

Breaking Up is Never Easy: PLANNING FOR EXIT IN A STRATEGIC ALLIANCE

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Everyone knows how to get into a relationship, but getting out is not so easy. In the pop music song, Paul Simon claimed there were fifty ways to leave your lover, but how much do we know about leaving our corporate alliances? In the last three decades we have witnessed an explosion in the number of strategic alliances, which we define as cooperative ventures focused on co-development, co-production, and co-marketing that entail risk- and reward-sharing between collaborating parties.¹ The number of alliances continues to grow at an unprecedented rate. For instance, in 2000 alone, approximately 10,200 alliances were formed worldwide. Not only does the number of alliances continue to grow, but so does their significance to the allied firms. A study conducted by Accenture reports that about 25% of executives said alliances account for at least 15% of their market value.² Similarly, Partner Alliances reports that 82% of *Fortune 1000* CEOs believe alliances will be responsible for more than 26% of their companies' revenues.³

Not surprisingly, the growth in the number and significance of strategic alliances has drawn much systematic research attention to the issues surrounding their formation and management. As a result, a great deal has been said about understanding and managing alliance formation and cooperation dynamics,⁴ choosing the right alliance partner,⁵ structuring an alliance,⁶ and appraising alliance performance.⁷ An important focus of this research has been on understanding some of the key management processes that may contribute to alliances' success. In this context, a critical insight is that, despite good intentions and comprehensive efforts to make them succeed, alliances are inherently difficult relationships and, as such, many of them fail—up to 50% by some accounts.⁸ Many alliances dissolve, falling victim to changes in the business environment and/or partners' strategies. It is therefore remarkable that so little

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thought, let alone systematic study, has been devoted to the reasons, planning, and procedures for exiting alliances. Echoing this research-related lacuna, many executives and alliance managers we interviewed acknowledged the strong presence of this gap in the world of practice; exit planning, if performed at all, is often not nearly thorough enough, leading to major breakdowns.

A senior executive of Sames (the Tokyo-based division of a U.S.-owned paint application OEM with primary operations in Grenoble, France) recounted a striking example to us. In 1997, Sames entered a strategic partnership with one of the major Japanese auto manufacturers. The auto manufacturer wished to “go green” and was considering refitting its worldwide plants with water-borne painting equipment (i.e., to replace solvent-based equipment). Sames was a perfect alliance partner for this project, given the firm’s expertise in paint-equipment manufacturing and its rapidly growing business with many of Japan’s

other major automotive players. Sames’s management acknowledged that they went into the alliance “bright-eyed and bushy-tailed,” as the partnership offered the potential opportunity to more than double corporate sales and develop an even stronger foothold in the Japanese paint equipment market. Amid the euphoria of sealing a major deal, Sames gave no thought to the potential dissolution of the partnership, relying on trust-based contracting—as is typical of Japanese business

relations⁹—with either company being able to exit freely. According to the agreement, Sames was to customize water-based paint equipment to the auto manufacturer’s needs. Thus the necessary R&D efforts required massive upfront investments by Sames, but there were no formal guarantees of a large-scale order from the auto manufacturer: an informal promise referred to a possible major contract to refit the automaker’s numerous plants with the new paint equipment, but the formal commitment was limited to the purchase, at cost, of two test units from Sames.

As Sames committed more and more to the partnership (e.g., by increasing R&D investments), the auto manufacturer exploited the trust-based relationship, making mounting demands for equipment improvements and additional specifications. In the absence of stipulated exit provisions, the automaker could easily disengage, likely obliterating any return on Sames’s R&D investments, given that the customizations Sames had performed were unlikely to fit other clients’ needs. Sames, therefore, had no choice but to fulfill the new requests, though this required transferring more and more engineers from France to Japan and reallocating the bulk of its human and technical resources from other Japan-based partnerships to the automaker’s project. Not surprisingly, these moves had a ripple effect on Sames’s other business relationships: the paint equipment manufacturer’s technical team was so overwhelmed by the automaker’s requests that it had difficulty attending to products for other lines of

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business. The alliance ended disastrously in 2001, when the automaker pulled out of the deal with Sames at little cost to itself, having purchased just the two test units, and gave the large contract to another paint equipment manufacturer. Left with over US\$5 million in irrecoverable R&D costs—the test-unit sales represented less than 1% of this figure—and rapidly deteriorating business relationships with other major clients, Sames was forced to file for bankruptcy shortly thereafter.

While the Sames story illustrates the potentially dire consequences of a failure to plan for exit, even companies that address exit planning to some degree often encounter mishaps. Consider, for instance, the troubled ECA joint venture formed in 2000, which groups together in one business the short-haul mainline routes of BMI British Midland, Lufthansa, and SAS Scandinavian Airlines to and from Heathrow and Manchester airports. Both Lufthansa and SAS were considering pulling out of the underperforming partnership but they cannot terminate the venture until 2008, a non-contingent exit date specified at the alliance's outset. Meanwhile, SAS's total losses in the venture amounted to about US\$55 million in 2005 alone. Similarly, Lufthansa expects to lose millions of dollars in the venture.

