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M&A ACADEMY TECHNOLOGY M&A ISSUES

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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

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

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

Biography



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Laurie A. Cerveney is an accomplished corporate, M&A, and securities lawyer. She has extensive experience counseling US and foreign issuers and their boards on mergers and acquisitions and the ongoing disclosure and reporting requirements of public companies, corporate governance matters, annual meeting and proxy-related issues, securities laws, SEC rules, stock exchange listing requirements, executive compensation, and various other matters affecting public companies and their officers and directors. Laurie is a deputy practice leader of the M&A practice area and a member of the firm's Advisory Board and of the steering committee for ML Women, the firm's women's initiative.



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Steven C. Browne concentrates on business and securities law, with experience in mergers and acquisitions, leveraged buyouts, corporate finance, private equity financing transactions, public offerings, SEC compliance, and technology transfer and licensing.

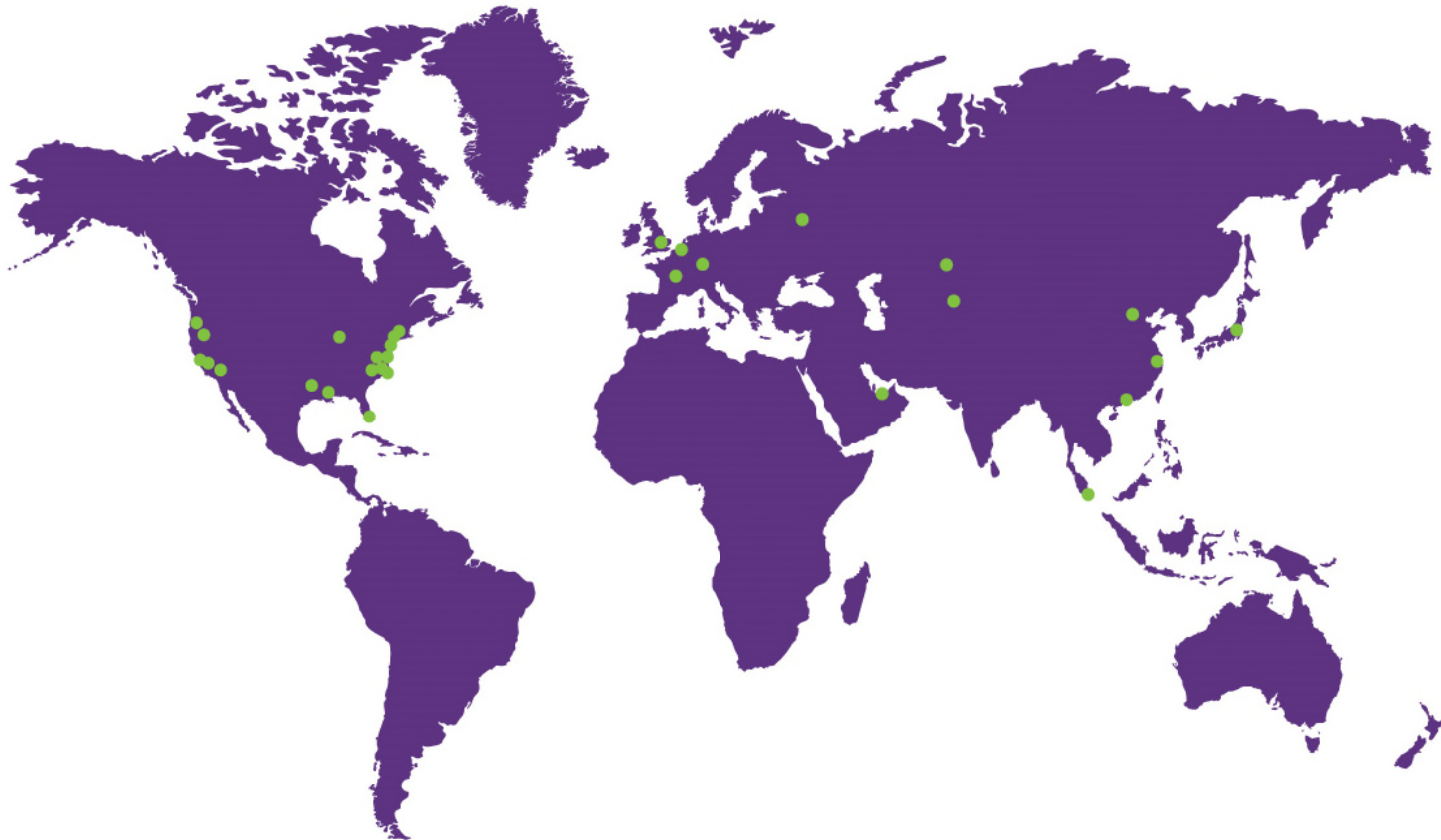
Steven is general counsel to public and privately held companies in a variety of industries and at all stages of growth. He represents a range of technology companies, from startup to global public company. He also represents private equity firms and hedge funds in complex structured finance transactions as well as early and later stage financings and restructurings. Steven is trusted counsel to boards of directors on corporate governance and related matters.

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