What To Know About Software Co. M&A As Deal Volume Rises

By **Zachary Turke and Edward Xia** (October 22, 2020)

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Software companies have been relatively shielded from the worst of the effects of the COVID-19 pandemic and the resulting economic fallout.

This has been borne out by the recovery in M&A volume in the industry in the third quarter of 2020, where total volume increased by 25% from the second quarter of 2020, and total transaction volume nearly quadrupled to $62.8 billion, representing the industry's peak for the last two years. It is now clear that both buyers and sellers in this space will remain interested in getting deals done in the near- and medium-term.

However, doing a deal in the software industry comes with its own unique challenges that make it different from doing deals in other, more traditional industries. Accordingly, whether you are considering buying or selling a software company, it is important that you familiarize yourself with the unique aspects of deals in this space.

What follows is an overview of the key issues specific to the software industry that you should begin thinking about before you start the M&A deal.

Intellectual Property

In many cases, the intellectual property assets of a software company are the most important assets that the buyer is looking to acquire. Accordingly, a smart buyer will want to focus particular attention in performing due diligence in this area, and, if issues are identified, it will need to make sure that appropriate protections are included in the purchase agreement to address those issues.

A smart seller should therefore conduct its own preemptive IP diligence to make sure any issues are resolved prior to going to market.

Appropriate Rights to IP

One of the first things that buyers look to confirm is that the target actually owns the IP it claims to. It is not uncommon for companies, especially those that did not have sophisticated counsel involved in the early stages of its existence, to have uncertainties in the chain of title of its IP.

Additionally, some companies neglect to have their employees and independent contractors involved in the creation of IP sign a valid, enforceable and encompassing agreement assigning any IP created to the company. Once chain of title is confirmed, it is also necessary to confirm whether the company is subject to any legal proceedings challenging its IP or exposing the company to significant damages or loss of its IP, including in particular patent infringement claims or litigation.

Issues can also present themselves, however, where IP is licensed rather than owned. In this area, the buyer will want to know that the company has the appropriate right, through a license or other contractual arrangement, to use any IP owned by third parties that is material to the business. If a target's IP was developed using government, university or military resources, these arrangements may present additional restrictions on the transfer of the IP that may greatly complicate getting a deal done.

Given the importance of IP to a software company, the prudent buyer will want to conduct thorough due diligence on these issues, including doing searches on public registries as well as reviewing all of the target's documentation and agreements related to IP. In addition, the acquirer will require specific and thorough representations and warranties to be made regarding these issues in the purchase agreement.

To the extent these representations are untrue and the impact is severe, the buyer may have the ability to walk away from the deal after a binding purchase agreement is signed. With respect to any breach, however, the seller will likely have to indemnify the buyer for any losses. The scope of such indemnification — including the amount of potential exposure, how much of the purchase price is withheld to secure any claims and the length of the claims period — is the subject of negotiation.

Open-Source Software

The improper utilization of open-source software could substantially reduce, or even completely eliminate, the value of a company's software to a potential acquirer. Certain open-source licenses impose reciprocity or share-alike requirements.

These licenses may provide that any user who develops proprietary software that incorporate the licensed open- source software into a so-called combined work must make the entire combined work available to third parties under the same terms as the open-source license. The combined work is deemed tainted, and, as a result, any for-profit software licensing business model becomes untenable.

Accordingly, buyers will usually conduct a thorough review of the target's use of open-source software, often retaining a third party auditor to assist them. Given the risk that issues with open-source software can scuttle a deal, sellers should consider conducting a preemptive audit prior to the sale process to identify potential problems and allow themselves sufficient time to resolve any issues identified.

Buyers will also require the inclusion of representations and warranties regarding open-source software issues in the purchase agreement. If issues are identified during due diligence, the parties will need to deal with them more specifically in the purchase agreement, including determining whether to include a specific indemnity for any identified issues, whether any specific issues must be resolved prior to closing, and whether the buyer or the seller is responsible for any remediation costs.

Employee Retention

The primary value of a software company that does not lie in its IP often lies in the talent of its key executives, engineers and developers. In these circumstances, both buyers and sellers must ensure that the target's employees are properly incentivized to remain with the organization going forward and drive the business after the deal is closed.

