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Realigning Technology in M&A Transactions

Joe Pennell

Andrew Stewart

Introduction – Technology's Impact on M&A

- M&A deals are increasingly impacted by technology issues
  - Clear technology link in one out of every five transactions[1]
  - Technology acquisition is the #1 driver of M&A pursuits[2]
- Today's focus: Carve-out deals
  - Why is technology so important in carve-out deals?
  - Key technology and services considerations for M&A planning and execution

1 Kengelback, J., Keienburg, G., Schmid, T., Sievers, S., Gjerstad, K., Nielsen, J., and Walker, D. (2017). *The 2017 M&A Report: The Technology Takeover*. Available at: https://www.bcg.com/publications/2017/corporate-development-finance-technology-digital-2017-m-and-a-report-technology-takeover.aspx

2 Deloitte Development LLC. (2017). *The state of the deal | M&A trends 2018*. Available at: https://www2.deloitte.com/content/dam/Deloitte/us/Documents/mergers-acqisitions/us-mergers-acquisitions-2018-trends-report.pdf

Agenda

- Carve-Out Divestiture Scenarios
- Technology Considerations for Transaction Planning and Due Diligence
- Key Agreement Considerations:
  - Sale and Purchase Agreements
  - Transition Services Agreements
  - Long-Term Services Agreements

Bank Carve-Out Scenario

- A Bank is doing a carve-out divestiture of its back-office processing operations through an auction process
- Target Business services the Bank’s internal operations worldwide and other regional banks with an outsourced services model
- Likely Buyers: all outsourced service providers in the financial services industry.
- The valuation for the target Business is based in large part on:
  - The value of its existing Customer Contracts; and
  - Moving from a U.S. FTE, people-based model to a low-cost SaaS model
- Long-Term Services Agreement between Business and Seller (Customer)

Manufacturer Carve-Out Scenario

- A manufacturing company is considering selling one of its portfolio brands
- Likely buyers: private equity firms (no manufacturing capability)
- The Seller's supply chain is fully integrated across many jurisdictions
- The Buyer has no manufacturing capability and will acquire one of the Seller's production facilities, but that facility is also a key production facility for certain products relating to the Seller's retained brands
- Seller will operate the divested production facility on behalf of the Buyer under a Long-Term Operation/Manufacturing Services Agreement

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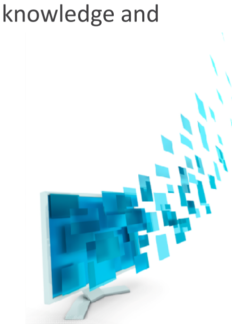
Technology Considerations For Transaction Planning And Due Diligence

Defining the Business – What Is Being Sold?

- **Seller must think of:**
  - What it needs to include in the Business to maximize value
  - But also what does Seller need to retain for its own business purposes?
- **Potential Buyer Rights to Technology:**
  - Entire ownership
  - Sole/exclusive license (territory and use restrictions)
  - Non-exclusive licenses
  - Royalties/license fees
  - An assignment of an existing contract

What Rights to Technology Are to be Given to the Buyer?

- **Does it matter what type of rights in technology a Buyer gets?**
  - Yes – if technology is the core reason for buying
    - Need complete ability to develop unfettered by third party rights?
    - Use technology as a barrier to entry (*e.g.*, against Seller, who has inherent knowledge and experience of the technology)
  - Not as much – if technology is not a core reason for buying
    - It's about use, not ownership
    - A royalty-free, perpetual, worldwide license could be enough?



Will Seller's Retained Business Need to Continue Using the Divested Business's Technology?

- If so, how and for what purposes?
- How critical is access to that technology? Can it be replaced with minimal effort and cost?
- Will the Seller need continued use of the technology that will go with the divested Business?
- Are there regulatory requirements associated with use or transfer of that technology?

How Easy Is it to Extract the Business from the ERP System?

- Is it set up as a Business in its own right in that system?
- If not, can it be re-engineered?
- Can the system cope with a transitional period where the Business stays within the Seller's system, despite ownership transfer.
- How will sales be booked, raw materials ordered, production ordered and deliveries made?

Due Diligence

Technology Due Diligence – Buyer and Seller Perspectives

- Technology issues increasingly form a significant part of the due diligence process
- Buyer’s perspective:
  - Important to understand what it needs from the Seller
- Seller’s perspective:
  - Need to collect this information in advance

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Likely Due Diligence Areas Related to Technology Include:

- Has relevant technology been created by employees – did they sign intellectual property assignment agreements?
- Are there any gaps in the chain of title to technology that the Seller should try to address now?
- Prior disputes and particularly 3rd party infringement claims
- Contracts for Third Party Technology
  - Change of control restriction/Prohibition on assignment without consent?
  - Transitional capability?

