THE EXIT STRUCTURE OF STRATEGIC ALLIANCES

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Today, many biotechnology firms are using strategic alliances to contract with other companies. In this article, Professor Smith contends that the governance structure of these alliances—specifically, the "contractual board"—provides an integrated restraint on opportunism. While an alliance agreement's exit structure could provide a check on opportunism by allowing the parties to exit at will, such exit provisions also can be used opportunistically. Most alliance agreements, therefore, provide for contractual "lock in" of the alliance partners, with only limited means of exit. Lock in, of course, raises its own concerns, and Professor Smith contends that the contractual board—which is composed of representatives from each alliance partner, each wielding equal power—addresses these concerns about opportunism via the potential for deadlock.

I. INTRODUCTION

Alliances have become a central feature of modern business. Although not inherently tied to a particular industry, alliances seem to be particularly common among biotechnology firms,[1] where alliances often involve a small research firm matching up with a large pharmaceutical company.[2] Despite increasing attention from economists, sociologists,

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1. *See, e.g.*, Josh Lerner & Robert P. Merges, *The Control of Technology Alliances: An Empirical Analysis of the Biotechnology Industry*, 46 J. INDUS. ECON. 125, 129 (1998) (presenting data on the increasing number of biotechnology alliances). Biotechnology alliances often involve research and development collaboration between a large pharmaceutical company and a small biotechnology company. In these relationships, the smaller company often engages in the initial research and transfers responsibility to the larger company as development progresses. As will be discussed below, this temporal division creates special risks for the smaller company that must be addressed by the relational contract.

2. *See, e.g.*, David T. Robinson & Toby Stuart, Network Effects in the Governance of Strategic Alliances in Biotechnology 1 (Mar. 1, 2000) (observing that "strategic partnerships have become the most significant source of external funding for the research activities of the young firms in the industry") (Working Paper, on file with the University of Illinois Law Review).

and management scholars,[3] strategic alliances have received only modest attention from legal scholars.[4] This article brings the learning of corporate law scholars to bear on one aspect of the governance of strategic alliances.

For purposes of this article, "alliances" are long-term, cooperative, relational contracts among two or more firms, and are characterized by nonfinancial investments and a profit interest by all parties.[5] Joint ventures, by contrast, involve the creation of a separate legal entity, and such structures are excluded from this study.[6] Transaction-cost economics has taught us to divide the world into markets and hierarchies, but alliances lie somewhere in between.[7]

In this middle region, the potential for opportunism is high, and alliance agreements are structured with an eye toward combating opportunism through the detailed specification of rights and obligations and the mutual staging of investments. Alliance agreements also contain mechanisms to regulate exit. In most instances, the termination provisions allow parties to exit an alliance only after a specified period of time or "for cause," which might include a material breach of the agreement, a change in control of the counterparty, or insufficient progress on the project.[8] By effectively locking partners into the alliance relationship, these termination provisions create incentives to mitigate opportunism.

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3. *See, e.g.*, MARK DE ROND, STRATEGIC ALLIANCES AS SOCIAL FACTS: BUSINESS, BIOTECHNOLOGY, AND INTELLECTUAL HISTORY (2003).

4. The *Case Western Reserve Law Review* published a short symposium entitled *The Role of Lawyers in Strategic Alliances*, 53 CASE W. RES. L. REV. 857 (2003).

5. Scholars have not reached a consensus on the definition of "strategic alliance," but from a legal standpoint, nothing turns on this definition because strategic alliances are not subject to special regulation. George Dent defines "strategic alliance" as a "sustained relationship in which the agreed performance of each party is complex and largely autonomous and each party has a profit interest." George W. Dent, Jr., *Gap Fillers and Fiduciary Duties in Strategic Alliances*, 57 BUS. LAW. 55, 56 (2001); *see also* Ranjay Gulati, *Does Familiarity Breed Trust? The Implications of Repeated Ties for Contractual Choice in Alliances*, 38 ACAD. MGMT. J. 85, 85 (1995) (describing an arrangement "whereby two or more firms agree to pool their resources to pursue specific market opportunities"); David T. Robinson, Strategic Alliances and the Boundaries of the Firm 2 (Nov. 15, 2001) ("A strategic alliance is an agreement between legally distinct entities that provides for the sharing of costs and benefits of some (significantly costly) mutually beneficial activity.") (Working Paper, on file with the University of Illinois Law Review).

6. *Cf.* Robinson, *supra* note 5, at 2 ("A joint venture differs from a strategic alliance in that the contracting parties form a new, distinct organization to administer the activities of the alliance. Since a new entity is formed, control rights are more clearly delineated *ex ante*, and the transaction more closely resembles a merger."). Rachelle Sampson refers to alliances as "pooling contracts" and distinguishes these from "equity joint ventures." She writes, "[a] pooling contract is a contractual arrangement where partner firms combine their capabilities for the purposes of collaborative R&D, but do not form a separate legal entity for the alliance." Rachelle C. Sampson, *The Cost of Misaligned Governance in R&D Alliances*, 20 J.L. ECON. & ORG. 484, 487 (2004).

7. As noted by David Robinson, "[a]lliances lie somewhere in the middle of an organizational spectrum, which at one end reside purely anonymous market transactions and at the other extreme reside integrated hierarchies." Robinson, *supra* note 5, at 2; *see also*, Sampson, *supra* note 6, at 488 ("On the market to hierarchy continuum of organizational forms, the pooling contract is close to market, while the equity joint venture is more hierarchical and closer to internal organization.").

