

OPEN SOURCE DUE DILIGENCE : A DECISIVE PREREQUISITE TO MERGERS AND ACQUISITIONS

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Introduction

The legal and financial reforms by the Government of India since the early 1990's have resulted in substantial growth of the Indian economy. With increasing globalisation and dispersion of technology, product life-cycles are shortening and competition is becoming intense, where there is little room for organisations to meet their growth aspirations through internal development or organic growth. In order to achieve speedy growth with limited market access, technology, finance and time, corporate world-wide have preferred to grow inorganically through the route of mergers and acquisitions (M and A). From the beginning of the 21st Century, India has witnessed a tremendous growth in M and A activities, both inbound and outbound. However, the recent economic downturn has eclipsed the M and A landscape almost halving the deals in both number and value. Indian companies have started acquiring some big companies outside India and have shown their global presence³.

Mergers and acquisitions refers to the aspect of corporate strategy, corporate finance and management dealing with the buying, selling, dividing and combining of different companies and similar entities that can help an enterprise grow rapidly in its sector or location of origin, or a new field or new location, without creating a subsidiary, other child entity or using a joint venture⁴. No other process is more complex and challenging as mergers and acquisitions. It is indispensable that everyone involved in the process has a clear understanding of the transactions.

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 3. <http://www.slideshare.net/KiranShinde2/mergers-and-acquisitions-an-indian-perspective>, last visited May 18, 2012.
 4. http://en.wikipedia.org/wiki/Mergers_and_acquisitions#1990s, last visited May 18, 2012.

In fact, the software industry has been subject to a high degree of consolidation over the past couple of decades. From 1988 to 2010, 41,136 mergers and acquisitions have been announced with a total known value of \$1,451 bn USD¹. The highest number and value of deals was set in 2000 during the high times of the internet bubble with 6,757 transactions valued at \$447 bn USD. In 2010, 1,628 deals were announced valued at \$49 bn USD². There are plenty of benefits involved in software mergers and acquisition, i.e., lesser cost of innovation, get your hands on new customers, increase market share, get bigger portfolio and increase IP ownership.

Due diligence in mergers and acquisitions

Due diligence refers to the investigating effort made by an individual to gather all relevant facts and information that can influence his decision to enter into a transaction or not. Exercising due diligence is not a privilege but an unsaid duty of every party to the transaction. For instance, while purchasing a food item, a buyer must act with due diligence by checking the expiry date, the price, the packaging condition, etc., before paying for the product. It is not the duty of the seller to ask every buyer everytime to check the necessary details. M and A due diligence helps the individuals avoid legal hassles due to insufficient knowledge of important details. It is exercised in a simple over-the-counter transaction or a complicated mergers and acquisition transaction. For instance, while acquiring a company, the buyer must do thorough research of the credentials of the company like its market valuation, status of accounts receivables, IP portfolios, past performance, determine transferability of contracts, etc.³ There could be a commercial due diligence, human resources due diligence, cultural due diligence, financial and tax due diligence, intellectual property due diligence and technological due diligence.

Conducting proper due diligence involves examining not only the financial information of a company but also assessing the company's key assets. For the vast majority of enterprises, this will necessitate a review of the intellectual property assets of the target company. The compelling need to conduct a thorough review of intellectual property assets (intellectual property due diligence) before engaging in investments is being influenced by a number of factors including the fact that the economy is technologically driven. While intellectual property due diligence will be essential in

1. http://www.imaa-institute.org/statistics-mergers-acquisitions.html#MergersAcquisitions_Asia-Pacific, last visited May 10, 2012.
2. http://en.wikipedia.org/wiki/Software_industry, last visited May 10, 2012.
3. <http://www.mergersandacquisitions.in/due-diligence.html>, last visited May 12, 2012.

connecting with an investment in virtually every type of target company, it is especially significant where the target is involved in the technology sector since in this industry, most products and services will involve intellectual property assets. In today's environment, this is key given the amount of investment in enterprises in the technology field¹.

Nexus between open source and intellectual property

Software is not free, as in the expression "the birds are free to fly". Software is someone's property, and you cannot use another person's property to fly or to do anything else, without that owner's permission. Software is a product of human intellect, and therefore it is a kind of intellectual property².

Further, the term "open source" refers to a computer program that is distributed along with a licence, or contract, that requires users of the program to comply with specified conditions. Among these stipulations are that the source code³ be distributed along with the software, and that others be allowed to modify the source code as they desire. In contrast, the source code of closed source⁴ software is proprietary, not publicly distributed and subject to alteration only by the software manufacturer. There is an inescapable relationship between open source software and intellectual property rights, including copyrights, patents, trademarks and trade secrets. Although a particular computer program may be designated as open source, it remains possible that an owner of the intellectual property may enforce its rights against open source software developers and users. If open source software is incorporated into an otherwise proprietary program, then the terms of the open source licence will apply to the entire program and defeat the intellectual property⁵.

Have non-employee authors assigned their rights the target? If not, the target may not own that intellectual property remember that copyright protection is the principal vehicle used to protect software code. Inquiry must be made as to whether any of the target's software code incorporates the so-called open source software. If so, the terms of the open source licence applicable to that code require in varying degrees that all related

1. <http://library.findlaw.com/2003/Dec/1/133278.html>, last visited May 12, 2012.

