AI and M&A

Taking opportunities – managing risks

Briefing

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I. Artificial intelligence: transformation and transactions

Artificial Intelligence (AI) is one of the key technologies of the present and the future. As the most prominent example, ChatGPT-4's launch for general use illustrates the enormous progress in AI development and its transformative potential for business and society.

The sudden and often unforeseen emergence of AI tools, which are now broadly used by businesses opens up a wealth of unimagined applications, for example in automated customer interactions, predictive maintenance, autonomous driving, cancer diagnostics, data-driven investment decisions, individualised insurance tariffs and fully interconnected smart cities. Yet the full spectrum of its impact on business remains largely uncharted territory. This applies equally to the economic opportunities associated with AI technologies as well as the potential risks, such as AI-supported hacking or cyber fraud.

Although the relevance of AI is widely recognised, there is widespread uncertainty about the possibilities for strategic integration and application in operational processes and value chains and how to implement them efficiently.[1] This affects not only corporate management, but also the workforce, which is concerned about the threat of job cuts and staff replacement by (strike-unable) AI. These must be addressed by executive management, possibly with the full involvement of the employee representative bodies. However, it seems clear that the emergence of AI requires the development of new business strategies to increase efficiency, quality and productivity. Many companies are therefore faced with the question of how to utilise the enormous potential of AI. As the develop-

ment of AI-based technology is neither cost-effective nor quick to implement, the alternative of purchasing AI-based technologies is becoming increasingly attractive ("make or buy").[2] In this respect, investments in and acquisitions of AI companies as part of M&A transactions are playing an increasingly important role.

It is not just the global market for AI that is developing rapidly. Meanwhile Germany also has a growing field of successful AI companies, including Aleph Alpha, Brighter AI, Nyonic and Celonis. With 508 AI start-ups and an average funding amount of USD 14.8 million,[3] Germany stands for innovative excellence in the AI sector and is therefore of great interest for domestic and international investors.

Investors have to face the question which opportunities and risks arise from the transaction process. At the same time, the field of Artificial Intelligence is currently the subject of intensifying legal regulation on the national, supranational and international level. Transaction and advisory practice must take this regulatory framework into account.

II. Regulatory approaches in the field of AI

It seems logical to address a cross-border phenomenon such as AI at an international level. In April 2021, the EU Commission presented a draft AI regulation, which is known as the "AI Act". The draft, that was published before the widespread launch of ChatGPT-4 – which brought the public debate on the need for AI regulation to a whole new level – has been the subject of intense discussion at a political level, in specialist circles and among economic players. If the AI Act now comes into force as expected,[4]

[1] This is one of the findings of the empirical study on the resilience of German companies conducted by GERMANTECH with the support of Noerr, EY, the Hasso Plattner Institute and Ada Health, focusing on the central role of AI, among other things, see https://www.companyresilience.com/de/, accessed 26.03.2024

[2] M&A wave rising in hot AI market | TechTarget, accessed 26.03.2024

[3] https://www.appliedai-institute.de/hub/2023-ai-german-startup-landscape, accessed 26.03.2024

its provisions will in general be applicable after a transitional period in 2026.

The AI Act will establish preventive prohibitions and compliance requirements for providers and users of AI systems. In the future, the risk class into which AI systems will be categorised should be checked in advance. Depending on the findings, different levels of protective measures will be necessary. Graduated requirements will be applied ranging from a complete ban on certain practices to exemption from specific compliance obligations.

Depending on the risk classification, the AI Act will contain

— provisions on testing AI systems,

— transparency of operation and functionality,

— documentation of processes,

— selection of training data,

— observation and

— the possibility of human intervention ("human in the loop").

A conformity) procedure may also have to be completed.

Accordingly, the costs for the companies concerned will increase in future, which could make certain AI-based business models uneconomical or less profitable. In some cases, there is a risk that this form of regulation will stifle innovation and the use of AI as such. For example, it has been criticised that the competitive impact of the AI Act due to significantly increased compliance costs – especially for SMEs – has not been sufficiently taken into account.

