Understanding and Structuring "Strategic" Corporate Partnering

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I. Overview

A. Introduction

This paper outlines the contract and corporate law issues of "strategic" corporate partnering.[1] A strategic corporate partnering is a system and an ongoing interdependent legal relationship in which the companies from complex structures that do not fit comfortably within any of the

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1 Throughout this paper this paper the term, "strategic" corporate partnering is used interchangeably with "corporate partnership", "corporate partnering" or "strategic alliances". Professors Jorde and Treece define a strategic alliance as "a bilateral or multilateral relationship characterized by the commitment of two or more partner firms to a common goal." *See* Thomas M. Jorde and David J. Teece, *Innovation, Cooperation, and Antitrust, in* Antitrust, Innovation and Competitiveness (Thomas M. Jorde and David J. Teece EDS., 1992) at 47, 55. Sometimes the term "joint venture" is also used interchangeably with corporate partnering. Some consider the joint venture a particular form of strategic alliances or corporate partnering, with later category considered to also include non-organizational forms of cooperation. *See, e.g.*, Steven R. Salbu and Richard A. Brahm, *Strategic Consideration in Designing Joint Venture Contracts*, 1992 Colum. Bus. L. Rev. 253 (1992). However, joint ventures are where two or more firms form a new entity, whereas corporate partnering operates separately but interdependent.

contemporary corporate and/or contract structures. As such, a srategic corporate partnering is considerably more difficult to structure and understand than more traditional partnerships. Furthermore, strategic corporate partnering is extremely varied, making it difficult to define in theory. Therefore, this paper does not offer a "unified theory" of strategic corporate partnering, but rather identifies and explains the benefits, opportunities and challenges of strategic corporate partnering.

Recently, partnering between companies has become very popular because corporate partners offer the promise of new markets and technologies.[2] The full effect of these emerging new business forms has yet to be felt. Nevertheless they are fundamentally reshaping the business, organizational and legal landscape that we know. As new business forms link the resources and the fortunes of the parties more closely than do other forms of inter-firm cooperation, our institutions and our theories will have to adopt to meet the challenge and the opportunity of a new digital-revolution-based world.

B. The Significance of Strategic Corporate Partnering for the Economic Development and Technological Innovation

1. Solution to "Institutional Dualism"

Many economies, developed and developing alike, remain burdened by some form of economic and technological dualism.[3] This dualism separates big, capital-intensive, market-integrated firms from more flexible

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2 A number of successful corporate partners have certainly gotten their share of press. Two examples are Microsoft's $150 million investment in Apple and Sun Microsystems' partnering with Netscape. But these partnerships are actually exceptions. To the rule; an estimated 60% fail. *See* Caroline Ellis, *Making Strategic Alliances Succeed; The Importance of Trust*, Harvard Business Review (July, 1996/August, 1996) at 8. John Harbison, a consultant at Booz, Allen & Hamilton, reckons that some 32,000 corporate partnerships have been formed around the world only between 1995 and 1998. Partnering now accounts for 18% of the revenues of America's biggest companies. *See The Science of Alliance*, Business Week (March 1998).

3 Dualism is a problem for the economy. More generally, dualism acts as a constraint on innovation, narrowing the range of technological and organizational forms available in the national economy. Nor do the majority of people enjoy greater wealth and freedom as a consequence of development in the vanguard sector. The dual economy condemns most to a life of drudgery and degradation, especially in the poorer of developing countries. *See* Tamara Lothian, *The Democratized Market Economy in Latin America (and elsewhere): An Exercise in Institutional Thinking within Law and Political Economy*, 28 Cornell Int'l L.J. 169, 171-172 (1995).

small and medium-sized enterprises with tenuous access to markets, capital and technology.

The large scale organizations can innovate, but only under certain circumstances. Extremely large size is not terribly important to innovation. They tend to bureaucratize. There is a strong temptation for large-scale organizations to enter into an alliance with politics to establish a monopoly. But, they can be innovative if there are a substantial number of small or mid-size organizations pushing an organization to innovate.

On the other hand, the small scale organizations have insufficient scale. They have a lack of capital to engage in sustained Research & Development (R&D) and the other aspects of the innovative process. They have a need to rely on information from very local or familiar partners. Moreover, they have the difficulty of capturing a substantial percentage of profits from innovation, with thus no incentive to innovate.

When constructed and managed effectively, corporate partnering can strengthen a firm's competitive advantage and narrow the gap between large firms and small players. The example of Silicon Valley is that central capital allows smaller firms to function as a network around the mid-size organizations that capture the economies of scale, of which smaller organizations can feed.[4] However, the legal system must offer the inno-

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4 Annalee Saxenian noted that blurring firms' boundaries was an organizational advantage for Silicon Valley in comparison to Route 128. Silicon Valley, CA and Route 128, MA are two of the premiere technological concentrations, not only in the United States, but in the world. (Geographically, Silicon Valley is an area of Northern California that contains a thirty-mile by ten-mile strip of land in Santa Clara County between the cities of San Francisco and San Jose. This economic region begins in the Northwest of the Valley in Palo Alto, where the bulk of theoretical and practical technological research in the area occurs at the Stanford University and the Stanford University Research Park. Traveling to the southeast, one finds the bulk of semiconductor firms ensconced in communities such as Sunnyvale, Cupertino, and Mountain View. Observers have identified the following regional advantages: world-class academic institutions (Stanford University and the University of California at Berkeley), brilliant scientists, military procurements of semiconductors and the pleasant climate of Northern California. Although similar to Silicon Valley with respect to its industrial emphasis (electronics), the Route 128 region around Boston presents a study in contrast in terms of its historical development, geography, community life, and degree of interconnectivity between firms. Like Silicon Valley, the development of electronics-related companies on the 65-mile highway surrounding Boston and Cambridge in the area's major research universities (The Massachusetts Institute of Technology and Harvard University) were influenced by academia, industry, and government.) Saxenian asked, "Why is that business in Silicon Valley is again flourishing while within Route 128 it continues to decline?" The answer, Saxenian suggests, has to do

vator appropriate industrial organization possibilities.[5] It is noted that: "The Silicon Valley model, which is quite different from many developing countries' models, is based on a judgment that smaller firms are the best innovators, because, in a small firm, employees have greater flexibility and greater incentives."[6]

Hence, in the Silicon Valley, corporate partners and venture capitalists provide financial support to a venture, while scientific and technological entrepreneurs obtain comparable portions of the ownership of the firm by contributing their labor and ideas. The Silicon Valley has developed special "corporate governance"[7] examples by which the relative interests of the venture capitalist, corporate partners and the entrepreneur can both be protected. And then, the successful new firms are sold to existing firms or to the public on the national securities markets. And corporate partnering provides this form, making possible a higher reconciliation of smallness and flexibility with economies of scale.

2. Solution to the "Cooperative-Competition"[8]

In traditional thinking, the relationship of cooperation to competition is still a problem. When there are obstacles in learning from one another, then there is a problem of cooperation. When information is flowing, and the knowledge is spreading easily, then there is a problem of competition.[9] When changes are constant in an industry such as knowledge-

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with the fact that, despite similar histories and technologies, Silicon Valley developed a decentralized but cooperative industrial system while Route 128 came to be dominated by independent, self-sufficient corporations. Indeed, during the 1980s Silicon Valley turned itself inside out, rendering almost useless the categories by which business traditionally defined themselves. Intense competitors became partners, sectoral lines merged and faded as technology advanced, and its distinctions between large and small firms all but collapsed. *See* Annalee Saxenian, Regional Advantage: Culture and Competition in Silicon Valley and Route 128 (1994).

5 *See* Joseph Bankman, *The Structure of Silicon Valley Start-Ups*, 41 Ucla L. Rev. 1737 (1994).

6 *See* John H. Barton, *The Impact of Technology on Legal Systems: Thoughts for Korea*, Faculty Presentation Series, Stanford Law School (1997) (on file with the author).

7 Numerous types of intermediate governance forms between markets and hierarchies exist and are frequently used as options for governing upstream stages of the value-added chain. For a discussion of alternative intermediate governance forms, *see* Oliver E. Williamson, the Economic Institutions of Capitalism: Firms, Markets, Relational Contracting (1985) at chs. 3, 7-8.

8 *See* Kenichi Ohmae, *The Global Logic of Strategic Alliances*, Harvard Business Review (March 1989/April 1989) at 143.

9 *See* William E. Kovacic, *The Competition Policy Entrepreneur And Law Reform In*

based or high-tech industry, cooperative-competition is likely to succeed.[10]

Corporate partnering is an economic and legal innovation, making it possible for firms to form various kinds of legal arrangements that allow tremendous flexibility in how one firm can compete yet at the same cooperate with one another. To implement successful economic development, though, there is a need for "cooperative competition," among small and medium, or decentralized divisions of large firms. They can simultaneously compete and cooperate, pooling financial, commercial, and technological resources.

