

Designing and renegotiating strategic alliance contracts

Africa Ariño and Jeffrey J. Reuer

Executive Overview

Research on strategic alliances structuring has been dominated by a concern for the choice between equity or non-equity agreements. However, little attention has been paid to other structuring aspects, such as the choice of the contractual provisions that will regulate the relationship. Contract design is an essential part of alliance structuring, and contract renegotiation may become a key element of successful alliance adaptation. Designing and renegotiating complex contracts entail costs that are worth bearing when contractual safeguards reduce the costs and performance losses that stem from exchange risks. In this article, we identify some important conditions under which contract complexity and contract renegotiation are worth the costs they involve. We offer recommendations for executives concerned with designing alliance contracts.

One important decision that executives make when forming an alliance is whether it will be equity-based or a non-equity agreement. This is a consequential decision, as the resulting governance form will set up different incentive and control mechanisms to shape inter-firm exchanges. However, this is not the only decision to be made when structuring an alliance. Executives have considerable leeway in designating duties, risks, procedures, and so forth through contractual provisions that determine exchanges in more precise terms. These contractual terms may help firms devise remedies for foreseeable contingencies or design processes for unforeseeable outcomes.¹ Thus, alliance structuring alternatives are far more numerous and complex than portrayed by most writings on alliances.²

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A well-designed alliance contract will be consistent with the alliance's purpose and with the partners' interests.³ Unless the partners engage in extensive and intensive developmental processes,⁴ the contract will not protect their respective interests. And it may be too late by the time they figure this out. For example, Coca-Cola and Nestlé

formed Coca-Cola Nestlé Refreshments Company (CCNR) with the purpose of manufacturing and distributing the iced coffee Nescafé.⁵ At the last minute, when they were about to sign the contract, they opened the agreement to iced tea without giving much thought to its implications. When business started, Coca-Cola realized that Nestea was cannibalizing the alliance's sales from Coca-Cola's own products. The contract did not cover this situation, as the partners had not considered this possibility.

However, even if the partners have a clear understanding of the alliance's intent and their mutual interests, designing a contract that anticipates all possible eventualities is not feasible, no matter how complex the contract may be.⁶ In fact, alliances are formed for the sake of flexibility in uncertain environments in which it is not possible to foresee all potential contingencies. When Oris, a French producer of medical diagnostics, and Synacor, a U.S. radio-pharmacy distributor, formed their alliance to distribute diagnostic kits, they did not foresee that medical diagnostic technology would move away from their technology. Writing a complex contract contemplating this and all other possible contingencies, and enumerating the parties' potential behaviors in response to them, would have been impossible.

When designing an alliance contract, executives therefore face a dilemma. On the one hand, the

more complex the contract, the less room for opportunistic behavior in the face of unforeseen events. On the other hand, the more complex the contract, the more costly it is to write it.⁷ Contract renegotiation is also costly. When is it best to bear the costs of designing fairly complex contracts? When is contract renegotiation worth the cost? These are the questions that we sought to address in our examination of how firms set up, and subsequently renegotiate, contracts in order to diminish both the performance and relational risks that alliances entail.⁸

Our findings about alliance contract design and renegotiation below are based on an extensive analysis of the academic literature and an in-depth study of 88 alliances, complemented with case study evidence and archival data. Our in-depth study of alliances is based on primary data collected through a detailed questionnaire responded to by executives in charge of alliance activities (see the Appendix for more details on the empirical research). Through our research we identified the conditions under which it pays for firms to use more complex contracts and the conditions under which it pays for them to renegotiate their contracts. Here, we present our insights from this research and offer recommendations for executives involved in alliance contract design and renegotiation.⁹

When to Use Complex Contracts

Designing a contract consumes resources. At a minimum, lawyers are involved, and frequently accountants' and consultants' services are also required. And executives need to devote precious time and attention to prolonged negotiations, taking them away from alternative projects.¹⁰ However, contractual safeguards may reduce the costs and performance losses from exchange risks. The actual contents of alliance contracts as well as the processes by which firms codify their intents for an alliance into a binding agreement may serve several important functions in managing exchange risks.¹¹ As one example, parties to an alliance may use the contract to set forth their mutual rights and obligations through the specification of inputs to the alliance, processes by which exchanges will occur and any disputes will be resolved, and expected outputs from the joint undertaking. The alliance contract establishes the scope of the collaboration as well as a division of labor by detailing partners' individual roles and responsibilities.

The contract also lays out constraints and obligations external to the alliance proper. For instance, before the alliance is operational, firms

can limit information disclosures and, during the operation of the alliance, the contract may specify how the parties will interact with third parties, whether other divisions of the firms, alternative suppliers, or the court system. The contract can also specify the way in which the alliance will end, firms' subsequent claims on intellectual property, and possible limitations on firms' competitive and hiring practices through non-compete and non-solicitation agreements, respectively. These functions of alliance contracts can be useful in mitigating exchange risks.

Thus, executives need to balance the costs of negotiating, monitoring, and enforcing complex contracts against the threat of opportunistic behavior. Next, we discuss the conditions under which the costs of designing more complex contracts appear to be justified. Figure 1 indicates the contractual provisions that deserve extra attention under those conditions.

