MASTERING [ALLIANCE STRATEGY]

A COMPREHENSIVE GUIDE TO DESIGN, MANAGEMENT, AND ORGANIZATION

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Introduction

What Is Alliance Strategy?

Alliances have come of age. In the last ten years, they have gone from being a peripheral tool of management, used mostly to enter restricted overseas markets, to a centerpiece of corporate strategy and competitive advantage. Today, many companies have portfolios of twenty or more alliances—and some have more than a hundred. Because of this, it is now common to see alliances account for 20–50 percent of corporate value—whether measured in terms of revenues, assets, income, or market capitalization. Alliances are fueling the success of a wide range of firms, including British Petroleum, Eli Lilly, General Electric, Corning Glass, Federal Express, IBM, Starbucks, Cisco Systems, Millennium Pharmaceuticals, and Siebel Systems.

As alliances moved from periphery to center of corporate strategy, the discussion surrounding them changed subtly. Executives are no longer asking "Why do an alliance?" but rather "How do we make our alliances succeed?" Over the years, numerous studies have shown that between 30 percent and 70 percent of alliances fail—that is, do not meet the goals of the parent companies. Whatever the number, it is clear that in many companies alliance performance lags far behind what could and should be achieved.

How can managers improve the performance of their alliances? Those involved usually have a unique story for why their alliance is troubled; popular among the reasons cited are unclear strategies, poor partner choice, weak or unbalanced alliance economics, dysfunctional governance, clashing corporate cultures and goals, and lack of sufficient operating staff skills and parent commitment. Although these explanations for alliance failure may be true in one case or another, we believe that they are expressions of a larger syndrome: companies are taking too narrow a view of what it takes to make an alliance succeed.

A simple memory aid will help. Instead of focusing on "the strategic alliance," we believe that managers should develop a comprehensive "alliance strategy." The term *strategic alliance* stands for a deal, a new venture, an organization—often one that is announced with some fanfare. An *alliance strategy* represents much more than the deal—it is an intent, a dynamic process, and a logic that guides alliance decisions. A strategic alliance without an alliance strategy is doomed to fail. Now that alliances are central to strategy, we must adopt this more comprehensive view of how they work.

The Four Elements of Alliance Strategy

This book discusses issues and presents guidelines for management of the four key elements that should be part of every alliance strategy: alliance design, alliance management, using a constellation of alliances, and building an internal alliance capability. Representative questions in each the elements are shown in Exhibit I.1.

Alliance Design

The business strategy of a firm or division must shape its alliance strategy and, ultimately, the design of every alliance. Corning Glass has long used alliances to exploit its glass technology in different vertical markets; this meant allying with Samsung in television glass, with Dow in silicones, and with Siemens in fiber-optic cabling. Cisco Systems uses alliances to scout for new technologies, with the intent of bringing these technologies in-house if they prove successful. Even though these are very different uses for alliances, in each

EXHIBIT I.1 Issues in Alliance Strategy.

Design of an Alliance

- Why use an alliance, as opposed to relying on internal resources, acquiring a company, or buying services and products on the market?
- What is the scope of the alliance, that is, what is included and excluded? Which markets or products, technologies, and business systems does it include?
- What are the criteria and methods for selecting a partner?
- What are the options for structuring the alliance, and what effects will these structures have on governance and value sharing?
- How should the alliance be negotiated, that is, what are the priorities, who should be on the negotiating team, how will the relationship be affected by bargaining, and so on?

Management of an Alliance

- How should the relationship be launched, that is, what should be done in the first 30 to 180 days?
- What is the process for making decisions in the alliance when issues arise that have not been resolved in advance, as they surely will?
- How will operational decisions be made within the alliance, on both routine business and new strategic directions?
- How will the performance of the alliance and the relationship between the parents be measured and monitored, and how will these measures be linked to individual incentives?
- What is the process for adjusting the alliance design (or even terminating the alliance) as the partners accumulate experience working together?

Design and Management of an Alliance Constellation

- Where in the business value chain and in the market space of the company should the alliances be formed, how many alliances should there be, and of what type?

EXHIBIT I.1 Issues in Alliance Strategy, Cont'd.

- What should be the relationship among the various alliances and partners in the constellation?
- How will interactions among alliances of different divisions be identified and managed?
- How should the company's multiple linkages be structured; for example, should there be a loose network, a stand-alone consortium, or an equity joint venture?
- How will the company's constellation compete with rival constellations and to whom will added value ultimately flow?

Development of an Internal Alliance Capability

- Who in the corporation should be responsible for specific tasks in alliance design, alliance management, and in coordinating the alliance constellation?
- What skills, human resources, processes, tools, and systems are needed in each area?
- How centralized or decentralized and how formal or informal should the alliance capability be?
- How will the corporation capture and disseminate learning from its own experience with alliances?
- What will encourage incorporation of alliance thinking into the general management of each business?

case the role and design of the alliances is consistent with a clear business strategy. By *alliance design* we mean identifying the role of the alliance in the business strategy; setting the goals, rationale, and scope of the alliance; determining the criteria and method for selecting a partner; and crafting the structure and processes for sharing value and decision making in the alliance.

In Part One of the book, issues of alliance design are covered in two sections. The first section deals with the links between strategy and alliances. It contains perspectives and advice on how to set strategic goals for an individual alliance, how alliances add value to a strategy, and how strategy shapes the general design of an alliance. The second section deals with key challenges in selecting a partner and designing the structure of the alliance. Among these challenges are how to collaborate with a competitor, how to negotiate an alliance, how to combine the legal and business aspects of an alliance, and how to differentiate between vendors and partners.

One broad conclusion from these chapters is that alliance designers must think beyond the narrow concerns of their day-to-day functional tasks. Lawyers must understand business objectives, competitors must also think like collaborators, negotiating teams must do more than bargain for the last dime, everyone must define risk broadly, and so on. By the same token, the task of designing an alliance should not be relegated to deal makers or some group of partnership specialists. Instead, alliance design must be an integral part of strategy making and business leadership.

