IN-DEPTH

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Preface

The fourth edition of *The Technology M&A Review* tells a story of changing times in the global tech M&A market. As we step into the editorship, we look back to late 2021, when the tech M&A market was engulfed in frenzied activity, before focusing on the events of 2022, which led, in many major jurisdictions, to the most challenging M&A market for over a decade.

While the first half of 2022 saw continued activity in the tech sector, accounting for approximately 25 per cent of all M&A activity in the first half of 2022, the full-scale invasion of Ukraine in February 2022, persistent supply shortages, comparatively high levels of inflation and rising interest rates started to take their toll. Global tech M&A volumes fell as the year progressed, but that does not tell the whole story – M&A activity remained resilient in certain subsectors, such as software, and new technologies quickly became a focus of investment. Artificial intelligence took the world by storm as big tech companies targeted the most promising early-stage and scaled-up businesses in the space. Quantum technology remains an area that promises so much and has been the subject of some notable deal activity.

Geographical distinctions should also be made. Geopolitical upheaval impacted some markets more than others, and as capital flows are realigned in the wake of the Russia–Ukraine war, it is perhaps no surprise to see reports of notable acquisitions in and from the UAE, growing investor confidence in the wider Middle East's tech sector and the resurgence of sovereign wealth funds in the global tech ecosystem. Similarly, practitioners in Egypt and Türkiye were upbeat in their reports of tech M&A activity throughout the period in review.

A consistent theme throughout the book is the impact of regulation, whether built on antitrust considerations or a desire to screen foreign direct investment. While these regulatory developments generally place greater control in the hands of regulators (such as the new investment screening regimes implemented by many EU Member States), we have also witnessed alternative perspectives, such as the desire to kick-start foreign direct investment in Egypt in recent years. On a global level, we cannot ignore the increasing role of antitrust regulators in scrutinising tech transactions, and as investment screening on national security grounds becomes the norm, companies at the forefront of technology have become the focus of the attention of regulators. The UK is not alone in struggling to balance its ambitions to become a science and technology superpower with the need to better regulate tech deemed sensitive from a national security perspective. Uncertainty also hangs over entire subsectors, with regulation struggling to catch-up with AI; it will be several years before we know whether an adequate balance can be found between maximising the opportunity and mitigating any negative impact on society.

Ultimately, economic and regulatory headwinds remain, and at the time of writing, the horrific events in Israel may signal the dawn of a new regional crisis at great human and economic cost. While international politics is influential on markets and eminently difficult

to read, we remain optimistic in the medium term. Following a valuation reset, with interest rates reaching their peak and new technologies continuing to emerge, we look forward to the final quarter of 2023 and the new year. In the editors' view, there is continued enthusiasm for high quality assets within a tech M&A market that is constantly evolving and driving truly game-changing developments.

Andrew Boyd and Gary Brown
Morrison Foerster
London
November 2023

Chapter 8

United Kingdom

Stuart Alford, Simon Arlington and Emma Bosworth[1]

I INTRODUCTION

We have witnessed a time of transition for the global economy, with the UK by no means spared. The country recovered well from the covid-19 pandemic, in part due to government support and an efficient vaccine roll-out,[2] with investment into high tech and recovery sectors fuelled by ultra-low interest rates. However, by mid-2022 the UK's tech M&A boom had been hit by a tidal wave of adversity. The full-scale invasion of Ukraine in February 2022 was compounded by persistent supply shortages and comparatively high levels of inflation, in turn combated by rising interest rates. The UK was left narrowly avoiding a recession by the end of the year.[3]

While this may appear gloomy, the software space remained resilient, and opportunities persisted for international investors in the UK public markets. There are also increasing signs that the UK has turned a corner, as interest rates move towards their peak;[4] valuations have been subject to a substantial reset and may give rise to increasing opportunities, and certain tech subsectors (particularly AI) have been insulated from the wider constraints on deployment of capital.

Economic, geopolitical and regulatory challenges remain; yet the authors' view is that a brighter future lies ahead as we approach the final quarter of 2023.

II YEAR IN REVIEW

The tech sector is increasingly seen as a bellwether for the wider M&A arena. The largest tech companies set the pace and scale of action in the market, with indices, like the Nasdaq, indicating confidence in areas from quantum computing and AI to online retail, consumer electronics and smartphone development. Towards the end of 2021, in the UK and further afield, the tech M&A market continued the frenzied trajectory set earlier in the year. The

1 Stuart Alford and Simon Arlington are partners and Emma Bosworth is of counsel at Morrison Foerster. The authors would like to thank all of their colleagues who contributed to this chapter, including Charlotte Walker-Osborn, Steven James, Hattie Chessher, Marie-Claire Strawbridge, Julia Kotamäki, Annabel Gillham, Mercedes Samavi, Oliver Spratt, Trevor James, Harry Anderson, John Burge, Chiraag Shah and many others.

2 United Kingdom Economic Snapshot – OECD.

3 UK Economic Outlook – KPMG UK.

4 Economic Update: Have interest rates peaked? (parliament.uk).

sector continued to brush aside the effects of the covid-19 pandemic, and in some quarters, such as telehealth and Web3, actively benefited from what many perceived would be the long-term effects of the pandemic. 2022 was a different story.

While the first half of 2022 saw continued activity in the tech sector, accounting for approximately 25 per cent of all M&A activity in the first half of 2022,[5] it is no exaggeration to say that growing economic and geopolitical pressures had a significant and detrimental effect on confidence – and consequently, on tech M&A – particularly in the UK and mainland Europe. By the close of 2022, global tech M&A volumes had dropped off – and the UK was no outlier. While activity in the sector decelerated fast, with notably fewer transactions in the markets most inflated due to the covid-19 pandemic, M&A among software businesses remained resilient at the right price, spearheaded by private equity sponsors looking for predictable returns and proven business models. Whether directly or indirectly, private equity-backed M&A activity in the software sector accounted for over half of all transactions by value in 2022.[6]

Of all private equity-backed M&A, the relative popularity of take privates grew most significantly across 2021 and 2022. Successive IPOs, with disappointing results for their public shareholders, coupled with numerous failed SPACs and de-SPAC transactions, helped to condemn the public markets to their worst year since the prior *annus horribilis*, 2008. Despite moves by the UK government to facilitate listings in the UK, there were only 45 IPOs in London in 2022, representing a 62 per cent decline on the year before; and those listings raised only £1.6bn in total.[7] While tech IPOs made up roughly a quarter of all IPOs globally, the volumes were still significantly lower than 2021. As the public markets continued to be hammered hard by the turbulent macroeconomic conditions, and share prices faced repeated corrections, the private markets fared little better. Even the most ambitious high-growth unicorns, previously eyeing an era-defining IPO, began to look elsewhere to realise value.