In parallel to the AI Act, the EU is working on a directive on the (civil,

non-contractual) liability for AI systems.[5] If compliance with due diligence requirements is not ensured in the design and construction of AI systems, there is a risk of liability, which the directive will strengthen and harmonise. In addition to the preventive compliance requirements of the AI Act, companies working with AI systems would consequently be held liable for damages.

Every AI application is based on data. The EU's legislative acts must also be taken into account with regard to the availability and usability of data. The European regulation on harmonised rules for fair access and user rights (often referred to as the "Data Act" in analogy to the AI Act) was adopted in December 2023.[6] It aims to create better access and usage for non-personal data. In addition, general data protection law, in particular the provisions of the General Data Protection Regulation (GDPR), will have to be complied with, which of course only applies if personal data is involved.

Finally, a whole bundle of EU legal acts on information security may need to be observed. In addition to the Cybersecurity Act, the NIS Directive and the Cyber Resilience Act should be mentioned in particular. Especially if third-party certification is required or extensive concepts for security incidents have to be drawn up, this means a considerable amount of work for the company concerned.

III. M&A in the AI sector[7]

1. Market development

Due to the weaker overall economic development, the number of M&A transactions worldwide fell in 2023. However, AI-related deals are booming, bucking the general market trend: global private investment in AI fell for the first time in 2022 by 26.7% year-on-year to USD 91.9 billion. Overall, however, there was an 18-fold increase compared to 2013.[8] The total deal volume in the AI sector also increased by 43% in Q1 2023 compared to the previous quarter (USD 8.9 billion) and by 175% compared to Q1 2022.[9]

[4] See the status report by Merkle, "Neue Spielregeln für künstliche Intelligenz", Börsenzeitung of 3 February 2024.

[5] Commission proposal for a directive in COM(2022) 496 final of 28 September 2022 (EUR-Lex - 52022PC0496 - EN - EUR-Lex (europa.eu)), accessed 26.03.2024

[6] Data Regulation: Council adopts new law on fair data access and use - Consilium (europa.eu), accessed 26.03.2024

[7] Information according to Artificial Intelligence Index Report 2023 - Stanford University Human-Centered Artificial Intelligence AI Index Report 2023 – Artificial Intelligence Index (stanford.edu), accessed 26.03.2024

[8] AI Report p. 14.

[9] M&A activity related to artificial intelligence decreased in the technology industry in 2023 (verdict.co.uk), accessed 26.03.2024

It can be assumed that M&A activity in AI has only just begun, especially as many AI companies are only gradually reaching market maturity.[10]
In addition to developers of generative AI and so-called large language models, AI elements are increasingly entering almost all segments of the tech industry, such as HealthTech, FinTech and PropTech. In addition, there are noticeable special economic trends in individual areas. For example, the current tense security situation (Ukraine, Israel) means that the growing defence & security sector is another industry with enormous financial strength that is interested in AI and, in particular, in acquiring AI start-ups. Given the increasing risk of democratic elections being jeopardised by (often also AI-generated) disinformation, particularly with a view to the upcoming US presidential election in November 2024, there is also growing interest in innovative AI companies in the field of information security.[11] In the segments mentioned above, competition among buyers and investors for promising targets is expected to intensify.

In addition to the acquisition of AI companies by strategic buyers or financial investors (private equity) as part of M&A transactions, in which the buyer acquires all shares or at least a qualified majority of the target company, AI-based business models are playing an increasingly important role in the area of venture capital investments. Venture capital investors have been on the lookout for the "next big thing" in the field of AI, and not just since the "big bang" in the field of generative AI with the launch of ChatGPT-4 by OpenAI, which was founded in 2015 and could reach a valuation of up to USD 100 billion in the next financing round. As a result, AI-based business models are increasingly attracting the attention of prominent US VCs such as Sequoia Capital and Andreessen Horowitz, as well as investors focused on the European market. According to a comprehensive quantitative study, the proportion of VC-financed "early stage" start-ups with an AI/machine learning business model is estimated to be around one-third globally at the end of 2023.[12]

