

# Headline Issues In Technology M&A Deals

Nick Abrahams and Daniel Atkin outline some headline issues raised in M&A deals in the technology sector.

Investment in technology companies globally is very active, prompting many journalists to describe current conditions as 'Bubble 2.0'. The statistics show that the market in the United States has some remarkable valuations for technology companies, but these valuations are largely directed at the 'Big 5', being Facebook, Zynga, Groupon, Twitter and LinkedIn, whose valuations total well in excess of \$71 billion. By contrast, in 1999 it took the 24 largest web companies to total a valuation of \$71 billion.<sup>1</sup>

There is definitely heat at the top end of the United States tech market. Goldman Sachs bought into Facebook on a valuation of \$50 billion<sup>2</sup> (some 100 times earnings)<sup>3</sup>, while three-year-old Groupon knocked back \$6 billion from Google in order to seek to list later this year for \$15 to \$25 billion.<sup>4</sup> LinkedIn just went to a \$9 billion valuation on its IPO.<sup>5</sup>

We have also seen significant upturn in technology sector M&A deals in Australia. For example United States coupon powerhouse WhaleShark Media acquired a relatively unknown Melbourne company retailmenot for almost \$90 million,<sup>6</sup> US venture fund Accel Partners picked up a minority stake in collaboration software company Atlassian for \$65 million<sup>7</sup> and a consortium of investors acquired a 40% stake in Scoopon/CatchoftheDay at a valuation of \$200 million.<sup>8</sup> There are many others.

The purpose of this article is to provide a high level overview of some of the key issues arising in connection with M&A deals that have a strong IP/IT focus. As with any transaction, it is important from the outset to undertake detailed due diligence investigations into the target's corporate profile, its assets and its major contractual undertakings. In particular, when dealing with a target with a key IP/IT portfolio, it is necessary to review the IP/IT assets and all agreements the target has entered into relating to those assets.

The following sections touch on some due diligence points and structural issues that prospective buyers and their advisers need to be mindful of when dealing with IP/IT matters.

## Ownership of IP

Confirmation should be obtained from the target that it either owns, or has valid enforceable rights to use, all IP/IT that is used in its business. The process of confirming ownership of IP can be done in a number of ways, but most practically by:

- searching relevant registers, governmental or otherwise (such as trade mark or patent registers or registers for ownership of domain names);
- reviewing all documents relating to the ownership of IP and any third party agreements pursuant to which IP rights are granted to the target; and
- interviewing relevant stakeholders.

*Depending on the nature of a particular transaction, if the core IP/IT is owned outside of the target group (and ownership of IP/IT, rather than rights to use, is a fundamental requirement), transitional arrangements may need to be put in place to ensure that IP/IT is transferred into the target group.*

From a transactional structuring perspective, it is also helpful to obtain detailed warranties around the ownership and use of IP/IT rights. What also follows from this is the need to ensure that the IP/IT owned and used by the target is all that is required to operate its business.

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## IP Infringement

Broadly speaking, the two core areas of concern to a buyer acquiring an IP/IT portfolio are as follows:

1 Evelyn M Rusli and Verne G Kopytoff, 'Investing Like It's 1999', The New York Times Dealbook (online), 27 March 2011 <<http://dealbook.nytimes.com/2011/03/27/is-it-a-new-tech-bubble-lets-see-if-it-pops/?partner=rss&emc=rss>>.

2 'Goldman Sachs stake values Facebook at \$50 billion', The Australian (online), 4 January 2011 <<http://www.theaustralian.com.au/news/breaking-news/goldman-sachs-stake-values-facebook-at-50-billion/story-fn3dxity-1225981412560>>.

3 Michael Evans, 'Get your money for nothin' but don't get fooled again', BusinessDay (online), 26 March 2011 <<http://www.businessday.com.au/business/get-your-money-for-nothin-but-dont-get-fooled-again-20110325-1ca3t.html>>.

4 Nicholas Carlson, 'Why Groupon Said No To Google's \$6 Billion', Business Insider (online), 8 December 2010 <<http://www.businessinsider.com/why-groupon-said-no-to-google-2010-12>>.

5 Ylan Mui, 'LinkedIn share price goes through the roof at IPO', The Sydney Morning Herald (online), 21 May 2011 <<http://www.smh.com.au/business/linkedin-share-price-goes-through-the-roof-at-ipo-20110520-1ewsu.html>>.

6 Renai LeMay, 'Aussie start-up snapped up for \$90m', ZDNet (online), 3 December 2010 <<http://www.zdnet.com.au/aussie-start-up-snapped-up-for-90m-339307730.htm?noredir=1>>.

