you pretty much knew the class selection and the textbooks. I never saw anything in the outside world and I never had a businessperson come in and lecture about business.

DAVIDSON: I have similar thoughts. I did see an occasional person from the business world, with visiting professors and with practical, legal problems, and I thought those courses were really intriguing. But—Larry, you and I have talked about this in many, many contexts—I think what you've done here, for example, in terms of getting the law school calendar in line with the university's quarter system, enabling many more interdisciplinary courses and greater course selection, and teaching collaboration and team problem solving—all of this is very important. The students do come out with a high level of energy and really a broad set of interests and an understanding of the world and enthusiasm to go make a mark on the world.

Here's an example. In our summer associate program, we post projects on our intranet. A couple of years ago the first project I posted asked, "What is the regulation of virtual currency in a virtual world?" and a summer associate chose that one. When she came in, I asked her why she picked that project and she said, "Well, I'm a third-level black belt in a video game with virtual currency, so I think I'll understand this, and I'm interested in the legal problem." The next project I posted had to do with a survey on corporate governance, based on reviewing some *Harvard Business Review* articles, and the same associate picked that project too! I asked her why, and she said, "Well, I subscribe to the *Harvard Business Review.*" So here you've got a law student who is an avid video gamer and subscribes to the *Harvard Business Review*. That's what law students are like today. They have varied interests. They're deep, they're thoughtful, they're curious. So they're enormously well equipped to do something great.

I think the mismatch is still when new lawyers land in a law firm and they have long hours and they do work that is viewed by them as tedious. You know, the really exciting stuff doesn't happen every day or right away, so I think there's a mismatch in the kinds of things they're equipped to do and interested in doing, and what the work is actually like for a first year lawyer in a law firm. So, the challenge for all of us is to continue to make a career in a law firm a fulfilling experience for the long term.

And I think the clinical programs are, again, a good thing. And I congratulate you for taking them to a new level here at Stanford Law School.

There are many other things that legally trained lawyers go on to do—as you know. They've been presidents of Fortune 500 companies, ambassadors, and people who have devoted their lives to curing diseases in third-world countries. They're high-performing, highly capable people. Broadening their legal education is a good thing.

DAUCHY: I agree. The legal training here at the law school is superb. But since you asked for a possible area of improvement, I would like to see, at least for new corporate lawyers, a bit more practical training. For example, I have taught a class at the law and business schools where we conduct a VC financing activity. I give the class a term sheet, and I give them reading materials to prepare them. I then divide the class into teams of venture capitalists and entrepreneurs and have them negotiate the term sheet. And they have to fashion the arguments for and against the various points. They don't know when they walk into the class if they're going to be the entrepreneur or the venture capitalist, so they have to know both sides. So they're getting negotiating experience, getting exposure to what it's like to be a VC, what it's like to be an entrepreneur. I know there's been an increase in these kinds of classes at Stanford, but in my dream world you would have even more. We all know a Stanford student can find the law—it's really the practical training that would help a first year jump into practice on day one.

KRAMER: Thank you. This was great.