8. David T. Robinson & Toby E. Stuart, *Financial Contracting in Biotech Strategic Alliances* 28 (Aug. 31, 2002) (Working Paper, on file with the University of Illinois Law Review).

This article focuses on one aspect of the exit structure that has been largely overlooked in the prior literature on alliances: the contractual board. Many alliance contracts create a contractual board—usually called the "management committee."[9] At first glance these committees look like a corporate board of directors, but closer examination reveals that they have a quite different function. While corporate boards of directors are primarily about centralized decision making, the contractual boards formed by most alliance agreements are concerned with opportunism prevention. One mechanism by which management committees police opportunism is by permitting the parties to deadlock, a method borrowed from the governance of closely held corporations.

Management committees typically are assigned the task of monitoring the alliance activities and shaping ongoing developments. The committees are comprised of representatives of each side, usually in equal numbers, but the absolute numbers are not so important, since unanimity is the norm. Because most alliances are comprised of only two parties, deadlocks are a real possibility.[10] Given that alliances usually do not provide for easy dissolution, the deadlocks are dealt with according to the terms of the contracts, which ordinarily include a dispute resolution mechanism. One purpose of management committees, therefore, is to provide an exit option. The price of exit is the cost of the deadlock procedures.

Part II of this article describes the problem of opportunism in alliances. Part III discusses the importance of exit. Part IV examines the contractual board and its role in forcing (or threatening to force) deadlock as a means of mitigating opportunism.

II. OPPORTUNISM IN ALLIANCES

Alliances are relational contracts[11] among two or more firms. The relationships are intended to last multiple years,[12] though failure rates reportedly are high.[13] The logic of transaction-cost economics supports

9. *Id.* at 24 ("One of the most common features of alliance contracts is the reliance on project-level monitoring based on research committees, as opposed to board-level control.").

10. *Cf.* George Dent, *Lawyers and Trust in Business Alliances*, 58 BUS. LAW. 45, 48 (2002) ("To prevent opportunism, partners often share control equally, but they then need devices to resolve deadlocks. These devices must be designed so that neither party is tempted to force a deadlock in order to reap one-sided benefits.").

11. Baker et al. define "relational contract" to mean, "an agreement between the parties that is so rooted in their shared experience that it cannot be enforced by a court, and so must be enforced by the parties' concerns for their reputations." George Baker et. al., *Relational Contracts in Strategic Alliances* 16 (Feb. 26, 2002), *available at* http://www.nbcr.org/books/stragalli/baker.pdf (Working Paper, on file with the University of Illinois Law Review).

12. *Id.* at 14 ("[A]lliances are not one-shot transactions, but rather involve continual interactions spanning multiple years.").

13. *See* Bruce Kogut, *The Stability of Joint Ventures: Reciprocity and Competitive Rivalry*, 38 J. INDUS. ECON. 183, 183 (1989) (presenting "strong evidence that joint ventures are highly unstable").

the notion that firms pursue joint ventures rather than alliances when contracting hazards are high.[14] This section explores the nature of opportunism in the alliance context.

Opportunism is a familiar concept in legal and economic studies. The most quoted definition of opportunism belongs to Oliver Williamson, who characterized it as "a condition of self-interest seeking with guile."[15] The distinctive feature of this definition is the notion of "guile," which Williamson describes as "lying, stealing, cheating, and calculated efforts to mislead, distort, disguise, obfuscate, or otherwise confuse."[16] In the more recent economic literature, opportunism is typically condensed into "shirking" and "cheating."[17] In the strategic alliance context, two forms of "cheating" are most prominent: stealing[18] and holding up.[19]

The temptation to act opportunistically in the alliance setting has several sources. Bruce Kogut suggests that "[v]entures are likely to be characterized by competitive rivalry over the residual claims . . . , over control of the operating management of the assets, or concerns over the loss of technology and brand labels."[20] The concern over technology loss was central to Joanne Oxley's examination of appropriability hazards, which she traced to "weak property rights, as they apply to transactions involving technology transfer within interfirm alliances."[21] Oxley argues further that "'appropriability hazards' can be traced to difficulties in adequately specifying payoff-relevant activities, monitoring the execu-

However, de Rond rightly observes that "the literature lacks a precise and consistent definition of collaborative success and failure." DE ROND, *supra* note 3, at 9.

14. *See* Gulati, *supra* note 5, at 89 ("[F]irms use equity alliances when the transaction costs associated with an exchange are too high to justify a quasi-market, nonequity alliance."); Joanne E. Oxley, *Appropriability Hazards and Governance in Strategic Alliances: A Transaction Cost Approach*, 13 J.L. ECON. & ORG. 387, 388 (1997) ("In choosing among different interfirm alliance types, the logic of transaction cost economics suggests that more 'hierarchical' alliances will be chosen for transactions where contracting hazards are more severe.").

15. OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS 6 (1975).

16. OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 47 (1985). *Cf.* Ian R. Macneil, *Economic Analysis of Contractual Relations: Its Shortfalls and the Need for a "Rich Classificatory Apparatus,"* 75 NW. U. L. REV. 1018, 1023 n.20 (1981) (describing guile as "taking advantage of opportunities with little regard for principles or consequences").