7 John Silvers, 'Atlassian Closes \$60 Million Investment from Accel Partners', Atlassian blogs (online), 14 July 2010 <[http://blogs.atlassian.com/news/2010/07/atlassian\\_closes\\_60\\_million\\_investment\\_from\\_accel\\_partners.html](http://blogs.atlassian.com/news/2010/07/atlassian_closes_60_million_investment_from_accel_partners.html)>.

8 Chris Zappone, 'Online minnow to take on Coles, Woolies', The Sydney Morning Herald (online), 23 May 2011 <<http://www.smh.com.au/business/online-minnow-to-take-on-coles-woolies-20110523-1ezg3.html>>.

## *where the target receives a licence to use a third party's IP/IT, the buyer should confirm that the scope of the licence is broad enough to cover all current and anticipated uses of the licensed IP/IT*

- infringement by the target of a third party's IP rights. IP infringement litigation is very costly (particularly patent infringement litigation) and can take years to resolve. Consequently, it is essential to understand what the key infringement risks are up front and make all necessary enquiries to determine whether the target will be restricted from operating without fear of infringement suits.
- infringement of the target's IP by third parties. Knowing whether the target is aware of third party infringement of its IP is useful in determining the value of the target's IP assets. Any infringement suits (or prospective suits) should be reviewed and considered in the due diligence process.

### **Contractual Rights**

A thorough due diligence includes a review of material agreements to which the target is a party, and from an IP/IT perspective, licensing arrangements are significant. It is also worth noting that licences can appear in a range of agreements that are not obviously identified as such, for instance research and development contracts, joint venture arrangements, consulting, distribution and software development agreements.

For agreements where the target receives a licence to use a third party's IP/IT, the buyer should confirm that the scope of the licence is broad enough to cover all current and anticipated uses of the licensed IP/IT (including the right to make modifications, if applicable) and contains ownership provisions allocating ownership of any permitted modifications.

For agreements where the target grants a licence to a third party to use the target's IP/IT, the buyer should confirm that the scope of the licence is narrow enough to ensure that:

- only those rights needed by the licensee are granted;
- the target's ownership of its IP/IT is clearly stated; and
- the licensee is obligated to maintain the confidentiality of the target's IP/IT.

Other key points to look out for in licence arrangements include: the parties, definitions and descriptions of the IP/IT involved, exclusivity and non-compete obligations, field of use, relevant royalties, term, warranties and indemnities, governing law and jurisdiction and any specific provisions that could impact on the proposed transaction (such as change of control and assignment provisions).

### **Source Code**

Possession of source code (which is, in its simplest format, IP in the form of copyright) is usually critical to the target's ability to operate its business platform and evolve its products and services. Care needs to be taken to ensure that, if the target does not have possession of the source code, appropriate arrangements are in place so that the third party provider is obligated to provide support to the target (and if required, its customers). The buyer should also confirm whether any source code for the target's products has been provided to any third party, whether to an escrow agent or directly to a third party licensee.

### **Open Source Software**

The manner in which open source software is used by the target, and the open source licence governing its use, can have a significant impact on the target's IT arrangements. It is therefore critical to obtain a complete and accurate listing of all open source software used by the target, copies of all applicable licences and a description of how such open source software is used (including any redistribution obligations). Depending on the nature of those open source arrangements and the underlying product, the buyer may decide that it has other preferred open source software products it wishes to integrate with the target business.

### **Contractor Issues**

Generally, in the absence of an agreement to the contrary and except where IP is developed in the course of employment, ownership of IP initially vests in the inventor or author. Regardless of the default position under the law, however, the buyer should confirm that relevant employees and contractors of the target have executed written agreements assigning ownership of all IP/IT developed by them during the provision of services to the target. In certain limited circumstances, a licence from the contractor to the target may be sufficient, though those cases should be carefully reviewed prior to a determination of sufficiency. In this context, it is also necessary to be aware that there can be a fine line between the classification of a person as an employee or a contractor.

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### **Non-Compete Obligations**

Once a deal has been struck it is prudent to ensure that, to protect the value of the buyer's investment, appropriate non-compete obligations are entered into by relevant stakeholders. Fundamental to this is ensuring the restraint is enforceable on policy grounds (for instance, if someone is paid for the restraint, it is more likely to be upheld). For the target, the key is to ensure that if there is potential to 'trip' the non-compete, appropriate 'carve outs' from the non-compete obligations are built into the transaction documents.

### **Conclusion**

There is no doubt that the United States is seeing some heady valuations and all eyes will be focused on the IPO market later this year, when a number of the big tech companies are targeting a listing. Australia has seen strong investment activity across the range of tech businesses and multiples, while high, are not necessarily excessive, given the historical revenue growth of these companies. Certainly the social commerce sector seems crowded at the moment and the time may be ripe for a consolidation, but the impact is not widespread enough to warrant comparisons to the bubble conditions of 1999/2000 – but of course, who knows what tomorrow might bring.

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