2. http://www.rosenlaw.com/pdf-files/Rosen_Ch02.pdf, last visited May 14, 2012.

3. Definition—http://en.wikipedia.org/wiki/Source_code, last visited June 15, 2012.

4. Definition—http://softwarelicenses.org/p1_proprietary_closed_source.php, last visited June 15, 2012.

5. <http://www.consumidoreslibres.org/cafta/RL32268.pdf>, last visited May 23, 2012.

code developed by the target be offered for free as open source code under the applicable open source license¹.

Open source risk management and due diligence

In the 1990s, contracts relating to routine technology development and licencing generally contained nothing about open source. Later on, when attorneys became more familiar with the concepts of open source, they have realised that the statements that the target assets contained no open source software were rarely true². Since last decade, the open source usage has increased significantly by various industries. The commercial technology developers/proprietary companies have started adopting open source and because of this recognition the conduct of open source in mergers and acquisitions has augmented.

Gartner Inc., the world's leading information technology research and advisory company unveiled that by 2012, 80 per cent. of all commercial software will include elements of open source technology³. As always, such "new" phenomena provide both opportunities and challenges. The latter includes the many pitfalls that open source code generates in business takeover situations⁴.

Understanding open source risks usually starts with analysis of the licence that governs the particular software code. There are many forms of such open source licences, but a widely used form is the GNU General Public Licence (GNU GPL), which is published by the free software foundation.

The free software⁵ foundation holds copyright in the GNU GPL⁶ and prohibits modification of the document. Open source licenses vary in terms from harmless to devastating, and companies must understand the different obligations associated with them. The most notorious and restrictive open source licences impose radical contractual obligations on licensees. For example, if a company programmer incorporates a single line of open

1. Edwin L. Miller Jr., *"Mergers and Acquisitions—A step-by-step legal and practical guide"*, Edition 1, 2008, <http://books.google.co.in/books?id=O2JQAzx8g4EC&pg=PT58&dq=Open+source+and+Merger+and+acquisitions&hl=en&sa=X&ei=FobrT4zfCIqrAeApoHEBQ&ved=0CFAQ6AEwBA#v=onepage&q&f=false>.

2. Heather J. Meeker, *"The Open Source Alternative : Understanding Risks and Leveraging Opportunities"*, edition 1, 2008, page 238.

3. <http://www.gartner.com/it/page.jsp?id=593207>, last visited May 20, 2012.

4. <http://www.grette.no/no/Medarbeidere/Jarle-Roar-Sabo/Open-Source-Code-in-Mergers-and-Acquisitions>, last visited May 12, 2012.

5. <http://www.fsf.org>, last visited May 17, 2012.

6. <http://www.gnu.org/licenses/gpl-2.0.html>, last visited May 17, 2012.

source code retrieved from the internet into the company's proprietary software program, that programmer may have "infected" the proprietary software with open source code. According to the terms of one open source licence, that the company is now obligated to freely distribute all of the company's proprietary code as a result of inclusion of just one line of open source code. This can take place without management even knowing it has occurred. Such a result could be devastating and could compel a company essentially to give away trade secrets to competitors, thereby diminishing the value of the company's assets and the value of the company in the acquisition market place¹.

As the abovementioned examples demonstrate, management should not ignore open source code at any cost. This step is indispensable to evaluate IP of a target company and this and can be decisive while negotiating. Moreover, there are loads of companies from different background, which have their own open source governance policies and they have implemented their due diligence process. Black Duck Software is the leading global provider of strategy, products, and services for enabling enterprise scale adoption of open source software (OSS)² ; they do provide open source due diligence services.

Conclusion

In mergers and acquisitions transaction, acquirer scrutinises all the assets of the target company, though target company is to disclose the entire open source it was using in its business. In addition to, target represents and warrants that all use and distribution of open source software is in full compliance with all open source licenses applicable thereto. The primary liability and risk associated with open source is the possibility that it may infringe third party rights. If this were the case, it would be just as important to know all open source used in a business as it would be to know all open source contained in a company's products³.

Now-a-days, open source software is on tremendous demand by IT/non-IT companies. It has loads of benefits like escape vendor lock-in, greater security and reliability, rapid pace of innovation and lower cost of ownership ; companies can use open source within their proprietary software model and can avail all the mentioned benefits. A complete

1. Article by Jeremy Logsdon, "Due Diligence In Use of Open Source Software—Benefits and Pitfalls", <http://www.mondaq.com/unitedstates/article.asp?articleid=57658>, last visited May 17, 2012.
2. <http://www.blackducksoftware.com/about>, last visited June 24, 2012.
3. Heather J. Meeker, "The Open Source Alternative : Understanding Risks and Leveraging Opportunities", edition 1, 2008, page 239.

understanding of legal and business consequences coupled with open source is essential to value the due diligence process and for a successful transaction. Despite the fact that, companies are not very much aware of open source due diligence in mergers and acquisitions transactions and they inadvertently overlook this. It is my belief that open source would be a milestone of innovation for the users and would be decisive prerequisite to mergers and acquisitions.