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# Strategic Alliances: Why, How, and What to Watch for

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# STRATEGIC ALLIANCES: WHY, HOW, AND WHAT TO WATCH FOR

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## I. INTRODUCTION

Banking companies in the United States have historically performed three crucial functions: (i) facilitating the payments system; (ii) acting as a trusted party; and (iii) acting as an intermediary between borrowers and lenders. These functions are not mutually exclusive and banks certainly play more than just these three roles in today's economy. For example, today a bank must meet the demands of the capital markets by creating "shareholder value" or risk a material reduction in the market value of the firm and, potentially, an end to its independent existence. Banks also have to face growing competition from both traditional competitors and new players in the financial services marketplace. The modern character of the financial services industry compels banks to invest in technology and other business infrastructure in order to meet the needs of their customers. It has also forced banks to set priorities as to which businesses they want to be in and which ones they will concede to other players. These and other competitive factors have driven banks to enter into partnering arrangements and other strategic alliances.

Banks are often criticized as being behemoth dinosaurs that are victims of the innovations of smaller, faster and younger companies.

This perception is not entirely baseless. There are instances where banks have been surpassed in certain of their core businesses by more innovative financial services companies. Specialty finance companies, which have obtained funding through the securitization markets, have taken a substantial slice of bank market share in the consumer loan business. Investment banks have created a bewildering array of innovative financing instruments to provide companies with direct access to the institutional debt markets as an alternative to traditional bank financing.

History shows us, however, that banks have often been innovating leaders as they strive to perform their core businesses better and with more convenience to their customers. Bank letters of credit gave merchants the ability to freely purchase and sell goods in cross-border transactions. Credit cards are one of the most commonly used methods of payment for retail purchases of goods and services in the world. Banks have been at the forefront of the development of the products related to electronic commerce and electronic banking.

Banks have repeatedly found that, to turn innovations into profits, they must often cooperate and ally with partners in other industries and, frequently, with one another. These cooperative arrangements have taken many forms. A common form is the creation of a network, such as the Visa and MasterCard credit card networks, national and regional clearinghouse systems such as ACH and CHIPS, the various regional ATM networks and the supranational networks of networks, such as the Cirrus system. Another common form of bank-centered alliances are the standard-setting initiatives that resulted in the standardization of numerous bank-to-bank payment protocols and, more recently, electronic banking and commerce initiatives, such as the Common Electronic Purse Specification (CEPS) for stored value payment services<sup>1</sup> and the proposed Interactive Financial Exchange (IFX) messaging specification for interoperable bill payment and presentment systems.<sup>2</sup>

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1. See Jeffrey Kutler, *Smart Cards: Wide Backing Is Claimed For Visa, Proton Projects*, AM. BANKER, Feb. 3, 1999, at 11.

2. The proposal came from the Banking Industry Technology Secretariat (BITS), a division of the Bankers Roundtable, an organization of the 125 largest banks in the United States, on February 2, 1999. See *Group Invites Comments on IFX On-Line Banking Standard*, AM. BANKER, Feb. 5, 1999, at 11. It was reported that over 20 organizations participated in the development of the standard, including a number of large banking

Today's special challenges have also forced banks to engage in one-on-one partnering arrangements with both bank and non-bank partners and to enter into alliances with a limited number of other financial institutions. Bank managements recognize that these arrangements are becoming increasingly important in allowing banks to excel in their core businesses. This article will focus on these new breeds of bank alliances and will serve as a tool for bank executives and that counsel in determining what types of alliances may best help a particular institution to reach its business goals.

Today's one-on-one or multi-bank alliances are generally the product of one or more of the following factors: (i) the desire to co-opt certain opportunities of potential competitors; (ii) the need for complementary resources; (iii) the desire to share risks of large projects too big for a single bank; and (iv) the need to unite in order to surmount barriers to markets and create economies of scale.<sup>3</sup> When one or more of these factors are present, companies will often find cooperative arrangements had better meet their needs than go-it-alone strategies.<sup>4</sup>

The strategic benefits of forming an alliance can be compelling. Alliances are an expedient way to crack new markets, gain skills, technology, or products and share fixed cost resources.<sup>5</sup> Through an alliance, a company is able to quickly access a range of strategic assets, including complementary products and technology, faster and cheaper than they could be developed internally.<sup>6</sup> Some alliances are established to speed entry into a new market, to develop and commercialize new products, or to gain skills and share costs.<sup>7</sup>

The rate of return is often higher on strategic alliance activity than the rate of return on other corporate activities. A Booz, Allen &

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organizations, two joint ventures involving banks (Integrion Financial Network and TransPoint), CheckFree Corp., and AT&T Corp. *See id.*

3. *See* JOSEPH L. BADAROCCO, *THE KNOWLEDGE LINK: HOW FIRMS COMPETE THROUGH STRATEGIC ALLIANCES* 4 (1991).

4. *See* THOMAS F. VILLENEUVE ET AL., *CORPORATE PARTNERING: STRUCTURING & NEGOTIATING DOMESTIC & INTERNATIONAL STRATEGIC ALLIANCES* 1-6 (3rd ed. 1999).

5. *See* Joel Bleeke & David Ernst, *The Way to Win in Cross Border Alliances*, *HARV. BUS. REV.*, Nov.-Dec. 1991, at 127.

6. *See* V. Scott Killingsworth, *Strategic Licensing: Leveraging Technology Through Alliances*, *CYBERSPACE LAW.*, Sept. 1998, at 13, available in WL, at 3 No.6 GLCYLAW 13.

7. *See* Bleeke & Ernst, *supra* note 5, at 127.

Hamilton study found that the average return on strategic alliances is 17%.<sup>8</sup> The study also found that investments in strategic alliances achieve 50% higher returns than the returns on the same company's base assets.<sup>9</sup> At the same time, the failure rate for strategic alliances is substantial.<sup>10</sup>

Strategic alliances (as our choice of name implies) tend to be of the highest strategic importance to each party, although their strategic goals and limitations may differ considerably. It is important that each party fully understand its and the other parties' strategic goals and limitations and business philosophies and how different strategic alliance structures may either facilitate or hinder achievement of these goals. Given the delicate nature of many alliances, it is important (but often difficult) to strike a balanced deal that is consistent with each party's strategies.

Although alliances are potentially valuable strategic tools for a financial services firm, obtaining the benefit comes at the cost of dealing with a number of critical business and legal issues that can potentially constrain the firm, both as an alliance participant and as a competitor generally.

Part I of this article will discuss in greater detail the different strategic alternatives that banks must consider when considering reaching outside of the bank to achieve a certain business objective. Part II will outline in detail the principal forms of strategic alliances and how each form may be suited to the bank's strategic objectives and constraints. Finally, Part III will discuss certain legal and regulatory considerations inherent in strategic alliances.

## II. STRATEGIC RATIONALE

The reasons for forming strategic alliances are as diverse and complex as the players themselves. The mix and weighting of these

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8. See JOHN R. HARBISON AND PETER PEKAR, INSTITUTIONALIZING ALLIANCE SKILLS: SECRETS OF REPEATABLE SUCCESS (1997).

9. See *id.*

10. See JOEL BLEEKE & DAVID ERNST, COLLABORATING TO COMPETE: USING STRATEGIC ALLIANCES AND ACQUISITIONS IN THE GLOBAL MARKETPLACE 18 (1993) [hereinafter COLLABORATING TO COMPETE]; Bleeke & Ernst, *supra* note 5, at 127. One McKinney study found that fewer than one-third of alliances continue to operate after ten years. See Bleeke & Ernst, *supra* note 5, at 131-35.

strategic drivers in determining whether to enter an alliance are among the most complex and sophisticated business decisions many companies will ever make.<sup>11</sup> The reasons or drivers are both positive and negative (or offensive and defensive, as we characterize them here). In this Part, we will discuss certain offensive and defensive drivers and illustrate how they may guide a company toward a strategic alliance. Although not exhaustive, we believe this discussion will illustrate the most common drivers that banks must grapple with in today's economy, keeping in mind that multiple drivers may be present in any alliance.