Another example comes from the 2001 partnership between AstraZeneca, a leading Anglo-Swedish pharmaceutical company, and three research universities. The alliance, while having a seven-year contractual life span, had a revolving two-year renewal provision: in theory, AstraZeneca could exit every two years if the alliance was underperforming. However, because the deliverables of the partnership were unclear and not specific enough to trigger exit, the alliance was renewed every two years for the entire seven-year duration despite poor performance. In addition, in many cases, a lack of a clear and systematic disengagement plan may trigger opportunistic advances by partners to appropriate value in the alliance at the expense of both their counterparts and the alliance itself. The devastating result of these tendencies is a dysfunctional relationship imbued with deep animosity among alliance managers.¹⁰

If the benefits of properly planning for and executing strategic alliance exits are clearly significant, why do so many managers fail to engage in such tasks? In our view, this failure is largely due to the absence of practical guidelines for exit planning. To fill this gap, this article offers a systematic way of thinking about disengagement from strategic partnerships. Our discussion is based on analysis of interview data collected in 29 interviews with corporate executives, advisors, alliance managers, and attorneys. Complementing our interview data analyses, we also analyzed multiple real-world strategic partnership dissolutions either firsthand or through secondary sources.

Rethinking Exit: Should It Be Easy or Hard?

Our discussions with alliance managers suggest that it is most natural for involved parties to think about alliance exit in terms of how easy or difficult they expect it to be. Indeed, most combinations of time- or capital-related exit

provisions may be categorized broadly as hard (lengthy and expensive) or easy (fast and inexpensive).¹¹ For example, a hard exit provision may require a firm to buy out its stake at a significant premium, with the buy-out spread over several months. Alternatively, an easy exit provision may require no capital transfers and only one month's notice of termination. Strong arguments may be made for establishing easy or hard exit options. Hard exit could be advantageous because it makes parties more likely to remain dedicated to the relationship during rough times, and to build trust and a deeper commitment in general. On the other hand, easy exit brings unparalleled flexibility with regard to strategic decision making and resource allocation.

Based on these arguments, then, a simple question is "Should a given exit be easy or hard?" We believe this is the wrong question to ask. Better questions are "*When* should the exit be easy or hard? And *for which partner* should it be easy or hard?" In other words, a well-structured exit plan incorporates, at the time of alliance formation, a set of contingency-based exit provisions specifying the relative difficulty of exit for each alliance partner. As such, an alliance agreement would incorporate not one but several exit clauses, wherein a given clause would be activated when a certain contingency is met. Among the infinity of exit-relevant contingencies, we focused on those that emerged in the course of our analyses as the most consequential. Our study is thus oriented toward priority rather than comprehensiveness with respect to drafting effective exit clauses.

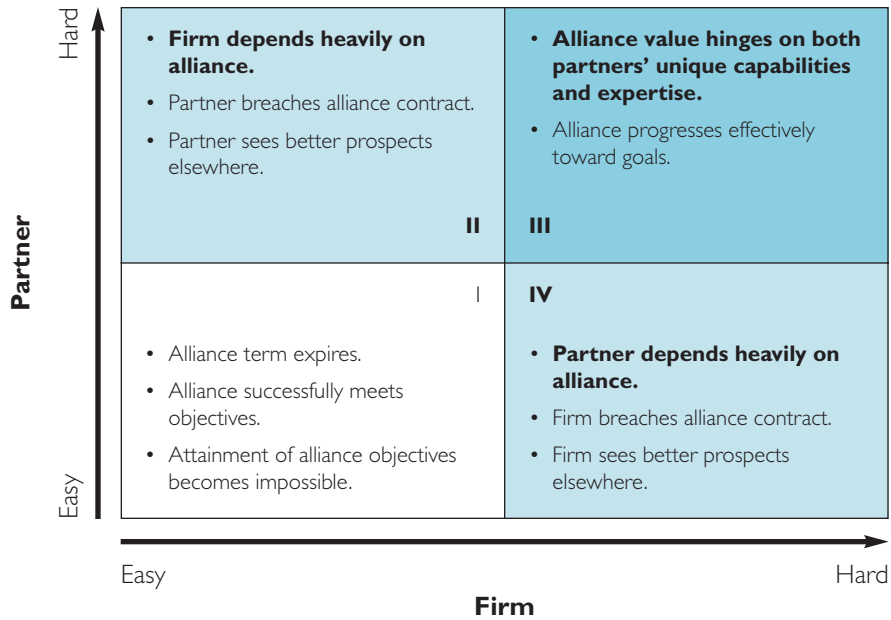
We have developed a framework to systemically think through exit planning around these contingencies (see Figure 1). The items in each of the boxes list the most critical contingencies that need to be addressed in planning for exit.