In early 2022, when the market capitalisations of long targeted and well-known public companies dropped sufficiently, some falling to significantly less than their recent IPO prices and others significantly less than their NAVs, private equity sponsors and well capitalised corporates pounced. In the first quarter of 2022, in the tech space, there were roughly £5 billion of UK take privates announced, including the £2 billion acquisition of Informa PLC by Mubadala and Warburg Pincus, the acquisition of Forterro by the Partners Group and the acquisition of Nucleus Financial Group by HPS Investment Partners.[8] Even complex institutional carve-outs looked to be money spinners until the end of the first quarter of 2022. However, as 2022 continued, the fallout from the war in Ukraine and lack of available acquisition finance took its toll. Although private equity sponsors were able to draw upon direct lenders to fill some of the financing gap, M&A activity – particularly in the tech sector, with the largest gulf in valuation expectations between buyers and sellers – dropped off.

The good news is that the lack of available financing (whether due to commitments made for the acquisition of Twitter (now X), Activision Blizzard or otherwise) is not a permanent feature of the tech M&A market. Most commentators, lawyers, bankers and corporate development executives see significant loosening in the financial markets from the third quarter of 2023. If public market valuations remain depressed, so long as SaaS

5 PwC: Global M&A Trends in Technology, Media and Telecommunications: 2023 Outlook.
6 PwC: Global M&A Trends in Technology, Media and Telecommunications: 2023 Outlook.
7 Data provided by Refinitiv.
8 GlobalData Technology Intelligence Center.

business models continue to perform, tech M&A ought to rebound strongly. Private equity remains flush with dry powder, and tech companies, or corporates looking to bolster their tech capabilities will be able to capitalise on lower valuations. Distressed sales might hail new opportunities for some of the more flexible and quick-footed buyers.

In addition, the correction in public markets is thought to have largely run its course. Multiples have fallen to more realistic levels, and newly listed public companies yet to confidently indicate a path to real profitability have already suffered significant damage. With the switch from an acquisition by Nvidia in early 2022, to the pursuit of a significant new listing, Arm should shine a light on the IPO market once more, and the market will be able to more confidently value some of the largest, exciting, and most innovative tech companies based in the UK and abroad.

All of this is without mention of the biggest single development within the tech sector in 2021. In November 2021, OpenAI removed the waiting list for GPT-3, and in doing so turbocharged any tech company with AI capabilities. This significant development has restored confidence in some forgotten stocks and buoyed private company valuations where AI (or advanced machine learning, particularly employing well developed large language models) is a central part of their business.

III LEGAL AND REGULATORY FRAMEWORK

i Merger control

Continued scrutiny of tech mergers

In the latter half of 2021 and throughout 2022 we witnessed continued high levels of CMA scrutiny of mergers in the tech space, with several parallel reviews taking place alongside other global regulators, including the EC and the US agencies (such as *Microsoft/Activision Blizzard* and *Broadcom/VMWare*), and the conclusion of four merger inquiries (including *NortonLifeLock/Avast* and *Nvidia/Arm*).

The CMA's appetite to expand the limits of its share of supply test to assert jurisdiction continued unabated, with one of its most high-profile interventions, namely *Facebook/Giphy*, being made on the basis of the parties' combined share of the supply of apps or websites that allow searches for GIFs by users in the UK, despite Giphy generating no revenue outside of the US.[9] The CMA's broad discretion over jurisdiction has firmly been upheld by the Competition Appeal Tribunal (*Sabre/Farelogix*, May 2021).[10]

Divergent outcomes

The period under review saw the most significant divergences yet in outcomes between the CMA and the EC in parallel reviews post-Brexit. The CMA cleared the *Facebook/Kustomer* merger at Phase 1 (with the EC referring it to Phase 2) and then blocked the *Cargotec/*

9 See the final report issued following the outcome of the CMA's investigation into the Facebook/Giphy merger: https://assets.publishing.service.gov.uk/media/635017428fa8f53463dcb9f2/Final_Report_Meta.GIPHY.pdf.

10 See the full text of the *Sabre Corporation v CMA* judgment: https://www.catribunal.org.uk/sites/cat/files/2021-05/1345_Sabre_Judgment_210521.pdf.

Konecranes merger, despite the EC clearing the same deal with remedies. This trend continued when the CMA prohibited the completed *Facebook/Giphy* merger – the same deal later being approved with remedies in Austria.

A key driver for these divergent outcomes (which is now a firmly established trend) is partly explained by a fundamental difference of opinion between the CMA and other regulators as to how best to resolve competition issues arising from mergers. Unlike the EC, the CMA is deeply sceptical of behavioural remedies, leading it to block deals where there is no structural solution.

Expanded jurisdiction: competition reform

The Digital Markets, Competition and Consumer Bill (the DMCC),[11] announced in spring 2022, as well as the proposal to introduce a (differentiated) Digital Markets Act in the UK, will introduce revised merger control thresholds. In particular, the DMCC includes the introduction of a new threshold to address a perceived gap in the CMA's ability to capture 'killer acquisitions'. This will give the CMA jurisdiction to review acquisitions where: (1) a party has a share of supply in the UK of at least 33 per cent; (2) that same party has UK turnover exceeding £350 million; and (3) the other party is either a UK business or body that carries out part of its activities in the UK or supplies goods or services to persons in the UK.[12] The intention is to allow the CMA to review conglomerate and vertical mergers as well as those raising horizontal overlaps, which is a clear limitation of the current share of supply test, which has, to date, held back the CMA from further expanding its approach to jurisdiction.

