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Preparing for the Exit

When forming a business alliance, don't ignore one of the most crucial ingredients: how to break up

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A word of advice for companies thinking about forming a business alliance: Before launching any partnership, make sure both parties agree on how you'll know, and what you'll do, when it's over.

There is no doubt this can be challenging. Like a prenuptial agreement, in which a couple discusses divorce options on their way to the altar, negotiating exit options while still at the formation stage of an alliance seems almost counter to human nature. For one thing, neither partner wants to admit that things could go awry. What's more, there's an eagerness to get the deal done -- and a fear that raising the worst-case scenario will undermine the euphoria and trust that often accompany a new deal.

But partners ignore the issue at their own risk. Discussing the trigger points for exiting, as well as the disengagement process itself, while still in the negotiation stage is paramount for an effective partnership. In many cases, exit planning may actually enhance the alliance's performance and longevity.

Interviews with managers who have overseen alliances reveal a pattern that sometimes emerges when a partnership with no adequate separation agreement becomes strained: Partner A grows dissatisfied with the venture and seeks an exit, but can't find any easy options; Partner A then attempts to covertly appropriate as much value as possible from the alliance before the venture goes completely sour, while creating a paper and action trail aimed at placing the blame for the failed venture on Partner B; an angry Partner B discovers the maneuvers, and takes countermoves.

The lack of an agreement is compounded by the fact that when tensions arise between partners, the alliance's

managers may be reluctant to alert their superiors back at the partner companies. They fear they may be blamed for the alliance's failure, which would hurt their own careers. So instead, the managers focus their tensions on their alliance counterparts. The typical outcome: a dysfunctional strategic alliance marked by deep animosity between alliance managers. Any ensuing discussions about possible alliance termination are likely to be emotionally charged and ineffective.

THE DISENGAGEMENT PLAN

So, what kind of exit-plan pact works best? One that clearly specifies the point of disengagement, tells both parties what their subsequent rights and responsibilities are, and provides a clear and effective procedural map that minimizes time and capital losses.

More specifically, a successful disengagement plan should comprise the following:

Clear definitions of what both parties will consider as exit triggers, or events that will set off specific exit provisions. A detailed description of each party's rights in a fair separation of the partnership's assets and products, as well as a determination of rights and responsibilities with regard to third parties, such as customers, suppliers and employees of the alliance. A detailed description of the disengagement process, including specific strategic options, guidelines for creating the core disengagement team, and clear timelines. A communication plan for continuous flow of information to alliance partners, customers, suppliers and other involved parties during the dissolution.

TRIGGERS FOR DISENGAGEMENT

Not clearly stating when an alliance should end can be lethal, even when partners have agreed on how the alliance should end. Partners' perspectives

on the timing of dissolution can differ, leading to lengthy and expensive haggling.

This is why the first step in devising a successful exit strategy is to have clear trigger provisions. Triggers may consist of such contingencies as the inability of the alliance to meet certain milestones, performance metrics or service-level agreements; breaches of contract terms; or the insolvency or change in control of one of the partners. When pharmaceutical and biotech companies team up to bring an experimental drug to market, the partners often use milestones as exit triggers, such as whether the drug reaches a particular stage of a clinical trial.

For example, a large U.S. pharmaceutical company we talked to often sets a deadline by which patients must be enrolled in Phase III clinical trials, typically the last round of tests before a drug is submitted to the Food and Drug Administration for approval. Other milestone triggers used in this area include failing to successfully complete Phase III trials, failing to attain approval from the Food and Drug Administration, or, for a drug that is already approved, failing to meet specific sales targets.

In some cases, exit triggers are linked not to goals but to events, such as a change in control of one of the partner companies. One large domestic dairy manufacturer we investigated, for example, when entering alliances, often stipulates that it will end the partnership if its partner's percentage of voting shares in its own company declines without the dairy company's prior consent. The dairy maker makes this requirement to avoid having an undesired firm indirectly obtain a stake in the alliance by buying shares in the partner company.

Once an exit trigger is reached, the next step is dissolving the alliance. This

raises the question of each partner's rights and responsibilities. What's the fairest way to split everything up?

Partners can start by breaking things down into two broad categories: stocks, which we'll define as the current products or services sold by the alliance, as well as the physical and intellectual assets used in their production; and flows, which are contractual commitments to third parties and to the partners.