Executives need to balance the costs of negotiating, monitoring, and enforcing complex contracts against the threat of opportunistic behavior.

High Investment in Assets Specific to the Alliance

If a firm invests in assets that are very specific to the alliance, the partner may threaten to terminate the alliance, which would result in the firm losing the value of those specialized assets.¹² In the AT&T-Olivetti collaboration in minicomputers, for instance, AT&T called for the use of an AT&T-proprietary processor. Olivetti was reluctant to make such a specialized commitment, which would have made getting out of the alliance extremely difficult, especially because Olivetti had doubts surrounding the continuity of AT&T's commitments to the alliance and to minicomputers.¹³ In many alliances, however, firms must make investments that are highly specific to the partner in question.

Once an alliance is formed, many different types of problems can arise for a firm such as monitoring difficulties, disruptions to the alliance, unforeseen contingencies, and threats to terminate the agreement. The costs and performance losses that result may be lessened when the contributed resources can be easily redeployed to another use. However, when assets are very specific to the alliance and difficult to use for other purposes, executives must devote more effort to design the alliance in a way that safeguards the value of these commitments.¹⁴

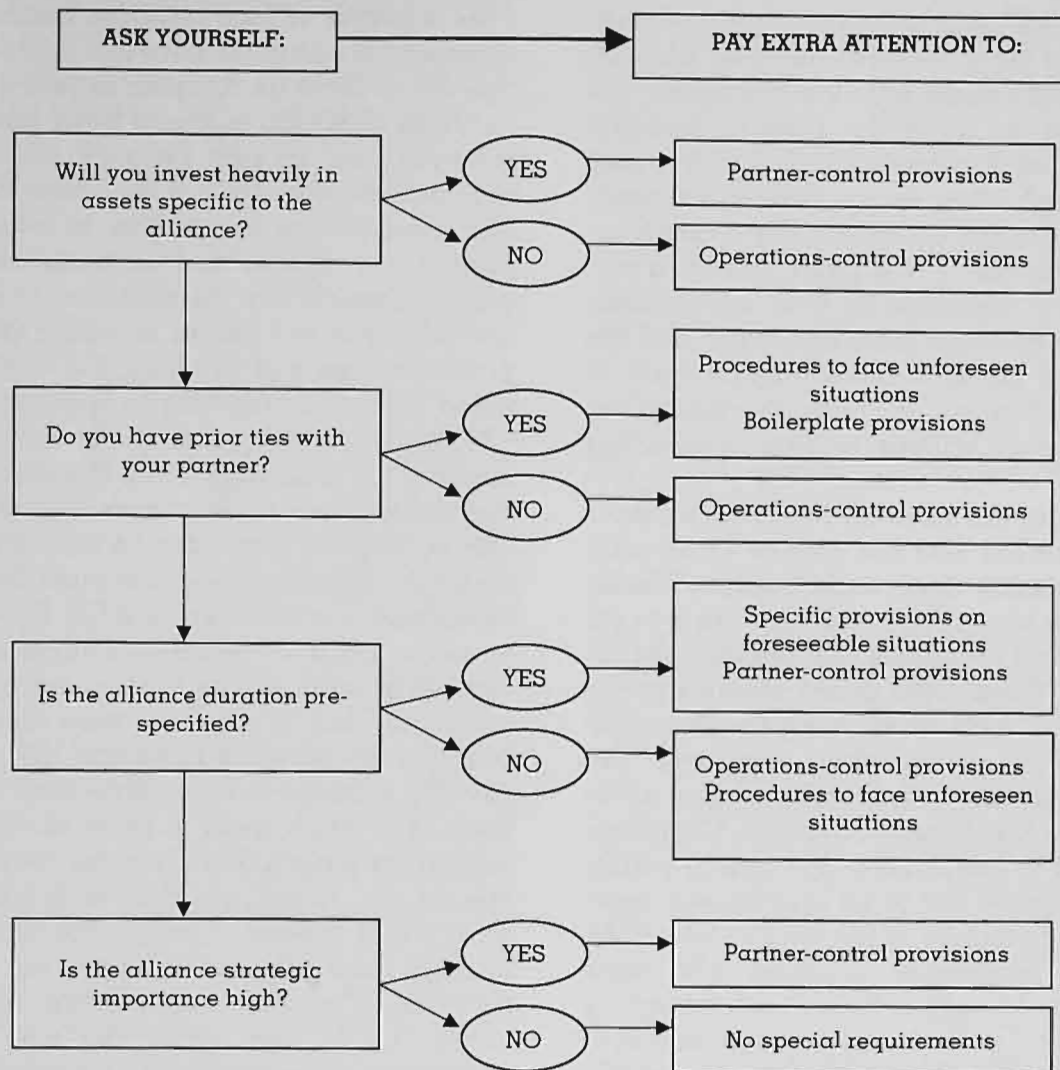


FIGURE 1
Which Contractual Provisions Deserve Extra Attention?

