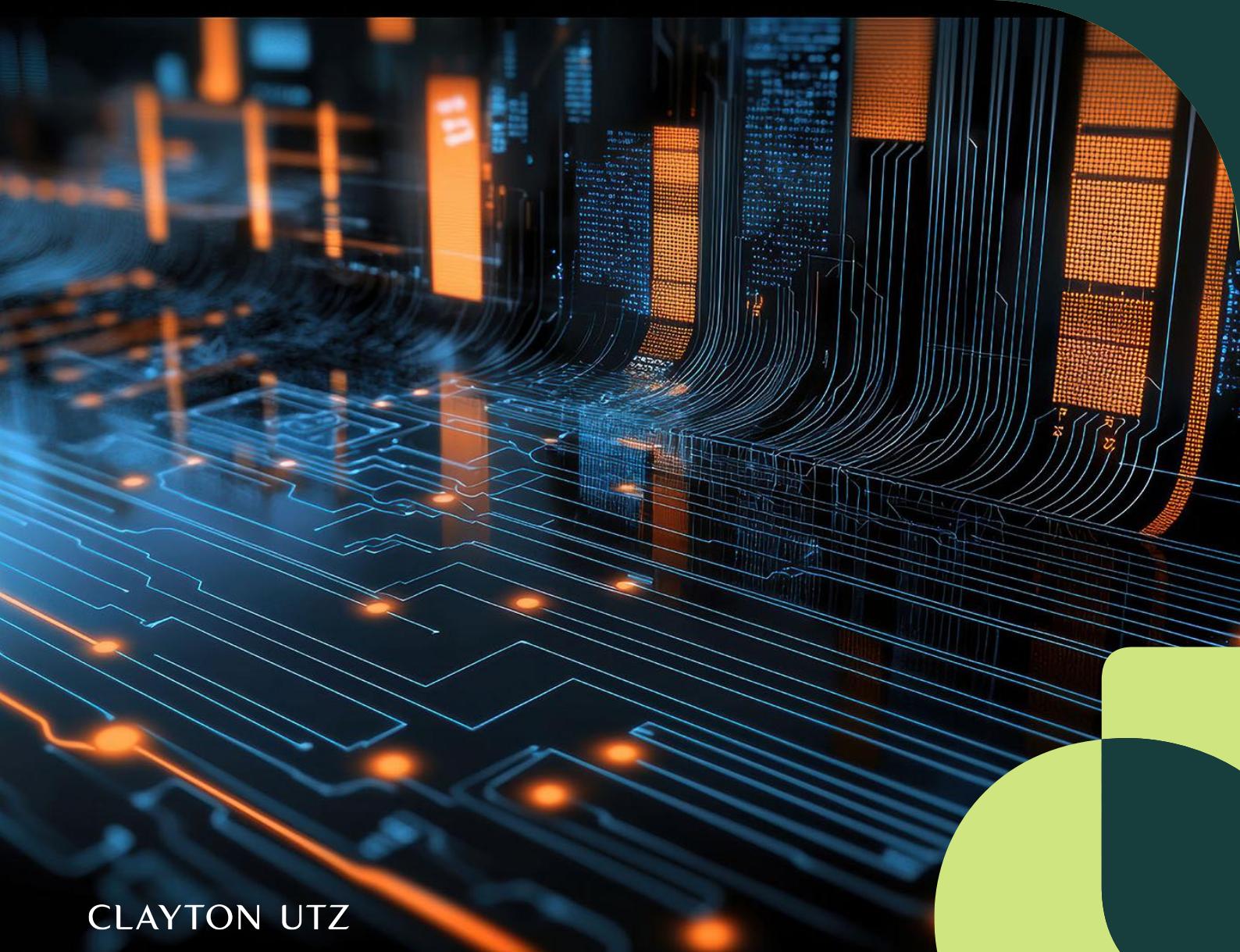


AI in M&A

Key Considerations in AI-Rich Investment





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As the adoption of AI technologies increases globally, we are seeing an increase in the volume of transactions involving AI, whether in the form of the sale of a target that uses AI, or the purchase of, or investment in AI-based technology companies. Large technology providers and global hyperscalers are making news with significant ownership investments into AI development companies. We predict this kind of activity will continue, and likely accelerate.

Whatever the form of transaction, the rapidly-evolving nature of AI, the way it works and the global regulatory frameworks that surround it means that advisors on both sides of a corporate control transaction must consider a raft of potential risks specific to the AI risk profile. These risks have the potential to permeate all aspects of a transaction; spanning initial requests for information and due diligence, the development of transaction documents, post-completion separation and integration activities. Certain risks may even necessitate the taking of additional steps in the transaction process, so that vendors and purchasers are able to properly understand the nature and impact of those risks and the parties can take appropriate steps to mitigate them.

