STRATEGIC ALLIANCES: CONTAINING OPPORTUNISM THROUGH GOVERNANCE AND DISPUTE RESOLUTION MECHANISMS

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Strategic alliances, being creatures of contract as opposed to formal legal entities with their prescribed rules and requirements with respect to governance and termination, provide significant potential for opportunism[2] and risks that one or both of the parties may appropriate the fruits of the pooling of resources and use them in ways that avoid the requirement to share profits with the other parties.[3] Recognizing this potential problem the parties typically spend a good deal of time negotiating and drafting detailed specifications of their rights and obligations and creating hurdles that will serve as disincentives for parties to abandon the alliance prematurely or attempt to circumvent the obligations they assumed at the outset of the alliance.

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[2] The most commonly used definition of "opportunism" is the one provided by economist Oliver Williamson: "a condition of self-interest seeking with guile." See O. Williamson, Markets and Hierarchies: Analysis and Antitrust Implications 6 (1975). Williamson described "guile" as "lying, stealing, cheating, and calculated efforts to mislead, distort, disguise, obfuscate, or otherwise confuse." See O. Williamson, The Economic Institutions of Capitalism 47 (1985). Others have connected opportunism with "shirking" and "cheating". See D. Nagin, et al., *Monitoring, Motivation, and Management: The Determinants of Opportunistic Behavior in a Field Experiment*, 92 Am Econ Rev 850, 852 (2002). In the context of a strategic alliance, the "cheating" actions most closely associated with opportunistic behavior seem to be stealing and holding up. See C. Ciccotello et al., *Research and Development Alliances: Evidence From a Federal Contracts Repository*, 47 JL & Econ 123, 127–28 (2004). Stealing refers to the possibility that one or both of the alliance partners may misappropriate assets developed during the alliance or assets contributed to the alliance by the other partner with the understanding that ownership of the assets would be retained by the owner. Holding up refers to efforts of one of the alliance partners to undermine the progress of the alliance toward its originally defined goals out of the self interest of that particular partner and at the expense of the other partner.

[3] The discussion of the risk of opportunism in the context of contractual strategic alliances and some of the steps that alliance partners might take to manage and reduce those risks, including the decisions made regarding governance and dispute resolution, is based in part on the excellent analysis appearing in D. Gordon Smith, *The Exit Structure of Strategic Alliances*, 2005 U. Ill. L. Rev. 303.

A. Risks of Opportunism in Strategic Alliances

Strategic alliances carry higher risks of opportunistic behavior for several reasons. First of all, it has been suggested that these types of "[v]entures are likely to be characterized by competitive rivalry over the residual claims . . . , over control of the operating management of the assets, or concerns over the loss of technology and brand labels".[4] Second, while the parties inevitably include detailed provisions in the alliance agreement regarding ownership and use of intellectual property and other technology contributed to, and developed during, the alliance, the general feeling is that property rights in this context are relatively weak and uncertain[5] and that there are substantial difficulties in monitoring the execution of the development activities during the alliance in a way that permits the parties to sort out property rights at any particular point in time. Finally, the risk associated with strategic alliances is difficult to manage simply because the parties generally cannot define "success" or "failure" with any degree of precision or clarity at the outside of the alliance, when the alliance agreements are being drafted, due to the unknowns associated with where the actual alliance activities might lead.[6]

Companies realize and appreciate the risks of opportunism associated with any business collaboration and generally attempt to address them in decisions made prior to the commencement of the alliance with respect to structure and governance. For example, researchers have suggested that in situations where the hazards of contracting are most severe the parties may opt for a formal joint venture structure, with a separate legal entity, rather than a strategically alliance based solely on a network of contracts.[7] A joint venture structure may also be the preferred solution when the parties conclude that the transaction costs associated with the exchanges of information necessary to pursue the objectives of the alliance are too high to attempt to rely only on contracts.[8] Other circumstances that might cause the parties to lean toward creation of a separate joint venture include when the relationship covers multiple products or technologies, when more than two alliance partners are involved or when the parties realize that it will be

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[4] Bruce Kogut, *The Stability of Joint Ventures: Reciprocity and Competitive Rivalry*, 38 J. Indus. Econ. 183, 185 (1989).

[5] See, e.g., J.E. Oxley, *Appropriability Hazards and Governance in Strategic Alliances: A Transaction Cost Approach*, 13 J.L. Econ & Org 387, 388 (1997).

[6] See, e.g., M. De Rond, Strategic Alliances as Social Facts: Business, Biotechnology, and Intellectual History 9 (2003) ("the literature lacks a precise and consistent definition of collaborative success and failure").

[7] See, e.g., J.E. Oxley, *Appropriability Hazards and Governance in Strategic Alliances: A Transaction Cost Approach*, 13 J.L. Econ & Org 387, 388 (1997) ("In choosing among different interfirm alliance types, the logic of transaction cost economics suggests that more 'hierarchical' alliances will be chosen for transactions where contracting hazards are more severe.").

