Corporate Investing: Strategic Alliance Issues and Considerations

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WHILE IT MAY BE OF NO SURPRISE THAT VENTURE CAPITAL INVESTING HAD A RECORD YEAR IN 2000 – IN TERMS OF BOTH THE TOTAL NUMBER OF COMPANIES FINANCED AND THE TOTAL DOLLARS INVESTED, YOU MAY BE surprised to know that corporate investors invested in over one-third of all venture capital deals in 2000, providing approximately $19.0 billion of investment.[1]

Corporate investing, also commonly referred to as the formation of a "strategic alliance," can offer the corporate investor more immediate benefits than a return on his investment at some future exit, sale or cash-out event. Similarly, the entity receiving the investment, or the "alliance entity," may also receive an investment more valuable to it than immediate cash from a typical venture capital investor.

Corporate investing developed as an important strategic tool decades ago when "joint ventures," typically among one or more comparably sized corporate partners, became common as businesses sought to develop new products, new technologies or enter new markets by pooling resources and know-how. While many of these goals remain the same today, corporate investment has become so important in the New Economy that many venture capitalists will not even consider an investment in a new venture without the identification, and in some instances investment by, possible strategic corporate investors. Ultimately, a venture capitalist may invest in an alliance entity alongside a corporate investor or may invest in an entity that has as one of its key objectives the formation of a strategic alliance with a corporate partner.

This article addresses the following topics associated with strategic alliances:

- Why do it – considerations by both the alliance entity and the corporate investor;
- Factors for all parties to consider in forming a strategic alliance;
- Elements of the strategic alliance that are common to both an investment by a venture capitalist and a corporate investor;
- How strategic alliances with corporate investors differ from a typical venture capital investment;
- Common reasons for failure of a strategic alliance.

1 Source: National Venture Capital Association and Venture Economics.

While there are many types of strategic alliances that do not involve the actual investment in an alliance vehicle by a corporate partner or the actual issuance of equity by the alliance to that corporate partner, an ownership position in an entity can, in many ways, more closely bind the corporate investor and the alliance entity than other forms of partnering relationships. These other corporate "partnering" relationships include:

- **Simple contractual relationship** – where one party agrees to provide goods or services to another party in exchange for cash, other goods or services or a combination of the foregoing;
- **Cross-licensing relationship** – where each party agrees to license its intellectual property to the other party, often on similar terms;
- **"True" partnership or joint venture** – where each party provides a mutual contribution of assets to a new entity and each party may receive mutual benefits back from the new entity (for example, each party receives a license of intellectual property from the joint venture and/or access to markets, manufacturing capabilities or distribution channels of the joint venture).

As a framework for our discussion, we will assume that the corporate investor is larger and more established than the alliance entity and has more substantial resources in many (but not necessarily all) of the following areas – human capital, technology, research and development capability, customers, suppliers, distribution channels, markets, etc. The alliance entity is a smaller, less established company which has fewer resources than the corporate investor but does have some key elements of its business plan or operations that are not readily available in a cost-effective manner to the corporate investor. While the profile of every corporate investor and alliance entity does not necessarily match this assumption, this scenario would be more typical for "true" venture capital investing by corporations.

Why Do It?

Why do a corporate investor and an alliance entity seek to join forces? Some of the benefits from a strategic alliance include:

- **Access to Resources.** The corporate investor and the alliance entity are seeking to access the resources of the other party. These resources may include information, technology, research and development capabilities, distribution channels, manufacturing, supplies and/or personnel. A party may need access to these items because it cannot develop them on its own (or, a key patent, trademark, copyright or trade secret), or, because it is too costly or time-consuming.
- **Risk and Cost Sharing.** When investment costs are high for both the corporate investor and the alliance entity, forming a strategic alliance allows both parties to share risks. This can be particularly true for resources that take a significant time to develop – for example, with respect to intellectual property or distribution channels in new markets. Moreover, the pooling of certain resources may allow each party to enjoy economies of scale, thereby reducing costs for each party.
- **Minimize Time to Market.** When time to market is critical to the success or failure of a product, each party can leverage the other party's lead time advantage and avoid building separate research and development efforts, thereby getting products to market faster.
- **Access to New Markets.** As discussed above, a strategic alliance may provide one or both parties with access to resources that are too costly for a party to develop or cannot be developed by a party on its own. This can be particularly apparent in new markets where distribution can be difficult or restricted. One party may use the other party's local connections, facilities, expertise, language ability and governmental approvals to funnel its product to new territories.
- **Synergies in Complimentary Areas.** While the corporate investor and alliance entity may have very different products (e.g., hardware vs. software), they may be parallel products with very similar markets and customers. By combining resources, each party in essence is able to deliver a more powerful or desirable product to its customers.
- **Test the Waters.** The corporate investor's strategy may ultimately be to purchase the alliance entity. By making a smaller investment up front, the corporate investor can obtain an early preview of the operations, performance and possible synergies with the alliance