Further, if assets are highly specific to the alliance, the partner may try to take advantage of the firm and impose conditions unfavorable to it. As the potential value loss increases with investments specific to the alliance, executives will find it beneficial to negotiate more complex contracts to cover the consequences of breach and termination as well as the processes by which such threats will be handled.¹⁵ In this way, they promote the good development of the collaborative agreement. These motives make it advantageous to incur the costs of negotiating provisions into alliances involving highly specific investments.

In fact, studies show that the contracts of strategic alliances in which partners have made highly specific investments are more complex than other alliance contracts.¹⁶ Our own research suggests that contracts of such alliances are more complex in that they contain more provisions concerning partner control. However, there is no difference in the incorporation of provisions concerned with op-

erations control, relative to alliances involving less specific assets. This implies that, in effect, executives worry more about improper partner behavior in proportion to how specific to the alliance their investments are. However, it does not make them more or less worried about the management of the alliance as such.

Lack of Prior Ties Between the Partners

Successive collaborative relationships between firms can reduce behavioral uncertainty and hence the need for more elaborate contracts for two reasons: first, trust emerges from those relationships; and second, the firms are likely to have developed inter-organizational routines that make their behavior more predictable.

When partners have not had prior relationships, they have not had the opportunity to cultivate mutual trust. Autobelt, a Malaysian company in the automotive components industry partly owned by

Swedish Autoliv AB, approached Philippine Qualibrands to form a joint venture. Autobelt had obtained Qualibrand's name from the Philippine Embassy and sent a letter to them.¹⁷ Initially, executives from each company did not have any reason to trust each other, except that the Embassy had mediated the initial contacts. Only a very fragile trust could emerge at that point. Absent a collaborative history, ascertaining how the counterpart will behave becomes more difficult,¹⁸ and the partners are less capable of relying on trust to regulate their exchanges. In these circumstances; executives are more willing to bear contracting costs.¹⁹

Also, when partners have not worked together before, they have not had the chance to develop routines to coordinate their work. Further, absent first-hand mutual knowledge, they are likely to set up interactions and processes that will require future adaptation. When Ciba Geigy entered an alliance with Alza, Ciba's head of the pharmaceutical division was afraid that imposing the bureaucratic procedures of a multinational company would stifle Alza's innovativeness. Coordination was limited to board meetings and to yearly meetings. This turned out to be insufficient, however, for the advancement of the joint project.²⁰ As firms enter into successive alliances with each other, executives develop a better understanding of the counterpart's procedures, management systems, cultures, and so forth. The mutual understanding that develops can help them mitigate coordination, conflict resolution, or information-gathering problems, facilitating learning about each other and mutual adjustment rather than being wedded to contractual terms.²¹ Thus, the costs of negotiating contractual provisions are more justified in alliances in which the partners have no prior ties than if those ties exist.

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On the other hand, when partners have worked together in the past, they have discussed certain conditions and agreed on them already. To the extent that some of these conditions are "boilerplate" or common terms, including them in a new alliance contract entails no additional cost.²² Therefore, in practice we might see that alliance contracts between partners with prior ties are complex nonetheless.

As a matter of fact, research findings show that contracts of alliances between partners with prior ties are at least as complex in terms of specificity as those in which partners have had no previous relationships, in part because boilerplate terms are used repeatedly.²³ Also, those contracts contain more provisions on how to respond to future problems, conflicts, and contingencies.²⁴ Our evidence suggests that the presence of prior ties does not influence the extent to which partner control provisions are put in place, but such ties lead to fewer provisions relating to operations control.

Considered altogether, these research findings suggest the following. First, the existence of prior ties reduces contracting costs, either because certain boilerplate terms can be used with no need to negotiate them again²⁵ or because the parties have developed a mutual knowledge that allows them to refine contract terms—for instance, regarding flexibility when facing future contingencies—at a lower cost than if prior ties were absent.²⁶ Second, because the partners have had the opportunity to develop routines to coordinate their work already, there is a lesser need to incur the costs of establishing provisions related to the control of alliance operations; seemingly this is achieved by non-contractual means. Finally, the trust developed through past relationships does not substitute for contractual partner control, but rather complements it.²⁷ In sum, prior ties may justify more sparse use of contractual terms related to the alliance operations *per se*; however, they do not justify the use of less complex contracts in terms of partner control provisions or in terms of boilerplate conditions.

Pre-Specified Duration of the Alliance Agreement

The choice of alliance contract design is influenced not only by the partners' past history, but also by their expectations for the alliance's future. When an alliance's time horizon is pre-specified, executives tend to be more concerned about issues such as ownership of proprietary technology, disclosures of confidential information, and the means by which the alliance will end. For example, these issues are of paramount concern for firms and government agencies around the world who are bringing together scores of partners to combine technologies for Lockheed Martin's new multiservice and multimission Joint Strike Fighter. A recent study of research consortia also indicates that patenting by participants declines as a consortium comes to an end and then increases substantially thereafter, suggesting that firms behave

opportunistically surrounding the ending of a collaborative arrangement.²⁸

Also, it is easier to foresee contingencies that might affect the alliance when its expected duration is known. By contrast, the costs of predicting future economic conditions for open-ended alliances and crafting appropriate contractual provisions are significant, and executives tend to rely more heavily on incomplete agreements under these circumstances.²⁹ Firms such as Corning have developed a reputation for giving alliances autonomy, staffing them with talented executives, and bringing partners into the firm's decision-making processes. Since these commitments stimulate good relations over time and are backed up by Corning's reputation as a firm with alliance capabilities, less need exists for its partners to be focused heavily on alliance contracts and proximate contingencies that might arise.