The emerging organizational structure builds not only on the idea of Schumpeterian competition but also on cooperation.[11] Firms not only compete, but they can also cooperate to provide common services, to shape "the rules of the market game," and to shape complementary investment strategies. Firms competing in some respects are able to cooperate in others, pooling financial, technological, and commercial resources and thereby ensuring their access to economies of scale. Firms developing among themselves networks of cooperative competition may require legal forms standing someplace on the continuum from contract to the corporation.

C. Some Antitrust Considerations

In particular, it has been argued that American antitrust laws are inhibiting American companies from forming business ventures, such as R&D or production joint ventures, considered necessary for innovation

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Formerly Communist And Socialist Countries, 1996 Am U.J. Int'l L.& Pol'y 437 (1996); *see also* William E. Kovacic, *Getting Started: Creating New Competition Policy Institutions In Transition Economies,* 23 Brooklyn J. Int'l l. 403 (1997).

10 *See, e.g.,* Joseph L. Badaracco, JR., the Knowledge Link: How Firms Compete Through Strategic Alliances (1991).

11 It was Joseph Schumpeter, the great mid-century economist, who offered the paradox that imperfect competition is necessary for efficient capitalism. Schumpeter wrote, in his classic, "Capitalism, Socialism and Democracy", that "every grocer, every filling station, every manufacturer of gloves or handsaws" depended on a degree of market power to assure profits - a miniature monopoly in a product perceived by consumers to be unique. *See* Joseph Schumpeter, Capitalism, Socialism and Democracy (1942). Historically, those minimonopolies have dependent on imperfect information. The Internet, of course, acts like a solvent on imperfect information because the Internet is a nearly perfect market, providing instantaneous information. *See* Robert Kuttner, *The Net: A Market Too Perfect for Profits,* Business Week (May 11, 1998) at 20.

and product commercialization. Combined with what is considered to be the more lenient treatment of collaboration in other jurisdictions, such as Japan and Europe, many commentators argue that America's antitrust laws place American business at a competitive disadvantage with its European and Far Eastern neighbors. It has been this line of thinking that has argued, for example, for the legislative reform of the antitrust treatment of collaboration.[12] Consider the example of research and development or production cooperation. A cooperation arises when two or more parties (often competitors) act together (usually in the form of a corporation) for the general purposes of developing and testing a new product. The crucial question is "why do parties need to band together, as opposed to acting individually, to engage in research and development or product development activities?" The reasons most often cited are that innovative activity requires access to assets and information that are usually outside the capabilities of one firm and that innovative activity is a very risky project. Thus, corporate partnering provides a neat contractual or organizational manner in which parties can share risk and obtain access to the things they need. However, whenever parties band together (especially competitors) the antitrust authorities tend to get uneasy.

The reason for the unease is that competitors, under the rubric of cooperation, can engage in some rather undesired activities such as price fixing (e.g. setting prices for the new product or existing ones) or market allocations (i.e., providing local monopolies to the parties that cooperate).[13] However, many commentators have argued that antitrust analysis is ill-suited[14] for cooperation between firms.[15] For example, it is dif-

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12 There is a mainstream economic literature on cooperative development. For a recent article in point, *see* William F. Baxter and Daniel P. Kessler, *Toward a Consistent Theory of the Welfare Analysis of Agreements*, 47 Stan. L. Rev. 615 (April, 1995) [hereinafter Baxter]. Also, for a review of some of the literature, *see* Oliver E. Williamson, Antitrust Economics: Mergers, Contracting, and Strategic Behavior (1987) at 87-90.

13 *See* William S. Comanor, *Vertical Price-Fixing, Vertical Market Restrictions, and the New Antitrust Policy*, 98 Harv. L. Rev. 983 (1985).

14 On the other hand, The U.S.A. National Research Cooperation Act (1984) aims to foster R&D cooperation as a remedy to the well known effort duplication drawback affecting R&D competitions. A similar view has been also adopted in the EU and Japan. For EU *see*, EC Commission, Competition Law in the European Communities, Volume 1, Rules Applicable to Undertakings, (1990). For Japan *see*, Goto, A. and R. Wakasugi, *Technology Policy, in* Industrial Policy of Japan (Komiya, R., M. Okuna and K. Suzumura, eds., 1988).

15 After reviewing traditional antitrust classifications of agreements, Professors Baxter

ficult to balance any anti-competitive harms from cooperation with their benefits as the benefits are hard to estimate and often not measured on the same scale as the harms.[16]

D. Definition and Criteria[17]

A strategic corporate partnering means either investing in a company's equity as an active investor, or/and pooling financial, commercial, and technological resources together to achieve business goals.

A strategic corporate partnering is a "relationship" – not just a contract – in which the parties must agree upon goals, remain independent, share benefits and control over assigned tasks and contribute on an ongoing basis.

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and Kessler conclude that these labels are unhelpful and misleading. The classification of an agreement as "horizontal" or "vertical" provides little guidance as to either its effect on social welfare or its legality under the antitrust laws. The authors propose an alternative system that classifies agreements based on the parties' economic relationships as producers of substitutes or of complements. *See* Baxter, *supra* note 12.

The term "horizontal" has been applied to agreements between firms performing a uniform function, between "competitors at the same level of the market structure," and "between companies performing similar functions in the production or sale of comparable goods or services." The term "vertical" has been applied to agreements occurring between producers of "auxiliary products," between "combinations of persons at different levels of the market structure," "between companies standing in a supplier-customer relationship," and between firms at different points on the "spectrum of production and distribution stages. F.M. Scherer, Industrial Market Structure and Economic Performance (2d ed. 1980) at 78.

16 In their conclusion Professors Baxter and Kessler argued that "agreements between producers of complements improve welfare, agreements between producers of substitutes injure welfare, and agreements involving aspects of parties' relationships both as producers of complements and as producers of substitutes have an ambiguous effect on welfare - do not by themselves indicate the appropriate treatment of agreements under the antitrust laws. Many, if not most, agreements have both "horizontal" and "vertical" qualities, and there is no general way to predict whether such an agreement is or is not in the public interest." *See* Baxter, *supra* note 12.

17 Unless otherwise indicated, all examples given in this paper about strategic corporate partnerships are driven from a specific industry, namely the embedded software market where strategic corporate partnerships have recently become a common practice between application software companies and operating system vendors. Embedded software systems are the microprocessors and related software hidden or "embedded" dedicated to a specialized task or set of tasks and are found in many common products such as telephones, automobiles, VCRs, ATMs, medical instrumentation and imaging systems, and industrial automation equipment such as robots. For the further description of the market, *see* the World Market for Eembedded Software Development Tools and Real-Time Operating Systems, A Study By Venture Development Corporation (December 1997).

A strategic corporate partnering is a way to manage the execution of a continuous transaction. A corporate partnering thus involves a mix of features of firms and of markets.[18] They resemble markets in that the partners remain separate parties, driven by their own interests. Each partner thus runs some risk that the other will act opportunistically, as traders might in the open market. Corporate partnering resembles firms in that the partners agree to coordinate their actions and participate in joint decision making.

Strategic corporate partnering must be "strategic" in nature. (For example, although recently there has been a teremendous amount of "partnering" activity between software companies, most deals are not strategic corporate partnering. They may rise to a strategic partnership level if there is some special strategic significance such as a major equity investment by one party in the other or the integration of the developer's application into vendor's operating system.)

E. The Players: Junior Partner and Senior Partner

Senior Partner is typically a larger, more seasoned company with existing product lines, mature manufacturing, sales, marketing and support organizations, established distribution networks, financial horsepower.

Junior Partner is typically a smaller, emerging-growth company, perhaps early-stage or mid-stage, with innovative technology, products and/or market strategy, entrepreneurial acumen and drive.

F. Objectives, Risks and Benefits for Each Partner

One of the most difficult but important tasks in structuring corporate partnering is to identify and understand each party's motives. Clearly, increased global competition and accelerating pace of technological inno-

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18 Oliver Hart and Bengt Holstrom, *The Theory of Contracts, in* Advances in Economic Theory: Fifth World Congress, (Truman F. Bewley ed., 1987) at 71-155. Without saying so, the authors have listed several features commonly found in corporate partnering or alliances and that typically help partners manage the incomplete contract between them – reputation, arbitration, allocation of decision rights, limitations, on control. On the theories of the firm and of contracts, *see* Oliver Hart, *An Economist's Perspective on the Theory of the Firm*, 89 Columbia Law Review 1757 (1989). A classic study of how common incomplete contracts are in business is Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 American Sociological Review 55 (1963).

vation are key factors. In general, I have found the cases I studied repeatedly offer the reasons below for entering into corporate partnering.