#### A. *Operating Cost Reduction*

In today's economy banks are more than ever conscious of the bottom line. A common way to protect and enhance profits is to reduce operating costs. The desire to reduce operating costs will drive management to analyze which of its businesses, or services, could be performed more cheaply and efficiently by employing either an outside party with economies of scale to provide the service or an alternative method of delivering the service. Once a business or service is identified as being more expensive than necessary, management will engage in a cost/benefit or risk/benefit analysis on whether to ally with a third party to reduce costs.

A common operating cost reduction strategic alliance is a service contract, or outsourcing, arrangement. Allying with a partner that can reduce a firm's fixed or variable costs is one way to improve a firm's bottom line. For example, outsourcing data processing (and other) services can often be more cost effective than doing the work in-house, as the vendor who will provide the service will have economies of scale. Contracting certain jobs to outside providers spreads the infrastructure and technology costs over a larger base of transactions. Outsourcing lets smaller institutions offer more sophisticated services than they could with their own in-house systems, frees management from the worry that the loss of key personnel could distress their own program, and may allow the bank to unload some

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11. See Douglas G. Scrivner, *Strategic Alliances in the 1990s*, COMPUTER LAWYER, Dec. 1992, at 24, 26.

pending technological headaches, such as Year 2000 (Y2K) issues.

Increased use of technology through more integrated alliances is another way firms can do what they do more efficiently. For example, in the banking industry conducting a transaction with a teller has an estimated cost to the bank of \$1. Transactions conducted through an ATM are estimated to reduce that cost to about a quarter, while transactions conducted on the Internet are estimated to cost the bank a penny.<sup>12</sup> As you can see, these may be identical transactions with identical revenue streams attached, yet the cost can be virtually eliminated. By allying with a partner with access to beneficial technology, a bank can increase its bottom line by lowering costs using technology.<sup>13</sup>

Most cost reduction alliances result in a third party's access to the bank's customers. Depending on the structure of the transaction, this can be a negative driver. This driver is usually negligible in the service contract arrangement because the customers are blind to the existence of the third party and the third party is not a competitor. In the ATM networks, however, that driver is more significant as the bank's competitors will interact with the bank's customers every time they use another bank's ATM. Most banks have found that the positive drivers outweigh the negatives in this cost reduction mode.

#### *B. Risk and Development Cost Sharing*

Banks and other companies will often want to become involved with a cutting-edge product or technology, but will be concerned about incurring substantial development and costs without assurance of recouping those costs, due to the product's or technology's uncertain probability of success. A strategic alliance is often a way to spread development costs and downside risk among a number of entities.

These drivers are often instrumental in a bank's decision to form a strategic alliance with a technology firm. In addition to sharing costs, each of the participants in an alliance reduces its economic risk

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12. See John L. Douglas, *Banking, Technology, and the Regulatory Environment: Never Better*, 2 ELEC. BANKING L. & COM. REP. 1 (1997).

13. See, e.g., Steven Marjanovic, *Chase Forms Retail Lockbox Partnership*, AM. BANKER, Feb. 12, 1999, at 12 (reporting formation of joint venture with Regulus Group to focus on lower-margin consumer-to-corporate remittance processing).



of failure with regard to the alliance initiative. For example, a bank and a technology firm may enter into an alliance because the technology firm wishes to share the costs and risks of its product development and the bank wants to engage in a new technology, but may wish to avoid the cost of establishing a potentially fruitless independent research effort. This is frequently a motivation for co-branded product alliances offered by firms with different skill sets.<sup>14</sup>

An element of risk and development cost sharing is the choice of technology risk (for example, which bill payment and presentment platform to choose). The risk of failure associated with developing the ultimately second place company's technology can be minimized with an alliance. To further spread this risk, banks may enter more than one alliance focusing on the same technology.<sup>15</sup>

### C. Network Effects

To the extent network effects are important, the degree of exclusivity will be affected. For example, fax machines are relatively useless unless there is widespread use of the product in the marketplace. Similarly, without widespread use and acceptance of certain technologies, such as credit, debit, and smart cards, the ability to market and profit from the ownership or licensing of such technology is limited. As noted above, the VISA and MasterCard networks and various clearing house and ATM networks confer network benefits on each alliance participant that would be unachievable without the alliance.<sup>16</sup>

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14. See, e.g., Michael O'D. Moore, *Insurance: Zurich to Cover On-Line Risks in Deal with IBM*, AM. BANKER, FEB. 9, 1999, at 10 (reporting alliance between Zurich Financial Services Group and IBM to sell E-Risk Protection Program, a risk management program for financial institutions, with Zurich providing insurance against electronic commerce risks and IBM providing risk-reduction consulting services); *Goldman, ADP start 401(k) Venture*, AM. BANKER-BOND BUYER, Feb. 1, 1999, at 1, 2, available in LEXIS, News Library, ABBB File (reporting offering of defined contribution plan designed for small businesses to be sold through Goldman Sachs Asset Management's network of independent financial advisors, where Goldman will provide investment management and funding for program and Automatic Data Processing, inc. will provide administrative and record-keeping services).

15. Citigroup has taken this approach to mitigate choice of technology risk in the electronic bill presentment and fulfillment area through its internal efforts and by entering into both the Integrion and the TransPoint alliances. See *Citibank Storms EBP&P Market In TransPoint Deal With MSFDC*, FUTURE BANKER, Dec. 7, 1998, at 16.

16. See, e.g., *Twelve U.S. Banks Band Together to Form SVPCo and to Advance—*

#### D. *Setting Industry Standards*

Banks often find that a new financial product or service will require adoption by a large number of industry players to gain the widespread customer acceptance necessary for its profitability. Widespread interest in developing such a product or service will cause the banks to band together to develop the new technology, support the product or service, to promulgate standards relating to the product or service, or create a common system to provide the product or service.

Modern check clearing and mortgage origination are two examples of the desire for industry uniformity yielding market efficiencies. Uniform standards for checks have permitted the application of high-speed check routing, sorting and capture to the check clearing business, with costs savings shared by all. The standardization of practices and documentation in the residential mortgage market effectively reduces the costs of everyone seeking to originate and sell mortgage loans in the secondary market. More recently, CertCo and eight global banks have announced the formation of a joint venture intended to facilitate business-to-business electronic commerce by creating digital certificates based on a common set of rules, contracts and business practices.<sup>17</sup>

#### E. *Gain Benefit of Partner's Expertise/Strength*

Non bank firms such as technology, specialty finance, insurance and mutual fund firms have developed various products and expertise which banks would like to provide to their customers. Usually it would be an expensive and lengthy process to develop and maintain these products and expertise inside the bank, which drives banks to align with these outside firms

In the technology context, these alliances often result in licensing arrangements. The bank licensing the technology is also able to avoid undertaking a separate research effort from scratch. In

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*Finally—the Electronic Transfer of Check Information.*, FUTURE BANKER, Dec. 7, 1998, at 100 (formation of for-profit partnership to sell electronic check presentment and ACH services to other financial institutions).

17. See *Global Institutions Unite to Create a Certificate Authority Network*, FUTURE BANKER, Dec. 7, 1998, at 46.

addition, the licensor company can often effectively leverage its technological advantage with the bank's resources.

