

Morgan Lewis

STARTUP & ACCELERATE

Key Issues in Tech M&A

May 12, 2022

Jeffrey P. Bodle, Ezra Church, Michael Ryan, and Eric Tajcher

Presenters



Jeffrey P. Bodle



Michael Ryan



Ezra D. Church



Eric Tajcher

Morgan Lewis

Technology Marathon 2022

Our Technology Marathon is an annual series of tailored webinars focused on hot topics, trends, and key developments in the technology industry that are of essential importance to our friends and clients. Now in its 12th year, our expansive curriculum kicks off in May and continues into June.

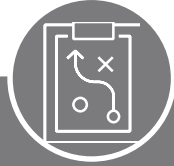
For more information:

<https://www.morganlewis.com/events/technology-marathon>

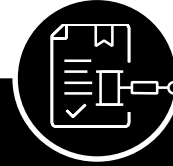
Agenda



Introduction



Why Do Some Tech Deals Succeed and Why Some Fail



Deal Structure and Consideration



Diligence Approach and Key Issues



Retaining Key Employees



Heavily Negotiated Technology M&A Deal Points

Introduction

Technology M&A

raises unique considerations, both for buyers and sellers

Our Goal Today

to introduce you to a number of those issues, several of which could be the focus of an entire presentation



Deal Structure

Typical M&A

- Asset Purchase
- Stock Purchase
- Merger
- Joint Ventures

Carveout Transactions

can be a combination of asset AND stock/merger; added complexity of commingled assets, know how, licenses

Technology M&A

can be any of the above OR can use a license or a technology transfer as a form of M&A

Deal Consideration - Basics

Consideration

- Cash
- Stock (consider securities law issues, private placement, registration statement, fairness opinion)
- Deferred Consideration / Promissory Note
- Assumption of liabilities
- Earn outs

Price Adjustments

- Indebtedness
- Working capital
- Deferred revenue
- Line-item adjustments

Consideration – Earn Outs

- Payment Conditions
 - Milestones
 - Performance
- Covenants
 - Post-closing control
 - Funding commitments
 - Key personnel
- Use as collateral for indemnification
- Restrictions under credit arrangements

Key Diligence Issues

Diligence - Generally

- Buyer gets educated about business
- Evaluation of commercial and legal relationships
- Evaluation of third party or governmental/regulatory consents
- Identification of material issues
- Provide support and knowledge about business to lenders and R&W insurers

Conducting Tech Contract Diligence



Identification and discussion of buyer's business objective with acquired assets/business



Detailed request list



Template for terms and conditions summaries



Detailed follow-up request list



Interview with key target personnel

Conducting Tech Contract Diligence

Detailed review of terms and conditions of IP related contracts

- Inbound / outbound licenses
- Employee / contractor IP assignments
- Ownership documentation
- Prior M&A agreements
- Settlement agreements

Key Issues

- Ownership issues, including for improvements
- Scope of license grants
- Confidentially / non-use obligations
- Change of control provisions / anti-assignment provisions
- Residuals clauses
- Non-compete obligations / exclusivity restrictions
- Source code escrow obligations

Key Diligence Issues – Open Source

- Many companies do not know what is in their code
- Many companies do not have open source policies
- Why care?
 - Buyer may inherit problems
 - Delayed revenue while fixing problems
 - Closing may be delayed or even prevented
- What types of problems can it cause?
 - Improperly incorporating certain open source policies can create an obligation (“tainting”) to release proprietary code under the same open source license; loss of ownership/exclusive rights
 - Open source does not typically push updates (e.g., no security updates or evolving vulnerability analysis)
 - Can result in inability to assert patent rights against others, or provide a great defense
 - Representations and warranties in customer contracts may be breached, resulting in indemnity liability
 - Reputational risk

Key Diligence Issues – Open Source

- Determine the value of software to target and how that software is used
 - is software a key asset?
 - is it revenue-generating?
 - what is the value of target's patent portfolio?
- Discuss with target developers how they use open source in writing code and what they think is in the code; target should disclose; recognize that target's disclosure will likely be incomplete
- For many technology acquisitions, a third-party audit/scan should be expected; be sure to build time (up to 2-3 weeks) and cost into process
- Target must provide a complete copy of the software to the scanning service
- Some surprises should be expected, but discovery of rampant misuse of open source can delay or prevent the deal from closing