Alliance Management

Even with the benefit of a good design, an alliance will never take care of itself—the partners must make continual investments of effort and adjust their relationship in response to new circumstances. The success of an alliance thus depends as much on the unfolding relationship between the partners, including the personal relationships between managers, as on its initial design. A prime example of this is Xerox's forty-year-old joint venture with Fuji Photo Film in Japan, which yielded benefits way beyond initial expectations because the partners were flexible and forward-looking in managing their relationship. Guidelines and case studies on alliance management are in Part Two.

In a real sense, the initial deal is merely an *opportunity* to develop an alliance—it declares the ground rules for the growth of the relationship that should bring value to the partners. Unfortunately, the tendency of an alliance to change dramatically over time is often misinterpreted as a weakness. At the extreme, change can lead to exit, resulting in the high divorce rate of alliances. But this attention to termination rates or general instability misses a central point—the stability of the alliance ought not to be a goal in itself; only the success of the alliance strategy matters.

The three sections in Part Two show how excellent practitioners manage the relationships between partners. The first section covers the basic mechanisms for working together and governing an alliance relationship. These mechanisms recognize that alliance managers have less exclusive control than they have in internal decisions, and that they must find ways to make joint decisions. That, after all, is the soul of an alliance. The second section gives evidence and advice on the role of alliance leaders, from top-level champions to day-to-day managers. Finally, the third section covers exiting from alliances—why alliances end and how to prepare for a graceful separation.

These chapters show that success in alliances is as much an organizational challenge as a strategic one. In fact, studies that have attempted to find which factors are most important in the success of individual alliances invariably have yielded a split decision: organizational issues in alliance management are about as important as strategic issues in alliance design. These two sets of issues determine the fate of individual alliances. In the remaining chapters of the book, we address ways to maximize value in a whole program of alliances.

Alliance Constellation

Because most business strategies include more than one alliance, success often depends on how the whole collection of alliances fits together. This collection of alliances has been called a *constellation;* it often acts as a distinct unit of competition. In fact, in many industries, competition has been transformed from a battle of firm against firm to one of group against group. Probably the best known example of this type of competition in the early 2000s was the battle among the airline constellations Star and oneworld. Part Three gives perspectives and lessons that help in designing and managing an effective alliance constellation.

Constellations are often important for companies in systems- or network-type businesses. At a minimum, business units that use multiple components will depend on multiple supply alliances, and business units that sell in multiple vertical or country markets will use a collection of allies to reach different customer sets. Airline alliances among various national carriers are examples of this strategy. Similarly, when a critical mass of sponsors is important to future market acceptance—as it is in many high-technology sectors—firms will often try to sign up many allies quickly. Standards battles in computer software, consumer electronics, and communications are good examples of such constellations.

But being involved in multiple alliances is not sufficient in these situations; the firm must also manage the constellation as a whole. In principle, two alliances of a firm may either complement each other or they may conflict with each other. The same is true, in spades, of a network of many alliances. A poorly designed and managed constellation can entangle the firm and waste scarce managerial bandwidth—the conflicts among partners will overwhelm any potential value to be gained from multiple partnerships. Good coordination, on the other hand, can save resources and diversify options for growth.

Part Three focuses on firms with extensive networks of partners, but many of the guidelines from this part are also applicable to firms with just a few partners. It examines two different forms of constellations. One is the portfolio of alliances of a firm, such as Coca-Cola's portfolio of bottlers. Another form is a collection of firms allied with each other, such as the groups of firms in Visa International or Colliers International. With both of these forms of constellation in mind, the first section in this part of the book outlines how strategic goals shape group design, how multipartner alliances may be governed, and how constellations spread and grow. The second section describes how constellations have flourished in three very different industries.

As these chapters show, constellations take many forms and are used for various purposes, just as is the case with individual alliances. In the same way, designing and managing constellations requires decisions, capabilities, and structures that are related to those important in individual alliances. But the complexity and scope of constellations adds new challenges.

Alliance Capability

Firms that use alliances as extensively as do our constellation pioneers have also discovered another important lesson: the success of external alliances often depends on having a supportive internal infrastructure. This lesson is by no means limited to firms with many alliances. Unfortunately, proofs abound in every organization. Managers involved with external relationships can all testify to how important it is to get internal organizational support for these relationships.

A good alliance strategy therefore starts at home. The firm must not only define a business logic for its alliances, keep an eye on the future, and manage the group of partners well, it must also align its organization to this strategy and invest the right resources in it. Firms that are doing this are frequently cited for their alliance capability. In some industries, such as pharmaceuticals, the early 2000s saw a rivalry among firms to become "partner of choice" by building an internal capability that would make them attractive to technology providers. The essence of this capability is that alliances are made part of the everyday functioning of the company. They are not special deals relegated to a group of alliance experts.

A firm that truly values its alliance capability will seek ways to share best practices among its business units and to develop special expertise where it is needed. The best practitioners therefore record the lessons from their own alliance experience, assemble tools for future alliance designers and managers, and train managers involved in alliances. Finally, a good internal infrastructure identifies and mediates the internal conflicts that can pit one alliance against another.

Part Four shows how leading firms have built their alliance capabilities and draws lessons from their experience. It covers such issues as how alliance knowledge can be managed, how alliances across business units can be coordinated, how managers can be trained for alliance work, and how the health of an alliance might be measured and tracked.

The evidence suggests that there are many ways to build an alliance capability. What works depends on the organizational culture of the company—some firms use extensive data storage and sharing tools, others do just fine with personal interaction and a minimum of technical overhead. Some firms place alliance management under a centralized organization, say at the corporate level, while others prefer to distribute responsibility for alliances across all business units. Furthermore, the degree to which a company is willing to invest in a permanent alliance capability, or indeed needs to do so, also depends on its organizational and strategic circumstances.