Take the example of the various providers of comprehensive, turnkey solutions that offer banks everything they need to begin offering their products and services over the Internet quickly and affordably. The suite of products offered frequently includes online banking software for retail customers, online banking software for small businesses, a customized web site, interactive calculators, secure account origination, account finder applications, search capabilities, and administrative tools, all of which would be very difficult to create on a stand-alone basis. The provider also can provide web site design, maintenance and hosting, customer service, training and support, online transaction processing, brand management, and marketing consulting. In other cases, however, a party may find that only one source exists for the technology they desire. Patents or the expertise of particular individuals may dictate that an alliance with a specific firm is the only viable way to obtain access to the desired technology, regardless of the time and money a firm is willing to spend independently.

Of course, a party seeking a technology or product solution from a third party risks dependence on another company. This dependence may cause the larger company to fail to undertake its own efforts in areas that are critical to its future. This failure can have devastating effects if the small company defaults on its obligations because of financial problems, lack of experience or capability, or if the smaller company is acquired by one of the larger company's competitors.

Creating new distribution channels and selling to customers with whom one has no prior relationship is extremely difficult, time consuming and expensive. An alliance can provide instant access to established and efficient distribution channels, as well as receptive customer bases.

In the insurance and investment product area, the bank's motivations for the alliance may be slightly different. In these alliances, the bank is often seeking to obtain a partner's operating, marketing or regulatory expertise, or access to a partner's distribution system or customer base. This is especially the case where certain products offered by the partner either cannot be provided by the bank

or the bank lacks the marketing expertise or regulatory authority to offer the product on its own. In addition, the sale of mutual funds or insurance products carry certain regulatory risks which can make mistakes in administering the sale of these products extremely costly. As the mutual fund and insurance firms are knowledgeable about these regulatory constraints, a partnering arrangement in these areas can eliminate the risks associated with violation the guidelines by transferring them to the partner. Banks should be aware, however, that many potential partners for such alliances would want access to the bank's customer information, which could be a negative driver for the bank.

By its nature, an alliance involves the sharing of access to crucial competitive tools for meeting customer needs. Unless care is taken, access to such tools can result in access to the relationship of an alliance participant with its customers. It is a commonplace today that participants in the VISA alliance compete with each other for the same customers, because of which many people have multiple cards. As data mining sophistication among financial services firms increases, firms considering participation in alliances will have to carefully consider what impact the alliance will have on their relationship with their customers and to factor such effect into their plans, whether or not they enter alliances.

#### *F. Funding*

Companies need capital. In the banking context, this driver often flows from a non-bank firm that needs investors. Banks generally are the providers rather than the seekers of capital, and will be driven into an alliance with a capital-seeking firm due to the presence of one of the other factors described in this Part. When entering an alliance, where the bank is providing capital, the bank will need to keep its own goals in mind when structuring the alliance and the means of funding the alliance. Disagreements regarding the method of funding can adversely affect the probability of forming the alliance. Each party may have different views regarding the appropriateness and desirability of equity, debt, or research and development funding. For example, the funded company may insist on contract research and development funding because it needs to

show revenues on its income statement. The bank or funding party, however, may believe that only a small portion of the funding should be made on a contract research basis and that the remainder should be equity or debt. The funded party may however have concerns about independence and may resist an equity investment. The funding party may request both the protections of debt and the potential upside of equity and may attempt to achieve this by suggesting a convertible debt investment. The funded company may object to the funding party wanting it both ways, or it may be unwilling to bear the burden of debt (since debt can affect its ability to obtain other loans and ultimately may have to be repaid) or the dilution to its shareholders of an equity investment (especially if the company believes its stock is likely to substantially increase in value over the short term due to an initial public offering or acquisition). The method of funding also may be important for other accounting and tax purposes, such as whether research and development tax credits and deductions are available and to whom they will flow.

#### *G. Competitive Advantage*

Participation in an alliance may enable a bank to obtain a strategic advantage over its competitors either by obtaining a “first user” advantage regarding a new product or service or by pre-empting competitors from obtaining such advantage. With the rapid pace of innovation and technological development, many firms will want to stay ahead of the rest of the industry in both the development and implementation of new products and technology. Today, bank customers demand an increased level of convenience and efficiency from their financial institution. Banks must therefore have access to two things (i) cutting-edge technology and (ii) a wide array of financial products.

Banks maintain an enviable position of trust with their customers, and still have perhaps the greatest array of contacts with customers of any financial services provider. The bank can strengthen existing customer relationships by placing the bank at the center of delivery of a wide array of financial and related products and services to the customer. The more products and services a bank can deliver, the more difficult it is for competitors to encroach on customer

relationships. Strategic alliances give banks the power and the ability to pioneer and innovate and thereby enter new sectors of the financial services industry while expanding and strengthening its customer base. Adept exploitation of new technologies through alliances with firms that are pioneering technologies, such as interactive kiosks, computer banking, and Internet banking, can enhance a bank's advantage in retaining and attracting customers. In addition, a bank may limit its competitors' access to a particular technology by prohibiting a strategic partner that has developed a unique technology from entering competing alliances.

By leading industry development into new markets, such as investment products and electronic banking, financial institutions can make it more difficult for customers to forego their product. Banks then become more than simply a convenient parking place for idle funds. Customers incur increasing "switching" costs as their use of new and sophisticated banking services expands. For example, a customer with a simple checking or savings account has little cost associated with abandoning one institution in favor of another. On the other hand, a customer that obtains a large number of products and services from the bank, and participates in a bank's loyalty programs, must devote substantial time and effort to change financial institutions and may sacrifice the benefits associated with being a long-time customer of the bank. Therefore, the more sophisticated products and services a financial institution offers, the more and better customers the institution is likely to attract and keep.

#### *H. Brand Extension*

A Bank will often want to increase the value of its brand by diversifying the number of products that it offers to its customers that carry the bank's brand. By heightening brand awareness, the bank will be seen as a larger market player. A Bank is in an ideal position to increase brand awareness as its customers have trust in the bank and its products and are willing to experiment with the bank's new brands. The desire to increase brand awareness will likely compel the bank to partner with firms that specialize in these products. Usually, the bank's partner will want to use the bank brand to market its products as it has not developed its own brand and therefore will have concerns

that a product offered in its name will not be accepted by customers. This melding of interests has led to the numerous private-labeling programs offered through banks.

### *I. Validation*

Many small technology or other types of companies may seek a strategic alliance as a means to validate themselves or their products in the marketplace. Often the non-bank company will look to a large bank or a well-respected smaller bank. The smaller non-bank company will anticipate that in offering its own products and services in conjunction with the identity of its larger, well-established alliance partner, the smaller company will ultimately obtain credibility with third parties. The smaller company will seek to exploit the fact that others should feel comfortable licensing their technology or using their services because XYZ Bank does so. The funded company will hope that these validation benefits (whether derived from a licensing relationship or an equity investment by the larger organization) will create a marketing "snowball." The measurable effects of the "snowball validation" are often less than the small company imagines.

Depending on the market, a firm's choice of alliance partners may have a dramatic effect on the firm's market image and strategy. Allying with a credible firm, such as a bank with a reputation as a trusted party, may be useful to capitalize on the bank's credibility or market image. Creating the alliance itself can build positive market awareness as a key player simply through publicity of the alliance. In addition, joining forces with a competitor in order to build or sustain market share may be a sound strategy. An alliance with other marketplace leaders can also help shape or design the market to one's own benefit.

Of course, association with a large bank partner may have a negative effect as well. Even where the smaller company is legally permitted to do business with competitors of the bank, the relationship itself may make the smaller company and its services unattractive to the bank's competitors for fear of the large bank partner having access to the competitors' sensitive information.

*J. Diversify*

As the lines between industries continue to blur because of regulatory and technological changes, an alliance with a key player may allow financial institutions, and technology firms, to offer new products and services. The ability to offer new products and services early may mean the difference between leading or competing in these new areas and being forced to take what is left over once those that lead the industry establish themselves. In addition, the ability to offer a variety of products and services can reduce overall enterprise risk by diversifying the bank's sources of income. Eventually, diversification will lead to stronger earnings, which will improve the bank's performance ratios, and hopefully elicit a positive response from the market.

