FENWICK & WEST LLP

Corporate Partnering

A Strategy for High Technology Companies

FENWICK & WEST LLP

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How to Use this Booklet

This booklet is intended to provide directors and executives of emerging technology companies with an overview of the process of finding and negotiating partnering arrangements.

The booklet is divided into five sections. The first section provides an introduction to partnering and discusses when a company should consider venture capital or a partnering arrangement. The second section provides a step by step description of the partnering process. The third section of the booklet provides greater detail about each partnering building block, outlining the positions that the technology company and its potential partner are likely to take in negotiations. The fourth section touches on some of the issues involved in using a joint venture. The fifth section addresses additional legal issues that arise in international transactions.

Corporate Partnering: A Strategy for High Technology Companies

Introduction

"Corporate partnering" and "strategic alliances" are terms used to describe a symbiotic long-term relationship between two companies for developing and exploiting technology, products and markets. The nature of the partnering relationship depends on the partners' strategic objectives. It can be as simple as a long-term distribution agreement or an equity investment. More complex arrangements may add research and development contracts, with manufacturing and licensing rights to the resulting technology or products. The key to a successful corporate partnering deal is combining the right set of options, so that the needs of both companies are met.

An emerging technology company (referred to as TechCo) and a large established company (LargeCo) typically have different objectives for entering into partnering arrangements. TechCos generally seek these arrangements to finance growth and obtain manufacturing and distribution capabilities. LargeCos typically seek these arrangements to obtain access to new technologies and products.

Successful partnering relationships can provide strategic, operating and financial benefits to each party. They allow both parties to reach their goals more cheaply and rapidly than they could alone. By contrast, ill conceived or badly implemented partnerships can deprive TechCo of critical technology or markets and limit TechCo's ability to obtain future partnering or financing arrangements.

Partnering in the 2000s

While partnering relationships have existed for a long time, they are becoming even more attractive in the 2000s. The costs of technology development and product introduction continue to grow, while capital is more costly to obtain. Even where capital is available, the founders' equity ownership may be severely diluted. Moreover, capital alone cannot provide the advantages of an established manufacturing or distribution infrastructure, name brand recognition or the management expertise of an established LargeCo.

The current economic climate also pushes LargeCos toward partnering relationships. Many LargeCos are starved for innovation and lack the flexibility necessary to respond rapidly to technological and market changes. The disappointing results of many 1980s acquisitions have made LargeCos more leery of acquiring companies with unproven synergy. With less risk than an acquisition, partnering allows LargeCos to leverage the strategic resources needed by TechCos, such as long-term R&D budgets, manufacturing capability, distribution and customer service.

Partnering vs. Venture Capital

When should TechCo pursue venture capital and when should it pursue a corporate partnering arrangement? When evaluating this issue, consider the following:

Does TechCo have proven technology? Partnering arrangements presuppose a certain degree of TechCo technological capability. A TechCo that has not yet established its technological capability is not a good candidate for a partnering arrangement, but may be a good candidate for venture capital.

Is TechCo's technology divisible by market, application or distribution channel? If TechCo's technology cannot be divided into distinct applications, markets or distribution channels, it may be impossible to structure a partnering arrangement that gives LargeCo enough rights without significantly reducing TechCo's value. Venture capital can provide needed capital without losing rights to technology or markets.

Is TechCo's cash need immediate? Partnering arrangements tend to be slower to develop than venture capital investments. It is generally preferable to use a partnering arrangement to assist expansion rather than to ensure survival. TechCo may not have the necessary staying power and negotiating leverage in discussions with LargeCo if it needs a short-term capital infusion to meet its payroll. Such capital may be better sought from venture capitalists.

Do LargeCo's strategic interests conflict with TechCo's? Where LargeCo's strategic goals conflict with TechCo's, it may have a greater conflict of interest with TechCo than a venture investor. Since venture investors obtain their entire return from their investment, they are motivated to ensure the greatest possible success for TechCo. Since corporate partners obtain greater returns from the commercial rights discussed below, they may desire to maximize the value of those commercial rights, even if that reduces the long-term value of TechCo.

Does TechCo need operating assistance and expertise? Corporate partners can provide very useful operating expertise (e.g., customer-driven product development, cross-licensed technology, or manufacturing and distribution capability) not generally available from venture capitalists.

Is TechCo likely to need future venture financing? A partnering arrangement in which LargeCo acquires TechCo equity at a high valuation is attractive but may make it difficult for TechCo to later raise venture capital. Since the venture capitalist does not obtain the "operating" benefits of a LargeCo, the venture capitalist is rarely willing to pay as much for equity. Having received a higher valuation from LargeCo, TechCo may not want to accept the venture capitalist's lower valuation.

Most TechCos will combine venture capital with a corporate partnering strategy, taking advantage of the strengths offered by each at the appropriate time. The remainder of this booklet will help management formulate a successful partnering strategy. (If venture capital is a more appropriate strategy at this stage of TechCo's development, please refer to the Fenwick & West booklet on Venture Capital: A Strategy for High Technology Companies.)

The Corporate Partnering Process

Step One: Strategic Objectives For Partnering

The first step in the partnering process is to identify the strategic reasons for seeking such an arrangement. What type of assistance does TechCo need from its partner? Too often, the immediate response from emerging companies may be "money," when money is really a surrogate for services and capabilities that TechCo has not yet developed, but that may be available from LargeCo. Even when funds are needed for technology development, should it be an equity investment (with the resulting equity dilution), development funding (with the resulting technology dilution), or some combination of both?