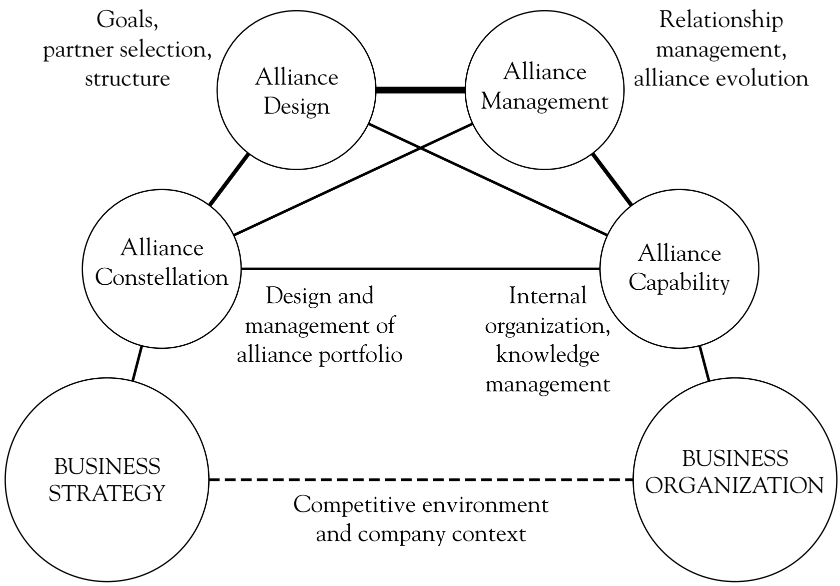
The Arc of Alliance Strategy

Superior performance comes from managing this whole array of issues. To help keep track of these issues, we designed the Arc of Alliance Strategy shown in Figure I.1. The four elements of the alliance strategy arc rest on a foundation that is the general strategy and organization of the firm. This arc represents an integrated view of what it takes to succeed with alliances. It is also a road map for this book.

Although mastery of these individual elements of alliance strategy is essential, it is the overall workings of the arc that drive success. Within the arc, the strongest links are between alliance design and management. The success of one clearly depends on the other. The design must set the stage for management, and management must strive to bring to fruition the goals set at design. These two elements apply to every alliance of the firm, and carry roughly equal weight in the success of any given alliance.

The other alliance elements shown—alliance constellation and alliance capability—apply to the collection of alliances of the firm.

FIGURE I.1 The Arc of Alliance Strategy.



Here too, there are important interdependencies. On the left side, constellation design often sets the stage for the design of individual alliances, because it influences goals and partner selection criteria. On the right side, the firm's alliance capability often determines how it will tackle alliance management. Weaker links exist between the management of the alliance constellation and the management of individual alliances, and between capability and design.

Finally, it is clear from this diagram that the whole arc rests on two broad foundations—the strategy and organization of the firm. These elements go well beyond alliance strategy and are influenced by considerations in other fields, such as marketing, finance, production, and so on. Broad strategic decisions help determine the constellation strategy of the firm, and broad cultural and organizational norms influence the way the firm will manage its alliance capability. The business model of the firm, in other words, shapes the arc of alliance strategy.

Using the Arc

How should managers navigate this arc? That depends on where one starts. Logically, one must reason up from firmwide strategy and organization to the top elements. But, practically, that is not how most managers will learn to master alliance strategy.

Most readers will come to this book with urgent needs at the top, and only later will address the broader elements at the bottom. Certainly, for newcomers to alliance strategy, it is more effective to start at the top—first understand the key success factors in design and management, and then work your way down to the broader implications for the firm. That is why the parts of the book are ordered as they are.

We encourage readers to enter at any level and move around this space. One can just as well read the book backward. Start by asking: What capabilities do we need? How do we design the overall constellation? And, only then: What are the implications for alliance design and management? But such an approach already assumes a good understanding of alliance strategy.

What is most important is to understand the logic and to keep a view on the whole arc. Wherever one sits, that element will doubtless loom largest and most important. That is why deal makers in business development think their alliance design activities are the keys to success and why operational managers in the alliance feel that it is their implementation of the deal that really matters. Both are right. And both sets of specialists must deepen their skills and advocate their views. But the specialists must also be generalists. They must know where their piece fits in the totality.

That is why alliance strategy is an essential part of general management. No general manager of a business unit or division or company would be content to leave financial decisions to the financial managers and marketing to marketing departments. So too, alliance strategy is too important to be left to alliance managers. It must become part of natural thinking in every general manager's mind.

This holds for top management too. Senior executives are not immune to tunnel vision, notwithstanding their role as overall company leaders. They too are sometimes fooled into adopting too narrow an approach, centering perhaps on striking this or that deal with such-and-such powerful ally. That is only one move in a dynamic alliance strategy. In addition, leaders of the firm must evaluate their total portfolio, ensure that there is follow-up management, and sustain performance by building lasting capabilities. This book is for them too.

Definition of Alliance

Before launching into the book, one bit of terminology is needed: What exactly is an alliance? In our definition, alliances can be used to fulfill a broad range of corporate goals, including gaining scale, reducing costs, accessing new skills, products, or markets, and sharing risk. In fact, any goal of corporate strategy can, in concept at least, be achieved with an alliance. The real question is whether such a goal is best achieved with an alliance or another organizational approach.

Answering that question requires understanding what kind of organization an alliance is. Here too, our definition covers a wide range of forms, from classic stand-alone equity joint ventures and non-equity relationships, including enhanced supplier agreements, contractual research collaborations, marketing affiliations, licenses, and multipartner consortia. What do these arrangements have in common?

Three characteristics. First, all alliances are agreements between two or more separate firms that involve ongoing resource contributions from each to create joint value. Typical partner contributions include technology, staff, customers, brands, capital, and equipment. Second, all alliances are in some sense an "incomplete contract"—a phrase from the economics of law that refers to an agreement in which the terms cannot be completely specified and agreed at the outset. As a result of these first two conditions, all alliances share a third characteristic: joint decision making to manage the business and share the value.

