

# Issues In Strategic Alliances

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Forecasting the issues and structuring the relationship to meet objectives is key to success.

**S**trategic alliances are becoming increasingly important in cross-pair-companies as the pace of developing new products has increased and the channels of distribution have become more concentrated. Strategic alliances differ from standard licensing and distribution relationships because of the greater degree of collaboration and integration between the parties. They also represent a more active approach by both parties to the development, marketing and distribution of a product.

In this discussion, we will use the terms "Junior Party" and "Senior Party" throughout the discussion. Some examples of strategic alliances include the investment and license between Adobe Systems Incorporated and Apple Computer, Inc.; the investment and distribution arrangements between Intel Computer Corporation and Kabusa, Ltd.; the joint venture, Maspacks Corporation, between Masco Corporation and Kabusa, Ltd.; and the investment and license between Microware Computer System, Inc. and IBM. Although the authors have both been involved in these types of transactions, these materials are general in nature and have not been prepared based on the specifics of any one transaction.

Strategic alliances can take many forms. They range from simple licensing through an equity investment with an option to purchase the entire business of the Junior Party. Strategic alliances involve many different forms. Several common forms include:

- Distribution of a Junior Party's existing product by a Senior Party;
- Development of a new product

by a Junior Party for off-line manufacture and distribution by a Senior Party.

• Joint development of a product with manufacturing by the Senior Party and distribution by both Parties.

This list is only suggestive and could be much longer. The spectrum ranges from one-length transactions to increasingly integrated ones, such as joint marketing, cooperative marketing, original equipment manufacturing, joint research and development agreements, cross-licensing, allocation of manufacturing capability, joint ventures, equity investment and licensing and so on. Recently, the term "copartnership" has come to mean a particular type of strategic alliance in which a Senior Party invests in the equity of a Junior Party and also receives a license for some of the Junior Party's technology. However, as the title of this article suggests, the discussion will not be limited to transactions in which the Senior Party makes an equity investment in the Junior Party.

The challenge for a licensing executive is to carefully analyze the strengths, desires and concerns of both parties. He or she must develop an understanding of the product, the development process, if any, and third-party agreements and relationships related to or necessary to the development, manufacture and distribution of the product. He or she must then structure the relationship based on an analysis of the relevant legal principles.

## Elements of Success

We have found that certain elements are critical to the success of strategic alliances and inter-industry licenses:

1. Each party to the greatest extent possible, must reach consensus

internally over objectives and constraints. The licensing executive can assist in this process but it is critical that he or she understand his or her "client's" objectives and limits. Although this process will be a continuous one, he or she can save his or her client considerable time and energy by ensuring that the goals of both parties are not too incompatible to be achieved.

2. It is important that negotiations be conducted at the appropriate level. Strategic alliances are unlike standard purchase or license agreements. They require the attention of more senior-level management than typically deals with distribution or licensing arrangements. Negotiations teams should include representatives both of higher level management and the actual line managers responsible for implementing the alliance. Although the senior-level managers may not be involved in the day-to-day negotiations, it is critical that they be kept informed of these negotiations so they can rapidly correct any departure from the initial agreement.

3. The parties should begin negotiations with a general discussion of each party's goals, desires and concerns to set the context for the discussions of specific issues. Once again, it is critical to make sure that the goals of each party are compatible.

4. Each party should maintain a healthy respect for the position of the other party.

5. It is important to recognize that the alliance will be a collaborative venture and that the negotiations should reflect this recognition. They should avoid a "win/lose" attitude.

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The parties will be working together closely for a long time and the substance of the relationship established by the negotiations is very important. When the parties complete the negotiations, they should view each other as "partners" in a collaborative enterprise and not adversaries.

#### PRE-NEGOTIATION ANALYSIS

Before commencing negotiations it is very important that the licensing executive for each party understands its potential contribution to the alliance, its desires for the alliance and its concerns in the alliance. We will briefly discuss the typical concerns of each party in the following sections.