## III. DIFFERENT FORMS OF ALLIANCES

Strategic alliances may fall anywhere in the gray area between traditional contractual arrangements and complete corporate acquisitions. Some alliances are no more than brief corporate affairs, lasting only as long as it takes one partner to establish entry into a new market. Others are the prelude to a full marriage of two or more companies' technologies and capabilities, at least in a product line, if not the entire organization. In fact, some have suggested the alliance between two firms is merely an incomplete form of merger.<sup>18</sup>

In the minds of most, the classic strategic alliance takes the form of a joint venture, where a separate entity is formed, jointly owned and controlled by the parties, to operate as an "independent" company. However, the term alliance in a broad sense encompasses a great variety of arrangements designed to address all parties' strategic needs, and accommodating their strategic constraints. Such structures may look like a classic joint venture, but with more severe constraints on the venture's operations, or take the form of a "servicing" arrangement or a consortium, designed to promulgate technology or operating standards, or a license agreement, relating to specified technology, or a joint development or marketing agreement, and may

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18. See George J. Stigler, *Mergers and Preventive Antitrust Policy*, 104 U. PA. L. REV. 176, 177 (1955).



or may not include equity investments or other equity up-side participation.

A leading authority on the subject defines a “strategic alliance” as, “any formal arrangement between two or more entities for purposes of ongoing cooperation and mutual gain.”<sup>19</sup> According to this authority, forms of strategic alliance include (but are not limited to): (i) joint ventures; (ii) licensing agreements; (iii) minority equity investments; (iv) value-chain partnerships; (v) co-marketing/co-development agreements; and (vi) consortia.<sup>20</sup> This authority further dramatizes alliances as either *pooling alliances*, where participants combine similar resources, or *trading arrangements*, where participants exchange dissimilar resources.<sup>21</sup> In all of these cases, there is at minimum a partnering agreement that is an exchange completed, often well-defined, over time.<sup>22</sup>

#### A. *Marketing Arrangements*

Marketing arrangements have always been popular in banking. Third parties always seek to market their products through banks due to the banks’ “trusted party” image and function, as well as banks’ powerful distribution networks. Banks have long sought the fee income and lower unit costs associated with offering other products through their distribution systems, such as travelers checks, insurance products and non-proprietary mutual funds.

Marketing arrangements have been effected in many ways. Historically, the most common methods of effecting marketing arrangements to bank customers have been through (i) direct marketing through the bank to customers (e.g., statement stuffers, ATM notices, branch advertising); (ii) the sale of customer lists; and (iii) referral arrangements, which have ranged from straight finder fee arrangements to percentage leases, where a bank rents lobby space to a third party who will market its products to the bank’s customers. Common methods of marketing bank products and services through

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19. Edward J. Zajac, *The Promises and Pitfalls of Strategic Alliances*, Presentation to the UNICON Conference at Northwestern University (Apr. 6, 1998).

20. *See id.*

21. *See* Stigler, *supra* note 18, at 176.

22. *See* VILLENUEVE ET AL., *supra* note 4, at 1-2.

third parties include endorsement and co-branding arrangements (e.g., credit card co-branding) and various exclusive and preferred provider arrangements, such as preferred placement on Internet web sites and the recently announced extension and expansion of the exclusive marketing alliance between First USA Bank and America Online.<sup>23</sup> The primary tension in a marketing relationship relates to control over the customer relationship.

### B. *Licensing Arrangements*

Licensing agreements are generally limited in scope and can range in importance to the parties from mundane (such as “shrink-wrap” licenses for commercially available software) to mission-critical (in a word, strategic). The latter arrangement will be discussed below.

In a license arrangement, one company will obtain existing intellectual property rights (either some proprietary technology or technical know-how trade secrets or a trademark relating to a proprietary product) from another company sufficient for the licensed party to reproduce the technology or offer the proprietary product with its own resources. The parties will enter an agreement setting forth the terms of their relationship, including the terms of the intellectual property license. Payment in these licensing arrangements typically will be in the form of up-front or on-going royalties.

Joint development agreements are a special breed of license arrangements where the objective is to design and develop a defined end-product (often a technology) within a specified time frame and cost, generally involving joint rights in the developed technology or product. Although the contract may call for R&D funding, payment is more typically made in the form of up-front and on-going royalties.

The primary tension in a joint development relationship relates to the parties' respective rights to use the technology or product for other purposes, particularly where the technology or product has been developed or highly customized for the financial partner. Depending on how much of the development costs are defrayed by the payments

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23. See *First USA in Marketing Agreement with AOL*, AM. BANKER, Feb. 4, 1999, at 28.

from the financial partner, the financial partner may insist either on strict limitations on the developer's ability to make the technology or product available to the financial partner's competitors or that the financial partner be entitled to receive a participation interest in the future royalty stream or an equity participation interest in the developer.

Parties resort to this structure when a more encompassing relationship is not reasonable or desirable, but where the technology or product partner has some proprietary technology rights or unique know how that cannot (or cannot easily) be replicated and the financial services company needs to avoid a time-consuming (if not futile) research and development effort. As with servicing and marketing arrangements, the cornerstone of these relationships is reliance on the unique skills of the partner to obtain a benefit that the financial partner realistically cannot obtain on its own. The benefits to the licensor (apart from the royalty stream itself) may include greater assurance of market acceptance of the technology or product (the "validation" effect).

### C. *Service Arrangements*

A servicing arrangement is what it sounds like; simply put, a party enters into an arrangement with a third party service provider to provide a service. Where the service is crucial and the servicing arrangement involves the third party assuming complete control over the operation of one or more of the bank's business functions, including providing its own employees, equipment and technology, for the bank (a classic "outsourcing" deal), the service arrangement may properly be called strategic.

Traditionally, these arrangements have related to "back-office" functions, such as data and item processing, customer support and call center operations, where either the only customer for the service is the bank itself or the service is provided on a private-label basis and the bank's customers are unaware that the bank is not itself providing the service.

Servicing can be defined to include any arrangement where a company delegates a core business function (or operations crucial to a core business function) to a third party. As such, servicing can be

thought of as a logical extension of a licensing arrangement. In a licensing arrangement, the licensee seeks to obtain from another company some crucial technology or intellectual property right sufficient for the licensee to utilize the technology or offer the product with its own resources. In a servicing deal, on the other hand, the party seeking to acquire servicing recognizes that merely licensing the particular "expertise" of the other party will not achieve its strategic goals. For example, the other party may possess no special technological advantage, but may merely operate at such a volume that it enjoys better economies of scale than the bank. Accordingly, one can view many "line-of-business" sale transactions, such as sales of merchant processing and credit card portfolios and corporate trust and transfer agent operations, as forms of servicing arrangements, albeit where a substantial portion of the future value in the relationship is being prepaid to the "seller" as purchase price.

Service contract arrangements are commonly found in the offering of electronic and computer banking services. Many banks have been providing electronic bill payment and fulfillment services through service contracts with entities like CheckFree Corp., and more recently, TransPoint (the Microsoft Corp., First Data Corp., Citigroup joint venture) and Integrion Financial Network, which have been focusing on the development of standard platforms and delivery systems for these services.

#### *D. Equity Participation*

Equity participations are non-controlling equity investments. Equity investments in an alliance partner can be a useful device to help close a valuation gap or to provide some measure of equity participation short of full control.

Equity participations usually take the legal form of a stock acquisition, governed by a stock purchase agreement. In a limited number of circumstances, however, equity participations have been created by using participation agreements.