17. Daniel S. Nagin, et al., *Monitoring, Motivation, and Management: The Determinants of Opportunistic Behavior in a Field Experiment*, 92 AM. ECON. REV. 850, 852 (2002). Borrowing from Dickens, Eric Orts refers to these two categories of behavior as "shirking and sharking." Eric W. Orts, *Shirking and Sharking: A Legal Theory of the Firm*, 16 YALE L. & POL'Y REV. 265, 280 (1998) (suggesting that shirking and sharking are "more limited concepts" than opportunism).

Williamson has a more expansive conception of opportunism than is often employed by other economists. *See* WILLIAMSON, *supra* note 16, at 101 ("Not only are the failures to self-disclose true attributes *ex ante* (adverse selection) and true performance *ex post* (moral hazard) both subsumed under opportunism, but the failure to tell the truth, the whole truth and nothing but the truth is implicated by opportunism.").

18. Joanne Oxley uses the highfalutin term "appropriability hazards." Oxley, *supra* note 14, at 388.

19. Conrad S. Ciccotello et al., *Research and Development Alliances: Evidence From a Federal Contracts Repository*, 47 J.L. & ECON. 123, 127–28 (2004).

20. Kogut, *supra* note 13, at 185.

21. Oxley, *supra* note 14, at 388.

tion of prescribed activities, and/or enforcing contracts through the courts."[22] Rochelle Sampson focuses on the risks of free-riding (shirking) and leakage (stealing) of technology.[23]

Much of the voluminous scholarship on alliances attempts to examine the structural mechanisms by which alliance partners address opportunism. For example, firms tend to choose more hierarchical structures (including joint ventures) when property rights are difficult to specify, when the relationship covers multiple products or technologies, or when more than two alliance partners are involved.[24] In short, hierarchy mitigates some forms of transaction costs.

One of the most important sources of moral hazard risk in alliances is the sequential performance obligation of the partners. This risk is typically confronted through various contractual mechanisms. For example, the larger alliance partner often makes a substantial upfront investment in the smaller partner.[25] After this initial investment, staging is a conspicuous feature of most alliance agreements.[26] In addition, each alliance partner typically owns separate assets, which, though dedicated to the alliance, are subject to the alliance partner's exclusive control[27] and revert back to the separate partners upon dissolution.[28] Intellectual

22. *Id.* at 389.

23. Sampson, *supra* note 6, at 491. Sampson writes, "Concerns over leakage of intellectual property may prevent partners from pooling their best technologies and most skilled labor." *Id.* at 493.

24. Oxley, *supra* note 14, at 402–06.

25. David Robinson and Toby Stuart have observed that this investment often takes the form of convertible preferred stock, with terms similar to those used in venture capital investments. Robinson & Stuart, *supra* note 8, at 3 (finding equity investments in sixty-five percent of sample alliances). The form of equity—common versus preferred—was heavily correlated with the nature of the investee firm. If that firm was a publicly traded company, common stock was the usual form of equity. On the other hand, if the investee firm was privately held, convertible preferred stock was the predominant form of investment. *Id.* at 17. Interestingly, the youngest firms in their sample did not receive equity backing at all. *Id.* at 18.

This movement from no equity through preferred stock and to common stock in later-stage companies leads Robinson and Stuart to conclude that "strategic alliances act as a form of late-stage venture capital." *Id.* at 19. While the size of this initial investment does not depend expressly on performance milestones, later-stage projects are more likely to receive upfront payments. *Id.* at 21–22. In addition, the authors found that "centrality"—as measured by past transactions between the alliance partners—was an important explanatory variable for the size of initial payments:

> One interpretation of these results is that R&D [Research and Development] partner firms with many past alliances are in a stronger bargaining position because they can credibly generate competition among potential clients, thus raising the probability and size of upfront concessions. The positive effect of centrality on upfront funding is also consistent with the interpretation of centrality as a proxy for the R&D partners reputation. Because upfront payments are non-contingent and thus eligible for misuse, clients are presumably less reluctant to provide them in deals with R&D partners that have better reputations.

Id. at 22.

26. Robinson & Stuart, *supra* note 8, at 13 ("Almost all deals make future investment contingent on achieving certain milestones.").

27. Sampson, *supra* note 6, at 488 ("Decision making in these alliances on all but the most critical decisions is typically decentralized (i.e., partners make their own judgments on how to best meet their obligations under the alliance agreement) . . . . ").

28. How are payments made to alliance partners? Three possibilities: (1) "efficiency wages" are paid before the state or any decisions are observed; (2) "bribes" are paid after the states are observed, but before the parties make asset utilization decisions; and (3) "subjective bonuses" are paid depend-

property also plays a central role in most alliances.[29] Most alliance agreements have extensive provisions allocating ownership over improvements or discoveries.

Despite the extensive contractual protections in most alliance agreements, a number of complicating factors emerge. First, to the extent that gaps in contractual protections persist, alliances operate in a space largely devoid of default rules.[30] Second, alliances do not obtain the benefits of hierarchy that are inherent in corporate governance,[31] namely, the exercise of centralized control. Finally, given the long-term goals of most alliances and their uncertain paths, contracts cannot be drafted with much precision. Because the alliance partners often perform discrete tasks, "firms have difficulty assessing partner contributions and cannot easily infer contributions by examining results, since the link between effort and results is highly variable."[32] And, if the parties themselves have difficulty monitoring contractual compliance, courts are even more handicapped by their insistence upon objective evidence of breach of contract. In such a contracting context, it is not surprising to find sociologists and legal scholars talking about "norms,"[33] "embeddedness,"[34] and "trust"[35] as mechanisms to mitigate opportunism.