Finally, the risk that one party will behave opportunistically is higher in alliances that have a pre-specified duration. For time-bound alliances, the partners benefit less from building a good relationship, and the fact that the counterpart will have fewer chances to reciprocate opportunistic behavior tempts executives to behave in this fashion.³⁰ On the contrary, in open-ended alliances that are expected to last a long yet unknown period of time, potential gains from future collaboration safeguard the alliance from a partner behaving opportunistically to obtain more immediate gains.³¹ This "shadow of the future" tends to make the alliance self-reinforcing and causes partners to think in win-win terms rather than in a zero-sum way.

The risk that one party will behave opportunistically is higher in alliances that have a pre-specified duration.

Our analysis confirms that alliance agreements with a pre-specified duration rely more heavily on partner control provisions. This is logical, as these provisions deal with what happens before and after the alliance is in operation, and these types of alliances tend to be designed as transitional mechanisms. Our analysis also agrees with evidence that long time horizons decrease uncertainty regarding a partner's potential opportunism, which results in less complex contracts.³² In particular, contracts of alliances with shorter time horizons are more specific,³³ as it is easier to predict relevant contingencies for these alliances than for open-ended agreements. Nonetheless, and for this very same reason, they also include fewer provi-

sions regarding adaptation to future contingencies, which diminishes complexity.³⁴ On a related point, as partners' strategic priorities are less likely to change,³⁵ contracts include fewer provisions related to operations control, as our own evidence suggests.

In sum, in the case of time-bound alliance contracts, it pays off to incur the costs of introducing provisions aimed at controlling the partner's behavior and at specifying terms regarding foreseeable contingencies. On the contrary, it does not pay off to incur the costs of establishing procedures to face less foreseeable contingencies, nor the costs of provisions aimed at controlling the alliance operations.

High Strategic Importance of the Alliance

It is widely perceived that alliances are becoming more central to firms' strategies. Several decades ago, the prototypical alliance was an equity joint venture by a multinational corporation (MNC) into a developing country, involving a one-way transfer of technology from the MNC to the local affiliate. The MNC probably invested in the alliance primarily for the purposes of accessing the local market and responding to the local government's restrictions on foreign direct investment.³⁶ Many alliances today continue to have these or similar features. Increasingly, however, the 'strategic' adjective has become more appropriate over time. Most of today's alliances are between actual or potential competitors, involve two-way knowledge transfers, have global market aspirations, and rely on considerably more complex deal structures in terms of the number of partners or auxiliary collaborative agreements.³⁷ About half of the alliances formed in recent times are among competitors. This proportion ranges from 25 per cent in the entertainment industry to as high as 75 per cent in the airlines sector.³⁸ Sony Ericsson Mobile Communications, Coca-Cola Nestlé Refreshments Company, the collaborations between Renault and Nissan and between American Express Financial and Charles Schwab, and the many alliances between airline companies are but a few examples of contemporary alliances between rivals.

Alliances of high strategic importance involve greater risks than more peripheral initiatives. Executives therefore have a larger incentive to specify the scope of the alliance and to clarify rights and obligations. Strategically important alliances also require more deliberation and clarity concerning the way the alliance will end in order to mitigate the risk of creating a competitor or having valuable resources fall into the hands of a third

- Do you have an equity alliance for relatively simple transactions?
 - ☐ Yes
 - ☐ No
- Did you invest heavily in assets specific to the alliance?
 - ☐ Yes
 - ☐ No
- Is your alliance contract fairly simple?
 - ☐ Yes
 - ☐ No
- Did the environment change in a way that affected the alliance significantly?
 - ☐ Yes
 - ☐ No
- Did your strategy or that of your partner change in a way that affected the alliance significantly?
 - ☐ Yes
 - ☐ No

The more "yes" answers, the more appropriate alliance renegotiation is.

FIGURE 2

Checklist to Decide on Appropriateness of Alliance Contract Renegotiation

party. Executives monitor these alliances more actively. They set forth the mechanisms facilitating the control of the alliance, the means by which disputes will be resolved, and ways in which the alliance's development will be managed. For all of these reasons, it is worthwhile to bear the costs of negotiating more complex provisions into strategically important alliances in order to ensure the desired outcomes from the collaboration.

Actually, we found that contracts of strategically important alliances tend to include more provisions regarding partner control. Contracts of less strategically important alliances do not.

