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Acredula is the Latin word for "owl," connoting wisdom. This newsletter is intended as wise counsel for boards and executives.

Not All Strategic Alliances Are Successful

This month's issue of *Acredula* is the second installment in our series on strategic alliances. A strategic alliance is a form of affiliation that involves a mutual sharing of resources. A strategic alliance differs from a traditional capital transaction as it is more than just an investment by one party in another and does not have an objective of a change in control. Large companies have used strategic alliances to retrench to their core businesses. At first,

Editor's Note

many encountered failures in their alliances. But they kept trying, learning from their failures. This month's feature article looks at some of those reported failures and what we can learn from them.



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Failed Strategic Alliances Teach Valuable Lessons

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Why do some alliances fail while others succeed? *Forbes Magazine* and other publications report that large companies learn from and use their past alliance failures to develop successful alliances in the future. We, too, can learn from the failed alliances of publicly traded companies as reported in their Form 10-K, 10-Q and stockholders' annual reports. We can also learn from those who have made successful alliances, including G. Richard Wagoner, CEO of General Motors, and Thomas A. Waltermire, President and CEO of PolyOne.

This article presents some business and legal considerations, based upon companies' reported failures and successes, to take into account before entering into an alliance. The business considerations are anticipatory, requiring business due diligence in advance so problems will not arise. Although the legal considerations reinforce the business considerations, they are typically reactionary, providing a means to resolve a problem after it arises.

Finding Mutuality

Business consideration: Do both alliance partners need each other?

A strategic alliance, by definition, is a form of affiliation that involves a mutual sharing of resources for the benefit of all of the strategic partners. “Mutuality” is key. The business consideration is whether both alliance partners need each other.

G. Richard Wagoner, CEO of General Motors, says that there must be a recognition that there are businesses, even within the automobile industry, that do things better than General Motors. Leveraging on someone who does it better allows you to get there faster.

Similarly, PolyOne management follows the three-point maxim of its President and CEO, Thomas A. Waltermire, when considering any alliance. Waltermire’s three points are:

- The alliance must create a product or service that is different from those of our competitors;
- Our customer should highly value that product or service; and
- The creation of that product or service can be executed more flawlessly with a partner than on our own.

The last point is key: The alliance partners working together can create or deliver a better product or service than they could if they were working separately.

The popularity of alliances is, in part, the result of the decrease in profitability of conglomerates. Many conglomerates have faced difficulty in finding both the capital and the management resources necessary to remain competitive in their products and services, especially since reduced barriers to global expansion have increased competition and technology has innovated ways of doing business. General Motors, according to Wagoner, has used alliances to retrench to the competitive strength of its core business, improving its products and services, regaining control over costs, and increasing productivity.

The first area of due diligence, even before beginning serious discussions, is to understand each potential alliance partner’s core business and to learn its plans for expansion or diversification. A reported example from which we can learn is the joint venture between Ford and Volkswagen to manufacture, sell and service luxury vans in Portugal. Ford decided that it could manufacture, sell and service the vans directly without Volkswagen. Ford withdrew, leaving Volkswagen with virtually no return on its investment. Greater business due diligence by both partners to determine if they needed each other may have avoided that failure.

Legal consideration: There are a number of considerations for providing a separation without involving litigation. Protracted problems can be avoided by contractually providing:

- A *window to withdraw*, typically from three to six months, within the first year or two of the alliance during which either alliance partner may withdraw. Most failures in mutuality become apparent to the alliance partners rather quickly. If none of the alliance partners elects to withdraw during the window, the term continues.
- A *put/call option* exercisable, typically after an initial period, by any alliance partner’s request that the other partner set a price at which that requesting partner has the option to either sell its interest or buy the other partner’s interest. As long as the alliance partners have the financial means to buy or sell, the put/call option generally encourages them to resolve disputes because the result of the option, if triggered, is never certain.
- A *break up fee*, similar to break up fees in mergers and acquisitions, that must be paid by the partner that elects to withdraw, within a defined period from the beginning of the alliance. The break up fee is a form of liquidated damages to the other alliance partner.

If Volkswagen had negotiated for a window to withdraw, a put/call option or a break up fee as part of its legal arrangement with Ford, Ford’s withdrawal may not have been as costly.

Avoiding Competing Interests

Business consideration: Can competing interests between the alliance and each of the alliance partners be eliminated?

Failure often occurs when the alliance’s business is viewed internally by one partner as competing with or not in the best interest of that partner’s business. An example from which we can learn is the alliance of IBM, Apple and Motorola to create a new PC chip to compete with Intel and Microsoft. IBM was so embedded with Intel chips that the management of IBM’s PC division viewed the alliance as a competitor. IBM eventually withdrew from the alliance.

Legal consideration: Contractually providing covenants protecting alliance property and opportunity may not prevent alliance partners from eventually developing competing interests. However, negotiation of such covenants will often result in greater business due diligence by all alliance partners to give some assurance that competing interests are

not immediately pending. Covenants beyond the typical non-competition should be considered, including:

- *Covenants protecting alliance property*, such as those providing that property developed or purchased by the alliance belongs exclusively to the alliance and may be used only for alliance purposes, and those requiring care to be taken to protect the proprietary and confidential nature of all property that is proprietary or confidential to the company and all ideas claimed to be novel; and
- *Covenants protecting alliance opportunity*, such as those prohibiting competition with business activities of the alliance; diversion of business away from the alliance; and interference with the alliance's relationships with employees, customers or suppliers.

