Hengeler Mueller



Challenges in Technology-Driven M&A Transactions

September 2020

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A. Introduction

Technology companies are constantly pushing into new areas. Tesla, for example, acts like a classic "technology player" in many respects. In doing so it is setting new standards in the automotive industry, a traditional "old economy" market. There is also a stream of reports on cross-industry development co-operations with a strong IT focus – such as between Mercedes and Nvidia just recently. The four largest technology companies in the world in terms of market capitalisation (Apple, Microsoft, Amazon and Alphabet) have each broken through the trillion dollar-barrier in market capitalisation and impressively demonstrate the enormous importance of technology in today's economy. With its highly efficient logistics operations, one of the main drivers of Amazon's success is the digitalisation of an "old economy" sector. In addition, there are new motivations for investments in technologies, such as higher data protection requirements and constantly growing cybersecurity risks.

It has become clear that digitalisation and a focus on technology is no longer an issue that only affects typical technology companies, but companies across various industries. This topic has become particularly relevant for companies that belong to "traditional" or "non-tech" industries – which now often want or need to boost their competitiveness by acquiring technology.

But how do companies gain access to new technologies and what are the risks involved? In order to find out, we wrote to over 300 M&A and IP experts and company executives together with M&A Review from June to August 2020.

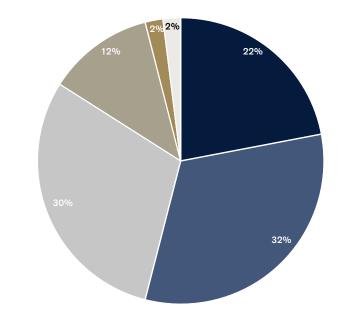


B. Report

1. IP/IT as a Key Driver for M&A Transactions

Companies frequently buy other companies because of their technology or IP assets and the resulting development opportunities: more than half of the respondents (54%) cited IP/IT aspects as a driving factor for their current M&A transactions. It is noteworthy that such high responses were not industry-specific, but were evident across companies in different industries.

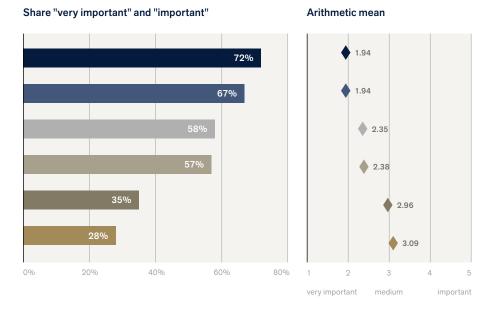
How often are IP/IT-related aspects a driving factor in your corporate acquisitions or joint ventures?



■ very rarely ■ rarely ■ occasionally ■ frequently ■ very frequently ■ n/a

2. Advantages of Technology-Driven Transactions

How would you rate the importance of the following aspects regarding your corporate acquisitions and joint ventures?



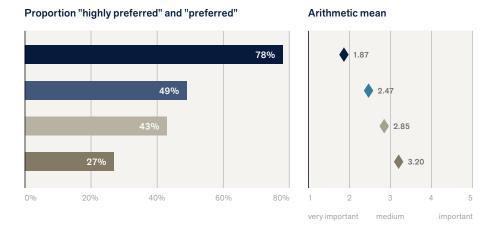
Expansion of product portfolio Expansion of customer base Acquisition of new fundamental technology Enhancing development capacities Improvement of technology infrastructure Acquisition of additional brands

The expansion of the customer base (e.g. new countries or cross-selling) was seen by participants as an important benefit to company takeovers or joint ventures. Equally important to the participants, with slightly greater variance, is an expansion of the product portfolio. This likely includes transactions in which, for example, a "bricks and mortar" retailer expands its product range by acquiring an existing online store with the corresponding IT infrastructure. The acquisition of new fundamental technologies is still important to the respondents, followed by an expansion of development capacities (e.g. taking on particularly qualified employees). An improved technology infrastructure (e.g. a more modern IT platform) is overall only considered of medium importance.

