As anyone who has watched *Survivor* knows, strategic alliances can be a path to success. Alliance partners can enhance each others' strengths and offset each others' weaknesses, while each partner retains the flexibility to re-align their strategies and tactics over time.

Of course, joint ventures and strategic alliances ("strategic alliances") preceded reality television by millennia. Ancient societies developed codes and laws to define the rights and responsibilities of partnerships, marriages and other strategic alliance-like relationships long before reality TV became entertainment for the masses. Feudal property laws recognized and gave legitimacy to strategic alliances in the forms of tenancies in common, tenancies by the entirety and joint tenancies. Strategic alliances and the legal structures that surround them continue to evolve to this day. Although some strategic alliances are simple single-project businesses, many other strategic alliances are complex, multinational commercial organizations.

Whatever the nature, parties in a strategic alliance must have a common understanding and be willing to coordinate their efforts over time. A strategic alliance's character as a long-term but flexible relationship makes strategic alliances especially attractive during economic downturns. Using a strategic alliance structure may allow parties to extract the efficiencies of a business combination without the financing or other up-front commitments required for an outright acquisition. Strategic alliances are also attractive for businesses seeking to expand into new jurisdictions, where forming a strategic alliance with a local partner can offer advantages in navigating complex regulatory schemes. In fact, some countries, like China and India, require certain foreign businesses to form joint ventures with domestic businesses in order to enter the market.

The options for structuring strategic alliances are virtually unlimited and continue to evolve. In all cases, strategic alliances need to be tailored to the specific needs of the parties. This article identifies some of the most widely used strategic alliance structures and highlights certain key issues that recur during strategic alliance negotiations.

No two strategic alliances are exactly alike. They vary in size, structure, assets, purpose and duration, among other characteristics, and they represent a wide range of issues and
challenges. There is no "standard form" strategic alliance agreement. That being said, there are a few recurring structures that are widely used as building blocks for forming strategic alliances. These structures are founded in two basic categories: (1) entity-based strategic alliances and (2) contractual strategic alliances. The choice of structure of a strategic alliance is typically driven by tax considerations and liability issues.

Entity-Based Strategic Alliances

One way for parties to form a strategic alliance is to invest in each other's equity, form a new entity together or invest jointly in a third party's equity. In each case, the legal framework that governs the strategic alliance initially is defined by the nature of the entity selected, the class and percentage of equity held by the investors and the entity's governing documents. Partnerships, limited liability companies and corporations can all be used as entity-based strategic alliances.

In selecting a form of entity for a strategic alliance, the investors must consider how their rights and obligations will be determined under applicable law in the absence of contractual commitments or expressions of their intent. Among other considerations, the extent of each investor's liability to the strategic alliance and the other investors, the governance and administration of the strategic alliance, and the tax and financing objectives of the investors will all be relevant in selecting a form of entity. The applicable default rules vary by jurisdiction. For example, some civil law jurisdictions give statutorily defined veto rights to minority investors in corporations, whereas common law jurisdictions may define the protection of minority investors only by reference to fiduciary duties. In addition, the tax treatment of the strategic alliance and the ability to issue different classes of voting and non-voting equity interests to different investors will vary by type of entity. It is critical to be familiar with all applicable default rules in designing an entity-based strategic alliance.

In the United States, large commercial strategic alliances are rarely formed as pure entity-based strategic alliances because the statutory default rules associated with a given entity would not address all of the issues that are likely to arise in a complex commercial relationship.

Contractual Strategic Alliances

Some strategic alliances do not involve equity investments. They are pure contractual relationships. Examples include software development agreements and pharmaceutical collaboration agreements. The only limitations on defining the parties' relative rights and
obligations in a contractual strategic alliance are the limitations on enforceability of contracts in the relevant jurisdiction.

To a layman, there is no bright line that distinguishes a contractual strategic alliance from an ordinary commercial relationship. Numerous factors, such as the term of the contract, the allocation of rights and responsibilities between the parties and the parties' intent may be relevant. The detail and extent of a contractual relationship may have implications for accounting, tax and legal considerations.

