JUNE/JULY 2021

DEVOTED TO LEADERS IN THE INTELLECTUAL PROPERTY AND ENTERTAINMENT COMMUNITY

VOLUME 41 • NUMBER 6

THE Licensing Journal®

Edited by Gregory J. Battersby and Charles W. Grimes

Wolters Kluwer

Special Considerations in Video Game M&A Transactions

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Between the global rise of competitive gaming and esports, the proliferation of mobile and console gaming, and the financial and cultural success of games such as *Fortnite* and *Minecraft*, it appears little can stop the growth of the video gaming industry. Having long since overtaken the annual revenues of the film and music industries, the global video game market continues to expand at a rapid pace, with consumer spending on video game products reaching a record $56.9 billion in 2020. With consumers largely being confined to their homes due to the COVID-19 pandemic, it is expected that this trend will continue in 2021.

The number of M&A transactions in the video gaming space has expanded in recent years to keep pace of the growth of the industry generally, including numerous acquisitions of game development studios by major platform holders and sales of many smaller and independent studios to larger development giants. Given the prevailing positive market trends, many actors both inside and outside the gaming industry are actively considering entering into their first video game M&A transaction. However, before entering into acquisition negotiations or executing a letter of intent, potential buyers and sellers of video game companies should understand the industry-specific legal issues that frequently factor into these transactions to give them the best chance for a successful deal.

Intellectual Property

IP often comprises the majority of assets held by a gaming industry company. Relevant IP can consist of the legal ownership rights to the code, narrative, design and other assets that make up a game, or the proprietary development tools and trade secrets used to develop the studio's titles. Given the high value of this IP, it is critical that the parties to a gaming M&A transaction ensure that all relevant IP is actually held by the target and that its rights in this area are subject to sufficient legal protections.

Accordingly, prior to entering into a sale process, sellers should register all valuable IP with relevant government authorities. As part of its diligence review, a buyer will conduct IP searches to verity that all seller-developed patents (such as novel development tools and processes) and trademarks (such as marks associated with games developed by seller) that drive value have been properly registered with the US Patent and Trademark office and that all code associated with software products have been registered with the US Copyright Office. If you are a seller, you will want to run your own searches in this area to get ahead of any potential issues that may derail your sale process. In general, most IP registration issues can be solved prior to a sale if they are caught early enough in the negotiation process.

The robustness of a company's employment and on-boarding process can also have a dramatic impact on the extent to which a company's IP is protected. As industry best practices, sellers should require all employees (and independent contractors, if applicable) involved in the development of IP to sign a valid proprietary information and inventions assignment agreement assigning all rights to the developed IP to the seller. Sellers should also ensure that their company's trade secrets are kept confidential by requiring all employees to sign confidentiality agreements during the company's hiring and on-boarding process. Buyers should perform extensive diligence in this area and require that these agreements be executed prior to the closing to the extent that any relevant employees may have fallen through the cracks.

A final area of concern with respect to a target's IP is open source software (OSS). OSS is commonly used in software development to quickly implement common functions and to save developer time. However, the usage of OSS typically requires acceptance of the terms of that OSS' license (such as the GNU General Public License or the MIT License), which can greatly

complicate a sale process. For example, the terms of an OSS license may contain restrictions on (i) the ways in which the final product incorporating said OSS code may be commercialized, and (ii) the ability of the owner of the developed software to keep the source code for their software private. As a result, buyers will want to have a firm handle on what, if any, OSS used in the target's products and the terms of any relevant licenses. Sellers may accordingly choose to limit their usage of OSS in their products and should catalog any existing OSS code (and its accompanying license) to assist in the buyer's diligence review.

Employment Issues

The other substantial driver of value in a video game M&A transaction is the talents of the developers, programmers, engineers, and other staff employed at the firm. As a result, both buyers and sellers should pay particular attention to the target's business' employment practices and compliance with employment law.

In recent years, a number of governmental authorities have looked to expand the definition of "employee" to include numerous working arrangements previously classified as "independent contractor" relationships (California's recently enacted AB 5 bill stands as a particularly strong example of this trend). As an industry that has traditionally relied heavily on the use of independent contractors, game developers may be particularly affected by this development. The misclassification of employees can result in significant tax issues and the imposition of other penalties. Accordingly, buyers will want to conduct a thorough review of the target's classification process. This review generally requires the application of a complex multi-factor test, including examining the amount of control exercised by the target, the location of work, flexibility of schedule, whether engagement is full time and other factors. You should engage skilled employment counsel to assist you in this specialized review.