The DMCC will also introduce a new safe harbour for 'small mergers' while increasing the CMA's existing target turnover threshold to call in mergers from £70 million to £100 million,[13] and maintaining the combined share of supply threshold at 25 per cent.[14] Separately, the DMCC will introduce for the first time a mandatory pre-completion, suspensory merger reporting regime in the UK where buyers having 'strategic market status' (SMS) cross certain voting/shareholding thresholds (15 per cent, 25 per cent and 50 per cent) in a target with a UK nexus and where the consideration is at least £25 million.[15] Following notification, the CMA will have five days to decide to open an investigation under the regular merger control regime.[16] SMS firms will need to consider this in their deal timelines, together with the possibility of engagement with the CMA.

ii Investment screening

The UK's investment screening regime forms part of a continually evolving European regulatory landscape in which foreign investment control is now widespread. By the end of 2022, across Europe, 25 of the 27 EU Member States either had foreign direct investment

11 The most recent form of the draft DMCC, as at the time of writing, can be found at: https://publications.parliament.uk/pa/bills/cbill/58-03/0350/220350.pdf. .

12 Schedule 4 Section 2(5) of the DMCC.

13 Schedule 4 Section 2(2) of the DMCC. .

14 Schedule 4 Section 2(3) of the DMCC.

15 Section 56 of the DMCC.

16 Section 61 of the DMCC.

(FDI) regimes in place or were in the process of implementing them. A thorough, multi-jurisdictional investment screening analysis is now essential when engaging in global transactions in tech-related sectors.

Overview of the UK's investment screening regime

2022 saw the first full year of operation of the UK's FDI regime, which came into effect in January 2022, pursuant to the National Security and Investment Act 2021 (NSIA). The NSIA grants the UK government broad jurisdiction to investigate (or 'call-in') transactions involving entities carrying on activities in the UK, where these raise national security concerns, including post-completion.[17] It also provides the UK government scope to impose remedies to address any concerns identified, including blocking the completion of a transaction, or requiring a completed transaction to be unwound.[18]

A mandatory and suspensory notification requirement applies under the NSIA where a transaction involves crossing certain shareholding thresholds in entities carrying on activities in the UK that fall within the scope of one of 17 sensitive sectors. These include a number of high-tech sectors representing areas of the economy that the UK government (like many governments worldwide) is keen to safeguard. These include advanced materials, advanced robotics, AI, computing hardware, cryptographic authentication and quantum technology.[19]

To fall within the definition of 'carrying on activities in the UK',[20] a target does not need to be incorporated in the UK – a sales office, branch or other presence may suffice. Importantly, a target that does not immediately appear to have activities relevant to national security may still be within scope of the mandatory notification regime, as the 17 key sectors are broadly construed. A variety of activities undertaken by a target in the UK (even limited to pure supply) can bring a transaction within scope, and in practice, the application of the NSIA can be a technical and complex exercise.

The consequences of failing to make a mandatory filing where triggered are severe and include not only that the transaction is deemed void but also potential criminal and civil fines.[21]

Transactions outside the scope of the NSIA mandatory notification regime, including asset deals, can be voluntarily notified.[22] This may be an appropriate course of action where the parties expect that a transaction will give rise to 'noise'; for example, the target's activities are sensitive, or the buyer's identity is considered high-risk.

17 Section 1 of the NSIA.

18 Section 26 of the NSIA.

19 The 17 key sectors are set out in the Schedules to the National Security and Investment Act 2021 (Notifiable Acquisition) (Specification of Qualifying Entities) Regulations 2021 (the NSIA Regulations).

20 Section 6(4) of the NSIA.

21 Sections 32 to 36 and 40 to 47 of the NSIA.

22 Section 18 of the NSIA.

Enforcement during 2022

In 2022, the UK government called-in and issued final orders on 17 transactions under the NSIA.[23] Of these, six fell within tech-related sectors, including semiconductors, computing hardware and AI. Of these six, four were blocked or unwound, and two were cleared – only one unconditionally.[24]

Remedies issued in the conditionally cleared transaction (*Sepura/Epiris*) included measures to protect sensitive information and technology, a requirement to maintain strategic capability in the UK and provision of certain services to the UK government, as well as provision of inspection and audit rights to the UK government.[25]

The prohibited transactions were all acquisitions by Chinese ultimate owners, highlighting scrutiny of Chinese buyers as well as transactions involving assets with potentially dual-use commercial/military applications. This trend mirrors that of other European FDI regimes.

IV KEY TRANSACTIONAL ISSUES

i Corporate form and transaction structures

Private M&A

In the UK, the most common corporate form is a private company with limited liability, which is separate and distinct from its shareholders. In private M&A transactions, buyers will either acquire a target by purchasing its entire issued share capital or purchasing all, or materially all, of its assets. A share purchase is overwhelmingly the more popular structure, unless there are deal-specific reasons to carry out an asset purchase, such as tax treatment or a desire to leave behind unwanted liabilities. In the current market, asset purchases are more commonly encountered in distressed deals, such as 'pre-pack' administration sales.

Public M&A

Public takeovers can be carried out through the following structures:

a schemes of arrangement; and

b takeover offers.

Schemes of arrangement are generally the most common method for acquiring public companies, provided that the target board is supportive of the scheme. In 2021, the vast majority of announced public acquisitions were completed using the scheme structure, which reflects a growing trend for their use, and requires approval of at least 75 per cent of holders of

23 The UK government publishes final orders issued online, at: https://www.gov.uk/government/collections/notice-of-final-orders-made-under-the-national-security-and-investment-act-2021.

24 The six transactions included: *Flusso Ltd/Shanghai Sierchi Enterprise Management Partnership* (cleared); *Newport Wafer Fab/Nexperia* (unwound); *Sepura Ltd/Epiris LLP, Epiris GP and Sword bidco GP* (cleared with conditions); *Manchester University Technology/Beijing Infinite Technology Company Ltd* (blocked); *Pulsic Ltd/Super Orange HK Holding Ltd* (blocked); and *HiLight Research Ltd/SiLight (Shanghai) Semiconductor Ltd* (blocked).

25 See the final order setting out the remedies issued in relation to the *Sepura/Epiris* transaction at: https://www.gov.uk/government/publications/acquisition-of-sepura-ltd-by-epiris-llp-notice-of-final-order.

each class of share in the target at a 'scheme meeting' organised by the target company (and a majority by number of shareholders). If this consent threshold is met, the scheme will be put before the court for its approval.

Alternatively, a bidder can make a direct offer to shareholders to acquire their shares. For an offer to be successful and become unconditional, at least 50 per cent of the target shareholders need to accept the offer; however, a bidder will only be able to acquire 100 per cent of the shares with certainty – by triggering the 'squeeze out' regime to force non-accepting shareholders to sell – if at least 90 per cent of the voting rights (not owned by the bidder) are acquired.

