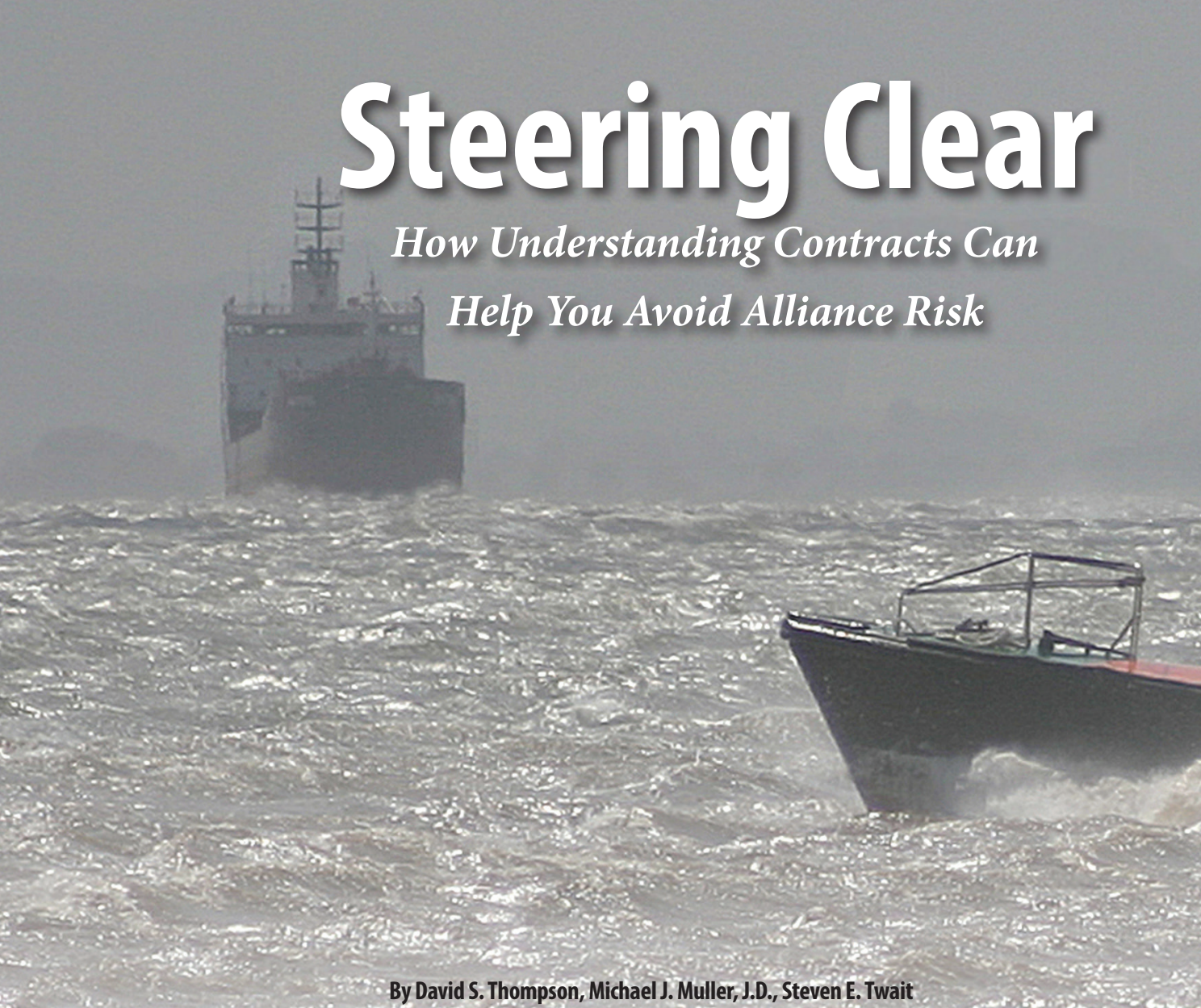
Steering Clear

How Understanding Contracts Can Help You Avoid Alliance Risk



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A harbor pilot is an experienced sea captain who guides ships in and out of port. He or she knows the harbor's secrets—its currents, underwater topography, and hazards—and can safely move vessels both large and small in the direction they need to go, even in rough seas. Learning to be a harbor pilot requires years of study and training, including a long apprenticeship.