entity without making a significant commitment to purchase the entire business.

- **Credibility.** For the alliance entity, in particular, obtaining an investment from a key corporate investor lends credibility to the alliance entity, providing additional value when seeking venture capital and other investors, as well as when attempting to sign up long-term contracts with other customers, suppliers, manufacturers or licensees.

Factors to Consider Before Forming the Alliance

Communication/Common Goals

It is imperative that the parties to a strategic alliance communicate to one another at the outset their goals and objectives in entering into the relationship. For example, are there capabilities that the corporate investor or the alliance entity lack that the other party can provide or can more cheaply or more quickly provide? Is a party seeking access to intellectual property, research and development, distribution channels or markets? Is the other party the best party, the most "reasonably priced" party or the most accessible party to provide these capabilities? What are the goals of the other party to the alliance? Do the parties' goals mesh? Is there "buy in" for these goals at all levels of management (not just the management cutting the deal, but the management that must implement the deal once the dust settles after closing)? As the corporate investor or the alliance entity, you will need to perform sufficient due diligence to answer these questions.

Due Diligence

Initially, after signing appropriate non-disclosure agreements, each party may share limited internal information to ensure that capabilities and strengths are complimentary. This internal due diligence should include interviews of senior management and possible review of corporate and financial records. In addition, each party should conduct as much external due diligence on the other party as possible (within the limitations of any non-disclosure agreements), including contacting other entities in the same or similar industries to confirm and understand the "reputation" and industry perception of the other party; contacting customers, suppliers, manufacturers, licensees/licensors and other parties that have a relationship with the other party to understand the performance, reliability and integrity of the other party; and conducting "on-line" and other research of publicly available records. Once the parties decide to proceed, more detailed internal due diligence would need to be conducted, including review of historical and projected financial performance, material agreements, interviews of personnel directly involved in ensuring the performance of any long-term contracts with the corporate investor and the alliance entity and review of any technology, manufacturing, distribution or other capabilities that are key components of the alliance. If permitted by the alliance entity, the corporate investor should interview any third parties that have similar relationships with the alliance entity.

Each party needs to understand what motivates it and what motivates the alliance partner for doing the deal and for staying in the deal. Understanding these motivations, and drafting alliance agreements that will continue to incentivize each party to support the strategic alliance, perform under the strategic alliance agreements and remain committed to the deal is the challenge. While is it possible, if not probable, that the parties have different motivations for entering into the alliance, if their goals are not aligned from an early stage, the alliance will be doomed.

Similarities to Typical VC Deal

Many of the elements of a corporate investment in an alliance entity are the same as a "typical" venture capital deal. For example, the form of equity in the alliance, the governance structure of the alliance, the special voting or veto rights, the anti-dilution protections, the exit strategy and the dispute resolution mechanisms can be the same or quite similar to what you find in a customary VC deal. These elements are summarized below. For a more detailed discussion of many of these elements, see Silverman, Gary R., "Venture Capital Investing in the New Economy," *The Venture Capital Review*, Issue 6, Spring 2000.

- **Form of Investment.** The corporate investor, like the VC, can negotiate a variety of securities in consideration of its investment, such as subordinated debt, convertible subordinated debt, preferred stock, convertible preferred stock, participating preferred stock, common stock, warrants or any combination of the foregoing.