**Hybrid Strategic Alliances**

Many large strategic alliances are hybrids of entity-based strategic alliances and contractual strategic alliances. For example, it is not uncommon in the United States for parties to form a strategic alliance entity as a limited liability company or corporation subject to an operating agreement or shareholders agreement. In hybrid strategic alliances, the investors should pay particular attention to whether applicable law permits them to modify contractually the statutory default rules applicable to the strategic alliance entity. For example, under Delaware law, partners in a limited partnership and members of a limited liability company may modify the fiduciary duties they owe to one another in their partnership agreement or limited liability company operating agreement. In Delaware, however, the duties of good faith and fair dealing (or similar concepts) cannot be eliminated by contract.

The advantage of forming a hybrid strategic alliance is flexibility. Even when the investors, under applicable law, are required to use an entity that is not flexible enough to accommodate all of their objectives, they may still be able to supplement the legal structure of their selected entity with a separate agreement to define their contractual obligations under the law of a different jurisdiction. For example, investors could form a strategic alliance as an offshore limited company but enter into a shareholders agreement under New York law. Strategic alliance agreements governed by a law of a jurisdiction other than the jurisdiction of formation of the strategic alliance entity are most effective when the selected courts have jurisdiction over the parties' assets in case the need to enforce a judgment arises.

Even in hybrid strategic alliances, it is important to continue to observe the corporate formalities associated with the selected entity, notwithstanding the contractual aspects of the strategic alliance. For example, to minimize alter ego liability and the risk of "piercing the corporate veil", investors should be assiduous about observing corporate formalities and
being clear in communications to third parties about which legal entity is the actor. They should not refer to themselves as "partners" in external communications unless the strategic alliance is, in fact, a partnership, lest a bona fide third party misunderstand the investors’ authority to bind the strategic alliance or the scope of their liability for actions and omissions of the strategic alliance. Investors should also be cautious about approving dividends or distributions when the strategic alliance is insolvent or becoming insolvent.

Management and governance rights vary across strategic alliances depending on the jurisdiction of formation, type of entity (if the strategic alliance is entity-based), relative economic interests and types of investors and other factors. These rights can be implemented at three different levels of a strategic alliance: (1) the investors, (2) the governing board and (3) management.

**Direct Rights of Investors**

Investors can exercise management and governance rights directly through their participation and voting at equity holder meetings, through the exercise of veto/approval rights and through the exercise of information rights. Different investors may hold different series or classes of equity in the strategic alliance, and each class or series of equity may entitle the holder to different rights and preferences, including approval/veto rights. These rights and preferences should be the subject of up-front negotiation between the investors at the time of the strategic alliance's formation.

It is customary for certain significant decisions of a strategic alliance to be subject to veto/approval rights, including the following types of decisions: acquisitions, dispositions, financings, capital calls, distributions, budgets, decisions regarding dissolution/liquidation/insolvency, amending organizational documents, forming subsidiaries, M&A transactions, changing the size of the board, related party transactions, issuing equity, and tax and accounting policies. These rights can be tailored to have ordinary course carve-outs or carve-outs for actions taken in accordance with annual plans/budgets previously approved by the investors. These rights can also be designed to expire (or increase) after a set amount of time during the life of the strategic alliance and/or to interact with transfer restrictions such that subsequent transferees may not have the same veto/approval rights as the initial investors in the strategic alliance. To protect their ability to exercise these rights, investors should ensure that they are required to be given adequate notice of meetings and that the applicable quorum rules ensure the investors' rights to participate in votes.
Governing Body

Typically boards of directors or comparable governing bodies are elected by the equity holders. A strategic alliance agreement can cap the size of the board and give certain investors the right to designate a set number of directors and/or board observers. These rights will interact with the default quorum and voting rules of the strategic alliance to empower (or dis-empower) investors with respect to specific matters that the board considers. Investors that contract for such rights must ensure that the rights persist for the full term of the strategic alliance and do not subside after the first election cycle for directors. Investors should not be permitted to remove other investors' designees on the board "without cause". If directors are removed "with cause", the investor who appointed the removed director should have the sole right to appoint the replacement director. Investors should also ensure that their rights to appoint directors extend to determining the composition of any committees of the board, especially key committees like the executive committee and the audit committee. Similarly, investors should ensure that the strategic alliance's subsidiaries offer the same governance rights to the investor as the parent company.