Learning to make your way around an alliance contract is a bit like becoming a harbor pilot: you begin as an apprentice to an experienced captain, learning the harbor's landmarks and its prevailing currents and tides. You then spend the rest of your career perfecting the art of piloting the vessels in and out of your harbor under all weather conditions.

In the context of an alliance agreement, the harbor pilot with whom an alliance manager apprentices is the lawyer or team of lawyers that creates and manages the partnership contract. The attorneys are the experts—the veteran harbor pilots, if you will—and as their apprentices, alliance managers can learn the craft as well as lighten the legal team's load for the benefit of the company and the alliance. Having a trusted apprentice working on an alliance can save money not only by freeing up limited legal resources, but also by addressing or avoiding legal uncertainties as soon as they are identified.

Imagine yourself in the role of contract apprentice. What might you learn from an experienced pilot? This article offers strategies that ultimately will help you mitigate alliance risk based on your knowledge and understanding of the contract. To reach that goal, we recommend that you:

1. Know what type of contract you're working with.
2. Have a strategy for reading and understanding the contract.
3. Understand how the money flows.
4. Learn to identify misaligned incentives.
5. Develop a list of questions that will enable you to develop a risk mitigation action plan.

Know Your Type

In our experience, two kinds of agreements can prove more difficult to navigate than a standard procurement contract. The first type is a procurement contract with a strategic vendor—a firm that supplies a product or service that has a significant impact on the partner company's value. The second type is a risk-sharing agreement between two or more parties to develop and commercialize a product or service.

If you are unsure which type of contract you're dealing with, a quick read of the governance and non-performance penalty sections will quickly clear up the matter. A contract written for a strategic vendor will generally allow the purchaser rights to audit and monitor the delivery of a product or service in a very direct way. This type of strategic vendor agreement will usually include penalties for missing key deadlines or for non-performance, often linked to a set of agreed-upon specifications.

Risk-sharing agreements, on the other hand, will contain more collaborative provisions, targets, and milestones. Audit provisions may be added to help manage the risk taken on by the respective partners, and dispute-resolution mechanisms will be geared toward enabling the parties to jointly resolve disputes if at all possible, rather than immediately triggering penalties.

Both types of agreements often involve long-term relationships. While agreements might start with modest goals, they are usually constructed to allow the relationship to evolve over time if it is successful. Contractual mechanisms often are built into the agreement to allow the relationship to expand. These can include development and marketing options, the addition of new services or products, and expansion into new opportunities

One important caveat: when an alliance manager takes on the role of contract apprentice, it is important to remember that only an attorney should dispense legal advice to clients. An alliance manager can convey his or her beliefs about what a contract says; however, he or she should never dispense legal advice and should always consult an attorney before passing along any legal opinion that might be acted upon. For example, if an alliance manager is asked whether a milestone payment needs to be made based on recent data, the alliance manager should say something along the lines of, "I believe it should be paid based on my reading of the contract, but I will check with our attorney to make sure." Being a conduit for legal information, rather than a font of legal advice, prevents the alliance manager's lack of legal education from being a liability, and it reinforces the authority of the lawyer assigned to the alliance. When both the lawyer and the alliance manager form a trusting bond, the alliance manager can deliver added value to clients.

In both of these more challenging types of contracts, alliance managers will need to manage the business risk, human risk, and legal uncertainties associated with the partnership and its agreement. The alliance manager also will need to anticipate how these risks evolve or play out over the life of the business alliance. Many of the tools used to manage these risks can be shared across both types of relationships.