- **Board Representation.** As with the VC, whether or not the corporate investor obtains a seat on the board is often the subject of significant negotiations. In addition, the ability of the corporate investor to maintain that board seat is also highly negotiated and is often tied to the corporate investor maintaining a level of equity investment in the alliance entity and maintaining and performing under its ongoing contractual relationship with the alliance entity (e.g., through its intellectual property license, manufacturing contract or distribution or supply arrangement).
- **Special Voting/Veto Powers.** Like the VC, the corporate investor will likely request a number of restrictive covenants. Traditional restricted areas include consent to a liquidation, merger involving a change in control, sale of all or substantially all of the alliance entity's assets, and payment of dividends or other distributions or redemptions. Rarely would a corporate investor be provided an outright veto over these events. More often, these restrictive covenants can be waived through super-majority consent of the board or possibly a super-majority consent of the shareholders (particularly if the corporate investor does not have a board seat). In addition, the corporate investor may be granted special approval rights over significant events, such as the annual budget, material capital expenditures, incurrence of material indebtedness or transactions with affiliates (or these events may require approval by a super-majority consent of the board or of the shareholders).
- **Anti-Dilution Protection; Pre-emptive Rights.** In some transactions, the corporate investor who invests through a preferred stock or convertible preferred stock instrument may have the benefit of "simple" anti-dilution protection (with respect to stock splits, stock dividends and the like), "weighted average" anti-dilution protection (which takes into account the price of the new issuance and the number of shares being issued in the new issuance relative to the total number of shares then outstanding) or "full ratchet" anti-dilution protection (which reduces the conversion price down to the price of the new issue without regarding to the relative number of shares being issued).

  Instead of obtaining anti-dilution protection, the corporate investor may have the right to participate in future rounds of investment, typically on the same terms as the future round, and typically in proportion to the corporate investor's existing ownership percentage.
- **Exit Strategies.** A key element of any VC negotiation relates to the ability of the VC to get out of the deal, particularly since the VC's fund may have a limited life and it has a fiduciary obligation to its fund investors to provide liquidity. While the corporate investor may not have the same concerns relating to fund investors, it will likely attempt to negotiate some sort of exit strategy. The long-term objectives of the parties will be particularly relevant in determining their preferred form of exit strategy which, in turn, may be relevant in determining the structure of the alliance. For example, the parties should consider whether they intend to license the products of the alliance, or to develop the alliance and its products with a view to eventual sale, or an initial public offering.
- **Redemption.** While not customary, the corporate investor may seek a specific time horizon on its investment, particularly if there is any change in or termination of the ongoing alliance relationship (e.g., the intellectual property license, manufacturing contract or distribution or supply arrangement) or if the investment is in the form of debt or preferred stock. The alliance entity will need to have the cash flow or access to capital necessary to effect the redemption. In addition, state law may limit or restrict a redemption if the alliance entity is too highly leveraged or has insufficient capital.
- **Registration Rights/Lock-Ups.** The most common form of liquidity granted to a corporate investor is registration rights, particularly if other investors have been granted these rights. Registration rights can be in the form of demand registration rights, where the corporate investor can force registration of its shares, or piggy-back registration rights, where the corporate investor can participate in a registration already being conducted by the alliance entity on its own behalf or at the request of another investor. If demand registration rights are granted, they are usually

effective only after an IPO; otherwise, the corporate investor could effectively cause the IPO with its demand registration.

- **Sale of Stock/Transfer Restrictions.** Since the corporate investor is often a key contributor to the alliance entity through its ongoing alliance relationship (e.g., the intellectual property license, manufacturing contract or distribution or supply arrangement), the alliance entity and other investors will often attempt to limit the corporate investor's ability to sell its stock in a private sale. While it may be difficult to limit a private sale entirely, the corporate investor may have some restrictions on its ability to sell stock in the early years when the alliance relationship is developing. In the early or later years, the corporate investor may have co-sale rights with any other investor, allowing the corporate investor to participate *pro rata* in any sales by that other investor. Hand in hand with this co-sale right is the right of another investor to drag the corporate investor along in the other investor's sales (typically in connection with a sale of control of the alliance entity) and/or the right of the other investor to participate in any sales with the corporate investor.

