

White Paper

Managing Your Intellectual Property Integrity During Merger and Acquisition Transactions

Palamida M&A Services Introduction



PALAMIDA[™]

Application Security for Open Source Software

215 Second Street, First Floor
San Francisco, California 94105
415.777.9400

www.palamida.com

Open Source in Today's M&A World

In today's software development environment, ready access to third-party code is an enormous benefit if used responsibly. By leveraging the intellectual property (IP) of commercial software development partners, outsourced engineering resources, and the open source community, companies can reduce costs, accelerate time to market, access global software innovation, and differentiate its own software products. This expanded opportunity for use of third-party IP, however, comes with the responsibility to comply with a complex set of licensing terms placed on the software by its IP owners in order to avoid claims of infringement for improper use. It also calls for the need to track the use of the third-party software to mitigate financial and legal risks by implementing development oversight to ensure that governance mechanisms are in place to provide for proper payment and compliance to license terms.

Most corporations have a hard enough time managing the third-party IP within their own code bases; doing so in mergers and acquisitions (M&A) transactions can be even more difficult, as inbound code built by unfamiliar development teams is often a blackbox of third-party code and licenses. Few M&A teams have the time to thoroughly audit the code they are acquiring or the expertise to analyze the code to evaluate IP risks and compliance issues. But accurate code audits are essential to acquiring teams during each phase of the M&A process by ensuring:

- Early IP risk assessment to eliminate wasted due diligence time and effort.
- Accurate inventory and analysis of inbound IP to mitigate accidental infringement issues.
- Quantification of the degree of innovation to properly value IP acquisitions.
- Rapidly location of potential IP issues that impact deal terms and close.

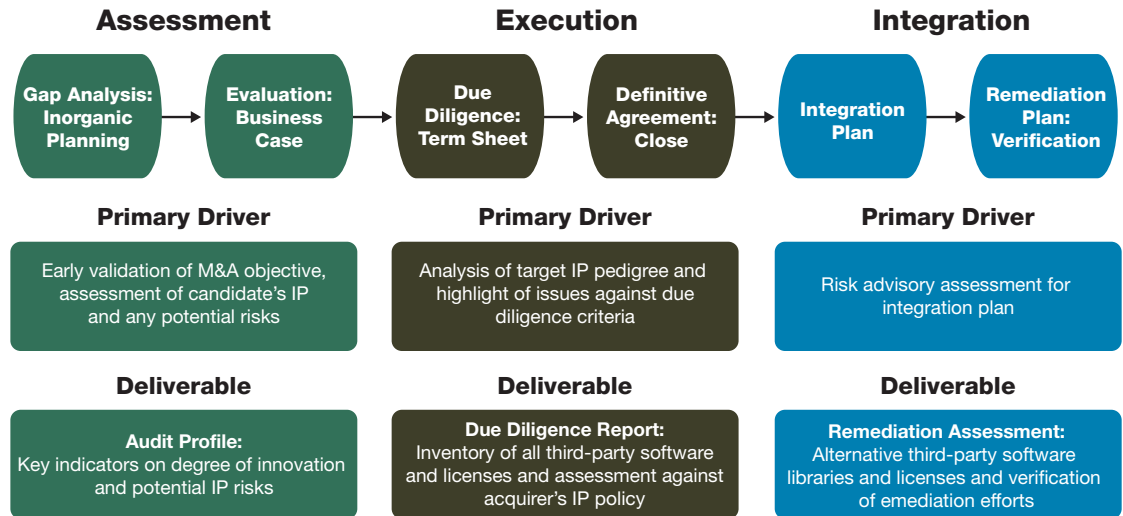
As software development environments are increasingly touched by open source code and outsourced third-party work, there is no better way to gain quick, accurate insight into IP value than by due diligence audits conducted by an experienced IP software technology team.

Services Overview

M&A opportunities are an effective corporate strategy to acquire valuable IP assets for market consolidation. Together with innovation, a premium is placed on accelerating deal-flow and undertaking precise but fast due diligence. The M&A process is difficult, time-critical and often contentious.