Takeovers of UK public companies (and, in certain circumstances, private companies) are predominantly regulated by the City Code on Takeovers and Mergers. The Code is designed to ensure that shareholders are treated equally and to avoid market disruption. The precise jurisdictional criteria are complex, so when considering the acquisition of a UK company, a buyer will need to consider whether the Code applies and take advice as to the conduct of any offer or scheme of arrangement.

ii Consideration and pricing

Locked box

In competitive sale processes and transactions where the sell-side holds the bargaining power, including those with private equity sellers, locked box pricing mechanisms continue to prevail.

A locked box structure involves the parties agreeing a final purchase price based on a set of pre-agreed accounts, often the most recent audited financial statements. The underlying purchase agreement contains provisions that seek to prevent the seller from stripping value out of the business (known as 'leakage') between the date of the locked box accounts and completion. In the event of any leakage, the seller will indemnify the buyer for it. In addition, in acknowledgement of the sellers running the business during the locked box period (from the date of the locked box accounts until completion), a daily amount, accruing over the locked box period, is typically paid to the seller on completion.

Completion accounts

An alternative pricing mechanism, more commonly used by US non-private equity or financial sponsor buyers is the use of completion accounts as a form of price adjustment. On completion, a preliminary purchase price will be paid that is subsequently adjusted post-completion. Following completion, bespoke accounts are drawn up (based on a pre-agreed methodology) by either the seller or the buyer to show the actual value of the target on completion. Any difference between the preliminary purchase price paid and the final purchase price shown in the completion accounts is then settled between the parties.

Earn-outs

As the tech M&A market has cooled, the divergence between the price sellers expect to receive and the price buyers are prepared to pay has widened. Consequently, (together with vendor financing) earn-outs, where part of the purchase price is contingent on the achievement of certain goals, have been increasingly relied upon to address buyers' concerns around overpaying in challenging market conditions.

iii Acquisition agreement terms

The share (or asset) purchase agreement is the definitive agreement setting out the terms of a tech M&A transaction and its execution. The agreement will address, among other things, the type of consideration, price adjustments, warranties and indemnities, conditions to completion, pre-completion covenants and deal protections.

While the core elements of a purchase agreement remain largely consistent across many jurisdictions, the format and terms may vary significantly. In the UK tech M&A market, the authors are increasingly encountering more buyer-friendly, 'US style' deals, with US purchase agreements adapted for use in the UK market and governed by English law.

iv Warranties, indemnities and insurance

Warranties

Warranties are used by a buyer both to ascertain information and to apportion risk. The latter applies where a statement is untrue and no qualifying disclosure has been made in respect of it. Unlike US market practice, warranties in UK transactions are rarely given on an indemnity basis. Instead, the buyer must be able to show loss was suffered as a consequence of the statement being untrue and any recovery is usually subject to certain limitations, although claims under fundamental warranties (i.e., title and capacity) will usually be carved out. Typical limitations include:

a time limits: A buyer will typically only be able to bring a claim within a certain period of time (typically 12 to 24 months for business warranties and between four and seven years for tax warranties);

b financial limits:
- *de minimis* threshold: Any claim below a certain threshold (typically 0.1 per cent of the consideration) will be excluded;
- basket threshold: Applying together with the *de minimis* and commonly a tipping basket; and
- maximum liability cap; and

c subject to disclosure: Warranties will be given subject to any matters fairly disclosed in the disclosure letter. What constitutes fair disclosure has been largely settled. If a disclosure meets that standard, a buyer will not be able to recover in respect of a relevant claim.

Warranties are given at a specific time. If there is a gap period, the parties will typically negotiate the extent to which the warranties are repeated and whether the seller can disclose against them.

Indemnities

Where a buyer has knowledge of an issue or a specific concern, a warranty will not be appropriate protection. Instead, a buyer will seek to include an indemnity to cover that risk crystallising and causing loss. Indemnities are usually structured as a right to receive pound-for-pound compensation for any loss suffered. It is also typical for a specific tax indemnity to be negotiated under which the seller provides the buyer with an indemnity relating to any tax liabilities arising during the seller's ownership of the business, although this may be provided by an insurer under a synthetic policy if none is offered by a seller.

W&I insurance

The use of warranty and indemnity insurance (W&I) continues as a fixture of UK M&A transactions, and, despite issues obtaining coverage in 2020 due to market saturation, the desire to utilise W&I in transactions remains strong. Private equity and financial sponsor sellers often insist on the use of W&I, but large corporates, particularly those with complex data flows, pharma companies and energy companies prefer not to use W&I on the buy-side because the areas of coverage most important to them are often those more likely to be excluded by the insurers.

In the UK, the seller typically gives the warranties, with liability backed off by buy-side W&I, but in the private equity market, management teams will be asked to give the warranties on the same basis (aside for the fundamental warranties), given management are considered to be closest to the day-to-day running of the business – and hence better placed to give the warranties or disclose against them. In the tech market, it can sometimes be a struggle for the W&I insurers to cover all IP and data security risks. However, with proper preparation and sufficient information, sufficient coverage ought to be achievable.

v Financing

Where transactions are financed other than through cash on balance sheet, evidencing certain funds remains a core element of UK market practice. On the equity side, this may take the form of an equity commitment letter provided by a financial sponsor. On the debt side, ensuring that the lenders are committed at signing, with limited conditionality that remains within the buyer's control, is essential for a debt-financed buyer to negotiate on a comparable footing to a cash-rich corporate acquirer.

Cheap money has been a staple of the past few years, particularly in the tech M&A space, to finance spiralling purchase prices. However, as economic headwinds picked up and inflation rose, traditional lending transactions became increasingly difficult and materially more expensive. Where lending was possible, lenders showed increased scrutiny and a recalibration of risk appetite. They placed greater consideration on debt covenants and focused on robust security packages, which is understandable when much of the value of tech companies lies in intangible assets.