- **Dispute Resolution Mechanisms.** Despite the parties' best efforts, not all strategic alliances are successful. As with many contracts that have a life after closing, the parties should set forth some dispute resolution mechanism in their governing documents. Common dispute resolution techniques include:

  - **Internal escalation measures,** whereby parties are given certain time periods to internally resolve a conflict, sometimes by having the conflict work its way up the organizational ladder (e.g., the vice president of one party must resolve the dispute with the vice president of the other during a time period before moving the dispute up the chain-of-command);

  - **Non-binding mediation**, which by its terms is non-binding, may provide the parties with a means to resolve a dispute more quickly and cheaply than arbitration or litigation with the assistance of an uninterested third party;

  - **Arbitration can be as simple as appointing one arbitrator** with little discovery to resolve a dispute in a matter of weeks and can be as time consuming and complex as full-scale litigation with discovery, deposition taking, presentation of expert witnesses and the use of the rules of evidence before a one or more "judge" panel;

  - **Litigation may be the first or last resort.** At a minimum, if the parties choose to side step dispute resolution techniques such as mediation and arbitration, the parties may want to consider agreeing in advance to the venue for any dispute.

Oddly enough, we have found that our clients either have no strong preference for any particular form of dispute resolution or have a strong preference, primarily based on a good (or, more likely, a bad) experience with one form of dispute resolution. While it is always difficult to predict the future, we recommend that our clients consider the likely areas of dispute, the complexity of the likely areas of dispute, the likely significance of that dispute to the client's business, whether the dispute is likely to be resolved in a short or long period of time, the leverage of our client relative to the other party and the likely time period during which the client will want the dispute resolved relative to the time period the other party may want the dispute resolved. For example, will the likely dispute relate to a key piece of source code that, if accessed by competitors, could be devastating to our client's business? Or, is the likely area of dispute the calculation of a royalty payment that could be remedied with a cash payment by our client? In the first scenario, our client may want a quicker resolution, whereas, in the second scenario, time may not be as critical. Certain scenarios, therefore, may lend themselves to a quicker resolution (e.g., mediation or short arbitration) vs. longer resolution (more thorough arbitration or litigation). Or, in a very complex case, it may be more important to be able to select the person deciding the dispute (perhaps an expert in the field rather than a retired judge). At a minimum, consider the various dispute resolution mechanisms in light of the likely areas of dispute, rather than simply copying the boilerplate dispute resolution mechanism from the last deal.

Differences from Typical VC Deal

The obvious difference between a corporate investment deal and a VC deal is that the VC pays cash whereas the corporate investor contributes assets in lieu of cash or in addition to cash. The corporate investor and the alliance entity typically enter into multi-year contracts for technology licensing, manufacturing or supply provisions, distribution arrangements, and/or research and development obligations.

As discussed above, the goals of the corporate investor and alliance entity should be aligned from an early stage. Accordingly, the parties should aim to be as specific as possible in structuring the alliance, by dividing up responsibilities, authority and costs and ideally committing their objectives and decisions to writing. The items discussed above could be used as a checklist for what should be considered, discussed and agreed upon up front. If the alliance is to operate efficiently on a day-to-day basis, joint decisions and responsibilities should be kept to a minimum.

Intellectual Property Issues

One of the main driving forces behind the increasing number of strategic alliances involving corporate investors is the rapid technological change of the New Economy. Alliances offer an opportunity to "share" the costs and resources involved in the research and development of new technologies, processes and products. It is also common for at least one of the parties to contribute some form of technology or R&D to the alliance. For these reasons, one of the most critical issues to consider in structuring the alliance is the protection and ownership of the intellectual property and proprietary information contributed by the respective parties, including customer lists, as well as the treatment of any intellectual property that is developed by the alliance itself.

The party contributing intellectual property may choose to enter into a license agreement with the alliance, rather than an outright assignment. The terms of the licensing arrangement that will need to be considered include:

- whether a royalty fee will be due from the alliance to the originating party or whether the license is "fully paid up;"
- whether the license will be exclusive or non-exclusive (or perhaps exclusive/non-exclusive for certain products, time periods or geographic regions);
- the duration of the entire license (or of portions of the license);
- the geographic scope of the license (or of portions of the license);
- whether the license is revocable under any conditions;
- the scope of use and how that might be revisited in the future; and
- sanctions for infringement and responsibility for enforcement against infringers.