The majority of private investment continues to come from the US, followed by China. German companies are also benefitting, as demonstrated by the third-largest private AI investment in 2022 of USD 1.2 billion in the German consulting firm Celonis and the financing round for Germany´s flagship AI company Aleph Alpha with a volume of around USD 500 million in November 2023. The revolutionary potential of AI suggests that this positive trend will continue, as the acquisition of AI companies enables rapid access to industry-specific expertise and is therefore a decisive competitive factor.

2. AI companies in the transaction process

There are roughly two aspects to corporate transactions: First, the due diligence of the target company prior to the actual transaction, including a validation of the valuation on which the deal is based, and second, the negotiation and drafting of the legal transaction documents. Both aspects are relevant for the acquisition of minority shareholdings by VC investors as well as for M&A transactions.

2.1 Characteristics of due diligence

The due diligence review of the target company from a technical, commercial, legal and tax perspective is a crucial part of every corporate transaction. It serves to obtain an overall picture of the company and to subject all value-creating factors to a critical review. It is necessary in order to calculate the profitability of the transaction, identify risks, reduce information asymmetries and determine synergy potential.

Special risks when acquiring AI companies

From a legal perspective, a whole bunch of potential risks can be identified along the AI-driven value chain that need to be taken into account in a corporate transaction involving AI. The new requirements of European digital regulation are of particular importance here, as they can result in severe penalties for violations. In the case of the AI Act, for example, these can include fines of up to 7% of the annual global turnover of the company concerned.

A rough distinction can be made between risks arising from the use of AI tools, which can potentially occur at any company, and risks arising from

[10] M&A wave rising in hot AI market | TechTarget, accessed 26.03.2024
[11] Q4 2023 Information Security Report | PitchBook, accessed 26.03.2024
[12] 2023 VC Emerging Opportunities | PitchBook, accessed 26.03.2024

the target company's development of its own AI.

The first group includes issues such as

— the rights to the output generated by AI tools,

— liability risks when using AI systems,

— (future) compliance with user obligations under the AI Act,

— the existence of any legal or technical restrictions on the use cases pursued with the AI tools,

— the resilience of the target company with regard to cyber security and data protection compliance,

— compliance with the requirements for resilience physical security of so-called critical infrastructures (KRITIS)[13] and

— any additional sector- or country-specific requirements.

This short list illustrates the complexity that needs to be managed for truly insightful due diligence. Close coordination between legal, regulatory and technical experts is essential here.

The subject area is even broader in the context of due diligence of target companies developing AI products or AI processes themselves. From a legal perspective, this raises questions about

— the ownership of the AI system (e.g., when using so-called open source components),

— the rights to the training data used by the AI,

— (future) compliance with provider obligations under the AI Act,

— liability management within the company including product safety compliance and

— the existence and structure of infrastructure contracts relating to the use of graphics processing units (GPUs) required for the operation of the AI.

In general, the challenge is that potential risks in AI companies can usually only be identified by the buyer or investor on the basis of an in-depth examination of the technology and operational processes. This raises a number of questions that are not part of a due diligence process for "conventional" companies.

For example, there are various cases where AI start-ups only claim to have a fully automated, self-learning system, while in fact many of their processes still run according to static specifications. Pre-transaction due diligence may also uncover risks related to the target's data management and compliance procedures, such as risks related to the type of data the target company processes. It is also unclear whether and to what extent there will be property-like rights to data in the future. This touches on a key issue when considering the main product of an AI company, as its value is often derived from its data sets and data analytics tools. Accordingly, the rights to the models, data and their "outputs" should be reviewed in the transaction process, which requires expertise in the areas of IP, data rights and data protection. This is the only way to categorise the opportunities of the transaction and the AI capabilities of the target company and to ensure that the rights can be transferred or co-acquired in the desired manner. In particular, clarifying the legal status of training data can be complex and uncertain. Training data may be subject to third-party rights, may infringe third-party rights or may have been acquired unlawfully. This can jeopardise not only the use of the training data and the generation result itself, but also the ownership of the algorithm as such, which was developed and improved using this training data. These difficulties can be exacerbated by what is often referred to as the black box problem: the fact that it is often not possible to explain exactly how an AI system is designed and works.