Investors can further empower their director designees by imposing supermajority voting rules for significant board decisions. Such rules can be very effective at protecting an investor's interests in a strategic alliance with a small number of investors and an evenly divided board. Such rules are less effective when a strategic alliance has (1) independent directors whose voting behavior may be unpredictable or (2) a large number of investors whose director designees' interests and alliances may shift over time. The effectiveness of supermajority voting rules at the board level also depends on the board's quorum rules: specifying whether a supermajority is calculated by reference to directors in attendance at the meeting or to the total number of directors may be important if there is a risk that an investor's designee will not be able to attend key meetings. One option is to provide that a quorum only exists if a supermajority of the total number of directors, including director designees of each investor, is present at the meeting. If the supermajority is calculated by reference to the directors in attendance, then it is important that directors be entitled to adequate advance written notice of meetings, that investors be entitled to send alternate directors to attend board meetings, and that written consents of directors be effective only when approved unanimously.

One issue to consider in designing a board of directors for a strategic alliance is whether to establish criteria for directors. For example, where the strategic alliance involves parties that are competitors, it may be desirable to specify that no investor can
designate individuals to serve as directors who are directors of the investor (to avoid implicating any applicable legal restrictions on director interlocks) or who are responsible for marketing and sales (to eliminate the fact or appearance of misuse of competitively sensitive information). In addition, for smaller, active boards where the directors will meet frequently and work closely with each other, investors may want to consider imposing character guidelines on directors. For example, the investors might require that directors have industry expertise, and/or not have a serious criminal history or substance abuse problems. In addition, investors might seek to impose restrictions on directors’ service on other boards to ensure the directors have adequate time to dedicate to the strategic alliance's board.

In structuring a board for a cross-border strategic alliance, investors should also consider social issues such as the language in which the board's meetings will be conducted and the location/medium of board meetings. The latter may also have tax implications.

Management

In certain strategic alliances, investors may reserve the right to designate a chairman of the board or specified executives to enhance their oversight and control over the strategic alliance. The chairman position can be just an honorary title, but the chairmanship can be an important role if the chairman has the authority to bind the company or a "casting" vote on matters that require board approval. Key positions may include the chief executive officer, the chief financial officer, the chief marketing officer, the chief information officer, the controller and/or the general counsel. In addition, if any investor has expertise in a particular area of the strategic alliance's operations, the investor may want the right to appoint the senior employees in that subject matter area to ensure that individuals with the relevant expertise are involved. Rights to fill key positions can alternate among investors over time. Investors can also design these rights to "spring" upon the occurrence of specified events. For example, if the strategic alliance's performance fails to meet certain benchmarks over a specified period, the right to appoint the executive leadership team may shift to a previously more passive investor.

Information Rights

Investors can use information rights to monitor their investment and the performance of management and other investors. Investors should bargain for the right to access a strategic alliance's books, records and management. In addition, investors should make sure that the scope of their access rights are adequate for them to satisfy applicable regulatory
reporting obligations and any investor-specific reporting obligations. The strategic alliance agreement should address whether investors have the right to request periodic audits of the strategic alliance’s financial statements and who is responsible for the costs of such audits. In some cases, where an investor is not actively involved in the day to day management of the strategic alliance, the investor should consider whether to bargain for the right to receive periodic compliance certificates from the strategic alliance’s management. Such compliance certificates could cover issues ranging from Sarbanes-Oxley-like matters to the accuracy of other information provided to the investors to a bring-down of representations and covenants akin to what is customary in credit agreements.