When to Renegotiate an Alliance Contract

As the relationship evolves, partners may discover that contract terms do not serve their needs as expected. Unfortunately, partners do not always try to adjust the contract in a mutually agreeable manner. Take the CCNR case. When Coca-Cola became aware that product cannibalization was happening, the partners failed to renegotiate the contract—in part due to Nestlé's perception that Coca-Cola was not fully committed to the joint venture. Eventually, this led to CCNR's demise.³⁹

Contract renegotiation can be as costly as contract design. Through our study of the literature, we have identified at least five circumstances that make it advisable to renegotiate an alliance contract.⁴⁰ These conditions may be grouped into two categories: initial conditions and *ex post* contingencies. Figure 2 contains a checklist on the con-

ditions that influence the advisability of contractual renegotiation.

Initial conditions that influence the need for and cost of contract renegotiation include the following situations:

Governance Form Misfit

Executives are subject to mistakes when choosing whether to structure the alliance as an equity or a non-equity agreement. One mistake executives may make is to establish an equity alliance for a simple relationship, which results in excessive governance.⁴¹ In 2000, Amazon.com and Toys-R-Us launched a co-branded website to sell toys online. Amazon operates the site and handles distribution and customer service, while Toys-R-Us is responsible for merchandising. The relationship is governed by a contractual agreement under which Toys-R-Us finances the inventory of toys in Amazon warehouses and records the sales as its own. In return, it pays Amazon.com a percentage fee to cover the costs of order handling, and an annual fee.⁴² For a well-specified relationship involving a single activity with modest coordination needs, such as the relationship between Amazon.com and Toys-R-Us, the creation of a separate business entity with shared equity and the institution of a board to oversee the collaboration is not required. Indeed, excessive governance may bring about slow decision-making and high organizational costs.⁴³

Executives may also make the opposite mistake:

using a non-equity arrangement when an equity alliance would be more appropriate, resulting in insufficient governance.⁴⁴ Sony Ericsson Mobile Communications (SEMC) is the result of the merger of Sony's and Ericsson's mobile phone activities in 2001 with the purpose of disputing Nokia's leadership in the industry. At the time of its formation, SEMC employed about 3,500 people worldwide, and its pro-forma combined revenues were about €7.7 billion.⁴⁵ For a complex relationship such as SEMC with a broad scope and high coordination needs, and in which partners' rights and obligations are difficult to specify before entering the alliance, a purely contractual agreement may not facilitate coordination. Also, it may not provide sufficient incentives to prevent opportunistic behaviors from either party.⁴⁶

Summing up, if an alliance suffers from either excessive or insufficient governance, executives may find the benefits from readjusting it worth the costs of renegotiating the contract. Naturally, the conditions dictating the form of the alliance will also change over time, and such changes may also prompt adaptations in the alliance's governance structure. We found evidence that renegotiation tends to happen more in those cases of equity alliances for which a non-equity agreement would have sufficed. However, we did not find analogous evidence in the case of non-equity alliances for which an equity agreement would be more fitting. This may indicate that the costs of excessive governance are greater than those of insufficient governance, as the former are actual (slow decision-making, organizational costs) while the latter are potential (possible opportunistic behavior). We also noted that small firms make fewer contractual adjustments in the face of governance misfit than large firms do, presumably because the latter are more powerful and, consequently, are in a better position to exercise discretion and adapt their relationships over time.

High Investment in Assets Specific to the Alliance

It is costly for executives to monitor all of their firms' alliances closely, and they are selective as to which alliances to oversee more closely. They tend to be more involved with alliances to which they have committed specific resources relative to others requiring modest resource commitments that are more reversible. Thus, they will be more aware of the need for change in the former alliances. Also, given that it is harder to make an alternative use of those assets, executives will find that changing these alliance contracts so as to keep them in place is worth the costs of contract

renegotiation. Further, if the counterpart notices executives' willingness to renegotiate so as to protect the value of those assets, they may try to renegotiate the terms in a manner that is beneficial to them.

Executives are more likely to renegotiate an alliance contract the less complex that contract is.

We found that in fact contract renegotiation is more likely to happen when the investment in assets specific to the alliance is high. Under these conditions, the value loss which those assets would experience if the alliance were terminated exceeds the renegotiation costs. Interestingly, small firms tend to make greater transaction-specific investments than larger firms, and these greater investments bring about more contractual changes.

Low Contract Complexity

As discussed earlier, there are reasons why many executives implement fairly simple contracts in many alliances and then alter them as the collaboration proceeds and as information is obtained about the relationship's challenges and particular needs.⁴⁷ On the other hand, other executives seek to avoid the risks associated with *ex post* renegotiations and specify more complex contracts at the outset in an attempt to reduce opportunistic behavior by increasing transparency, improving monitoring, and clarifying rights and duties up front.⁴⁸ Simple contracts require renegotiation as information becomes available, while more complex contracts contemplate a wider range of contingencies, often incorporating procedures to adjust to future ones,⁴⁹ and therefore see less need for renegotiation. Intel teamed up with Rambus and supported high-speed Rambus memory chip technology. However, it turned out that PC manufacturers preferred slower but cheaper types of memory. Changing the alliance was difficult as Intel had a contractual obligation specifying that its Pentium 4 microprocessor should support Rambus memory.⁵⁰ We found evidence that executives are more likely to renegotiate an alliance contract the less complex that contract is. In fact, an alliance contract may be simple so as to give flexibility to the collaborative relationship while avoiding the costs of incorporating contingency provisions.