Equally important is to identify what strategic objectives LargeCo could have for partnering with TechCo. LargeCo may seek time to market advantages or to reduce costs, increase revenues, or improve its quality or competitive position. A successful partnering arrangement results when the value each obtains exceeds the costs (current and strategic) incurred in meeting its partner's objectives.

There are many different ways to look at how partnering arrangements can provide these benefits. The chart on the next page focuses on typical strengths held by TechCo and LargeCo in meeting different functional responsibilities during a product life cycle.

Understanding the Building Blocks of Partnering

To achieve TechCo's and LargeCo's partnering objectives, TechCo and LargeCo must mix and match five partnering building blocks to create an agreement that best meets those objectives. These basic partnering building blocks are:

Equity: LargeCo purchases an equity stake (usually a minority position) in TechCo in return for either a seat on TechCo's Board of Directors or contractual rights to TechCo's technology. Equity purchases may be supplemented or replaced by options to purchase TechCo stock, loans to TechCo or an option to acquire TechCo.

Development: LargeCo funds TechCo's development of specific technology or products in return for rights to the resulting technology or products.

Manufacturing: LargeCo receives the right to manufacture products using TechCo's technology.

Distribution: LargeCo receives the right (frequently exclusive) to distribute TechCo's products within a particular geographic territory or vertical market.

Licensing: LargeCo receives the right to use and modify TechCo's technology within a particular geographic territory or vertical market in a broader way than a manufacturing or

Typical Strengths of TechCos and LargeCos

Responsibilities	TechCo Strengths	LargeCo Strengths
Product Development	Creativity	Broad market expertise
	Focused development	Broad technical capabilities
	Speed	Better lab and test facilities
	Less developmental bias	
	Flexibility	
Legal/ Regulatory	Cutting-edge technology patents	Cross-license opportunities
		Guidance on regulatory or patent approvals
Manufacturing	Faster, low volume capability	Component purchasing power
	Prototyping capability	Tooling and manufacturing
	Specialized niche manufacturing	Quality assurance capability
Marketing	Understanding of niche market	Broad market understanding
	New technology or new market excitement	Established product lines
	Creativity	Volume edge
	Competitive edge	Trade name recognition
Distribution	Specialized niche distribution	Established customer base
	Flexibility	Established distribution and shelf space
		Better storage and transportation
Service/Support	Expertise in new technology problems	Established quality standards
		Warranty, service and customer support procedures
Product Revisions	Next generation capability	Better product life extension
		Established user groups

Partnering Building Blocks

Building Block	TechCo Objectives	LargeCo Objectives
Equity Investment	Capital infusion	Window on TechCo's technology or market
	Enhance TechCo's market credibility	Influence on TechCo's strategic direction
	Strengthen other relationships with LargeCo	Strengthen other relationships with TechCo
	Access to LargeCo's operating and market expertise	Block competitors from obtaining access to TechCo's technology
	Precursor to LargeCo's acquisition of TechCo	Precursor to acquisition of TechCo
Technology Development Agreement	Access to LargeCo's technology and patents	Precursor to acquisition of TechCo
	Funding for TechCo's own R&D program	Access to TechCo's technology and patents
		Basis for obtaining manufacturing, distribution or licensing rights
Manufacturing Agreement	Access to LargeCo's test and regulatory approval capabilities	Access to TechCo's faster, cheaper and more flexible development capabilities
	Avoid capital expense of building own plant	Use excess manufacturing capacity
	Ship product more rapidly	
Distribution Agreement	Obtain LargeCo's quality and test capability	Broaden manufacturing capability into new area
	Arrive at specialized vertical or geographic market faster	Ensure quality of product to be acquired
		Complement and broaden current product line; diversify into new markets
Licensing Agreement	Get benefit of LargeCo's market reputation and support capacity	Control sales and service process
	Royalties from markets that TechCo would not otherwise address	Incorporate TechCo's technology into LargeCo's products
	Gain access to LargeCo's technology and patents	Right to change TechCo's technology itself
	Gain manufacturing and distribution capability	Right to use TechCo's technology in other parts of its operations

distribution grant (e.g., OEM agreements or internal use licenses). Licenses give LargeCo more information about the technology and typically bear royalties.

There is no typical partnering arrangement. Each partnering arrangement is a hybrid of some or all of these building blocks and can be formed during or after the development of the technology. Since strategic objectives of individual companies differ, TechCo may find that seemingly similar LargeCos may be interested in partnering arrangements with very different structures. For more detailed information about each of these partnering building blocks, see the last section of this booklet entitled "Formulating The Partnering Proposal."

To determine which of these building blocks is appropriate, it is important to understand what advantages TechCo and LargeCo might see in any particular building block. The chart on the next page sets up a matrix of possible strategic objectives that TechCo and LargeCo may try to achieve through each building block.

Determining Strategic Needs/Bargaining Chips. Once TechCo's objectives and the likely objectives of a prospective partner have been analyzed, the next step is to list TechCo's strategic needs and likely bargaining chips. "Strategic needs" are those items of strategic value that TechCo wants to obtain. "Bargaining chips" are those items of strategic value that TechCo can offer to a potential partner. Initially, these lists should be as comprehensive as possible. Once the process of selecting specific partnering candidates begins, the lists should be pared down to those items applicable to a given potential partner. To illustrate, TechCo's strategic needs and bargaining chips lists might look like the following:

TechCo's Strategic Needs

- Approximately $5 million in capital, revenues or reduced expenses;
- Distribution capability, particularly overseas or in a defined vertical market;
- Customer leads, credibility;
- Offshore manufacturing capability;
- Related product lines, particularly those that create an opportunity for TechCo system sales;
- Additional technology to incorporate into current or planned products; and
- Sourcing of certain parts or raw materials.