Board observers are another form of information right. They are individuals who are entitled to attend board meetings and receive materials distributed to the board, but they are not entitled to vote on matters that the board considers. Board observers are widely used by investors that, for regulatory reasons, are not permitted to "control" a strategic alliance but nevertheless want to be apprised of developments in the strategic alliance’s businesses. Board observers are also sometimes used by investors that are pension funds or have pension fund investors to comply with ERISA requirements.

Valuation issues in strategic alliances tend to be more complicated than those in asset sales, stock sales and mergers. In the latter, the investors typically value the transaction at a single point in time, subject in some cases to limited earn-out or purchase price adjustments. For strategic alliances, the investors have to value the transaction at the outset by determining the relative values of their initial contributions to the strategic alliance. However, they also have to establish guidelines for their respective future contribution obligations in light of the projected performance of the strategic alliance. This double layer of complexity generates numerous valuation issues for strategic alliances.

What is the Value of Assets the Initial Investors Contribute to the Strategic Alliance upon Formation? The investors may contribute cash, assets, management services, employees or opportunities. Apart from cash, these assets may not have an objectively measurable fair market value. Accordingly, the investors may need to conduct extensive mutual due diligence prior to forming the strategic alliance, and may have to develop assumptions about future performance. Where the investors seek credit at the outset for services they will provide to the strategic alliance in the future, they need to develop a mechanism for the strategic alliance to enforce their obligation to provide services (e.g., if the investors fail to provide required services, then their equity stakes could be reduced by an agreed amount).
How Many Liabilities Can the Initial Investors Contribute to the Strategic Alliance upon Formation? The investors must determine whether the strategic alliance will assume responsibility for historical liabilities related to the contributed assets or the investors themselves. These historical liabilities may include tax liabilities, environmental liabilities and litigation, among others.

How Does the Value of Assets (Including Cash or Securities) and Liabilities Contributed to the Strategic Alliance Translate Into an Equity Interest or Future Rights in the Strategic Alliance? Once the investors agree on the appropriate valuation for their initial and future contributions, they need to decide how to allocate that value as between initial voting and economic power and the right to receive future returns. The formulae the investors design to reflect the economics of their deal should align with their other objectives (e.g., just as with employment agreements, deferring compensation/returns can drive investors to be more committed to long-term results). To protect their agreed allocation of the strategic alliance’s equity, the investors should ensure that future equity issuances be made on a pro rata basis, or at least that the investors have preemptive rights.

What are the Investors' Future Capital Contribution Obligations? This is often a very contentious issue. Nobody likes to throw more money into a sinking ship. That being said, at times it may be more rational to extend additional capital than to borrow from third parties or permit the strategic alliance to become insolvent. As a general rule, the investors’ ability to veto capital contribution requirements should correlate to their rights to vote on capital expenditures and other material operational matters. If an investor may be required to make involuntary additional capital contributions, it is advisable to agree in advance the scope of those contributions (amount, timing, recourse, parity with other equity holders, etc.). The investors should also specify contractual penalties for any failure to fund required capital contributions. These penalties can range from financial penalties to the loss of equity or the loss of voting or contractual rights.