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The relatively low acknowledgement of improved technology infrastructure is in line with our experience that only a few transactions are driven primarily by the technology infrastructure of the business partner – this usually plays (only) an indirect role, because the technology infrastructure is used to operate a product or service or enables access to a new customer group. Only rarely – for example in insourcing – is the technology infrastructure itself the object of the transaction.

3. Paths to Technology Acquisition



How do you generally prefer to secure technology necessary for your products?

Acquisition of businesses possessing the technology Licenses and partnerships

Isolated purchase of technology

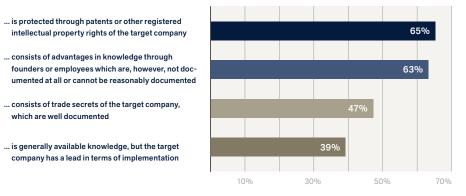
Joint Venture with carriers of technology

The acquisition of companies with technology is clearly the preferred way to secure necessary technologies for products, followed by licenses and partnerships and the separate acquisition of technology. Despite the cost efficiency of a separate acquisition of technology, participants often cite the limited development possibilities that result from a lack of employees with the necessary know-how transferring to the acquirer and a lack of integration into their own corporate structures as disadvantages to acquisitions of technology (only). Joint ventures with technology providers also tend to be less popular. This comparatively unfavorable view of joint ventures is surprising – after all, joint ventures are usually perceived favorably given the opportunity to combine different strengths. Although joint ventures are often thought of by respondents as necessary to combine different expertise (e.g. cross-industry cooperation) as well as to share costs and risks, they were also often seen as challenging to implement and associated with a high degree of dependence on the respective cooperation partner. Free-text responses from study participants suggest that companies see the risk of losses due to disputes between the joint venture partners as a major disadvantage. In other words, a joint venture seems preferable to an acquisition only if there are other important reasons for choosing the JV structure, such as a combination across industries, development opportunities that are otherwise not available, or a high financing requirement.

Accordingly, in our experience it is crucial that the parties jointly think through all "life phases" of their joint venture from the outset and find good contractual provisions for all essential scenarios in advance. This applies in particular to the rules for resolving disputes over the joint venture, which can arise for a variety of reasons. Just as important is careful planning of the joint venture's corporate governance structures, as this must be suitable for day-to-day operations as well as permitting the resolution of – possibly fundamental – differences of opinion. For many study participants, making arrangements for these issues from the outset seems to be excessively time-consuming and costly at the time of the joint venture's formation. This additional effort clearly pays off however, should the joint venture, like many long-term projects, encounter difficulties at a later date. When negotiating joint venture arrangements, particular caution is required against reaching compromises that consist of adding alternatives and variations in settling particular issues. Although such provisions can often solve the specific negotiation situation at hand, they often add a level of complexity that is not suitable for day-to-day operations and merely postpone problems to a later date. In our experience, the additional time and energy spent at the outset to find a simple and workable compromise solution is usually well invested.

4. Forms of Technology Protection

Frequently, the relevant technology when expanding the product portfolio or acquiring a fundamental technology ...



Almost two thirds of participants (65%) report that the relevant technology is protected by patents or other registered property rights of the target company when the product portfolio is expanded or a fundamental technology is acquired.

Also almost two thirds of the participants (63%) found the sought-after technology manifested itself in a knowledge advantage of the founders or employees, which, however, is not documented or cannot reasonably be documented. Only slightly less than half (47%) of respondents saw the technology as consisting of trade secrets of the target company, which are well documented.