TechCo's Bargaining Chips

- Existing proprietary products, technology or patents;
- R&D capability to create a unique product or component meeting LargeCo's specifications;
- "Influence" on TechCo's future direction, reflected by a LargeCo seat on TechCo's Board of Directors or R&D Committee;
- Product manufacturing capability in the United States;
- Vertical distribution capability in defined areas or markets; and

- Intangibles, such as the ability to move quickly, market focus, customer awareness, image and reputation in market niche, productivity and trend setting ability.

Step Two: Developing The Partnering Plan

Having determined the strategic needs and the current capabilities of TechCo, the next step is to create a partnering plan. Although investment bankers or consultants may help, the key managers of TechCo must be actively involved in creating an effective plan. This plan will help focus the advisors and management team as TechCo goes through the partnering process. A typical plan covers the following types of issues:

- Strategic, operating and financial objectives that support TechCo's strategy for increasing market share;
- Strategy for developing the partnering process;
- Proposed deal structures, including likely alternatives, implications and negotiating limits;
- Anticipated, realistic timetable;
- Materials to be furnished to the potential partner: the first information pack to spark interest in TechCo and a second set to provide adequate disclosure for LargeCo's initial decision regarding degree of interest; and
- Target list of partnering candidates by types, with brief reasoning and priorities.

Planning for Multiple Partnering Arrangements. Partnering arrangements are inherently more complex than a "straight" venture financing, acquisition, R&D contract, or manufacturing, distribution or licensing arrangement taken alone. For a successful partnering arrangement, TechCo must meet the strategic objectives of LargeCo and provide LargeCo with substantial rights to TechCo's technology and market. At the same time, TechCo must ensure that it does not give away a disproportionate part of its technology and market to LargeCo in exchange for a minority equity investment or R&D contract.

When making concessions to LargeCo, TechCo must consider that it will want to do other partnering arrangements in the future. The existence of multiple arrangements adds another layer of complexity. It is often helpful to negotiate with two prospective LargeCos simultaneously, so as to have an alternative when negotiations get difficult. When partnering arrangements occur in sequence, TechCo should use previous arrangements as a baseline for later negotiations. A long-term, exclusive grant of rights in one partnering arrangement may limit TechCo's flexibility in creating later relationships unless each agreement is carefully structured to fit into TechCo's strategic plan.

Step Three: Selecting LargeCo Targets

One of the most critical issues in the partnering process is determining which companies to approach. Enormous amounts of time and resources can be wasted with inappropriate candidates that are not likely to meet TechCo's strategic needs. Ideally, each potential candidate should meet the following criteria:

- Ability to meet TechCo's strategic objectives;
- Strategic objectives that TechCo can meet without having LargeCo dominate TechCo's business;
- Clear need for TechCo's bargaining chips at the operating (not just the corporate) level;
- Distinct and non-conflicting target markets;
- Familiarity with TechCo's technologies, products and markets;
- Interest, or successful experience in making similar deals;
- No recent major change in identity or organization;
- Compatible people and corporate cultures; and
- Ability to complete the transaction within the required timeframe.

It is difficult to obtain this type of information about potential partners and no one partner will meet all these criteria. Still, gathering this type of information and using it to prioritize the list of candidates will both reduce the amount of time spent with inappropriate candidates and increase the likelihood of success.

Designing the Responsibility List. Once the list of prospective candidates has been prioritized, the investment banker, or specific members of the management team or Board of Directors, should be assigned the responsibility of contacting one or more of the top-priority targets. Ideally, the assigned person should have a personal contact within the target LargeCo who is already familiar with TechCo. Only contact a few companies at a time, both to avoid overwhelming management and to avoid giving the impression that TechCo is being "shopped." As the process continues, the responsibility list should be updated to show the current contact status of each active candidate.

Foreign vs. Domestic Partners. To be a global competitor, U.S. TechCos may need to enter into partnering arrangements with foreign LargeCos. From TechCo's perspective, Pacific Rim or European partnerships can provide TechCo with immediate credibility, influence and access to customers in markets that TechCo would take years of effort and losses to penetrate on its own. TechCo also may obtain manufacturing know-how, parts sourcing and complementary technology not available to it in the United States.

Pacific Rim LargeCos may be more open to acquiring new technology and products from U.S. companies, and may be less subject to the "not invented here" syndrome than their U.S. counterparts. Moreover, many Pacific Rim LargeCos appear to have a better long-term perspective on investing in new technology and markets. Both Pacific Rim and European LargeCos view partnering with U.S. TechCos as a good way to diversify and familiarize themselves with the U.S. market and distribution channels. Such companies also tend to have experience with partnering arrangements. All of these characteristics may make foreign LargeCos more receptive to partnering proposals than U.S. LargeCos.

On the other hand, geographic distance, language barriers and cultural differences will increase both the time and management effort needed to negotiate and implement a partnering arrangement with a foreign LargeCo. In addition to understanding and satisfying the strategic needs and objectives of a foreign LargeCo, TechCo must be sensitive to the cultural needs and expectations of its potential partner. Dealing with foreign partners also adds another layer of legal complexity, potentially subjecting the arrangement to foreign laws and regulatory approvals. From a competitive perspective, a Pacific Rim LargeCo, in particular, may prove to be a significant long-term competitive threat to TechCo, even in the U.S. market.