How to Read a Contract

Alliance managers might choose to review a contract cover to cover--but unless one is attempting to cure insomnia, this might not be the best approach. While it's important to have a full understanding of the agreement, our experience is that poring through a contract looking for specific types of risks is a better approach. Once these areas are identified, an alliance manager can develop a plan to manage, eliminate, reduce, or avoid the risks as they arise. When reading, the alliance manager should focus on business risk, human risk, and legal uncertainties, which often manifest themselves in areas of ambiguity where future disputes are likely to arise. (See "High Risk to High Reward: Using the Skills and Tools of Servant Leadership to Manage Risk," *Strategic Alliance Magazine*, Q4, 2011.)

Break the habit of hand-writing notes in a contract. Each page that contains a handwritten note creates a new and different document. This same concept holds true with notes on any document you create in an alliance. This may seem like a trivial point, but if a discovery request or investigation asks you to produce the contract and all documents related to the contract, the copy with the handwritten notes is likely to be considered a relevant document and may need to be sent in to the demanding authority. Unofficial contract notes or interpretations and meeting-minute "graffiti" might complicate issues in a dispute.

If an alliance manager was not part of the original deal team, before reading the contract he or she should sit down with the attorney and business development deal team to understand the intent of the agreement and to identify areas that proved difficult to negotiate. Special attention should be paid to any language that the other party demanded or that was significantly altered during negotiations. This information will enable the alliance manager to pinpoint these sections of the contract for a more intense review.

While there is no single right way to read a contract, we have found that starting with the governance section helps an alliance manager understand how decisions will be made and how conflict will be escalated. While reading the governance section (and any other section for that matter), take time to look up in the contract's "definitions" section any legal terms you don't understand. Pay close attention to any language that is complicated or seems to be written in "legalese." If any terms seem odd or unusual, set up time with your attorney to have them explained.

Be sure that after reading the governance section you can diagram the basic governing structures of the alliance and how they relate to each other. As part of this exercise, you should understand how disputes will be resolved and who has final decision-making authority. Some common final decision-makers are alliance leaders from each company, chief executive officers, and binding arbitrators, but they could also include courts of various jurisdictions. If you're not already familiar with the process used to resolve disputes, this would be a good topic to take up with the alliance attorney, with the goal of learning several important things: the pros and cons of the process, how the process would actually work if triggered, whether the process has actually been used before to settle a dispute between the parties, and the history of negotiations around the dispute-resolution terms.

After you have mastered the governance section, take a quick hop to the "breach of contract" section. As the name implies, this section contains a list of situations that could cause the contract to end and penalties to be assessed. Pay close attention to any language that covers events that have a real possibility of happening. Such language usually has to do with meeting specific time lines and with resource commitments. Located in or near this section is usually the "right to audit" section. Review this language and understand what can trigger a "for-cause audit" and how regularly scheduled audits can be conducted. Keep this in mind too: the next time your company believes it's a good idea to audit the partner, this likely will trigger the partner's decision to audit your company, if a reciprocal audit provision exists. As you read, continue to look up any unfamiliar legal definitions that you encounter.

After the alliance manager has reviewed the contract, he or she should highlight important elements and then create with the partner an on-boarding document that can be used to orient new alliance members. This on-boarding document should always be reviewed by both companies' legal teams. While secondary to the actual contract, the on-boarding document is a useful device for ensuring that team members know how decisions are made and how disputes are resolved.

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Next, review the sections that deal with how money will be exchanged, who will book product sales, and how milestone and royalty payments will be made. If possible, meet with the people in your finance department who are responsible for operationalizing this section and have them draw a simple diagram of how the payment system should work. (In the next section of this article, we provide more information on analyzing the incentives built into contracts.)

The finance section is also likely to include forecasts of expenses or revenues. An alliance manager should be aware of these provisions, including how

planning within the alliance aligns with the business planning of each partner and how the alliance is tracking relative to the expectations contained in the contract.

The finance section usually includes guidance on the timing of payments, so check to see if the timing of forecasts and payments are in sync with each company's planning calendar. Individual payment terms in the contract (e.g., 30 days following receipt of invoice) may be different than your company's standard payment terms, and this can cause an issue if the situation is not managed proactively. This section might also include tax and currency provisions. The alliance manager can add significant value to the partnership by fully understanding how these provisions are intended to operate and how they will impact the operations of the alliance.