##### Senior Party

Typically, the Senior Party brings capital and a distribution network to the relationship. It may bring an installed base of its own products upon which the Junior Party's product can be used. It may bring the capability of manufacturing the Junior Party's product in volume and at lower cost than the Junior Party. The Senior Party may also provide other services, such as package design, advertising and customer support (such as engineering and field maintenance, which the Junior Party may not yet have developed).

The Senior Party generally wants a capital infusion of the new products based on the Junior Party's technology either to supplement its existing product line or to expand its product line to new or related product areas. It may wish to obtain expertise from the Junior Party in a specific market in order to facilitate the Senior Party's entry into that market. Another frequent goal is to obtain access to a stream of new products and technology, a "win-win" or new developments. The Senior Party may also want to expand its management and employees to the more aggressive and entrepreneurial corporate culture of the Junior Party. Finally, the Senior Party may view the relationship as a first step toward the potential acquisition of the Junior Party.

The Senior Party will be concerned about the product availability, such as quantity, quality and timing. It will also typically be concerned about the cost of both the development and the manufacture of the product. Another common concern is the Senior Party's ability to continue supporting the Junior Party's product, if the relationship with the Junior Party should end or the Junior Party should cease doing business. The Senior Party will also want to ensure that it will benefit from its contribution in the Junior Party's success. However, the Senior Party's goals will differ from those of a typical investor. It will probably be more interested in control of the Junior Party to ensure that the product remains a priority for the Junior Party. The lack of investment experience of the Senior Party may prove to be a problem—for example, the Senior Party may not be expecting to invest in future rounds of financing as would a typical investor. In addition, accounting issues will be much more important (see below) for the Senior Party than for the typical investor. Finally, it will be more interested in product development than simply a return on its investment.

##### Junior Party

The Junior Party generally brings cutting-edge technology to the alliance. Its technology can be used in existing products or future products. It also brings a more aggressive, entrepreneurial corporate culture that supports the risk taking that is essential to bring new products to market quickly. Finally, the Junior Party may bring expertise in marketing its particular technology.

The Junior Party's goal generally is to sell products and to finance additional research and development. It may also wish to establish and expand its manufacturing capacities by using the Senior Party's facilities or by using capital from the Senior Party to build such facilities. The strategic alliance may also provide credibility in the marketplace for the Junior Party and assist it to obtain funding from third parties. It may also gain access to the Senior Party's packaging, advertising and distribution expertise, which the

Junior Party may not have in its own organization. Finally, the Senior Party may provide an alternative to more traditional liquidity paths, such as an initial public offering, through a possible acquisition by the Senior Party.

The Junior Party will be very concerned about the protection of its technology. These risks include "leakage" by the Senior Party and disclosure of technology to third parties through the Senior Party. This concern about third parties will be particularly acute if the Senior Party is a large multinational with one or more subsidiaries who are potential competitors of the Junior Party. The Junior Party may be concerned about its ability to meet the product delivery obligations and make a profit based on the pricing and payment schedule if these obligations are negotiated before the product exists. It will also be concerned about the strength of the commitment of the Senior Party. These commitments could take such forms as additional capital, management time or manufacturing facility access. The capital commitment for the Senior Party will inevitably be much less than that of the Junior Party. Consequently, a change of product focus by the Senior Party that affects the strategic alliance could have disastrous consequences for the Junior Party. The Junior Party will also be very concerned about maintaining its managerial and technological independence. It will want to maintain its flexibility to market future products and to obtain future financing through a public offering or acquisition by third parties.

#### FORM OF THE ALLIANCE

##### Joint Issues

One of the earliest issues the parties must decide is the form of the strategic alliance. In simplest terms, the issue is whether the alliance will be exploited in the form of a joint, separate entity or whether it will be contractual, relying only on existing entities. Both forms have their own advantages.