The alliance between Microsoft and Sendo Limited, a smartphone company from Birmingham, England, illustrates the potential for opportunism that arises in alliances. The two companies met at the T99 Telecom Fair in October 1999 and almost immediately began discussing a possible alliance to develop a "smartphone" (i.e., a telephone that could also access the Internet and serve as a personal digital assistant).[36] Sendo was already developing a product called the Z100, and Microsoft was developing a software product with the code name "Stinger."[37]

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ing on whether the asset utilization decisions are appropriately tailored to the state. Baker et al., *supra* note 11, at 16.

29. In Robinson and Stuart's sample of 125 genomics alliances, 113 (ninety percent) involved licensing agreements. Robinson & Stuart, *supra* note 8, at 11. The authors interpreted the big percentage of licensing agreements as evidence of bargaining power on the part of smaller technology firms. *Id.*

30. Dent, *supra* note 10, at 47–48 (discussing how default rules, like those in the Uniform Commercial Code, fill gaps in incomplete contracts).

31. *Id.*

32. Sampson, *supra* note 6, at 491.

33. *See, e.g.*, Amitai Etzioni, *Social Norms: Internalization, Persuasion, and History*, 34 LAW & SOC'Y REV. 157 (2000).

34. *See, e.g.,* Mark Granovetter, *Economic Action and Social Structure: The Problem of Embeddedness*, 91 AM. J. SOC. 481 (1985). For a discussion of embeddedness in the context of alliances, see Ranjay Gulati, *Alliances and Networks*, 19 STRATEGIC MGMT. J. 293, 299 (1998).

35. On trust generally, see NIKLAS LUHMANN, TRUST AND POWER (Tom Burns & Gianfranco Poggi eds., 1979); Lynne G. Zucker, *Production of Trust: Institutional Sources of Economic Structure, 1840–1920*, 8 RES. IN ORGANIZATIONAL BEHAV. 53 (1986). For a discussion of trust in the strategic alliance context, see Dent, *supra* note 10, at 49–52.

36. Plaintiff's Original Complaint at 5, Sendo Ltd. v. Microsoft Corp., No. 502CV282 (E.D. Tex. filed Dec. 20, 2002).

37. For more details on the Microsoft-Sendo relationship, see Andy Reinhardt & Jay Greene, *Death of a Dream*, BUS. WK., Feb. 10, 2003, at 44.

After a year of negotiation, the parties entered into a Strategic Development and Marketing Agreement (SDMA) and various license agreements in October 2000.[38] In a complaint filed after their relationship deteriorated, Sendo described the primary terms of the SDMA:

> The SDMA provided, in part, that: (1) the Sendo Z100 Smartphone would be a market leading product; (2) Microsoft would prioritize the Sendo Z100 Smartphone; (3) Microsoft would pay an amount of money plus a contribution to expenses towards development of the Z100; and (4) Microsoft would receive a substantial percentage share of the Net Revenue from sales of the Z100 as it had contributed to the development cost.[39]

In addition, Microsoft promised a future investment in Sendo.[40] Microsoft made that investment of $12 million in May 2001.[41] In exchange, Microsoft received the right to appoint a representative to Sendo's Board of Directors, which it did in the person of Marc Brown.[42] Brown was not only a director of Sendo, but was head of Microsoft's Corporate Development and Strategy Group, which monitored the progress of the relationship under the SDMA.[43]

During the ensuing months, development of the Z100 lagged. According to Sendo's complaint, the delays were all part of Microsoft's plan:

> Microsoft's Secret Plan was to plunder the small company of its proprietary information, technical expertise, market knowledge, customers, and prospective customers. Microsoft had been unable to successfully access the wireless market because the major handset manufacturers would not use their [Microsoft's] software. So instead, . . . Microsoft used Sendo's knowledge and expertise to . . . gain direct entry into the burgeoning next generation phone market and then, after driving Sendo to the brink of bankruptcy, cut it out of the picture.[44]

According to Sendo's complaint, Microsoft's interest in Sendo was part of a "master plan" to dominate the market for mobile handsets.[45] Under this version of events, Sendo was attractive to Microsoft for three reasons: (1) Sendo had employees who were experienced in the technology of mobile handsets; (2) Sendo had existing relationships with major companies who would be the major customers for such handsets; and (3) Sendo had experience with the technical requirements imposed by carri-

38. Plaintiff's Original Complaint at 6, *Sendo Ltd.* (No. 502CV282).
39. *Id.*
40. *Id.*
41. *Id.* at 7.
42. *Id.* at 7, 9.
43. *Id.* at 9.
44. *Id.* at 4.
45. *Id.* at 3.

ers (this was especially important because some of these requirements were not written).[46]

In October 2002, Microsoft announced that it had teamed with High Tech Computer Corp. to produce a unit similar to the Z100 for Orange, a British telecommunications company.[47] The SPV (which stands for "Sound, Pictures, Video") was riddled with technical bugs, but Orange and Microsoft are working on new versions.[48] In November 2002, Sendo switched from Microsoft's software to a product made by Symbian Ltd., the other main competitor in this industry.[49] Symbian is a London-based consortium owned by the giants of the electronics industry: Nokia, Motorola, Ericsson, Sony-Ericsson, Samsung, Matsushita, Panasonic, Psion, and Siemens.[50]