Step Four: Contacting The LargeCo Targets

Corporate vs. Operating Staff. One difficulty in introducing a partnering proposal to LargeCo is that although LargeCo's operating staff frequently will have the greatest interest in the potential arrangement, it rarely will have the authority to engage in a significant transaction without corporate approval. For example, LargeCo's R&D department might well have an R&D budget that would allow it to pay $500,000 in advances against royalties on an R&D contract. However, a proposal consisting of a $2 million paid-up license and $3 million of equity investment would likely exceed its authority and require corporate involvement and approval. Since most LargeCos require corporate approval for an equity proposal, TechCo may want to first consider a nonequity partnering proposal.

When the operating group in LargeCo cannot complete the partnering arrangement alone, carefully consider how to approach LargeCo. If LargeCo has a corporate business development or strategic development group, TechCo should approach that group. If not, TechCo will probably want to start with or get an introduction to an appropriate person in the operating unit. Such a person can act as the champion within the corporate structure, attesting to the feasibility and value of the technology and the available market. It is critical that TechCo identify a credible and persuasive champion within LargeCo who has a vested interest in the success of the relationship. Without such a champion, partnering negotiations may eventually stall. TechCo must be prepared for the inevitable frustration, complexity, delay and re-education that results from having to work with both the operating and corporate staffs.

TechCo also should realize that the LargeCo corporate staff members who negotiate the partnering arrangement generally will not be responsible for implementing the arrangement. Successfully completing negotiations is only the first step in creating an effective partnering arrangement. Once it is clear that a partnering arrangement will be concluded, both parties must focus on how the partnering arrangement will be implemented. While a discussion of how to effectively integrate the partnership is beyond the scope of this booklet, continued communications, commitment and execution by both parties is an absolute priority to achieve sustainable success.

Confidentiality Agreements. Before attending any meetings with LargeCo, TechCo should decide exactly how much technological, business plan or market information it is willing to provide to LargeCo without getting a signed confidentiality agreement. The first information given to LargeCo should be sufficiently general that no confidentiality agreement is necessary. Large companies rarely sign confidentiality agreements before they have concluded that they have some threshold degree of interest in pursuing the opportunity.

Once that level of interest is attained, it is important that TechCo get a signed confidentiality agreement from LargeCo. Corporate partnering relationships invariably require TechCo to relinquish proprietary information. This is information that TechCo will not want LargeCo to use outside the scope of the proposed partnering arrangement. TechCo needs to consult with its lawyer regarding the appropriate form of confidentiality agreement and other mechanisms that can help protect its proprietary information during the partnering process. From LargeCo's perspective, TechCos frequently try to protect information that does not rise to the level requiring protection. Experienced counsel can help balance the needs of both parties and avoid having initial meetings revolve around the scope of the confidentiality agreement. In addition to confidentiality, TechCo may wish to have LargeCo agree not to solicit TechCo's key employees for some extended period of time.

Initial Meetings. TechCo can expect at least two or three initial meetings with LargeCo staff, over a period of several months, to discuss TechCo's objectives, strategy, technology and markets. Advisors will help TechCo develop a comprehensive presentation to be given by TechCo's senior management. In these initial meetings, TechCo should be prepared to outline briefly what it wants to achieve in the proposed transaction, even though LargeCo generally will not be ready to negotiate or respond to TechCo's proposal at this stage. It is important, however, to inquire about LargeCo's strategic objectives in order to determine how TechCo can modify its proposal to fit the mutual objectives of the two companies.

Step Five: Creating A Proposal

TechCo should expect to formulate the partnering proposal. LargeCo typically will not feel the same degree of urgency as TechCo to generate a timely and creative proposal and TechCo will want to drive the process. LargeCo's staff will help refine the proposal, establish LargeCo's negotiating limits, and will assist in gaining corporate approval.

Valuing the Proposal. In formulating the proposal, consider LargeCo's strategic objectives and try to separate perceived "investment objectives" from "operating objectives." For example, LargeCo generally will purchase equity in TechCo because it is considering acquiring the company, because TechCo requires an equity investment, or because such an investment may give LargeCo some influence over TechCo, not primarily because LargeCo wants an equity return.

LargeCo generates its returns from its operating business. As a result, LargeCo will tend to value the TechCo partnering proposal based on an operating discounted cash-flow analysis of the commercial rights that LargeCo will obtain. To determine LargeCo's cash-flow benefits from these arrangements, it is important to understand the nature of the LargeCo decision. Is this a strategic direction LargeCo cannot achieve without TechCo, or a "make or buy" decision (i.e., can LargeCo accomplish its objectives faster or cheaper through TechCo than it can by doing it itself?)? A careful understanding of LargeCo's alternatives will help TechCo interpret LargeCo's discounted cash-flow analysis. Thus, TechCo should primarily analyze the partnering proposal in terms of its operating present value returns to LargeCo.

Initial Proposals. Initially, proposals should be kept in outline form, leaving the details to be developed in negotiations. Initial proposals must be realistic and businesslike. Unrealistic expectations or poorly thought out proposals may jeopardize an otherwise promising relationship. The initial proposal should accomplish the following:

- Indicate generally what TechCo wants from the transaction, leaving any equity valuation issues until later;
- Define what TechCo is prepared to give in the transaction, including deliverables or rights to be granted to LargeCo;
- Address and satisfy LargeCo's objectives and concerns;
- Prepare for future negotiating trade-offs; and
- Set a timetable for completion.