**Separate Entity.** If the project requires a long-term commitment of

management resources and significant investments, a separate entity may be appropriate. Generally, the choice of entity focuses on a partnership or corporation. However, the parties in international joint ventures may be able to obtain some of the advantages of both types of entities through the use of foreign entities such as a Gesellschaft mit beschränkter Haftung ("GmbH") or Societe Anonyme ("SA"). These entities do not have exact analogs in American law but include characteristics of both corporations and partnerships.

A partnership has the advantage of a single level of taxation because of its "pass-through status." It is also very flexible in allocating losses and profits separately and in its management structure. However, a partnership has the disadvantage of unlimited liability, although this disadvantage may be minimized by the use of "single purpose" subsidiary corporations.

A corporation, on the other hand, has limited liability and a much more flexible capital structure. For example, corporations can have various types of preferred stocks with different rates of return and voting rights. A corporation is very rigid about the allocation of profits and losses, although this rigidity may be ameliorated by using preferred stock and other securities. The parties may also pay taxes twice on their profits if they choose to obtain their returns through corporate dividends; the profits of the corporation will be taxed first at the corporate level, then the dividends paid to the "shareholders" will be taxed as income.

Contractual. The contractual form is generally more flexible and simple. It also avoids many of the difficult management issues that arise in forming a separate entity. On the other hand, it may not be an effective way of exploiting the technology if such exploitation requires commitment of substantial resources over a long period of time. In addition, a "complex" contractual alliance may be a *de facto* partnership without the advantages of a written partnership agreement. A purely contractual relationship can be supplemented by an

equity investment in the Junior Party. As we mentioned above, this form of relationship is frequently referred to as "corporate partnering."

In the next section we will discuss the concerns that should be addressed in structuring a separate entity. If the strategic alliance is in the form of an investment or only a contractual relationship, these issues are addressed below.

#### Structure of a Separate Entity

The issues involved in structuring a separate entity are similar for both partnerships and corporations although they may be expressed differently in each type of entity.

**Capitalization.** The initial capitalization of the entity and its future needs will be a major concern to both parties. Generally, the Senior Party contributes cash (and perhaps some technology), while the contribution of the Junior Party is primarily technology. The initial question that arises is the valuation of the relative contributions. For new or untried technology this problem can be a particularly difficult one.

However, once the initial capital contributions are made, the parties must ensure that a method of obtaining future capital contributions is defined. The Senior Party may wish to obligate the Junior Party to participate in future capital contributions. The parties must decide upon what basis such capital calls can be made. The Junior Party must be very careful to ensure it has sufficient flexibility to fund the cash or another alternative if it does not have the cash at the time of the capital call. The parties should also be prepared to deal with the circumstance in which the Junior Party is not able to contribute cash. One solution is to permit the Senior Party to obtain preferred stock or preferred debt, or perhaps a greater share in the equity of the entity if it provides the Junior Party's share of the capital call. This issue is a very delicate one since a shift in the equity interest will affect the control issues, which we will discuss later.

**Form of Investment.** The Senior Party must decide on the form of its investment. If the entity is in the

form of a separate corporation, several alternatives are available. The most common alternatives are common stock, preferred stock, debt or warrants. These types of investments are rarely in the form of debt since that form would limit the potential return to the Senior Party. Generally, the investment is in the form of preferred stock because it can offer preference on liquidation, special voting rights and anti-dilution protection. Anti-dilution protection can be particularly important for an early stage financing when the value of the company is unclear and future financing rounds may be sold at lower prices. Another advantage of preferred stock is that it does not necessarily increase the price of common stock and, thus, permits continued use of common stock as incentive for employees. The owners of preferred stock can also be granted a seat on the board of directors even though their percentage of ownership of the corporation would not normally permit such representation. In addition, the consent of such series of preferred stock may be required prior to a merger or other sale of assets. This right gives the owner of a controlling interest in a series of preferred stock considerable leverage over the corporation.

A simpler form of investment is a warrant. A warrant is a right to purchase the least number of shares at a fixed price. It permits the Senior Party to share in the success of the Junior Party without actually investing any money.

