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An Integrated Approach to Preventing Alliance Disputes:
An Ounce of Prevention is Worth a Ton of Armour
(Part 2)

By Jonathan Yuen and Dr. Melanie Billings-Yun
Global Resolutions

Understanding why alliances fail

It is reliably estimated that a staggering 55% of alliances and 78% of mergers and acquisitions fall apart within three years of conception.[1] Obviously a good corporate counsel wants to ensure his client is in the winning minority. But if piling on thicker coats of legal armour is inadequate for preventing or resolving disputes in alliances, what else can be done?

Start by understanding that most alliances fail not because of poor drafting of contractual terms or because due diligence was performed with insufficient diligence, but rather because the alliance partners did not understand their own or their partners' true interests and expectations. In some cases, the parties were so keen to make the deal that they shut their eyes to impending problems, avoided asking uncomfortable questions or even papered over disagreements with vague language. As a result, while the parties may have agreed to the *same* terms on paper, they may actually have had very different expectations about how the agreement would work in practice.[2]

We have helped negotiate shareholder disputes in companies of all kinds: from small local partnerships to multimillion dollar international alliances. No matter what the size, they all followed the same pattern at their inception: one or all of the parties rushed into the relationship with their eyes so focused on how much money there was to be made that they never stopped to consider how they would work together.

A recent example is a "divorce" we negotiated between a biotechnology firm that had developed a patented wood pulping machine and its investor partner, a private equity firm. The alliance had worked smoothly until the machine was up and running. Then the parties fell out over the most basic of questions: what were they marketing? The biotech company wanted to guard its technology while ensuring sustainable returns by marketing the pulp. The private equity firm, on the other hand, under pressure for quicker returns from its own investors, wanted to produce and sell the machine itself, and had even scouted some interested buyers. In the dispute, both sides felt they were 100% in the right. The biotech firm considered itself to be the 'core' or 'substantive' part of the alliance because it held the IP and the expertise and did not take kindly to being told how to conduct its R&D and manufacturing processes. On the other hand, the equity partner considered *itself* to be the 'core' or 'substantive' part of the alliance because it had pulled the biotech firm out of near insolvency, had funded the machine's development, and had found buyers for the product—and did not take kindly to being told it was "perverting the whole business plan."

While there was enough ambiguity in the contract to fuel years of lawsuits, it was clear that the real issue in this case was that the parties had radically different understandings of the 'spirit' of their relationship. Because the parties had avoided the hard but necessary work of arriving at a true meeting of the minds in the courting stage, their "marriage" was doomed even before the ink dried on the alliance agreement.

How then do you best protect your clients from this fate? By enabling them to succeed through helping them to understand both the *spirit* and *letter* of the alliance agreements they are signing. We suggest the integrated "**Three I**" process: Identify, Inform, and Include.

Step One: Identify your client's true interests and expectations

Potential alliance partners should always ask themselves these basic questions:

1. Why do we *actually* want this alliance? What do we expect to gain?
2. What are we willing to give up to achieve that? Are there better alternatives?
3. What are our concerns? What do we need to know/do to alleviate them?

4. How will we work together? What do we expect the level of interaction and integration between both firms to be? (issues of scope, responsibility, anticipated returns, risk, knowledge-sharing, ownership, etc.)

5. How long are we in this for? ("For as long as there is money to be made" or "Until our circumstances change" are simply not satisfactory answers!)

Step Two: <u>Inform</u> all parties of those interests and expectations

Quite aside from merely identifying interests, concerns and expectations, it is *absolutely vital* that potential partners share this information with each other. Assuming that potential problems will work themselves out once the relationship develops is deeply dangerous. If you were embarking on a trek through the Gobi desert, wouldn't you ask your guide what you'll do when the water runs out? Or would you be satisfied with "Don't worry, we'll figure something out when the time comes"? Unfortunately, open communication prior to a signed deal is more the exception than the rule (which may help explain why successful mergers are so few).

To raise the level of vital pre-contract information sharing, you should:

1. Discuss your client's concerns and expectations and assess the other side's response;

2. Elicit the other party's concerns and expectations and discuss with your client how that may impact his business goals;

3. Question any special contractual terms requested by the other side and use them as a measure for further understanding the other side's interests and intentions;

4. Engage all parties in problem-solving discussions where interests seem to be in conflict;

5. Be willing to break off a deal if, after close exploration, the parties turn out to be incompatible (bearing in mind it is much less destructive to your client if the potential partners find this out *before* the alliance).

Step Three: <u>Include</u> contractual terms that reflect the spirit of the understanding

Only after completing the first two steps will potential partners be in a position to draft a contract that captures the spirit of the alliance. To further increase the chances of a successful union, we suggest that teams from both sides (including at least one person from each side trained in the law and another who will be involved in actually implementing the contract) work *together* to crafting the agreement. This will not only create a sense of mutual ownership and responsibility for the finished product, but will give the finished product a much higher chance of realistically being fulfilled.

The alliance agreement should include ***clear*** and ***unambiguous*** statements on:

1. Agreed expectations about the nature, goals, and duration of the alliance;

2. The directors' and shareholders' decision-making process (both "how" and "who");

3. The operational and management flow of reporting chains;

4. Relationship management mechanisms, including explicit procedures for frequent, regular meetings to discuss issues as they arise between the partners and to update each other on their own situations, so as prevent day-to-day problems or differences from building into misunderstandings that could destroy trust within the alliance;

5. Dispute resolution provisions and procedures for all levels of the alliance;

6. Provisions for re-negotiation and re-evaluation of the alliance to handle not just "material changes", but also changes in work flow, expectations, etc.

7. Termination-of-alliance procedures that set out in plain language such potentially contentious issues as how the company auditor will be selected, who will bear the cost of the valuation, who will have first right of refusal, etc.

Conclusion

Alliances are easily formed, but notoriously difficult to maintain. Countless alliances have failed to stay together or to produce their intended value because the negotiators focused on "winning the contract" as opposed to creating *a winning contract*—or because they confused prospective allies with potential enemies and "assisted" the client by wrapping him in armour.

We would argue that the art of the deal is more analogous to matchmaking than to the art of war. The goal is a prosperous union, not a bloody battlefield. And a contract is not an end in itself, but is more akin to a wedding ceremony: the solemn vows that enable the two parties to get to the real business: producing something fruitful together.

We therefore believe that more attention needs to be given to the pre-agreement stage: identifying, informing and including a deep understanding of each party's interests, concerns and expectations, as an essential part of a integrated approach to drafting alliance agreements.

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1 Stuart Kilman, "Avoiding Litigation: Corporate Counsel's Role in Ensuring Successful Alliance Implementation", Vantage Partners, 2000.

2 Ron S. Fortgang et al, "Negotiating the Spirit of the Deal", *Harvard Business Review*, Feb 2003.