The more successful covenants do not give the injured partner the right to enjoin the competing interest, but instead allow the injured partner to terminate the alliance and receive liquidated damages akin to a break up fee from the partner with the competing interests. In the IBM alliance, all of the partners may have reconsidered entering into the alliance if their legal arrangement had included a covenant giving the injured partners liquidated damages.

Dedicating Resources

Business consideration: Will resources be dedicated exclusively to the alliance or be divided between the alliance and the contributing alliance partner?

Failures have occurred when key resources are used separately by the alliance and by an alliance partner rather than being dedicated exclusively to the alliance. Key resources include anyone who serves as a key manager of the alliance. An example is Pendesic, a joint venture of Intel and SAP. Sales for Pendesic were supervised by managers of Intel and SAP who were simultaneously engaged in sales for Intel and SAP. Because these key resources were divided rather than dedicated to the joint venture, they focused on the sales of their own products instead of the joint venture's products. Would this failure have occurred if these key salespersons had been dedicated exclusively to the joint venture?

Legal consideration: Although most corporate law imposes a duty of loyalty on a corporation's directors and officers, alliance partners may not be subject to such a duty unless created contractually. Contractually providing duties of loyalty on the part of the alliance partners may produce a chilling effect on a partner that might otherwise be disloyal

or may compensate the partner harmed by the disloyalty.

Typically, the duty of loyalty contractually imposed requires partners to act in good faith and in a manner reasonably believed not to be opposed to the best interests of the alliance. Unlike the covenants protecting alliance property and opportunity, successful duties of loyalties often give the injured partner the right to enjoin the disloyal act. In addition, such breaches also can allow the injured partner to terminate the alliance and receive liquidated damages akin to a break up fee from the disloyal partner.

Attending to Governance

Business consideration: Can the alliance partners agree upon a form of governance with which the partners are both familiar?

Although a lack of mutuality is the surest reason for failure, a lack of attention when forming the alliance's governance is the most frequent reason for failure. Too often, unilateral control rather than mutual benefit is the focus of one or more of the alliance partners. An alliance can overcome the dominating partner if the alliance partners are each receiving sufficient value from the alliance. However, a governance structure that is responsive to the needs of the alliance and is familiar to the alliance partners is also critical.

Alliance partners should consider a board-CEO corporate model of doing business, which has become the dominant model in the United States and throughout the world. Under this model, a CEO manages the business subject to the overall direction and *independent* oversight of a board that represents the owners. The three major characteristics of the United States' corporate form are:

- Ownership is separate from management;
- Management is directed by representatives designated by the owners; and
- Management is headed by a CEO, who is subject to the direction and oversight of the designated representatives.

Many successful alliances are governed by a governing board, akin to a board of directors, with enough independence from the alliance's day-to-day operations to provide independent oversight. From reported failed alliances, such as the joint venture known as "Concert" formed by AT&T and British Telecom, we have learned that a board should be composed of management representatives, rather than the CEOs of the alliance partners, who have

the time to focus on the alliance when necessary.

Under the United States' corporate model, boards provide oversight and not day-to-day management. Likewise, a board of an alliance may wish to delegate day-to-day management authority to someone having the powers of a CEO, just as a board of directors delegates to a CEO. In fact, the alliance of General Motors and Isuzu Motors faltered until an executive with powers akin to that of a CEO was jointly appointed.

Attempting to manage a joint venture without a governing board, but simply with an operating officer who reports to the alliance partners, typically fails because eventually one of the alliance partners will mistrust the operating officer's decisions, resulting in that officer's resignation or removal. An example is the Global One joint venture of France Telecom, Deutsche Telekom and Sprint. The joint venture was governed by layers of committees that resulted in slow and often inconsistent decisions. As a result, a frustrated Deutsche Telekom struck out on its own, acquiring Telecom Italia, a competitor of the joint venture.

Likewise, managing directly by a governing board with no CEO, as with a partnership, typically results in a decision making process that is slow and decisions that are too often compromises lacking any clear direction. An example is the Intgrion joint venture of IBM with 17 banks. Each had a representative on a governing board that tried to manage the venture. As a result, no one person assumed responsibility for execution of any action directed by the governing board.

Legal consideration: There are a number of legal provisions that support the business consideration of attending to governance, including:

- *Creating a governing board* with authority, similar to that of a corporation's board of directors, to direct and provide oversight of the alliance's business and affairs;
- *Empowering an individual with the authority of a CEO* to head the day-to-day management of the alliance, subject to the overall direction of the governing board, including the authority to hire, fire and compensate all other alliance employees or associates; and
- *Reserving, if deemed necessary, authority to one or more of the alliance partners* in the form of a veto of any action authorized by the governing board or being taken by the CEO, or in the form of an alliance partner vote or consent before such action may be authorized or taken. To avoid possible breaches of the duty of loyalty by a governing board's members, any veto power or super-majority vote should be taken by the alliance partners rather than the members, or certain members, of the governing board.

Would the AT&T and British Telecom joint venture have survived if it had been managed by a board that was independent from their CEOs? Would Deutsche Telekom have struck out on its own if there had been someone with CEO powers to address its concerns?

Conclusion

From failed alliances, we know that they require hard work, even before the formalization of the alliance. To promote successful alliances, companies must ensure that (1) there is sufficient mutuality, (2) competing interests can be avoided, (3) resources will be dedicated exclusively to the alliance rather than divided with one of the partners, and (4) a form of governance familiar to each party can be implemented.

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