1. Funding

This motive, though easy to understand, is often difficult to structure. Each party may have different ideas about whether equity, debt, or contract R&D funding is more appropriate or desirable. (The funding party may request both protections of debt as well as the potential upside of equity and may attempt to achieve this by suggesting use of a convertible debt investment. The funded company may object to the funding party wanting it both ways, or it may be unwilling to bear the burden of convertible debt since debt can affect its ability to obtain other loans and ultimately may have to be repaid or dilution to its shareholders of an equity investment; especially if the company believes its stock is likely to substantially increase in value over the short term due to an initial public offering or acquisition).

2. Risk Sharing

Risk sharing is a common motivation, especially in industries where the high costs of product development and testing are matched by the high likelihood of failure of any particular product. Often the smaller company shares the cost of its product development with the harger company, and the larger company avoids the costs and technology risks associated with establishing an independent research effort. (For example, in the embedded software market, operating software company subsidizes part of the application software company helps ensure the marketability of the platform by providing applications that run on the platform; the platform company may receive the right to bundle the software with its platform.)

3. Junior Partner's Perspective

Benefits to Junior Partner are (i) Capital for Business Objectives: lower cost of capital, lesser percentage equity dilution, better valuation, sometimes reduced risk of loss of operating control than venture capital investment; (ii) Future Revenue Stream: revenue stream through product sales and distribution, royalty and license income, finances future growth of enterprise into other market arenas; (iii) Market Credibility, Product Validation: well-regarded Senior Partner creates market accept-

ance, auro of credibility, validation of technology in financial community (and better valutaion for later rounds with outside investors); (iv) Acess to Mature Distribution Channels: Senior Partner offers Junior Partner access to established markets, additional, leverage and strength for sales and marketing efforts; Junior Partner piggybacks on existing distribution network of Senior Partner with enhancements to existing products lines, or filling oud product lines; and (v) Organizational and Resource Support: Junior Partner may have innovative technology ant intelligent marketing strategy, but lacks manufacturing, quality assurance, maintenance and field support resources; Junior Partner can acceletate learning curve by access to these resources of Senior Partner.

Risk to Junior Partner are (i) Loss of Independence: substantial commitment of resources with dominant partner with other market, product and financial agenda; loss of other business opportunisties while satisfying obligations to Serior Partner; market foreclosure; acquisition by Serior at unattractive valuation because Junior Partner fails to diversify and build value in other product areas; and (ii) Loss of Entrepreneurial and Technological Edge: Senior Partner dominates Junior Partner and imposes its own corporate culture; loss of incentive by key employees; inability to pursue independent business opportunities and other development programs.

4. Senior Partner's Perspective

Benefits to Senior Partner are: (i) Rapid, Low-Cost Introduction of Technology and Products: technology and products designed to fit peculiarly into Senior Partner's strategic marketing plans, enhancing existing prdoducts, filling out gaps in product lines, expanding product lines; (ii) Window on Technology: insights for Serior Partner on new technological developments or shifts in market strategies; (iii) Access to Entrepreneurial/Technology Acumen: ongoing relationship fosters future collaboration for other product/market solutions; and (iv) Low-Risk Acquisition Candidate: offers test of relationship without full commitment of acquisition; if seccessful relationship, Senior Partner desires to bring enterprise "inside" its organization; agreements may provide for a bey-out option.

Risks to Senior Partner are: (i) Failure, Lost Opportunity and Market Foreclosure: if failure of alliance, Senior Partner may forfeit opportunity to develop expertise internally; dedicated unrecoverable resources to a project if failure; targeted market is foreclosed because Senior Partner

lacks alternative sources of technology and now behind on the development curve; expertise no longer available; barriers to entry have become too difiicult to pursue market opportunity; and (ii) Risk of Competition: if Senior Partner lends technology or does not get market exclusivity, runs risk that Junior Partner may be next competitor.

II. Structuring Strategic Corporate Partnerships

A. Contractual-Based Structuring

There are many ways in which to structure the corporate partnering between the large and small company. The form of transaction is driven by the business objectives regarding products and markets, corporate and contract laws considerations, the desired relationship between the parties, the type of technology involved and the ultimate situs of ownership of the technology.

The corporate partnering must be structured to accommodate the organic or dynamic aspects of a relationship that will evolve over time. The arrangement itself cannot possibly anticipate every fortuity or eventuality. That is not its purpose. Instead, it should serve as a guidepost that the parties can look to for direction, but it cannot possibly provide direction at each and every step. That is why traditional contract theories are not well-equipped to provide an adequate corporate parntership structure.

There are three theoretical contracting models associated with business organizations: classical, neoclassical, and relational.[19]

(i) Classical contracts are discrete and highly fixed. Classical contracts are discrete because they isolate an individual transaction between contracting parties and limit the sphere of the contract to that transaction. Classical contracts are also fixed, meaning that they fix at the time of contracting the precise expectations for the future performance and the remedies available in the event of breach.

(ii) Neoclassical contracts reduce classical precision by contractually substituting additional governance structures for complete presentation.

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19 Ian R. Macneil, *Contracts: Adjustment of Long-Term Economic Relations under Classical, Neoclassical, and Relational Contract Law, 72 NW.U.L.REV. 854 (1978) at 856.*

(iii) Relational contracting, on the other hand, is the more flexible, emphasizing organic development of collaboration in response to change in business climate.[20] It is highly fluid, emphasizing receptiveness to modification over time rather than detailed and inflexible front-end specifications of expectations that maximize coordination. Corporate partnering is usually subject to conflict between the desire to improve coordination and the need to remain flexible.[21]

In the simple product development funding transaction, the large company provides the small company with all of the funding required to developed a product under a development agreement and receives in return the right to purchase the product on favorable terms and/or to receive royalties on sales by the small company to third parties. The large company agrees to provide funding on a periodic basis so long as certain development milestones are met. Upon completion of the development process, the large company owns the technology or has an exclusive license to defined market opportunities. The large company may then grant a license to the small company to manufacture, use and sell the developed product in return for royalties and agrees to purchase certain quantities, or minimum annual volume commitments, of the product in order to maintain exclusivity.

A variation on the product development funding transaction is one in which the small company ultimately owns the developed product but the large company has the option to acquire or license the technology on an eşclusive basis for a base price royalties. In this arrangement, the large company desires to manufacture and market the product after it has been developed, but believes that the development will occur faster and cost less if a small company undertakes it. The motivation of the small company in this type of transaction centers on a desireto create the product, but it has no interest in putting together an organization, with the attendant cost structure, to market the product once it has been developed.

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20 But for the deficiencies of relational contracting or "investing," *see* Edward B. Rock, *Controlling The Dark Side of Relational Investing*, 15 Cardoso L.Rev. 987 (1994).

21 For a discussion of the ways in which the trade-off between flexibility and coordination affects firms' boundary decisions, *see* Graham Astley and Richard Brahm, *Organizational Designs for Post-Industrial Strategies: The Role of Inter Organizational Collaboration, in* Charles C. Snow Ed., Strategy Organization Design and Human Resource Management (1989) at 233-70.

B. Equity Based Structuring

There are various equity forms of corporate partnerships such as venture capital, joint ventures,[22] families of interlocking firms like Japanese *keiretsu*,[23] and acquisitions.[24] However, several issues arise in "strategic" corporate partnering that separate and distinguish them from other equity forms. Typically, the small, funded company (Junior Partner) wishes to ensure that the investing party (Senior Partner) will not attempt to (i) acquire greater than a specified percentage ownership without Junior Partner's consent, (ii) interfere with the management of strategic direction of Junior Partner, or (iii) participate in similar actions by others.

For example, in a joint venture, the two joint venture partners establish an independent corporation.[25] The joint ventures partners are the stockholders of the new company. To that extent that participant companies interact with the joint venture.[26] However, corporate partnering in minority equity investment, unlike corporations or joint ventures, does not rely on the constitution of a separete legal entity to resolve questions of governance.[27]

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22 *See* Steven R. Salbu and Richard A.Brahm, Strategic *Considerations in Designing Joint Venture Contracts*, 1992 COLUM. BUS. L. REV. 253 (1992).

23 On the interlocking firms like Japanese keiretsu, see Erik Bergloff & Enrico Perotti, *The Governance Structure of the Japanese Financial Keiretsu*, 36 J.Fin.Econ.259, 260 (1994); Ronald Gilson & Mark Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization*, 102 Yale L.J. 871, 875 (1993). *Also see generally* Michael Gerlach, Alliance Capitalism: the Social Organization of Japanese Business (1993); *Masahiko Aoki, Toward an Economic Model of the Japanese Firm*, 28 J.ECON.LIT. 1 (1990).

24 *See* David J. Bendaniel and Arthur H. Rosenbloom, the Handbook of International Mergers and Acquisitions (1990).

