PRYOR CASHMAN LLP

LEGAL UPDATE

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OPEN SOURCE ISSUES IN MERGERS & ACQUISITIONS

According to Ernst & Young's *Global Technology M&A Update: October-December 2014*, global merger and acquisition deals in the technology sector are achieving post-dotcom-bubble records, showing significant growth in deal volume for a fourth consecutive quarter at 959 deals and reaching aggregate deal value of $237.6 billion in 2014 – higher than any year on record except 2000. Ernst & Young noted that deals targeting cloud/SaaS, smart mobility, internet of things, security, and advertising and marketing technologies contributed considerably to the record-breaking aggregate volume and deal values in 2014. When this market activity is viewed in tandem with the fact that, according to Forrester Research Inc.'s *Development Landscape: 2013*, the overwhelming majority of software engineers and developers today incorporate open source software into their work, technology companies that intend to take advantage of the current market to grow their business through mergers and acquisitions should fully understand and address the issues surrounding the use of open source software in their business and its impact on potential deal-making.

Although the use of open source software offers many benefits (*e.g.*, better quality code, security and significant cost-savings), the licensing and compliance issues that arise in connection with such use present challenges for technology companies that incorporate such software in their business. For example, one common type of open source license, known as a "viral" license, requires any company incorporating, modifying or otherwise using the open source software to make its source code generally available to the public (which could potentially allow competitors access to what would otherwise be proprietary information) and to license their software to all third parties under the same terms as the open source license. During the negotiation of a transaction, the discovery of open source software issues such as those described above could adversely affect the target company's valuation, delay closing, or de-rail the contemplated transaction entirely. For both the buyer and seller, therefore, understanding the implications of the target's use of open source software should play a significant role in preparing for, and evaluating, a contemplated merger or acquisition.

To shift the risks associated with the use of, and reliance on, open source software, acquiring companies today often ask the target company to provide a representation in the relevant transaction document similar to the following:

> "No open source software, freeware or other software distributed under 'viral' or similar licensing or use/distribution models has been incorporated into any of the software or application comprising or included in any Company Products or Company Intellectual Property that, as utilized in the business of the Company as currently conducted, would (i) obligate the Company to disclose free of charge to any persons the source code for any proprietary software or proprietary application comprising or included in Company Products or Company Intellectual Property or (ii) infringe, misappropriate or otherwise violate any open source licensing agreements."

Variations on the above representation can limit the representation's scope, including, for example, knowledge qualifiers which limit the representation made to the knowledge of the target company's key employees (*i.e.*, any use of open source software that is unknown to the target company's key employees would not be a liability of the target company, but a risk borne by the acquiring company) or materiality qualifiers which limit the representation to only those circumstances in which use of open source software is material to the target company's business (*i.e.*, any minor use of open source software would not be a liability of the target

company, but a risk borne by the acquiring company). In other transactions, target companies may make the above representations (or some variation thereof) and also disclose particular usages of open source software in their business. Specific disclosures like these can be used to carve out particular risks related to use of the disclosed open source software and shift such risks to the acquiring company. Technology companies being asked to make the above representation, or negotiating changes to that representation, in the context of a contemplated sale should be keenly aware and knowledgeable of the use of open source software in their business.

Today, well-run companies are fully aware of, and rely on various means of tracking, their use of open source software and the licenses governing that use. For companies that have not rigorously managed their open source software, software programs such as Black Duck and Palamida can scan significant volumes of code and cross-check them against databases of open source code, allowing such companies (as well as acquiring companies) to quickly and effectively assess open source license compliance. The discovery of non-compliant open source use during the due diligence phase of a transaction may lead to significant delays due to renewed negotiation of a target company's valuation or the demand for the target company to take measures to be compliant (*e.g.*, removing infringing code and substituting it with new, non-infringing code) prior to consummation of the transaction. If open source violations are discovered after a transaction has been consummated, breach of the representation could lead to liability for related losses incurred by the acquiring company in remediating such violations and, depending on the extent to which the violations impact a target company's business, the failure to keep track of open source software could also result in claims relating to inaccurate financial statements that may not accurately account for ownership and use of the target company's intellectual property.

In order for a technology company to effectively reduce the risks posed by the use of open source software and the related issues that may arise during a merger or acquisition, it would be advisable to implement robust policies and procedures relating to the use of such software at an early stage of the company's development. A technology company should implement company-wide policies to ensure the limited use of open source software and additional protocols for the efficient disclosure and tracking of any use and compliance with applicable open source licenses. Companies should also regularly assess their open source compliance internally by taking advantage of available audit tools in order to remediate any issues before such issues can impact potential transactions. Once a company finds itself negotiating a merger or acquisition, it would be advisable that the open source representation provided is one that is narrow in scope and that discloses all known uses of open source software. It is the clear and comprehensive grasp of open source usage in a company's business that will allow the company to take full advantage of the benefits of open source software while limiting the related risks when a merger or acquisition opportunity presents itself.

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The foregoing is merely a discussion of Open Source Issues in Mergers & Acquisitions. If you would like to learn more about this topic or how Pryor Cashman LLP can serve your legal needs, please contact Jeffrey C. Johnson at (212) 326-0118, or jjohnson@pryorcashman.com .

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