

Exercising due caution with regard to open source software in private equity transactions

2 August 2023 6 min read

Private equity investors play a role in supporting the growth and development of companies in South Africa. When a private equity investor is considering an investment in a company whose business is centred around software which has been developed for use in the operation of the business and/or which is licensed to customers in the form of software products and services, it is important that you have the right legal team guiding you on the legal due diligence aspects of your potential investment transaction – especially where open source software has been used in developing its software.

When conducting a legal due diligence (“**DD**”) on a company which operates in the technology space, it is normal for a legal team to make enquiries regarding the circumstances surrounding the development of the software which is used and/or licensed by the company in selling products and services to its customers. This is because the software concerned is often considered by the company and its shareholders (as well as the private equity investor) to be one of the ‘core’ assets of the company for purposes of determining the value of the company and its business.

If the company advises that the software used by it in its products and services to customers is owned by it, then the DD must verify that the copyright in all source code associated with such software is indeed owned by the company alone (i.e. that such copyright is not owned in conjunction with any other person). This includes verifying that external consultants who were involved in developing the source code, have contractually assigned ownership to the company, to the extent that the company did not exercise control over the making of the source code.

A DD could uncover that the employees or external consultants, who were involved in developing the company's software, used open source software (“**OSS**”) alongside code written by themselves, in the development of the company's software stack. According to reports 78% of companies are using OSS extensively with OSS components being found in over half of proprietary software.

Section 1 of the Copyright Act 98 of 1978 (“**the Act**”) states that an author of a computer program is the person who exercises control over the making of the program. As a point of departure, subject to the exceptions listed in section 21 of the Act, ownership of copyright in a work vests in the author. If new works are created using OSS, licence terms and conditions applicable to that OSS may affect the rights and impose obligations on the author/owner in relation to such works. This may affect the value of the new software, and by implication, the value of the company (if a large part of its value is derived from its software).

The term ‘open source’ could give many people the wrong impression that OSS can be freely used however you wish and for whatever purpose, without any intellectual property obligations or restrictions with regard to their use of, and copyright ownership in, works created by using OSS or which is incorporated into new software.

There are upwards of 80 types of OSS licences and the terms and conditions of such OSS licences (i.e. the terms and conditions which regulate a user's rights to use, modify or distribute such OSS) can differ materially from case to case.

For example, the terms and conditions of certain OSS licences place restrictions on the sub-licensing of the new works generally or specifically for commercial gain, which would be problematic if the company sells licences for its software products if these comprise OSS or in respect of which OSS has been used, to which such restrictions apply.

Another example of a common OSS licence is a “GNU GPL” (General Public Licence) which requires a user (i.e. the company) to make available, under the same licence terms and conditions, the complete source code of works or modifications of the original source

code. In other words, the source code which the company has created (and which it may believe to be proprietary to it and commercially valuable) may actually be subject to the same 'open source' copyright and other licence terms and conditions as the OSS used in its development. This means that there could be an obligation on the company to make such newly created software available to the public on the same terms and conditions.

Often software developers do not have a full appreciation of the legal implications associated with using OSS in the development of a company's software systems and products as they are not always aware of the types of licence terms which apply to the use of third party software (including OSS) and which licence terms they have in fact agreed to on behalf of the company which they represent in the course and scope of their duties as an employee or contractor.

Companies should make their developers (internal and external) aware of these considerations and require them to understand the terms and conditions associated with using third party software (in particular OSS). It is also important that companies retain records of the licences agreed to by their employees and contractors when using third party software, including OSS, in the development of the company's software. This information becomes very important in the context of a DD, as it assists the investor and its legal team to assess the legal aspects of the company's software more efficiently if it is readily available.

In the context of a DD, records of such information will enable a legal team to identify the OSS used in the development of the company's software. With the help of technical experts, where required, a DD team will seek to determine the functionality of the OSS in the context of the company's overall software stack, including how and where it is used by the company's business as well as determining if the OSS is modified in any way.

The lawyers involved in the DD will review the licence terms and conditions associated with the OSS used by the company to ascertain the consequences thereof in relation to the company software, including in relation to ownership, on-sale and sub-licensing.

Depending on the nature and extent of the use of OSS in the creation of software in the company's business and the importance/purpose of such software in the business, as well as the effect of the OSS licence terms on such software, the assessment of these considerations could materially affect the investor's view of the software that has been developed by the company and the valuation to be placed on the company.

As such, it is important that private equity investors instruct the right legal team who can advise them on the above issues in the context of private equity transactions involving technology companies whose core assets comprise software developed by or for the company's business.

Please note that this article is intended for information purposes only and should not be considered legal advice.



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