RIGHTS TO STOCKS

Stocks include inventory of products and materials, any land and facilities, as well as intellectual property. The less integration there has been between the partners, the easier it is to determine these rights. The difficulties increase where joint ownership or joint operations are concerned, and even more when the alliance has grown to involve multiple product lines with competing brands and geographically dispersed physical infrastructure.

If a partial or complete buyout is a possibility, one has to consider not only present but future value of stocks. Certain contingencies can have huge effects on the alliance's revenue streams and all manner of agreements involving revenue sharing, royalties and licensing, and options to buy or sell products or services in the future.

A recent alliance between a U.S. software maker and a Japanese electronics company included an exit agreement that paid particular attention to the assignment of intellectual property rights in case of certain contingencies. The agreement between the pair, which teamed up to produce a color-management system for the software maker's new operating system, stated that if for any reason the operating system never made it to market, rights to intellectual property developed by the alliance would default to the Japanese company.

Similarly, in many of the biotech-pharmaceutical alliances reviewed, the partners made it very clear at the outset who would retain the rights to jointly produced intellectual property if the alliance ended.

RIGHTS TO FLOWS

After rights to stocks comes the question of fulfilling contractual commitments -- the so-called flows of the alliance. Big losses in an alliance's value can arise from uncertainty about who is responsible for what.

Flows typically include contracts or other relationships with customers, suppliers, service providers, employees and providers of capital. If such relation-

ships are mishandled during a dissolution, profits and productivity can suffer. Customers, for example, might switch to competitors in order to avoid service disruptions, or might seek to modify payment terms. Suppliers and other service providers might stop treating the alliance organization as a high priority. Employees, fearing uncertainty, might leave.

There's a leading sports-apparel company that outsources almost all of its production in numerous small alliances and yet maintains tight control over its supply chain -- even when an alliance occasionally ends. The company tries to manage the procurement processes of the suppliers in those alliances. This way, when terminating an alliance, it can forecast exactly how much inventory it will need from that supplier right up until the termination point. It also eliminates the risk of having the inventory go into brand-damaging outlets, such as discount stores.

DISENGAGEMENT PROCESS

A typical disengagement agreement can include various strategic options such as rights of first refusal to various stocks and flows, or buyout clauses based on different conditions. The specifics of these are dictated by the nature of the exit trigger, changing markets and partners' shifting strategic priorities.

Some constants can be followed, however, and interviews with alliance managers suggest a three-step process that can serve as a kind of roadmap to disengagement.

First, partners should agree to a mandatory unwind period. An unwind period gives each party enough time to implement its exit strategy successfully, and ensures that the alliance organization is able to fulfill its obligations and remain competitive in the marketplace until the time when it is dissolved.

Second, a core team of disengagement managers should be formed, drawing on managers not only from the parent companies but from the alliance itself. When a team comprises only managers from the parent companies, attorneys get involved too early and negotiations tend to focus solely on the observance of rights to stocks; this tends to alienate alliance managers and to hurt not only what remaining value the alliance has, but the flows of the partner companies as well. Additionally, the smartest companies assign the supervision of disengagements to senior corporate personnel at the parent companies who weren't originally linked to the alli-

ance. Such supervision not only enforces clear accountability and allows for greater impartiality, it enables alliance managers to better clear organizational and legal roadblocks during the disengagement process.

Finally, there must be a clear timeline for achieving goals related to disengagement, and managers should coordinate all related activities with relevant departments at the partner companies. If you've got plans to drop a product or service, discontinue sales in certain territories or to certain customers, close a plant or renegotiate a contract, you have to let the right people at both partner companies know.

When a partnership has to be dissolved, a strong communication plan is key. In our view, a number of companies have learned that mishandling communications during a break-up can damage a company's reputation and significantly hinder its chances of finding future partners. During disengagement, it's important to avoid offending partners and to maintain your own company's reputation.

Maintaining transparency with partners, customers, employees and even rivals helps to manage the impact of news about the breakup on financial markets; it also helps maintain morale at the alliance, and helps to preserve any value that remains in the alliance. Lack of transparency leads parties to focus on protecting their own interests without regard for those of the partner, and eventually causes things to implode.