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Bricker & Eckler LLP's *Acredula* is available to clients and friends of the firm, and highlights information of particular importance to boards and executives. The information contained in this newsletter is not to be construed as legal advice or opinion.

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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

One of the most important considerations in forming a strategic alliance is the extent to which alliance opportunities are protected from competing, diverting or differing interests of the alliance parties. Alliance partners' use of alliance property and ability to engage in the same line of business are prime considerations.

Alliance parties should develop a detailed understanding of the purpose and business of the alliance; perform due diligence on the other party's existing and intended lines of business; and delineate permitted and prohibited activities by the alliance parties.

Any party may pursue any opportunity with the consent of the alliance after full disclosure. However, in many past cases, either consent was not obtained or full disclosure was not given. For this reason, courts have developed tests, generally known as the business or corporate opportunity doctrine, to determine whether a competing, diverting or differing interest is barred by someone in a fiduciary position with the business.

Under the line of business test, a fiduciary is prohibited from pursuing an opportunity if it falls within the alliance's business or purpose. Some courts require that the alliance have the financial wherewithal to develop or take advantage of the opportunity for the prohibition to apply.

Editor's Note



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Under the expectancy test, a fiduciary is prohibited from pursuing an opportunity if the alliance has a reasonable expectation that the opportunity belongs to it. Typically courts look for a contractual right that the opportunity belongs to the alliance. As with the line of business test, some courts require that the alliance have the financial wherewithal to develop or take advantage of the opportunity.

Under the fairness test, a fiduciary is prohibited from pursuing an opportunity when substantive fairness and equity require protection of the alliance. Under this test, courts will apply the prohibition if the opportunity is of material value to, or was developed at the expense of, the alliance. Courts will also apply this restriction if the alliance party learned of the opportunity as a result of its position with the alliance.

This month's feature article focuses on these and other matters that businesses should address before considering an alliance.

Entering into Strategic Alliances Requires Careful Preparation

John P. Beavers, Partner, Bricker & Eckler LLP

Many businesses today are finding joint ventures, joint development agreements, marketing or distribution agreements, and other forms of strategic alliances to be more productive ways to keep companies going than the traditional capital transaction, merger or acquisition. Already common between developed businesses, alliances are becoming increasingly popular between emerging and developed businesses. Offering guidance to emerging and developed businesses, this month's feature article focuses on the requisite steps these businesses must consider before entering into an alliance.

Protect Your Resources

Before considering a strategic alliance, you should protect your resources in the same way you would before considering a merger or acquisition. Most importantly, this includes protecting your human resources with employment agreements requiring notice before resignation and protecting your business opportunity and business property with covenants, including those that cover ownership of know-how and improvements.

Entering into a confidentiality agreement before any representative has any discussions with any potential strategic alliance candidate is another good way to protect your resources. The confidentiality agreement should protect not only the confidentiality of all information to be presented, but also the "novelty" of any proprietary technology information, products and processes.

These agreements often contain prohibitions on offering employment to each party's personnel involved in the transaction.

The common theme among alliances is that each party does something better than the other, and the alliance allows each party to focus on what it does best.

Perform Due Diligence

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.

The first area of due diligence, even before beginning serious discussions, is to determine whether there is possible mutuality with each potential alliance partner. This involves finding and reviewing publicly available materials to understand the potential partner's core business and to learn its plans for expansion or diversification. Avoid having any discussions if it appears that the candidate's core business or plans for expansion or diversification would compete or conflict with the purpose of the alliance.

Understand Principle Business Terms

It is important to have an understanding of the principle business terms that are likely to be discussed when considering a strategic alliance.

Structure

Strategic alliances take many forms, from outsourcing a function by one party to another (especially to jump-start one party's business, pursuant to a marketing, warehousing or distribution agreement) to jointly performing a function pursuant to a joint agreement (such as researching or developing a product or marketing products) to its most developed form, a joint venture or partnership as a separate organization. The common theme among alliances is that each party does something better than the other, and the alliance allows each party to focus on what it does best. Often, the form is determined by answering three questions:

1. **What belongs to each party?** One of the most significant business considerations in a strategic alliance is determining what belongs to each party. Typically, this is determined by what each party brings to the alliance, with each party being deemed to own what it brings.