Although it is possible to invest in common stock, this type of investment is rarely used because it raises the price of the common stock. This increase in price reduces the effectiveness of options to buy common stock as an incentive for employees.

**Control.** Another important issue is that of control. This issue takes two forms: policy and day-to-day management. Policy issues present the most difficult problems since they are the most likely to affect the success or failure of the alliance. Decisions on these issues are also likely to require the greatest obligation on the parties, financially or

otherwise.

The parties frequently require that policy-level issues be approved by a special vote. The parties will agree that certain types of decisions require either a super-majority vote or unanimity between them. Naturally, the more issues in this category, the greater the chance for deadlock. Examples of these types of issues include: a change in the direction of the research; changes in the budget share a certain percentage; the requirement of significant contributions of new capital by the parties; the admission of third parties to the alliance; and the sale of interest in the entity to third parties.

Policy issues are generally decided by the board of directors (or its equivalent in a partnership). The representation of the parties on the board is very important. The business owner's solution to this problem often is an equal number of directors for each party. However, this solution increases the chances for deadlock on important issues. Other solutions to this problem are discussed below. The parties must also be very careful to specify the manner of filling vacancies for such positions and the numbers necessary for a quorum in order to conduct business. Otherwise, one party may find itself the victim of major policy changes if one of its directors cannot attend a meeting. In the corporate context, some of these issues can be dealt with through class voting and shareholders' agreements. However, some issues may still be subject to deadlock because of their importance to both parties.

#### • Anticipate Problems •

The licensing executive should try to minimize the chances of deadlock by anticipating potential problems and trying to provide solutions for them. An issue that often leads to deadlocks is the contribution of additional capital. It is generally quite difficult to predict at the beginning of an alliance how much capital will be required to develop a product. If the product requires a significant additional investment of capital for development, the Junior Party may be un-

able or unwilling to provide a share of such capital. In such situations, the licensing executive should provide the Junior Party with alternatives such as a reasonable time to raise the capital or contribution by the Junior Party or the "Junior Party's share" for a greater share of the profits of the entity if a higher return on its contribution.

However, the agreement should also provide a procedure to resolve deadlocks. One solution for deadlock is to provide a neutral director who can act as "swing" man. Unfortunately, such directors are difficult to find. Another solution is to provide for resolution at senior management levels of both the Junior Party and Senior Party. Arbitration is also frequently mentioned as a possibility, but this solution may prove to be illusory unless the parties have defined standards for the arbitrator upon which the dispute can be resolved. Arbitrators may not be advisable if the potential deadlocks are likely to involve a policy decision where no single "correct" answer exists. Finally, for cases of irreconcilable deadlocks the parties should provide for a buy-out either through a bidding process or liquidation option (in which the desiring party offers to buy out the other party at a certain price, but is willing to be bought out himself at that price). The Junior Party is at a significant disadvantage in a buy-out option because of the greater financial strength of the Senior Party. This disadvantage can be reduced by permitting the Junior Party a longer time period to raise the purchase price or permitting the Junior Party's purchase be paid in the form of an installment note with payments spread over several years.

The day-to-day management issues can be handled in a variety of fashions. If the project is significant, the parties may wish to recruit an independent management which is not associated with either party. Otherwise, the day-to-day management is inherently performed by a manager or key man of one of the parties. The parties may also wish to alternate those managers over periods of time to minimize conflicts of interest. Another con-

venient solution is to have one party manage the entity under a management contract.

The licensing executive must carefully consider the structure of the alliance and the effect it will have on the actual managers. For example, in an alliance structured as a corporation, its corporate officers and directors will have a duty of loyalty to the corporation, not the parties. This duty might prove to be particularly awkward because of the corporate opportunity doctrine in which the officer or director would have a duty to present the opportunity first to the "alliance corporation," instead of the party for whom he or she works. Partnership law imposes a similar, though less stringent, obligation of fiduciary duty between partners and the partnership.

These questions also bring into focus the critical issue of competition between the alliance entity and one of the parties or its affiliates. The parties must carefully consider the scope of the alliance and what types of competition will be permitted.