[8] Ranjay Gulati, *Does Familiarity Breed Trust? The Implications of Repeated Ties for Contractual Choice in Alliances*, 38 Acad. Mgmt. J. 85, 89 (1995)

difficult to identify the property rights that will be contributed to the alliance and/or developed during the course of the alliance.[9]

With respect to governance, selection of an equity joint venture structure and the use of a separate entity, such as a partnership corporation, provides the parties with default rules with respect to governance[10] and deadlocks/early withdrawal[11] that have already been extensively interpreted by scholars and the courts and which can be referred to when necessary to fill in any gaps that may arise as the alliance activities unfold. Parties that decide to set up their alliance using a network of contracts must realize that there are no external default rules available and that the provisions in the contracts will be the primary guide for the parties during the alliance and for the courts afterwards in the event that problems arise. It is difficult, if not impossible, to draft language that will cover every possible contingency that might arise in a strategic alliance that is projected to continue

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[9] See, e.g., J.E. Oxley, *Appropriability Hazards and Governance in Strategic Alliances: A Transaction Cost Approach*, 13 J.L. Econ & Org 387, 402-406 (1997).

[10] For example, if the parties elect to operate their alliance in a separate joint venture legal entity such as a corporation they will automatically have access to the centralized decision making process offered through the board of directors and the reporting channels that exists between the board and the officers appointed by and overseen by the directors. Corporate laws also offer safeguards to protect the interests of the alliance partners in their roles as shareholders. Finally, the fiduciary duties of each of the alliance partners to the entity and to each other include limitations on the ability of partners to lawfully appropriate for their own account "opportunities" that might rightfully belong to the corporation.

[11] Historically the default rule for partnerships was that a partnership could be dissolved "at will"; however, the partners generally provide by agreement that the partnership will continue in existence for a specified period of time (or until a particular event occurs), thereby removing the "at will" nature of the partnership, and will allow partners to elect to exit or withdraw from the partnership prior to the end of the term in exchange for a duty to pay damages to the remaining partners in the event that exit or withdrawal amounts to a breach of the partnership agreement. Under corporate law shareholders do not generally have the right to withdraw from the ownership group; however, in a closely held corporation, which is what would be formed when a corporation is used for a joint venture to pursue activities typically undertaken in a strategic alliance, the parties are allowed to enter into buy-sell and other shareholders' agreements that provide procedures for "early withdrawal" including mechanisms for computing the costs of withdrawal that must be borne by the departing shareholder. Even when these agreements are used they do not create unfettered withdrawal rights and usually require that the corporation be in existence for at least some minimum period of time before a request for withdrawal can be made and typically also include other conditions on such requests such as failure of the corporation to achieve specified milestones or a material breach by the non-requesting party of its operational obligations to the corporation. Corporate statutes and court decisions can also be turned to for assistance in dealing with oppression of minority shareholders in a corporate joint venture or resolution of a deadlock between the shareholders in that context.

over an extended period of time and which may take twists and turns not contemplated by the parties at the very beginning simply because of the unknown nature of the technology and products to be developed through the combination of resources by the parties.[12] Accordingly, the parties will build various safeguards into the governance provisions to place boundaries around the ways in which the alliance may get "off track". For example, activities to be carried out under the umbrella of the alliance are broken out into stages in order to allow for termination or amendment at various points along the way if incremental milestones prove elusive, infeasible or improperly defined.[13] In addition, the contributions of the parties to the alliance will be made via licenses and leases so that the parties can retain exclusive ownership and control over their assets and require that the licenses and leases expire upon dissolution of the arrangement.[14]

B. Early Termination Rights

One area of particular concern is those provisions in the alliance agreements relating to regulating the ability of a party to exit—terminate—the alliance. The term and termination provisions commonly found in most alliance agreements begin with the basic structure typically included in partnership agreements and in shareholders' agreements for corporate joint ventures—the parties will agree that the alliance and most of the obligations of the parties in the alliance agreements will continue until the earlier of a date certain or completion of a carefully defined event and that prior to this fixed termination date a party will only be allowed to exit the alliance if the other party

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[12] Another issue is that many of the tasks and activities that must be completed during the course of an alliance are conducted by the parties away from the scrutiny and oversight of the other party, often at the facilities of the party engaged in the activity, and that makes it difficult to continuously monitor the work that is being done and the time and effort exerted to complete a task or activity.

[13] In many of the corporate partnering arrangements discussed elsewhere in this chapter the senior partner will make a fairly significant initial investment in the junior partner and will also promise to make additional investment provided that the junior partner achieves specified milestones to the satisfaction of the senior partner. Another example of "staging" is the common practice of starting the alliance with a research and development period and then giving one or both of the parties the "option", once the development efforts have been successfully completed, of extending the alliance to cover other activities such as manufacturing, marketing and/or distribution. Ironically, if the option is exercised the parties may decide to conduct the subsequent activities as a joint venture through a separate jointly-owned legal entity.

