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An Integrated Approach to Preventing Alliance Disputes:
An Ounce of Prevention is Worth a Ton of Armour
(Part 1)

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Some 700 years ago, the royal courts of England and France faced off in a dispute over who was next in line to take over the French monarchy. Both sides felt they had the weapons that would ensure them an early victory. The result was the Hundred Years War. At the battle of Crécy in 1346 the French, decked out in the best armour money could buy, were decimated by English longbows. Some 500,000 arrows rained down on the French, felling some 1,200 knights, most of them even before they were able to join the fight. Those who survived learned a powerful lesson (unfortunately the wrong one): *we need more armour*.

Over the next half a century, the French gradually added ever thicker layers of armour to their knights and horses until, by 1415, when they met the English again at the battle of Agincourt, they weighed about 50% more than their predecessors. Protected by all of that gleaming steel, the French knights were brashly confident of victory, vying with one another for the right to lead the charge. What they did not foresee was what would happen if they were knocked from their horses: the sheer weight and inflexibility of their armour would mire them in the mud to be trampled or picked off by English foot soldiers. At the end of the day, the fields of Agincourt lay strewn with the bodies of 5,000 French knights…and lots and lots of expensive armour.

Like the knights of old, shareholders', partnership and other alliance agreements today are increasingly encased within legal armour—clauses aimed at protecting the respective interests of the signatories. Language setting out the rules of share transfers, rights of first refusal, pre-emptive rights, liquidated damages and arbitration clauses, just to name a few, are so common that they are often (unfairly) referred to as 'boiler-plate' clauses.

The present paradigm is that when difficulties or disputes in the alliance arise, parties primarily turn to these clauses to defend themselves or to advance their own position versus that of their putative ally; and lawyers, wishing to protect their clients from any possible adverse outcome during a dispute, work to ensure that their clients are fully protected from the start through layering on tighter and thicker legal armour.

The critical question is: will heavier and better legal armour necessarily ensure a better overall outcome for the client? There are three reasons for disagreeing.

First, as every litigator knows, there is no such thing as a "perfect contract." For every corporate counsel who seeks this Holy Grail there is a trial lawyer who will counter by finding the "holey clause," resulting in a perpetual legal "arms race." Moreover, contracts are temporal: based on a set of realities that exist at the time of agreement and perhaps a few imaginable predictions of possible change. But even the most comprehensive agreement can fall to an unexpected blow.

For example, as we saw first-hand, the 1997 Asian financial crisis pulled the rug out from under hundreds of partnerships that remained fixated on the terms of their contracts. Once the value of the affected currencies fell in half and public demand for foreign products dropped through the floor, the detailed schedules and arrangements in the contracts simply didn't make sense anymore. When the economically unaffected partners tried to sue on their contractual rights, the distressed side cried foul and claimed "materially changed circumstances." Their courts agreed. Not only did they reject most lawsuits brought on noncompliance, but they allowed local companies to repudiate contracts altogether. In their wake, new companies untainted by the bitterness of judicial battle, snapped up deals at great prices—and are now thriving in the much stronger economy. In other words, companies that relied on their legal armour and insisted on the strict letter of the law in honouring their contracts, lost both the courtroom battle and future business that could have earned them millions of dollars.

This raises two questions, which underlie the **second** reason for looking beyond protection clauses. What is a contract? Any dictionary will tell you that it is simply a formal "agreement" or "understanding" of expectations and obligations between two or more parties. The word comes from "to reduce": in other words,

to reduce an *overall understanding* of mutual aspirations into concise words. The second and even more important question is: why do people enter into contracts in the first place? Because they wish to turn those mutual aspirations into mutual benefits. That cannot be done through punitive clauses, but only through trust and cooperation in fulfilling those expectations and carrying out those obligations. While protection *of all parties* plays an important part in any contract, it is only *one part*.

The quest for the "perfect contract," on the other hand, begins from the point of view of *disagreement*, building protective walls to ensure one's own side emerges the victor in an eventual fight. In some cases, these contracts not only assume, but actually create distrust, by focusing so heavily on restrictions, obligations and dispute resolution procedures that they fail to deal with the essential goals of the contracting parties. In the process (and the language), the concept of *understanding* can get entirely lost.

