

Don't open yourself to problems: Open source technology and M&A due diligence

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The collaborative nature of open source software development has shaped the way in which technologists create revolutionary tools.

From the most agile blockchain, health care, and telecommunications startups, to the world's largest banks, automotive and insurance companies, open source software is an omnipresent factor in virtually every technology-enabled organization.¹

However, the risks of using open source software should be recognized along with its advantages.

Particularly for technology companies seeking an exit event — be that through a merger, acquisition, initial public offering or other means — an understanding of potential open source software risks should be considered early in the development stage, lest the presence of an unanticipated or “infectious” license affect their future valuation.

In this commentary, we delve into open source software considerations and their potential impact in the context of a mergers and acquisitions deal.

Although open source software offers a tremendous opportunity for commercial ventures to leverage high-quality, low-bug, royalty-free software code, risk management in the use of open source software hinges on an understanding of the complex array of licensing conditions and practical implications at play.

For technologists seeking to minimize risks while taking advantage of the benefits of open source software, understanding the implications inherent in each type of license, anticipating the representations and warranties the company will have to make during the M&A process, and assembling comprehensive open source software policies and procedures are all vitally important.

I. UNDERSTANDING OPEN SOURCE LICENSING

Open source software can best be described as computer software that is made available to the general public in object or source code form under a no-cost license granting users the rights to study, change, and distribute the software with limited or minimal restrictions.²

These restrictions, as discussed in more detail below, range from relatively permissive to restrictive, and to infectious, with respect to derivative works.

'PERMISSIVE' AND 'RESTRICTIVE' LICENSES

Unlike licenses for most commercially licensed software, open source software licenses do not restrict licensees according to the technology (e.g., number of users, internal business purposes, length of use or other licensing structures).³

By using open source software to create derivative products, or functionally linking source code to an open source software library, developers subject themselves (or their companies) to conditional restrictions, depending on the terms of the license.

Rather, open source software licenses are offered subject to restrictions on the user's ability to impose conditions on the open source software's use and availability to downstream third parties.

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Notable among those restrictions are ones that limit the ability of licensees to create proprietary, non-open source derivative or linking products.

As such, many companies delineate open source software licenses between those that are permissive of downstream proprietary licensing and those that are restrictive.

Permissive, or “academic,” licenses, such as those offered by the Massachusetts Institute of Technology, Berkley Software Distribution and Apache, impose relatively few restrictions on users, allowing the software to be generally compatible with typical closed sourced business models.

These licenses allow for the free sharing of source code without requiring the licensees to license their innovations and modified versions of the software under the same terms, or worse, to make their source code public.

The MIT open source license, for example, provides that software may be used “without limitation to the rights to use, copy, modify, merge, publish, distribute, sublicense, and/or sell copies of the software.”⁴

As such, MIT open source software is a favorite of many businesses, as it may be modified to create proprietary software without requiring that the derivative work be redistributed under the original license.⁵

With this licensing model, businesses need only comply with the limited restrictions imposed by the open source license, such as the inclusion of the license terms with copies of their proprietary software, and they do not need to release their code base to the public domain.

Conversely, restrictive, “copyleft,” “viral” or infectious licenses, like the Free Software Foundation Inc.’s GNU general public license, Affero general public license, and in some cases the GNU lesser general public license, provide user restrictions that are less friendly to downstream licensees.

The most recent GPL version 3, known as GPLv3, provides, for example, that a “work based on” the open source software, or “the modifications to produce [software] from the program, in the form of source code” must meet certain conditions, including licensing the “whole of the work” under the GPLv3.⁶

This type of downstream restriction on works derived from GPL-licensed software intends to expand public access rights to the newly created software by ensuring that the freedoms guaranteed by the GPL apply to such derived works.

The infectious nature of such restrictive licenses necessitates that licensees use extreme caution with respect to how improvements, additions and/or modifications of open source software are undertaken — lest a derivative work be created that is subject to the terms of a restrictive open source license.

Parties anticipating an M&A transaction,⁷ must be acutely aware of what open source software they incorporate into their code base; which licenses govern such open source software; the compatibility of such open source licenses with other licenses; and the representations and warranties that may be required of them in the future.

II. ANTICIPATING REPRESENTATIONS AND WARRANTIES

The infectious nature of certain types of open source licenses has made many larger companies hesitant to acquire technology reliant upon code licensed under a restrictive license.

Typically, during the M&A process, an acquiring party will require that the selling party disclose the software used in connection with the licensing or sale of the company’s products/services that is licensed under any (a) “open source,” “copy left,” “freeware” or “general public license,” (b) license that is substantially similar to those listed on the Open Source Initiative’s website, (c) license that meets OSI’s “open source” definition or FSI’s “free software” definition, or (d) any Creative Commons license.

The acquiring party may also require the selling party to identify the license applicable to each item of open source software and the manner in which it is incorporated into, linked with, distributed with or used in the development with any of the selling company’s products.

Similarly, the target company may need to warrant that it has not used, modified, distributed, incorporated or linked to any open source software that does or could require distribution or disclosure of any source code for any company products.

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Acquirers require such a warranty because open source software licenses that impose material limitations, restrictions or conditions on the acquirer’s right to distribute any of the target company’s products may torpedo the value of the technology — or the deal itself.