This shift in attitude meant that buyers who could afford to pay in cash (i.e., larger corporates) held an advantage over both other buyers and sellers who were less able to find alternative buyers. In several cases, cash-funded acquisitions have been partially refinanced with debt at a time of the buyer's choosing, without the pressure of raising funding alongside transaction-driven timelines. More creative approaches to financing have also been seen in the market, and there has been a continued increase in the use of private debt funds to provide financing.

vi Tax

Research and development

The UK has two regimes for research and development (R&D) tax relief, one for small and medium enterprises (SMEs) and one for large companies. Typically, eligible tech start-ups can avail themselves of the SME R&D tax relief regime and claim R&D SME tax relief in the form of an additional deduction in calculating their profits. They may also claim R&D tax credits as cash if the company is loss-making. In the context of an acquisition, any unclaimed

R&D tax credits may be of significant value to a buyer or seller. Proposed reforms to the R&D tax relief regime mean it is vital to properly agree and document this complex area of tax law.

Broadly, a company is an SME for R&D tax relief purposes where it meets certain limits on the number of employees and a financial test. Where a company exceeds the employee test or the financial test because it has been taken over by another enterprise and is no longer independent, the company will cease to qualify as an SME for the accounting period in which the change occurred; and it is possible to lose the SME R&D reliefs for that accounting period. Where one company is taken over by another, the two entities are 'linked enterprises' for the purpose of the R&D tax relief regime.

Typically, to preserve the SME R&D reliefs, the accounting reference date of the company can be changed to end just prior to completion. Recent proposals will also introduce, for accounting periods beginning on or after 1 April 2023, a transitional procedure whereby, if an enterprise was treated as an SME and a linked enterprise becomes 'large', the first enterprise will continue to be treated as an SME for that accounting period as well as the following accounting period, reducing the burden of amending accounting reference dates in the group context.[26]

The UK tax authority (HMRC) has also highlighted concerns regarding abuse and fraud under the SME R&D scheme.[27] As such, part of the reforms are designed to help counter errors and fraud, including requiring additional information to support a claim, details of any tax advisers involved in advising on the R&D tax claim, and endorsement of the claim by a senior officer of the company. Companies will be required to notify HMRC of an intention to claim R&D tax relief.[28]

Especially considering the economic climate, it is possible that HMRC will be more active in challenging claims made under the R&D tax regimes and for disputes to arise. It would be prudent to not count on reliefs or credits being granted and for buyers to include sufficient warranty and indemnity protection in any purchase agreement. Moreover, tax compliance obligations should be widened to catch the new obligations on companies making R&D tax claims.

Pillar two

The Organisation for Economic Co-operation and Development (OECD) has made significant progress on its two-pillar solution to reform the international tax framework. The OECD published model pillar two rules in December 2021,[29] with the UK releasing draft legislation in July 2022 to bring the rules into UK law.[30] The pillar two rules set out a minimum level of taxation on multinationals with annual revenues over €750 million, which

26 Finance Bill 2022-23, Schedule 1, Part 6 (published 20 July 2022), available at https://www.gov.uk/government/publications/research-and-development-tax-relief-changes.

27 HM Treasury, R&D Tax Reliefs Report (published 30 November 2021), available at https://www.gov.uk/government/publications/rd-tax-reliefs-report.

28 Finance Bill 2022-23, Schedule 1, Parts 3 and 5 (published 20 July 2022), available at https://www.gov.uk/government/publications/research-and-development-tax-relief-changes.

29 OECD, Global Anti-Base Erosion Model Rules (Pillar Two) (published 20 December 2021), available at https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.htm.

30 Finance Bill 2022-23, Part 1 (published 20 July 2022), available at https://www.gov.uk/government/publications/introduction-of-the-new-multinational-top-up-tax.

clearly is applicable to many international tech firms. These rules introduce a set of rules that permit implementing states to impose top-up taxes on parent entities that have an interest in entities located in other jurisdictions, where the group's profits arising in these jurisdictions are taxed at below the minimum rate of 15 per cent.

These are notable developments, and any financial due diligence of potential targets will need to consider several factors, including whether the acquisition will bring the target in scope of the pillar two rules, and, if so, the impact this will have. In addition, the novel nature of the rules presents further difficulty when it comes to transaction documentation in allocating the risk of paying future top-up taxes between buyer and seller, or allocating the risk of new jurisdictions implementing the rules.

vii Due diligence

While the benefits of comprehensive due diligence is widely recognised, tech buyers will place particular emphasis on understanding the target's IP portfolio, data monetisation, data protection and data security issues as well as other regulatory compliance. In addition, IP and employment due diligence will run side-by-side, to ensure that IP created by an individual in the course of their employment falls under the ownership of the employer.

Sellers can prepare themselves for the due diligence exercise by ensuring that their knowledge is up to date, and all information is well presented and supported. A properly considered vendor due diligence exercise will assist a process, although buyers (and W&I providers) will always want to review matters themselves to varying degrees.

For further information regarding key due diligence focus points, see also Section V for IP protection, Section VI for data protection and security and Section VII for employment issues.

viii Cross-border issues

While the UK has a regulatory framework for export controls impacting those who export or trade in goods, software or technology (including data, information and technical assistance) in certain sensitive areas, there are few cross-border complications for overseas acquirers that have not otherwise been addressed in this chapter.

V IP PROTECTION

IP naturally continues to be a key focus of M&A in the tech sector. It is essential to understand what IP a target owns and uses, both in terms of protecting the assets of the business and in terms of any material third party IP used and necessary for it to trade. At a core level, it is important to assess both registered and unregistered IP, the nature and extent of any licensing arrangements in place, whether there are any encumbrances that affect the rights and the existence of any pending or threatened disputes. In the case of more novel technology, scrutiny in this area can be more cumbersome. In many countries around the world, there is still changing law around the IP position concerning AI, for example.

Whether the IP protecting a target company's technology is registered (for example, in the form of a patent) or unregistered (such as the copyright which subsists in any software, or a trade secret), it will be essential to verify that the target is the owner of the relevant rights and that the individual inventors of the technology no longer own the rights in the core assets (see also Section VII on employment issues) or, alternatively, that the core asset licence rights derive the rights and value necessary for the ongoing business once bought.

If it is asserted or appears that an asset is a trade secret (which may be the case for, for example, certain source code or algorithms), the buyer will need to establish the technological, legal and security measures that have been taken to keep the asset a secret in order to verify whether it will be treated as a trade secret in law. In the UK, there are two parallel regimes giving protection to trade secrets, namely the common law of confidentiality and the Trade Secrets (Enforcement, etc.) Regulations 2018. If the right kind of protective measures are taken, trade secrets can be protected indefinitely (unlike patents or copyright, which are only protected for the limited periods prescribed by statute).