Parties often use the equity participation structure where an existing company is in need of capital to finance growth or research and development and other parties interested in providing capital to the company believe that there is potential upside in an equity investment

and want to share in that potential. Often these arrangements will result in the equity participants enjoying certain pricing or other preferences from the developer company. The equity participants also have the advantage of participating in the business and reaping the rewards of the end product, as well as learning about the product before it is released to the marketplace.

There are significant risks related to an equity participation arrangement. The participants can experience a complete loss of their investment. In addition, banks are very protective of their image and a failure of the company in which they have invested could negatively impact the participants' reputations, as they will have been perceived as endorsing both the product and the company they have invested in.

In addition, there are certain tensions inherent in the equity participation alliance. The minority investors will generally have no control over changes in business direction, or worse may be subject to another minority participant's veto on a change in the developer company's direction. In addition, depending on the size of the investment, there may be a lengthy regulatory process to be contended with before any investment can be made.

The equity participation form of investment is appropriate to be used as a means of leveraging a limited investment through several partners where control is not crucial. An example of banks engaging in an equity participation in another banking enterprise is Security First Network Bank. Security First was itself a financial institution, a virtual thrift that existed only on the Internet. A group of banks made an equity investment in Security First and thereby got an inside view into the operation of Internet banking. Interestingly enough, in the summer of 1997 when Security First was having difficulty due to lagging investor confidence, six of its competitor financial institutions, including Citicorp, Huntington Bancshares and Barnett Banks, Inc., made a \$14 million investment in Security First.<sup>24</sup>

Mondex is an example of banks investing in a technology company as a means of getting access to a cutting-edge financial product. In 1996, Wells Fargo Bank, N.A., Michigan National Bank, The First National Bank of Chicago, Texas Commerce Bank, and

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24. See Steven Marjanovic, *6 Big Names Aid Net Pioneer With \$14M Injection*, AM. BANKER, Aug. 8, 1997, at 1.

AT&T Universal Card Services, Corp. all invested in equity participations as minority owners in two LLCs to operate the stored value system originated by Mondex U.S.A. Each bank participant made their investment in Mondex through newly-formed operating subsidiaries of the banks. The banks' investment in Mondex gave them an early opportunity in the stored value card business.<sup>25</sup>

The bank investments in Security First Network Bank and Mondex are examples of pure equity investments, without other formal entanglements between the parties. These are rare. More often equity investments are entered into incident to marketing, servicing or research and development licensing arrangements.

The First Union Corporation investment in Nova Corporation is an example of an equity investment coupled with a servicing arrangement. In 1995, First Union sold its merchant processing portfolio to Nova in exchange for approximately 32% of the stock of Nova. The alliance has been mutually beneficial as it has given Nova enhanced credibility in the marketplace and First Union has been able to enjoy the equity upside of Nova's success.<sup>26</sup>

An example of an equity participation arrangement coupled with a joint development arrangement is Phoenix International Ltd.'s relationship with its investor banks. In 1993, 11 community banks invested in client/server core processing software that was being developed by Phoenix, a Maitland, Florida company. The Phoenix International arrangement was designed to be an active strategic alliance between the company and the investor banks. The company encouraged the banks to invest by discounting the price of the software license to the investors. The company wanted the banks to be involved with the design of the software to ensure that it would meet the needs of the company's targeted customer base. The Phoenix International equity investments allowed the banks to enjoy the potential upside of an equity investment in Phoenix while providing Phoenix with needed research and development capital and receiving a

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25. See Jeffrey Kutler, *Wells, Chase Take Lead Stakes As Seven Invest in Mondex USA*, AM. BANKER, Dec. 5, 1996, at 1.

26. See Robert Jennings, *1<sup>st</sup> Union, 1<sup>st</sup> Fidelity in Deal With Processor*, AM. BANKER, Nov. 2, 1995, at 19 (reporting the alliance); Jeremy Quittner, *Merchant Processing Turmoil Seen in CoreStates Deal*, AM. BANKER, Dec. 3, 1997, at 13 (discussing the 32% stake acquired).

discounted license for use of Phoenix's products. It appears that the collaboration has been a success. As of the end of 1996, Phoenix International had 121 bank customers.<sup>27</sup>

Banks will also engage in equity participations as a means of protecting their customer relationships from developers of new financial products. MECA Software, L.L.C. is owned jointly by subsidiaries of BankAmerica Corporation, Citigroup, Fleet Financial Group, Royal Bank of Canada, U.S. Bancorp, and the insurance company New England Financial.<sup>28</sup> MECA performs data processing services related to its personal finance program, "Managing Your Money." One of the strategic decisions prompting the banks' acquisition of MECA was the need for the banks to take control of the customer relationship and an unwillingness to cede that relationship to Microsoft (Money) and Intuit (Quicken).<sup>29</sup>

### E. Joint Ventures

In a classic joint venture, two or more firms form a separate entity subject to their joint control to engage in some discrete business, either dealing with customers directly or providing products and services on a branded or private labeled basis through the parties. Parties resort to joint ventures in order to share specific opportunities and risks, generally independently of (although often related to) the other on-going activities of the partners, while providing a vehicle to measure their relative contributions and the benefits to be derived and to contain possible liabilities associated with the venture's activities.

In many cases, the partners will narrowly define the permissible scope of the venture's activities, either limiting the venture to a product or technology development role or limiting the scope of

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27. See Drew Clark, *Banks Putting Their Money Where Their Mouse Is*, AM. BANKER, Dec. 29, 1998, at 1.

28. See OCC Interpretive Letter 677 [1994-1995 Transfer Binder], Fed. Banking L. Rep. (CCH) ¶ 83,625 (June 28, 1995); Royal Bank of Canada, 82 Fed. Res. Bull. 363, 364 (Apr. 1996).

29. As of January 1999, MECA reported that more than a million customers use Managing Your Money through its financial institutions and claimed a 30% share of personal financial management home banking customers. See Jeffrey Kutler, *On-Line Banking: Software Pioneer Meca Seeks Buyer to Move Beyond Financial Services*, AM. BANKER, Jan. 28, 1999, at 1. MECA also reported that it was seeking a buyer, attempting to expand beyond the financial sector. See *id.*

products that it may offer to prevent cannibalization of existing customer relationships. According to many of the management consultants who review joint ventures, too narrow a scope for the joint venture may imperil the joint venture, either by foregoing the benefits of scale operations (for example, if the venture is limited to product development) or precluding access to markets closely related to the markets permissible to the venture.

The legal form of the joint venture entity may be a corporation, general or limited partnership, or limited liability company. The choice of entity will be determined primarily by liability limitation and tax considerations, although there are some fiduciary duty concerns that militate in favor of a limited partnership or limited liability company structure.

There are many examples of classic joint venture arrangements involving banks. The vast majority of these arrangements have centered on the development of new technology concepts to assist in the delivery of services related to the modernization of the payments system. Integrion, TransPoint, and the never-realized ECTC<sup>30</sup> are examples of joint ventures with this focus.

In 1996 Integrion Financial Network, L.L.C., a joint venture between twelve national banks, with IBM and other financial institutions, was formed to provide home banking and other financial services to the customers of the participating banks.<sup>31</sup> Each participant made a minority investment in Integrion through an operating subsidiary. Integrion was established to design, develop, license, and market services enabling participating financial institutions to offer their customers various services, such as traditional home banking and financial services. Integrion intends to provide its bank customers an

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30. Electronic Commerce Trust Co. (ECTC) was to be the result of a recent collaboration led by Huntington Bancshares to be engaged in the electronic bill presentment and payment business. The ECTC collaborators commissioned an extensive feasibility study and ECTC was to be a major competitor to TransPoint and CheckFree. To the authors' knowledge the ECTC venture has never materialized.