If LargeCo indicates an interest in negotiating an arrangement based on the summary proposal, TechCo should prepare a detailed version of the proposal, modified to reflect what has been learned to date. A useful way to prepare for discussions is to complete a chart similar to the chart below.

Our Proposal	Possible LargeCo Responses	Our Expected Responses
1.	1a.	1a.
	1b.	1b.
	1c.	1c.
2.	2a.	2a.
	2b.	2b.
	2c.	2c.
3.	3a.	3a.
	3b.	3b.
	3c.	3c.
4.	4a.	4a.
	4b.	4b.
	4c.	4c.

Legal, Tax and Accounting Assistance. TechCo should seek competent legal, tax and accounting input early in the negotiating process. Not only may legal restrictions make some agreements impossible, but tax implications may make certain legal structures far more costly than others. In many cases, experienced counsel will know of simpler, safer and more cost-effective mechanisms for accomplishing TechCo's objectives.

When analyzing the issues in the individual building block agreements that make up a partnering arrangement, TechCo and its counsel must consider how these issues are affected by the interaction of several of those agreements together.

Formulating The Partnering Proposal: The Building Block Approach

The following section looks at each of the five partnering building blocks in detail, focusing on the issues TechCo must consider and resolve when using that building block in its partnering arrangement. In addition, this section outlines the positions that TechCo and LargeCo are likely to take in these arrangements and highlights areas where TechCo may gain valuable economic concessions from LargeCo.

The rights described in this booklet can be granted to either TechCo or LargeCo. LargeCo may come to TechCo for its manufacturing expertise in a new process or technology or with a desire to capitalize on TechCo's greater customer understanding or its niche sales and marketing capability. For simplicity's sake, however, the remainder of this booklet assumes that TechCo is seeking equity or development funding and that LargeCo is seeking manufacturing, distribution and licensing rights to TechCo's technology.

Block One: Equity Investment

Preferred vs. Common Stock: TechCo generally will want LargeCo to purchase convertible Preferred Stock instead of Common Stock. Common Stock in private companies often sells at a fraction of the price of Preferred Stock because of the perceived value of the preferences. Selling Preferred Stock enables TechCo to minimize dilution and have employees who acquire TechCo stock after the partnering arrangement pay less per share than LargeCo. LargeCo also may want to purchase Preferred Stock for the additional rights and downside protection that it provides.

Type of Preferred: LargeCos generally will expect the same types of rights as those given to venture capitalists. While normal liquidation preferences are necessary, mandatory redemption preferences and special voting rights may be inappropriate given the value of the contractual rights typically granted to LargeCo and LargeCo's potential conflict of interest as a "product-oriented" partner of TechCo. (See the Fenwick & West booklet on Venture Capital: A Strategy for High Technology Companies for a more detailed discussion on rights, preferences and agreements typical in venture financings).

Preferred Price: TechCo generally will want LargeCo to pay more per share than a venture capitalist because of the additional commercial returns to LargeCo. On the other hand, TechCo may choose to include LargeCo in its normal venture round to avoid LargeCo controlling a separate series of preferred stock.

Amount of Stock: LargeCo frequently will want to keep its investment below 20 percent of TechCo's equity since financial accounting rules would require LargeCo to include the corresponding percentage of TechCo's losses on LargeCo's financial statements if its ownership were larger. TechCo generally will want to keep LargeCo's investment below 50

percent of TechCo's equity to avoid LargeCo control (at least until a clear acquisition route has been charted).

TechCo Board Seat: LargeCo may want a seat on TechCo's Board of Directors or its R&D Committee. TechCo should evaluate such a representative's inherent conflict of interest when disseminating sensitive information to the Board and when receiving that representative's input on the strategic direction of TechCo.

TechCo Covenants: LargeCo also may want TechCo to agree to restrictions on how TechCo will do business in the future (e.g., the right to approve budgets, new lines of business, deals with other LargeCos, sales of assets or acquisitions). TechCo must evaluate those restrictions to ensure that it does not lose necessary operating flexibility.

Information Rights: LargeCo will want the same information rights as venture capitalists (e.g., financial statements, budgets, inspection rights). In addition, LargeCo may request specific information rights regarding TechCo's R&D progress. TechCo should consider LargeCo's conflict of interest when agreeing to grant LargeCo detailed information rights.

Right of First Refusal: LargeCo may ask for a right of first refusal to participate in future equity offerings or transfers of technology by TechCo. This severely limits TechCo's flexibility and should be avoided. It may be preferable to grant LargeCo the right to bid in those circumstances.

Option to Buy TechCo: LargeCo may ask for an option to purchase TechCo at some future date or milestone. To grant such an option requires that the parties negotiate in advance all the elements of an acquisition (e.g., price, payment mechanism, earnouts, indemnities, escrows, noncompetes and employment agreements). (See the Fenwick & West LLP booklet Mergers & Acquisitions: A Strategy for High Technology Companies for a more detailed discussion of those issues.) This negotiation is not generally cost-effective at this stage of the relationship and should be avoided by TechCo. Moreover, such an option will likely preclude LargeCo from obtaining pooling of interest accounting treatment when acquiring TechCo.

Exit Mechanism for Bad Deal: The parties should consider an exit mechanism if the partnering arrangement fails to meet its strategic objectives. TechCo could retain an option to repurchase LargeCo's shares within given windows, triggered either by time or failure to reach milestones. The price could be set by formula (e.g., price plus agreed-upon return) or left to appraisal by a third party.

Block Two: Technology Development

Development Specifications: This will be one of the most difficult elements of the arrangement. If TechCo agrees to specific budget and time deadlines, LargeCo should commit

to firm specifications, with any change orders to be mutually agreed upon and paid for by LargeCo.