Thorough, pre-emptive consideration of AI-related risks will ultimately assist both vendors and purchasers. It will deliver a more accurate understanding of value, clarify the degree to which that value is conditional or risk-affected and enable factually informed discussions about the allocation of that risk. Naturally however, transaction considerations will be nuanced, depending on whether a party is approaching an investment in an AI-rich entity from a vendor or purchaser perspective. This outline details some key considerations for purchasers in approaching investments in AI-rich companies.

Whatever the form of transaction, the rapidly-evolving nature of AI, the way it works and the global regulatory frameworks that sit around it, means that advisors on both sides of a transaction must consider a raft of potential risks particular to the AI risk profile.

Use cases

Fundamentally, purchasers must understand the types of AI systems or tools that are being provided, developed, deployed and/or used by the target business and for what purposes. From simple AI-driven back-office software tools to core systems and customer-facing products, it is important to first understand relevant use cases. From there, intelligent assessments can be made as to those AI-specific risks relevant to potential applications. This, in turn, can then inform a purchaser's assessment of, and a sensible negotiation as to, asset value.

For example, where the target:

- employs AI-driven automated decision-making processes, bias and discrimination risk exposure will become important to investigate. Given the potential for algorithmic bias in some AI systems, it is prudent for prospective purchasers to investigate (as part of due diligence) whether the vendor has conducted audits of the relevant systems (including algorithmic risk assessments) and to understand the outcome of those audits; or

- has its own 'proprietary' AI system, ownership status of the intellectual property rights in that system will be an essential matter for consideration, particularly given the potentially murky interaction between AI-generated works, and existing copyright laws.

If the target is an AI company with proprietary value in AI-based developments, consider the following: What is the target's product? How does it function? What are its functionally unique outputs (content, decisions, predictions)? Who uses them and for what purpose(s)? Purchasers should also consider the market in which that system is offered, the level of competition in it and whether the development roadmap for the product will allow the target to compete in its market on an ongoing and sustained basis, given the rapid evolution of AI technologies.

If the target uses AI, consider the following: What are the purposes of the target's use? How is output being used and by whom? Is the target using customer-facing and/or automated decision-making systems that have a real-world effect on anyone, or is the use primarily concentrated around the enhancement of back-office processes?

Technical infrastructure

Purchasers should consider the technical infrastructure on which the target's AI systems are operated (cloud-based, on premise, etc.) as well as the technical requirements for the operation of those systems post-completion – whether additional or new systems or solutions will need to be procured (such as data centre colocation services, hosting services, additional servers) and importantly, whether the purchaser has the data, personnel and resources to operate the systems effectively. These post-completion considerations will likely have an effect on the purchaser's ultimate valuation of the target.

If the transaction involves an older AI system, consider the legacy code, technical debt or outdated infrastructure and technologies that may need to be upgraded or replaced.

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Transparency and explainability

The way that AI systems work, and the extent to which their operation can be explained, can vary greatly. While some systems and their operation may be transparent, others may be more opaque. Whether the target is a provider or user of AI, it is vital to understand the extent of the 'explainability' of the relevant system, whether any less-explainable AI creates risk exposure (including from the perspective of any applicable, or incoming, laws or regulations) and who is ultimately liable for that risk (including under contract).

For example, where an AI system being provided or used by the target has an automated decision-making function that has the capacity to affect individuals (such as employees and end customers), legal risk may arise if the target is not able to explain how those automated decisions are made.

It is also important to consider the extent to which the degree of explainability of an AI system may impact the purchaser's future plans for the use of that system and whether that system is fit-for-purpose. Please refer to our [separate article](#) for a more fulsome commentary in relation to the concepts of transparency and explainability.

Governance

It is vital to consider how the target governs and regulates its use of AI. In particular, a purchaser should understand whether sufficient controls are in place to identify, assess and manage risks in relation to the use of those systems and how those controls have been developed.

- **Model frameworks:** Consider how the target has developed its internal governance frameworks, including whether they have been developed by reference to market best practice, drawing from established and reputable governance methodologies such as the OECD AI Principles, EU AI Act Guidelines, ISO/IEC standards and/or the NIST risk management framework.
- **Policy framework:** Consider the target's AI-related policy framework, including any risk registers, risk/impact assessment processes, acceptable use (or similar) policies, product development roadmaps, customer-facing policies and other governance artefacts related to AI and the issues set out in this guide. This will provide a clear indication of the target's risk posture and the extent to which it manages AI-related risk proactively.
- **Roles and responsibilities:** Consider the AI-related roles and responsibilities within the target and assess whether there are clear lines of communication, reporting and accountability in respect of the procurement, deployment, use and management of AI and AI-related risk.