For ease of exposition, we use the context of a bilateral strategic alliance: the framework's horizontal axis reflects the difficulty of exit for the firm, while the vertical axis reflects its partner's level of exit difficulty. The optimal exit difficulty, in turn, is tied to a set of contingencies or circumstances surrounding the alliance. The core idea underlying this framework is that the difficulty of exit for the firm and its partner can and should vary independently, depending on the context. Hence, exit provisions in an alliance may fall into one of two broad categories: *symmetric*, where exit is either easy or hard for both partners; and *asymmetric*, where exit is hard for one partner but easy for the other. We subsequently suggest four quadrants that unify the contingencies based on the optimal set of exit provisions applicable to them.

The framework should be applied as follows. First, it is designed for application at the alliance formation stage. Given the potentially negative consequences of failure to plan exit in an alliance, it is critical that managers try to develop exit provisions at the inception of the alliance, even though it may be awkward and seem counterintuitive to discuss the possibility of divorce while walking to the altar.¹²

Second, it requires managers from each of the partners in an alliance to develop a joint understanding of the contingencies and of the exit provisions that can be the basis for specific contractual provisions.¹³ A clear and mutually agreed-upon set of definitions of contingencies surrounding exit provisions can

FIGURE 1. Contingency-Based Difficulty of Exit



help obviate devastating and opportunistic haggling should the alliance need to be terminated.

Third, some of the contingencies can be clearly assessed at the time of alliance formation. In other words, they are triggered by the information available *ex-ante* to the alliance managers. For instance, the preliminary assessment of partners' dependence on each other is available *ex-ante*, before the initiation of the alliance. The *ex-ante* contingencies (in bold in Figure 1) can be used to set up the initial exit provisions, or those that would govern the partnership in the absence of other contingencies. The initial set up would thus include the analysis of partners' relative dependence on each other, wherein the less dependent party should take on a harder exit provision to mitigate the asymmetry. It would also entail the analysis of how important the unique contributions of each partner are to the partnership, wherein symmetrically hard exit provisions would be used in alliances where partners are seemingly irreplaceable. In the absence of these initial triggers, parties can resort to the symmetric easy exit setup.

Finally, while some of these contingencies are likely to be triggered by information available *ex-ante* or at the time of alliance formation, in other instances such information may be available *ex-post* or after alliance formation.¹⁴ Take, for instance, the case of asymmetric exit provisions where one of the partners takes on a harder exit option. The contingencies of a partner breaching the contract or seeing better strategic prospects elsewhere that may trigger such asymmetric exit provisions can only be activated *ex-post* when the alliance is

underway. Thus, following the initial set up, parties may agree on some guidelines for updating the exit provisions. For instance, if an alliance hits a major milestone signifying its successful progression toward its goals, it could take on bilaterally hard exit provisions reflecting the third quadrant.¹⁵ Also possible are more complex rules, which would entail agreed upon adjustments to the initial set up (rather than overriding it entirely), based on the initial set up itself and on certain contingencies. Also, some flexibility should be retained to update the original set of contingency-based exit provisions as the alliance unfolds.

Symmetric Exit Provisions

The scenario in which exit should be easy for both firms reflects a simpler set of symmetric exit provisions. Straightforward contingencies here include the expiration of the alliance term, successful fulfillment of alliance objectives, or a market shift that makes the alliance futile and doomed to failure, each of which signifies clearly the partnership's end and should allow for smooth and easy exit for both partners (Cell I). When anticipating such situations as when achievement of alliance objectives becomes impossible or when the alliance turns into a substantial liability for both partners, alliance partners should make exit easy for each other in these cases.

Consider the example of MKE-Quantum Components, a joint venture (JV) between Matsushita-Kotobuki Electronics Industries (MKE) and Quantum. Formed in May 1997, this recording-heads joint venture combined Quantum's recording-heads technology expertise and operations with MKE's manufacturing process know-how. The industry environment, however, soon made it impossible for the joint venture to realize its potential: over-capacity among recording-heads manufacturers nullified the joint venture's economies of scale advantage, making JV losses unsustainable for both partners and motivating them to execute an easy dissolution of the alliance in October of 1998. Thus, if a JV fails to meet its goals for reasons other than opportunistic behavior by one of its partners, exit should be made easy for all parties. For instance, if a new government regulation prohibits development of a certain category of drugs, an alliance formed for the joint development of such drugs should offer a quick and easy exit for all parties.