Within this fast-paced environment, M&A-focused companies must ascertain the true value of a candidate's software IP quickly. They must also establish due diligence criteria for certifying the origins and ownership of IP. With up to 80 percent of a software maker's valuation coming from its IP in many instances, the companies that can discern the real worth of software IP will be the ones who are the most successful in fulfilling their M&A objectives.

Palamida provides unique services during each critical phase:

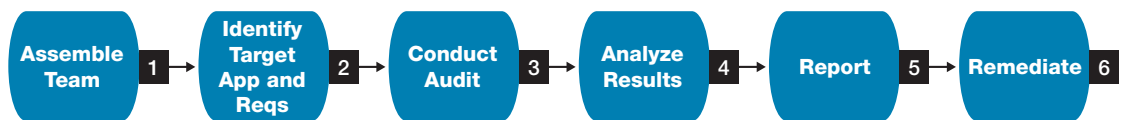


Code Audits in M&A Process

Palamida has refined a common six-step best practices methodology for each phase of M&A due diligence. This paper is an introduction to this methodology used in multiple engagements for some of the world's largest corporations during M&A transactions, legal mediations, and compliance audits.

Getting Started on Code Audits

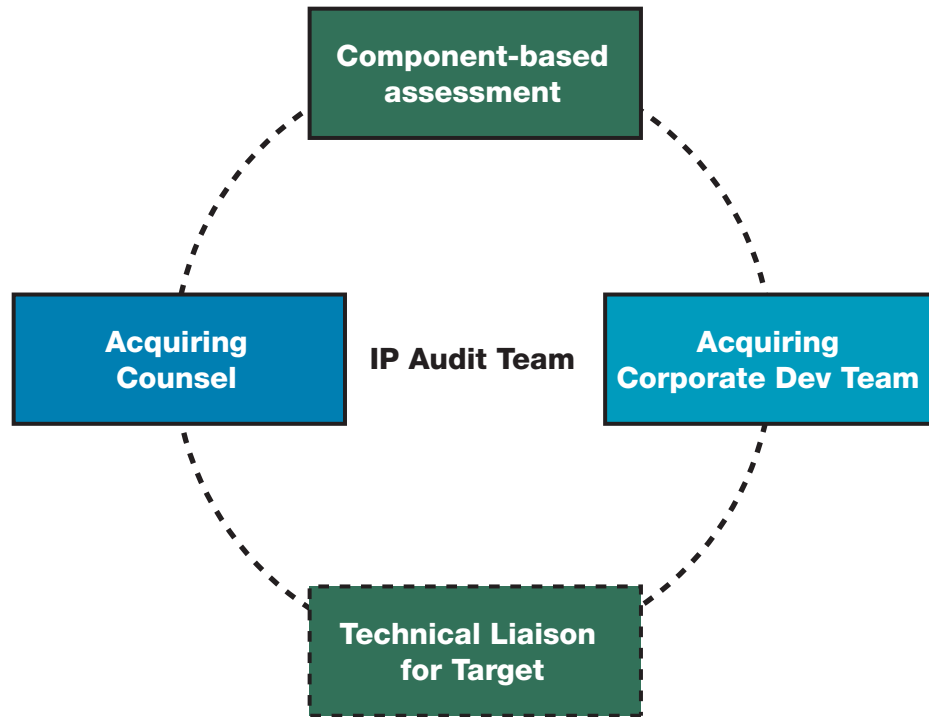
In each of the M&A due diligence phases, Palamida's code audits follow a common six-step methodology.



6-step Audit Process

Step One: Assemble the Team

Every code audit requires buy-in, cooperation and support from a strong cross-functional team. There are four primary roles represented on the team: Palamida Consultant, Acquiring Counsel, Corporate Development Liaison, and Technical Liaison from the candidate company.



Audits Require Corporate Buy-in

Palamida Consultant

For code audits, a Palamida Consultant serves as the central figure of every audit. Her job is to support the needs of the cross-functional team by listening to the audit requirements, conducting the code scan, analyzing results, consulting with the development team to help resolve questions surrounding the origins of unknown pieces of code, reporting the results of an audit during check-in meetings, and delivering a final audit report.