[14] Licenses, like any other form of contract, present challenges in drafting and no licensor can be absolutely sure that it will enjoy the level of protection for its licensed technology that it expects or needs. Moreover, when the licensed technology takes the form of trade secrets it becomes even more difficult for the licensor to control. In fact, there is a real risk that even though a party commits to a strategic alliance contractually it may not make its best technologies and human resources available due to concerns about intellectual property leakage, thus dooming the alliance to failure before it even has a chance to get off the ground.

commits a "material breach" of the alliance agreements or some other event occurs that provides the party with justifiable "cause" to want to exit the alliance.[15]

Another method that may be used for terminating an alliance is to provide that one or both of the parties would have the right to terminate or dissolve "for any reason" as long as they provide the other party with sufficient notice of their election to terminate. Creating a right to dissolve the alliance can be a potent and meaningful safeguard against opportunism; however, dissolution, or "exit", rights can also be abused by a party seeking to act opportunistically by "manufacturing" a reason to dissolve the alliance when it is no longer convenient or appears to create a roadblock for the party's ability to proceed on a particular strategy unencumbered by duties and obligations to the other parties involved in the alliance. When a provision of this type is included the parties will want to include some safeguards against surprises that create unnecessary turmoil and thus it is common to delay the effectiveness of the provision for a specified period of time, such as two years, to allow the alliance to get off the ground and also require that parties must give lengthy advance notice of the proposed termination date (e.g., six or nine months) in order to facilitate an orderly winding down of alliance activities and allow the parties to perhaps bring in new alliance members to replace the party that wishes to leave.

C. Management Committees

While provisions included in the alliance agreements dealing specifically with termination events and procedures are certainly important there are other areas of the contractual relationship that significantly impact the ability of the parties to seek opportunities to exit the relationship. One such area deals with the formation and operation of the contractual oversight board, typically referred to as the "management committee". Strategic alliance management committees are often compared to the board of directors of a corporation; however, there are definite differences that must be understood and appreciated. For example, the board of directors of a large corporation is composed of independent members seeking to act in the best interests of all of the shareholders in a manner consistent with established fiduciary responsibilities and duties. The purpose of the board in that situation is to facilitate centralized decision making and oversight of the activities of the managers appointed by the directors. In contrast, the management committee of a strategic alliance is concerned not so much with governing the alliance but with preventing parties from acting opportunistically and deviating from the original goals and objectives in a manner that undermines the alliance and effectively

[15] The general practice is to provide that a party cannot act to terminate the alliance until a specified minimum period of time since the alliance was launched has passed or the party is able to demonstrate that termination "for cause" is justified (e.g., the other party has committed a material breach of the alliance agreements, there has been a change in control with respect to the other party or the alliance has failed to achieve mutually agreed milestones of progress by specified dates). The termination provisions are designed, among other things, to create some level of "commitment" to the alliance for a sufficient amount of time to create a good opportunity for success and dissuade the parties from abandoning the alliance prematurely.

triggers a potential termination of the alliance. Specifically, the alliance management committee is generally established to improve the flow of information between the parties and improve the processes for making major decisions relating to the alliance by establishing a governance structure that forces the parties to either reach consensus or enter into an elaborate sequence of stations that must be visited on the way toward the drastic step of terminating the alliance.

Management committees are composed of representatives from each of the alliance partners and are tasked with collecting and analyzing information regarding the progress of the alliance activities and discussing how that progress measures up to expectations and possible changes in the market and operational strategies of the alliance. The alliance agreements also typically provide that the management committee must approve any of the actions enumerated on a lengthy list agreed upon the parties at the outset and that unanimous approval of the members of the committee will be required. This provision creates a powerful tool to regulate the actions of the parties since each of them can throw the alliance into "deadlock"; however, in order to avoid making it too easy for parties to act opportunistically by simply forcing a deadlock the alliance agreements mandate that the parties cannot free themselves from the obligations they originally undertook in the alliance agreements until they have completed the dispute resolution processes provided for in the agreements.[16]

A variety of methods may be used for determining the size of the management committee and the allocation of membership. Many parties and their lawyers want to have the right to appoint a majority of the members or, at the very least, want to have an equal number of members from both parties. However, while it is easy to understand why a party might be concerned about having a minority of the members of such a committee as a practical matter they should have sufficient protection from oppression through the use of provisions that require that decisions of the committee must be by consensus, with each of the parties having one collective vote.

