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M&A and AI
And it ain't steak sauce

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If you're like many of us, AI might as well be called A1, like the steak sauce, as our Secretary of Education seemed to think in a recent viral moment. But it's everything everywhere and all at once and its share of the dealmaking landscape is expanding rapidly.

The AI industry, says Baker McKenzie's Derek Liu, can be divided into three parts, like Ceasar's Gaul. There is the infrastructure sector presided over by gargantuan data centers that are the bricks and mortar of AI, and the semiconductors that fill up those data centers. Then there is the LLM layer, the "large language models" that are the algorithmic responses to a mass of data such as Google's *Gemini*, Meta's *Llama*, and xAI's *Grok*. Lastly, there is the application layer of AI, the firms that build bespoke AI systems that can be plugged into a myriad of disparate businesses across the global economy.

Derek Liu
Baker McKenzie

It is the application space where M&A dealmakers have found their natural grazing ground. And the herds are thundering in. Two years ago, in 2023, there were 717 AI deals valued at a total of $44 billion, according to a March 10 article in

Law360, written by Al Barbarino and entitled *Growing Influence on M&A Creates a High-Stakes Game*. In 2024 the number of deals jumped by 187 and the value levitated from $34 billion to $78 billion. Venture capital firms, private equity groups, a proliferation of new law firm practice groups, strategic and financial buyers and sellers, and angel investors are rushing in where none no longer fear to tread. PE deals involving AI two years ago moved from 272 transactions valued at $21 billion to 332 deals worth $26 billion the next year. Venture capital deals during the same time period rose from 8,748 deals worth $89.2 billion to $134.1 billion, according to Mr. Barbarino.

But let's pause here to ask just what is this AI of which we speak? We turn to an expert to provide a primer that you might want to read secretly to avoid appearing as clueless as Linda McMahon. Unlike Madame Secretary, Derek Liu knows of what he speaks. He has a B.A. from Harvard and a J.D. from Columbia. He started out as an associate at Wachtell Lipton, followed by an associateship and then partnership at Wilson Sonsini, and he is now a partner in the San Francisco office of Baker McKenzie where he has practiced for the last five years.

"I moved to the West Coast because I've always been a bit of a tech geek and I wanted to be close to the scene. Ever since then, all the way to today, my practice has been basically 80 percent technology and 20 percent life sciences." His roster of M&A deals has an aggregate value of $110 billion including some of the most transformative M&A transactions in the tech sector. "I wish I'd invested in all of them rather than just representing them," he says with a laugh.

At its simplest, Mr. Liu explains that AI is the ability of computers to access incomprehensibly large data sets and to generate meaningful information from that absorption. "An LLM looks through all of the texts that humanity has ever created and digitized and when you have a specific query, it turns that data into a set of responses based on analysis of all the text that's out there. That is the broad definition of AI."

But, he says, there is far more to AI than chatting. "Think about Waymo's self-driving cars. AI takes millions of hours of video footage and other sensor data of cars driving around and turns that into an algorithm for how to drive your particular car in your particular space. Similarly, to develop new pharmaceuticals, AI parses through billions of compounds and determines which might work to fight a particular disease.

Mr. Liu says in his ten years in Silicon Valley, this is the second "hype wave," as he calls them, that has transformed how software is developed and delivered to customers. "Have you heard the term 'SaaS, which stood for Software as a Service?" he asks his interviewer. "No? Remember when you and I were growing up, to get software you went to your local big box store and you bought a box. The box came with a CD. You put the CD in your computer to load the software into your computer, and you basically got to use that piece of software for however long you wanted it. That's the way software used to be done. Then came SaaS, a whole different way of acquiring software. You paid a subscription. You got a username and a password and you had the right to use that software for about a year. This completely unlocked the way that people interacted with software," he says." It allowed for the huge proliferation of the software ecosystem that we have today. We fundamentally changed the way that software was sold and delivered to consumers. I would think about AI in that same way. It is not a thing in itself. It is a feature that unlocks productivity on a massive scale."

What made SaaS such an overpowering success? "Let's carry the analogy further," suggests Mr. Liu. "What enabled SaaS to work? It was the revolution in cloud computing." Microsoft Azure, Google Cloud are leviathans of hosting sites, the so-called "hyperscalers". SaaS could simply build their products on these sites and forego any concern with infrastructure. "They didn't need to buy their own servers and maintain their own server files and their own data centers," Mr. Liu says. "They could just pay one of the hosting sites to build the infrastructure and then they could sell their software on top of that."

Two of the three sectors in Mr. Liu's tripartite model of how AI works have yet to see M&A explode the way it has in the application layer of the AI phenomenon. "In the infrastructure layer, it's more about investments than M&A—new data center builds, new energy sources to support those data centers, new semiconductor fabs." AI's physical infrastructure involves massive data centers and GPUs, or graphics processing units, powered by a voracious appetite for energy. The

upfront costs to play in this space are quite considerable, particularly when you are talking about standing up a new semiconductor fab or a new data center.

Turning to the LLM layer, the typical LLM business model is to assemble masses of data, spend the funds on training costs to educate its system, and then charge customers for each question asked. This is usually a small fee, sometimes fractions of a penny, but the payments quickly add up to fantastical fortunes, a return on the equally stunning investment costs of assembling an LLM.