25 Jean-Francois Hennart, *A Transaction Costs Theory of Equity Joint Ventures*, 9 STRATEGIC MGMT. J. 361, 367 (1988).

26 For an explanation of the joint venture as a complex organization, *see* J. Peter Killing, *How to Make a Global Joint Venture, Work*, Harvard Business Review, vol. 60 (1982) at 120-27.

27 For this hybrid (joint) governance structure, *see* Jean-Francois Hennart, *A Transaction Costs Theory of Equity Joint Ventures*, 9 Strategic MGMT. J. 361, 367 (1988). For governance and authority issues, *see* John C. Coffee Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 Colum. L. Rev. 1618, 1618-19 (1989). This approach views the corporation as a "nexus of contracts." *See* Daniel R. Fischel, *The Corporate Governance Movement*, 35 Vand. L. REV. 1259, 1261-62 (1982); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305, 311 (1976); Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 (Yale L. J. 857, 862 (1984).

There are many arrangements pursuant to which a large company may acquire an equity position in a small company as part of a corporate partnership. The large company could participate with or after venture capital in preferred stock of the small company or it cold be the primary source of capital. As part of the investment, the large company may receive certain marketing and distribution rights for the developed product. The equity investment is the one that most closely parallels the venture capital invsetment. However, there are many important differences between strategic corporate partnership investment and venture capital investment.[28]

C. Differences from Venture Capital Investing

In a corporate partnering, the founders of the small company typically retain their equity position in the company and also maintain a certain degree of control over the future direction of the company.

Corporate partnering allows the small company to concentrate on technological goals as opposed to the return on investment which venture capitalists typically expect the company to achieve within a short period of time. Unlike a venture investment, a small company may benefit from the marketing ability and sales organization which the large company provides for the resulting product.

The downsides of the corporate partnering include the necessity of the small company to communicate with and operate within the structure of the large company, and the knowledge that its relationship with the large company could terminate at any time. By contrast, if venture capitalists have invested in a business entity, they possess a willingness to continue funding until a return on their investment is realized, or until it is obvious that no amount of additional financing will provide a return. In the corporate partnership structure, the motivation of the large company to continue financing the development efforts of the small company may cease much earlier and more rapidly.

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28 For a classic study on "Venture Capital," *see generally*, William A. Sahlman, *The Structure and Governance of Venture Capital Organizations*, 27 Journal of Financial Economics 473 (1990).

III. Contract Law Issues

A. Treatment of Confidentiality/Proprietary Information

Each side may be contributing proprietary or confidential information so the protection of each partner's proprietary information is a central issue. In the case of Junior Partner, it may be technology, which has potential to extend, enhance or leapfrog over existing Senior Partner's products. It is critical to delineate ownership rights in information and provisions relating to manufacturing, non-development of competitive information, non-competition, marketing rights, support and maintenance.

Existing Information: assuring that each party's proprietary information is clearly defined and ownership is specified; affirmation of owner's right to use pre-existing information in activities outside the scope of venture.

Developed information: rights to developments must be addressed; developed technology may draw upon, enhance, practice, imbed or incorporate existing information and creates issues about ownership; rights to use developed technology in specified applications must be defined.

Third Party Information: information or rights (e.g., licensed software) of the third party can not be violated.

B. Product Development

The parties should attempt to define the development project in terms understandable by both the technical and business representatives. There are two differing approaches to defining the development project: extensive detail or generic description. The parties should generally start from a generic description of the development project because (i) the direction of future development is inherently difficult to define; (ii) the long-term nature of the relationship requires that a general course of development be agreed upon which is broad enough to accommodate unanticipated future paths; and (iii) the risk of default is less if objectives are defined in terms of general, rathr than specific, criteria.

1. Control of Development Project

Interests of Junior Partner: Junior Partner has strong motivation to control pace and direction of development activities; risks and conse-

quences of failure are greatest to it during development phase. Interests of Senior Partner: because it has committed and will continue to commit funds and resources to the project Senior Partner has interest in exerting as much direct or indirect influence as it can, and should have the right to approve all substantial changes in the products in order to protect ongoing investment.

2. Use of Development Milestones

Defining development milestones, with appropriate carrots and sticks, is an effective method of imposing controls on Junior Partner during the development phase. One advantage of establishing development milestones: forces parties to break down the development process into discrete steps and create realistic set of exqectations regarding the feasibility and timing of the project. Milestones serve as tools for monitoring progress and adherence to development objectives; benchmarks for providing additional funding by Senior Partner; triggers for the transfer of substantive ownership, manufacturing or distribution rights; and bases for terminating the relationship before loss of complete investment by both parties.

C. Distribution and Marketing Rights

Senior Partner generally will desire to capture as broad a range of marketing rights as possible and limit sphere of potential competition from Junior Partner. Junior Partner wants to carve out certain areas of permitted activity to itself in order to maximize its market penetration and to lessen dependence on a single large customer.

1. Exclusivity:

Granting exclusive marketing and distribution rights in certain spheres to Senior Partner is often the cost of corporate partnering to Junior Partner. Exclusivity may be defined in terms of (i) geographical territory; (ii) vertical linkage, e.g., use of software restricted to certain hardware or operating systems; (iii) time, headstart for Senior Partner; and (iv) restrictive applications of technology.

Exclusivity may be achieved by agreement of Junior Partner not to compete with Senior Partner within defined parameters.

2. Termination of Exclusivity

Once exclusive distribution rights are granted by Junior Partner, responsibility for achieving market success rests primarily with Senior Partner. To minimize risk of market foreclosure, Junior Partner will require termination of exclusivity upon certain events short of breach of agreement or outright termination of relationship. These may cause the termination of exclusivity (i) failure to achieve specified sales or royalty levels, minimum volume commitments; (ii) failure to make scheduled product introductions; (iii) failure to undertake specified levels of marketing activities; and (iv) marketing of directly or indirectly competitive products.

D. Pricing the Product/Techonolgy

Pricing distribution rights to the products and/or technology developed involves many of the same uncertainties as does defining the product; i.e., the physical and functional characteristics of the product, which may be largely unknown at the outset of the project, will dictate to manufacturing cost and pricing and profitability; not in the interest of Senior Partner to drive down Junior Partner's margins on the product to the bone, nor in the interests of Junior Partner to squeeze the maximum profit from the product. Because of the mutual interdependence or the parties in the sphere of interest of the joint enterprise, both Senior Partner and Junior Partner should be assured of a fair return on their efforts in order to sustain incentives and motivations for the relationship.

1. Nature of Payments

Nature of payments are purchase price for product manufactured by Junior Partner and sold to Senior Partner for distribution; and royalty payments or license fees paid by Senior Partner for use of technology to manufacture and sell products.

2. Factors affecting Pricing

Grant of exclusivity by Junior Partner carries a premium in pricing because Junior Partner is locked out of other markets for exclusivity period. Junior Partner more willing to make concessions in pricing if Senior Partner could achieve high levels of sales. Senior Partner, on the other hand, will be reluctant to commit irrevocably to pre-determined sales volumes.

Market competition in the market dictates pricing; partners usually willing to make concessions on the supply side of the equation, if necessary, to maintain a competitive market position.

3. Possible Solution

Possible solution would be pricing based on forecasted volume, with bill-backs or other adjustments if Senior Partner does not achieve forecasted sales. It would also be pricing based on forecasted volume, with loss of exclusivity if minimum volumes not achieved. Another solution would be would be Fixed prices for a limited period only, with renegotiated pricing thereafter. Finally it would be pre-determined formula for adjusting pricing, such as annual percentage increase.

E. Terms of Sale

Long-term nature of corporate partnerships imports a greater significance to the terms of sale than does the typical vendor/customer relationship. Bargaining leverage and the inertia of corporate bureaucracy generally result in Senior Partner's commercial terms being imposed on Junior Partner.

1. Sublicenses

If Junior Partner's products or technology include rights that are licensed from third parties, Senior Partner may be required to comply with sublicensing requirements of agreements to which it was not originally a party; may require a specific form of sublicense agreement be used in downstream channels, causing distribution issues for Senior Partner and its customers; the parties may be faced with negotiating terms of Junior Partner's license agreement or adopting sales and marketing procedures that will comply with third-party agreement.

2. Trademarks and Labeling

Junior Partner has interest in the manner and prominence given to its name in connection with the marketing of the developed products to the extent that name recognition may enhange its ability to operate independently from Senior Partner.

F. Project Coordination

Successful corporate partnering depends upon effective communication and coordination among the participants. Both parties have an interest in assuring that they have the right of access to key personnel in the other party's organization to deal with any problems, which might arise. An effective mechanism to achieve communication and coordination is to establish a series of one or more working groups or liaison committees with periodic meetings and with responsibility to monitor the progress of project.

G. Termination

1. General

Interdependence of the parties requires that termination be based only upon material breaches of the agreement which have not remedied after ample provision for cure has been made. Remedies short of termination should be considered, such as financial incentives/penalties, lapse of exclusive rights, reduced pricing models, realization or volume commitments, etc. Adequate cure periods should be defined based on scope of breach of contract.

