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The George A Leet Business Law Symposium: The Role of Lawyer in Strategic Alliances - Introduction

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THE GEORGE A. LEET BUSINESS LAW SYMPOSIUM:

THE ROLE OF LAWYERS IN STRATEGIC ALLIANCES

INTRODUCTION

The rapid proliferation of strategic alliances – such as joint ventures, dealerships, franchises, and licenses – is transforming the way the world does business. Alliances have become indispensable in many industries due to globalization and to the acceleration of technological change. To flourish in these industries a firm must access foreign markets and develop new technologies quicker than it is capable of on its own; it must gain the resources of another firm through a business alliance. Those resources may be financial or in the form of expertise, as in technology or marketing.

The growth of alliances is also spurred by two new forces that pose a dilemma for firms. One is pressure to concentrate on a firm's core competencies and shed activities where competitors have greater expertise. We have learned that conglomeration is bad and focus is good. The other trend is to insist that firms not stand pat but constantly seek new sources of profit. To satisfy these seemingly incompatible demands, firms often try to maintain their focus while expanding their activities by partnering with firms that have complementary strengths. In the past, suppliers and customers dealt through ordinary contracts, but alliances better allow firms to speed innovation while maintaining flexibility to adapt to rapidly fluctuating market conditions.

Alliances are also transforming the work of business lawyers. In alliances the parties must trust and cooperate with each other much more than in the financings and acquisitions that are the traditional staples of corporate practice. As a consequence, in negotiating and drafting contracts for alliances lawyers must not only master a new set of substantive terms but assume a new demeanor, one that fosters such trust and cooperation.

Unfortunately, legal academia has almost completely ignored this trend. Finance and business authors have generated reams of books and articles poring over the theoretical and practical issues of alliances, but in law the literature comprises little more than the proceedings of a few continuing legal education programs. The probable reasons for this oversight are illuminating. Traditionally, firms acquire goods and services in one of two ways: they either "make" them within the firm or "buy" them in market purchase contracts. In legal academia, the former is covered in business associations; the latter, in contracts. Strategic alliances do not fit into either established category and seem to be falling between the cracks.

George A. Leet endowed the Business Law Symposium to tackle new issues and to cultivate imaginative analyses and solutions; therefore, this Symposium marks the first serious effort by legal academia to study strategic alliances. Since alliances differ from other business transactions fundamentally and not merely in technical details, any serious examination of alliances must incorporate several perspectives. One of these is a traditional legal analysis of the consequences of choosing a particular form of business organization (such as the joint venture) and of various contract terms. Another is a corporate finance analysis that investigates how alliances allocate property rights and address agency costs so as to maximize the parties' profit. Both these approaches rely on insights from psychology and sociology regarding how trust and cooperation are created and maintained so as to minimize risk to both parties.

To this spectrum of disciplinary perspectives must be added another set of perspectives, those of the various players in the game. First there are the parties, whose interests vary depending on their financial resources, the significance of the particular alliance within the firm, the inputs that they offer to the alliance, and the benefits that they hope to reap from it. Then there are the lawyers, who may be outside or in-house counsel. Finally, there are investment bankers, accountants, and others who advise the parties or facilitate the transaction.

The speakers for this Symposium bring a wealth of experience and represent a wide variety of these perspectives. Our first principal speaker, Stephen Fraidin, is a distinguished corporate lawyer who has also taught in law schools and written extensively about business transactions.[1] His article focuses on the control issues in

[1] *See* Stephen Fraidin & Radu Lelutiu, *Strategic Alliances and Corporate Control*, 53 CASE W. RES. L. REV. 865 (2003).

strategic alliances, especially where one partner in the alliance makes an equity investment in the other. In some cases this investment is complemented by a right of the investing company to acquire its partner. Alternatively, the investing company may make a takeover bid for its partner. What contract terms are desirable to cover these possibilities? And what are the fiduciary duties of the investing company to its partner?

