M&A ACADEMY

M&A Investment Into AI Companies

Speakers:
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What is AI?

• Technology that simulates human intelligence
  – Analyze data to reach conclusions about it, find patterns, and predict future behavior.
  – Learn from data and adapt to perform certain tasks better over time.
• Algorithms (sets of code with instructions to perform specific tasks) that makes predictions
How does AI Work?

- AI works by combining large amounts of data with fast, iterative processing and intelligent algorithms, allowing the software to learn automatically from patterns or features in the data.
- Not “AGI”
- Based on data and training
- Many different varieties
Types of AI

- Algorithm and data driven
- Computer Vision
- NLP
- Neural Networks
- Machine Learning
- Supervised Learning
- Unsupervised Learning
- Reinforcement Learning
- Deep Learning
How is it different?

- Auditability/Transparency ("Black Box")
- Bias/Discrimination
- Vaporware
- Regulatory Compliance
- Reputational Risk
- IP Ownership
- Data Privacy/Training Data
- Cybersecurity
- Liability
FTC Guidance

On April 8, 2020, the FTC issued guidance in its Tips and Advice blog on how organizations can manage consumer protection risks that arise from artificial intelligence use, emphasizing that AI algorithms should be:

- Transparent;
- Explainable;
- Fair;
- Empirically sound; and
- Foster accountability.
The blog post focused on fairness and accountability and stressed the following items:

- Don’t discriminate based on protected classes.
- Focus on inputs, but also on outcomes.
- Give consumers access and an opportunity to correct information used to make decisions about them.
- Ask questions before you use the algorithm.
- Protect your algorithm from unauthorized use.
- Consider your accountability mechanism.
FTC Guidance

• On April 19, 2021, the FTC posted to their business blog additional guidance – focusing again on using AI truthfully, fairly and equitably, noting that they have decades of experience enforcing the following three laws:
  – **Section 5 of the FTC Act.** The FTC Act prohibits unfair or deceptive practices. That would include the sale or use of – for example – racially biased algorithms.
  – **Fair Credit Reporting Act.** The FCRA comes into play in certain circumstances where an algorithm is used to deny people employment, housing, credit, insurance, or other benefits.
  – **Equal Credit Opportunity Act.** The ECOA makes it illegal for a company to use a biased algorithm that results in credit discrimination on the basis of race, color, religion, national origin, sex, marital status, age, or because a person receives public assistance.
FTC Guidance

- **It also provided some principles for companies to act by:**
  - Start with the right foundation.
  - Watch out for discriminatory outcomes.
  - Embrace transparency and independence.
  - Don’t exaggerate what your algorithm can do or whether it can deliver fair or unbiased results.
  - Tell the truth about how you use data. Do more good than harm.
  - Hold yourself accountable – or be ready for the FTC to do it for you.
EU Proposed Regulation on AI

- On 21 April 2021, the European Commission published its proposal for a Regulation on Artificial Intelligence which included:
  - Binding rules for AI systems that apply to providers, users, importers, and distributors of AI systems in the EU, regardless of where they are based.
  - A list of certain prohibited AI systems.
  - Extensive compliance obligations for high-risk AI systems.
  - Fines of up to EUR 30 million or up to 6% of annual turnover.

- Defines AI systems as software that is developed with machine learning, logic, and knowledge-based or statistical approaches, and that “can, for a given set of human-defined objectives, generate outputs such as content, predictions, recommendations, or decisions influencing the environments they interact with”.