As one example of where those two layers are converging, several companies launched earlier this year a joint venture to build AI infrastructure in the United States. The group plans to assemble $500 billion over the next four years with an initial expenditure of $100 billion. “The process of absorbing all the information that’s out on the internet and creating a model out of that, well, that is a process that costs hundreds of millions of dollars. “It’s insanely expensive to play in this layer,” Mr. Liu says.

In the infrastructure and the LLM layers, the truly big guys are just too big to buy for traditional M&A players.

The application layer does not loom over potential mergers and acquisitions with such indomitable power. “What you’re seeing now in the AI marketplace is a competition between the incumbents racing to build AI into what they do,” Mr. Liu says, “and on the other hand you’re seeing a few AI native startups rushing to see if they can build a better mousetrap and displace the incumbents. The startups will end up getting scooped up by the incumbents who are starting to say to themselves, ‘Hey, rather than spending a year building this ourselves, let’s look for someone who’s already built it for us. Let’s buy them and plug them into our product.”

This last point is what Mr. Liu calls his punchline. “This application layer is where the vast amount of M&A activity will happen: large companies that have good solid businesses buying startups to accelerate the AI deployment into their products. The thing about AI is that it is now seen as essential to all forms of commerce and tasks all over the world. Take online meetings, the new reality of the post-Covid world. In the pre-AI age, some participant had to take notes, clean them up after the meeting, and summarize key action items for the group. In this AI age, that same meeting can be transcribed with AI, which can then create those same summaries and action plans with a keystroke, all of which is ready within minutes after the meeting ends. And as it advances, that same AI can translate conversations from one language to another, effectively removing all linguistic barriers to global collaboration.

Next up as one of his examples of the ubiquity of AI is the business of law. “Everyone’s talking about legal tech using AI to make our work more efficient. For instance, the providers of legal data are getting into the AI game. Each of them started with a huge database of cases, their own treatises or deal information. They basically stuck an LLM model on top of it. They didn’t create their own LLM because that would be too expensive. They just applied someone else’s LLM and trained on their own data to create a model that they then sell to lawyers.”

Why would this be useful to lawyers? Everyone can simply go online and ask questions of any one of the available LLMs. “But remember,” Mr. Liu says, “Most of those LLMs trains on the entire internet so I’d be getting all the kooks and crazies talking about what they think Delaware law should be, for example. If I do the search on an AI enabled platform, I’m getting a curated set of content that is actual case law and my confidence goes up. As a lawyer, I’m willing to pay the extra money to get that extra confidence because I can’t be ninety percent right for my clients. I have to be one hundred percent right.”

And yet, nothing in life is simple. AI has created its own complex world that is not without barriers and pitfalls. The classic business model for LLMs centers building an expensive, proprietary model and then charging fees to customers to use those models. However, a startup from China, DeepSeek uses the open-source model, which essentially means they’re giving the entire model away. Anyone can use it. Anyone can modify it. “So on the one hand,” says Mr. Liu, “you’ve got these companies that are valued at hundreds of billions of dollars, and on the other hand, you’ve got companies who are giving away a roughly comparable product for free. If you’re a big company you say to yourself, ‘Well, I could either pay $X billion

to buy one of the LLM model makers out there—if we ignore the antitrust risk for a moment—or I could get it all off the internet for free. It is the ultimate experiment on whether proprietary or open source will win out."

What's more, it's not as if AI, as new as it is, can ignore the rule of law. Just ask the Attorney General for California. Rob Bonta. "AI may be a new technology but the laws that apply to it aren't new. They already exist," Mr. Bonta declared at a recent Berkeley conference. "All of the criminal laws currently apply, all of the consumer protection laws, all the civil rights laws, all the data privacy laws that already exist apply to AI. You can't use AI to commit a crime and then say, 'We're new. We don't have any laws that apply to us yet." [See, **The Berkeley Spring Forum on M&A and the Boardroom**, *The M&A Journal*, Volume 24, Number 6.]

And then there are the antitrust regulators. The new administration looks likely to be more sympathetic to mega-transactions but members of the newly appointed teams in the U.S. also emphatically promise not to be pushovers. [See, "**The New Federal Trade Commission**, *The M&A Journal*, Vol. 24, Number 6.] What's more, as all dealmakers know, there are investment regulatory agencies in dozens of countries. The European Commission, for one, has not hesitated to challenge the actions of Big Tech no matter where it has its headquarters. [See **What EU Merger Control is all About: Guillaume Loriot of the European Commission,** *The M&A Journal*, Vol. 24, No. 6.]

Innovation is the mother of litigation, to paraphrase an old saying, and AI is facing off in court against significant content holders. In late December of 2023, a lawsuit was filed against an AI company for allegedly using a significant amount of copyrighted content without permission or payment to form the build of its language model. It is considered to be one of the first major challenges related to copyright law in the field of AI.

It won't be the last. As recently as June 9, a landmark U.K. copyright case began at London's High Court brought against Stability AI, The plaintiff is accusing Stability AI of scraping millions of the content holder's materials from their websites to "train" its Stability Diffusion, a system that can create images from text inputs. Stability AI, a leader in the generative AI space, is flush with hundreds of millions of dollars in funding and in March announced an investment from one of the world's largest advertising agencies. The amount involved was not disclosed.

Stay tuned!

AI, Baker McKenzie, Derek Liu

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