31. Conditional Approval Letter No. 221 (Dec. 4, 1996), *available in* 1996 OCC Ltr. LEXIS 139. Integrion was established as a limited liability company owned and operated by IBM, ABN AMRO North America, Bank One, Bank of America, Barnett Bank, Comerica, First Bank Systems, First Chicago NBD, Fleet Financial Group, Key Corp, Mellon Bank, Michigan National Bank, NationsBank, Norwest, PNC Bank, Royal Bank of Canada, and Washington Mutual, Inc. In 1997, First Union National Bank and Citibank joined Integrion. Visa U.S.A. also joined following Integrion's acquisition of the operations of Visa's Visa Interactive home banking and bill payment subsidiary.



alternative to existing online banking systems and products by providing a common platform for both business and consumer banking customers.

In 1998, Citigroup joined an existing joint venture called MSFDC between Microsoft Corp. and First Data Corp. As a result of Citigroup's investment in MSFDC, the venture changed its name to TransPoint. TransPoint is a provider of electronic bill presentment and fulfillment services and competes with Integrion in this area. The TransPoint investment gave Citigroup, which is also a member of Integrion, an opportunity to hedge its bets as to which player would emerge as the predominant electronic bill presentment and fulfillment provider.

Banks may also form or become involved in joint ventures as an alternative to, or in connection with a servicing arrangement. As discussed above, banks often decide to outsource certain core businesses, as they do not have the inclination or the resources to engage in these businesses in any type of scale. Certain banks, however, still want to enjoy the potential upside of the successes of these lines of business. Banks may therefore participate in joint ventures, which perform these services to a broad base of customers, as a way to derive profits from these businesses without directly engaging in them. For example, First Data Corp. has offered a joint venture structure as an alternative when it purchases merchant processing portfolios from larger banks.

#### IV. LEGAL CONSIDERATIONS

In our view, the principal obligation of counsel to strategic alliance participants is to structure and document the alliance in a manner that permits the parties to achieve, to the extent practicable, their respective strategic goals and to accommodate (or avoid) the various constraints on achievement of such goals through the alliance. To that end, counsel should carefully consider whether and to what extent the "tools" described in this section are appropriate for or can be adapted for use in the proposed venture. We use the term "tools" (as opposed to "legal issues" or some similar phrase) only to make the point that counsel may select any number of devices or techniques in designing and documenting the alliance and that the choices

appropriate for one structure and one set of strategic goals and constraints may well be inappropriate for another.

#### A. *Control and Governance*

Control is both a business and legal consideration. In acquisitions, the presumption is that the acquiror will make all business decisions after consummation (although the seller's shareholders may be "represented" on the Board of the acquiror). In a strategic alliance, however, the very nature of the relationship requires that the parties cooperate over an extended period.

From a business perspective, control may be best split evenly between the participants in a strategic alliance. Many alliance participants are so concerned about controlling the alliance that they fail to nurture it, with the result that participants fail to develop the alliance's "collaborative advantage" and thereby neglect a key resource.<sup>32</sup> A study conducted by McKinsey & Co. suggested that 50-50 strategic alliances are more likely to succeed than ventures in which ownership and management are not evenly split between participants.<sup>33</sup> The study found that the 50-50 alliance was a success for the participants 60% of the time, contrasted with only 30% success where ownership was not evenly split. The study reasoned that when the participants have equal interest in the alliance, there is a commitment to mutual success and a recognition that both participants must work hard to achieve the alliance's goals. When one participant has a majority stake, it tends to dominate decision making and put its interests above those of its partner, or for that matter, the alliance itself, with the result that both partners tend to be worse off.<sup>34</sup> This suggests that control should be allocated in such a manner as to avoid deadlock problems.

Regardless of the form of the proposed alliance, one party (or possibly both parties) will likely conclude that the achievement of one or more of its strategic goals will require that it be able to exercise

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32. Rosabeth Moss Kanter, *Collaborative Advantage: The Art of Alliances*, HARV. BUS. REV., July-Aug. 1994, at 96.

33. See McKinsey & Co., Seminar Presentation on Achieving Growth with Alliances in McLean, Va (Nov. 19 1997).

34. See Bleeke & Ernst, *supra* note 5, at 129.

some degree of control over some important aspect of the alliance or may conclude that one of its strategic constraints is that it must retain control over some aspect of the alliance's activities (such as access to its customers). In many contexts there are two conceptual varieties of control: positive control (the power to direct) and negative control (the power to reject or veto changes or, ultimately, to terminate the relationship). Control is a slippery concept, however, and frequently overrated as a useful tool, so it may be helpful to explore some of the various flavors of control, the circumstances in which they arise and possible techniques counsel may use to allocate control between the parties so as to vindicate, to the extent possible, each party's expectations.

### 1. Scope of Alliance and Obligations of Parties

Counsel should seek to reflect in the definitive alliance agreement the parties' agreement as to the intended scope of the alliance and the parties' respective rights and obligations. A clear definition (and understanding) of scope, rights and obligations may reduce the chance that the parties will later have a major misunderstanding that sours the relationship.

Of course, no one is prescient and it is neither necessary nor possible (or some would say, desirable) to cover every conceivable circumstance contractually. Counsel, however, should use the drafting process to encourage the participants to explore a wide range of possible outcomes to ensure that the structure they create is flexible enough to accommodate those outcomes. Alliances may have problems meeting their initial goals, either due to unrealistic projections at the outset or because trends, such as shifting markets, new technologies, or changing customer needs, can rarely be predicted.<sup>35</sup>

Even where the parties have entered into an alliance with a shared view as to the intended scope of the alliance's activities and their respective rights and obligations, they may differ substantially in their willingness to permit that scope or those rights and obligations to change materially in response to changing conditions. That should be

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35. *See id.* at 128.

unsurprising. One would expect the strategic goals and constraints applicable to each party to change as circumstances change, and those changed goals and constraints might well lead the parties to desire more substantial changes to the alliance (including possibly termination of the alliance) than the change proposed by the other party. As with most control issues, these are issues of positive control and negative control.

In most contractual arrangements, be they licensing arrangements or marketing alliances, veto power over the scope of the alliance is allocated to each party by default. The parties will describe the permitted uses of the licensed technology or product, will define in reasonable detail the obligations of the parties to support each other's efforts, and will set forth certain limitations on the parties' activities relating to the alliance, including limitations on the use of confidential and proprietary information. Although the agreement may leave certain matters to be agreed upon by the parties over time (for example, the precise terms of marketing efforts), the agreement generally will be quite precise as to the scope and duties of the parties and any waivers or amendments will usually require the written approval of each affected party, effectively giving veto power over changes to each party.

Unfortunately, too rigid a structure may doom the alliance. The marketplace changes quickly and the parties should place a premium on flexibility, rather than on veto power *per se*. In practice, rational parties will cooperate with each other and will agree to proposed changes to the relationship so long as their respective goals are still being met with the revised relationship.

Although the basic balance of shared veto power often works in practice, counsel should consider advising their clients to build some flexibility into the terms of the agreement. For example, in a joint development agreement, the parties may need to adjust the requirements for the technology or product being developed to account for changes in the needs of the marketplace or for unanticipated setbacks in the development process.

The parties should also pay special attention to those aspects of the relationship that they are most concerned about and only retain veto power over those matters. For example, most banks regard their customer base and the various bank-based marketing channels

available to reach those customers (proprietary mailing lists, statement stuffers, ATM notices, lobby advertising) as their most valuable intangible assets and, with good reason, are loathe to permit direct access to those customers or marketing channels without strict limitations and oversight by the bank and mechanisms to avoid diluting the bank's relationship with its customer. Hence, the frequent use of private label programs to offer products and services under the bank's name (for example, in such contexts as agent bank offerings of credit cards and offers of many investment products) and more recently through co-branding arrangements.<sup>36</sup> While the bank may be more concerned about the manner in which customers will be solicited, the third party may desire the flexibility to meet market demand by modifying the precise terms and conditions of the product or service being offered. To the extent counsel can elicit sufficient information from the parties to recognize those differing concerns, counsel can draft the agreement to provide the bank veto control over the marketing (and cross-marketing) arrangements, while giving the alliance partner the positive power to adjust the terms of the product without threat of veto by the bank.