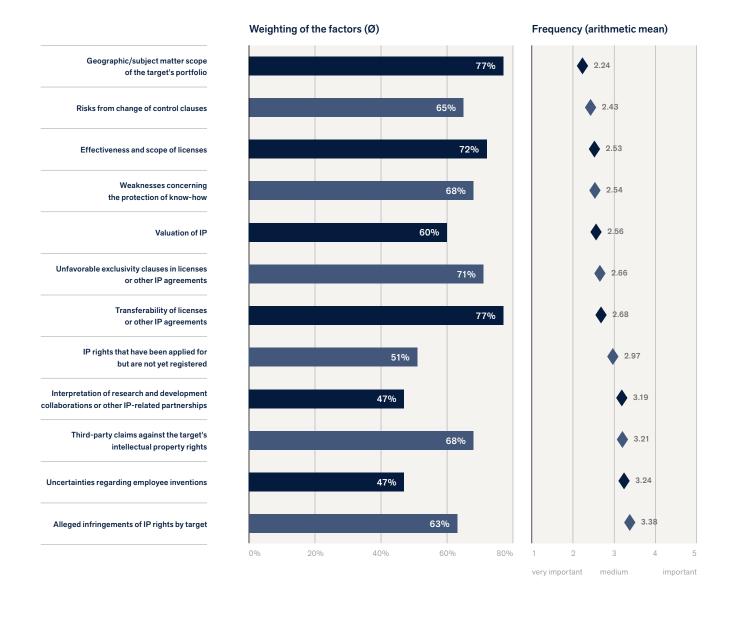
Overall, this suggests that employee retention in the context of transactions is of considerable importance in achieving the technology goals pursued. Accordingly, study participants apparently also assess the different ways of acquiring technology (company acquisition, joint venture, etc.) according to whether the transfer of key employees is secured. Mechanisms for the transfer and retention of employees with know-how are a central aspect in M&A transactions, in addition to securing the "classic" IP rights portfolio.

In transactions in which we were involved, typically strong involvement of the parties' business teams was required to convince key employees to transfer to the acquirer or the joint venture, as well as legal and financial incentive mechanisms such as management participation programs. In addition, it is usually important for both parties to define at which degree of participation of the key employees a transaction is (still) economically viable and, if necessary, to find individual contractual solutions with key employees at an early stage.

More than a third (38%) of the participants consider the sought-after technology to be generally known but that the acquisition of the target company is nonetheless interesting because of the implementation advantage enables access to. This suggests that "time-to-market" and the rapid gain of market and mind-share are very relevant for business success in these cases.

5. Possible Problems in Technology-Driven Transactions

How often were the following factors relevant in your corporate transactions and how important were they in the respective transaction? How did you address them in your transaction?



According to our study participants, the geographical or subject matter scope of the target company's portfolio is the most common problem factor in corporate transactions. Risks due to change of control clauses come in second place and finally, the effectiveness and scope of licenses comes in third place. The prominence of these factors is not surprising, as they all play a major role in determining whether the business case for a transaction is valid: if the business case provides for expansion into technology fields or countries in which the target company does not enjoy IP protection as owner or licensee and thus does not have exclusivity over competitors, this calls revenue and profit projections into question. If – for example, in the pharmaceutical sector – a start-up's main asset is a license, such as those granted by universities, the entire business model is, in the worst case, at risk if the license is lost or becomes more expensive due to a change of control provision.

In terms of relevance, 77 per cent. of the participants see the transferability of licenses or other IP contracts as the most important issue. In second place is the effectiveness and reach of such licenses, as mentioned above, with 72 per cent. Unfavorable exclusivity clauses in licenses or other IP contracts come in third with 71 per cent. These figures are also confirmed by our practical experience: in quite a few target companies, at least part of the business is based on incoming or outgoing licenses (this is may be relevant, for example, in the pharma sector already mentioned, or when software is licensed-out by start-ups to pilot customers or large customers). If the licenses are not transferable or – especially due to restrictive exclusivity clauses or narrow fields of permitted use – structured unfavorably, this generally impairs the prospects of a successful transaction.