Key Diligence Issues – Open Source

- Upon receiving scan results, further discussion with target may be warranted
- Consider whether remediation is appropriate, and the timing and process
 - Pre- or post-closing?
 - What resources will be necessary?
 - Who pays?
- Revisit structure and purchase price
 - Is a purchase price discussion appropriate?
 - Should a special indemnity be considered?
 - Should closing be delayed (are fixes a condition to closing)?
- Advice to potential sellers: face the issue ahead of time; scan your code, know the issues and the risks, and fix them before they impact your deal

Key Diligence Issues – IP

Four primary areas of focus for IP due diligence:

- Ownership and control of IP assets
- Strength and value of IP assets
- Liability for infringement
- Assignability

Why Care?

- For technology companies, IP is one of the primary assets being purchased; buyers want the benefit of their bargain
- Buyer may inherit liability for infringement, and litigation over ownership issues
- Breach of representations and warranties in customer and supplier agreements can result in costly indemnification obligations

Key Diligence Issues – IP

- Work with outside counsel to prepare a thorough and detailed IP due diligence request list covering patents, trademarks, copyrights, trade secrets, and licenses
- Make sure all registrations have been either obtained or applied for and are up to date with the appropriate filing office
- Make sure a clear chain of title exists from the inventor, author, or previous owner to target company
- Ensure that appropriate assignment documents are recorded in the public record if/as necessary; confirming the existence of an appropriate assignment from each and every inventor is critical with patents
- Ensure that there are no encumbrances (run UCC lien searches), such as security interests or liens, on the assets or, if they exist, that they are understood and/or will be terminated at closing
- Review trade secret policies and procedures, including the way in which target company handles trade secret information
- Understand whether any public entity has funded the technology (i.e. a public university or the military) and, if so, the implications of such funding

Key Diligence Issues – IP

- Ownership and Control of IP
 - Perform appropriate chain of title and open source due diligence and carefully review the results and their impact
 - Review licenses in and other IP agreements for scope of license, liabilities, assignment provisions and/or necessary consents or additional licenses
 - Review licenses out to ensure the scope of rights given away is not overly broad
 - Review IP settlement agreement terms

Key Diligence Issues – IP

- Strength and Value of IP Assets
 - Consider whether certain IP assets are critical to the post-deal business objectives and, if so, whether further diligence is appropriate
 - Review the form of protection for IP assets and its strength and suitability generally
 - For patents, consider a review of prior art for validity, scope, and quality of patent claims
 - Analyze the market and whether competitors will have an easy time designing around the patents
 - Consider whether to request freedom to operate searches/right to use
 - Perform similar review on trademark and copyright files

Key Diligence Issues – IP

- Liability for Infringement
 - Identify actual or threatened litigation or claims against target
 - Identify actual or threatened litigation or claims made by target against third parties
 - Review all notices, letters, complaints, case files, and opinions (if any)
 - Review all settlement agreements and releases
 - Understand the status of any ongoing proceedings
 - Consider the merits of the claims and assess the potential outcome

Key Diligence Issues – IP

- Assignability
 - Requires detailed review of license provisions
 - Interpretation of assignability provisions is tied to the deal structure
 - Are there any other impediments to assignment?

Key Diligence Issues – IP

Impact on the deal – Consider whether any IP due diligence findings merit:

remedial action as a closing or signing condition

special indemnification and/or special escrow

third-party consents as closing or signing conditions

post-closing covenants and/or liability for associated expenses

changes to representations and warranties

alternative integration approach

Key Diligence Issues – Data Privacy Compliance

- Why care?
 - Depending on the industry, poor compliance can directly impact revenue
 - Data privacy laws exist in over 120 countries worldwide
 - Enforcement is increasing
 - Sanctions are expensive and can bring business to a halt
 - Reputational risk of a breach can be severe
 - If there are problems, provide time to fix them early
 - Consider how target's compliance will fit into buyer's existing compliance structure
- Data privacy issues are particularly relevant in Big Data, SaaS, and cloud computing services deals, tech providers in sectors with heavy privacy regulation (health, money, kids) and/or in any industry/business that collects personally identifiable information (PII)

Key Diligence Issues – Data Privacy Compliance

- First, ask a lot of questions
 - Who is responsible for managing data privacy compliance?
 - What type of sensitive information does target have?
 - customer
 - healthcare
 - employee
 - financial
 - Is target in an industry that is heavily regulated?
 - What jurisdictions are relevant?
 - Does target have written policies? Are they compliant? Are they followed?
 - How does target approach cross-border compliance?
 - Has target developed a culture of compliance?
 - Has target ever had a breach and, if so, what did it do?