For more senior executives, the buyer may require that they sign employment agreements as a condition of the transaction. Such agreements give some assurance to the buyer that these executives intend to stay on for a certain term after the closing, while usually giving the executives protection in the form of severance payments if things do not work out.

For sellers, it is important to remember that if having these agreements signed constitutes a condition to the deal, there is risk of executives holding up a closing in order to negotiate better employment terms.

Given that employees, with or without employment agreements, can always terminate their employment at any time, buyers should also consider providing equity incentives to tie employees to the long-term financial performance of the business and therefore incentivize them to remain with the company.

Accordingly, acquirers will often put in place a new equity incentive plan for the go-forward company or allow the acquired employees to participate in the buyer's existing equity incentive plan. The exact type of plan will depend on the structure of the entity issuing the incentive.

To be effective, however, these plans should be subject to time-based vesting, in addition to other vesting conditions, in order to encourage retention. The buyer may also consider cash bonus programs to encourage retention.

In circumstances in which there is particular risk of employee departure, the buyer may want to pay part of the purchase price as contingent consideration in what is commonly known as an earnout. In this structure, part of the consideration is held back by the acquirer and only paid out when and if certain employees stay on with the business for a negotiated period of time and/or if certain performance measures are met.

From a buyer's perspective, this helps to ensure that it will not overpay for a target that will not justify its price tag if it does not have the required employees to deliver on its projections.

From the seller's perspective, however, earnouts can cause concern because the seller no longer owns the target company during the measuring period of the earnout and thus does not have ultimate say in what steps the business can take to retain talent and thus satisfy the earnout.

Accordingly, when an earnout structure is used, there will be significant negotiation as to what covenants will be included in the purchase agreement to limit what the buyer can do without the seller's agreement. These protections may include restrictions on discontinuing the business, requiring the buyer to act in accordance with an agreed upon business plan and allowing the seller to have a say over hiring and firing decisions, among others.

Capitalization

Given the large startup costs associated with forming a software company, it is not unusual for these businesses to have more complicated capital structures than a typical company. Understanding the capital structure of the company and resolving any issues relating to equity rights is an essential part of getting a software transaction over the finish line.

Resolving issues with minor shareholders is often the most complicated capitalization issue parties to a transaction will deal with. If the transaction is structured as a sale of equity, then each shareholder must sign the purchase agreement and agree to sell its shares.

To the extent there is a real risk that a minor shareholder may refuse and therefore hold up the deal, the parties may consider structuring the transaction as a merger or sale of assets, which are transaction structures that do not require every shareholder to sign on. This decision should be made early on in consultation with your tax advisers, as picking the wrong structure can have significant tax impacts and switching transaction structures in the middle of a deal will result in substantial cost and delay.

In some cases, if permitted under the company's governing documents, the major shareholder may have the ability to force the minor shareholders to participate in the sale, known as a drag right, although this right often has procedural hurdles that must be followed. Investors with a larger stake may also have specific rights to block a sale regardless of the structure, and so they will need to consent to any sale.

With respect to existing equity incentives that have been provided to employees prior to a transaction, it will be prudent for a seller to have its legal and tax advisers to review the existing plan prior to going to market. Even if there are no issues with how the plan was implemented, a buyer will almost always require those incentives to be cashed out and terminated at closing.

Consequently, the buyer will often require that termination agreements be signed with each employee holding equity incentives as a condition of the transaction. If these incentives are of no value, i.e., under water, or of little value, getting these agreements signed may be challenging and time consuming. It will be important to evaluate the authority of the applicable plan administrator to determine the extent to which termination agreements are necessary.

The other question that must be resolved is how much holders of equity incentives are treated as other shareholders — meaning they provide indemnification, have any proceeds withheld to cover indemnification claims and participate in any earnout payments. Having them treated like other shareholders dilutes the risks of the other shareholders but also gives equity incentive-holders the benefit of the upside if there is an earnout and increases the ability for holdouts as they all have to sign the purchase agreement.

Conclusion

As you can see, there are a number of unique issues that need to be addressed when you are considering buying or selling a software company. The above discussion only scratches the surface of the complexity that is often involved in dealing with these issues — and these only represent a small fraction of all of the issues that need to be resolved as part of your transaction. Ultimately, however, almost every issue is solvable if you leave yourself enough time. Planning ahead, then, is key.

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