More important is the ownership of what is developed by the alliance, including ownership of any know-how or improvements with respect to the property of any of the parties. Ownership of jointly developed property is often deemed to be jointly owned by the parties as tenants in common. However, one of the key matters for negotiation is the extent to which each party is permitted to use the jointly developed property separate from the alliance. For example, may one party use the jointly developed property in competition with the other strategic partner or with the alliance itself?

2. What is shared by each party?

Another important business term to define in a strategic alliance is what is to be shared by each party:

- **Expenses.** Almost every alliance must deal with expenses, determining whether each party is to bear its own expenses or expenses are to be shared. If expenses are to be shared, the alliance must deal with how those expenses are to be funded and how the parties are to contribute to that funding.
- **Revenues.** Many alliances must deal with revenues, especially if the alliance involves the sale of products or services to third persons. Sometimes, revenues are shared with each party bearing its own expenses, but more typically revenues are shared with expenses. When revenues are shared, it is not uncommon for revenues to be shared differently among parties than expenses (i.e., in different amounts or ratio).
- **Profits.** Some alliances, mostly joint ventures, share profits or losses rather than revenues and expenses. This is especially true where revenues and expenses are *not* shared among parties differently than expenses.

3. How will exposure to liability be limited? Sharing profits or losses generally results in the venture being considered a partnership, resulting in each party having joint and several liability. Therefore, when profits and losses are being shared, ways to limit each party's liability must be considered. Typically, this is a question of the alliance's form or structure. Forming a limited liability company is a popular way to limit liability where

pass-through taxation is desired. A corporation remains a popular form to limit liability where it is desired that the alliance be a separately taxable entity.

For other alliances, the form of the alliance may also determine how to limit each party's liability, especially if a limited liability company can be used. However, with alliances that do not involve a sharing of profits or losses, the parties will want to provide expressly that the alliance is not intended to constitute a partnership and that neither party is responsible for the liabilities of the other.

Valuation

Although the most critical business term in a merger or acquisition is valuation, valuation is typically less important in a strategic alliance. Valuations are important in an equity alliance where one or both of the parties makes an equity investment in

the other. However, unless the alliance involves an investment by one party in another, determining the alliance's current value is not as important as determining its future value.

Determining an alliance's future value is a highly subjective process. Although there are economic parameters and measures, the goal of the process is a "fair" rather than a "precise" result. In fact, the statutory test under most organizational laws is whether the result of the transaction is "fair" to the shareholder or other owners.

The two most common methods of determining the future value of an alliance are:

- 1. Multiple of earnings method.** This is a popular method for alliances sharing profits and losses. For alliances that are not taxable as a separate entity, this is usually a multiple of earnings before interest, income tax, depreciation and amortization (EBITDA). The multiple is determined based upon earning of publicly traded companies in the same industry with adjustments to take into account size, competitive position, liquidity and performance differences between the alliance and those publicly traded companies. For alliances that are separate taxable entities, a multiple of earnings after taxes or taxes at an assumed rate is common.

To maintain mutuality, alliance parties will need to resolve any situations in which any party has interests adverse to, or in competition with, the alliance.

2. Discounted cash flow method. This method determines the present value of the alliance's generated cash flow. This is a popular method for alliances that do not share profits and losses.

Protecting the Alliance's Property and Opportunity

Mutuality is vital to an alliance. To maintain mutuality, alliance parties will need to resolve any situations in which any party has interests adverse to, or in competition with, the alliance. This includes ownership of property, especially jointly developed property, and whether one party may use that property in competition with the alliance or its parties. This also includes whether one party may solicit or retain the employees, customers and suppliers of the alliance or of the other parties to the alliance.

Many alliances require their parties to include covenants protecting property and opportunity:

- **Alliance property covenants.** These covenants provide that property developed or purchased by the alliance belongs exclusively to the alliance and may be used only for alliance purposes. They also require that care be taken to protect the proprietary and confidential

nature of all property and all ideas claimed to be novel.

- **Alliance opportunity covenants.** These covenants prohibit 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.

Often, these 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 party with the competing interests.

Governance

Authority of the alliance. An essential consideration is what authority will the alliance have separate of the alliance partners. Alliance partners generally delegate authority to the alliance at the outset so the alliance's business and affairs can be conducted without having to obtain the consent of each party for each action. Typically, the alliance is vested with the authority to govern most aspects of its business and affairs, except for the authority or power expressly reserved for the parties.