What are the Investors' Relative Rights to Receive Dividends/Investment Returns from the Strategic Alliance? Distributions do not have to be proportional to the investors’ equity contributions or voting power. For example, strategic alliances can be structured with distribution waterfalls that allow one investor to recoup a pre-determined yield before the other investor receives an investment return. The ability of the investors to receive debt-financed distributions is often a subject of negotiation. The ability of the investors to receive tax distributions (subject to the availability of capital), in contrast, is rarely contentious.
In the Event One Investor Exits the Strategic Alliance (see “Exit Rights”, below), are the Other Investors Required to Buy Out the Departing Investor’s Interests in the Strategic Alliance and, of so, at What Cost? It is very difficult to pre-wire an exit valuation because the exit date is an unknown variable. One option is to specify that the exit price will be a "market valuation" or "public company valuation", but this is not always workable if the strategic alliance is a private company that holds illiquid assets. Another option is to establish a mutually agreeable valuation mechanism. For example, each investor could obtain a valuation from an independent investment bank, and then the investors could submit the two initial valuations to a third investment bank for resolution of any discrepancies. However, investment banking valuations are only as good as the financial information on which they are based. If the strategic alliance's management team has not produced reliable projections, or the investors do not share a full range of relevant diligence information with the investment banks, then the valuations the banks produce are not likely to be reliable. An alternative valuation mechanism is to "create" a market, either by using a buy-sell mechanism or a ROFO or ROFR coupled with an auction (these mechanisms are described in greater detail below). One additional thorny issue in connection with valuing exit rights is how the intellectual property owned or created by the strategic alliance will be allocated to the investors. Such intellectual property rights are not always easily divisible and it can be difficult for one investor to protect those rights against misappropriation or infringement by a former co-investor.

Strategic alliances are long-term relationships. The investors may find themselves collaborating for years to come. Not all strategic alliances are successful, however, and not all strategic alliances are intended to be permanent. For that reason, strategic alliance agreements usually contemplate a variety of different exit or termination scenarios.

Termination rights could include mutual termination rights that are triggered by the passage of time and the occurrence of a "drop dead date", the achievement of milestones (such as the attainment of all of the anticipated and objectively measurable benefits of the strategic alliance), or the occurrence of a management deadlock. Strategic alliances may also have termination rights that are exercisable unilaterally by one of the parties, including rights triggered by breaches/defaults by another investor, the failure to achieve milestones, changes of control or insolvency of an investor, or a default by the strategic alliance on its financing or material contracts.

Strategic alliances may also contemplate exit rights in the form of sale arrangements, including rights of first offer ("ROFOs"), rights of first refusal ("ROFRs"), drag-
along rights ("Drags"), tag-along rights ("Tags"), buy-sell arrangements and forced sale arrangements.

If a strategic alliance agreement includes a ROFO, prior to selling its interest in the strategic alliance the selling investor must first offer its interest to the ROFO-holder. If the ROFO-holder passes on the opportunity, then the selling investor is free to sell its interest to any third party. With a ROFR, the selling investor must first find a potential third party buyer and then offer its interest to the other investor before consummating a sale to the third party. A ROFR can have significant adverse valuation consequences for the selling investor because it can make it difficult to run an auction.

Drags allow a selling investor to force a non-selling investor to sell its interest. Typically, the dragging and dragged investors would each sell on a pro rata basis. Drags are typically desirable where one investor has a significantly larger equity stake than the other investors; they are less common in 50/50 strategic alliances. Tags give non-selling investors the right (but not the obligation) to sell their interests when the other investors do so. Again, the sales are typically pro rata if the buyer is not acquiring 100% of the selling investors' shares.

Forced-sale provisions give one investor the right to require the sale of the entire strategic alliance to a third party after the occurrence of a triggering event or upon the passage of time. Puts allow an investor to force the other investors to purchase the selling investor's equity, typically applying a predetermined valuation formula. Calls allow the non-selling investor to force the other investors to sell their equity (again, typically at a predetermined valuation). The valuation of these rights becomes more challenging the longer the maturity period of the rights.

Under a buy-sell, after the occurrence of a triggering event (such as a management deadlock), one or more investors is permitted to trigger a buy-sell. The triggering investor must notify the other investors of the proposed value of the strategic alliance. In theory, the valuation should represent the amount that the investors would be entitled to receive if the strategic alliance were dissolved. The non-triggering investor must then elect within a specified period either to buy the triggering investor's interest or sell its own interest to the triggering investor. Because of the non-triggering investor's optionality, the triggering investor does not have an incentive to under-bid or over-price its stake. Buy-sells must be crafted in conjunction with information rights in cases where not all investors are actively engaged in the operations of the strategic alliance, otherwise information asymmetries will disadvantage passive investors. Buy-sells can also
disadvantage financially weak parties and parties with high capital costs because it may be more difficult for them to obtain financing within the buy-sell period, even if they believe the buy-sell price is favorable.

