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Introduction

• All M&A deals are not the same
• Technology M&A raises unique issues, both for buyers and sellers
  – structure
  – due diligence
  – definitive agreement
  – integration
  – tax issues
• Our goal today is to introduce you to a number of those issues, several of which could be the focus of an entire presentation
Why Do Technology Buyers Buy?

- Acquire a key technology without the R&D investment and time to market
- Eliminate a competitor or acquire control of a competing technology
- Hire scarce talent
- Acquire customers and a revenue stream
- Acquire a new distribution channel
- Improve financial performance
- Gain entry into a new market; diversification
- All of the above
Why Do Technology Companies Sell?

- Liquidity for investors and employees
- Access to working capital
- New markets and complementary products
- Critical mass and necessary infrastructure
- Alternative to pursuing next strategy of growth phase which may require significant new cash investments
- Bigger customer base
- More partnering opportunities
- Access to complementary technologies
Why Might Technology M&A Fail?

- Failure to timely capitalize on synergies
- Cultural incompatibility
- Loss of critical employees and/or failure to motivate
- Failure to execute on transaction strategy
- Technology incompatibility or performance issues
- Failure to integrate the technologies
- Unexpected technology ownership issues
- Buyer’s sales force cannot effectively sell target’s products
- Customer concerns and departures
- Poorly structured earnouts that demotivate target’s management
Deal Structure and Consideration

- Typical M&A
  - Asset Purchase: acquire only specific assets and liabilities; technology and other important assets must be transferable
  - Stock Purchase: best if target has few stockholders or is foreign; technology and other assets transfer as a function of the deal structure
  - Merger: state law mechanism; allows for cashout of unwilling stockholders; assets transfer as a function of the deal structure

- 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 Structure and Consideration

• Typical M&A Deal Consideration
  – Cash
  – Stock (consider securities law issues, private placement, registration statement, fairness opinion)
  – Debt
  – Assumption of liabilities
  – Some or all of the above

• Technology M&A deals sometimes also include an earn-out (especially where valuation views have not converged)
Key Diligence Issues – Open Source

• Many companies do not have open source policies, yet according to a third party code auditing service, 20%-50% of code scanned is open source
• Many companies do not know what is in their code
• 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
  – 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

- How to conduct open source due diligence?
- First, 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
- 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

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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?
• Is a purchase price discussion appropriate?
• Should a special indemnity be considered?
• Should closing be delayed?
• 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

• 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

• 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
Key Diligence Issues – IP

- How to conduct IP due diligence
- Ownership and Control of 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

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Key Diligence Issues – IP

- Ownership and Control of IP
  - Perform appropriate 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
  - 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

• 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
  – Perform similar review on trademark and copyright files
  – Analyze the market and whether competitors will have an easy time designing around the IP; what are the barriers?
  – Consider whether to request freedom to operate searches/right to use or opinions
  – Review any contracts for field of use and geographic or transferability restrictions that may limit the value of the asset to the buyer
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
  – Review potential insurance coverage
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
    – additional assignments by inventors or others
    – necessary licenses or amendments to existing licenses
  – third-party consents as closing or signing conditions
  – changes to representations and warranties
  – special indemnification and/or special escrow
  – post-closing covenants and/or liability for associated expenses
  – alternative integration approach
Key Diligence Issues – Import/Export Compliance

• Why care?
  – Successor liability is firmly established
  – It can be expensive, time consuming and very public
  – Penalties are harsh
  – Strict liability in some cases
  – For technology companies in particular, cloud computing and other network issues can create unintended or unanticipated exports requiring licensing

• But thorough due diligence and mitigation efforts can help

• Fines, penalties, and damage to the business can be minimized based on:
  – How quickly violations are reported
  – What training and compliance efforts are implemented to address past violations
  – Level of cooperation with and transparency to regulators
Key Diligence Issues – Import/Export Compliance

- How to conduct import/export compliance due diligence?
- Audit the target’s trade policies, procedures and practices
- Make part of your standard due diligence request list and carefully review
  - Who is responsible?
  - What is the import/export compliance program and how is it implemented?
  - Assessment of product classifications
  - Proper markings, tariffs, required documentation
  - Compliance of third-party resellers, distributors, vendors, and agents
  - US sanctions and embargos compliance based on product, buyers, end users
  - Past violations
  - Compliance training programs and manuals
Key Diligence Issues – Data Privacy Compliance

• Why care?
  – Depending on the industry, poor compliance can directly impact revenue
  – Data privacy laws exist in over 100 countries worldwide and are getting stricter
  – 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, and/or in any industry/business that collects personally identifiable information (PII)
Key Diligence Issues – Data Privacy Compliance

- How to conduct data privacy compliance due diligence?
- 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?
Key Diligence Issues – Tax

• NOLs
  – Common in technology companies
  – Are NOLs valuable to the buyer? Were they part of the valuation discussion?
• 409A issues in light of heavy use of options?
• 280G concerns?
• Sales Tax?
How to Retain Key Employees

• Acquisitions are stressful on target employees
  – hard work, long hours
  – uncertainty about future role, job prospects, career path
  – larger organization with a different reporting structure
  – change in culture
• Focus early on who is important to keep, and how best to do so
  – what entity will he/she work for?
  – salary, cash bonus, retention bonus, equity cashout, equity with vesting
  – assumption of existing plans, versus need (or desire) for new plans with a strong retentive component
• 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
Heavily Negotiated Technology M&A Deal Points

- “Knowledge” qualifiers in IP reps; “knowledge” and/or “materiality” scrapes
- Employee classification reps (especially if target uses many contractors)
- Tax provisions
- Survival periods, specifically with respect to IP representations
  - Whether IP reps are “fundamental”
- Indemnification caps and tipping baskets/deductibles
- Earnout provisions (often put off until the bitter end)
- Special indemnities and escrow for high risk areas
- Carve outs for “fraud,” how it is defined, and who is liable when it is committed (big focus for PE/VC sellers)
- Sandbagging, anti-sandbagging and non-reliance provisions
- Non-compete provisions
- Identification and treatment of key employees
- Increasing use of Rep and Warranty insurance

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Biography

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