Commitment to Development: Both parties typically participate in the development project. The parties should clearly define their commitments to the development project (e.g., technology, personnel, facilities, equipment, funding and services). Each party should designate one person to communicate information to the other party. All joint development projects should be overseen by a joint committee, but headed by a single project manager.

Development Milestones: LargeCo generally will want to provide funding in stages, marked by development milestones. If TechCo fails to meet these milestones, LargeCo will want to cease its funding or obtain rights to the technology developed to date.

Acceptance Criteria: The parties should agree from the outset on acceptance criteria. The parties must agree on acceptance tests and the personnel and procedures for these tests, including how long the technology must work to be acceptable and provisions for dealing with defects.

Confidentiality: The parties must agree on procedures to ensure that each party's proprietary information is used only in the joint development. Where commingling of information realistically cannot be avoided, TechCo's development staff should be instructed not to disclose that information to LargeCo's staff without authorization.

Ownership of Technology: The parties must carefully define ownership and use rights, not only for the technology jointly developed and any future revisions to that technology, but also for the base technology brought into the project by LargeCo and TechCo. Frequently, the parties will grant exclusive rights to LargeCo within one particular application, vertical market or geographic market, with TechCo retaining all other rights. Where LargeCo has contributed technology of its own, it is important for TechCo to get a cross-license to permit further use of that technology in its products. (See the Fenwick & West booklet on Acquiring and Protecting Technology: The Intellectual Property Audit for a detailed discussion of these issues.)

Support & Warranty: The parties also must agree on who will be responsible for support and warranty work. If LargeCo is a mere distributor or licensee, TechCo probably should provide support and warranty service to LargeCo and (perhaps) LargeCo's customers. These obligations are inappropriate if LargeCo acquires all rights to the developed technology.

Block Three: Manufacturing Rights

Exclusivity: LargeCo may ask for exclusive manufacturing rights. Even where TechCo grants exclusivity, TechCo should retain the right to manufacture if LargeCo fails to meet TechCo's volume requirements or if TechCo's customers require that the product be second-sourced. In

a pure manufacturing agreement, LargeCo should be prohibited from manufacturing TechCo's products for a third party.

Payments for Exclusivity: LargeCo may be willing to pay TechCo a lump sum payment for exclusive manufacturing rights, amortized over an agreed-upon number of units to be manufactured by LargeCo.

Tooling: TechCo frequently will want LargeCo to pay tooling costs for TechCo's product, such cost being amortized over an agreed-upon number of units manufactured by LargeCo. TechCo should obtain ownership to such tooling and the underlying drawings, technical specifications and documentation, and LargeCo should be barred from using them for third parties.

Manufacturing Qualification: The parties must establish procedures for TechCo to transfer information required for prototyping, manufacturing and testing to LargeCo. TechCo must verify whether it needs an export license from the Department of Commerce or the Department of State before shipping such technical data to offshore manufacturing companies. TechCo should be able to terminate the arrangement if LargeCo fails to meet TechCo's quality standards.

Product Revisions: TechCo should reserve the right to require product revisions upon mutually agreeable terms. LargeCo should be prohibited from revising the product without TechCo's prior consent, and title to any such revisions should be transferred to TechCo under mutually agreeable terms. LargeCo may seek manufacturing rights to TechCo's next generation of products.

Production Quantities: LargeCo generally will ask for manufacturing quantity commitments from TechCo. TechCo must ensure that it is only liable for products actually ordered, not estimates agreed to at the front end. The parties should agree upon lead times for ordering product or reducing or cancelling orders.

Distribution: LargeCo may want to distribute TechCo's products to third parties. (See the discussion about "Distribution Rights" below.)

Confidentiality: Ensuring confidentiality of proprietary information is a significant problem in offshore manufacturing arrangements. The manufacturing agreement must clearly establish that the information regarding the product and its manufacturing process belongs to TechCo. In addition, TechCo must be vigilant in policing the use of that information by LargeCo.

Payment: Payment terms can vary widely in partnering arrangements. LargeCo may require that TechCo guarantee payment for the initial products manufactured by an irrevocable letter

of credit, or LargeCo may agree to payment for the products 120 days after delivery. What TechCo negotiates will be a function of financial concessions made by the parties elsewhere.

Warranty: TechCo will want to obtain an extended warranty on the product. Ideally, such a warranty should run from the date that TechCo sells the product to an end-user, not the date it is sold to TechCo by LargeCo.

Block Four: Distribution Rights

Exclusivity: LargeCo may ask for exclusive distribution rights to TechCo's products. Frequently, such exclusivity will be limited to a market segment or a geographic territory. TechCo must analyze the availability of intellectual property protection and the need for export or re-export authorization for each country covered by the territory.

Payment for Exclusivity: LargeCo should make some significant nonrefundable advance payment, prepaid order of product, or other financial concession for the grant of exclusivity.

Limits on Exclusivity: Exclusivity should be conditioned upon LargeCo attaining agreed sales quotas. TechCo may want to retain the right to sell product to U.S. companies (and their subsidiaries), OEMs, the U.S. government or other specified customers.

Products Covered: LargeCo may ask for the right to distribute all TechCo's future products. TechCo should consider the strategic fit between LargeCo's distribution capabilities and TechCo's present and projected product mix before agreeing to this.

Best Efforts Marketing: TechCo will want LargeCo to agree to use its best efforts to market the products. TechCo should specify what it expects from LargeCo (e.g., percentage of LargeCo revenues from the product to be spent on marketing, number of LargeCo personnel working with the product, attendance at a minimum number of trade shows in the territory, inventory levels and advertising budget).