**Transfer of Interest.** The ability to transfer an interest in the entity is very important to each party, since the relationship in a joint venture often differs from the standard distribution or license arrangement, the non-transferring party will wish to be certain that it is not forced to accept an unsatisfactory substitute as a member of the alliance. Consequently, in most cases, the transfer of one party's interest is prohibited without the prior approval of the other party. However, this requirement may be too restrictive. One solution is to provide for a right of first refusal to the non-transferring party. This solution sidesteps the valuation problem by permitting a third party to set the value of the interest. Unfortunately, it is very difficult to find a third party to bid in such circumstances. Third parties are understandably reluctant to spend the time and energy necessary to evaluate adequately the value of the interest if they can be bought out by the other party. Generally, the solution to this problem is a "buyout," similar to the one we described in the previous

vention.

**Return.** The parties must also decide how they will obtain their profits from the entity. They can take their profits directly, either by distributions (partnerships) or dividends (corporations), although this method may involve undesirable double taxation if the alliance is in a corporate form. However, the parties may obtain their profits in a variety of other ways, such as through sales of components to the entity, or royalties on their technology licenses.

**Dissolution.** One of the most important issues, and one that is rarely addressed adequately, is the question of the rights of the parties in the entity's property and technology upon its dissolution. The most important question is generally the rights of each party to the technology that has been developed and is owned by the entity. Another important question is the responsibility for paying off the entity's current obligations and future obligations (either contingent or unknown).

If the parties do not address these issues directly they may find themselves joint owners of the technology with all the disadvantages of such joint ownership (see below.) One potential solution is to have the party that accepts responsibility for the entity's liabilities be the owner of the technology with the other party obtaining a perpetual, non-transferable license to use the technology.

**Special Issues Relating to Investments in the Junior Party.**

If the Senior Party invests directly in the Junior Party, the Senior Party must deal with the traditional issues related to such investments. These issues are described as follows:

**Voting Rights.** The Senior Party may wish to require special voting provisions for certain actions (for example, two-thirds majority instead of a simple majority), such as mergers or sale of assets to preserve its position.

**Registration Rights.** These rights are very important if the Senior Party acquires liquidity for its investment through a public offering of its

stock in the Junior Party. If the Senior Party's investment in the Junior Party is significant, the Senior Party may be considered an "affiliate" for securities law purposes and will not be able to sell its stock without a registration, even after the Junior Party is a public company. These registration rights take two forms: (a) "piggyback rights," which permit the Senior Party to participate in registrations of stock by the Junior Party after the initial public offering, and (b) "demand rights," which permit the Senior Party to require the registration of its stock by the Junior Party. These rights generally also permit the Junior Party to delay such offerings for a limited time to wait for a better market.

**Anti-dilution.** Anti-dilution provisions can be very important for early investments in a Junior Party when the value of its stock is uncertain. The Senior Party may want protection against future financing rounds at lower prices.

**Liquidation Preference.** Liquidation preference is available on preferred stock to ensure that the Senior Party obtains the return of its initial investment. This preference may not be as important in traditional businesses or "liquidation" (because very few assets may be available) as in "cyclical" price markets where it can be very valuable.

**Redemption.** Another method to protect the Senior Party from downside risk is a requirement that the Junior Party repurchase the Senior Party's shares at some future date at a set price ("redemption right"). A redemption right requires that the Senior Party will obtain the return of its capital and, perhaps, a certain return on that capital. It also provides a method of liquidity if the Junior Party has not yet become a publicly traded company or otherwise achieved liquidity by a certain date.

**Dividends.** The requirement to pay dividends is often found in preferred stock, although dividends can guarantee certain minimum returns on investment, this return is frequently illusory since few high-technology companies actually pay dividends.