Investors in strategic alliances are not fungible. The most successful strategic alliances involve a degree of collaboration and trust between investors, and different investors bring different skills to the table. For that reason, certain direct and indirect transfers of investor’s interests in the strategic alliance should be prohibited. Otherwise, an investor could find itself “in bed” with a stranger or a competitor.

The scope of a strategic alliance’s transfer restrictions may hinge on the identity of the transferee, the size of the transfer, the structure of the transaction resulting in the transfer, the timing of the transfer and the applicability of regulatory or other third party restrictions on transfers. Any transfer restrictions must be coordinated with exit provisions, such as drags and tags. For example, if an investor has a drag right, then it typically would not be subject to a transfer restriction over the drag transaction. The scope of transfer restrictions is also highly context-dependent. For large, complex investors with diverse businesses, for example, a strategic alliance agreement should not block M&A activity at the ultimate parent level. For investors with debt financing that requires pledges of subsidiary equity, pledges of their equity in the strategic alliance should not be prohibited a “transfer” if possible.

Strategic alliance agreements typically do not restrict direct or indirect transfers of shares in publicly traded companies (i.e., the transfer restrictions would expire upon the occurrence of an initial public offering of the strategic alliance and the expiration of any applicable underwriting lock-up periods). Indeed, strategic alliance agreements relating to publicly-traded companies, or businesses that may complete an initial public offering, frequently provide registration rights to investors.

A strategic alliance agreement should address the ability of the strategic alliance to incur debt. Limitations may include veto rights for the investors, maximum leverage ratios, restrictions on recourse to the investors and restrictions on borrowing from certain lenders. The strategic alliance agreement should also address whether the investors (or their affiliates) are required to give any guaranties of the strategic alliance’s debt and what the investors’ recourse will be if they are required to make payments on the guaranties. In some cases, if the strategic alliance is expected to incur a lot of debt, the investors may attempt to set up the strategic alliance as a bankruptcy-remote entity.
Another potentially contentious issue in strategic alliance negotiations is the existence and scope of non-competes. Passive investors typically would not agree to be subject to a non-compete, but investors that are actively involved in managing the strategic alliance may well agree to narrowly tailored restrictions. Where investors currently compete with each other and may, in the future, compete with the strategic alliance, they will often seek to restrict each other from engaging in certain competitive activities. Any such restrictions must comply with antitrust/competition laws and applicable limitations on the enforceability of non-competes. Non-competes should also be drafted narrowly so that future expansions of the strategic alliance’s activities (especially those that occur without an investor’s consent) do not preclude the investor from continuing to engage in its existing operations. Other relevant factors to consider in drafting a non-compete for a strategic alliance include geographic scope, term, scope of products or businesses subject to the restrictions, the impact of M&A activity resulting in the acquisition of competing products/businesses and the type of remedy for breach of the non-compete.

When investors continue to operate independent businesses outside of the strategic alliance, they should consider to what extent they should be required to offer opportunities to the strategic alliance in the first instance. For example, if Party A and Party B form a strategic alliance to produce widgets, can Party A thereafter obtain a patent to produce a better widget and compete with the strategic alliance? If the strategic alliance agreement does not clearly address what investment opportunities are to be allocated exclusively to the strategic alliance, legal frameworks like the corporate opportunity doctrine may imply certain obligations. These issues can also be addressed in the contractual design of governance structures for the strategic alliance.