While very effective in situations such as those above, easy bilateral exit provisions can lead to dismal outcomes if used without restraint. In some cases, an alliance with easy exit becomes vulnerable to inter-partner frictions, resulting in a very unstable relationship. For instance, a leading Washington D.C. law firm was an equity alliance among six partners. Though successful, the partnership became embroiled in a compensation dispute: one partner demanded a 36% share of net profits, while the other five insisted on a more symmetrical 16.6% share each. The partnership agreement had no clause preventing unilateral dissolution, enabling the eventual outcome: the disgruntled partner dissolved the alliance without any notice or discussion.¹⁶

Similarly, easy exit for both firms—outside of the contingency scenarios for which this symmetry is most appropriate (outlined earlier)—may prevent partners from developing high commitment levels and engaging fully in the venture. This was the case in the 1991 alliance between BellSouth Enterprises and TeleSciences, wherein the latter provided a customized billing system for the former's cellular services.¹⁷ The alliance included the stipulation that either company could terminate the agreement within 30 days, no questions asked. Because either firm could walk away so easily—without regard for the condition of the alliance or the other firm—the partnership was fraught with issues related to low commitment and underperformance. It is precisely for these reasons that our framework forewarns alliance partners against installing a singular symmetric easy exit provision at the offset of the partnership. Instead, it indicates that easy and symmetric exit provisions are best suited for a certain set of contingencies (indicated by Quadrant I) and should only be activated once the alliance encounters one of those contingencies.

Another symmetric scenario in our framework involves substantial and costly exit provisions (or hard exit) for both partners (Cell III). Symmetrically hard exit provisions are most effective and should be tailored toward the following two situations: when the alliance is progressing successfully toward its goals; and when the alliance's value relies heavily on the unique contributions of both partners making it costly for one partner if the other abandons the alliance. The first of these situations is relatively clear-cut: companies have all the more reason not to exit an alliance when its success is likely; the symmetrically hard exit provisions in this situation may, for instance, simply reflect the potentially high costs of buying out a partner's stake in a successful venture. Given that this provision—just like others—is developed and implemented at the onset of the alliance, it requires partners to develop clear and agreed upon alliance performance metrics, monitor them closely as the alliance evolves, and tie the difficulty of exit to the achievement of those metrics. The second situation in which costly exit provisions for all partners are most appropriate typically involves alliances that generate value based on the unique combination of the partners' skills and capabilities. As such, if one of the firms in such an alliance exits, the value of the alliance will likely be lost, even if another firm steps in as a substitute. While it is reasonable to expect partners in such an alliance to exhibit naturally lower propensities toward exit,¹⁸ adequately protecting the alliance's and the partners' interests mandates a lock-in through hard exit provisions for both partners. For instance, a current partnership between Northwest Airlines and KLM Royal Dutch Airlines entails a three-year exit period, a relatively hard exit provision. Each partner in this relationship is heavily dependent on the other: dissolution would require each to rebuild on its own its distribution network in Europe and the U.S., respectively, or to incur the costs of developing a new alliance with an equally effective partner to do so. This dependence is best addressed with hard exit provisions.

In both of the situations outlined above, the stipulation of easy exit provisions for one or both partners is not advisable, as there is no rationale for giving

either partner the right to disrupt the successful progress of the venture or destroy its value via a costly unilateral exit. Moreover, granting such a right to only one of the partners equips it with a power advantage, which can and often does come into play in emotionally charged situations, often destroying the alliance's value. Managers should also be forewarned that failure to incorporate hard exit provisions in a thoughtful, contingency-based way could lock alliance partners into an underperforming venture (as was the case with the earlier described Lufthansa and SAS partnership) or into an alliance with objectives impossible to meet.

Asymmetric Exit Provisions

While a symmetric alliance, in which all parties have equal levels of exit difficulty, may appear appropriate for all situations, this is not the case. Sometimes tipping the exit-difficulty scale in one partner's favor can contribute to the alliance's success. These situations fall in the remaining two cells of our framework (Cells II and IV), which are mirror images. In most strategic partnerships, such situations entail one or more of the following: asymmetric dependence; breach of contract by one of the partners; and unexpected change of strategic direction by one of the companies.

The first case in which asymmetric exit provisions make sense is an alliance with substantial disproportion among inter-partner levels of dependence. If a firm depends heavily on its partner for critical input and would have trouble obtaining this input elsewhere, exit should be more difficult for the input-providing partner. Our research indicates that such situations often arise in the U.S. automotive industry—contrary to popular belief, large auto manufacturers often grow dependent on smaller suppliers that provide a unique component customized to the manufacturer's needs and thus not readily substitutable. No less common, of course, are instances in which an automotive manufacturer consumes all of a supplier's output (along with those of several other suppliers), a reversal of the asymmetric dependence described above.¹⁹ In such instances, it is clear that easy exits by the less-dependent firms would have a ripple effect on their counterparts' well-being, allowing companies with the upper hand to coerce partners into an unfair distribution of value by threatening exit.²⁰ An asymmetric exit provision, then, by making exit harder for the less dependent partner, would provide a safety buffer for their more dependent counterparts.²¹ More generally, attending to the possibility of asymmetrically hard exit provisions would help smaller enterprises avoid entering into outright disadvantageous alliances, formed under the option-like approach by larger enterprises. Under such an approach, larger firms deliberately form numerous alliances with more dependent, usually smaller companies with the intent of keeping only a few of the partnerships down the road. While this tactic of exercising only select options may grant some strategic flexibility to the option holder, it forces many firms into an a priori unfair strategic setup. In these situations, designing asym-

metric exit provisions may help more dependent firms deter the least committed partners.