If the relevant technology was created as part of a collaboration with a third party, then the buyer will need to review the agreements in place with the third party and the underlying terms governing how the IP is to be owned, any restrictions on how it is to be used and the profits to be shared.

In software transactions, it remains important to verify the extent to which any open-source software (OSS) has been used in writing any code, and if so, what the OSS licence terms are that apply to this use and whether the target complies with these terms. If the use of the software is subject to any 'copyleft' open-source licences, then this could cause significant issues if compliance with these terms would require the disclosure of all code in relation to the asset (depending on the relevant OSS license). If that were the case, the target would likely need to consider whether it will be possible to reengineer its code to exclude the OSS, and how extensive a task this would be, given this can involve significant time and expense. As a result of the risks posed by OSS, buyers will want to seek appropriate contractual protections on the use of OSS and compliance with the relevant licence terms, and they may also wish to engage specialist OSS consultants to analyse the software of interest and flag any OSS code for further review.

It is increasingly recommended to look at any cross-sectoral regulations and guidelines for any non-compliance that may affect the value of a target or technology, its ability to trade or operate and areas that may require rectification. This can be very technology-specific. There are a plethora of new regulations and guidance affecting AI, the internet of things (IoT)/smart tech and autonomous vehicles, for example, with increasing regulation being a trend that the editors expect to continue. ESG diligence is also of critical importance to many technologies, so that a current understanding of ESG credentials can be ascertained and, if needed, a pathway set out for future compliance with impending ESG laws, emissions targets and energy considerations.

As AI continues to be a developing and complex area, particularly following the significant growth in popularity of generative AI systems and large language models, there are additional considerations for both buyers and sellers. There are complex issues to consider regarding the protection of works created by AI as copyright works, the ownership of any copyright in works generated by AI systems without human intervention and whether computer implemented inventions are capable of patent protection, all of which is the subject of debate. One other key issue is whether the training of any AI system has involved any acts of infringement by the copying of third party works; there is scope for a substantial increase in disputes in this area. From a due diligence perspective, as part of the IP and data usage review, it is important to understand what data the AI has been trained on and whether the requisite rights have been given under contract or if there is a permitted right of use under law.

In the UK, there have been government proposals under consideration to expand the scope of a permitted act in the Copyright, Design and Patents Act 1988, which allows text and data mining (TDM) and could therefore apply to the training of AI systems. Currently,

the exemption only applies to TDM for non-commercial research purposes and is of limited use to AI innovators. In 2022, it was announced by the UK government that, following a consultation, the scope of this TDM exemption would be extended to cover TDM for any purpose.[31] The UK Intellectual Property Office is now instead focusing its efforts on drafting a voluntary code in relation to copyright and AI, which will seek to balance the interests of rights holders and AI innovators.

In view of these issues, buyers or users of AI systems will be well advised to seek warranties confirming that training data that feeds these systems has been appropriately licensed, and to seek broad indemnities for any third-party IP infringement arising from a failure to obtain any such licences. Sellers will of course want to address these issues before marketing a company and should present a clear narrative to potential buyers.

VI DATA PROTECTION AND SECURITY

The role and prominence of a target's data protection and security practices has emerged as a priority in almost all tech M&A. Tech businesses tend to have data at their heart, and the acquisition of companies harnessing vast troves of personal information and digital assets has become increasingly common. This has reshaped the way sellers approach the target's compliance with data protection laws, and prospective buyers have focused increasingly on stress testing data protection compliance in due diligence.

i Data security

Prioritisation of cybersecurity by UK businesses is more important than ever before, with government data[32] indicating that 39 per cent of UK businesses had identified a cyberattack between 2021–2022. While recent trends show that businesses in the tech sector are particularly susceptible to cyberattacks and security incidents or breaches, UK companies in all industries face a similar threat.

In the context of tech M&A transactions, a technical review of the target's data security will be essential, but legal due diligence is also necessary to determine whether the target's written policies and procedures align with the technical setup. As an example, given the rapid rise in security incidents, a target stating in its incident logs that it has no known incidents could even be considered a red flag, as it may be a sign that the target's detection system is flawed.

During the due diligence phase, prospective buyers should pay close attention to a target's security practices and breach history as well as any cybersecurity insurance cover. This involves a thorough review of the target's data security policies, incident response plans, data breach logs, penetration testing reports, security audits, training and systems. In addition, checks can be made against the public complaints/enforcement register[33] maintained by the UK data protection authority to establish whether there is any trend of complaints or action against the target.

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31 Artificial Intelligence and Intellectual Property: copyright and patents: Government response to consultation – GOV.UK (www.gov.uk) It was later confirmed by the Minister for Science, Research and Innovation in a House of Commons debate in February 2023 that a general TDM exemption will not be proceeding.

32 Cyber Security Breaches Survey 2022 – GOV.UK (www.gov.uk).

33 Data protection complaints – data sets | ICO.

Ultimately, regulators have made it clear that buyers who purchase a company with any historic security incidents or breaches could be on the hook for enforcement action; lack of awareness will not be an immediate defence.

Additionally, it is important to understand technical security within a system. If it is found lacking but a decision is taken to proceed in any event, a buyer could be required to expend a significant amount of time and money to rectify any flaws. Contamination of existing systems merged with target systems belatedly found to be insecure can cause serious disruption and even large-scale security incidents. Buyers will want to ensure that the technology assets and business are secure and in compliance with legal obligations; not simply those required currently, but also those proposed for the future.

ii Disruptive technologies

Targets operating within the IoT, AI and augmented and virtual reality (AR/VR) spaces have seen increased regulatory focus – both in terms of regulatory direction and instruction (e.g., codes of practice, guidelines and recommended practices) as well as enforcement action in relation to their data processing. Disruptive technologies often involve the collection and utilisation of vast amounts of personal information or other data, which can significantly increase the complexity of data protection considerations, IP and information law considerations.

There is no substitute for proper and thorough due diligence of the target's data protection practices and governance structure. This will flush out any red flags in what the target says it does versus what the target actually does with personal information. The most common outcome of due diligence is that the target (particularly if it is a fast-growing tech scale-up) does not have sufficient data protection documentation or processes to comply with its legal requirements. However, when novel technologies such as AI or biometrics are involved – especially if they are the core part of the target's business – the due diligence process requires not only a standard review of the target's data assets but also the innovative technologies that power them.