TechCo Marketing Assistance: LargeCo will want to specify the type of marketing assistance TechCo must provide (e.g., sales materials, demonstration equipment, product updates, technical and sales training). This is another area where TechCo can seek financial concessions from LargeCo. For example, TechCo can loan demonstration equipment to LargeCo at TechCo's expense, or LargeCo can agree to prepay TechCo for the cost of the equipment, thus providing TechCo with the cash necessary to build the units.

Pricing: TechCo should reserve the right to change its prices over time while LargeCo may insist upon a "most favored customer" clause for future pricing. TechCo restrictions on LargeCo's resale prices generally violate antitrust laws and should be avoided.

Payment: TechCo may want LargeCo to guarantee payment for products ordered from TechCo by an irrevocable letter of credit, confirmed by a U.S. bank. LargeCo typically will want to purchase on open account. TechCo should evaluate LargeCo's payment history with other suppliers before agreeing to an open account relationship.

Confidentiality: Each party will want the other to respect the confidentiality of its proprietary business and customer information.

Trademarks, Patents & Copyrights: TechCo should ensure that the products are sold under TechCo's trademarks and that it properly registers such trademarks in TechCo's name in LargeCo's territory. LargeCo may want rights to the trademarks in its territory. TechCo should secure foreign patent and copyright protection, where applicable.

Packaging and Notices: TechCo will want to ensure that LargeCo distributes the products with all packaging and proprietary notices intact so that end users know that the products are TechCo's, not LargeCo's (compare with a license, OEM or manufacturing arrangement, where LargeCo may have its label on the product).

Maintenance, Support & Training: The parties must agree on what warranty and support TechCo will provide to LargeCo and how customer warranty and service problems will be resolved. TechCo should visit LargeCo's territory frequently to understand customer needs and evaluate LargeCo's performance.

Information and Reports: TechCo will want LargeCo to provide it with the following types of periodic information: marketing budgets, sales forecasts, inventory status, sales reports and market conditions in the territory.

Infringement by Others: TechCo will want LargeCo to police infringement of TechCo's proprietary rights within LargeCo's territory and assist TechCo in investigating and taking legal action against infringers. TechCo should retain control of these actions.

Term and Termination: The parties must agree on a term for the agreement. Two to five years is common. The agreement should allow either party to terminate after an agreed "cure" period if the other fails to meet its material obligations. Provisions allowing termination on 90 to 120 days notice without cause may be unenforceable in some countries.

Block Five: Licensing Rights

Hybrid Nature of License: Licensing arrangements generally include manufacturing, distribution, modification and use agreements. The issues discussed in this booklet under those titles also will apply to licensing arrangements.

Scope of License: The most important aspect of any license is defining the scope of the license grant. Typically, TechCo will grant LargeCo an exclusive license to a particular application of a technology in which LargeCo has special expertise and market power, while reserving for TechCo all rights to remaining applications of that technology.

Localizations: LargeCo usually will want TechCo's product to be modified to meet the language, legal, trade customs and consumer preference needs of LargeCo's territory. TechCo may wish to have LargeCo perform such services. TechCo should require that all localizations be approved by and assigned to TechCo upon agreed terms.

Pricing: Rather than pay a purchase price for product, LargeCo normally will pay TechCo a royalty on each unit of product manufactured and sold (or licensed) by LargeCo. However, where per-unit royalties appear to pose a stumbling block to the relationship, the parties may agree to a fully paid-up license for a lump sum payment. Such lump sum payments can be large and provide a nondilutive way for TechCo to raise capital.

Royalty Rates: Royalty rates will vary depending upon the industry and other negotiated rights and concessions.

Withholding Taxes: While sales income from a foreign country generally is not subject to tax in that country, royalties paid on sales in a foreign country frequently are subject to withholding taxes on expatriation. For example, there is a 10 percent withholding tax on royalty payments from Japan to U.S. companies. Where withholding taxes apply, TechCo must consider if it wants or will be able to gross up the royalty rate so that the withholding tax does not affect the net amount received by TechCo.

Exchange Controls: TechCo must determine if there are exchange controls in LargeCo's country that restrict LargeCo's ability to transfer royalty payments to TechCo. In many foreign countries, license agreements must be governmentally approved before U.S. dollars can be transferred out of the country. Similarly, if LargeCo is located in a developing nation, TechCo should determine if there are countertrade or offset requirements to receiving U.S. dollars from that country.

Indemnities: In any technology agreement, the party receiving the technology or products should receive an indemnity providing that the technology does not infringe any third party's patent, copyright or other proprietary rights. Where technology is jointly developed, or LargeCo is allowed to modify licensed technology, cross-indemnities should be considered. Where LargeCo distributes or licenses technology in a foreign country, LargeCo may ask TechCo for an indemnity providing that TechCo's products do not infringe any intellectual property rights in LargeCo's territory.