This discussion leads to a reasonable question: How could a disproportionately dependent firm convince its partner, who is less dependent and hence holds a power advantage, to accept an asymmetrically disadvantageous exit provision? The key consideration to keep in mind here is that two distinct processes contribute to the value that each firm derives from a collaborative exchange. One is *value creation*, which refers to the two alliance partners' joint efforts to enhance the size of the value pie available for distribution. The other, *value appropriation*, indicates the ability of a given partner to claim a portion of the created value for itself or, in other words, to maximize the size of its pie slice. Studies show that being in a position of power may indeed help a firm to appropriate more value at a partner's expense, but the power struggles and coercion that accompany such asymmetrical distribution of value typically damage the collaborative process significantly.²² Thus, in actuality a more powerful firm engaging in such behavior may be getting a bigger share of a rapidly shrinking pie, which often results in a net loss. As such, an asymmetric exit provision, which would tip the scale in favor of a less powerful partner, would provide a safety buffer not only for the less-advantaged partner, but also for the more powerful firm by helping to establish a more cooperative relationship. The Sames alliance described in the opening called for exactly this type of asymmetric exit provision. While the automaker's level of dependence remained constant, Sames grew more and more dependent on the alliance due to Sames's high level of irrecoverable R&D investments. Thus partners' failure to stipulate and activate a contingent asymmetric exit provision, which would have made exit harder for the automaker, contributed directly to the partnership's demise, depriving both Sames and the automaker of the potential future benefits of joint collaboration.

The second contingent scenario for which asymmetric exit provisions should be tailored is when a partner has violated a specific contractual agreement. In this case, the other firm should be afforded an easy exit. For instance, Krispy Kreme Doughnuts executed an easy exit from a strategic partnership with Great Circle, a company operating 28 Krispy Kreme stores in Southern California, following Great Circle's default on royalty and brand fund fees. In such cases, the perpetrator should be forced to choose among several courses of action, based on the partner firm's preference: staying in the partnership and paying a penalty, paying a penalty and exiting, or buying out the other firm's stake through some form of put option stipulated by the partner firm. Krispy Kreme opted to terminate the partnership and cancel its licensing agreement with Great Circle. In either case, at the very onset of the alliance, exit for the violator should be stipulated to be expensive (i.e., hard), while the injured party should be able to take advantage of a quick and easy exit.

While blatant breaches of contractual obligations are easy to prove and penalize with respect to exit, it is a greater challenge to establish more subtle forms of opportunistic behavior as instances of contract violations. In such cases,

even if the alliance has a contingent easy exit provision for the injured party, implementing it may be difficult, as disputes may drag on and stagnate at various levels of the alliance's and partners' hierarchies. Thus, to ensure effective implementation of the exit provision following a breach, we recommend the following steps. First, alliance partners should develop a specific sequence of internal hierarchical review for dispute resolution, with a clear timeframe attached to each level. For instance, the contract could stipulate that partners first attempt to resolve the dispute at the committee level; if a resolution is not reached at this level in, for example, 30 days, then the responsibility for dispute resolution should elevate to the senior officer level or that of the contractually designated decision-maker. Second, a useful idea to consider is the establishment of a contractual board, a jointly established governance body with authority to determine breach of contract.²³ At this stage, parties may utilize mediation, or the assistance of two or more interacting parties without authority to impose an outcome.²⁴ Finally, should a breach of contract fail to be identified and resolved internally, the alliance agreement should have clear guidelines for resolution by an outside party. In general, the use of voluntary arbitration, wherein a third party imposes a binding outcome, is preferred to litigation, for reasons of time and cost savings. For instance, an alliance agreement between BioNumerik Pharmaceuticals, a Texas-based company specializing in oncology drugs, and ASTA Medica Aktiengesellschaft, its German counterpart, contained the following provision: "If [a] matter is not resolved by the Alliance Steering Committee representatives of BioNumerik and ASTA Medica within 60 days after the commencement of . . . discussions, either Party may request, in writing, that the matter be resolved by binding arbitration."²⁵ In sum, setting up an asymmetric exit provision in the case of an alliance agreement breach requires a particular level of focus on the stage of actual implementation of the provision. Specifically, the effectiveness of an easy exit provision for the injured party may be significantly diminished if the exit provision fails to stipulate an expedient execution process.

