8 Issues AI Firms May Encounter As M&A Action Accelerates

By **Scott Schwartz and Kishan Barot** (October 3, 2024)

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For the past several months, increased merger and acquisition activity has been brewing in the artificial intelligence space. The major tech companies, unfazed by high interest rates and economic uncertainty, have shown a willingness to pay higher and higher purchase prices for talent and technology in order to gain market influence.

Meanwhile, many AI startups have spent years wedged between high development and computing costs on one hand and disproportionately small revenues and fierce competition on the other.

Now, the cost of legal compliance is expected to increase, as new laws and regulations are being passed to govern AI — including 17 laws from California in the past month. These factors continue to justify increasing consolidation by strategic players in AI.

This summary addresses the eight key issues we anticipate will arise for AI companies and their acquirers as they engage in M&A activity.

1. Wide Valuation Swings

The task of valuing AI companies will be a difficult one due to the competitive landscape, the lack of useful comps in a novel industry, the low number of companies surpassing revenue, financing and cost hurdles, and the high interest exhibited by mature companies looking to gain leverage, technology and human capital through acquisitions.

The result of this disruption can lead to fluctuations in valuations and bidder uncertainty when calculating acquisition prices.

One factor that may contribute to this phenomenon is the lack of a proven business model for newer AI companies. Emerging players in the AI space can struggle differentiating themselves and gaining customers, particularly against market leaders like OpenAI, Microsoft Corp, Amazon.com Inc. and Google LLC.

An added factor that could depress valuations, especially for smaller acquirers, is litigation risk, specifically the risk of manifold intellectual property claims arising out of the target's approach to data sourcing.

At the same time, acquirers and targets are aware that AI is rapidly becoming more effective and can clearly be profitable at scale: more compute, more data and more users produce more valuable results. Technologies produced by new AI companies may have novel science and highly skilled founders, but they can benefit from the excess computing power, data, business organization and user bases that can be deployed by strategic acquirers.

Speaking about his company's acquisition of the cybersecurity startup Splunk earlier this year, Cisco Systems Inc. CEO Chuck Robbins noted the promise of training Splunk's AI on

Cisco's massive data stores. This strategy, Robbins observed, could be deployed by just about any major company sitting on historic data:

> [Artificial intelligence] is a revolution that actually favors incumbents with large datasets and that's unique. A lot of times in the past, the big technology waves have allowed smaller companies to compete and disrupt markets. That's still a risk, but large companies with large datasets that use AI effectively are going to increase their competitive differentiation.[1]

Private equity firms are no doubt aware of these synergies and have been attempting to anticipate and capitalize on them. Some firms, like Blackstone, have publicized and acted upon their strategies to acquire or invest in data centers and other companies supplying ancillary elements of AI.

Foreseeably, private equity firms may seek to capitalize on the value of their investments by reselling these strategic ancillary targets to large, strategic acquirers attempting to build out and compete in AI services and product development.

Parties engaging in M&A transactions involving AI should be aware of the push and pull between the risks and upside potential of emerging AI companies, and the companies that support them, as they analyze and consider the value of such companies.

2. Earnouts and Related Litigation

Valuation challenges affect not only the upfront price of a transaction, but also the terms of any postdeal earnout. Given the slow economic climate, an increasing number of transactions are being structured with payment of a portion of the purchase price through postclosing performance earnouts. Earnouts increase the risk of postclosing disputes between the transacting parties.

For example, in 2023, Anduril Industries, an AI-based autonomous aircraft manufacturer, was sued for $15 million in damages related to the alleged nonperformance of an earnout obligation owed to the seller of a company it acquired. The lawsuit accused Anduril of intentionally hampering advancement of the target's project's postclosing and causing it to miss milestones that would trigger Anduril's earnout payment obligations to the seller.

The possibility of disputes, especially for AI companies with longer time horizons for substantial revenue generation and profitability, should be carefully considered by both parties negotiating an earnout component to their M&A transaction.

Allegations of earnout tampering are possible against strategic acquirers that merge AI startups into their existing operations. Special attention should be given to the language of the earnout provisions and the metrics by which the earnout amount will be determined.

3. Heavily Negotiated Letters of Intent

The common obligation for a seller to grant exclusivity to an acquirer for a period following the execution of a letter of intent transfers significant leverage from the seller to the buyer during negotiations. Longer exclusivity periods are already quite common due to detailed financial and legal due diligence review periods and lengthier definitive deal documents.

But lengthy exclusivity and diligence review periods can have an outsized adverse effect on an AI target due to the rapid evolution of the AI marketplace. The relevance and value of AI companies are subject to more fluctuation and risk during longer exclusivity and diligence review periods than more traditional companies.

Furthermore, large strategic acquirers have the ability to intentionally overinvest in AI in an attempt to seize market share and can lock up key players in exclusivity periods even if they do not ultimately acquire the AI target.

In such a case, the buyer would be able to neutralize competitors by pursuing lengthy exclusivity periods while still developing its own AI platforms. Savvy sellers' counsel should attempt to negotiate more detailed deal terms into letters of intent beyond basic deal elements in order to reduce the number of open points to negotiate during the exclusivity period, and should attempt to shorten and renew periods of exclusivity rather than encourage the client to agree to lengthy periods of exclusivity at the outset.