[13] KRITIS umbrella law from (October) 2023, see BMI - Legislative procedure - Draft law to implement the CER Directive and strengthen the resilience of critical facilities (bund.de), accessed 26.03.2024

Buyers and investors in AI companies also face the risk of the future legal and ethical status of an AI system. It should be noted that the law itself is subject to constant change and adapts to economic necessities, changing values and considerations of political expediency, as the current regulatory dynamics at national, European and international level outlined above show. In this respect, a legally protected data processing system may lose its legal basis or, conversely, gain a secure legal basis. Business models must therefore be able to adapt to the relevant legal situation in order to guarantee their marketability and product protection in the long term. This aspect requires the broadening of the perspective of the traditionally more backward-looking due diligence process (which risks are "hidden" in the company due to the business activities developed to date?) to include forward-looking, future developments in the consideration and evaluation.

2.2 Aspects of contract drafting

The contractual core of a corporate transaction in the field of M&A is the share or asset purchase agreement (SPA/APA) or, in the case of VC investments, the investment agreement and the shareholders' agreement concluded between the shareholders. The contractual instruments developed in transaction practice are generally suitable for adequately reflecting acquisitions of or investments in AI companies. However, there are a number of special features and AI-specific challenges that require the further development of the drafting of contracts and establish best practices.

Contractual liability regimes

The first task is to adequately reflect the risks identified in the due diligence process in the transaction documentation and to protect the buyer or investor in the event that any risks materialise. Usually, this is done by means of reps & warranties (for unknown risks) or indemnities (for known risks) provided by the seller or the target company or its shareholders, a practice that has for long been a regular feature of transaction processes. With regard to AI tools used or developed by the target company, transaction practice is in the process of developing customised clauses within the contractual warranty catalogue, e.g., relating to the legally compliant processing of training data or compliance with data protection regulations.

In the M&A market, particularly in transactions involving private equity investors, the conclusion of so-called W&I (warranty and indemnity) insurance has become a widespread standard element in recent years. Such specialised insurance policies cover liability in the event of a breach of contractual warranties, but therefore require sufficient in-depth due diligence on the part of the buyer and corresponding disclosures by the target company. So far, the W&I insurance market has shown itself to be flexible to new technological developments and open to the extension of insurance cover to transaction-specific risks (such as tax risks or known risks uncovered during due diligence). It can therefore be assumed that appropriate insurance cover will also be available for the transaction risks typical of AI.

Guarantees and warranties, however, are past-oriented from their point of view. They protect the buyer or investor against risks arising from the target´s business operations until the transaction is completed. Future risks are much more difficult to deal with. These can be particularly virulent in the dynamically developing market for AI applications. For example, it is conceivable that the profitability of an AI-based business model can be impaired or even become impractical by stricter legal regulation or changing ethical and moral values. Such (fundamental) risks must either be "priced in" to the valuation on which the transaction is based or reflected in the transaction structure (see below). Once again, it is essential to keep a close eye on the evolving regulatory environment (see above) and (as far as possible) to carry out an anticipatory and holistic evaluation of the target, covering not only technical, legal and financial aspects but also political, ethical and socio-psychological elements.

Valuation issues

For the valuation of established companies, recognised valuation methods are available to determine the equity value, which are based, for example, on a derivation from historical financial surpluses projected into the future

(discounted cash flow method) or the application of multiples to certain key financial figures of the target company (EBITDA, turnover). AI companies are usually young companies that are still in the start-up phase and for which meaningful historical key financial figures are naturally not available. In addition, innovative, AI-driven business models often lack peer companies whose stock market price or valuations achieved in transactions could be used as a basis for determining the equity value. For the AI sector with its great potential for innovation, there is also the fact that AI systems can quickly become outdated and a (supposed) market lead can be lost quickly.