To do this effectively, it is crucial that prospective buyers understand both the fundamental aspects of their own business models, including how they plan to amalgamate their own data processing activities with the target's activities, as well as the array of regulatory frameworks that may become applicable to them as a result of acquiring the target's technology and data assets.

iii UK International Data Transfer Agreement

Both buyers and sellers looking to make transfers that are caught by UK data protection law to certain third countries must put in place new contractual arrangements. In 2022, the UK government introduced (1) the International Data Transfer Agreement (IDTA), and (2) the International Data Transfer Addendum, which is a shorter, alternative version of the IDTA. The Addendum works by incorporating the current version of the EU Standard Contractual Clauses (EU SCCs) to make them effective for transfers from the UK. Under the IDTA's transitional provisions, any contracts concluded on or before 21 September 2022, using the prior version of the EU SCCs will be a valid means of exporting personal information from the UK until 21 March 2024, provided that processing operations remain unchanged.

VII EMPLOYMENT

A common feature of tech M&A transactions is that much of the value of a business will sit with the founders and other key employees and, in turn, the IP that they create. However, it is not uncommon for tech companies to have limited or inadequate documentation in place. Additionally, the continued growth of the remote working environment, combined with the prevalence of 'employer of record' (EOR) organisations – essentially, a third-party organisation who will employ individuals in one country to provide services to an end user 'employer' in another country – has allowed businesses to operate more easily across several jurisdictions. Tech companies regularly engage a global workforce, with many employees and consultants located outside the company's primary centres of operation in lower cost jurisdictions. In many cases, these overseas workers will either be engaged as contractors or employed through an EOR. These factors give rise to employment law considerations for buyers in tech transactions, which are highlighted below.

i Founder and 'key employee' contracts

A primary area of employment due diligence for any buyer is confirming that a target's employees are employed on appropriately drafted employment contracts that contain the necessary protections for the employer, particularly around the protection of confidential information; IP assignment; and post-termination restrictive covenants. However, in many cases involving start-up and scale-up tech companies, targets will either not have any written employment contract in place with founders (or other key individuals); they will be employed on a basic form of contract (which provides limited protection to the employer), or simply engaged as contractors. This should be considered at an early stage by buyers, including whether to require founders to enter into appropriately drafted employment contracts as a condition to completion.

Where founders or key individuals at the target are engaged as contractors this could also give rise to historic tax and employment status risks, particularly with HMRC implementing the new 'off-payroll' working rules with effect from April 2021. Appropriate warranty and indemnity protection should be considered to address these risks.

ii Intellectual property rights

As much of the value in any tech transaction will pertain to the target's IP, understanding and confirming IP ownership is another key area of due diligence in any tech transaction. While English law gives an employer automatic ownership of most IP rights created by its employees,[34] this is not the case where the IP is created by a third party, such as independent contractors and consultants, as well as employees employed through an EOR. Buyers must, therefore, pay particular attention to the IP provisions in a target's employment agreements and its agreements with any third-party contractors or consultants and EORs to ensure that IP is assigned to the target. While many EORs will put in place IP assignment provisions between the employee and the EOR and the EOR and the target, which provide that any IP created by the employee will become the target's property, particular care should be taken

34 The Patents Act 1977, The Copyright, Designs and Patents Act 1988, The Registered Designs Act 1949 and The Copyright and Rights in Databases Regulations 1997 (SI 1997/3032) provide employers automatic ownership of patents, copyright, database rights, unregistered designs and registered designs in works created by employees in most circumstances.

when reviewing these provisions, especially where the employees are located outside the UK, in which case local advice should be sought. To further protect buyers in this respect, a well drafted IP assignment clause should be included in the purchase agreement.

iii Post-termination restrictive covenants

It is well-established that the English courts tend to take a restrictive approach to the enforcement of post-termination restrictive covenants for employees, and such restrictions must, therefore, be clearly drafted to ensure they go no further than is reasonable to protect the employer's legitimate business interests and are tailored to each employee. This is, therefore, another key area of employment diligence, particularly in the context of founders and other key employees, who could substantially harm the target's business if they were to leave and set up or join a competitor business.[35]

iv Global workforce; the growth of the EOR

As many tech companies employ a global workforce – either by engaging workers as contractors or employing through an EOR – buyers should consider engaging local employment counsel in the impacted jurisdictions to review and advise on the contractual arrangements in place and, more broadly, to advise on any particular risks or challenges that could arise out of such an arrangement, including whether the arrangement could fall foul of local 'employee leasing' or other similar laws.

The employment or engagement of individuals in overseas jurisdictions could also create a 'taxable presence' in such jurisdictions, and so local tax advice might also be required to evaluate whether such a presence has been created and how this might impact the target.

v TUPE and the automatic transfer of employees

Although, as noted above, share purchases remain the most common transaction structure in tech M&A, buyers should bear in mind the potential impact of the Transfer of Undertakings (Protection of Employment) Regulations 2006 (TUPE), which could result in the automatic transfer of employees to a buyer in the context of an asset or business sale. If TUPE applies to a transaction, employees of the target based in the UK who are assigned to the assets or business being acquired will automatically transfer to the buyer under TUPE and the buyer will inherit these employees on their current terms and conditions of employment (with limited scope to amend those T&Cs) as well as any historic employment liabilities. The seller and buyer will also have to inform and consult with employee representatives regarding the proposed transfer. Equivalent legislation to TUPE exists across the EU, and in other jurisdictions globally, so local advice should be sought where a target has a global workforce. Buyers should ensure that appropriate indemnity protections are included in any purchase agreement to address the risk of TUPE (or equivalent legislation) applying to a transaction.

35 The UK Government has confirmed its intention to amend legislation to include a cap on non-compete clauses in employment to a period of three months' from termination of employment. It is unclear when any such legislation will be implemented, and this will not impact other post-termination restrictions, such as non-solicitation and non-dealing clauses. See further: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1156211/non-compete-government-response.pdf.

Even if the underlying transaction is not structured as an asset sale, it is possible that TUPE could be triggered in the event of any pre- or post-completion employee reorganisation processes resulting in the transfer of employees from one group entity to another, so this should also be factored into any structuring decisions from the outset.