Key Diligence Issues – Data Privacy Compliance

- Next, ask for and review documents
 - Local registrations with data protection authorities, or reasons for not registering
 - Sources of protected data and how it was obtained, how it is used, and how it is retained
 - Written policies
 - Security breaches and actions taken
 - Privacy and data protection audit results from prior years
 - Notices to individuals
 - Past complaints or claims
 - Penalties or fines
- Last, assess the risk
 - Remediation, special indemnity, special escrow, post-deal integration issues?

How to Retain Key Employees



Employees are particularly valuable to tech companies



Acquisitions are stressful on target employees



Focus early on who is important to keep, and how best to do so



Provide assurances about future location, job description, culture and resources



Provide assurances about future benefits



Balance the “deal reward” and the “retention component” to maximize likelihood that key employees will stay



Consideration holdback for seller-employees tied to retention

Deal Points

Heavily Negotiated Technology M&A Deal Points

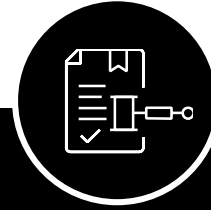
Heavily negotiated M&A deal points generally fall into three categories



Structure/purchase price



**Representations and
warranties**



Indemnification

Heavily Negotiated Technology M&A Deal Points

Structure/purchase price

- Structure
- Price adjustments
- Earnouts
- Closing conditions

Heavily Negotiated Technology M&A Deal Points

Representations/Warranties

- Subject matters
 - Sufficiency of IP and title to IP
 - Presence and terms of employee/independent contractor IP assignment provisions
 - Compliance with law and contractual terms/conditions
 - Employee classification (especially if target uses many contractors)
 - Non-infringement (in-bound and out-bound)
 - Presence/ catalogue of open source software
 - Data privacy
 - Obligations to third parties
 - Source code escrow
 - Exclusivity / non-compete obligations
- Qualifications
 - Knowledge, materiality and MAE

Heavily Negotiated Technology M&A Deal Points

Indemnification Considerations

- Stand-alone IP indemnification
- Scrapes (knowledge and/or materiality)
- Survival periods
- Caps, general baskets/deductibles and minimum claim threshold
- Whether IP reps are “fundamental”
- Special indemnities
- Fraud considerations (i.e., is it defined, and who is liable when it is committed (big focus for PE/VC sellers))
- Use of Rep and Warranty Insurance

M&A Academy

The Morgan Lewis M&A Academy, is a 20-part series of tailored webinars led by a diverse team of firm lawyers, provides a comprehensive M&A overview and is ideal for learning about the latest M&A issues and developments. It is geared not only toward M&A professionals but also toward specialists with particular areas of focus (e.g., benefits, intellectual property, tax), whether they deal with M&A issues regularly or occasionally.

**For on demand viewing of our sessions please visit
morganlewis.com/events/ma-academy**

CLE is not available for viewing of recorded sessions.



QUESTIONS?

Morgan Lewis

Save The Date

STARTUP & ACCELERATE

**CFIUS Considerations with Foreign
Investors**

Thursday, June 9 @ 12:30pm ET

THANK YOU

© 2022 Morgan, Lewis & Bockius LLP
© 2022 Morgan Lewis Stamford LLC
© 2022 Morgan, Lewis & Bockius UK LLP

Morgan, Lewis & Bockius UK LLP is a limited liability partnership registered in England and Wales under number OC378797 and is a law firm authorised and regulated by the Solicitors Regulation Authority. The SRA authorisation number is 615176.

Our Beijing and Shanghai offices operate as representative offices of Morgan, Lewis & Bockius LLP. In Hong Kong, Morgan, Lewis & Bockius is a separate Hong Kong general partnership registered with The Law Society of Hong Kong. Morgan Lewis Stamford LLC is a Singapore law corporation affiliated with Morgan, Lewis & Bockius LLP.

This material is provided for your convenience and does not constitute legal advice or create an attorney-client relationship. Prior results do not guarantee similar outcomes. Attorney Advertising.