The need for contract renegotiation is also influenced by two primary *ex post* contingencies: environmental changes and partner strategy changes.

Environmental Changes Affecting the Alliance.

Environmental changes alter executives' assessments of an alliance's value. The resources that executives access through an alliance may not be as valuable in the face of environmental change as they were before, or the value of these resources may increase.⁵¹ The evolution of medical diagnostic technology made the Oris-Syncor alliance lose value. The Intel-Rambus collaboration lost value as the market preferred slower but cheaper microprocessors. In the face of such environmental changes, executives may also adjust their behavior, leading to perceptions of unfairness by their counterparts. In sum, when environmental changes affect the alliance, executives alter their assessments of the alliance value.⁵² Under these circumstances, they are likely to renegotiate contractual terms so as to reflect current conditions better.

Changes in a Partner's Strategy Affecting the Alliance

Just as occurs when facing an environmental change, executives' valuations of an alliance vary when their firm undergoes a change in strategy.⁵³ The new strategy may place a lower value on the resources that the partner contributes. Laura Ashley's alliance with Federal Express Business Logistics Services collapsed when FedEx closed its unprofitable European operations. On the other hand, an alliance may increase its value to the partners. As the joint venture Fuji-Xerox became more and more important to Xerox's new product development initiatives and its revenue expansion, sequential renegotiations were undertaken to increase the funds available to the venture in a way that was consistent with its global aspirations. Alliances are embedded in the strategies of parent firms and co-evolve with them, so when the parents' strategies change, alliance structures also change.⁵⁴ As a matter of fact, we found that executives tend to renegotiate alliance contracts when their firms change strategy in a way that affects the alliance in an important manner. When thinking about their alliances, executives therefore have to consider the broader context established by the evolving strategies of parent firms.

Lessons on Alliance Contract Design

Given the costs of designing and renegotiating alliance contracts, what should executives consider when working out the details of alliance design? The conditions we have examined begin to

provide the basis for corporate development staff and alliance executives to decide when to write complex contracts and when to renegotiate them. Thus, one first lesson for executives is to *consider whether circumstances surrounding the alliance justify the cost of negotiating a fairly complex contract.* One executive from an Italian company reported to us that he had signed each of the two thousand pages composing the contract of an alliance to build and equip an assembly line for refrigerators, train personnel, and transfer technological know-how. Before incurring enormous costs of drafting and negotiating a complex contract, consider if the level of investments in assets specific to it, the prior relationships binding your company to the partner, the alliance time horizon, and the strategic importance assigned to the alliance are such that those costs are warranted.

Alliances are embedded in the strategies of parent firms and co-evolve with them, so when the parents' strategies change, alliance structures also change.

Beyond what we outlined earlier, we suggest the following overall considerations for alliance contract design:

Balance the need to safeguard your interests in the alliance with the need for contractual flexibility.

Costs are involved not only in drafting and negotiating an alliance contract but also in renegotiating it. Executives whose companies operate in highly uncertain environments cannot forecast, for instance, the value of their respective contributions to the alliance, as they cannot ascertain which assets will be more relevant to compete in the future. Under these conditions, contractual flexibility will make it easier for them to adjust to changing circumstances. Granted, flexibility can be built into the contract terms by establishing procedures to face future unforeseen situations; however, this may be more costly than keeping a contract flexible and renegotiating it when needed. Indeed, some of the firms we encountered in our research found it worthwhile to change alliance contracts multiple times. Flexibility is especially important in alliance contracts because, typically, the resources which parties access through the alliance are not readily available in the market. Otherwise, the chances are that the alliance would not have been formed, and instead an

arm's-length relationship would likely be in place. Thus, while the partners remain autonomous, they are also interdependent in that they need one another if they are to fulfill their respective goals. Therefore, it is in their mutual interest to accommodate as new circumstances dictate.

Engage in negotiating contract provisions once you and your partner share a mutual understanding of the alliance's purpose and of the partners' contributions.

It is the executives' job to define the nature of the business deal; the lawyers' job is to draft a contract that makes the deal happen.⁵⁵ Grupo Palex, a company in the healthcare industry located in Barcelona, started negotiations with an Argentine firm to enter the Latin American markets. When the lawyers sketched out the first contract document, the Argentines believed it did not reflect the spirit of the business deal, which contributed to the eventual ending of negotiations.

Establishing mutual consent—one of the requisites for a contract to be legally enforceable—involves reaching "a meeting of the minds." This is especially hard in strategic alliances, as specifying the details of the agreement requires the parties to negotiate over how the resources contributed by each party serve their mutual interests.⁵⁶ The CCNR case noted earlier exemplifies these difficulties. When negotiating the deal, too little attention was paid to the alliance business plan. Market pressures were such that executives rushed into the collaborative agreement, leaving the strategy discussions for the alliance management team once the alliance was in place. The contract was signed in one weekend, and most of the time was devoted to the "divorce clause." Not surprisingly, the cannibalization issues surfaced, altering the relationship to such an extent that CCNR was dissolved in three years, despite the fact that the contract stipulated a horizon of one hundred years.