The average profile of a Palamida consultant includes:

- 10+ years of professional development experience
- In-depth knowledge of Open Source licenses, projects and repositories (e.g. sourceforge.net)
- In-depth knowledge of Java, C#, C/C++, Python, Perl and PHP
- Knowledge of XML and related technologies, such as XSLT and XPath
- Experience in Ant and Make, and SCM systems such as CVS, Perforce SourceSafe and/or Subversion
- Knowledge of Windows, Linux, Solaris/Unix
- Experience with object-oriented development, including UML and design patterns

As part of its services, the Consultant uses the Palamida Compliance Edition software as her primary means of conducting the code audits in addition to drawing on her 10+ years of software development and deployment. Our consultants have participated in M&A audits worth tens of billion over the course of the last five years.

Acquiring Counsel

The Counsel role is usually the acquiring attorney who is charged with assessing intellectual property issues either for the corporate transaction or whose ongoing job is to manage licensing and IP issues for the company's products. As part of the cross-functional team, Counsel will help define the requirements for the audit, set IP policy, and advise on remediation plans.

Corporate Development Team Member

The assigned Corporate Development Team Member is usually responsible for the deal. His role is to facilitate access to the candidate company during the audit process, advise on IP policy and assists in business aspects of the audit priorities and evaluation of the deal.

Technical Liaison from Candidate Company

During the course of an audit, the Palamida consultant may need to consult with the developers who wrote the audited code. Using the Palamida Compliance Edition, a Consultant will be able to automate almost of all the detection. But in order to provide comprehensive IP analysis, which involves reviewing scan results, confirming and inventorying the third-party code, and providing severity and remediation analysis, she may need to rely on the expertise of the broader development team and their intimate knowledge of the code base to answer any outstanding questions about code origin. The assigned Liaison is usually responsible for the developers who wrote the code that is being audited. His role is to provide access to the developers during the audit process.

Step Two: Identify Target Application and Audit Requirements

Before a code audit, the IP audit team needs to identify the target application and have answers to some basic questions.

Palamida's services team generate three standard reports for the different phases of M&A due diligence: Risk Profile Report, Due Diligence Forensic Report, and Remediation Assessment

1. What is the name of the product to be audited?
2. What does the product do?
 - Are there portions of this code base that are Server or Client-based only?
 - Are there portions of this code base that are shared between client and server modules?
3. How old is this product?
4. Have other names ever been used for the company or the product?
5. What software languages is the code written in?
6. How big is the source tree in megabytes?
 - How many files are in the source tree?
 - How many lines of code are in the source tree?
7. What is the IP policy of this Audit? (if appropriate)
 - What products/licenses do we consider Severity I, II, and III issues?
 - What products/licenses do we consider acceptable?
8. What type of deliverable is required for this Audit?

Report. See **Report** section for more information on each. Custom reports can be generated by request.

In addition to the pre-Audit questions, during this stage, teams need to create remediation plans to resolve Severity I, II, and III issues. A common mistake made by companies is to begin an audit without a well thought out remediation plan should issues appear in the scan results. Thoughtful and well-communicated remediation plans mitigate unnecessary consternation at the end of an audit.

Step Three: Conduct Code Audit

With the basic questions answered, the Palamida Consultant can begin the code audit. Timeframes for audits vary depending on size of code base and deliverable required. Typical audits can be accomplished within two weeks and range longer, depending on code size and complexity.

Step Four: Analyze Scan Results

A Palamida Consultant spends the majority of her time focusing on the analysis phase. While the Palamida Compliance Edition will automate the majority of the detection of third-party code and licenses and compares them to the company's IP policy, the Consultant begins analyzing the results of the scan, confirming third-party usage, consulting with the Technical Liaison (if needed), offer opinion on technology risks, and suggests open source and commercial software alternatives (if required).

Step Five: Report

Once the analysis phase is completed, the Palamida Consultant generates standard or custom reports as required by the IP Audit team. Standard reports include: Risk Profile, Due Diligence Forensic Report, and Remediation Assessment reports.