Using Joint Ventures

Companies considering a partnering arrangement often talk about entering into a "joint venture" with their prospective partner. The term joint venture typically refers to the parties forming a separate legal entity to pursue their long-term business objective, but generally will include one or more of the other building blocks discussed above. For example, LargeCo and TechCo may remain independent, but undertake the development, manufacturing or marketing of the technology and products in a joint venture (by creating a new corporation, partnership or limited liability company). In such a joint venture, typically TechCo contributes technology rights, LargeCo contributes cash or services and both companies provide new employees to the joint venture. The most common reason for wanting a joint venture is the perceived need to create an identity for the new venture, separate from the two partners. Using a joint venture entity may be appropriate when it is critical to your proposed partnering relationship that you:

- develop and market a product that requires the technical expertise of multiple companies, no one of which intends to focus on that market except as a supplier of components;
- collaborate on developing an industry standard solution;
- ensure one partner's operating control over the venture;
- establish a local entity in a foreign market to avoid bias against non local companies;
- minimize the risk of technology loss from one partner to the other;
- consolidate all the expertise in one entity, making it easier for LargeCo to acquire it downstream; or
- *create a combined, market-focused entity and management team* better-suited to consummate a successful initial public offering than either participant.

Joint ventures are inherently complex. They require that you consider a host of additional business, commercial, liability, return on investment, tax, accounting, and control ramifications. In addition to the issues previously discussed, you must determine:

- What is the best form of joint venture entity?
- What will each party contribute to the joint venture?
- How will the joint venture determine and raise needed capital?
- How will the joint venture be managed and who is in charge?
- On what terms will third parties be admitted?
- What is the exit or buyout rights for each party?
- Can management equity incentives be included consistent with the corporate partners' respective economic, tax, control and exit strategy requirements?

It is outside of the scope of this booklet to address the additional issues that arise when structuring or operating a joint venture entity. Joint ventures are a more complicated form of partnering arrangement and should only be used where they are clearly the optimal way

to meet critical objectives. For more information please refer to Fenwick & West's booklet entitled *Joint Ventures—An Overview and Structuring Guide*.

Additional International Legal Issues

Since many partnering arrangements are between foreign LargeCos and U.S. TechCos, it is important to consider the legal effect of this international element. This next section will briefly discuss international issues not addressed in previous sections.

TechnologyTransfer Laws: When licensing technology into a developing country, TechCo should verify if that country has a technology transfer law. These laws may characterize a license as a sale of technology, restrict how long confidentiality provisions may continue, limit the amount of royalties that may be paid and provide that foreign choice of law provisions are unenforceable. Where such laws apply, TechCo should get assistance from local counsel and delay releasing sensitive technology until the final terms of the agreement have been approved by the local government.

Foreign Antitrust Laws: TechCo should consider the effect of foreign antitrust rules on restrictions in its licensing and distribution agreement. Japan and the EEC, in particular, may prohibit resale price maintenance, exclusive grant backs, customer restrictions, noncompetes and territorial restrictions beyond what is specifically allowed.

Arbitrate vs. Litigate: TechCo and LargeCo should consider agreeing to arbitrate rather than litigate their disputes. Arbitration may be more appropriate for many issues given the multiple relationships between the parties and the greater expense and uncertainty of litigation in foreign forums. Where the technology is highly complex, the parties can require that the arbitrators have the appropriate technical background. Arbitration also should permit the parties greater control over the schedule of the proceedings. However, many companies prefer to litigate proprietary rights issues because they feel that injunctive relief and the discovery and appeal rules of court actions may better protect those rights.

Choice of Law: TechCo will want U.S. law as the governing law for the agreement with LargeCo because the United States has well-developed intellectual property law. On the other hand, LargeCo may want the law of its territory to apply. As a compromise in distribution agreements with respect to purchase and sale issues, the parties may choose the Convention on Contracts for the International Sale of Goods (CISG). While similar to the Uniform Commercial Code, TechCo must be careful about oral contracts (which are binding under CISG) and offers that encourage detrimental reliance by a buyer (which will be irrevocable under CISG).

Effect of Local Law: TechCo must determine if a U.S. choice of law provision will be enforceable in LargeCo's territory. Local law in the foreign territory may override the contract in matters such as termination, technology transfers, trademarks, antitrust, consumer

protection, limitations of liability and warranty disclaimers, and ownership and assignment of copyrights (including moral rights).

Choice of Forum: The agreement should choose a forum sharing the same language as the governing law and where the governing law is likely to be understood. TechCo should avoid forums with insufficient statutory and case law regarding proprietary rights in the licensed technology.

Choice of Language: If there is both an English and a non-English version of the final agreement, the agreement should have a governing language clause specifying that the English language version governs.

Conclusion — Creative Proposals for the 2000s

What type of partnering arrangements are most likely in the 2000s? TechCo should not expect early-stage equity investments or overpriced acquisitions by LargeCo. It is far more likely that LargeCo will invest in areas that quickly generate operating returns. As a result, partnering arrangements are more likely to take the form of engineering, manufacturing, distribution or licensing arrangements, with associated royalties and other commercial payments. TechCo must understand and plan for dilution of its rights to technology, as well as any equity dilution.

The leverage in partnering is created by the financial and strategic resources of LargeCo and the fact that LargeCo can receive economic returns from operating benefits based on TechCo's innovations. Unlike venture capitalists, LargeCo does not require liquidity events for all its returns. Partnering is also the logical precursor to a possible LargeCo acquisition of TechCo, since it tests joint strategies and economics and provides proof in the form of results. Favorable joint economics in a partnering arrangement will increase the likelihood of a closer relationship between the two companies.

From TechCo's perspective, understanding its own objectives and the strategies of industry participants and developing an effective partnering plan are prerequisites to successful partnering. While this process can be complicated, it is important for two reasons. First, it permits TechCo to efficiently target realistic potential partners. Second, with the assistance of experienced advisors, it permits TechCo to construct proposals composed of the building blocks discussed in this booklet - proposals that meet the strategic objectives of both parties while leaving TechCo the flexibility it needs for the future.

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