The first commentator on Fraidin's article is another distinguished corporate lawyer and an alumna of our law school, Jeanne Rickert, who explores three issues in strategic alliances.[2] First, trust and cooperation in an alliance depend heavily on what will happen when the alliance terminates. The lawyers must help the parties in negotiating the alliance to focus on that issue which, in their desire to think positively and avoid conflict, they might prefer to ignore. Second, there is an inherent conflict of interest when an officer, who owes allegiance to the partner who is her employer, also participates in the governance of the alliance, where she owes duties to both partners. She notes that courts have not resolved this conflict, so it behooves the parties to work it out by contract. Third, non-competition clauses between partners can raise sticky problems when one partner is acquired by a company that competes with the other partner.

The second commentator on the morning panel is Dan Austin, a prominent investment banker in mergers, acquisitions, and alliances.[3] He notes the potential problems when partners have different goals, like creating jobs on one side and maximizing profits on the other. Next he discusses how detailed alliance agreements should be arranged. Partners want to maintain flexibility to meet unexpected circumstances and to avoid haggling over contingencies that could undermine trust and cooperation, but a thoughtful, thorough set of rules can enhance trust and cooperation.

Following the comments was a lively colloquy among the panelists and the large audience, which included several experienced participants in business alliances. Among the issues discussed were the need for lengthier negotiations than in other deals because the parties have to reach mutually acceptable terms; the difficult role of lawyers and the need for business people to talk without lawyers present; the desirability of arbitration and other

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[2] *See* Jeanne M. Rickert, *Keep Your Eyes Open: Avoiding Unintended Consequences in Joint Venture Relationships*, 53 CASE W. RES. L. REV. 897 (2003).

[3] *See* Daniel F. Austin, *A Businesspersons' Perspective Concerning Joint Ventures*, 53 CASE W. RES. L. REV. 905 (2003).

dispute resolution clauses; and the possible benefits of outside advisors.

The main speaker on the first afternoon program was Rachelle Sampson, a finance and management scholar who also holds a law degree.[4] She begins by noting that an alliance can entail either profit-sharing, perhaps through a separate entity (like a joint venture partnership or corporation), or a contract with stipulated consideration instead of profit-sharing. She then asks under what circumstances either of these is preferable to the other. One approach by scholars to this issue focuses on the allocation of property rights to induce the most efficient investments by the partners. Another approach – transaction cost economics – focuses on protecting a partner who has made an investment from holdup by the other party, who may refuse to cooperate after the investment has been made.

In theory, an equity (or profit-sharing) alliance (like a joint venture) is more suited for complex arrangements, where it is difficult to specify the rights and duties of the parties in advance, in order to monitor the partners' compliance and to enforce the contract by proving a breach if one occurs. Equity joint ventures are not always optimal, though. They are often too costly to set up and operate in simpler transactions where a traditional contract will suffice. Another determinant of alliance structure is whether there are prior dealings between the parties or a social network within an industry that reduce moral hazard problems so that costly formal structures are not needed.

Professor Sampson measures this theory against her empirical study of alliances. She gauged the complexity of a number of equity and non-equity alliances and then ascertained how many patents each alliance succeeded in obtaining. She finds that in complex alliances the equity joint venture outperforms the pure contract mode, but that in simpler alliances the opposite is true. In short, practice confirms theory; structure matters.

She also looked at alliance successes as a function of prior alliance experience. She found that the more alliances you do, the better you get at them; that recent experience is more valuable than older experience; and that experience is most important for success in equity joint ventures – i.e., alliances with highly uncertain activities. During the symposium colloquy, she also noted that firms with wide experience in alliances have begun to institutionalize their alliance design and management processes. She concludes

[4] *See* Rachelle C. Sampson, *The Role of Lawyers in Strategic Alliances*, 53 CASE W. RES. L. REV. 909 (2003).

that since structure matters and lawyers can play a critical role in designing alliances structures, lawyers should not be excluded or slighted in negotiating alliances.