Depending on where the target is domiciled, such policy frameworks and broader governance processes may be more mature and robust due to the requirements of law (for example, under the EU AI Act in respect of high-risk AI and general-purpose AI models) or conversely, may be non-existent. To the extent that any gaps in the target's governance frameworks are identified, the purchaser should consider whether warranty protection is required under the relevant transaction documents.

Intellectual Property

Where a target is a mere AI user (i.e. not a developer or provider), it will seldom hold any intellectual property rights in the systems. However, where an AI system is a transaction asset, it is essential to consider the associated intellectual property rights in that system, in assessing the ultimate value of the target. Purchasers should consider the following:

- **Nature of the rights:** Understand the intellectual property rights subsisting in the AI system (e.g. patent or design rights, know-how, copyright), whether the target has taken any measures to protect those rights and whether they can be enforced. Not all intellectual property rights in an AI system or its data are protectable and the protection of an AI system may require a multi-faceted approach, including reliance on copyright, trade secret and patent protection, in addition to confidentiality obligations and other contractually-imposed protections.
- **Ownership:** If the target represents that the system is 'proprietary', understand the extent to which the target owns the intellectual property rights in that system, including any developed components (for example, created by employees or third parties), which should have been assigned to the target.
- **Third party components:** If a system incorporates components licensed by third parties (including open source code), understand whether the target is compliant with those licenses, whether they would be affected by the transaction (such as triggering a supplier termination right) and whether those licenses allow for the purchaser's intended use of the system post-completion.
- **Data:** Training data for an AI system may be copyright protected. Purchasers must consider any infringement risk related to the target's collection and use of training data, as well as its use of the relevant systems' output data.

Data and data governance

While data (particularly training data) is an essential component of any AI system, its use - whether in the course of the use of a system or for the purposes of training it - can give rise to a range of risks.

- **Training:** Consider whether the AI system provided or used by the target is pre-trained (i.e. trained by the original provider) or has been trained or fine-tuned by the target. This will allow the purchaser to understand who should bear primary responsibility for any issues that relate to the use of that training data in the context of the use of the AI system.
- **Data origin:** Consider how the AI system's training data corpus has been obtained, from where (including whether it has been 'scraped' from the internet) and importantly, whether it has been procured lawfully with consent (if required). This will allow the purchaser to understand whether there are any privacy, confidentiality or intellectual property-related risks relevant to the possession and use of that data, such as liability for infringement or failure to obtain appropriate privacy consents.
- **Ongoing use:** Consider whether the terms on which training data has been collected by, or licensed to, the target will allow the purchaser to use that data post-completion for its intended purposes.
- **Data quality:** Consider the quality of the training data used by the relevant AI system, including by assessing the measures put in place by the target or the relevant provider (as applicable) to ensure data quality, the proper operation of the relevant system and production of high-quality outputs free from bias, inaccuracy and the like. To this end, purchasers may need to investigate whether the target has undertaken any assurance processes (including algorithmic risk assessments and data validation exercises) or may even necessitate the undertaking of re-verification by the purchaser itself, which would represent an additional transaction cost.

- **Governance:** Consider the robustness of the target's data governance and cybersecurity frameworks, including in relation to data quality control, collection, sharing and retention and its established mechanisms to ensure legal, contractual and regulatory compliance.

Material contracts

Where the target is an AI provider, it will be important to consider the terms on which the target provides its system to customers (including via peripheral documents like acceptable use policies) and importantly, whether those terms may expose the purchaser to risk that would affect the valuation of the target. Relevant considerations include the following:

- **Liability:** Understand the liability exposure of the target under contract and the extent to which it is liable for loss or damage caused by use of the relevant system, including under any warranties and indemnities that the purchaser may need to stand behind post-completion (intellectual property infringement indemnities, warranties as to functional errors or defects, intellectual property rights ownership, algorithmic bias, etc.).

Where the target is an AI provider, it will be important to consider the terms on which the target provides its system to customers (including via peripheral documents like acceptable use policies) and importantly, whether those terms may expose the purchaser to risk that would affect the valuation of the target.

- **Intellectual property:** Understand whether customer contracts confer on the relevant customer any intellectual property rights in the system, or any inputs and/or outputs, and consider whether this is an issue in the context of the relevant transaction and the purchaser's future plans for the target.
- **Performance:** Understand the technical and performance obligations and liabilities arising under customer contracts, including in relation to service levels, output quality, defect and bias remediation and data handling commitments. For example, if the target provides service level commitments in relation to an AI system, the purchaser must consider whether it will be able to meet those service levels post-completion.
- **Target data rights:** Understand the extent of rights that the target has to re-use (for training or otherwise) any personal information or confidential information that resides in the AI system itself or in the training data corpus, including data that has been collected via use of the system.