The third situation that calls for an asymmetric exit provision is when a partner's strategic direction changes and it wants to exit an alliance for reasons not related directly to the partnership; exit for such a partner should be hard. Again, at the very onset of the alliance, partners should install a contingent exit provision, wherein if one of them seeks to exit the alliance for strategic reasons, it would activate an asymmetrically hard exit provision for that partner. For instance, when Renault and Nissan decided to dissolve their German Renault-Nissan Deutschland joint venture in 2007, exit had to be harder for Nissan, because the dissolution was prompted by Nissan's effort to reorganize its European activities. In this situation, Renault should be compensated for this change in the partner's strategic direction and allowed some time to make necessary related adjustments to its own business. For an example of a properly established and executed asymmetric exit provision related to changes in a partner's strategy, one could also look at the alliance between a major energy supplier and a utility partner (as described to us by the energy supplier's management). After the utility partner was acquired by another utility, the com-

bined entity's management approached the energy supplier and suggested dissolution of the alliance, as it was incongruent with their new strategic direction. This move required strategic adjustment on the energy supplier's part, as the firm had been guaranteed a certain number of supply contracts from the pre-acquisition utility under the alliance agreement. The energy supplier then had to find alternate procurement channels and establish contractual relationships with new partners, which required significant time and capital expenditures. Because a clear asymmetric exit provision was in place, the energy supplier was compensated by the utility for the adjustment costs resulting from premature dissolution.

Besides making exit hard for partners, firms often further hedge against allies' potential changes in strategic direction by stipulating flexible contingent exit provisions for themselves. These provisions are generally related to major changes in the asset structure or in the ownership of the partner firm. For instance, one large domestic dairy manufacturer stipulates in one of its alliance agreements that following "a sale of all or substantially all the assets of the Partner or a change in the ownership of more than fifty percent (50%) of the voting securities of the Partner in a single transaction or single series of related transactions" and "unless such change is consented to in advance" by the company, the dairy maker can exercise a call option on the partner's stake in the alliance at a predetermined price. In this case, the call purchase price is determined as the aggregate net book value of the partner's share in the alliance—defined as the book value of assets, less the book value of liabilities—which would often be lower than the true market value of the partner's share.

These examples reflect the core objectives of the asymmetric exit arrangement: to make exit hard for the partner who is no longer interested in the alliance due to strategy shifts, but relatively easy for the other firm, which must adjust accordingly, including potentially seeking a new partner. Such asymmetric exit conditions should be crafted thoughtfully and with caution, because if exit is made more difficult for one alliance partner without careful consideration of the circumstances, the consequences could be quite grim, such that the asymmetric exit provisions could even increase the likelihood of the alliance's failure. For instance, in situations of asymmetric power and dependence, if the more powerful actor is able to exit more easily than the weaker one, it creates an even greater incentive for the former to exploit the latter. One major domestic airline, for instance, typically establishes very easy exit provisions for itself in partnerships with smaller regional carriers. Because the larger airline provides its regional partners with nearly their entire air fleets, the partners would have to incur significant switching costs to find other allies that could provide so many planes, should the major airline decide to pull out of the venture. The airline's exit, however, would be relatively painless for it, given the ease of finding other regional carriers for partnerships. Further, the exit provisions stipulate that the airline can effectively withdraw from its partnerships within one quarter with no substantive penalties, allowing the airline to squeeze and exploit the more dependent regional partners with impunity. This situation

obviously forces the regional carriers to be extremely and asymmetrically dependent on the airline; thus a harder exit provision for the airline partner would be more appropriate. In fact, while the current exit provisions seem to serve the major airline's interests, in reality they could backfire, as over time the exploited firms might develop feelings of resentment regarding their treatment by the airline, thereby diminishing the alliances' value creation and ultimately withdrawing from these partnerships altogether.

Similarly, neglecting to establish appropriate asymmetric exit provisions in anticipation of potential strategic shifts can lead to dismal consequences. There are many situations, especially in high-velocity markets and industries, where a change in the strategic direction of the firm makes a given alliance less desirable for it. An easy exit provision for such a firm can leave its partner empty-handed, forced to make high-cost adjustments to its own business without adequate compensation from the firm that motivated these. Alternatively, a hard exit provision for the partner unjustifiably locks it into a possibly dysfunctional relationship to which the other firm may be much less committed due to new strategic aspirations. It is also obvious that asymmetric exit provisions do not apply to the contingencies for which we recommend easy bilateral exit. That is, unreachable alliance objectives, expiration of the alliance term, and the successful meeting of alliance objectives are conditions in which there is no need to constrain one firm's exit more than the other's, and a friction-free disengagement for both partners is the best provision.