This phenomenon has always been known in the venture capital market. As a result instruments and methods have been developed to reduce the risk of valuation misjudgement for investors and companies or to arrive at a valuation that is (presumably) in line with the market. To some extent, however, every valuation is nevertheless characterised by a certain "hope value" or the "belief", beyond strictly economic parameters, that the team in question, the business idea, the specific technological solution in question will ultimately prevail and lead the company to success. The AI sector has once again illustrated this phenomenon, particularly in a market environment that is generally characterised by stagnating or even falling valuations and has already provided astonishing examples of astronomical valuations for young to very young companies. The French AI start-up Mistral, for example, achieved a valuation of around USD 2 billion just seven months after its foundation in a financing round at the end of 2023 with a volume of EUR 385 million, thus achieving the coveted "unicorn"[14] status in the first year of the company's history.

In transaction practice, there are tools for dealing with valuation uncertainty and the uncertain future performance of the target company after closing, which can also be used for AI companies. In the M&A sector, for example, so-called earn-out mechanisms have to be taken into account, according to which a (possibly substantial) part of the purchase price is not paid immediately at the closing of the transaction, but over time and depending on the achievement of certain economic performance targets. In addition, acquisitions of fast-growing tech companies are often struc-

tured, at least in part, as a so-called paper deal. This means that the sellers do not or only partially receive cash for their shares, but "swap" them for a stake in the acquirer, so that they continue to bear the economic risk of failure of the company they are selling (but also share in the chances of success) together with the buyer (and its other shareholders). Transactions in the AI sector appear predestined for the use of such elements.

In the VC sector, a milestone-based investment structure is often applied in financing rounds for AI start-ups. Typologically related to the aforementioned earn-out model, some of the financing is made dependent on the achievement of certain targets (technical development stages, customer acquisition, sales figures, etc.) within a contractually agreed timeframe.

Governance

The particularities of the AI sector in the transaction context are not limited to valuation issues and the distribution of risk between buyers/sellers and founders/investors. They also affect the "inner workings" of AI companies. For example, an acquirer or investor will ensure that the target company, if it does not already have one, establishes an AI governance structure and will ensure this through appropriate contractual agreements. This will include for example

— the adoption (and ongoing review/adjustment) of an AI policy within the company,

— the creation of bodies such as an AI compliance committee and

— the integration with existing functions such as data protection and IT security officers and general compliance officers.

Given the implications of AI applications, which go far beyond questions of economic success or failure and on which the protagonists of the AI scene in particular often take a prominent position,[15] there is a growing need to institutionalise a kind of permanent self-regulation in the govern-

[14] The term refers to non-listed (tech) start-ups with a documented valuation of at least EUR/USD 1bn.

[15] See, for example, the statements of OpenAI founder Sam Altman Sam Altman warns AI could kill us all. But he still wants the world to use it | CNN Business, accessed 26.03.2024

ance structure of the companies concerned. For example, ethics boards have already been set up in a number of cases to advise and support decision-makers in the company on fundamental questions of AI-related compliance, moral-ethical dilemmas or legal edge cases. The emergence of best practices can therefore already be observed here too, which are likely to become even more differentiated and relevant as the number of transactions in the AI sector increases – and in light of the presumably not entirely absent aberrations and excesses of further developments and shifts in the limits of what is technically possible.

IV. Conclusion/Outlook

Investments in AI companies offer great opportunities for strategic access to business-critical applications and for financial investors. However, both the M&A market and the legal standards for assessing and securing such deals are still in their infancy. This makes it all the more important to adopt a 360-degree approach that takes a comprehensive and forward-looking view of the opportunities and risks. A close interaction between business, technical and legal expertise is crucial to the success of investments in AI.

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