Why do firms enter into such loose agreements, and willingly endure the difficulties and risks associated with all three characteristics? In simple terms: the alternatives are less attractive for the given situation. One alternative to an alliance is an arm's-length contract. In many situations, such contracts do not provide sufficient incentives for firms to collaborate deeply. Another alternative is a merger or acquisition. In many cases, such an approach is infeasible, or too expensive or risky. As an arrangement short of merger but deeper than an arm's-length contract, an alliance may strike just the right balance.

Mastering Alliance Strategy

So, how do you *master* alliance strategy? As in other activities, mastery comes from deep understanding, frequent practice, and some wisdom from others. This book is designed to help on each of these fronts.

This is not a book of best-practice formulas—we don't believe in the cookie-cutter approach to management. Instead, we have gathered here what we consider the best thinking that is also useful in practice. Best-practice formulas have limited shelf lives and narrow applicability; best thinking, on the other hand, prepares managers for sustaining good practices even when the situation changes.

Best-practice surveys used to be all the rage a few years ago. But companies that invested in these surveys have come to realize that no matter how successful a practice is in one company, it may be completely wrong for others. The effectiveness of a management practice depends critically on its organizational and strategic contexts. To know what works for you, therefore, you must first understand not only *what* another company is doing, but *why* its people are doing what they are doing. Then, you must know how to translate the foreign experience to your own company.

That is where best thinking comes in. This book gives practical approaches, frameworks, examples, models, and other tools to spark your thinking. The result, we hope, is a deeper understanding of how alliance strategy works, why some companies do what they do, and what you might consider doing in your company. But the work of applying it to your own organizational and strategic context remains yours.

Sources of Wisdom

Most of the chapters in this book are based on articles in *The Alliance Analyst,* a management strategy newsletter that from 1994 to 2001 documented every few weeks what leading companies were doing and thinking with their alliances. The three authors of this book were instrumental in driving that publication—as editor, adviser, and publisher.

Many of the original articles were written with or about experienced practitioners. Over the years, we interviewed more than a thousand executives, many on multiple occasions, and in the process came to understand their issues deeply. The original articles have been revised, updated, and edited for this book with one goal in mind: to sharpen their lessons and advice. What remains is alliance wisdom accumulated over eight years and filtered down to its essence.

Many of the case studies are presented here as histories. They are not intended to portray how individual companies operate today or to rank one company over another. Instead, they were chosen for the timeless lessons they teach. Many of the companies described have continued to develop their alliance practices or taken different directions. But their experience will serve as a guide for others.

How should readers use this book? Browse it, read what is most intriguing, and most of all, discuss and debate the implications for your firm. The varying and sometimes even contradictory views of different contributors have not been forced into a common prescription, intentionally. Each may see the world slightly differently, but they are here because their views will help you find the answers that work best for you.

You already recognize that your company cannot succeed if it tries to do everything by itself—you know you need alliances. But you will not be helped by a strategic alliance here or there; you need a comprehensive alliance strategy. This book will help you craft one. The rest, as they say, is practice.

7

Crafting the Agreement

Lawyers and Managers

David Ernst, Stephen I. Glover, James D. Bamford

Crafting an alliance can throw lawyers and executives into a bitter struggle. Lawyers often want to limit risks and create future options for the corporate parent. They tend to favor alliances that are narrow in scope and long on contractual detail. Executives, on the other hand, tend to be more concerned with building successful businesses. They are more focused on growth and often argue for broad-based alliances with running room for scope expansion. In addition, ownership structure and decision rights, for example, are a familiar battleground: while lawyers often shun 50-50 joint ventures because of the risk of deadlocks in decision making, executives often see them as ideal for encouraging trust and independence.

Tension between lawyers and executives may not be unique to alliances, but it is more extreme here than in other business development strategies. In acquisitions, for example, legal and business views tend to be more closely aligned on the objectives of minimizing liabilities, seeking the lowest acquisition price, and easing the integration process. The same is true in divestitures: lawyers and business leaders want to maximize the price to the firm and minimize disputes after closing.

But when forming an alliance, managers and lawyers often part ways. Indeed, many executives believe it best to keep the legal team away from the alliance negotiation for as long as possible. This is a mistake. The best firms combine legal and business best practice when structuring alliances. To show how this works, we've focused on five essential deal terms: ownership, scope, structure, valuation, and exit. Each area demonstrates how the traditionally divergent views of lawyers and executives can be combined into a powerful model for forming alliances.

Ownership: Allocating Decision Rights

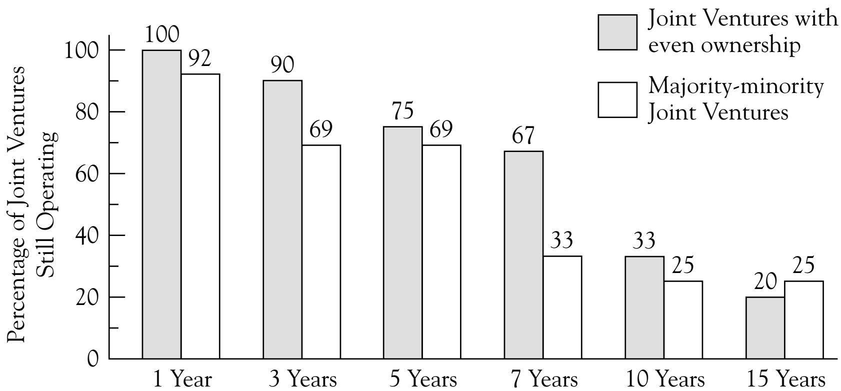
Companies entering an alliance are often concerned about their share of economic ownership in a venture. In part this comes from a desire to maximize financial rewards, but it also stems from a belief that ownership determines the extent to which the firm will control (or have influence over) critical venture decisions. A McKinsey study of more than five hundred alliances involving large U.S., European, Asian, and Latin American companies found that many ventures fail because of unclear decision-making rights. Creating smooth decision-making processes can be particularly difficult in a 50-50 alliance, where both partners often have equal influence, and where the managing board is composed of an equal number of directors from each corporate parent.