**Board of Directors Representation.** The Senior Party may wish to have a representative on the Board of Directors to ensure that it is kept abreast of the decisions of the Junior Party. Such representation can be achieved by class voting rights for preferred stock or a voting agreement with the other shareholders. Such a representative poses a potential conflict for the Junior Party since the Senior Party may only be involved in one part of the Junior Party's business and the Junior Party may not wish the Senior Party to be aware of its plans in other areas. A solution to this potential problem is to accord the Senior Party's representative "observer" status rather than a position as a member of the board of directors.

**Call-Back Rights.** This right ensures that if the founders or other significant shareholders are selling their stock, the Senior Party can participate in the sale at the same price (up to a certain percentage of its holdings). It ensures that the Senior Party will be able to share with other investors an opportunity to obtain liquidity.

**First Refusal on Future Financing.** The right of first refusal to participate in future financing rounds ensures that the Senior Party can maintain its relative ownership of the new entity (or the Junior Party). If these rounds of financing are at a lower price per share than its original investment, this right of first refusal can be another method of minimizing the dilution of the Senior Party's holdings.

**Staged Purchases.** If the Senior Party is concerned about the performance of the Junior Party, it can make its investment in installments. Generally, such installments are based on meeting certain milestones. However, they can be simply based on the passage of time. Milestones reduce the Senior Party's risk if the Junior Party fails. They also give the Junior Party an incentive to perform. Unfortunately, this protection can be illusory because the Senior Party generally will be committed to the project after the initial installment and may waive any performance milestones except for very severe failures by the

Junior Party. Nevertheless, staged investments can provide the Senior Party with significant negotiating leverage when the Junior Party has failed to live up to its obligations.

**Buy-Out Option.** If the Senior Party is considering the purchase of the Junior Party, it may wish to establish a method of setting the price at an early stage. The inclusion of such an option will depend on the goals of the parties and whether such an option would sap the entrepreneurial spirit of the Junior Party. The Senior Party must also be careful that its method of acquiring equity of the Junior Party does not affect its options on future mergers with the Junior Party. For example, if the Senior Party acquires more than twenty percent (20%) of the Junior Party's equity, that acquisition may preclude a tax-free, reverse triangular merger (see Section 368(a)(2)(E) of the Internal Revenue Code.)

**Accounting.** The Senior Party must also be sensitive to the accounting treatment of its investment. For example, a Senior Party's acquisition of more than 10% of the Junior Party's voting common stock or common stock equivalent will eliminate the availability of "pooling" treatment if the Senior Party decides to acquire the Junior Party. In addition, a Senior Party owning more than 20% of the Junior Party's stock must generally include its share of the Junior Party's profits or losses in its own income statements.

**Anti-trust Issues.** If the investment rises to the appropriate level, it may be subject to a Hart-Scott-Rodino premerger notification. The standards for such notification are complex, but we have included a brief summary of the transactions to which it applies. These standards are most likely to apply if the Senior Party has assets or annual sales of \$100 million or more and the Junior Party has annual sales or assets of \$10 million or more. Notifications to the Department of Justice and the Federal Trade Commission is required before the Senior Party is able to acquire (a) voting securities of the Junior Party with a value greater than \$5 million, or (b) more than 10% of the voting securities of the Junior Party. However, this

rule-of-thumb may be misleading, because the notification may not be required if the transaction falls within the complex rules regarding minimum transaction size.

**Acquisition by Foreign Persons.** Under the Omnibus Trade and Competitiveness Act of 1988 ("Act"), the acquisition by "foreign persons" of "control" of either assets or company that will "threaten to impair the national security" may be suspended or prohibited by the President. The possibility of such prohibitions can be avoided by filing a notice with the Department of the Treasury, which must then oppose the transaction within a fixed time. The application of the Act has been further complicated by Congress' failure to extend the authority to enforce the Act. Several bills are pending at the time this article was written to extend the authority, and transactions are still being revised. The authority to enforce the provisions of the Act under different statutory authority is open to question, but prudent counsel will continue to comply with its requirements.