As Acredula's two-year anniversary approaches, it's time to evaluate how it is helping boards and executives understand corporate governance issues. Our goal is to make each issue of this newsletter an informative, enlightening one. To help us accomplish this, we invite you to share your opinions about Acredula with us.

This month's issue includes a short survey that's designed to explore readers' thoughts about not only article content, length and readability, but also our associated websites. We're also interested to learn how you'd like to receive Acredula, and at what frequency.

Please take a moment to share your thoughts with us. If you prefer to communicate by mail, please complete the enclosed survey and return it to us in the accompanying postage-paid envelope. Recognizing how valuable your time is, we're also offering a web-based version of the survey. To complete the survey online, log on to www.acredula.com/survey. Regardless of the survey option you choose, your responses will be completely confidential.

We're anticipating your comments by Monday, November 26. Watch for survey results in an upcoming issue of Acredula, and thank you for helping us continue to improve our publication.

Authority reserved for the parties. Typically, the authority or power reserved for the parties includes:

- Changes to governing documents;
- Changes to business or purpose;
- Admission of additional parties;
- Transfer of any party's interest in the alliance;
- Sale of substantial assets or any merger or acquisition involving the alliance;
- Dissolution or termination of the alliance; and
- Obligations for which an alliance party is liable as a partner, accommodation party or otherwise.

Veto power. Often, one or more parties may want veto power to negate any action authorized, or not authorized, by the alliance. To avoid possible fiduciary duty conflicts that may arise if a veto power is exercisable by a manager or board member governing the alliance, any such veto power is typically granted directly to the alliance party desiring the power.

Use of a board. Many successful joint ventures are governed by a board akin to a corporation's board of directors. The boards are composed of the alliance parties'

representatives and sometimes of independent members representing the alliance as a whole. Again, an alliance's governing board, like a corporation's statutory board, is typically authorized to provide overall direction to the alliance with oversight of its operations. Management of operations is often delegated by the board to the alliance's officers or managers.

CEO authority. Many successful joint ventures delegate authority for day-to-day management of the alliance to an officer or manager having authority akin to that of a CEO of a corporation. This usually includes the authority to hire, discharge and compensate all employees and other associates of the alliance.

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Resolving Deadlocks

Traditional negotiation and mediation. Disagreements are likely to arise within the alliance or among the alliance partners. It is important to have a mechanism in place to resolve any deadlock that arises from these disagreements. The traditional mechanism is to require negotiation between the parties involved and, if not resolved, to refer the matter in dispute to mediation or arbitration.

Encouraging agreement. Perhaps even more important than a mechanism for resolving a deadlock is a mechanism to encourage agreement. One such mechanism is a coin flip coupled with the forced departure of the loser. The uncertainty of a coin flip, especially if coupled with the loser's departure on terms favorable to the remaining parties, is often enough of a "chilling" uncertainty to encourage the parties to work for agreement. A similar "chilling" mechanism is a Chinese put/call exercisable, after an initial period, by any alliance partner's request that another partner set a price at which the requesting partner has the option to either sell its interest or buy the other partner's interest in resolution of a deadlock.

Withdrawal and Dissolution

A withdrawal occurs when one party leaves the alliance, and either the business of the alliance or the restrictions on the withdrawing partner's activities contrary to the alliance continues. A dissolution occurs when the business of the alliance is terminated and the parties are free to compete.

Most successful alliances do not make withdrawal or dissolution easy, but encourage the parties to try working together for a minimum period of time. However, courts are not prone to enforce absolute restrictions on withdrawal or dissolution. For this reason, it is wise to provide a mechanism for withdrawal or dissolution that will avoid protracted litigation, such as:

- **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.

Duty of Loyalty

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

Conclusion

Although often rewarding, you should only begin considering an alliance after you have taken some steps to prepare. At a minimum, these steps include protecting resources, performing due diligence and understanding the principle business terms. Only after proper preparation can you proceed toward approaching potential

candidates and papering the deal. Continuing our guidance to emerging and developed businesses, next month's article will focus on the actions necessary to "paper" or document the terms of an alliance.

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