Yet 50-50 alliances have a substantially higher success rate than those with uneven ownership—50-50 deals succeed 60 percent of the time, whereas majority-minority deals meet the financial and strategic expectations of the parents in 31 percent of the cases examined. Moreover, 50-50 joint ventures have a somewhat longer life span than those with uneven ownership (Figure 7.1). The McKinsey study concluded that in 50-50 ventures where both partners are equally committed, the partners are more likely to work harder to make the venture succeed. Also, 50-50 ventures are typically more independent of the parents than are majority-minority deals.

The Lawyer's Perspective

Lawyers typically advise against 50-50 joint ventures, recommending that the client take a majority position and management control. This ensures clear decision power (translation: we decide)

FIGURE 7.1 Lifetimes of Joint Ventures.



Source: McKinsey & Co.

while also protecting the parent's interests (translation: since we decide, we can easily protect our interests). And sometimes, these solutions are acceptable to both partners, especially when there is a large disparity in their strengths or contributions, or when one of the partners sees the venture as a potential step toward divestiture and is therefore willing to cede control of a non-core business.

But companies do not always heed the lawyer's counsel against 50-50 joint ventures. Frequently, neither partner is willing to turn over control to the other side. When ownership is split 50-50, lawyers will attempt to protect parent interests by drafting a detailed joint venture contract specifying that both partners will have equal seats on a governance board. Although the joint venture CEO will be given day-to-day operating responsibility, the board will have veto power over a list of key decisions, which typically include acquisitions or divestitures, the annual budget, capital expenditures in excess of a specified amount, strategic plans, changes in product or market scope, transfer pricing to and from the parents, appointment of the top two to five officers of the venture, and designation of auditors.

If either partner vetoes a key decision, the contract will often specify a cooling-off period, an obligation to use best efforts to work out the differences, referral of the issue to a higher level within the parent organizations, or possibly outside mediation or arbitration. If all of these conflict resolution devices fail, the venture may be terminated under prearranged conditions.

The Executive's Perspective

Some executives approach the issue just as lawyers do: try for majority ownership and a controlling vote on the board and, at a minimum, reserve the right to veto key decisions. Others look beyond the matter of economic ownership and focus on decision-making control, for instance, by identifying a few key issues and agreeing how each will be resolved before the agreement is signed.

Consider a U.S. firm and a Latin American firm that were negotiating a joint venture to manufacture and sell the U.S. firm's product in Latin America. The U.S. firm was concerned that its local partner would be unwilling to fund the construction of a second regional plant. Under the terms of the typical agreement, the local firm would be able to block the investment by virtue of its veto power on the board.

To address this situation, the U.S. firm made several alterations to the standard alliance agreement. First, the partners agreed in advance to a plan for capital expenditures, including plant expansions, for the first several years (again, subject to performance conditions). Second, the partners agreed that in the event one partner wished to fund expansion while the other did not, then either partner could fund the incremental investment and in return would receive a larger share of ownership and dividends in the joint venture. If one partner wished to invest and the other partner was not willing to have its ownership stake diluted, then the investing partner could build the plant as a wholly owned entity and sell the product in a specified set of markets outside the core focus of the joint venture.

This solution was carefully tailored to fit the immediate circumstances. However, it illustrates the typical conflict situations that are likely to arise and the possibility of crafting creative solutions that fit with the business strategy and protect parent interests while also increasing the odds that the joint venture does not fail as a result of conflicts and decision gridlock.

The Best of Both Worlds

Since clear decision making lies at the heart of successful alliances, both partners can derive substantial benefits from combining the best of legal and business best practice. The ideal approach contemplates using five mechanisms.

Separate Economic Control from Decision-Making Control. It is natural to assume that economic control (what percentage of the venture the firm owns) will be same as decision-making control (how much say the firm has in decisions). But there is no reason that this needs to be so. In the energy industry, one consolidation joint venture had a 65-35 split in terms of economic ownership but operated as a 50-50 partnership on all decisions. Conversely, a joint venture in the office equipment business was 50-50 in economic control, but one partner operated the alliance and controlled all major decisions.

Seek the Casting Vote or Veto Power on Certain Decisions. It is often possible to protect parent interests simply by having real influence over one or two decisions. One leading international oil company signed a 50-50 joint venture in the Indian market after concluding that a casting vote on capital expenditures was enough to protect its interests. In other cases, firms have focused on decisions that involve changes in the basic venture goals, quality control, and regulatory and fiduciary responsibilities. In focusing on the control of a few decisions—rather than control of the entire venture—firms will be more flexible in deal making and more successful in their alliances.

Agree in Advance on Ten to Fifteen Key Decisions. With some decisions, it is both possible and advisable to reach agreement before ever forming the venture. One candidate for such treatment is capital expenditures. As mentioned earlier, partners can develop a capital expenditures plan, including investments in product development, manufacturing, and new markets, for the first several years of the alliance. Other times, firms may want to agree in advance on transfer pricing, venture staffing, and dividend policies. In scripting certain decisions, partners will uncover potential areas of conflict and speed decision making once the alliance is operational.

Develop a Decision-Making Map. Smooth decision making depends on a clear understanding of roles in different decisions. To promote this understanding, the partners should consider developing a decision-making protocol—a road map of the twenty to fifty most important decisions that the alliance will face. This protocol will spell out which decision makers (JV CEO, JV board, EVP of operations, and so on) will be involved in which alliance decisions (annual budget, spot discounts to customers, and so on) and the nature of the involvement (propose, consult, decide, and so on) in those decisions. In most cases, it is possible to develop such a decision-making road map during a workshop at the outset of the alliance.

Create Conflict Resolution Mechanisms. Partners should include opt-out or wild-card provisions in the alliance agreement to avoid or resolve conflict after it arises. For example, the JV agreement might allow one partner to fund investments while diluting the other's ownership stake. Alternatively, it might allow one of the partners to take on activities within the initial scope of the alliance if the other parent does not empower the alliance to do so. As a third example, the alliance might be allowed to buy crucial inputs or sell its output on the open market if the parents fail to reach agreement on transfer prices. All of these creative decision-making strategies may prevent termination.