In all strategic alliances, it is usually desirable that investors be required to disclose their conflicts and recuse themselves from the relevant approval processes. For single asset joint ventures, there should generally be no obligation to refer opportunities to the strategic alliance or any limitation on the outside activities of any investor. For multi-asset joint ventures, there are a number of alternatives: (1) no restrictions on either party, an approach that works well when each party’s approval is required to approve any new investment; (2) restrictions only on parties that are actively engaged in the operations of the strategic alliance, an approach that works well for private equity funds; and (3) restrictions on all parties, an approach that is workable for a strategic alliance with a small number of active investors and a well-defined scope. The range of restrictions the strategic alliance agreement could impose may include the following: (1) opportunities are exclusive to the strategic alliance within a defined scope (e.g., type of opportunity, size of the opportunity, geography, expected return profile); (2) opportunities are exclusive to
the strategic alliance if they arise within the existing business of the strategic alliance; (3) opportunities are exclusive to the strategic alliance if they are presented by or to specified persons; and (4) the strategic alliance has a right of first refusal or right of first offer over the opportunity.

Investors should also commit to maintain the confidentiality of strategic alliance-related information (except as required by law or the rules of applicable self-regulatory organizations and stock exchanges). Investors that are subject to freedom of information act or other mandatory disclosure regimes may even want to bargain for the ability to restrict the information provided to them.

As with any investment, strategic alliances are not without risk. These risks range from the risk that the strategic alliance will not be successful in achieving the investors’ objectives, to the risk that an investor will not be able to perform its obligations under the strategic alliance agreement, to the risk of unknown events outside of the investors’ control. The strategic alliance agreement should address what will happen in the event any of these risks materializes.

As described above, a strategic alliance agreement can address the risk that the strategic alliance will not be successful by providing for exit or termination rights. The parties should view this as an amicable divorce in accordance with a prenuptial agreement. The strategic alliance agreement should address the level of effort and commitment the investors should be required to dedicate to the enterprise before electing to walk away from a losing investment. A strategic alliance agreement can also address the risk of non-performance or breach through exit and termination rights. The dispute escalation and resolution provisions will also be relevant.

Certain risks are unpredictable, but can dramatically impact the "benefit of the bargain" for the investors. In a traditional, one-off sale agreement, it has become customary in U.S. M&A practice to allocate these types of risks between signing and closing through the inclusion of a "material adverse effect" concept. This concept, with all of the carve-outs that have become customary in U.S. M&A agreements, does not work as well as a risk allocation technique in long-term strategic alliances. In those cases, for example, there may be times when changes in law, political risk, force majeure, and industry-wide and economy-wide downturns should be taken into account in determining whether to continue or unwind the strategic alliance. Again, carefully tailored exit rights can be crucial for providing a roadmap for resolving these issues.
Investors are often reluctant to contemplate deadlock or dispute resolution issues when they are still working collaboratively during the formation stage of a strategic alliance. It is critical, however, that the investors agree a framework for resolving disputes before the disputes or deadlocks arise.

Deadlocks can arise when investors exercise veto rights or when the board of directors is unable to reach agreement. Not all deadlocks are bad: where a deadlock simply results in the strategic alliance being unable to take an action, the deadlock has the same effect as a veto. However, deadlocks that prevent the strategic alliance from operating in the ordinary course (such as a deadlock over approving an annual budget or necessary capital expenditures) can adversely affect the strategic alliance if left unresolved.

The mechanism(s) the investors select to resolve deadlocks will depend on the structure of the strategic alliance and the relative leverage of the investors. Where one investor has greater leverage, that investor might be given a "golden share" or “tie-breaking vote” to break deadlocks. Where the investors have equal leverage, they might instead provide for an escalation mechanism to raise deadlock issues out of the board level to the senior managers of the investors or to a third party expert or arbitrator. Using experts to resolve deadlocks can be very effective where the deadlocks arise from the investors' having different interpretations of technical issues. Using experts is less desirable where the deadlocks arise from the investors' having fundamentally different core values, objectives for the strategic alliance or risk profiles. In those cases, the investors should not agree to allow a third party to resolve deadlocks because the third party expert is unlikely to take into account the unique regulatory issues, capital costs, investment horizons or other concerns of particular investors.