On December 20, 2002, Sendo filed a complaint in the United States District Court in Texarkana, Texas, alleging misappropriation of trade secrets, unfair competition, fraud, breach of fiduciary duty, and breach of contract, among other things.[51] Sounds bad, but according to Microsoft, it sounds much worse than it is.[52] In an Answer and Counterclaim, filed on February 3, 2003, Microsoft referred to Sendo's account as "fanciful" and claimed that the failure of the Z100 was the result of Sendo's many breaches of the SDMA.[53] Moreover, Microsoft claimed that Sendo misled Microsoft about the true nature of Sendo's finances.[54]

The Microsoft-Sendo alliance generated classic allegations by Sendo against Microsoft of shirking (albeit in service to a "secret plan" to appropriate Sendo's technology) and stealing. The parties ultimately settled Sendo's lawsuit to undisclosed terms, and the alliance agreement is not publicly available. Nevertheless, the case provides an excellent illustration of the risks of opportunism in the alliance setting. The next section examines the importance of exit as a means of combating the potential for such opportunism.

46. *Id.* at 4.

47. *Id.* at 14.

48. *See, e.g.*, Tony Hallett, *Orange Offers "World's Smallest Smart Phone,"* (June 8, 2004), *at* http://networks.silicon.com/mobile/0,39024665,39121183,00.htm; *Orange Hunts Flaws in Microsoft Product*, WALL ST. J. EUR., Jan. 16, 2003, at A7 (regarding the bugs in Microsoft's software).

49. The Sendo alliance was Microsoft's third failed attempt to enter the mobile handset market. It was the primary investor in Teledesic, the satellite network that ultimately failed in 2002. Then in 2001 Microsoft backed out of a joint venture with Qualcomm. *Qualcomm Takes Over Ownership of Venture With Microsoft Corp.*, WALL ST. J., Nov. 6, 2001, at A10.

50. See Symbian's website *at* http://www.symbian.com/about/ownership.html.

51. Sendo's U.S. office is located in Irving, Texas. On February 3, 2003, Microsoft filed a motion to transfer venue to the Western District of Washington, Microsoft's home state. Defendant's Motion to Transfer Venue at 1, *Sendo Ltd. v. Microsoft Corp.*, No. 502CV282 (E.D. Tex. filed Feb. 3, 2003).

52. Defendant's Answer and Counterclaim, *Sendo Ltd v. Microsoft Corp.*, No. 502CV282 (E.D. Tex. filed Feb. 3, 2003).

53. *Id.* at 25.

54. *Id.*

III. THE IMPORTANCE OF EXIT

The problems of opportunism that lie at the heart of strategic alliances are a familiar feature of the scholarship of business organizations. In particular, general partnerships and closely held corporations share the challenge of creating a lasting and cooperative relationship among a small number of participants.[55] In both forms of organization, the potential for stealing and hold-up loom large, and exit structure plays a crucial role in regulating the potential for opportunism.[56]

The default rule of exit in partnership law is at-will dissolution.[57] Exit, or the threat of exit, is a powerful constraint on opportunism. Like the two-edged sword, however, exit rights also might be used to act opportunistically.[58] In many partnerships, therefore, the default rule is changed, and the parties agree that the partnership will endure for a particular term or specified undertaking. Of course, even in such arrangements, the partners are allowed to exit, but if a partner leaves the partnership under circumstances not sanctioned by the partnership agreement, the departing partner may be subject to damages for breach of contract. The result is a form of "lock in" that attempts to discourage opportunistic exit.[59]

Shareholders in a closely held corporation are also subject to lock in.[60] Unlike partners in a partnership for term, however, shareholders do not have the unilateral power of dissolution. That is, absent contractual or statutory right, shareholders are not entitled to exit at the time of their

55. John A.C. Hetherington & Michael P. Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 VA. L. REV. 1, 2 (1977) ("[T]he close corporation is the functional equivalent of the partnership.").

56. For a classic study of exit in the partnership context, see Larry E. Ribstein, *A Statutory Approach to Partner Dissociation*, 65 WASH. U. L.Q. 357 (1987). With respect to closely held corporations, see Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387 (2003); Hetherington & Dooley, *supra* note 55.

57. UNIF. P'SHIP ACT § 31 (1914), 6 U.L.A. (pt. II) 370 (2001); UNIF. P'SHIP ACT §§ 601, 602 (1997), 6 U.L.A. (pt. I) 163–64, 169 (2001).

58. *Cf.* Dent, *supra* note 5, at 93–94 ("The power to dissolve without fiduciary restrictions invites opportunism.").

59. Blair, *supra* note 56, at 388 ("The phrase 'lock-in,' when used in the context of corporate law, generally has a negative meaning, suggesting the dreaded fate of a minority shareholder in a closely held corporation who cannot sell her shares (perhaps because there are restrictions on stock sales, or perhaps because there is just no market for such shares), and cannot compel the corporation to pay out any of its income or assets to shareholders."). For a similar idea in the strategic alliance context, see Dent, *supra* note 5, at 95–96 ("The opposite of the problem of opportunistic termination is lock-in: a party who wants to exit a venture may be unable either to dissolve the venture or to sell its interest therein.").