Applying Exit Framework Over the Course of Alliance Development

Our exit framework suggests a contingency-based set of exit provisions, wherein some contingencies are observed at the time of alliance formation and are used to set up the initial ease or difficulty of exit; while other contingencies are anticipated in the contractual agreement and, if encountered, are used to overrule or adjust the initial exit set up. While this discussion sheds some light on a dynamic application of the framework, it is incomplete in that it views each alliance as an endpoint in the relationship of two firms. Companies often benefit most by approaching their strategic partnerships with a mindset wherein an alliance is viewed as progressing over multiple development stages, which could involve signing new alliance agreements.²⁶ For instance, one obvious instance of this is when the dependencies between the partners in the alliance may change over the course of the alliance, necessitating a reconsideration of the exit provisions. Because each alliance stage involves a different set of contingencies, distinct governance structures and exit provisions should apply to each stage. Thus "exit" in such dynamic frameworks would signify the end of one development stage and the beginning of the next, rather than the dissolution of the entire alliance.

The 1982 partnership between Merck and Sweden-based Astra, established for the joint development of pharmaceutical products, provides an exam-

ple of a dynamic alliance.²⁷ In the partnership, Astra contributed its R&D capabilities in early-stage product development, while Merck took responsibility for later stages, capitalizing on its clinical trial and marketing expertise. The initial agreement was structured as an arm's length transaction, but it contained an exit provision: if sales of jointly developed products hit \$500 million over a one-year period, the partners would exit the current relationship and begin a new one by creating a new entity. The alliance's hugely successful product sales soon topped the \$500 million threshold and activated the stipulated hard exit provision—an appropriate arrangement for a successfully progressing venture, per our framework—requiring that Astra pay Merck \$820 million for a 50% share in the new joint venture, Astra Merck Inc. (AMI). As the new alliance progressed, another scenario discussed here arose: a change in strategic aspirations for one of the partners. Astra had grown increasingly aware that it could benefit from a stronger presence in the U.S. market, but the partnership terms with Merck precluded Astra from allying with other drug companies. Thus the joint venture had become a liability for the company. In line with a hard exit provision—consistent with our principle of compensating the partner for the exiting company's change of strategic direction—Astra offered Merck a \$4.4 billion cash buyout, coupled with partial rights to revenue streams from AMI products 10 years into the future. Pundits estimate that the total cash windfall for Merck would fall between \$7 and \$10 billion dollars, depending on AMI's sales. In return, Astra was able to establish Astra Pharmaceuticals, bringing its own and AMI's manufacturing, development, and marketing operations under Astra's exclusive ownership.

While the Astra-Merck example reflects a successful alliance, the dynamic application of the exit framework is particularly relevant to underperforming ventures. A 2004 McKinsey study found that more than 70% of surveyed companies had major underperforming alliances,²⁸ and scholars have increasingly realized that the absence of clear exit provisions often locks companies into such lagging ventures. One study, for instance, described an alliance formed to make a joint bid for an \$800 million defense contract, an offer that was ultimately rejected.²⁹ As the interviewees involved in the study recollected, "it then took about 8 months to end the joint venture because, again, we could not agree on anything."

The dynamic application of the exit framework becomes particularly important given that many organizations allow their alliances to continue in their initial form for too long, while the original conditions change in unforeseen ways, sometimes favoring a new structure. For instance, a 2004 McKinsey study found that more than 70% of companies were part of major alliances in need of restructuring. McKinsey's results further indicate that alliances that change their scope have a 79% success rate versus 33% for the ventures that remain essentially unchanged.³⁰ The dynamic application of the exit framework suggested above offers one set of tools to make sure alliances remain vibrant structures that are responsive to changes in the alliance's, partners', or external conditions.

Alliance Exit Blind Spots

Our discussions with industry practitioners and legal experts working on alliance-related issues suggest that alliance managers can successfully plan for exit by avoiding the following four typical blind spots. First, alliance managers often fail to think about explicit exit strategies while formulating their alliances, thereby falling prey to *planning-stage honeymoons*. It is not surprising, then, that we often observe a false sense of agreement between alliance partners on generally vague definitions regarding alliance terms, all in service of securing the deal. The vagueness, while providing alliance managers with an immediate sense of security, often plants seeds that sprout as disastrous dynamics during alliance dissolution. Alliance managers should therefore take time out during the alliance formation stage and plan for uncertain events or nuances that could significantly benefit one or both parties. This would involve, for example, overcoming the fear that discussing exit before a deal is cemented looks inappropriate.