2. Remedies

Remedies are completion and payment for work in progress; settlement of subcontracts and agreements with other parties; and continuing performance beyond termination:

Repair and warranty: either Junior Partner will continue to support products in the field based on its standard terms an charges or, alternatively, Senior Partner will acquire limited rights, including rights to use Junior Partner's proprietary information, to perform support itself.

Confidentiality, nondisclosure, non-use restrictions, indemnification for patent, trademark and copyright infringement and violation of proprietary rights should continue to bind both parties.

H. A Case: Between a Development Tool Company (Licensor) and a Real-Time Operating System Company (Licensee)

Licensor and Licensee entered into a VAR (Value Added Reseller)

license agreement (License Agreement).[29] Later, the terms of the License Agreement were amended and expanded by an agreement entitled "Preferred Supplier Status."[30] The issue is that this relationship is more than "technology licensing" or distribution relationship; it is a strategic partnering and it should be considered as a strategic partnership. Why?

1. The Parties

Licensor is a Delaware corporation with its principal place of business in Santa Barbara, California.[31] Both Licensor and Licensee are engaged in the business, among other things, of developing software and licensing and selling that software for use and distribution by others.[32]

Licensor has partnerships with numerous manufacturers across the embedded marketplace.[33] Besides Licensee, the company also has partnerships for real-time operating system compatibility with other Licensee's main competitors.

2. History of the Parties' Relationship

Before the Agreement, Licensee had allied itself with another company and relied on that company to supply most of the software development tools that it needed to use and to offer in conjunction with its Real Time Operating System (RTOS). Later, with the new developments Licensee weakened its relationship with that company. Licensee then

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29 This VAR agreement can be viewed in "http://www.ghs.com".

30 This amendment can be viewed in "http://www.ghs.com".

31 *See* website "http://www.ghs.com".

32 Licensor, established in 1982, is a leading supplier of software development tools for the 32 bit and 64 bit embedded systems market. The company supplies a family of optimizing compilers for all major programming languages, an integrated development environment, and a pair of real-time operating systems. Licensor offers a comprehensive line of optimizing compilers for use in the embedded marketplace, which includes C, C++, Embedded C++, Ada 95, Fortran, and Pascal programming languages. Licensor also offers the MULTI integrated development environment, which provides the programmer with a source-level debugger, program builder, editor, profiler, version control, run-time error checking capabilities, and a class and program browser. Licensor's product line offers extensive microprocessor support, and thus sells its software across a wide variety of vertical market segments. The World Market for Embedded Software Development Tools and Realtime Operating Systems, A Study By Venture Development Corporation (December 1997) [Hereinafter the World Market for Embedded Software].

33 *See* the website "http://www.ghs.com".

asked Licensor to provide to Licensee software development tools and products to replace the other company's software development tools.

However, Licensee was unwilling to make any royalty advances or royalty commitments to Licensor. Because of this fact, Licensor wanted to ensure that it would receive benefits sufficient to justify the direct and indirect costs of developing a product for sale with RTOS. When Licensor raised these concerns with Licensee, Licensee responded by assuring and representing to Licensor that it was strictly an RTOS company and that it would not, and had no plans to, develop its own software development tool technology or to acquire any rights to the technology of or any interest in any software development tool company other than Licensor. Licensor relied on these representations and promises in proceedings to negotiate an agreement with Licensee.

Ultimately, Licensor and Licensee agreed to a "level playing field" structure which provided, in essence, that Licensee would treat Licensor at least as well as it treated any other software development tools vendor whose software development tools and products could be used in connection with Licensee's RTOS. The License Agreement was negotiated to effectuate this understanding. Various provisions of the License Agreement implement the level playing field principle. In the agreement, for instance, Licensee and Licensor agree to promote the Licensed Programs and Licensed Products in a manner that conforms with the terms and conditions as follows:[34]

Under the heading, "Promotional Literature," "Comparable coverage to that given to competing products shall be given to Licensor's Licensed Programs in applicable literature including, but not limited to, advertisements, customer data sheets, mailers, and press releases."

"Licensee shall produce and distribute data sheets for the Licensed Programs where data sheets are provided to customers by Licensee for competing products. These Data Sheets shall be included in relevant standard sales literature kits."

Under the heading, "International Promotion," "Licensee shall allow Licensor access on an annual basis to the sales organization for training in the Licensor's Licensed Programs by Licensors personnel."

Under the heading, "Trade Show Participation," "Licensee shall demonstrate the Licensed Programs at relevant Trade Shows. Licensor

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34 These provisions can be viewed and downloaded from website http://www.ghs.com.

shall have the option to provide personnel to demonstrate the Licensed Programs in Licensee's booth as a part of a joint marketing and sales program to be developed between Licensor and Licensee."

Other provisions of the License Agreement also implement the parties' agreement that Licensor's products would be promoted to at least the same extent as the products of any of Licensor's competitors offered by Licensee.

After executing the License Agreement, Licensor and Licensee worked together to develop the initial product integration that is, the initial integration of Licensor's software development tools and products with Licensee's RTOS. Licensee expressed to Licensor that it was excited by the prospect of developing customized Licensor software development tools for use with Licensee's RTOS. Licensee asked Licensor to expand its relationship with Licensee in order that this goal could be achieved.

However, at this point in time, Licensor also was selling software development tools and products through another leading RTOS company and Licensee's most significant competitor. The relationship proposed by Licensee appeared to Licensor to jeopardize the continuation of Licensor's relationship with the competitor.

Before agreeing to changes in its relationship with Licensee that would weaken its relationship with the competitor, Licensor wanted to ensure that it would receive sufficient benefits from Licensor to justify the direct and indirect costs of developing this new relationship. Initially, Licensor wanted Licensee to commit to an exclusive relationship with Licensor; that is, Licensor wanted Licensee to agree that it would use and sell only Licensor's software development tools and products.

3. Establishing A Strategic Contractual Relationship: "Preferred Supplier" Status

Ultimately, Licensee committed to accord to Licensor what was called "Preferred Supplier" status. That established a real strategic relationship between parties that is more than a simple licensing agreement and should be considered as a *de facto* strategic partnering.

The principal terms of the Preferred Supplier relationship, as presented by Licensee, were that:

(a) Licensor would be preferred over, and its software development tools and products promoted in preference to the products of, any other software development tool supplier;

(b) Licensee would spend more money promoting Licensor's software development tools and products than it would spend promoting competing products; and

(c) Licensee would commit to continue this relationship and to promote Licensor and its software development tools and products for a long period of time.

Licensee proposed that, in return for these benefits:

(a) Licensor would make a continuing commitment and investment in engineering products for Licensee; and

(b) Licensor would substantially reduce its commitment to Licensee's competitors.

In return for being accorded Preferred Supplier status and for other benefits afforded to it Licensor made significant concessions to Licensee, including that Licensor agreed to modify and improve its software development tools and products to meet certain specifications established by Licensee.

4. Legal Issues

Did Licensee violate Licensor's rights and their strategic relationship by marketing of a new but competing product, a software development tools product line that was released by Licensee? Contractually, Licensee was obligated to promote Licensor's product ahead of competing products. Did Licensee violate these obligations by secretly acquiring several competitors of Licensor and integrating their products to create a new product, possibly to compete with Licensor? Does Licensor have any right to benefit from the new product out of this strategic partnership? What is the ownership structure of the new technology? Based on facts, how can we evaluate this strategic partnership if we can say there is one? What happens to Licensee? What happens to Licensor? What happens to the new technology? What happens to the ongoing partnership? Is this strategic corporate partnering a failure? If it is, how can we offer a solution for the future?

5. Breach of Strategic Corporate Partnering?

Licensee acquired companies whose products were in direct competition with Licensor's software development tools and products. Therefore, the software development tools portion of the new product included no Licensor's software development tools or products, but instead included a combination of software development tools provided to Licensee by acquired companies. Licensee developed a new product package that would not include any of Licensor's software development tools or products.

Licensee did not grant Licensor access to new releases and specifications and system-level debugger technology as such information became available or as it was made available to any customer, other supplier, or competitor of Licensor. Licensee's introduction of the new software development product in this fashion constituted a breach of the strategic partnership under the understanding of strategic partnership in this paper.

6. Recommendations

This partnering transaction between Licensee and Licensor involved complicated technology-licensing arrangements. Licensee desired to incorporate Licensor's software into some or all of its products. This transaction is different from a simple technology licensing agreement because their goal is to create a structure in which both companies work closely together on an ongoing basis. And the relationship is strategic for both parties because it is critical that the Licensor's software does not stand alone. Rather, it must be incorporated into a larger body of software: *the integration of the developer's application into the vendor's operating system*. The issue in this strategic partnering is that what happens to the Licensee or the company that owns the larger body of software enhances the existing technology while excluding one of its strategic partners, in this case, the Licensor. The most sensitive issue is ownership and right of the future technology.