60. For an excellent discussion of the benefits of lock-in in the corporate setting, see Edward B. Rock & Michael L. Wachter, *Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations*, 24 J. CORP. L. 913, 918–20 (1999). "For at least the Silicon Valley start-up, the explanation for the choice of form is an operational factor: the need to lock-in parties while developing vulnerable match-specific assets. Reduced agency costs are the result rather than the cause." *Id.* at 919.

choosing and to be paid the value of their shares.[61] As one would expect in such a circumstance, shareholders often contract for exit rights through buy-sell agreements,[62] which take various forms but generally entitle a shareholder to sell her shares back to the corporation (or another shareholder) upon her departure. This is the corporate version of at-will dissolution, and it is usually limited by date or event restrictions.

In the absence of contractual exit rights, minority shareholders might still obtain liquidity under the law of minority oppression.[63] Whether implemented by statute or by common-law decision, the law of minority oppression usually requires dissolution of the corporation or buyout of the minority shareholder when events suggest that the majority shareholder is acting opportunistically.[64]

As noted above, alliance partners are not subject to default rules. The termination structure of alliances is entirely contractual, and as we would expect, alliance partners often strive to obtain the benefits of lock in without constructing a suicide pact.[65] Most alliances have termination provisions that are tied to the completion of a specified undertaking. Prior to that event, the partners may exit only "for cause," a term that typically includes breach of the alliance agreement and may include other events.

If those were the only termination provisions, the exit structure of alliances would look very much like a partnership for term or a closely held corporation subject to the law of minority oppression. Another method of exit that is commonly employed in alliances, however, is exit via deadlock. This exit strategy is implemented through the contractual board.

IV. THE CONTRACTUAL BOARD

Many alliances of the type discussed in this article have contractually constituted management committees comprised of representatives of

61. Margaret Blair contends that this feature—which she describes as "the ability to *commit* capital, once amassed, for extended periods of time—for decades and even centuries"—was crucial to the development of the corporate form in the eighteenth century United States. Blair, *supra* note 56, at 390.

62. Andrew P. Campbell & Caroline Smith Gidiere, *Shareholder Rights, the Tort of Oppression and Derivative Actions Revisited: A Time for Mature Development?*, 63 ALA. LAW. 315, 316–17 (2002) ("Professional firms and other corporations frequently use such buy/sell agreements that essentially create a private market and give the minority shareholder an out in the event of a falling out or disagreement with the majority shareholder.").

63. F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S OPPRESSION OF MINORITY SHAREHOLDERS § 1.05 (2d ed. 2003).

64. Robert C. Art, *Shareholder Rights and Remedies in Close Corporations: Oppression, Fiduciary Duties, and Reasonable Expectations*, 28 J. CORP. L. 371, 402–05 (2003).

65. While it is not uncommon for an alliance agreement to be terminable at the will of the larger party, that right typically requires substantial forewarning. For a recent example, consider the Exclusive License and Collaboration Agreement between MedImmune, Inc. and Critical Therapeutics, Inc., July 30, 2003, at § 10.2 [hereinafter Critical Alliance Agreement] (on file with the University of Illinois Law Review), which provides that MedImmune has the right to terminate on six months notice.

each alliance partner. This institution is somewhat enigmatic and has gone largely unexplored by alliance scholars. Rachelle Sampson suggests two functions for such institutions: (1) improved information flow and (2) improved coordination on strategic-level decisions by forcing consensus.[66] This section describes the usual structure of the contractual board and explores its possible functions.

In the paradigmatic alliance comprised of two alliance partners, each partner appoints several representatives to a management committee, but regardless of the number of committee members, each alliance partner has one vote.[67] A recent strategic alliance agreement between Memory Pharmaceuticals and Hoffman-LaRoche is illustrative.[68] Memory is a biotechnology company that develops pharmaceutical drug candidates to treat neurological disorders, such as Alzheimer's disease.[69] Several of its drug candidates are currently in clinical development, and it has forged alliances with Hoffman-LaRoche, one of the world's largest pharmaceutical companies, to facilitate this development.[70] The alliance is governed by a "Joint Liaison Team" (JLT) comprised of five members, three of which are to be designated by Memory and two of which are to be designated by Hoffman-LaRoche.[71] Despite the imbalanced representation, the agreement provides that "[d]ecisions of the JLT shall be by consensus, with each Party having one collective vote."[72]

Most alliance agreements assign a variety of tasks to the contractual board. The unifying theme of these provisions is the need to fill gaps in the alliance agreement as the relationship matures. The Memory Alliance Agreement, for example, delegates to the JLT the tasks of preparing development plans, supervising the progress of the alliance, "recom-

66. Sampson, *supra* note 6, at 484–85.

67. Josh Lerner and Rob Merges suggest that bargaining power disparities might account for circumstances in which one party gains outright control over the management board. Lerner & Merges, *supra* note 1, at 136 (discussing a joint venture between Ciba-Geigy and ALZA).

68. Strategic Alliance Agreement, among F. Hoffman-La Roche Ltd., a Swiss corporation, Hoffman-La Roche Inc., a New Jersey corporation, and Memory Pharmaceuticals Corp., a Delaware corporation, Aug. 19, 2003, [hereinafter Memory Alliance Agreement] (on file with the University of Illinois Law Review).

69. Prospectus of Memory Pharmaceuticals Corp., Apr. 5, 2004, at 3 (on file with the University of Illinois Law Review).

70. *Id.* at F-16.