All-in-all it should be noted that even the IP/IT problems that occur less frequently are in practice – when they do occur – of high relevance for a transaction. This is especially true for the classic IP-dispute topics (attacks on intellectual property rights in the target portfolio or attacks on the target company due to alleged/actual infringement of intellectual property rights). It is also notable that weaknesses in know-how protection achieve high relevance values. On the one hand, this correlates with the high significance of documented/undocumented know-how of the target companies for the execution of the transaction from the perspective of the study participants. It is, however, also understandable given that know-how protection has received increased attention by the new German law for the protection of trade secrets and the EU know-how directive behind it. The EU's know-how directive and the resulting trade secret law implemented in Germany have set up additional hurdles for "know-how owners", at least from a German point of view, with the requirement to put in place appropriate secrecy measures in order to profit from legal protection. This protection is particularly important, for example, if a violation of trade secrets requires action to be taken against persons to whom the owner of the know-how is not already contractually bound.

The legal acquisition of employee inventions by the target company, which has been highly problematic for years, seems to have lost some of its practical relevance. This can be explained against the background that the statutory framework already changed in favor of employers in October 2009. Thus, for "old cases" of incorrectly claimed employee inventions, claims for injunctive relief prohibiting the use by the target company should in many cases already be (or will soon become) time-barred.Furthermore, participants found IP rights that have been applied for but are not yet registered to be a less relevant factor. This indicates a certain focus of the participants on the current situation of target companies. Nevertheless, based on the answers received, the unrestricted transfer of IP in the application stage should still be relevant.

6. Solutions in the Transaction Process

How did you address the following factors during your transactions?

The toolkit used to deal with IP/IT problems is fairly typical for M&A transactions (e.g. due diligence on IP/IT issues, warranties, indemnities, closing conditions, purchase price deductions, termination of the deal if necessary) and no particular variant seems to be particularly frequent. This suggests that the solutions are usually tailored to the relevant transaction and specific problems identified and therefore vary as widely as the transactions and problems themselves. It also shows that the expertise of experienced M&A and IP/IT advisors will pay off, because they can apply these different solutions quickly and effectively to the individual case.

However, participants also mentioned mechanisms that are otherwise less often used in M&A transactions, in particular negotiations and agreements with third parties. The involvement of (unpredictable) third parties often poses challenges for the usual "roadmap" for M&A transactions – think of tight schedules and high demands on confidentiality and transaction security. Accordingly, experience and creativity are equally required in these cases to fit negotiations with relevant third parties into the transaction structure. In our experience, alternative solutions are often used to reduce friction caused by the involvement of the third party, such as earn-out provisions or adjusted transaction structures such as a staggered closing across different regions. In practice, however, it is often challenging to design these solutions so conclusively that no new points of contention arise between the parties at a later date

C. Conclusion

In summary, the results of the study demonstrate that technology is not only a frequent diligence-item in M&A transactions; it is becoming an area of greater and increasingly key importance.

Interestingly, this is not only about the protection of registered IP rights. Great importance is also being attached to taking over employees who have special and often undocumented know-how regarding relevant technology. Accordingly, the study participants assess the various transaction structures for the acquisition of technology according to whether the transfer of key employees can be secured.

Companies are also risk-aware when it comes to how technology is acquired. This was particularly prominent with regard to entering into joint ventures. These often occur in the technology sector, among other things because they enable a combination of expertise and the sharing of risks and costs across industries. However, they are also more challenging and more contentious in their practical implementation, so that it is important to find robust solutions in advance, especially regarding corporate governance issues and exit scenarios.

To address the relevant challenges in technology M&A transactions, on the one hand common M&A mechanisms are used (due diligence, warranties/exemptions, etc.), but on the other hand, alternative approaches are also often required, such as parallel negotiations and agreements with third parties. It is crucial to focus on solutions that work in practice and, if necessary, to develop new provisions and tools to ensure that the goals pursued with the transaction are achieved.

D. About the Survey

Together with M&A Review, from June to August 2020, we reached out via email to more than 300 M&A and IP experts and company executives, asking them to complete an online questionnaire. 57 people took part in the detailed survey.

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