

Issues in mergers & acquisitions — The prepared seller

April 2008

BY ALAN S. WERNICK, ESQ.

T: 847.786.1005 – E: ALAN@WERNICK.COM

Buying or selling a business involves a certain amount of risk and planning. Whether you are a business owner looking to groom your business for an eventual sale, or a buyer looking to acquire a business, an understanding of the information technology and intellectual property law risks in the merger or acquisition is critical.

Consider the case of Seller, Inc., a manufacturer of widgets. The owners are planning to sell the company and want to put the company in the best possible valuation position. Since the company's information technology systems are critical to its business strategy, the owners are concerned about the company's information technology legal health as it relates to the valuation.

Like most businesses, Seller uses multiple business-critical computer software applications subject to third-party license agreements. Seller has developed a portion of its software in-house, and some of this software includes open source software that integrates with some of the licensed third-party software. And, some of the software development has been done by independent contractors.

Standard due diligence often fails to consider the implications of information technology laws and contracts on the legal health of the business. The intellectual property laws, often intertwined with the information technology law issues, are changing through new legislation and case law developments, and the nuances of these laws have in recent years played decisive roles in the valuation of a business.

One example is the discovery during due diligence that the company's "proprietary" business-critical software turns out to contain a material amount of open source code software subject to license agreements that make the company's "proprietary" software subject to the open source license agreement.

Another example where the standard due diligence may prove inadequate is the contracting practices of the information technology industry.

Contracts for information technology goods and services of any degree of sophistication are different from most business contracts. The reasons for this include the nature of certain key information technology laws, intellectual property laws, and privacy laws, all of which can be closely intertwined in computer contracts; the technical computer and information industry terms and customs (open source code, source code escrows, SaaS, framing); and the intangible nature of some of the contract deliverables.

Delving slightly deeper than the standard due diligence, consider the following checklist of some issues for the Seller:

Third-party licensing agreement language: Are there terms that trigger termination or renegotiation of the license if the licensee is sold?

In some transactions, the software licensor is concerned that if the licensee company is sold, then the licensed software could end up in the hands of a competitor to the licensor. The licensor may have included a termination trigger to address this concern.

Are there terms that limit the scope of use of the software in ways that are inconsistent with the buyer's needs?

Open Source Code: Of the more than 50 different open source code licenses, many contain provisions that state that any derivative works built using the open source code licensed software must be made available under the same terms of the open source code license.

How do you check whether or not the company's proprietary software contains open source code, and what are the applicable open source code licenses?

There are companies that provide the code analysis to report on the existence of open source code and correlate it with the applicable license, but the results of the report should be reviewed by legal counsel familiar with open source code licensing practices.

If the buyer is concerned about the proprietary status of the software used by the seller, then the presence of open source code in that software may adversely impact the valuation.

Necessary or desirable registrations by the seller to fully protect the intellectual property rights of the company (the copyrights, trademarks, trade secrets, and patents):

Copyrights: Was all the software developed by independent contractors subject to written agreements containing the statutory language for a work made for hire?

Trade secrets: Are all of the company's nondisclosure agreements signed? Are any of these NDAs about to expire?

There are, of course, numerous other information technology and intellectual property law issues relevant to the due diligence aspects of the company's valuation and legal health.

In a growing number of companies today, the information technology and intellectual property assets of the company comprise an increasing percentage of the financial status. The bottom line for a company looking to obtain or maintain the highest valuation in the event of a merger or acquisition in a challenging economy is to be mindful and proactive about what a knowledgeable buyer's due diligence may require.