Design a good contract that safeguards your interests, but don't run the alliance by the contract.

As one executive told us referring to alliance agreements, "You need to have a very good contract, and then... put it aside when running the alliance." Executives driving their alliances by the letter of the contract signal that sense-making processes are not in place and that a good understanding between the partners is lacking. Prior to the demise of CCNR, executives from Coca-Cola

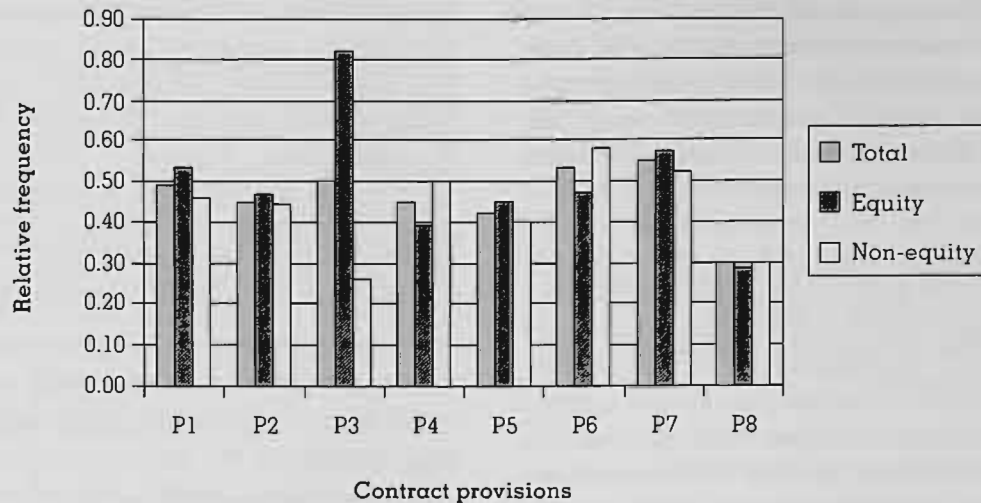
proposed to enter the Asian market with oolong tea. Nestlé representatives were hesitant, as they felt their brand did not have enough strength to back up this product. "Is herbal tea really tea, or is it something different?" Coca-Cola executives posed this question to a philologist, as a way to ascertain whether oolong tea fell within or outside their contractual agreement. Not surprisingly, CCNR was left non-operational a few months later.

"You need to have a very good contract, and then... put it aside when running the alliance."

If an alliance is run by the contract, problems will surface when the parties need to go beyond the contract in order to accomplish their mutual goals. As the partners have not developed reciprocity rules outside contractual boundaries, they are unlikely to trespass beyond those boundaries when this makes one of them temporarily vulnerable to the partner's actions, even if desirable for all parties involved.

However, although an alliance is not to be managed by the contract, a good contract serves as a safeguard against potential opportunistic behavior from the other party and can clarify initial conditions. For example, one executive complained to us that his company had formed an alliance with a foreign company in which his firm was to contribute market knowledge and the partner its know-how. Within a year, the partner had appropriated market knowledge and had left the firm out of the market. Some contractual provisions might have avoided this unhappy end.

We have offered suggestions on alliance contract design and renegotiation which are based on research carried out in Western countries. Thus, our recommendations might not apply in full to companies in other parts of the world. One condition that might moderate their applicability is the different costs that contracting may entail in various regions. Although different costs might affect the average level of contract complexity or the frequency of contract renegotiation, the situations that make contracts more or less complex and which affect the frequency of renegotiation may still be similar. Another condition is that the extent to which formal contracts and trust are considered as complements or substitutes may also differ across the globe. If they are considered as substitutes—as may happen in Asian countries, for instance⁵⁷—our recommendations may not be as applicable as if contracts are seen as a complement to trust.



Total N = 88; equity N = 38; non-equity N = 50.

P refers to the provision number, as referred to in this Appendix.

FIGURE 1a
Distributions of Specific Contract Provisions

Despite these caveats, this article offers useful insights. Designing the contract is an essential part of alliance structuring. Renegotiating the contract may become a key element to successful adaptation by the alliance. Executives involved in alliances should be prepared to assess when writing a complex contract is worth its costs and when it pays off to renegotiate an alliance contract. This article has flagged some important conditions under which contract complexity and contract renegotiation are worth the costs they involve. By considering these factors, executives may be in a better position to structure and adapt their alliances to serve their firms more effectively.