- Employs a risk–based approach with different levels of risk requiring corresponding compliance requirements: (i) unacceptable risk (prohibited); (ii) high-risk; (iii) limited risk; and (iv) minimal risk.
EU Proposed Regulation on AI

- **Prohibited Systems:**
  - Subliminal techniques that distort behavior or cause harm
  - Exploits vulnerabilities of a specific group based on age, physical or mental disability
  - “Social Scores”
  - Real-time remote biometric identification in public areas (with certain exceptions)

- **High-Risk AI Systems:**
  - AI systems intended to be used as a safety component of products (or which are themselves a product)
  - AI systems whose use may have an impact on the fundamental rights of natural persons

- Imposes compliance obligations on AI systems, providers and users
EU Proposed Regulation on AI

- **Enforcement**
  - **European Artificial Intelligence Board** ("EAIB") – Establishes the EAIB, to advise and assist the Commission and facilitate effective cooperation between the national supervisory authorities and the Commission.
  - **National competent authorities** – Member States must designate national competent authorities and a national supervisory authority responsible for implementing and enforcing the regulation.
  - **Enforcement**: Member State are required to conduct market surveillance of AI systems and impose corrective action.
  - **Sanctions** – Financial penalties of up to €10m – €30m or 2% – 6% of the global annual turnover, whichever is higher, with the level depending on the nature of the violation.
Other Applicable Laws

- Regulated Industries (Banking, Financial Services, Healthcare, etc.)
- Data Protection and Privacy, GDPR/HIPAA
- Consumer Protection Laws
  - Fair credit reporting
  - Equal opportunity
  - Fair trade practices
- Anti-Discrimination
- Anti-Competition Laws
- IP and Copyright Laws
- Trade Secrets Act
- State and Local Laws (e.g., Facial Recognition Restrictions) – laws regarding AI have been introduced in at least a dozen states in each of the last three years
- CFIUS
- Export Controls
How is AI used?

• How does the target utilize AI?
  – Offer as a standalone product, service or license
  – Offer as part of a larger offering, including integrated with hardware
  – Internal Uses
    – Part of product or service development
    – Compliance
    – Other functions (Sales, Marketing, Analytics, Customer Support, HR, etc.)
• “Off-the-Shelf” solutions
• Need to understand scope in order to develop diligence plan, representations and warranties and gauge risks.
Types of Transactions

- Investments
  - Minority
  - Majority
- Licenses
  - Exclusive
  - Non-exclusive
- Partnerships and JV’s
- M&A
Diligence

- Code Audit/Open Source
- IT Audit
- IP/Ownership
- Training Data
- Licenses
- Warranties
- Product Liability
- Data Protection and Privacy
- **Compliance with Laws**
- Insurance
Representations and Warranties

- Definition of AI
- Scope of AI Usage (Products, Services, etc.)
- IT Systems and Cybersecurity
- Data Protection and Privacy
- Ownership of IP and Improvements
- Licenses
- Compliance with Laws
- Training Data
- Transparency
- Accountability/Bias
IP Diligence In AI is largely driven by the reasons for the Transaction:

1. To acquire innovative technology.
2. To access or use proprietary data that may not be available through licensing.
3. To acquire talent that may be difficult to grow internally or bring in on a piecemeal basis.

- Use an integrated technical and commercial diligence team.
- Might need product managers, data scientists, technologists, and IT experts on the team for AI diligence.
- Diligence checklists are a good idea.
IP – Acquiring Innovative AI Technology

- How material is IP to the target company’s business/AI Technology?
  - Determines the level of detail for the diligence and areas of focus.
  - Does the IP provide a competitive advantage?
    - Identify the IP assets (patents, copyrights, software, data)
    - Are there commercially available alternatives?
    - Does the company own or license its IP, what is its provenance?
    - Review IP – related agreements, including out-licenses, in-licenses, R&D agreements, employment and consulting agreements.
IP – Acquiring Innovative AI Technology

• Has or will a University be involved in the transaction?
  - Look at role of the University or professor involved in the development of the technology.
    - Get a copy of the University’s IP policy.
    - Was any federal funding used to develop the IP?
  - Will the University or professors continue to be involved?
  - What steps can be taken to clarify IP rights from future collaboration?
    - Might need a three way agreement with target and University

• Is Detailed Software or Patent Diligence Required?
  - Open source vs proprietary software.
  - Patent coverage of target’s products and competitor’s products.
IP – Acquiring Innovative AI Technology