Finally, make sure that you understand any requirements in the contract regarding intellectual property or confidentiality firewalls, government compliance issues, non-compete provisions, options, or antitrust related matters. Ask the alliance attorney about any of these issues and any special care that needs to be taken to remain safely within the harbor channel.

Follow the Money

In any agreement, one set of contractual elements deserves special attention: the incentives. Ideally, all incentives should encourage behavior that fulfills the alliance's mission. Designing and accurately capturing these incentives is especially critical when it comes to the financial sections of the contract.

Depending on the deal, the financials can be simple or complex. For an alliance manager, it is important to understand how the money flows within an alliance. In particular, look for any contract incentives that generate unintended and undesirable consequences (also known as "perverse incentives") that may eventually increase the business and human risks and legal uncertainties of the partnership.

Align Incentives

No one we know would write a contract that deliberately sets up perverse incentives. But they can arise inadvertently when complex concepts are unintentionally misconstrued. Earlier we suggested looking at a simple diagram to see how the payment system will work. When doing so, be sure to look for perverse incentives, which usually create some sort of "money machine" or unexpected profit center that becomes a source of revenue for a particular department in an alliance. One example might be a provision that dictates cost reimbursements for administrative support or other

personnel at a rate much higher than what is actually accrued or intended.

In practice, it is difficult to recognize such incentives at the start; they usually come to light slowly as the alliance is implemented. Where unintended and inadvertent incentives are created by operation of the agreement—and you uncover what you think to be perverse incentives—we recommend that you consult with your attorney before formally documenting your observations. Failing to consult and sending off a series of well-meaning but misguided communications could generate unnecessary work and unnecessarily trigger distrust within the alliance.

If after consulting with legal you still see an issue, raise the question with the finance department to find out whether they see it the same way. Regardless of who benefits from the perverse incentive—you or your partner—it needs to be eliminated. The manner in which this is done can greatly enhance the relationship between the partners. The resolution to this type of issue becomes more difficult, however, if one party constantly looks for private wins at the expense of the partnership. Keep discussions focused on finding a mutually agreeable resolution to avoid unnecessary distractions within the alliance.

Ask the Right Questions

After you've studied the contract, working your way from the governance elements to the financial section, it's time to focus on what this all means from a risk-management perspective.

Certain contractual elements entail unavoidable tensions. These risks may be obvious, or they may only emerge once the alliance is under operation. Do a quick check for risk whenever the contract describes:

- Points of absolute control
- Points of negotiated solutions
- Wording that can be open to interpretation

Orient yourself to the risk-mitigation approach by answering a series of pointed questions:

- What are the obvious pitfalls listed in the contract that could damage the alliance? What are the less-than-obvious pitfalls? (These could include perverse incentives and corporate business planning calendars, public vs. private company reporting requirements, conflict resolution issues, changes during the life cycle of the alliance, etc.)

- Given my company's unique culture, which of these pitfalls might be the most damaging to my company? Which might be most damaging to the partner? What are the primary, secondary, and tertiary consequences of these pitfalls?

- Can any of these issues be worked on within the alliance? Which of these issues need to be worked on by only one partner? Do any of these issues overlap with the alliance manager's areas of expertise? Do any of these issues require possible future amendments to the agreement? What are the other potential resources available to assist with the other identified issues?

- Is there anything that can be done during the start-up phase that might help the alliance avoid any of the pitfalls identified? Are there any personality traits of leadership that might help or detract from the alliance? What materials need to be developed for producing an on-boarding document?

- Are there any processes that should be built to address anticipated risks that might arise later in the relationship? Have I created an action plan to address any issues raised by asking the questions listed above?

Armed with the answers to these questions, the alliance manager will be able to construct start-up and risk-mitigation plans that will be extremely valuable at each stage of the alliance.

As apprentice harbor pilots, alliance managers collaborating with the alliance attorney can bring great value in guiding and protecting the partnership through inevitable underwater obstacles and turbulent weather. The more the alliance manager understands the contract and its specific provisions, the better job he or she will do in helping the partners reach their destination and achieve the alliance's full potential. ■

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