#### TECHNOLOGY LICENSE

The technology license between the Senior Party and the Junior Party is very important. It must address many of the same issues that are found in any technology license. However, many of these issues take on a more profound importance because of the cooperative nature of the relationship between the two parties and the importance of the product to the parties. The negotiators of the Senior Party concerning investment terms may conflict with its ability to negotiate advantageous terms on the technology license because of the conflict between the considerations involved in the investment relationship and the technology licensing relationship. The parties should take care to ensure that the incentives in both relationships are coordinated. These issues and the concerns of both parties are outlined briefly below.

**Scope.** One of the most critical issues in establishing a strategic alliance is determining its scope.

This determination includes elements of both product and territory. The product element can be defined in several ways: a single product, an entire product line, or the right to use the technology in a particular market. The Senior Party wants access to the Junior Party's current and future products, but the Junior Party wants to limit the scope of the alliance to preserve its flexibility in future marketing.

The territorial scope may be worldwide or limited to certain countries. The Junior Party will want to ensure that it has the strongest possible position in each market while the Senior Party may wish to be able to exploit the Junior Party's technology throughout its product lines worldwide.

The decision on scope will affect the nature of the technology contributions by both parties. The contributions may be in the form of third-party licenses or limited to the licensing or assignment of certain patents and copyrights. The Junior Party will be particularly concerned about the Senior Party's rights in future technology developed by the Junior Party. However, one issue that may arise and may not be recognized is the rights of the Junior Party as the future development of the Senior Party based on the Junior Party's technology. These grant-back issues could be very important to assist the Junior Party in further developing its technology.

**Ownership.** The ownership of the technology developed as part of the alliance is one of the most difficult issues in an alliance. If the development work is performed by the Junior Party as part of a development agreement without the creation of a separate entity, the Junior Party will retain title to the technology. However, if the development work is a collaborative one, the parties must carefully define their respective rights in the technology. Frequently, this objective may be accomplished by cross licenses in a particular field of use or ownership of the technology by the new entity. One party may suggest joint ownership as a "solution." Unfortunately, joint owner-

ship of technology has many pitfalls. First, the effect of joint ownership varies among the different types of intellectual property (i.e., patents, copyright, etc.) even within the same country. For example, the joint owner of a patent in the United States can license it nonexclusively without any obligation to its other joint owner. On the other hand, the joint owner of a copyright in the United States may license it nonexclusively, but has a duty to account to its other joint owners for all profits derived from such licensing (unless both owners have agreed otherwise). Second, the effect of joint ownership varies from country to country. In many European countries, the license of a jointly-owned copyright must be signed by all of the joint owners in order to be enforceable. Finally, the effect of joint ownership in litigation can prove very embarrassing because the joint owners are often considered a "necessary" party who must be joined to the suit. Joint ownership of intellectual property should be avoided whenever possible.

**Technical Support.** The junior party must be careful to allocate its limited technical resources to ensure that they are not completely committed to the strategic alliance. It may also wish to recover its expenses for such technical support. These issues are often addressed by limiting the scope of technical support to a certain number of man-hours in a month. One frequently overlooked issue for the junior party is the commitment of management resources for "progress report meetings" and "quality control" inspections, which are common in these agreements.

**Product Discontinuation and Modification.** The junior party will want to retain the flexibility to control the product line and modify as necessary. On the other hand, the Senior Party will have a considerable investment in a particular form of the junior party's product. The junior party may wish to grant the Senior Party a limited manufacturing license that enters into effect if the junior party decides to cease production or to discontinue manufacturing a product.

**Exclusivity.** The Senior Party may wish to obtain rights to exploit a product in a particular market or territory. Such agreements can be very dangerous for the junior party because of the limitation of its future marketing options. This grant may also limit the ability of the junior party's product to become an industry standard. A junior party must ensure that any exclusivity is tied to very clear obligations by the Senior Party to exploit the product or technology to ensure that it does not "shelve" the junior party's technology.