Structure: The Form of the Alliance Tie

Potential partners must determine what sort of legal structure will hold them together. At the most basic level, this is a choice between a "newco" joint venture and a non-equity (contractual) alliance where no new entity is created. As a general rule, joint ventures are favored when the partners seek to make deep combinations of tangible assets (technology, equipment, factories, and so on). And since joint ventures often take substantial time to form, start up, restructure, and undo, they are preferred when the alliance is stable in direction and expected to last for at least several years. In contrast, non-equity alliances are generally favored when planned integration is less deep, or centers around intangible assets (brands, ideas, and so on), which can be hard to value. Non-equity alliances are also favored in short-term or fluid situations.

The decision on venture structure is more complex than the choice between joint venture and non-equity alliance, however. Below these basic options lie more choices. For instance, in the United States, firms must select one of four joint venture structures: corporation, general partnership, limited partnership, or limited liability company.

The Lawyer's Perspective

In choosing an alliance structure, lawyers tend to focus on four dimensions: liability, governance, tax, and regulation. Traditionally, the main concern has been liability—how much exposure the company has to lawsuits and other large downside risks. This focus led to a preference for joint ventures—and in particular the corporate, limited liability, or limited partnership forms, which limit the firm's liability to the amount of its venture investment. By contrast, a non-equity alliance or general partnership joint venture may expose all the assets of the corporate parent to the liabilities of the alliance.

In recent years, lawyers have revised this view somewhat, adding sophistication to their arguments. Experienced lawyers now tend to follow new guidelines. (Tax and corporate laws are unique to each country. This discussion focuses on the United States. In addition, specific tax and accounting rules tend to change frequently, so the practitioner should seek the advice of counsel.)

Liability Concerns Are Not Primary. Through appropriate structuring, partners can achieve limited liability even if they opt for the general partnership or contractual joint venture forms. For example, if the partners choose a general partnership, they can establish new wholly owned corporate subsidiaries that will be the partners in the venture. If the partners choose the contractual form, they can form new corporate subsidiaries that will enter into and perform the contract. As long as the new subsidiaries are adequately capitalized and the venture participants adhere to corporate formalities, the partners should enjoy the protection of the corporate shield.

Neither Is Governance. Different entities certainly use varying management structures (a JV corporation is managed by elected officers and overseen by a board of directors, a partnership is run by general partners), but the partners can typically achieve their governance goals under a range of structures. If the partners of a 50-50 joint venture want a group of four individuals to govern the venture, they can establish a corporation with a four-member board of directors, a limited liability company with a four-person board of managers, or a general partnership with, again, a four-person managing board. In a contractual alliance, the partners can create an alliance steering committee with two representatives from each partner.

But Taxation and Accounting Treatment May Be. In most cases, the key tax question will be whether the entity is taxed as a corporation or a partnership. Owners of corporations will be subject to double taxation—income will be taxed not only when it is earned by the joint venture corporation but again when it is distributed to the venture shareholders. By comparison, the income of entities that are treated as partnerships will not be subject to double taxation. Instead, they will be taxed only at the partner level. (Tax and corporate laws are unique to each country. This discussion focuses on the United States. In addition, specific tax and accounting rules tend to change frequently, so the practitioner should seek the advice of counsel.)

Entities that are taxed as partnerships also offer greater flexibility than the corporation with regard to the allocation of gains or losses. Thus, for example, under certain conditions the partnership documents might provide that one party will receive 50 percent of the gains generated by the partnership but 99 percent of the losses, or they might provide that one partner will receive 80 percent of the profits while holding 50 percent ownership.

A venture partner may be interested in consolidating the joint venture for tax or accounting purposes. The tax and accounting consolidation and income reporting rules generally will apply in the same way whether the venture is a corporation, limited liability company, or a partnership. If the partner owns an 80 percent or greater equity interest in the venture it should be able to consolidate for tax purposes, and if it owns a greater than 50 percent equity interest or otherwise exercises control it should be able to consolidate for accounting purposes.

Payments from a venture to a venture parent may be treated differently for tax purposes depending on whether the joint venture is a corporation on one hand, or a limited liability company or partnership on the other—thus, if the partners expect the venture to make substantial dividend payments to the parent, they should consider this issue in making their structure decision.

Regulation Often Is. Under the rules applied by the U.S. Department of Justice and the Federal Trade Commission under the Hart-Scott-Rodino Act, the formation of a non-equity alliance or a joint venture that is a general partnership, limited partnership, or limited liability company ordinarily is not a reportable transaction. The formation of a corporate joint venture, by contrast, is reportable if the partners or the contributed assets meet certain size tests. Where the partners are concerned about potential delays due to antitrust review, the partnership or limited liability company form of joint venture may thus offer significant advantages. (Obviously, avoiding a Hart-Scott-Rodino filing does not insulate the alliance from antitrust challenges.)

The Executive's Perspective

Executives faced with a broad range of alternative structures can become overwhelmed and spend a great deal of energy making a choice. In other cases, they arrive with preconceived notions about the ideal structure and are unwilling to consider alternative forms. Both approaches present obvious drawbacks. Partners should be flexible about the choice of structure and willing to consider alternatives that will help them achieve their underlying business goals.

Executives should focus on business issues that will affect the choice of structure. Do they want an alliance that is an autonomous business like Dow Corning, or does the success of the alliance depend on integrating parent assets? Do the partners plan to make additional capital investments? If successful, will the alliance last for three or more years? Is one partner likely to sell its interest to the other partner or a third party, or will the venture be spun off to public investors?

The answers help partners decide whether to establish a joint venture or a contractual alliance. If they answer yes to any of these questions, then establishing a joint venture may be useful.

The Best of Both Worlds

These perspectives can be combined by taking three steps. First, encourage the executives to articulate what concerns the structure should address—for example, autonomous management or the possibility of a spin-off. Listing these concerns will help determine whether the partners should form a separate entity and how that entity should be governed. The executives should also be the ones leading the discussion about governance procedures and board composition.