71. Memory Alliance Agreement, *supra* note 68, at § 7.2(a).

72. *Id.* § 7.2(c). A recent alliance between Pfizer Inc. and Eyetech Pharmaceuticals, Inc. displays a similar governance structure:

> In order to fulfill the objectives of this Agreement, the Parties agree to establish a Joint Operating Committee (JOC), a Commercialization Subcommittee (CSC), a Clinical Development/Regulatory Subcommittee (CDRSC), and a Manufacturing Subcommittee (MSC), and such other committees and subcommittees as may be established by mutual consent of Eyetech and Pfizer. Each committee and subcommittee shall have two co-chairpersons, one designated by each of Eyetech and Pfizer. All decisions of the committees and subcommittees shall be by a vote of the co-chairpersons, each co-chairperson having one vote, and all decisions shall be by unanimous consent of the co-chairpersons.

Collaboration Agreement by and between Pfizer Inc. and Eyetech Pharmaceuticals, Inc., December 17, 2002, at § 3.1 [hereinafter Eyetech Alliance Agreement] (on file with the University of Illinois Law Review).

mending actions in response to unforeseen events, [and] supervising the transition of development and manufacturing activities from Memory to Roche and development of preclinical and clinical strategies (including clinical candidate selection, the commencement of the Initiation of Phase I and the Initiation of Phase IIa)."[73] From the standpoint of the original negotiators of the alliance agreement, these sorts of decisions are unfathomable because they depend on events that occur subsequent to the formation of the alliance.

The open-textured nature of the JLT's authorization is typical of other alliance agreements. The following is a provision from the recent alliance agreement of MedImmune, Inc. and Critical Therapeutics, Inc.:

> The Committee will (i) provide guidance regarding Development of Products, including the review of Product Development plans, (ii) make decisions regarding the Research Plan for the Development of Products for each Indication, and regarding the respective roles of each Party in the Development of Products, (iii) address such other matters as either Party may bring before the Committee, (iv) perform such other tasks and undertake such other responsibilities as may be set forth in this Agreement, and (v) attempt to resolve any disputes relating to this Agreement that may arise between the Parties.[74]

In addition to composing the contractual board and allocating to it various responsibilities, most alliances agreements require the board to meet on a periodic basis, usually at least semiannually or quarterly.[75] As noted above, any decisions of the board made at these meetings must be unanimous, thus presenting, in a two-partner alliance, the possibility of deadlock. Of course, the parties recognize this possibility, and alliance agreements routinely provide for dispute resolution in the event of deadlock. The usual provision in such cases involves referral from the committee to senior officers of the respective partners, who are charged with bridging the gap. In the event that the tête-à-tête fails to resolve the matter, the alliance agreements either allocate decision making authority to one of the parties or send the matter directly to arbitration. The Memory Alliance Agreement takes the first tack:

> If the JLT is unable to decide a matter by consensus, the Parties shall refer such matter for resolution to the Head of Global Research or the Head of Global Development on behalf of Roche and the Chief Scientific Officer of Memory ("Alliance Executives"). If the Alliance Executives are unable to resolve any such matter after

73. Memory Alliance Agreement, *supra* note 68, at § 7.2.

74. Critical Alliance Agreement, *supra* note 65, at § 2.1.01.

75. *See, e.g.*, Memory Alliance Agreement, *supra* note 68, at § 7.2(b) (requiring semiannual meetings, but allowing the parties to change the frequency by mutual agreement); Critical Alliance Agreement, *supra* note 65, at § 2.1.02 (requiring quarterly meetings); Eyetech Alliance Agreement, *supra* note 72, at § 3.2 (providing for meetings "quarterly, or as otherwise requested by one of the Parties").

good faith discussions, then the final decision shall rest with Memory.[76]

Although the parties appear to have provided a straightforward solution to deadlock, the agreement also contains an arbitration provision triggered by "[a]ny dispute, controversy or claim ('Dispute') arising out of or in relation to this Agreement, or the breach, termination or invalidity thereof, that cannot be settled amicably by the Parties after a good faith discussion to resolve the Dispute by the appropriate officers of the Parties."[77] These two provisions seem to be in direct conflict, the one providing that Memory has ultimate decision making power and the other requiring arbitration of any disputes that remain unresolved after the senior officers have had their turn. While the former appears to apply only to a subset of disputes (*i.e.*, disputes within the JLT), the JLT decision making power is expansive enough that the subset might consume close to the whole set of alliance disputes.[78]

Many other alliances take a more direct route to arbitration. For example, an alliance between BioNumerik Pharmaceuticals, Inc., a Texas corporation that recently filed documents with the Securities and Exchange Commission in preparation for an initial public offering, and ASTA Medica Aktiengesellschaft, a German corporation, contained the following provision: "If [a] matter is not resolved by the Alliance Steering Committee representatives of BioNumerik and ASTA Medica within 60 days after the commencement of . . . discussions, either Party may request, in writing, that the matter be resolved by binding arbitration . . . ."[79]

At first glance, the contractual boards created by many alliance agreements bear a resemblance to boards of directors in the corporate context. Just as modern corporation statutes provide broad authority to corporate boards to manage the corporation's affairs,[80] alliance agreements usually give contractual boards expansive authority to manage the development of the alliance. Unlike most corporate boards, however, the contractual boards are constructed to facilitate deadlock. That the

76. Memory Alliance Agreement, *supra* note 68, at § 7.2(c). *See also* Critical Alliance Agreement, *supra* note 65, at § 2.1.03 (providing that any issues not resolved by negotiation will be decided by the Chief Executive Officer of MedImmune).