The first commentator on Professor Sampson's presentation was Professor Susan Helper, an economist at our Weatherhead School of Management who has, *inter alia*, closely studied supplier-customer relations in the automobile industry.[5] She first notes that factors that were omitted from Professor Sampson's study, rather than choice of alliance structure, could account for differences in there success – i.e., we cannot necessarily conclude that alliances that obtained fewer patents chose the wrong structure. She also discusses how one or both partners may have other goals than to maximize the number of patents obtained. For example, one partner may be primarily interested to learn more about a product, industry, or market.

She discusses how a major purpose of an alliance may also be to get acquainted with a partner with whom one may eventually want a closer relationship. Accordingly, alliance partners typically start with a small project and progress to larger, more complex projects if their initial experiences are positive. In such cases, mutual trust accumulated over time may substitute for carefully drafted contract provisions and control structures.

Finally, Professor Helper suggests that lawyers may play a significant role in designing the proper incentives, like incentives to encourage people to share information. Toward this end it may be desirable to de-emphasize more traditional legal concerns, like intellectual property rights.

The second commentator on Professor Sampson was Sanjiv Kapur, a corporate lawyer with wide experience in international alliances.[6] He noted that the terms of an alliance may be influenced by its purpose; e.g., whether it entails cross-border marketing as opposed to research and development. He also noted that legal issues, like firm liability, fiduciary duties, and the need for a domestic partner in a foreign market, influence choice of alliance structure.

He then listed some potentially significant business considerations not previously mentioned. For example, some firms want an alliance to be a separate entity in order to encourage the individuals participating in the alliance to identify with it and to be ex-

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[5] *See* Susan R. Helper, *Governing Alliances: Advancing Knowledge and Controlling Opportunism*, 53 CASE W. RES. L. REV. 929 (2003).

[6] *See* Sanijv K. Kapur, *Structuring and Negotiating International Joint Ventures: Anecdotal Evidence from a Large Law Firm Practice*, 53 CASE W. RES. L. REV. 937 (2003).

posed to a new culture. Accounting and tax considerations may also play a role. He agreed with Professor Sampson that complexity weighs in favor of an equity joint venture structure.

Finally, Mr. Kapur discussed his experience with several deals that either were never consummated or fell apart. In both contexts he noted the importance of changing needs and circumstances. He later noted that one kind of significant change is a change in the personnel in one partner, since trust rests partly on personal contact. Further, he discusses how the facts regarding each deal are unique, so that generalizations are hazardous. During the symposium colloquy, he discussed the importance of providing for termination since so many alliances do eventually unravel.

The last presentation was my own, which focused on the problems lawyers face because strategic alliances are so different from the other business transactions they usually handle.[7] First, the goals of partners vary and may not be apparent to the lawyer. Second, although partners often shun protracted negotiations and long, detailed agreements, the lawyer may be blamed if the client comes to grief because of a gap in the contract. Accordingly, the lawyer must consult with the client about its goals, its expectations, and its willingness to assume various risks more than in other deals.

Alliances involve complex situations with great uncertainty that can never be completely eliminated by a detailed contract, so the parties must rely more on trust than on legal enforcement of contract terms. This, too, is unusual and problematic for lawyers. The role of advocate or hired gun that is instilled in lawyers can backfire by eroding the trust that is crucial to the success of an alliance. Instead, the lawyer has to strive for win-win solutions to problems that will please the other party, without neglecting the needs of the client.

The need of partners to trust and cooperate, often for many years, means that lawyers face greater difficulties in designing governance and termination mechanisms and protecting confidential information and property rights from opportunism. For the same reasons, disagreements are likely to occur, but litigation is impractical if the alliance is to continue. Therefore, the lawyer must devise dispute resolution mechanisms that maintain trust and cooperation. Because alliances are so diverse, lawyers cannot resort to their favorite drafting technique, which is simply to change

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[7] *See* George W. Dent, Jr., *The Role of Lawyers in Strategic Alliances*, 53 CASE W. RES. L. REV. 953 (2003).

the names from their last deal. Training lawyers to handle these problems will require major changes in legal education.