Second, lawyers should be asked to identify the governance, tax, regulatory, and liability concerns that favor one form over another. This is clearly within the scope of their professional expertise. Third, work together to generate the answer. Choosing the optimal alliance structure is a collaborative act—between the partners, and between the executives and lawyers. The answer must address the strategic and managerial concerns that so consume executives, while at the same time satisfying the tax, liability, and regulatory issues that matter so much to lawyers.

Scope: Where the Alliance Begins and Ends

Another essential task is defining the scope of the alliance—what the venture and the partners can and cannot do. Defining scope requires the partners to establish boundaries of geography, product categories, customer segments, brands, technologies, and fixed assets between the alliance and the parents. They must identify the activities in which the alliance may engage and those reserved for the parents. They must decide how the alliance can use the parents' technology and other assets and who can use those assets that the alliance develops.

The Lawyer's Perspective

Lawyers often want to define the scope of an alliance narrowly and reserve the right for the parent to expand into related areas in the future with or without the partner. This cautious approach can be enormously helpful in reducing risk. For example, one U.S. manufacturer granted a twenty-year exclusive license covering several large emerging markets to a single company in the region, with royalty fees set as a percentage of revenues. When its partner underperformed and competitors proliferated, it had little leverage to renegotiate the arrangement. A more cautious approach—limiting the scope to specific countries, signing a nonexclusive agreement, setting a shorter term, or building in minimum performance requirements—would have been a much better strategy.

Lawyers understand that defining scope narrowly has drawbacks. First, it can interfere with ongoing venture development, especially if technology licenses from the parents are too restrictive. Second, to the extent that a narrow scope means that the alliance will depend on the parents for resources (for example, marketing and sales support and sourcing of key components), transfer pricing issues will loom as a continuing source of conflict. And third, a narrow scope limits the alliance's ability to respond to change—to adapt to new market conditions.

The Executive's Perspective

Executives often want to create a broad and autonomous venture with running room for growth. As one joint venture CEO said: "The parents should put all of the relevant activities and markets into the pot, pay me based on the profitability of the JV, and leave me alone to run the business. Otherwise, conflicts are guaranteed."

Executives understand that defining alliance scope narrowly may reduce risks and prevent a big giveaway to the alliance or other partner. But executives also recognize that a narrow scope may reduce the likelihood that the alliance—and hence the parents—will succeed in the long run. A McKinsey study involving the 150 largest multinational corporations showed that 65 percent experienced major conflicts in the first years of an alliance. Many of the successful joint ventures in the study were substantially expanded in scope. Looking at the 49 percent of cross-border joint ventures that failed to meet the strategic and financial objectives of the parents, one of the most common causes of failure was that the parents did not scope the alliance broadly enough. An obvious solution is to scope an alliance narrowly at first and then expand it at the appropriate time. But this is much easier said than done. Restructuring an alliance to expand its scope can be even more time-consuming than the initial negotiations.

The Best of Both Worlds

Five approaches can help to bring the "best of both" from legal advisers and business managers when structuring an alliance. Alliances should build in room for growth, and companies should select partners that are not competitors. They should establish exclusive agreements only when necessary, and they should anticipate the probability of changes in scope and negotiate them in advance. In addition, they should define how each of the parents will use the technology developed by the alliance.

Create Room for Growth. The partners should minimize the potential of conflicts between their current businesses on one hand and the business of the alliance on the other, by giving the alliance sufficient scope to grow for some period of time. For large joint ventures, this period should be at least three to five years. The corporate parents should also restrict their right to engage in activities within that scope during that time. For a more fluid non-equity alliance, this period may be much shorter.

Select Partners That Are Not Competitors. This step will reduce disputes over the activities of the alliance and ensure commitment. Collaborating to compete need not mean collaborating with direct competitors. McKinsey has found that alliances between direct competitors are more likely to fail and more likely to terminate within the first three years than alliances involving parents that are not direct competitors.

Establish Exclusive Arrangements Only When Necessary. When compelled to establish an exclusive arrangement, partners should link the term and scope of the exclusive arrangements to performance requirements and exit triggers.

Anticipate and Negotiate Changes in Scope in Advance. When possible, partners should agree on the conditions under which the product, market, technology, and value chain scope will be changed. For example, a European manufacturer of vehicles negotiated an alliance with a Korean company aimed at distribution throughout Asia. However, the initial geographic scope of the venture was confined to a single country, with plans to expand to other countries after Korean sales were established.

Define How Parents Will Use Technology Created by the Alliance. There are a number of ways to do this: by geographic area, product category, or end-user customer segment. Two chemical manufacturers, for example, might decide to collaborate to develop a new type of plastic, with one of the firms having the right to sell to the automotive segment, and the other retaining rights for all other customers.

Valuation: Sorting Out Economic Interests

Structuring an alliance introduces a series of valuation issues—how much each partner's contributions are worth, what economic interest in the venture the partners will receive in return for these contributions, and how the partners will value the output of the alliance. These valuation questions are complex and important.

The Lawyer's Perspective

When it comes time to make proposals regarding value, a lawyer's reflexive response is to negotiate aggressively to minimize client resources devoted to the alliance and maximize its share of future profits or other outputs. Of course, lawyers recognize that larger parent contributions may benefit the alliance and thus ultimately help the client. But fundamentally, lawyers approach valuation from the perspective of the client. Lawyers do not act as an advocate of the alliance—indeed they are ethically barred from doing so, except in the rare case in which specifically retained for this purpose. The result is that lawyers, by taking aggressive positions on behalf of their client that result in a win-lose outcome, may interfere with the creation of a strong business.

The Executive's Perspective

Some executives are more likely to advocate valuation solutions that create a strong alliance. For example, they might provide a generous valuation to certain partner assets in order to create such benefits as partner trust. Executives may also be quite willing to value assets (or set transfer prices) on favorable terms for the alliance, and thus improve its chances of sustainable business success. But executives also understand that creating a strong alliance makes sense only if the result is consistent with the goals of the company—that is, maximizing shareholder value for the parent company. And thus executives understand the value of careful analysis and aggressive negotiation on behalf of the parent.