The license will also need to reflect the exit strategy of the alliance as a whole. For example, the license may be subject to consent requirements upon a change in control, and the parties should agree upon the effect of a breach by any member of the alliance on the license.

Another important consideration is to protect the alliance's interest in the intellectual property on which it relies in the event of the bankruptcy of any of its members. One method of protecting against a loss of control IP is to place the technology or source code underlying a license arrangement into escrow and to agree on the terms on which it will be released from the escrow arrangement to the non-bankrupt party.

The ownership of intellectual property developed or improved by the alliance should be determined up front. The common practice is that the intellectual property would belong to the party that developed it; but, this can become less clear when the intellectual property is developed as the result of a collaborative effort of two or more otherwise distinct and competing entities. The parties may also wish to distinguish between new intellectual property developed by the alliance and improvements to existing technology that was contributed by one of the members to the alliance. The alliance should also have an agreed approach to issues such as licensing arrangements with third parties including all of the terms discussed above and responsibilities for patent and trademark prosecution.

The branding of the alliance itself is another hot button to consider. For example, if any member to the alliance has strong name recognition, it will need to decide whether it is prepared to allow the alliance to use its name and/or trademarks for the promotion of the alliance and, if so, there will inevitably be some conditions imposed as to the use of that name and/or trademark. Each member will be anxious to ensure that the actions and products of the alliance do not have any adverse impact on its reputation.

Ongoing Commitments

Although it is difficult to provide for every eventuality, it is necessary to establish a framework for the types of events and contingencies that can reasonably be expected to occur during the life of the alliance. The parties should therefore give some consideration to the commitments they are prepared to make to the alliance on an ongoing basis, including:

- future commitments of capital and other resources;
- contributions of technology or improvements to existing technology;
- obligations to route customers;
- direction of business opportunities; and
- usage of the product.

With respect to the alliance's ongoing capital needs, the parties should discuss how it is envisaged that these will be met, for example:

- debt and how it should be protected;
- equity and how the upside will be treated; and
- contract R&D funding and utilization of any associated tax credits.

Course of Dealing and Non-compete

A considerable number of strategic alliances are created to produce a product or provide a service necessary or ancillary to the other operations of one or more of the parties, to the alliance that cannot be justified for purely internal consumption. As a result, the parties to the alliance are likely to be a major, if not the most significant, consumer(s) of the alliance's products and/or services. For this reason, some consideration must be given to the terms on which the products and/or services will be provided, both to the members of the alliance and to third parties, including whether there will be any "most favored nations" deals.

It is also common to find that the alliance and one or more of its constituent members have an overlap in market or customer base. Therefore, it is important to set the parameters of any non-compete provisions, both during the term of the alliance and after the expiration of any party's involvement, for example, whether the alliance may compete with the parties and, if so, on what terms, and vice-versa. This issue is significant when considering the respective interests of the parties upon termination of the alliance, such as the acquisition or increased ownership by one party to the exclusion of the other. The parties should also consider and include terms relating to the non-solicitation of each other's and the alliance's employees and customers.

Termination and Exit Strategy

The goals of a strategic alliances are often qualitative and, therefore, it may be difficult to evaluate whether the project is a success according to the usual indicators such as revenues or profits. The parties should consider setting performance measures or objectives in order to have "benchmarks" or "milestones" by which to determine whether the project is "successful" and worthy of ongoing investment and dedication of time and resources.

Another result of the difference in objectives between an alliance that is formed to share information, develop technologies or for the purposes of the joint exploitation of new markets, and the conventional "for profit" enterprise, is that the parties need to be able to withdraw from the alliance not just for cause, in the event of breach or non-compliance by the other party, or if the enterprise is successful by sale or other disposition, but also in the event of mediocre performance. Failure to attain the performance measures set forth initially may be used as a termination trigger. Because of the differences between alliances and the conventional business model, some have adopted a "grid-approach" to termination provisions that applies different penalties or consequences depending on the underlying cause for termination. The following circumstances may deserve consideration and different treatment:

- breach of or non-compliance with an alliance agreement;
- curable breaches as opposed to non-curable events;
- bankruptcy of any party;

- change in control of any party;
- failure to achieve the predetermined milestones, whether or not “caused” by any party.