Where a target uses AI systems provided or licensed by third parties, these same considerations will be relevant to the contracts with those parties (in addition to any other considerations that ordinarily form part of supplier contract due diligence).

Regulatory

Based on the information provided by the target about its AI use cases and the geographical reach of its operations, purchasers should tailor their due diligence investigations to identify any laws and regulations with which the target must comply, as well as any known compliance issues. For example, a target that 'makes available' a high-risk AI system or general-purpose AI model will need to comply with the conformity assessment requirements under the EU AI Act. Further, the extraterritorial application of those laws could mean that non-EU-domiciled entities are also caught.

Due diligence investigations should also consider the long-term product roadmap of the relevant AI system, or the purchaser's future plans to use that system, in order to understand any future regulatory issues or compliance obligations that may apply to the target (or the purchaser), as well as any regulatory requirements or approvals in particular jurisdictions (for example, TGA approval in Australia for software-based medical devices).

However, purchasers should be careful not to limit such investigations to AI-specific laws, as there may be a raft of other laws which do not specifically contemplate, but nonetheless regulate, an organisation's deployment and use of AI systems – for example, privacy, intellectual property, employment, discrimination and consumer protection laws.

Purchasers should tailor their due diligence investigations to identify any laws and regulations with which the target must comply.

Personnel

Employee transfer and redundancy issues are reasonably commonplace in corporate transactions but may be more relevant in AI-related transactions where a system is being purchased with a view to automating or entirely replacing a business process or function that was historically manual or human workflow-based. To the extent that any rationalisation of target personnel (or even purchaser personnel) needs to be undertaken in connection with a transaction, ensure that appropriate advice is sought as to how to achieve this in a way that mitigates legal risk.

Regardless of whether the target is an AI provider or an AI user, purchasers should consider the need to retain key technical personnel that manage, maintain and govern the use of AI in the target business (designated AI officers, programmers, software engineers and other technical experts) and ensure these personnel can be transferred as part of the transaction. This will help to preserve the value of the underlying asset, mitigate the risks associated with future use cases and reduce the amount of technical handover that may need to occur post-completion.

Employee transfer and redundancy issues are reasonably commonplace in corporate transactions but may be more relevant in AI-related transactions where a system is being purchased with a view to automating or replacing a business process or function entirely.

Valuation

Purchasers should consider the accuracy and fairness of the proposed valuation of the target business and the corresponding purchase price given the outcome of due diligence, including in light of:

- the rapidly-evolving nature of AI technology and the potential for the obsolescence or redundancy of the technology post-completion (and how long after completion this may occur);
- market competition for similar products, or even the potential for equivalent solutions to be developed by the purchaser (and the ease with which this may reasonably be achieved);
- any possible mitigation strategies in respect of issues and risks identified during due diligence, which may be employed to avoid a recalibration of the purchase price; and
- whether the purchaser will achieve outright ownership of all parts of the AI system(s) in question (including data), noting that the 'value' of such a system and its data may only be theoretical.

Sale documentation

As always, it is imperative that transaction documentation is customised and tailored to the risk profile of each relevant transaction. Investing in AI-rich companies is no different.

The parties must ensure that the sale documentation addresses the risks, issues and information gaps identified during due diligence. From a purchaser's perspective, this may require warranties and/or indemnities that protect against identified or reasonably predictable risks, including in relation to matters such as intellectual property infringement, privacy liability, data security risk, litigation risk and regulatory liability, to the extent sufficient comfort cannot be obtained through appropriate investigations

Transition

Where the proposed transaction contemplates post-completion migration into the purchaser's technology environment, this will require the parties to migrate both the AI system itself as well as the data it holds. In this scenario, additional considerations will include:

- the transfer of know-how, documentation and expertise (including personnel) to the purchaser;
- the purchaser having to ensure or procure (whether itself or via a third party) the capability and computational power to host the system and its data;
- the purchaser having to establish governance frameworks and processes to ensure the proper (and compliant) operation and use of the system in the purchaser's environment;
- to the extent that any third parties have licensed to the target any components of the AI system, the procurement by the target (on behalf of the purchaser) of any consents necessary to allow the purchaser to use those components in the manner it intends, post-completion; and
- the projected duration of transition and migration activities and the parties' respective obligations to contribute towards a successful migration.

Generally, it is imperative that transaction documentation is tailored to the risk profile of the relevant transaction – an AI-centric transaction is no different, and the parties must ensure that the sale documentation addresses the risks, issues and information gaps identified during due diligence.



Like to know more?

Our leading Corporate and Technology teams are uniquely positioned to support you over the entire life cycle of AI-related transactions.

We can assist our clients with the identification of issues relating to emerging technologies and ensure maximisation of transaction value across all industries and sectors.



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