**Product Ordering.** One of the most significant advantages of strategic alliances is the ability of the junior party to rely on a certain level of orders from the Senior Party. This assurance permits the junior party to achieve economies of scale and to "ramp up" naturally to meet future needs. On the other hand, to take advantage of this opportunity, the junior party must be willing to carefully plan its marketing and accurately estimate its needs.

**Pricing.** The determination of the price of a product under development is inherently risky because of the uncertainty of manufacturing and other costs. The Senior Party wants to ensure reasonably fixed costs in order to be able to plan its distribution and use of the product. On the other hand, the junior party must understand the problems of the junior party and ensure that the prices are realistic.

If the relationship involves the manufacture of the junior party's product by the Senior Party, the usual issues about royalties will arise: whether the royalties will be charged on a per-unit basis or as a percentage of sales cost, if so, when a "sale" is a sale for royalty purposes and the rate on "combination products." For example, if the junior party's product is only sold bundled with that of the Senior Party (and it is never sold independently), the parties will find it very difficult to determine the amount of royalty that must be calculated as a percentage of "sales" of the junior party's product. Other royalty issues include term, cap-tains and currency of payment.

The natural adjunct of the payment of royalties is the right to obtain reports and conduct audits. Reports can be very valuable in determining the success of the product and where to focus energies in the new markets. Audit rights are critical for the junior party to ensure that it is receiving the proper amount of royalties. These audit rights should include a requirement by the Senior Party to maintain records for a reasonable period of time. The junior party should be sensitive to the Senior Party's concerns in these areas and, except in unusual circumstances, not require the retention of such records beyond the normal records retention policy established by the Senior Party.

**Term and Termination.** Careful drafting of the termination provision may provide solutions for many of the potential problems that can arise during the alliance. For example, the failure to meet sales quotas by the Senior Party is not unusual. However, the junior party should have an alternative to terminating the Senior Party since such a draconian solution may be expected only in the most extreme circumstances. One potential solution for such failure is to reduce the junior party's rights from exclusive to nonexclusive, thus avoiding termination of the entire agreement. The Senior Party may also have concerns on termination. For example, if the junior party decides to cease manufacturing the product, the Senior Party may wish to phase out such production to avoid interference with the Senior Party's distribution of the products. The agreement should also provide for expedited termination of the agreement for certain breaches, such as violation of the proprietary rights of the other party.

**Antitrust.** The parties must be sensitive to antitrust issues that may be raised in the technology license. For example, if the license includes patents, the parties should be careful to adjust royalties upon expiration of the patents to avoid a patent misalignment. They should also be sensitive to the prohibition on horizontal agreements between competitors and tying issues. If the

technology agreement is in the form of a supply agreement then both parties should be sensitive to concerns raised by the Robinson Patman Act.

#### Development Agreement

Development agreements raise special issues. One of the most important is the nature of the development obligations on the Junior Party. This requirement can range from an absolute obligation to develop the product, to best efforts, to "reasonable commercial" efforts. An absolute obligation is very dangerous in any area of new or untried technology because if the Junior Party fails to create the product, it might be held liable for all funds advanced by the Senior Party.

A "best-efforts" obligation is little better for the Junior Party because this obligation has been interpreted very loosely by the courts. The Junior Party should attempt to maintain its obligations at the level of "reasonable commercial efforts." The Senior Party should be willing to rely upon the commercial incentives to create that the development is completed. If the Senior Party insists on a "best-efforts" obligation, a reasonable compromise is to state what "best efforts" means in this context, such as certain number of man-hours in a certain period of time.

Another important issue is development agreements as the method of dealing with changes in the specifications. This issue should be addressed directly to avoid delays

or increased costs due to such changes. The parties should establish a procedure to estimate the cost and delay of such changes as well as procedure for approval of such changes.

#### CONCLUSION

Strategic alliances, by their nature, present a host of issues. They call on many different skills of the licensing executives who create them. They must structure the commercial relationship between the parties in a manner that meets their goals and concerns. Licensing executives involved in creating strategic alliances should be particularly careful to remain flexible and creative in addressing these issues.