The sanctions that may be applied in the various circumstances include:

- financial penalties;
- liquidation;
- merger/sale with third party;
- buy-out by one of the alliance parties.

The parties will also need to consider the mechanism for any sale or merger to third parties or to the other alliance member(s), including control and responsibility for the transaction, the circumstances under which participation may be forced and the pricing mechanisms, including the valuation method to be applied.

Just as important as determining the circumstances under which the alliance will be brought to an end is for the parties to agree on the consequences of termination. Obviously, this determination will be somewhat dependent on the type of alliance and the stage at which it finds itself at the date of termination. Nonetheless, the parties should give some thought to:

- revenue sharing;
- restrictive covenants;
- customer relations and lists;
- release of source code or other intellectual property held in escrow.

Potential Risks and Pitfalls

If due consideration is given to the areas and issues outlined above, the alliance will have been structured on a sound basis. Even so, people and priorities change, and the alliance must maintain the flexibility to move with the times if it is to succeed.

- **Clearly Established Goals and Common Understanding.** The possibility for change underlies the need to have a clearly established and mutually defined set of goals or objectives which will steer the direction of the alliance. To do so, the parties need to have a common understanding of the operating procedures and their respective responsibilities that will be employed in the pursuit of those goals and objectives. Thorough planning and communication are vital in a strategic alliance, particularly where the parties have different motivations and are operating outside of their usual reporting hierarchy.
- **Ongoing Communication.** Ongoing communication will also be critical to ensure that the alliance develops and executes contingency plans to respond to unexpected events such as market changes or economic instability in order that the original goals may still be achieved.
- **Multiple Level, Organizational Buy-In.** Another common cause for failure of strategic alliances is that they are often dependent upon the efforts and enthusiasm of one or two key personnel. If those individuals cease to be involved, the driving force behind the alliance is often lost. It is therefore important to ensure that people at different levels within each of the parties are involved and that there has been a multi-level “buy-in” to the project which will withstand personnel changes.
- **Remaining Independent; Avoid Being Overly Restricted.** Entering into an alliance can also mean that a party becomes too dependent on its partner’s technology and the cost and resource savings made now mean a loss of flexibility or opportunity in the future. This will be exacerbated if the parties have bound themselves very tightly together and is a factor to be borne in mind when considering the terms of the alliance that will be most restrictive, such as non-compete provisions. In addition the parties should ensure that the deal does not become so all-inclusive that it essentially becomes an acquisition and has therefore made the alliance unattractive to other partners. For example, broad exclusivity and non-compete provisions can effectively make one party a service-provider for the alliance alone.
- **Protect Your Reputation.** All of the interested parties in an alliance arrangement must remain cognizant of the potential risk or downside to their general reputation resulting from an involvement in an unsuccessful venture. While the failure of a

strategic alliance can be harmful to a corporate investor, particularly if the alliance was "branded" with the corporate investor's identity, the same failure can be the death-knell for the alliance entity.

Conclusion

Strategic alliances offer a flexible investment vehicle which has the advantage of lower costs and less risk exposure for its members than if they were to undertake the project alone. The potential disadvantages to entering into an alliance include risks to the existing core business by diversion of resources, risks to the party's intellectual property and other proprietary information and possible adverse public reaction to failure.

While it may not be possible to anticipate all eventualities, careful understanding, planning and drafting is the key to the success of a strategic alliance. Even so, alliances may fall victim to a change in strategy of the constituent members, perhaps as a result of changing economic conditions or of industry changes that undermine one of the party's dedication to the alliance. The magic is knowing when to be specific in some areas of the alliance contracts, in order for a strategic alliance to stand the test of time, while maintaining flexibilty to address future unknown events and provide each party with incentives to stay committed to the deal.

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