All too frequently, however, it is not clear to whom the customer "belongs." For example, in the many arrangements banks have entered into with Intuit to offer home banking services through Intuit's Quicken personal finance software, is a bank customer who is using the Intuit product the customer of the bank or the customer of Intuit? Is it realistic to expect Intuit to refrain from providing links from the Intuit web site to various providers of competitive credit and investment services? Where a third party who generally offers certain products and services to the public agrees to provide discounted products and services to customers of the bank (and perhaps a commission to the bank) in return for the bank offering those products and services to its customers, how do the parties accurately identify who is a bank customer responding to the marketing efforts and who, therefore, ought to be "off-limits" for "predatory" cross-marketing by the third party? The parties may set forth certain presumptions (e.g., customers arriving via a link on the bank's web site or calling a

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36. See, e.g., Michael O'D. Moore, *Nationwide Teaming up with Key Corp on Annuity*, AM. BANKER, Feb. 8, 1999, at 13 (describing proposed offering of Nationwide Financial Services co-branded variable annuity through KeyCorp).

dedicated toll-free number assigned to the bank belong to the bank) or solicit feedback from the customer (“How did you learn about our services?”) to determine to which party the customer belongs, but those are imperfect devices at best.

In the major outsourcing arrangements, control concerns raise different issues. More so even than in other contractual relationships, the parties will define in excruciating detail the respective obligations of the parties, standards for performance, and the like, but there will always remain a desire to preserve the flexibility to adjust the relationship for changed circumstances. For example, an acquisitive bank may be concerned about getting priority in accommodating its desires for the timing of conversion of acquired companies’ systems. A possible seller may desire the flexibility to sell the institution without paying an extortionate termination fee. An outsourcing arrangement also creates a long term dependence on a single vendor. The bank will have lost, in most instances, equipment, personnel and day-to-day control over a vital component of its business. Since the fate of the vendor may become the fate of the bank, the bank may desire the ability to revisit the arrangement after a period of time or to terminate the relationship even in the absence of breach.

Similarly, in combined sale and marketing arrangements, retention of the power to adjust the relationship may be of vital importance to the seller. Where banks have sold their credit card or merchant processing portfolios to larger players, the acquiror will typically insist on a long-term (often five to seven year) exclusive marketing relationship and the right to purchase any subsequently acquired portfolios. When the selling bank acquires a bank that is also subject to such a marketing obligation, it must either be able to terminate the acquired bank’s arrangement or, if unable to do so, must be able to carve that bank’s franchise out of its own obligations.

If the scope of the strategic alliance is too narrow, or the terms too restrictive, the alliance participant may lock itself into a relationship as a result of which it is unable to adjust its business to react to competitive or technological changes. Similarly, smaller alliance participants (particularly a smaller technology or niche product company) may be concerned that the terms of the alliance put such constraints on its options that the alliance becomes, in effect, an inadvertent (at least from the smaller company’s perspective)

acquisition of the smaller company by the larger participant. This latter concern can occur where licenses are broad (covering technology, especially core technology, and not just products) and exclusive, or where restrictive rights of first offer or first refusal on new products make it extremely difficult for the smaller company to do deals with any third party. An over-broad or exclusive license may also make acquisition of the smaller participant unattractive to third parties.

## 2. Control Over Other Party

Most alliances are entered into only after careful consideration of the proposed alliance partners and the expertise, proprietary knowledge and technology and financial resources that they bring to the table. Accordingly, it is not unusual to find that most alliance agreements provide that the parties' respective rights and obligations are not assignable (sometimes even to affiliates) without the prior consent of the other party and that if one party experiences a change in control, the other party may terminate the alliance.<sup>37</sup> Further, many alliance agreements will treat an assignment by operation of law (other than perhaps to an affiliate) as a change in control, perhaps entitling both the assigning party and the other party the right to terminate the alliance.

These concerns also commonly express themselves in the form of non-competition and non-solicitation covenants, where one party obtains covenants from the other party that it will refrain from entering into certain competitive lines of business during the life of the venture or refrain from soliciting customers. In the case of ventures, the covenants might run to the business and customers of the venture. In other cases, the covenants might run to business and customers of the venture partners. To the extent the non-competition covenants extend to affiliates (and they usually do), the covenanting party will desire that exceptions be drawn for pre-existing relationships and investments, fiduciary and custodial investments on behalf of trusts,

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37. See, e.g., Cheryl Winokur, *Do Marketer Buyouts Hurt Customers? Some Small Banks Fear Client Poaching If Rival Buys 3d-Party Firm*, AM. BANKER, Feb, 1, 1999, at 6 (describing concerns expressed by small banks about large bank and insurer acquisitions of third party marketing firms that small banks use to distribute investment products).

employee benefit plans, advised mutual funds and the like, de minimus (typically less than 5%) equity investments in public companies, and immaterial acquisitions of businesses engaged in competitive businesses (with either the power to retain the immaterial competitive business or to enjoy some reasonable period to dispose of it in an orderly manner).

### 3. Control Issues Specific to Ventures

Alliances that take the form of a jointly owned enterprise raise substantially similar control concerns, but the range of circumstances is potentially broader and the opportunities to design creative governance structures are more numerous. Ventures are typically created as a separate entity, jointly owned and controlled. In these cases, there are likely to be three levels of authority: (i) the highest authority, being at the shareholder or partner level; (ii) the day-to-day operational authority, being at the board of directors or partnership level; and (iii) the executive authority, being at the officer or general manager level. A well-crafted alliance agreement will deal with the kinds of matters that must be approved by the shareholder or partners, the kinds of matters that must be approved by the board of directors or the partners committee, and the kinds of matters that are delegated to the officers of the venture.

Perhaps second only to management concerns, parties seek to exert some measure of control over their financial commitment. Where a separate venture is created (and often in other structures as well), the parties are often expected to make a financial commitment to the enterprise, either in the form of equity contributions to an entity (either a venture or as a minority equity investment) or to expend funds or otherwise devote significant resources to the alliance.

Although the parties may readily agree on the initial financial obligations of the parties, more difficult questions arise when the alliance needs more working capital, either to make additional capital expenditures or to fund operating losses. The decisions regarding these additional obligations and their allocation among the participants must be discussed thoroughly in advance, and mechanisms for allocation should be specified in the alliance agreement. In addition, a decision should be made as to the relative liabilities of each participant



in the event a venture borrows funds.

One of the more difficult aspects of an alliance entails deriving a procedure for approving annual operating and capital budgets. Generally, all of the participants will want to participate in such a decision, particularly if the decision means contributing additional funds to the alliance. On the other hand, the alliance could be stymied by the failure of one participant to agree to a budget in order to avoid making additional capital contributions.

A solution may be to have five-year budgets at all times. In that case, should the participants be unable to agree on a budget in the second year of a five-year budget, the second year budget of the original five-year budget would be deemed approved for the new year. Though the second year of a five year budget will inevitably be in error, this flawed solution may be preferable to operating with no budget. Alternatively, the parties may agree that, in the absence of agreement, the alliance will operate under the prior year's budget, perhaps adjusted for inflation or business volume.

Alternatively, the alliance may agree to institute a majority rule for budgets, with the majority being obligated to advance the funds either as a loan or as a dilution of the equity of the non-advancing partners. Of course, various default and termination provisions (discussed below) could come into play in the case of the participants being unable to agree on a relevant budget.