Although diversity is often trumpeted as a strength, it is often an obstacle to the creation of trust; people tend to trust those who are like themselves and to distrust those who are different. Sociologists and psychologists have discussed techniques for overcoming distrust born of diversity, and lawyers need to know these techniques. However, Professor Sampson noted in later colloquy that, despite the difficulties of fostering trust between diverse people, alliances of diverse parties often produce superior results.

The first commentator on my presentation was Hewitt Shaw, a respected tax lawyer.[8] He argued that, despite the need for trust between allies, efficiency is served when each lawyer zealously represents his client. However, in so doing a lawyer must act with more finesse and understanding for the situation than in many other commercial arrangements. He stressed that often partners have very different firm cultures. For an alliance to succeed, the parties and their lawyers must recognize and cope with these differences. The lawyer's instinct to identify questions and nail down answers is extremely useful in this regard.

Mr. Shaw noted that after a contract is signed, the partners often disregard it; instead, they use the contract as a backup in case major disputes arise. Nonetheless, the process of reaching agreement is an important step in educating the partners as to what to expect from the alliance. He stressed that the shorter, less comprehensive contracts that business people often profess to favor can be both difficult to draft and dangerous in their incompleteness. He advised lawyers to alert their clients to gaps in the agreement.

Shaw reminded us that the trust needed for alliances is not blind faith. It rests largely on understanding how the partner's goals coincide with one's own and how they differ. Such a clear-eyed understanding is necessary to avoid unrealistic expectations about one's partner. Shaw also discussed the difficult questions of loyalty that can arise when a lawyer for one partner is asked to advise management of an alliance while also owing duties to the other party.

The last commentator in the Symposium was Wendy Shiba, a former professor of law, who contributed the unique perspective of

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[8] *See* Hewitt B. Shaw, Jr., *The Role of Outside Counsel in Forming Strategic Alliances*, 53 CASE W. RES. L. REV. 965 (2003).

the in-house counsel.[9] She began by noting that the common comparison of alliances to marriage is problematic because, unlike spouses, partners often enter an alliance because of their differences and their contrasting strengths, and not because of their compatibility. She further noted that the design of the alliance depends in part on whether the partners expect to remain separate or whether they see the alliance as possibility leading to an acquisition.

Ms. Shiba reiterated Steve Fraidin's point that change-in-control clauses can wreak havoc and therefore should be reviewed carefully by lawyer and client. Related thereto, she stressed the importance of due diligence to determine, *inter alia*, whether the possible partner has change-in-control or non-competition agreements that might interfere with the proposed alliance. She also reiterated the importance of fiduciary duties; *e.g.*, clarifying the fiduciary obligations of employees of a partner who will be directors or agents of the alliance.

Shiba discussed the role of in-house counsel, particularly the importance of maintaining an independent voice, even if it means advising the business people to abandon a deal to which they are emotionally committed. She repeated the importance of getting the lawyer involved early in the deal and noted that in-house counsel may enjoy an advantage in that regard. As Jeanne Rickert noted in later colloquy, in-house counsel usually understands the firm's business better than outside counsel can. Ms. Shiba suggested that outside counsel should try to learn the client's business by arranging tours and briefings without charge to the client. She also mentioned alternative billing strategies that might benefit both client and lawyer. Finally, she suggested that business people are becoming disenchanted with complex joint venture arrangements and may be moving to simpler alliances, like licensing agreements.

This Leet Symposium is the first such event in legal academia to focus on strategic alliances; it certainly will not be the last. The economic importance of alliances is large and growing rapidly. Alliances are also increasingly important to lawyers and the law, but neither lawyers nor legal scholars have adequately addressed the distinctive problems that alliances create. I hope that this Symposium will ignite an interest in resolving this shortcoming.

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[9] *See* Wendy C. Shiba, *Representation of Joint Ventures: A Practical Perspective from In-House Counsel*, 53 CASE W. RES. L. REV. 971 (2003).

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