If the selected deadlock escalation mechanisms are ineffective and the investors are unable to resolve a deadlock, the operations and value of the strategic alliance can deteriorate rapidly. For that reason, it is wise to back-stop the deadlock resolution mechanism with an exit right for the investors.

Deadlocks and disputes are distinct. In deadlocks, the parties are exercising their rights in accordance with the governing agreement, but they are unable to reach agreement. In a deadlock, it is possible that neither party is at fault and that the parties are disagreeing over matters that reasonable people can disagree about. Exit is a viable solution for a deadlock because when investors in a strategic alliance deadlock over material issues, it may be a symptom of an inability to continue the collaboration. In disputes, in contrast, one of the investors is typically alleging that the other investor is in breach of
the strategic alliance agreement such that the first investor is being deprived of the benefit of its bargain.

Dispute resolution mechanisms can include any of multiple layers of "escalations", including (1) a cooling off period, (2) escalation to senior officers of the investors, (3) mediation or submission to an expert, (4) arbitration, and (5) litigation. Why impose these additional steps, which can cost the parties time and money? The hurdles may discourage disputes. For example, although arbitration may appear desirable because it allows the parties contractually to designate the rules of engagement (e.g., evidentiary rules, confidentiality rules, deadlines, etc.), arbitration can also make the process of resolving disputes "too" easy. When traditional litigation is the only option, and it is a "mutually assured destruction" alternative, the investors may go to greater lengths to work out their disputes in an amicable fashion rather than incurring the costs and reputational damage associated with full-scale litigation.

Regulatory filings/approvals may be required in connection with the contribution of assets to a strategic alliance, as well as in connection with the ongoing operations of the strategic alliance. In the U.S., these filings/approvals may include a Hart-Scott-Rodino Premerger Notification and/or industry specific filings/approvals (such as for insurance companies or energy companies).

In addition to filings/approvals that must be made at the outset of a strategic alliance, investors may be required to supply information or incur costs in connection with the strategic alliance's future regulatory compliance. Investors should also consider the risk that, in some circumstances, they may be deemed to own the strategic alliance's assets for antitrust purposes, which could limit their future independent expansion and acquisition activities.

The tax issues associated with strategic alliances are complex and beyond the scope of this article. Clearly, investors should involve tax advisors at the outset of discussions regarding forming a strategic alliance. Three key topics that investors should consider with their tax advisors are: (1) how to keep tax costs low upon the formation of the strategic alliance, (2) how to maintain the lowest possible tax rates for profits of the strategic alliance and for distributions out of the strategic alliance, and (3) how to minimize taxes payable upon termination or dissolution of the strategic alliance or the exercise of exit rights. Different investors may have different needs from a tax perspective, and those needs will be informed not just by the investors' unique concerns but also by what jurisdictions assert taxing authority over the investors and the strategic alliance itself.
Spotting and resolving strategic alliance issues is always challenging. Because of the complexity of strategic alliances, it is often desirable for the parties to commence their negotiations with a term sheet or letter of intent to flesh out key issues before jumping into drafting definitive documentation. As a rule of thumb, if the prospective alliance partners cannot reach agreement at the term sheet phase, then it is unlikely that they would be able to achieve the type of long-term collaboration required for a successful strategic alliance. That being said, in the formation and negotiation phase of a strategic alliance, it is important that the parties not lose sight of the relationship and trust that is the basis for their desire to form the strategic alliance and will need to be the basis of their relationship going forward. If negotiations get overheated, it is often better to use external advisors to negotiate the most contentious issues so that the principals remain on friendly terms.

Strategic alliances are only truly successful to the extent that all parties are able to achieve their business and financial objectives. Given the flexibility and range of options available in structuring strategic alliances, creating a structure that works for all is not only feasible, it should be the primary objective. Negotiations may be long and protracted, but in the long run they will be worth the effort.

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