VIII SUBSIDIES

While certain elements of the UK's grant funding ecosystem remain in development following the Brexit transition period, there are several sources of grant funding available to emerging companies, compatible with the UK Innovation Strategy's focus on boosting private sector investment and making the UK a global hub for innovation.[36] The main sources of grants for start-ups are UK Research and Innovation (UKRI) and the UK's national innovation agency, Innovate UK; government departments including the Department for Science, Innovation and Technology (DSIT); and, on a more regional level, councils and local enterprise partnerships (LEPs).

In a tech M&A context, if ownership of a company changes during a grant-funded project, Innovate UK has the right to suspend or terminate the grant. Innovate UK can also recover the value of all grant monies paid from the beginning of the project.[37] As a general principle, it is important that the terms of any grant funding agreements are reviewed during the due diligence process to ascertain whether the funding provider needs to be notified of an actual or potential change of control and whether the grant funding may be repayable at completion of the transaction.

In general, relatively low rates of corporation tax, a reliable judiciary, an educated workforce and a strong base of IP law have proven to be sufficient to attract tech investment without the need for large-scale subsidies. That said, it remains to be seen how the UK (and its European neighbours) will compete with the US Inflation Reduction Act.

See also Section IV on tax and accounting issues, which provides an update on R&D tax relief.

IX DISPUTE RESOLUTION

The parties to tech M&A transactions must consider what they perceive to be the best jurisdiction and forum for submission of disputes arising in connection with their transaction. Even at a simplistic level this involves considering several interrelated variables, including the jurisdiction of the parties; jurisdiction of relevant assets; deal subject matter; transaction value; enforcement requirements and time period for procedures; governing law of the agreements; and confidentiality concerns. The parties' respective bargaining power and likely need for enforcement options often dictates the outcome.

English courts remain a popular jurisdiction choice for M&A transaction documents (particularly where the governing law is England and Wales), owing largely to the long-standing reputation of its judiciary and experience with complex business disputes, including in the

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36 UK innovation strategy (https://www.gov.uk/government/publications/uk-innovation-strategy-leading-the-future-by-creating-it/uk-innovation-strategy-leading-the-future-by-creating-it-accessible-webpage).

37 Terms and conditions of an Innovate UK grant award (published January 2023), available at https://www.ukri.org/wp-content/uploads/2023/02/IUK-15022023-Terms-and-conditions-of-an-Innovate-UK-Grant-Award-Jan-2023-FINAL-with-Header.pdf.

tech sector. However, many parties increasingly recognise that England's standing as a forum for disputes where enforcement in the European Union is a possibility has diminished following Brexit. The UK has not entered into equivalent jurisdiction treaties to replace the EU regimes that allow for swift or automatic enforcement of judgments. English court judgments therefore receive the same treatment in EU Member States as those rendered by courts in other non-EU states. This increases the chances of delay and further costs, and it may even result in a *de novo* review of the dispute with a different outcome.

Accordingly, market practice has seen parties increasingly turn to arbitration (often seated in England) as their forum of choice for resolution of disputes arising out of M&A transactions in the tech sector. Arbitration offers parties several benefits, including the ability to appoint specialised tribunals with requisite technical experience or knowledge, tailored proceedings (including expedition as required) and straightforward international enforcement of awards through the New York Convention on the Recognition and Enforcement of Arbitral Awards (which now has over 170 party states). Well drafted multi-tier dispute resolution clauses can also direct smaller, or localised, disputes to the correct court jurisdiction, with more systemic (and commercially sensitive) disputes with international enforcement implications being referred to confidential arbitration. These clauses require careful drafting and negotiation to avoid unintended consequences, such as unenforceable jurisdiction clauses.

X OUTLOOK AND CONCLUSIONS

While fears of rising interest rates and the prospect of global recession loomed large as we moved into 2023, inflation has started to fall and interest rates are expected to reach their peak in the coming months. Although the war in Ukraine continues to cast a shadow over Europe, in the authors' view, market conditions should pick up as we approach the final quarter of 2023.

The valuation reset that took hold in 2022 will lead to opportunities for investors, both in private equity but also for corporates that do not need to tap the debt markets. With the pound still relatively weak, listed companies remain vulnerable to takeovers from overseas acquirers. Tech companies that have accelerated their growth during an era of cheap money may find themselves susceptible to opportunistic buyers in distressed deals.

Consultations on radical reforms to the UK listing regime may result in greater flexibility for tech companies through a relaxation of the eligibility criteria and continuing obligations on listed companies. However, it remains to be seen whether these reforms will counter the magnetism of the US markets, which have offered higher valuations for tech companies and a deep pool of capital. If companies return to UK public markets, then this may impact the volume of tech M&A exits in the medium term.

Certain sectors are likely to remain buoyant, with investment in the booming AI sector set to continue apace as tech companies seek to secure their position by acquiring the most promising early-stage and scaled-up businesses in the space. While AI is likely to remain the hottest ticket in town, the ability to monetise rich data from many tech deals will be critical, and a wider recovery in deal activity in areas ranging from foodtech and agritech to healthcare appears to be on the horizon.

The authors envisage that the main legal themes and developments for the upcoming period will be as summarised below.

a Regulatory scrutiny (both antitrust and FDI) of tech M&A transactions will continue to be a crucial factor in transaction planning and timetables, including where transactions fall outside traditional merger control thresholds: substantive risk assessment will be key.

b The continuous developments in the tech space will continue to stretch regulators, particularly in the field of AI. The UK government will need to balance its strategic vision to make the UK a science and technology superpower with the need to better regulate and build public trust in AI.[38]

c Ensuring that any tech assets or businesses that are bought or sold carry with them the requisite IP rights and protections will be critical, especially those concerning cutting edge technology.

d Following significant debate and review over 2021 and 2022, the EU–US Data Privacy Framework (DPF), and the UK extension to the DPF are set to enter into force, building on their predecessors, Safe Harbor and Privacy Shield, to establish a new framework for transatlantic transfers of personal information.

e In challenging market conditions, more in depth due diligence, increased conditionality and earn-outs are likely to increasingly become part of the M&A toolbox.

f More buyer-friendly, 'US style' deals, will continue to feature in the UK market as US tech acquirers flex their muscles and seek greater protection in the face of increased regulation and longer gap periods to completion.

38 AI regulation: a pro-innovation approach – GOV.UK (www.gov.uk).