Game studios and other businesses in the video game industry often grant their employees stock options as part of their compensation packages. Special care must thus be taken as part of your deal to ensure that existing employee stock options are adequately dealt with as part of the closing. either by paying off and cancelling existing stock options or by having the buyer assume the existing options. Both the buyer and seller will want to carefully review the target's existing stock option plan documents to ensure any cancellation or assumption of the plan is compliant with the plan's requirements. As part of the deal, the parties must also determine the extent to which stock option holders will participate in the sellers' post-closing indemnification obligations to the buyer, and, if applicable, any "earn-out" contingent payments earned after the closing.

The topic of "crunch" in game development studios has also become a hot topic in recent years, with many prominent developers promising to reduce the duration and frequency of crunch periods during game development. The increased number of employee overtime hours associated with crunch introduce a number of potential employment law issues that must be examined closely by sellers and buyers. Failure to appropriately compensate employees for overtime hours worked can lead to substantial statutory penalties and potential class action lawsuits, which may prove fatal to an M&A transaction if not preemptively addressed.

Special employment issues present themselves in video game M&A transactions where talent acquisition is a major driving force behind the buyer's interest. In these deals, care must be taken by the buyer to provide acquired employees with adequate incentive to remain at the target post-transaction and ensure that you do not overpay for the target if they ultimately leave. Buyers and sellers can generally collaborate on deal structuring to solve these issues. For example, part of the purchase price may be subject to an earnout that is only paid if the key employees remain with the target for negotiated period following the closing. Buyers may also want to consider issuing new equity options to these employees to incentivize them to remain with the business during the applicable vesting period.

Contractual Issues

Video games are seldom developed in a vacuum. Publishers, middleware and game engine distributors, asset creators, and platform holders all frequently contribute to the final game that is sold at retail. Each of these relationships is governed by contractual arrangements that must be reviewed during the due diligence process of an M&A transaction to confirm business terms and to ensure that the transaction does not violate the terms of any critical contracts or raise other legal issues. As discussed above, it is essential to review all contracts with third parties that involve the acquisition or licensing of assets or code for use in a final game to ensure that the proper licenses are granted and

that the transaction will not violate any key licenses previously granted.

Seller's contracts with parties not directly related to game development (such as the seller's leases, agreements with vendors, and loan documents) should also be reviewed by legal counsel to determine if, among other things, these agreements (i) are enforceable and in-effect as of the day of the transaction, (ii) are subject to commercially reasonable terms, (iii) are assignable to buyer in the transaction, and (iv) contain provisions or requirements that could delay or prevent the M&A transaction from occurring. If your transaction is to be structured as an asset sale, the parties should work together to discuss which of these contracts will be assigned to the buyer at the closing.

Regulatory Compliance

Data collection and storage is a vital part of the game development and maintenance process, as user data provides game developers with critical feedback regarding feature usage, bugs, and game balance. However, the collection of user data is subject to increasingly complex rules and regulations, which differ on a state-by-state and nation-by-nation basis and need to be reviewed as part of your transaction.

The European Union's General Data Protection Regulation law, which went into effect in 2018, dramatically increased the security and privacy obligations data collectors have regarding data collected from EU citizens. California's recently-enacted California Privacy Act seeks to do the same for data collected from California residents. Parties in video game M&A transactions should confirm that the target is in compliance with all relevant data collection privacy laws to avoid any post-closing liability for applicable violations.

Governmental regulatory agencies across the globe have increasingly expressed interest in regulating "lootboxes" and other in-game monetization practices, especially those found in games targeted toward children. Belgium has taken a heavy-handed approach to the regulation of lootboxes, requiring developers to restrict access or remove these features from their titles in that region, while other nations, such as the United Kingdom, appear to be taking affirmative steps to enact a new regulatory framework governing in-game microtransactions. While the consequences for noncompliance with these new regulatory regimes are largely untested, targets employing these practices should closely monitor changes in relevant regulatory bodies to ensure that their products comply with local law as they could raise issues for your deal.

Conclusion

M&A transactions in the video gaming industry should remain robust for the foreseeable future. However, these deals require that special consideration be paid to certain areas of potential risk that are not present in transactions in other industries. To help ensure your interests are adequately protected, we recommend that you engage the services of a seasoned deal team of professional advisors (including dedicated M&A counsel) who are experienced in these transactions to help you navigate potential pitfalls. By approaching your sale process in a deliberate and informed manner, you will give yourself the greatest chance of a successful closing.