Appendix

Information on Companies and Alliance Profiles

Primary data were collected through detailed questionnaires. To detect announcements for alliances, we conducted an exhaustive search of the Funk and Scott's Countries Index-Europe. This data source contains brief entries on products, services, and companies as reported in leading business publications. Material is gathered from trade journals, major business newspapers, business magazines, and special reports and publications issued by government agencies, industry associations, and independent organizations. We compiled an initial sample of 436 alliances, but we sent questionnaires only to the firms in which a key informant directly related to the alliance could be

identified. Responses were obtained for 91 cases out of 189 that were mailed (yielding a 48 per cent response rate), and we used 88 questionnaires in the study. Of these, 43 per cent referred to equity alliances and 57 per cent to non-equity ones. Most of the alliances (85 per cent) were cross-border. The alliance contract had been renegotiated in 22 per cent of the cases, and 46 per cent of the alliances had a pre-specified duration. Companies represented in our sample came from a variety of industries: energy (7 per cent), chemicals and allied products (15 per cent), machinery except electrical (5 per cent), electronic equipment (4 per cent), transportation equipment (4 per cent), transportation (7 per cent), financial services (41 per cent), and other services (17 per cent). Companies varied in size also, with 43 per cent having less than 500 employees, 40 per cent between 500 and 5000, and 17 per cent more than 5000. The same percentages for the partner companies were 32 per cent, 33 per cent, and 35 per cent respectively.

To assess the extent to which alliance contracts were complex, we examined whether or not certain provisions were present in them. Our results are presented in Figure 1a. We chose to study the provisions that Parkhe⁵⁸ had identified as elements of alliance contracts through a computer-aided search of legal literature, corroborated with senior executives. In increasing order of stringency, these provisions were: (P1) periodic written reports of all relevant transactions, (P2) prompt written notice of any departures from the agreement, (P3) the right to examine and audit all relevant records through a firm of CPAs, (P4) designation of certain information as proprietary and subject to confidentiality

provisions of the contract, (P5) non-use of proprietary information even after termination of agreement, (P6) termination of agreement, (P7) arbitration clauses, and (P8) lawsuit provisions. An alliance contract was considered more complex the more of these provisions it contained and the more stringent the provisions were. On a 0 to 1 scale (from none of the 8 clauses appear in the contract to all of them appear), the mean contractual complexity was 0.45.

Results from factor analysis of tetrachoric correlations suggest that the clauses examined tend to appear clustered together in two sets. One set includes provisions P4 through P8, which deal with concerns about the partner's behavior outside the alliance itself; thus, we called this set *partner control provisions*. The second set includes provisions P1 through P3, which relate more directly to the monitoring of the collaborative agreement per se; accordingly, we labeled this set *operations control provisions*. Regarding the existence of contract renegotiation, we assessed it in a straightforward manner: we asked executives whether the initial alliance contract was renegotiated during the course of the alliance.

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Endnotes

¹ Poppo, L., & Zenger, T. 2002. Do formal contracts and relational governance function as substitutes or complements? *Strategic Management Journal*, 23(8): 707-725; Reuer, J. J., & Tong, W. Real options in international joint ventures. *Journal of Management* (forthcoming).

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⁶ For a discussion on this issue, see Alvarez, S. A., & Barney, J. B. 2001. How entrepreneurial firms can benefit from alliances with large partners. *The Academy of Management Executive*, 15(1): 139-148.

⁷ Williamson, O. E. 1985. *The economic institutions of capitalism*. New York: Free Press.

⁸ Das, T. K., & Teng, B-S. 1999. Managing risks in strategic alliances. *The Academy of Management Executive*, 13(4): 50-62.

⁹ For a comprehensive overview of alliance contracts from a legal perspective, see Campbell, É., & Reuer, J. J. 2001. International alliance negotiations: Legal issues for general managers. *Business Horizons*, January-February: 19-26.

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¹¹ For a related discussion, see Ring, P. S. 2002. The role of contract in strategic alliances. In Contractor, F. J., & Lorange, P. (Eds.), *Cooperative strategies and strategic alliances*. London, UK: Elsevier Science. The author elaborates on the elements that make a contract legally binding: The parties have to be *legally competent*; the contract must be based on *consideration*, which encompasses the rights, interests, profits, or other forms of benefit accruing to one party or some detriment, disadvantage, responsibility, or loss assumed by the other party; *mutual consent* must be evident; and the contract must contemplate a *valid subject matter*. Ensuring that all these elements are present entails substantial costs, although benefits are derived as well.

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¹⁵ Williamson, O. E. 1983. Credible commitments: Using hostages to support exchange. *American Economic Review*, 73: 519-540.

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²¹ Ibid.

²² Ring, op. cit.

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²⁵ Ryall & Sampson, op. cit.

²⁶ Luo, op. cit.

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⁵³ See for instance Ariño & de la Torre, op. cit.; Doz, op. cit.; and Zajac & Olsen, op. cit.

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⁵⁷ Dyer, op. cit., provides evidence in this direction.

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Africa Ariño is associate professor of general management at IESE Business School, University of Navarra. She holds a Ph.D. from UCLA. Her research interests include process issues in international strategic alliances and understanding alliance contractual features. Among other outlets, her research has appeared in *California Management Review*, *Journal of International Business Studies*, *Journal of Management*, and *Organization Science*. Contact: afarino@iese.edu.



Jeffrey J. Reuer is an associate professor at the Kenan-Flagler Business School at the University of North Carolina. He holds a Ph.D. from Purdue. His research interests concern the application of organizational economics to firms' external corporate development activities. Among other outlets, his research has appeared in *Strategic Management Journal*, *Academy of Management Journal*, and *Organization Science*. Contact: reuer@unc.edu.