Second, most alliance contracts are based on the assumption of a static business relationship, hence *missing a moving target*. As the alliance progresses, the underlying economics of the partnership can change. For instance, one partner could grow more dependent on the alliance—as was the case with Sames—thus altering the initial balance. Our research indicates that most alliance managers not only fail to consider the dynamic aspect of alliance evolution, but also underestimate their own dependence on the alliance. To avoid the grim consequences of such shortsightedness, we advise alliance managers to pay close attention to major phases in alliance development, both at the stage of alliance formation and throughout the alliance's lifespan. A dynamic application of the exit framework we suggest would require breaking down alliance development into distinct stages and considering carefully how the contingencies that alliance encounters can change from one stage to the next. This will help managers map out appropriate exit provisions for each stage.

Third, alliance managers often fail to successfully quantify the value created by the alliance, thereby running into the *Quantification Dilemma*. This may result in their inability to restructure the alliance at the right time, trigger an exit, or accurately value stocks and flows at the time of disengagement. Although stocks, given their tangible nature, are easy to value, most alliance managers find it exceedingly difficult to quantify the value of relationships they develop as a result of both various alliance-related flows and the value created by their alliance partners. Furthermore, in quantifying alliance value, most alliance managers find it difficult to estimate the possible impact the alliance can have on the firm's other lines of business. Sames, for instance, overestimated the value of its relationship with the Japanese automaker and underestimated the negative impact of emphasizing this relationship over others. While anticipating an alliance's effect on a firm's other business operations is understandably difficult at the outset, we encourage managers to think broadly about the impact of the focal alliance on the firm, including thinking beyond effects on the immediate set of business operations covered by the agreement.

Finally, in many organizations the employees who initiate the contact with the alliance partner and negotiate the terms of the deal are usually not the ones running the alliance. With respect to exit provisions, this creates what we call a *Functional Funnel*, wherein the managers of the alliance not only have no ownership of alliance exit provisions, but also sometimes have no idea what they are and how the alliance got set up that way. Specifically, in many pharmaceutical companies we interviewed, finding the partner and negotiating the alliance rests with the Business Development, Science, and Legal personnel, while managing the alliance is often split between Project Management and Alliance Management functions. The solution, aptly implemented for instance in the Eli Lilly organization, lies in involving alliance managers in the alliance formation process as early as possible. This, however, should be done with a certain degree of wisdom. First, following Lilly's example, it is reasonable to install some clear initial hurdles in the partnership screening process, so that the alliance management personnel's time and energy are spread over a manageable number of potential deals. Second, if the company pursues an aggressive negotiation philosophy, then it is advisable to keep the alliance managers in the background rather than directly involving them in the haggling process. Thus, while letting them observe the deal-structuring process and having their voices heard, it would not create the perception of alliance managers' exclusive loyalty to the parent organization at the expense of the alliance partner and the alliance itself.

Conclusion

While there may be fewer ways to leave your corporate alliance than your lover, the suggested framework is likely to save managers a lot of grief. Our recommendations about alliance exit do not merely fill a gap in the business literature. They provide the business community with a framework for planning exits from interorganizational alliances; they describe the dynamism that can make such alliances more flexible and thus more enduring and more successful; and they alert managers to some of the most common pitfalls in this process, along with offering strategies for avoiding them.

What our research demonstrates is, first, that attending to exit provisions should take a more prominent place in the alliance formation process. Despite the awkwardness of discussing a breakup when the prospective partners are still courting one another, it is paramount to discuss the possible dissolution in a thorough and systematic manner. Failure to do so may just be the first step toward a failed alliance. Second, managers should think about exit provisions not as being singular and universal, but rather as a set of several clauses activated by specific contingencies. Any singular exit provision is simply incapable of addressing all critical contingencies surrounding the market, the alliance, or its partners. Having contingency-based exit provisions enables the alliance partners to set up hard and easy exits that are either symmetric or asymmetric for the parties, depending on the nature of current and anticipated circumstances. Third, exit provisions should be conceived within a dynamic framework, where

new contingencies may overrule current setup of exit provisions, and where exit from one phase of the alliance may signify the beginning of the next. This provides the best way to manage an alliance as it progresses along different developmental phases in its lifecycle. We offer one way to think about planning for and managing such dynamism. Finally, there are four dangerous hurdles that often preclude effective planning for exit in alliances, and our research enables us not only to flag those but also to suggest ways of avoiding them. Taken together, these insights offer an integrative tool set for designing effective exit provisions in a corporate alliance, thereby enabling more robust governance of the partnership.

Notes

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13. Cf. P.S. Ring and A.H. Van de Ven, "Developmental Processes of Cooperative Interorganizational Relationships," *Academy of Management Review*, 19/1 (January 1994): 90-118.
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15. Generally, this rule would imply that once exit is initiated by one of the parties, then no future contingencies would override the active exit provisions. Exceptions, however, should be made for contract violations. For example, consider a situation where a firm's strategic direction changes and it initiates exit under an asymmetrically hard exit provision (Quadrant IV in Figure 1). If, however, a partner breaches the contract during this time, then the asymmetrically easy exit provision for the firm would be activated (Quadrant II in Figure 1).
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