On the other hand, consider also a different scenario that affects the Licensor's ability to do other deals in the future. Licensor may want to limit licensee rights with respect to (i) items developed for others or for special markets (unless made generally available by licensor); (ii) enhancements that it considers "new products" or markets under a different name; or (iii) products or processes that are significantly different or that lead to dramatic cost reductions or increased efficiencies.

Therefore, one issue that arises is that of the rights of Licensor in the future developments of Licensee, based on Licensor's technology. The answer to these issues generally lies with the original intent of the parties. For example, the licensor may be willing to accept a lower royalty rate for the license of the original technology if it is contemplated that the licensee will be developing new improvements that will be owned by the licensor at the time that the development work is completed. However, if the improvements are of the type that could only be developed by the licensee in light of its particular skills and resources or are of a type that is unexpected or unrelated to the original licensed subject matter, it may be appropriate for the licensee to be vested with full title to such improvements, perhaps with an appropriate adjustment to the amount of royalties for the original technology or an appropriate agreement regarding use of the new technology by the licensor.

One possible solution that might be used in cases where parties are working together on developing various improvements to the original technology, in this case the software, is to provide that each party will own any improvements that it develops independently and that the parties will jointly own any improvements that arise from their cooperative efforts. In order to implement this alternative, the licensee has to submit each improvement to the licensor for review. The licensor would agree to maintain any such submission in confidence and to advise the licensee if it agrees with the licensee's claim of independence or with the other partners' development.

If the licensee owns the improvements, it may simply retain all of the rights in the new discoveries, without any further obligation to the licensor. This may occur when the licensee has made a large lump-sum payment to the licensor at the time that the license agreement was originally signed. In effect, the licensee is taking the position that it purchased the original technology in order to serve as a starting point for further research and development work.

In usual licensing cases, licensor retains greater control over the licensee's use by withholding ownership and its prerogatives in copyright law.[35] But there are always changes in technology and the market that licensee might find itself to enhance the existing product. When these changes occur the licensor cannot easily disengage itself from licensee

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35 *See* Lance Rose, *End-User Licensees of Computer Programs – Are They Allowed to Compete with their Licensors?*, 13 Rutgers Computer & TECH. L. J. 297, 300-03 (1987).

because of the integration of the developer's application into the vendor's operating system. Since the parties' relative positions may change when new technological and market opportunities emerge, the relationship should ensure flexible protection of each party's posture and potential. Predicted changes in software technology and markets may raise a host of software enhancement issues for licensing. The complexity and monitoring entailed in such agreements and relations will lead inexorably toward higher transaction costs.

Parties to a software license may have widely divergent goals and purposes, like parties to any contract. However, in this partnership the motivation of the parties was clear: technology access allowed the licensed company to leverage the other's lead-time advantage; the licensed party was able to avoid building a separate research effort from scratch. The relationship was strategic. Economies of scale and marketing power can be joined with entrepreneurial spirit and innovation, when companies form alliances to enhance and expand existing product lines.[36] Broad partnerships, however, may fail to specify the rights of each party to enhancements of the technology. Their goal should be to realize the 'Partnership Paradigm' that was the original motivation and foundation of the relationship. Analyzing the case here, and in setting up strategic relationships, it should be a "win-win" situation for both companies and should be a natural partnership environment.

Most strategic corporate partnerships fail. And it is hard to estimate which has failed, and which has not. It is often difficult to determine whether a corporate partnership has succeeded or failed. Most eventually end because of lack of communication, interest, and trust, or more serious problems. But if both parties have received an adequate return on their investment before they become dissatisfied, the deal is hardly a failure.

IV. Corporate Law Issues

The corporate law issues which arise in the corporate finance structure (representations and warranties, affirmative and negative covenants, preferred stock terms) are similar to the ones dealt with in a conventional venture capital investment; however radical top-line differences can be found in valuation, control features, liquidity options, accounting treatment and ownership objectives.

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36 Mark Radcliffe and Howard Clowes, *Strategic Alliances and Intra-Industry Licenses*, 8 Computer Law. 21 (1991).

A. Several Issues

1. More Favorable Financial Terms

The valuations of the Junior are less price-sensitive or the equity dilution of the Junior Partner is less in corporate partnerings then in the case of a venture investment. The deal is not priced as aggressively by the Senior Partner because he is less concerned about squeezing the maximum internal rate of return from the Junior Partner.

2. Board Representation

Senior Partner's representation on board and composition of board (management, outsiders and Senior Partner) is always an issue. Issues abound about participation by Senior Partner at meetings where perceived conflicts of interest or opportunity for Senior Partner's access to proprietary processes or non-public product and marketing plans exist.

3. Pre-emptive Rights, Participation in Future Financings

One of the issues is the ability of Senior Partner to control the "equity destiny" of Junior Partner. Equity investment is the first step towards pre-emptive acquisition. The Junior Partner should consider to have the ability to "finance away" from Senior Partner if the relationship stagnates and sours.

4. Negative Covenants

Sometimes Senior Partner demands contractual prohibitions on the future behavior of Junior Partner: veto right on mergers, other acquisitions, other strategic alliances with partnerships; restrictions on licensing the core of technology, effectively blocking the ability of Junior Partner to pursue other market opportunities.

5. Typical Preferred Stock Terms

Convertible preferred stock is the most popular investment instrument for strategic corporate partnering. Convertible preferred stock allows investors to participate in any growth in the company while providing them with a preference in liquidation in the event that the company is not successful.

The typical preferred stock terms include liquidation preferences,

anti-dilution provisions, board representation, conversion right, dividend provisions, voting rights, provision for redemption of the referred stock, and, in certain cases, super-majority voting requirements in the event of specified corporate transactions. Convertible preferred stock typically votes along with the common stock on all matters and is entitled to one vote for each share of common stock into which the preferred stock is permitted to convert at the time of the vote.

In addition, holders of the preferred stock may be given the right to vote as a separate class on certain corporation transactions, including the issuance of new securities, mergers and acquisitions and so on. The preferred stock may be given a class vote with respect to the election of directors. For example, the parties may provide in the articles of incorporation that the preferred stock has the right to designate two out of the five directors and that the remaining directors are to be designated by the holders of the common stock, voting as a separate class.

While common stock is the simplest form of investment instrument, it is rarely used in connection with a strategic corporate partnering investment because the corporate partner cannot have any dividend or liquidation preferences.[37] Moreover, the sale of common stock to investors establishes a market value for that type of stock that must be applied to stock sales or option grants made to employees, thereby greatly increasing the cost of equity ownership to this group. On the other hand, when the other corporate partner is actually a public company, common stock may be used for the investment transaction due to the relative ease of valuation and liquidity.

6. Controls on Management

The corporate partner in a corporate partnering investment is usually interested in having some means of corporate control by having one or more representatives on the corporate board of directors. The degree of participation varies depending on the particular circumstances. For example, a corporate partner may be content to elect minority or majority members of the board. Another common scheme is to provide that both parties will have equal representation on the board, perhaps with the added option of allowing the designated directors to appoint additional independent board members. There are a number of pros and cons

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37 Edwin M. Martin and Stephanie Monaghan O'Brien, *Equity Oriented Corporate Partnering Arrangements, in* Corporate Partnering: Advantages for Emerging and Established Companies (Practising Law Institute, 1989).

to be considered by management with respect to the degree of control that will be given to the corporate investor. Certainly, corporate partner participation on the board provides a good method for ensuring that the corporate partner is kept informed of corporate activities and for building a strong consensus on appropriate business strategies.

B. Exit Strategies

Exit strategies can take many forms. Customarily, they include "lockups" or other restrictions on the transfer of shares by other shareholders. The partners can obtain the right to sell shares pursuant to registration rights on demand, or a piggy-back or tag-along basis, to sell to the public under securities laws or the right to sell to the new venture in a "put-option."

1. Restrictions on Transfer of Securites by Senior Partner

Equity relationship is designed to provide incentives to Senior Partner only and are designed as non-transferable to third parties, particularly competitors. Junior Partner has a rihgt of first refusal on attempted transfers by Senior Partner. Sale is to a party approved by Junior Partner or which is not a competitor of Junior Partner. Sale is permitted in connection with a public offering, under the private placement, or in a merger or stock acquisition approved by the board of Junior Partner.