A 1999 KPMG study on why so many mergers and acquisitions fail found that companies that focused their pre-merger considerations on financial or legal issues to the detriment of other areas were 15% less likely than average to have a successful deal, whereas those who concentrated on "gaining a clear understanding of *what* and *where* value can be obtained from a deal" were 28% more likely than average to succeed.[1] The reason is that the latter built trust. In a follow-up report published this year, based on interviews with alliance managers, KPMG singled out trust as the key factor in every alliance: "Virtually all the executives interviewed emphasized the need to take time to develop a trust-based relationship *before* entering into a partnership relationship"[2]

On the other hand, a study done by researchers at Harvard Business School and Northwestern University's Kellogg School of Management has shown that "the use of binding contracts seems to have kept interacting parties from seeing each other's cooperative behaviors as indicative of trustworthiness." The authors warned that "attempting to mitigate risks early in the relationship can make it difficult to build trust necessary to take greater risks in the future…and when companies or individuals use the structural force of a contract as the primary (or sole) basis for their relationship they may encounter tremendous difficulties when the contract does not fulfill its intended purpose"[3]

This is not to suggest that tightly-drafted contracts are ineffectual or harmful. Far from that, a well-drafted, unambiguous contract can provide clarity and direction in carrying out the agreement and assist alliance partners when difficulties inevitably arise in their relationship. Even more fundamentally, the exercise of drafting the agreement can become the basis for important conversations between *all* parties as to the goals they are seeking to achieve, their visions and timelines, how they intend to carry out their roles, and how they would like to handle problems as they arise. By carefully examining the language proposed by the other side, corporate counsel can gain insight into the other party's motives and values which, at minimum, will generate an important set of questions he should ask on behalf of his client prior to entering into the agreement, and possibly avoid potential inequity or injury to his client.

The point to be drawn is that the agreement should be an *integral part* of the web of the entire business relationship between alliance partners. In the words of Jeswald Salacuse, Professor of Commercial Law at the Fletcher School of Law and Diplomacy, "While negotiators must necessarily be concerned about a deal's contractual provisions, they should also lay a solid foundation for a business relationship from the *very start of talks*".[4] In other words, the desire for legal certainty cannot come at the price of practical implementation, mutual benefit and, most importantly, the relationship between the parties.

Admittedly, this is a difficult balancing act. The oft heard question of frustrated corporate counsel is "How do we know when we have crossed over from being protective of our clients to causing harm to the relationship between the potential alliance partners?" While common, this question misses the point. The paradigm needs to be shifted from protecting the client from failure to *enabling him to succeed*. Success in business, marriage or any contract must begin with open sharing of visions and expectations, mutual respect, and a solid, cooperative relationship built on trust. The important job of the lawyer is to facilitate that understanding before the contract, then build an agreement that both summarizes that understanding and facilitates future cooperation.

The **third** reason for disagreeing with calls for heavier legal armour is that ultimately when something goes bump in the alliance (and something *always* goes bump), the 'wronged' party has to sue on the relevant clause(s) in the agreement in order to enjoy the 'right' to its protection or intended effect.

The obvious problem with this "rights-based" approach is that these "rights" *have to be first brought before, adjudicated on and thereafter enforced* by a Court—a costly, lengthy, and unpredictable ordeal. Even if it is successful, litigation usually destroys a once profitable business alliance. Sending the matter for arbitration is similarly damaging. Finally, add to this unfortunate mix that the majority of alliances are now between transnational alliance partners, who may be far removed from the arm of any enforcement mechanism you might call upon, and the value to your client of contractual safety systems decreases exponentially—while the risk of catastrophic failure of the alliance itself exponentially increases.

We have all experienced cases where the contract "clearly" protected our client, but the local court system found extenuating circumstances favoring their native son—or where the foreign side was found guilty by the courts, but simply refused to pay the damages. Even the intervention by US President George Bush (backed up by several detailed contracts as well as rulings by both a state panel in India and the International Court of Arbitration in London) couldn't get Maharashtra State to honor the Dabhol Power agreement with Enron.

So, if piling on thicker coats of legal armour is inadequate for preventing or resolving disputes in alliances, what else can be done? That will be the topic of the second and concluding part of this article.

To be continued in a future issue of The Intellitrainer….

1 KPMG, "Unlocking Shareholder Value: The Keys to Success," *Mergers and Acquisitions: Global Research Report*, 1999.

2 KPMG, "Alliances and Joint Ventures: Fit, Focus and Follow-Through," *Transaction Services Advisory*, June 2005.

3 Deepak Malhotra and J. Keith Murnighan, "The Effects of Contracts on Interpersonal Trust," *Administrative Science Quarterly*, Sep 2002.

4 Jeswald W. Salacuse, "The Deal is Done—Now What?", *Harvard Negotiation Newsletter*, Nov 2005.