The Best of Both Worlds

When it comes to valuation, the executive's desire to develop a strong alliance and the lawyer's advocacy on behalf of the parent both have their place. But a real concern in resolving valuation issues is that it is very difficult for a single team of dealmakers to advocate for the alliance and at the same time negotiate on behalf of the parent. To combine these views, consider *establishing three deal teams*. Each company would have a separate negotiating team—a group of executives and lawyers assigned to protect parent interests and analyze the alliance from the parent's perspective. Their focus is on valuing and negotiating required capital contributions, expected return on the parent's investment, and zero-sum issues such as equity split and initial contributions.

A third team would consist of executives from both sides. Its role is to protect the interests of the alliance—to develop a business plan and determine how the alliance can maximize synergies, including resource requirements such as cash, assets, technology, and management. This team should be permitted initially to develop its own plan without significant input from the negotiating teams.

Discussions about value and capital contributions are likely to be adversarial and disruptive, especially if these negotiations take place before the benefits of the alliance are established and trust is built between the partners. They will interfere with the development of the spirit of cooperation that is essential to the creation of a strong alliance. Once the benefits have been validated, the negotiating teams should test whether the partners can agree on valuation and other deal terms.

Exit: Preparing for the End

An alliance is rarely a permanent arrangement. McKinsey's analysis shows that the average life span of a joint venture is about seven years, with more than 75 percent of terminated joint ventures acquired by one of the partners. Given these statistics, even partners with a high degree of confidence in the longevity of their alliance should consider exit provisions to protect their interests.

The Lawyer's Perspective

Lawyers recognize the need to negotiate exit clauses and will almost always insist that these clauses be included in the alliance agreement. They will ask their clients to identify the events that will trigger a right to exit. These triggers might include a change in control of one of the parents, the inability to agree on a key issue, the failure to achieve an important business milestone, breach of contract, or a sunset date after which either partner can terminate the alliance upon notice to the other.

Lawyers will also ask their clients to discuss how the exit should be made once an exit right is triggered. In joint ventures, it is common to propose "put" provisions, under which one partner has the right to require the other to purchase its interest. Lawyers may further suggest that partners be given the right to sell their interests to third parties once exit rights are triggered. And they may recommend that this transfer right be subject to a right of first refusal, under which the non-selling partner would have an option to acquire the interests of the selling partner before the selling partner may transfer its interests to a third party. Alternatively, the lawyers may suggest that the exit be effected by selling the alliance in its entirety or conducting an initial public offering.

Finally, good lawyers will ask their clients to focus on termination-related valuation issues. If the partner is going to sell its interest to the alliance or other partners, what price should be paid? Frequently, firms adopt "buy-sell" provisions under which one of the partners sets a price and the other partner then chooses whether to buy or sell at this price. Alternatively, lawyers may suggest the use of an outside appraisal (by one or more investment banks or advisers) to set a "fair price."

The Executive's Perspective

Executives tend to approach exit provisions differently. Many want to defer detailed discussion on the grounds that such discussions can reduce trust. The very act of suggesting exit provisions, let alone debating their content, can seem like a proof of bad faith. Executives may want to avoid discussion of exit provision for a second reason: it forces an uncomfortably blunt assessment of whether the parent is the natural buyer or seller of the assets. If the parent is the natural seller—say, because the business really does not fit the company portfolio but cannot be sold for an attractive price today—this can be embarrassing for the managers running the business.

The Best of Both Worlds

As with most other elements of alliance negotiations, both lawyers and executives have perspectives that should be combined in the integrated negotiation plan.

Address Exit Up Front. Given the importance of exit provisions in determining the terminal value of the alliance, the partners should consider them in detail in the negotiations. Recognizing the sensitivity of the issue, however, it makes sense to discuss exit provisions after the business team has confirmed the value of the alliance and the overall terms of the deal. Moreover, it is best if a separate team consisting of financial and legal staff negotiate the exit provisions, using guidance from the business team. This way, the managers who have to work together after the ink is dry can avoid being in the middle of a tense prenuptial negotiation.

Be Careful with "Buy-Sell" Provisions. Using this device to set alliance value upon termination has become quite common in recent years. But it is appropriate only when each partner is just as likely to be the buyer or the seller.

It is dangerous for a company that is likely to be the seller to agree to a "buy-sell" provision. Once the alliance is under way, it will be very difficult to conduct an open auction to sell the business. The partner that is likely to be a buyer will be in a very strong bargaining position, because it will have had the opportunity to meet customers, absorb know-how, evaluate the true economic value of the business, capture much of its synergies, and learn how to operate the venture as a stand-alone business. In theory, a third company could buy the joint venture, but this rarely happens. The bargaining power of the likely seller is at its strongest on the day before the alliance contract is signed.

Assess Who Is Likely to Be Buyer or Seller. It is often possible to anticipate which of the partners is more likely to be the acquirer by looking at how closely the alliance's business is connected to each partner's core activity and at the ability of each partner to invest. It also helps to consider which of the parents controls patents and technology and which of the partners controls the customer channels. If the company is likely to be the seller, it should try to negotiate a valuation approach that either locks in the current value of the business as a floor price or sets a future valuation based on a formula.

Conclusion

Both lawyers and executives have much to offer in crafting alliance agreements. Best business practices suggest that some of the typical lawyers' concerns—the desire to define scope precisely and the reaction against 50-50 joint ventures—are overblown. Similarly, the lawyers' views on such issues as exit mechanisms and structure can provide significant help to the executives. A good working relationship between the two parts of the negotiating team should increase the likelihood that the resulting alliance will be well designed and successful.

Further Reading

George T. Geis and George S. Geis. *Digital Deals: Strategies for Structuring Partnerships*. New York: McGraw-Hill, 2001. Chapters 6–10.

Source

This chapter is based on "Tug of War: Combining Legal and Business Best Practice" by David Ernst and Stephen Glover, *The Alliance Analyst* (July 1997). The article was edited for this book.