(i) "Lockups" and Other Restrictions on the Transfer of Shares. Transfer restrictions are based on the unspoken assumptions that the Junior Partner will be committed to the venture's success by not having an easy exit strategy of their own. Such "lockups" may permit transfers only with the Senior Partner's consent, or only if certain objective standards have been satisfied that relate to the "unspoken" assumptions. Such standards may refer to objective tests, such as the transferee Senior Partner's financial condition or its not being a competitor, etc. Alternatively, the Senior Partner may only have the right of first refusal or a right of first offer, instead of a veto. Care should be taken to include indirect, as well as direct, transfers of assets or shares as triggering events and covered transactions. Certain transfers could be barred, such as to competitors or other specified persons. Permitted transferees should be required to assume certain obligations in connection with any transfer. Certain specified transfers could be prohibited as well, such as the pledging or mortgaging of shares.

(ii) "Drag-Along" Rights. A "drag-along" right entitles the Senior Partner to force certain other shareholders (usually the Junior Partner) to be dragged along in a sale by the Senior Partner to a third party. This might enable the Senior Partner to sell control without owning control. Obviously, such a right depends on the triggering event and raises questions of the procedure for the "drag-along" sale.

2. Rights to Sell Senior Partner's Shares.

(i) "Demand Registration" Rights. Under a "demand registration right," a Senior Partner has the right to force the company to register the Senior Partner's securities with the Capital Market Board for sale to the public. The number and timing of such demand registration rights is highly significant to the realization of the maximum gain on the shares. Junior Partners typically seek to limit demand registration rights to circumstances that would not generate severe adverse consequences to themselves, the company or other shareholders. Demand registration rights involve complex definitions of the frequency, number of shares or percentage to be registered (including priority and cutbacks), timing, the nature of the obligation to complete the process (subject to limitations, covenants to do a road show and to receive attorney's and accountants' comfort letters, etc.). Since disclosures are an essential part of any registration process, the investor may require continuing disclosure of relevant information. The Senior Partner may require the company to "lock up" any other securities from being offered simultaneously.

(ii) "Piggyback" Registration Rights. A piggyback registration right entitles the holder to sell shares in an initial public offering that is initiated by the company or another investor. Such rights are not as onerous on the company or as valuable to the investor as a "demand registration" right. Key issues unique to piggyback registration rights include the degree to which the piggyback rights holder can participate or affect the nature, timing or scope of the registration process, the degree to which (and criteria for) cutbacks by the underwriter will affect the number of shares registered for sale, and the sharing of expenses of one legal counsel by all piggyback rights holders.

(iii) "Tag-Along" Rights. "Tag-along" rights allow a Senior Partner to participate in another shareholder's sale of interests. Non-management investors and minority investors find this right to be very valuable to that the Junior Partners are not allowed to exit alone. Tag-along rights are generally considered to cover the right to obtain registration of secu-

rities owned by the financial investor when someone else's securities are being registered for public offering. Tag-along rights also cover the more specific right to force a sale of control.

(iv) "Put" Options. A put option is the right to force another person to purchase the Senior Partner's interests for a specified price on specified terms. Put options are useful when the Senior Partner and the company can reasonably expect to have cash on hand at the time the put option becomes exercisable by the financial investor. Hence, put options are generally reserved for later-stage financing, such as "second stage" or other "mezzanine" financing after a first round.

3. Rights to Concentrate Control in One Shareholder

(i) Right to Acquire Control: "Call" Options. A "call option" is the right to buy interests of another investor on specified terms. Call options might entitle the investor to take control of the company by acquiring shares from either the Junior Partner or the company or both.

(ii) Forced Sale of Control. The investor could have a right to force the other shareholders - who, with the investor's shares would, own "control" - to sell control to the investor or a designee of the investor. This right is somewhat similar to a "drag-along" right, but forces the others shareholders to be "dragged along" with the investor.

(iii) Buy-Sell Arrangement. The right to force a "buy/sell" entitles the investor to initiate a process where a transfer of ownership occurs, but the investor could be either the buyer or the seller, depending on the outcome of the process. The process could be initiated at any time, or only on the occurrence of a default, a deadlock or the passage of time.

Many possible buy-sell mechanisms are available. In one variation, the party offering to buy or sell fixes a price, and the other party either agrees to sell or agrees to buy at that price. In another variation, the party offering to buy fixes a price, and the other investor must accept the offer (and sell at that price) or make a counter-offer to buy the first party's interests at a higher price. A third variation involves sealed bids by both parties once either has initiated the process. A fourth variation relies upon a valuation established by a neutral appraiser, and the party who did not initiate the process has the choice to sell out or buy the initiating party's interests at the appraised value.

Implementation of a buy-sell arrangement can be quite complex, tak-

ing into account differing pricing mechanisms, financial deposits prior to closing (to act as liquidated damages), the sale of all or only partial interests, the existence of multiple co-investors exercising the rights to buy or sell, and remedies on default. Post-closing issues include covenants on hiring of employees, competitive conduct and post-closing cooperation.

C. Organizational Strategies

In these cases, the strategy of the companies is to coordinate joint activity between participating firms within limits structured by a series of agreements rather than involving a new venture or joint ownership of a legally separate firm or any other equity investment which exploits the shared technology. In these cases parties try pooling financial, commercial, and technological resources together contractually, not organizationally. What is left out is equity investment. In this sense, corporate partnering means investing in a company's equity as an active investor to establish an organizational link to each other.[38]

Many of the newer allies eschew more formal equity links in favor of limited operational tie-ups such as co-branding deals, marketing alliances, co-marketing projects, R&D agreements and so on.[39] But, strategic corporate partnerships can come in equity investment forms such as joint ventures,[40] strategic minority stakes,[41] families of interlocking firms like Japanese *keiretsu,*[42] and acquisitions.[43]

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38 *See* Edwin M. Martin and Stephanie Monaghan O'Brien, *Equity Oriented Corporate Partnering Arrangements, in* Corporate Partnering: Advantages for Emerging and Established Companies (Practising Law Institute, 1989).

39 *See The Science of Alliance*, Business Week (March 1998).

40 *See* Steven R. Salbu and Richard A. Brahm, *Strategic Considerations in Designing Joint Venture Contracts*, 1992 Colum. Bus. L. Rev. 253 (1992).

41 *See* Edward B. Rock, *Controlling The Dark Side of Relational Investing*, 15 Cardozo L. Rev. 987 (1994) at 990-98.

42 On the interlocking firms like Japanese *keiretsu, see* Erik Bergloff & Enrico Perotti, *The Governance Structure of the Japanese Financial Keiretsu, 36 J. Fin. Econ. 259, 260 (1994);* Ronald Gilson & Mark Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization, 102 Yale L.J. 871, 875 (1993). Also See generally* Michaeel Gerlach, Alliance Capitalism: The Social Organization of Japanese Business *(1993);* Masahiko Aoki, *Toward an Economic Model of the Japanese Firm, 28 J. Econ. Lit. 1 (1990).*

43 *See* David J. Bendaniel and Arthur H. Rosenbloom, the Handbook of International Mergers and Acquisitions (1990).

In a joint venture, the two joint venture partners establish an independent corporation.[44] The joint venture partners are the stockholders of the new company. To the extent, the participant companies interact with the joint venture.[45] However, corporate partnering in minority equity investment, unlike corporations or joint ventures, does not rely on the constitution of a separate legal entity to resolve questions of governance.[46]

One popular business myth holds that total ownership is best when another company is important to a company's future. Full control may be needed when major strategic or operating changes must be made to serve a buyer's goals. Also, with an acquisition, the purchaser can fully benefit from the new unit's growth and expertise. However, acquisitions of unrelated or culturally different companies have a poor track record.[47] More often than not, hoped for synergies are lost. But with minority investment, companies can build many of the policy-level connections and operating links that make acquisitions attractive. Moreover, to the extent one company owns another's equity, it shares in that company's growth.[48] Further, these alliances retain the qualities acquisitions so often destroy.

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44 Jean-Francois Hennart, *A Transaction Costs Theory of Equity Joint Ventures,* 9 Strategic MGMT. J. 361, 367 (1988).

45 For an explanation of the joint venture as a complex organization, *see* J. Peter Killing, *How to Make a Global Joint Venture Work*, Harvard Business Review, vol. 60 (1982) at 120-27.

46 For this hybrid (joint) governance structure, *see* Jean-Francois Hennart, *A Transaction Costs Theory of Equity Joint Ventures,* 9 Strategic MGMT. J. 361, 367 (1988). For governance and authority issues, *see* John C. Coffee Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role,* 89 Colum. L. Rev. 1618, 1618-19 (1989). This approach views the corporation as a "nexus of contracts." *See* Daniel R. Fischel, *The Corporate Governance Movement,* 35 VAND. L. REV. 1259, 1261-62 (1982); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure,* 3 J. FIN. ECON. 305, 311 (1976); Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls,* 93 Yale L.J. 857, 862 (1984).

47 *See* Farok J. Contractor and Peter Lorange, *Why Should Firms Cooperate? Strategy and Economics Basis for Cooperative Ventures, in* Cooperative Strategies in International Business (Farok J. Contractor and Peter Lorange eds., 1988).