Unfortunately, we have seen this happen. During M&A due diligence, an acquirer learned that its target company had embedded software licensed under a viral open source license into its purportedly proprietary software.

As a result of the specific license language for the open source software the target licensed, and the manner in which the target used it, the source code for the target’s *entire* product arguably had to be made available to the public at no cost under that same viral open source license.

Although there were potential work-arounds and solutions to the issue, the buyer got cold feet and walked away from the deal.

As this example shows, not properly anticipating, documenting and analyzing open source issues can have profound implications on an M&A transaction.

Technical due diligence regarding open source software is burdensome enough⁸, but the time, cost and complexity are all exacerbated if the target is disorganized and unprepared.

Further, when the target does not have its ducks in a row, the buyer often becomes more skeptical. This feeds further diligence and leads to tighter and additional representations and warranties.

Open source representations may be treated as fundamental to a transaction where the underlying technology is the primary revenue driver of a target's business. This can result in unpleasant ramifications for the target, including increased escrow expectations and length of indemnification survival.

With this in mind, it is of the utmost importance that target companies understand the contractual terms under which each third-party component of their code is licensed, the manner in which the licensed code is utilized, and each license's impact on, or compatibility with, other open source licenses used in their technology portfolio.⁹

For example, depending on the licensor's definitions of "derivative work" and "distribution," the manner in which a derivative work is created — whether through dynamic linking, static linking or compiling the code itself — may have an impact on the licensee's downstream obligations.

Many companies have engaged third-party vendors, such as Black Duck, to perform scans of its code base for open source software usage and license compliance.

These vendors can identify open source software utilized in a code base and match such software with the applicable license. The company's technical team and legal advisers can then review the reports provided by these vendors to remediate any identified issues.

Companies beginning to explore bringing on new institutional investors, lenders or a full M&A exit team should consider the value such a vendor engagement can have in heading off the many questions that will arise during the due diligence process.

Though compliance with these types of representations and warranties may seem burdensome, effective open source software policies and procedures (especially when adopted early on) can significantly lessen those burdens.

III. OPEN SOURCE SOFTWARE POLICIES AND PROCEDURES

For even the most sophisticated technology companies, the infectious nature of the GPL and other restrictive licenses can create problems.

With many relying on public code repositories available on websites like GitHub and Stack Exchange, there is a high potential for a developer to unknowingly utilize code that is accompanied by a restrictive license.

This is especially so when target companies mischaracterize the licenses under which they have licensed their code, or when code is uploaded without a clear license regime.

Although larger companies often have sophisticated software management systems in place to prevent such restrictively licensed code from infecting their ecosystem, smaller organizations often lack such resources.

In those instances, smaller organizations can (and should) effectively manage open source software integration risks by implementing policies that set out procedures for the use of open source software.

Such policies should, at a minimum, require:

- (1) Proactive disclosure as to any current or proposed use of open source software and maintenance of an ongoing list of all such usage, so as to better prepare management for representations in the future;
- (2) That all proposed new use of open source software be accompanied by an approval from senior members of the development and management teams, so as to better protect against unintentional adoption of restrictively licensed code;
- (3) Management of accepted use cases for previously approved open source software license; and
- (4) Legal review of all inbound open source software licenses.

Although many organizations find these obligations overly burdensome, an ounce of prevention is truly worth a pound of cure with respect to open source software.

If a company finds itself unable to maintain formal open source software management procedures, it should at least consider educating its development team on the risks and importance of proper open source hygiene.

Another valuable tool is the creation of a white list of approved licenses/use-cases. A white-list will not provide all of the benefits of the formal procedures, but it should limit the amount of cleanup a company may need to perform during an already chaotic M&A due diligence process.

Notes

- ¹ See Bob Lord, Embracing Open Source Could Be A Big Competitive Advantage for Businesses, FastCompany, June 17, 2019, opining that the "vast majority of Fortune 500 companies consume open source at some level or another."
- ² See Open Source Initiative, definition of "Open Source Software," for a more comprehensive definition. <https://bit.ly/2IXJFZs>.
- ³ See Matuszesky, John & Quittmeyer, Peter, Computer Software Agreements: Forms and Commentary §13:36, Westlaw.
- ⁴ The MIT License, Open Source Initiative. <https://bit.ly/33w0dkK>.
- ⁵ Ayala Goldstein, Open Source Licenses in 2020: Trends and Predictions, WhiteSource, Jan. 23, 2020, <https://bit.ly/394DIEX>.
- ⁶ GNU General Public License version 3, Open Source Initiative. <https://bit.ly/2xSwl6C>.

⁷ These considerations also apply to companies seeking financing (e.g., venture money), but the focus of this commentary is M&A activity.

⁸ A recent survey of participants involved in financial technology (FinTech) M&A reported that 76% of participants found conducting open source software due diligence to be “very” to “quite” difficult. See Fintech M&A: Acquiring a competitive edge in financial services, Ropes & Gray and Mergermarket, Sept. 2019.

⁹ For example, incompatibility between licenses can create complicated legal hurdles if the code contains open source elements licensed under two different restrictive licenses, and the licenses contain contradictory requirements.

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