Key Issues for Tech M&A: Open Source Software

- Why worry about Open Source Software (OSS) in M&A transactions?
  - May materially undermine value of Business AND of the Buyer (post-close)
  - Remediation time and costs
  - Security vulnerabilities
- Black Duck scans provide visibility into Open Source Usage
  - Build in time and use experts to review Black Duck scans
  - Categorize risks and consider remediation and other alternatives
- Tailor Open Source representations and warranties in Purchase Agreement based on risks identified

Key Issues for Tech M&A: Cybersecurity and Data Privacy

- Breaches decrease valuation; Risks of non-compliance, fines, and lawsuits
- Due diligence:
  - Written Information Security Policy (WISP)
  - Compliance with privacy and data protection laws
  - Can Seller lawfully transfer/disclose personal data to the Buyer at closing?
- Data privacy and cybersecurity representations and warranties:
  - Representations that target has materially followed WISP
  - Representations regarding known or suspected data breaches or other cyber incidents
  - Representations that target has complied with laws, obtained consents, and that transfer is permissible

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Key Agreement Considerations

Sale and Purchase Agreement

Transfer of ownership of technology

- Identification of assets transferring
  - Asset deal
    - What will be the standard for asset transfer
      - “exclusively ” used/“primarily” used ?
  - Stock deal
    - Directly linked to due diligence results
    - no need for ownership transfer if everything is already owned by the entity being sold
  - Carveouts from multinationals

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Representations: What Comfort Will a Buyer Get that It’s Getting the Technology It Needs?

Ownership	Accuracy of information in data room
No disputes and no circumstances that might lead to one	Escrow arrangements for key code?
Fees paid up-to-date	System quality
Relevant filings made	Maintenance contracts
Complete copies of all relevant agreements (licenses in, out, title assignments etc.)	Upgrades applied
Compliance with agreements – no rights to terminate	Virus attacks
All consents to transfer and use obtained	Sufficiency of assets

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Sufficiency of Assets

- Single most important representation in a carveout?
  - Except as set forth in Section [ ] of the Seller Disclosure Schedule, the assets, rights, properties and services transferred or made available to Purchaser and its Affiliates pursuant to this Agreement, the other Transaction Agreements, the Assigned Contracts and the Assigned Lease will, as of the Closing, comprise assets, rights, properties and services that are sufficient to permit Purchaser to operate the Business immediately following the Closing Date in substantially the same manner as the Business is being operated as of the date hereof.
  - The Transferred Intellectual Property, together with the Intellectual Property to which the Seller is granting a license pursuant to the Ancillary Agreements, comprise all of the Intellectual Property material to or necessary for the conduct and operation of the Business.

Conditions to Closing

- Transfer of key technology contracts – third party consents
- Bank Carve-Out Scenario
  - Assignment of [X]% of the Customer Contracts for the Business
- Manufacturer Carve-Out Scenario
  - Cloning the ERP system

Transition Services Agreement

- The Seller is not a traditional outsourced service provider
- Service standard: Same level that the Seller provided to itself, subject to:
  - modification for changes in laws and dependencies on divested entity
- Other key terms:
  - Change Control
  - Term and Third Party Consents
  - Simplified Pricing Structure
  - Indemnities and Limitations of Liability
  - Privacy and Data Security

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Long-Term Services Agreements

- More resemblance to traditional outsourcing agreements than TSAs
- Divested Businesses (or the Seller) still are often not as sophisticated as a professional outsourced service provider
- Often critical to long-term operations of Divested Business and Seller
- Often more contentious, complex, and time-consuming than Purchase Agreement

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Long-Term Service Agreement: Bank Carve-Out Scenario

- Five-Year Agreement for Business to Service Seller's retained business
- Examples of Key Buyer Contracting Goals:
  - Standardization (*e.g.*, assigned Customer Contracts of the Business)
  - Flexibility to evolve the Business towards a SaaS model (*e.g.*, change rights)
- Examples of Key Seller Contracting Goals:
  - Favorable/outsourcing type terms (as Seller is the biggest customer of the Business)
  - Service changes: Approval rights, or long notice periods and exit rights
  - Avoid undermining the SaaS rationale for the Business's valuation

Long-Term Service Agreement: Manufacturer Carve-Out Scenario

- Ten+ years Operation/Manufacturing Services Agreement
- Seller operates the divested manufacturing facility for the Business
- Examples of Key Buyer Contracting Goals:
  - Set good liability incentives for the Seller (*e.g.*, exceptions to limits of liability)
  - Limit Seller termination rights (Business is dependent on Service Agreement)
- Examples of Key Seller Contracting Goals:
  - Reduce risk profile in liability provisions (*e.g.*, exclude consequential damages and lost profits without exception)
  - Excused performance standards (*e.g.*, shutdowns to prevent safety incidents)

Conclusion

- Technology and Services are no longer ancillary issues in M&A
- Focus on these issues early and throughout the process to ensure success:
  - Transaction Planning
  - Due Diligence
  - Negotiation of Key Agreements
  - Post-Signing

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QUESTIONS?

Joe Pennell
Partner, Chicago
+1 312 701 8354
jpennell@mayerbrown.com

Andrew Stewart
Partner, London
+44 20 3130 3929
astewart@mayerbrown.com

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