Risk Profile Report

The Risk Profile provides quantification of how much code is unique to the candidate, an inventory of the open source and commercial code and licenses inside the code base, and highlights of potential IP risk indicators. This report helps you make timely decisions on whether to continue pursuing a candidate.

Due Diligence Forensic Report

The Due Diligence Forensic Report provides the IP pedigree and inventory of the detected third-party commercial and open source code and licenses, detailed supporting evidence of the code similarities, and comparison of the third-party inventory against your existing IP policy. The results provide your team with actionable remediation steps for a candidate to address before deal close and/or quantifiable information that may impact your term sheet.

Remediation Assessment Report

Remediation Assessment Reports provide risk advisory for key redevelopment areas, such as open source and commercial alternatives for third-party products in question. They also provide a final inventory of all the third-party code and licenses inside the code base so you have a baseline for managing the IP integrity of the code base going forward.

Step Six: Remediate

After the audit, the IP Audit team refers to the remediation plan they outlined in order to resolve any issues that may have been discovered. If desired, Palamida has partnerships with several systems integrators and outsourced software engineering firms who provide custom software development solutions based on specific remediation requirements.

Case Studies

Case Study I – Multi-billion Dollar Technology Company

A multi-billion dollar technology company was acquiring a VoIP software company. They liked the technology and felt it would strengthen their position in the telecommunications market.

The target company's software was to be integrated into their existing telecommunications product line.

Task

The target company had provided an inventory of components used in the software; however, the acquirer wanted an independent party to review the code base. And they wanted the review done quickly and discreetly. During the due diligence phase of the acquisition, the acquiring company's legal team engaged Palamida to perform an audit of the target company's software.

The acquiring legal team provided Palamida with their IP policy. The target company provided Palamida with their code base and fielded questions regarding the product's distribution model. Palamida performed an IP audit of the target company's code base, matching it against a database of over 884,000 versions of popular open source projects, as well as the acquirer's IP policy. The audit uncovered several red flag issues based on the IP policy, including components licensed under the General Public License (GPL), an open source license that was incompatible with the acquirer's business model.

Results

The acquiring company discovered that despite the target company's best intentions to manage third-party components, several open source projects were not included in the "third-party" code folder in the source code system, nor were they listed in the original inventory list. GPL code had made its way into the target company's code base and had become an integral part of the technology. As a result of the audit, the acquiring company was able to avert potential distribution issues by having the target company replace the GPL code before the acquisition was completed.

Case Study II – A Multi-billion Dollar Entertainment Company

A Multi-billion Dollar Entertainment Company acquired a European based consumer software company with the objective to commercially license and sell the acquired product. They believed that the acquisition would give them a new OEM revenue stream from PDA manufacturers that wanted to give consumers a way to download music to their devices.

Task

During final preparations to launch the product, an astute technical team at the acquiring company noticed indicators that some of the software appeared to contain open source code that could possibly be associated with the GPL, a license that was incompatible with how the company wanted to sell and license the new product. The acquiring company engaged Palamida's Services team to perform an IP Audit on the product to verify suspicions of the extent of the new product's reliance on open source code. Scanning the code base with the Compliance Edition, Palamida discovered that a key area of the target code was licensed under the GPL, representing almost half of the overall application code. This was a significant disparity from the target's disclosure documentation during the M&A due diligence, which lists the open source licenses, and the open source licenses actually in used within the product.

Results

An IP Audit prior to the completion of the acquisition could have alleviated the problem of disclosure disparity. Moreover, an IP Audit during due diligence could have quantified the business values and risk factors for the acquiring company. Because of the substantial amount of

GPL code in the product, the acquiring company would face many restrictions and liability issues in commercializing and reselling the target product. Palamida's audit report pinpointed the risk factors of our customer's remediation plan with the acquired company. The remediation plan estimated that it would take up to 12 development man-years to re-architect the product for commercial resell. Had the acquiring company known about these legal risks during diligence, they could have cancelled the deal or at least renegotiated the purchase price. Still, discovering the licensing issues prior to product shipment saved them from certain legal problems down the road.