4. Buyer-Friendly Agreement Provisions

AI is exciting for many reasons, one of which is the high price tag some emerging AI companies have commanded. To compensate for these lofty valuations, buyers may pursue aggressive and protective deal terms in the transaction documents.

For instance, consider the copyright and other novel legal issues implicated by the training of AI. Noninfringement representations (or no-undisclosed-liability representations) could be breached where the target lacks the intellectual property rights to the data used to train their models.

Buyers may insist on expansive representations regarding the target's right and ability to operate and control its intellectual property, as well as longer survival periods for intellectual property representations.

The buyer may also push for sandbagging provisions, which would create liability for sellers for breaches of representations even in the event that the buyer was aware of such breach or due diligence issues prior to the closing.

Both the acquirer and the target should be aware of how the inherent risks of AI investments will be managed in an M&A transaction, especially given the reality of the acquirer's leverage during the exclusivity period. The generative AI boom involves many legal unknowns, seemingly none of which will stall acquisitions today. Rather than wait for these legal issues to be resolved, buyers will simply manage risk directly within the deal terms.

5. Significant Chain-of-Title Diligence

It is elementary that parties to an M&A transaction engage in due diligence to ensure that the target actually possesses a clear title to the assets at the center of the deal. But where an acquisition involves the transfer of data used to train AI — i.e., potentially petabytes of text entries, images or video files — this can become an exceedingly detailed exercise.

Data used by AI companies may be scraped from the internet and premised upon a claim of fair use, or data may be licensed from third parties, albeit based upon a retroactive terms of use that the Federal Trade Commission has claimed is unlawfully deceptive.[2] The complexity of chain-of-title diligence in the AI context only reaffirms the likelihood that buyers will seek expansive indemnification protection in the deal terms.

6. Talent Retention Agreements

Talent is clearly a potent differentiator in AI. In fact, the so-called Googlers who wrote the seminal paper that kick-started all things generative AI, entitled "Attention is All You Need," went on to found many of the industry's most notable startups including:

- Essential AI, founded by Ashish Vaswani and Niki Parmar;
- Cohere, founded by Aidan Gomez;
- Sakana AI, founded by Llion Jones; and
- Inceptive, founded by Jakob Uszkoreit.

And now, Google has recently decided to pay $2.7 billion, a staggering amount, to rehire one of these authors, Noam Shazeer of Character.AI, in addition to obtaining a license to Character.AI's proprietary technology.[3]

Suffice to say, any acquisition of an AI company will involve a consideration of how to retain the target's highly skilled programmers and other technicians. To accomplish this, parties may consider any number of incentives, including retention bonuses, restricted stock units and change of control payments, as well as noncompete and nonsolicitation agreements. Consider paying out such bonuses or benefits a specified number of months after closing, so as to ensure talent remains with the target company postclosing.

7. Post-Publicity Litigation

As discussed, some AI companies face significant litigation risk, particularly with respect to copyright infringement claims. Smaller startups with relatively small pockets and user bases may be accustomed to existing without these risks, due to their size and limited assets.

However, the period between the public announcement of a deal and its closing could trigger increased interest in the AI company target by plaintiffs firms or competitors, either of whom could assert claims or file lawsuits in advance of closing in order to pursue a settlement with the smaller company prior to it being acquired or to disrupt the transaction.

A claimant could also believe that the larger strategic acquirer would be more inclined to push for an agreement to settle such a claim in order to proceed with a smooth closing. Considering all of these potential risks, parties should use every effort to keep the deal and all information related to the deal confidential prior to closing of the transaction.

8. Antitrust Scrutiny

AI has captured the attention of lawmakers and regulators worldwide. This spotlight will affect M&A deals in untold ways, but one aspect is immediately apparent: As strategic acquirers buy more and more companies in the AI space, the specter of antitrust enforcement becomes unavoidable.

The FTC, for instance, opened this year by announcing investigations into "three separate multi-billion-dollar investments: Microsoft and OpenAI, Amazon and Anthropic, and Google and Anthropic."[4]

Regulators promised to assess "whether investments and partnerships pursued by dominant companies risk distorting innovation and undermining fair competition."

More recent reports indicate that the U.S. Department of Justice is presently investigating Nvidia Corp.'s April acquisition of the startup Run:ai for antitrust concerns. Were the message to the industry somehow unclear, the department also hosted a conference at Stanford University in May, titled "Promoting Competition in AI,"[5] and in July, the FTC issued a joint statement with European regulators on competition concerns attendant to the AI industry.[6]

In an attempt to avoid regulatory oversight, some large tech conglomerates have opted for a transaction structure that avoids the typical stock or asset acquisition by arranging an "acqui-license," whereby the AI technology is licensed, rather than sold, and the top employees at the AI startup are hired, leaving behind the target entity as primarily a licensor collecting royalties and avoiding a change-of-control of the target.[7]

Conclusion

Regardless, the inference is clear: The federal government is closely monitoring M&A activity in the AI space, especially when the acquirer is a dominant technology company. The risks posed by this scrutiny must be assessed on a case-by-case basis.

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