Due Diligence in M&A Transactions: Information Technology Considerations

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The importance of the appropriate focus on information technology, including software, in due diligence projects where the target is an information technology company, or where the target's business is heavily reliant on information technology is obvious. However, the extent to which information technology permeates all aspects the very existence of corporate entities today, dictates that information technology be afforded adequate attention in all due diligence projects.

This article provides a short introduction to some considerations that are relevant when preparing for an information technology disclosure or considering such disclosed information in a due diligence contexts.

The point of departure in considering the information technology aspects of a due diligence is the same as that for any other aspect of the due diligence process – the structure of the proposed transaction. This could include for example a share purchase, an asset purchase or a merger. Depending on the proposed structure of the transaction, different aspects of the information technology due diligence may require special consideration. For example, in the event that a proposed transaction is an asset transfer, prohibitions or limitations on the assignment of software licenses will be relevant, while change control provisions will be relevant in the case of share purchases.

Moving on from the structure of the proposed transaction, it is important to form an adequate understanding of the information technology that will form the subject matter of the due diligence review. In broad terms, it will be necessary to obtain details of (i) the information technology assets owned or used by the target, (ii) the rights of and obligations to third parties in respect of those information technology assets and (iii) documents relevant to both the information technology assets and third parties, including for example documents related to service levels, technical and functional specifications and possibly warranties.

The adequate disclosure of information technology assets and the particular role such assets fulfil in the target's business is important as it will enable prospective buyers to determine how material particular assets and third parties are to the business operations of the target and accordingly the value of the proposed transaction. By way of illustration, if a particular software asset provides the target with a competitive advantage in its industry, or is otherwise a direct driver of revenue, that particular software asset will be significant to the prospective buyer and accordingly in the due diligence review.

Information technology assets will include hardware and software. With respect to hardware, relevant information could include (a) diagrams of the hardware architecture, (b) an inventory of the relevant hardware assets, (c) relevant third party agreements such as license, purchase, support, maintenance and service level agreements and (d) possibly disaster recovery and business continuity protocols.

With respect to software assets relevant information could include (a) an inventory of software used by the target, including information on ownership and licenses, (b) agreements related to the software assets such as license, support, maintenance, development, assignment, and escrow agreements, (c) documentation, including policies, manuals and information on user access protocols and (d) active or planned development programs.

In respect of both hardware and software assets, agreements with third parties and in particular license agreements are of particular importance. These agreements contain rights, and the scope of those rights, that the buyer may acquire through the proposed transaction. Licensing provisions may however, not only be contained in “license” agreements, but also as part of various other agreements, such as development, joint venture, consulting and possibly settlement agreements (to mention only some). It is to be noted that the use of open source software is subject to the terms of open source software licenses and where open source software had been used by a target (and such use has become prolific), steps may need to be taken to identify the relevant open source software, license and source, as well as the information technology asset it has been integrated in and the nature of such integration. Open source software licenses can be important in a proposed transaction as they may dictate the terms on which software derived from such open source software is licensed to third parties.

Agreements with third parties are also relevant in the event that the information technology operations of the target are to be integrated with that of the proposed buyer. The buyer’s due diligence may identify duplications in the information technology systems of the buyer and that of the target that it may wish to remove. Where such duplications relate to third party contracts, it is important that the relevant contracts are considered with a view to the possible termination or cancellation thereof.

The focus of the approach to the due diligence set out above is on a more “traditional” information technology environment. Information technology is increasingly being acquired as “software as a service” or in the context of “cloud computing” and where a target engages or makes use of such services, this category of agreements will require separate and careful technical consideration.

As a result of the extent to which information technology has become an integral part of the way in which businesses operate, if not often a significant contributor to or source of competitive advantage, the appropriate review of information technology during a due diligence project is essential.