Deciding upon the formal scope of the activities of the management committee calls for some degree of extrapolation into the future to identify those issues and areas that are likely to become important yet which are not addressed in detail in the original version of the alliance agreements. For example, the management committee often has the right and responsibility to prepare and oversee development and operating plans, supervise the overall progress of the alliance, make recommendations to executives of each of the alliance partners about how everyone should deal with events and issues that were unforeseen at the time the alliance was formed and developing and implementing plans for the transition of the main functional activities of the alliance as time goes by (e.g., transitioning from the development of new technology to the manufacture and sale of

[16] See George Dent, *Lawyers and Trust in Business Alliances*, 58 Bus Law 45, 48 (2002) ("To prevent opportunism, partners often share control equally, but they then need devices to resolve deadlocks. These devices must be designed so that neither party is tempted to force a deadlock in order to reap one-sided benefits.").

products using the technology developed earlier in the alliance relationship).[17] It is impossible for the drafters to anticipate everything that might need to come before the management committee given that so much depends on the outcome of events and activities that will occur so far down the road and the committee should be properly seen as a flexible tool for communications rather than a closed system with tightly defined boundaries that cannot be crossed. In fact, in addition to the fairly specific list of rights and responsibilities described above the management committee should be charged with addressing such other matters as either of the parties brings before the committee[18] and attempting to resolve any disputes that may arise between the parties with respect to interpretation and implementation of the alliance agreements. The role of the management committee as a forum for information sharing is facilitated by requirements that the committee must meet regularly, typically no less often than semi-annually or quarterly, and the right of each party to call special meetings and require that reports relating to alliance activities be prepared and disseminated among committee members.

D. Dispute Resolution Procedures

Given their contractual underpinning alliances cannot thrive and survive absent continuous consensus regarding overall direction and the major strategic purposes and goals for the alliance. The first attempt to channel the parties toward consensus is, of course, the requirement of unanimity for decisions made by the management committee. However, more than just that is needed and the alliance agreements must provide for escalating dispute resolution mechanisms in the event that the management committee is deadlocked. Typically the parties begin by requiring that issues that have run aground within the management committee must be sent to senior officers of each of the parties

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[17] As is the case with the board of directors the activities of the management committee can be temporarily or permanently delegated to one or more specialized committees and subcommittees that include members from both parties that are different than the members of the management committee. For example, the parties may create a development subcommittee, a manufacturing subcommittee and a sales and commercialization subcommittee, each of which will have members from both of the parties and which will be under the same general "consensus" rule for decisions as the management committee. If consensus cannot be reached among the members of the subcommittee the first recourse would be to the management committee. Use of subcommittees allows the parties to include functional specialists who can both contribute to the specific alliance-related issues and challenges and liaison back to the larger functional department of the party that the specialist represents.

[18] It should be noted that while the term "lock-in" can be used to refer to rules and regulations created to make it more difficult for a party to act opportunistically there are also situations where a party concludes that an alliance no longer makes financial or business sense but is unable to force termination or dissolution under the alliance agreements absent either a breach by the other party or engaging in unproductive behavior on its own to force a crisis that leads to termination. In that situation the party wishing to exit the alliance can turn to the management committee as the forum for launching discussions that can hopefully lead to an orderly winding down.

who are assigned responsibility for attempting to iron out any problems and reach a decision.[19] If the senior officers cannot achieve the necessary consensus the alliance agreements should specify what should happen next—either a decision is made by one of the parties[20] or the dispute is referred to mediation and/or arbitration conducted in accordance with the procedures agreed upon in advance by the parties and memorialized in the alliance agreements.[21]

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[19] The senior officers should be identified in the alliance agreements by title and it is not necessary that the chief executive officers of each party be brought into the process as long as the officers assigned to the task have ongoing knowledge of and exposure to the activities of the alliance and are familiar with the overall goals and objectives of the alliance. It is recommended that notice of required senior officer involvement in a dispute be sent further up the organizational hierarchy of each party (e.g., to the chief executive officer and/or one or more members of the board of directors) for informational purposes since the inability of the members of the management committee to achieve consensus is often a "red flag" of potential trouble even if a particular dispute is resolved quickly at the senior officer level.

[20] Obviously the parties must tread carefully when determining what decisions will be allocated to just one of the parties and this type of authority should generally be limited to issues that fall within the specific skills and expertise of the party that will be making the decision. For example, differences relating to manufacturing issues should probably be resolved by the party that has primary responsibility for manufacturing products developed during the course of the alliance; however, an effort should be made to avoid situation where a decision made by one party might have an unforeseen material adverse impact on the other party including increased costs, delays and/or changes to technology or products that might undermine original projections regarding sales or product performance specifications.

[21] It is unwise to attempt to set the ground rules for mediation or arbitration when a conflict has already arisen and tempers may be flaring and it is therefore imperative for the parties to negotiate dispute resolution procedures at the very beginning when the alliance agreements are being drafted.