48 *See* Daniel H. Case and Standish H. O'Grady, *An Overview of Venture Capital* (Hambrecht and Quist Group, San Francisco, 1993). Although they state this feature of equity investment as disadvantageous in venture capital financing for the company that receives investment, it can be beneficial for both companies in corporate equity investment arrangements.

D. Strategic Minority Investment

In a minority investment strategic corporate partnering, one company buys stock from another as part of a mutually desired strategic relationship, which involves a minority equity investment.[49] A form of strategic minority investment is more integrated than a one-dimensional technology license agreement. It is more active than a traditional minority investor venture capital investment.[50] Yet it is less integrated and controlled than an acquired business. It is somewhere between a simple third party arrangement and a complete business combination.[51]

The corporate partner in a corporate partnering investment usually is interested in having some means of corporate control by having one or more representatives on the corporate board of directors. The degree of participation varies depending on the particular circumstances. For example, a corporate partner may be content to elect minority or majority members of the board. Another common scheme is to provide that both parties will have equal representation on the board, perhaps with the added option of allowing the designated directors to appoint additional independent board members.

There are a number of pros and cons to be considered by management with respect to the degree of control that will be given to the corporate investor. Certainly, corporate partner participation on the board provides a good method for ensuring that the corporate partner is kept informed of corporate activities and for building a strong consensus on appropriate business strategies.

On the other hand, management, as well as any other outside investors, may have serious concerns about significant corporate partner presence on the board of directors. An issue of some importance is the effect that corporate partner involvement will have on the ability of man-

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49 Usually not more than 20%. *See* Edwin M. Martin and Stephanie Monaghan O'Brien, *Equity Oriented Corporate Partnering Arrangements, in* Corporate Partnering: Advantages for Emerging and Established Companies (Practising Law Institute, 1989).

50 For the comparison, *see* Edwin M. Martin and Stephanie Monaghan O'Brien, *Equity Oriented Corporate Partnering Arrangements, in* Corporate Partnering: Advantages for Emerging and Established Companies (Practising Law Institute, 1989); *and see* Daniel H. Case and Standish H. O'Grady, *An Overview of Venture Capital* (Hambrecht and Quist Group, San Francisco, 1993).

51 *See* Jeffery Atik, *Technology And Distribution As Organizational Elements Within International Strategic Alliances,* 14 U. PA. J. Int'l Bus. L. 273 (1993).

agement and the other investors to make key strategic decisions, including those on the relationships with actual or potential competitors of the corporate investor. For example, even though IBM owned 12% of Intel at the time, it couldn't prevent Intel from working with Compaq to beat IBM to market.

An equity-structured corporate partnering has its own advantages and disadvantages. For the bigger company, the corporate partner, the equity investment is a means by which it can participate in the development of new and even complementary technologies without altering its own business operations. It is also a means by which it can actively participate in the enhancement of its own investment since the success or failure of the investment in the smaller company is in part influenced by its own marketing and distribution efforts of the developed product. Therefore, the bigger corporate partner may be seeking a window on new technologies, a good return on its investment, and the benefits of an entrepreneurial environment without attempting to modify its own corporate culture and internal development efforts in order to replicate the atmosphere necessary to develop the innovative technology within the time frame necessary for market acceptance. Also, a direct, non-controlling investment provides the opportunity for the corporate partner to establish the organic link that takes the relationship to an acquisition.

For the small company that is being received an investment, the advantage of having equity corporate partnering is that it sends a positive signal to the market and perhaps shows a stronger commitment by the corporate partner. For example, the small partner receives capital to fund its development efforts and appropriate publicity of the strategic relationship. More importantly, the small partner should ensure that the investment brings a thoughtful sharing of the bigger partner's expertise and experience with respect to business, financial, and technical expertise through board participation and other means.

An equity corporate partnering also has disadvantages. For the corporate investor the risk is that the development process may be unsuccessful and the equity investment may be worthless. The investment is usually made when the small company has a weak development record. The big company has only indirect control over the incentives and motivations of the key employees and managers of the small company.

For the small company, the downside is the issuance of its equity at less than fair value and decreased operating control. The ability of the

small company to seek alternative strategic partnerships may be adversely impacted by the big company. Furthermore, the big company may exercise a significant amount of influence over corporate activities, either through the position of its representatives on the company's board of directors or under the terms of any special voting rights or shareholder's agreement.

When the strategic partnership is progressing, the corporate partner which has an equity stake in the venture may be more sensitive to the need for additional funding, since it has a direct organizational and ownership interest in seeing the product developed and in ensuring the success of the strategic partnership. Finally, this strategic relationship can lead to an acquisition where the corporate partner buys the controlling stock of the other party.

V. Conclusion

Corporate partnering has increasingly become important especially in high-technologies such as computer and software companies as the price of developing new products has increased, the channels of distribution have become more concentrated, and "time-to-market"[52] is extremely vital for success. Corporate partnering differs from standard technology licensing relationships because of a greater degree of collaboration and integration between parties. Corporate partnering also represents a more active approach by both parties in the development, marketing, and distribution of a product.

In the successful relationship the investor functions as a monitor, both to make management accountable to shareholders, and to enhance the firm's objective. The corporate partnering can be a superior solution to some problems of traditional capital financing and sharing resources between firms. For example, corporate partnering allows the small company to concentrate on technological goals as opposed to the return on investment which venture capitalists typically expect the company to

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52 *See* Joseph T. Vesey, *The New Competitors: They Think in Terms of "Speed-to-Market"*, Academy of management Executive (May 1991) at 23-33. For additional reading *see* Brian Dumaine, *How Managers can Succeed Through Speed*, Fortune, (February 13, 1989); Thomas G. Gunn, Manufacturing for Competitive Advantage, (Ballinger Publishing Company, 1987); Gary Relner, *Lessons from the World's Best Product Developers*, Wall Street Journal, (August 6, 1990); David St. Charles, *Don't Toss it Over — Break Down the Walls*, Automation (June 1990); and Richard J. Schonberger, World Class Manufacturing (1986).

achieve within a short time. In addition to financing, unlike a venture investment, a small company may benefit from the complementary resources of the partner.

The corporate partnering can also be a superior solution to fill the gap of traditional intermediary financial institutions. The pooling of resources creates economic efficiencies such as risk sharing, access to complementary resources, economies of scale and scope, and the elimination of duplication and waste. Closely related to the desire or the need to share costs is the use of corporate partnering to share risks of a particular initiative, and to reduce the risk of failure by having access to resources of multiple organizations.

Corporate partnering is subject to a conflict between the desire to improve coordination and cooperation and to remain flexible. Regardless of the complementary skills that the parties bring to the partnering, tension will always exist such as the conflict regarding control, strategy, lack of trust and/or cooperation incompatibility of corporate cultures, opportunistic behavior and so on.

Mutual commitment and competitive incentives appear likely to induce conflicting behaviors, since the former is essentially cooperative in nature while the latter is competitive. The paradox is consistent, however, with the ambivalent relationship underlying many corporate partnerings competition among firms persists for indefinite periods during which they continue to operate in like or related industries, but it is tempered by *ad hoc* cooperation as strategic corporate partnering.

Companies that form corporate partnerings tend to be competitive at some level. When companies engage simultaneously in cooperative and competitive behavior, it is important to maintain incentives to comply with both the words and spirit of the corporate partnering form. As a result, companies contemplating cooperation are often concerned with the utilization of contractual provisions that may enhance the likelihood that prospective partners will behave cooperatively and not opportunistically.[53]

Cooperative competition will increase in importance as a business form as the digital revolution blurs the lines of distinction between part-

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53 *See* Peter J. Buckley and Mark Casson, *A Theory of Cooperation in International Business, in* Cooperative Strategies in International Business (Farok J. Contractor and Peter Lorange eds., 1988).

ners and competitors.[54] The all pervasive nature of digital technology in the global economy necessarily means that corporate partnering will be constantly reshaped as yesterday's competitors become today's partners and *vice versa*.

When both parties can mutually benefit in a defined market space, they will naturally move to a cooperative business construct regardless of past competitive positions. This is especially the case with digital information technology where the value is not in plant and equipment, but in the intrinsic value of the intellectual property. Hence, "intellectual factories" are far more receptive to cooperative competition, as they can move quickly with a high degree of flexibility.

54 The rise of inter-firm collaboration has led to new empirical and analytical research on corporate partnering and alliances. Good collections of recent work on this topic are Farok J. Contractor and Peter Lorange, Eds., Cooperative Strategies in International Business (1988); David C. Mowery, International Collaborative Ventures in U.S. Manufacturing (1988); Lynn Krieger Mytelka, Ed., Strategic Partnerships: States, Firms, and International Competition (1991); and Joel Bleeke and David Ernst, Eds., Collaborating to Compete (1993).