• Does the technology operate in an ethical manner?
  – Consider IEEE and European Commission guidance on AI ethics.
    – Consider:
      – Compliance with privacy laws and regulations
      – Interpretability, transparency and accountability of the AI system
      – Biases, diversity, fairness
      – Well being of people that will interact with the AI from legal, policy and health and wellness perspectives
      – Embedded values within autonomous and intelligent systems
      – Societal and environmental well-being

• Reps and warranties covering ethical considerations tailored to the AI system should be included in addition to more routine reps and warranties.
IP – Acquiring Data Used in AI Transactions

• Often the value of an AI Player has more to do with the data used to train the AI system than the AI technology itself.
  – Do not underestimate the value of the data in AI systems.
  – Consider the sources of the data.
    – Does the target have lawful access to or ownership of the data?
    – Does the target have any necessary licenses or consents to use the data?
    – Are there any embedded privacy issues associated with using the data by the company now, after the transaction is completed, or given the way in which the data or AI system may be used in the future?
    – Copyrights in images, audio, and text can potentially be implicated depending on the AI system

• Robust reps may be needed with respect to the data if the value of the data is high and verification of its provenance is difficult to ascertain.
IP – Acquiring Talent in AI Transactions

• Who are the key players at the AI Target?
  – Get them involved in the diligence process to answer technical and ethical questions.
  – Did they have prior employers?
    – Look at prior employment and non-compete agreements.
    – Do they have any prior confidentiality agreements that may limit the scope of their activities after the acquisition?
    – Are there any restrictions that will prevent them from being productive on the acquiring company’s team?

• Are any key players not part of the deal?

• Do any founders or third parties own IP that is essential for the company outside of the target being acquired?
Post-Closing

- Integration
- Retention of Key Employees
- Transparency/Interpretability/Oversight
- Risk Management
- Quality Management
- Assistance with Regulatory Inquiries
- Documentation
- Security
- Monitoring
- Confidentiality
- Non-Compete
- Protection of Code/Models
Conclusion

• Raises many of the same issues as software and Saas companies, but some notable differences

• Proliferation of AI “enabled” or “enhanced” products/services

• Imperfect fit as existing legal paradigms are applied to novel technologies

• Changing legal landscape as lawmakers and regulators seek to address issues raised by the technology

• Investors and advisors to understand the legal issues implicated, especially as:
  – Underlying technology continues to develop;
  – Companies continue to deploy or implement AI solutions; and
  – Laws and regulations are adopted or change in response
QUESTIONS?
Coronavirus COVID-19 Resources

We have formed a multidisciplinary Coronavirus/COVID-19 Task Force to help guide clients through the broad scope of legal issues brought on by this public health challenge.

To help keep you on top of developments as they unfold, we also have launched a resource page on our website at www.morganlewis.com/topics/coronavirus-covid-19.

If you would like to receive a daily digest of all new updates to the page, please visit the resource page to subscribe using the purple “Stay Up to Date” button.
Tony Chan is the leader of the firm’s interdisciplinary corporate practice in Washington, DC, where he advises clients on public and private company mergers and acquisitions (M&A), private equity, growth equity, and venture capital transactions, as well as on corporate governance, joint ventures and corporate finance. Tony’s clients include global strategic buyers and sellers as well as financial sponsors and their portfolio companies in the life science, healthcare, investment management, technology, and video game sectors. He also regularly advises on complex international and cross-border transactions.
Rob Bertin has over 20 years of experience negotiating transactions involving IP, litigating patent, trademark, trade secret and copyright cases throughout the United States, and counseling clients on intellectual property (IP). He has represented clients at the center of some of the largest patent portfolio sale and licensing events in the high tech industry and leverages a technical background to represent large and small companies on IP issues.
Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

Abu Dhabi
Almaty
Beijing*
Boston
Brussels
Century City
Chicago
Dallas
Dubai
Frankfurt
Hartford
Hong Kong*
Houston
London
Los Angeles
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