77. Memory Alliance Agreement, *supra* note 68, at § 17.

78. Interestingly, the Critical Alliance Agreement also contains an arbitration provision that would seem to apply if the negotiation at the senior officer level failed:

> The Parties shall negotiate in good faith and use reasonable efforts to settle any dispute, controversy or claim arising from or related to this Agreement or the breach thereof. If the Parties do not fully settle, and a Party wishes to pursue the matter, each such dispute, controversy or claim shall be finally resolved by binding arbitration in accordance with the Commercial Arbitration Rules and Supplementary Procedures for Large Complex Disputes of the American Arbitration Association ('AAA'), and judgment on the arbitration award may be entered in any court having jurisdiction thereof.

Critical Alliance Agreement, *supra* note 65, at § 11.6.01.

79. Strategic Alliance Agreement between ASTA Metica Aktiengesellschaft and Bionumerik Pharmaceuticals, Inc., Jan. 18, 2001, at § 3.5 (on file with the University of Illinois Law Review).

80. Del. Gen. Corp. L. tit. 8 § 141(a) (1999); Mod. Bus. Corp. Act Ann. § 8.30 (2002).

parties count this a real possibility is clear from the fact that the alliance agreements describe processes to resolve deadlocks.

What are we to make of these provisions? The ultimate answer to this question will require more detailed empirical investigation, but the structure of the agreements evokes several possibilities. Under the elaborate, multistage, dispute resolution process, four outcomes are possible: (1) the partners could resolve the dispute at the committee level; (2) the partners could resolve the dispute at the senior officer level; (3) the partners could resolve the dispute by reference to the contractually designated decision maker; or (4) the parties could take their dispute to arbitration. Of course, the existence of a series of procedures may itself encourage early resolution. For example, the lower-level officers who staff the contractual board might be reluctant to refer matters to their senior officers on the theory that such a referral is evidence of failure. Also, the prospect of arbitration and separation may not be attractive in a surplus producing alliance, thus encouraging vigilant negotiations.

All of this begs the question: Why create a committee to do this work? Most contractual relationships are managed at the firm level by a single employee (the contract manager) or a small group of employees whose existence is never acknowledged in the written agreement. They are not required to meet with representatives of the counterparty (though they might), and they are given no express authority within the body of the contract to make decisions affecting the relationship (though they may be given such authority by their employer). In short, they are invisible to the reader of the express contract. That alliance partners feel the need to create a contractual board, define its authority, specify its regular meetings, and provide decision making and dispute resolution rules is suggestive of a different purpose.

The contractual board provides one supremely important advantage over the contract manager: exit without breach. This advantage turns on a critical aspect of alliances, namely, that opportunistic behavior is extraordinarily difficult to police via contract. If one alliance partner is chiseling, the other party may know it but may not be able to prove that the behavior constitutes a breach of the alliance agreement.[81] Faced with such a circumstance, a contract manager is in a difficult position. She may be able to persuade the counterparty that opportunistic behavior is immoral, unprofitable, or unwise, but without the possibility of at-will dissolution, she will be helpless to force a change by any means short of retaliatory opportunism, which could backfire if later found to constitute a breach of the alliance agreement.

An alliance partner, by contrast, can use the contractual board to its advantage. The board is both required to meet and delegated authority

81. Economists would describe this state of affairs using the rather awkward phrasing of *observability without verifiability*.

to make certain decisions. In most instances, that delegation is broad enough to provide the alliance partners with the flexibility to address opportunistic behavior. By forcing a decision at the committee level, a strategic partner may curtail opportunism before it has a chance to do substantial damage to the alliance. Even if the problem is not resolved at the committee level, reputational forces or the desire to maintain a productive alliance may pressure the opportunistic party to resolve the dispute at the senior officer level. And if that fails, the complaining partner either imposes its will on the other partner (if the complaining partner has been assigned ultimate decision making power) or exits through arbitration.

Under this view, one of the key advantages of alliances over partnerships or corporations is that the partners have a built-in check against opportunism. An alliance partner who feels put upon has the power to force deadlock, which triggers a substantial process that is capable of addressing the opportunistic behavior or providing a means of exit.

V. CONCLUSION

Perhaps the biggest challenge confronting scholars who study contractual structure is the inevitable heterogeneity produced by private ordering.[82] This article relies on the empirical observations of others regarding patterns of behavior among alliance participants.[83] This general approach is well-known in transaction-cost economics.[84]

The structural feature of alliances that is most interesting for present purposes is the contractual board. Such boards are an important vehicle for discovering and disseminating information about the activities of the alliance. Moreover, these institutions offer decision making capacity in a highly fluid environment. In addition to these commonly recognized roles, however, contractual boards also play a somewhat surprising role in the exit structure of many alliances: They serve as a means of exit without breach.

82. For an interesting exploration of heterogeneity in the alliance context, see Jeffrey J. Reuer & Africa Ariño, *Contractual Heterogeneity in Strategic Alliances* (Nov. 13, 2002) (Working Paper No. 482).

83. As noted by de Rond, "despite the idiosyncrasy of alliances, there *is* order." DE ROND, *supra* note 3, at 4.

84. For examples of such efforts in the strategic alliance context, see Richmond D. Mathews, *Strategic Alliances, Equity Stakes, and Entry Deterrence* (Working Paper, Dec. 8, 2003) (examining equity ownership in alliances) (Working Paper on file with the University of Illinois Law Review).