In the event that a participant fails to contribute the additional funds required of in the original agreement, a remedy must be carefully crafted. The first and most critical remedy should be to divest the defaulting participant of its control or vote with respect to the alliance. The second remedy should deal with the monetary obligation. This remedy would include the right to dilute the ownership of the defaulting participant, the right of the non-defaulting participants to make loans to the alliance at penalty interest rates, the right to sue the defaulting participant for its failed contribution and the right to buy its interest at some specified formula price.

In the event that it is difficult to determine which participant is in default because no participant actually contributed the required funds to the alliance (because the non-defaulting participant may not want to contribute its funds to the alliance if the defaulting participant refuses to contribute, and the alliance is close to insolvent) an escrow

arrangement may be appropriate. An escrow arrangement may be used to verify the defaulting versus the non-defaulting participant and to protect the funds of the non-defaulting participant from going into an alliance that is in financial trouble. This remedy, however, is only useful if the alliance and the non-defaulting participant have a good remedy against the defaulting participant, such as damages, liquidated, or otherwise.

Although not unique to venture investment, the venture agreement typically will contain restrictions on the ability of any participant to dispose of its equity investment without the consent of the other parties. This may be reflected in an absolute prohibition against transfers or in some form of first refusal or buy/sell option.

#### 4. Control Issues Specific to Minority Investments

Alliances that include as an element a minority equity investment raise different control concerns, which may be reflected in the corporate charter, partnership agreement, LLC operating agreement, shareholders' agreement, or similar document. To the extent the investing party has concerns about activities of the investee company that relate to the operations of the alliance itself (for example, marketing activities in a marketing alliance, licensing restrictions in a development alliance, and concerns about change in control of the other party), those concerns generally are not affected by the amount or level of equity investment and are best dealt with in the agreement governing that aspect of the relationship. There are, however, control concerns that both the investor and investee have that are directly related to the equity investment, and that may not be appropriately dealt with in the corporate charter, partnership agreement, or a shareholders' agreement.

Many investors will request the right to designate one or more persons to serve as directors of the investee. Such a right may pose a variety of issues when, as is typical, the investor is a customer of the investee or a competitor or potential competitor of the investee or other customers of the investee. Because of its board rights, the investor will potentially have access to information sensitive to the investee or other customers of the investee. Even if the investor does not have a representative on the investee's board, it may have access

to sensitive information through visitation rights or through financial information covenants included in the stock purchase documentation or as part of the investor's general rights as a stockholder of the investee. In addition, the very fact that the investee has a relationship with the investor may have a chilling effect on the investee's relationships with competitors of the investor.

In order to address these concerns, the investee often will negotiate restrictions on information to be provided to the investor and/or its representatives on the investee's board. In addition, agreements may be negotiated requiring the investor's designated directors to excuse themselves from portions of board meetings at which specified matters are discussed. Any such agreements must delicately balance the desire of the investor for information relevant to its investment, the desire of the investee to maintain the confidentiality of such information and to maintain relationships with third parties, and the fiduciary obligations of the investor's board representatives. If appropriate restrictions are negotiated on the investor's access to information, the investee may want to negotiate a clear understanding that it can disclose the terms of the restrictions to other customers to allay their concerns regarding the relationship between the investee and the investor.

Another control concern arising in the minority investment context is control over the business activities of the investee apart from the subject matter of the alliance. As discussed above, bank regulatory concerns may require the bank investor obtain from the investee commitments to refrain from engaging in business activities not permissible for banking organizations, lest the investor be required by its regulators to divest its investment at a time and price that it (and presumably the investee) regards as unfavorable.

The investor may prefer that these activity restrictions be contained in governing documents (such as corporate charter, partnership agreement or LLC operating agreement) to provide the strongest layer of protection, although a provision in a binding shareholders' agreement may be sufficient in many cases. The principal issues relate to enforceability; the investor will prefer the impermissible activities be beyond the power of the investee; if reflected in a shareholders' agreement, there is risk that a court will conclude that the investor has an adequate remedy at law and will

refuse to order the investee to terminate the impermissible activities.

In certain circumstances, the investee may feel so strongly about the need to retain the flexibility to engage in other businesses that it is prepared to agree to buy out the investor's stake (assuming that is acceptable to the investor and subject to resolution of any disputes regarding value) or reject the equity investment altogether. Where the investee is prepared to accept the restrictions, it will expect the investor to exercise reasonable efforts to obtain regulatory approval for the proposed new activities, but this raises other questions. Who will bear the costs of obtaining regulatory approval? Should the investor be required to sue its regulators to obtain approval? Should the investor be required to shift the investment within its corporate family to a location that may permit the broader activities?

Other control concerns relate to maintenance of the investor's position as a minority investor. For example, the investor may require either veto power over new financings (particularly financings involving securities senior to or *pari passu* with its securities or the admission of competitors as investors) or a right of first refusal on future financings, either to take the entire financing or to take up to an amount that will maintain its *pro rata* ownership percentage. The investor will be concerned about avoiding dilution from a cheap stock price in future financings, which may or may not be adequately reflected in the anti-dilution adjustment provisions of the investor's convertible preferred stock or warrants (as applicable). The investor may require first refusal rights on the securities of other investors. The investor may be concerned about the transfer of securities to competitors or loss of focus by the investee company. The investor also will be concerned about remaining trapped in its minority investment, requiring consideration of a right to sell its shares on a *pro rata* basis with sales by other shareholders (a "co-sale" right) and the various exit mechanisms discussed below.

The investee may insist on standstill restrictions on the ability of the investor to acquire securities above a certain threshold. Although that request may be motivated by a genuine concern on the part of the investee that the investor will acquire control over the company without having paid a control premium to all shareholders and without the approval of the board of directors, the investee may

also be concerned about market perception of that possibility (even if the investee regards that as unlikely), both from the standpoint of employees finding value in stock-based incentive programs and from the standpoint of customers who are competitors of the investor. In the latter case, it may be important to the long-term health of the investee (and the long-term value of the investor's investment) that the investee be able to reassure its employees and customers that, under no circumstances, can the investor acquire control of the company and be able to publicly disclose the terms of the standstill to provide that reassurance.

Finally, the investor may desire the right to acquire the entire company under certain circumstances. These provisions can be very difficult to negotiate. The parties are unlikely to agree on a buy-out price in advance, meaning the parties must either resort to a formula-based option price or seek an appraisal of the company when the buy-out option is invoked. In either case, the investee is justifiably concerned that the buy-out price be high enough to provide meaningful incentives for management and the employees to work hard for the success of the venture. On the other hand, the investor wants the buy-out price to be set at a price that is consistent with the middle range of expectations for the company's performance over time, so the option, in fact, will have value if the company exceeds expectations. In addition, the investee is likely to object to such an option if it will adversely affect its perception in the marketplace. More palatable to the investee would be a provision granting the investor a right of first offer for the entire company if and when the investee chooses to pursue possible sale of the company of its own accord. Although the investor may insist on a right of first refusal under those circumstances, the investee will likely argue that a right of first refusal will unnecessarily chill the bidding for the company and that the investor should be prepared to offer the highest price for the company if it expects to acquire the company.

### *B. Fiduciary Duties*

In every strategic alliance, regardless of structure, there are potential fiduciary duty issues to be addressed. In general, those duties can be placed in two categories: duties an alliance participant

owes to its own constituencies and duties an alliance participant owes to the alliance and/or its alliance partners.

### 1. Duties to Own Constituencies

Nearly every alliance will have the result of impairing, to some degree or another, the flexibility of an alliance partner to engage in other activities, to acquire other entities or to be acquired. Alliance features that lock in a party to the relationship or that preclude a party from engaging in certain activities or utilizing its expertise on behalf of others require consideration of fiduciary concerns.

As a general proposition, absent factors (such as conflicting interests or threatened change in control of the company) that require a more stringent judicial review of the decision-making process, corporate decisions to acquire or dispose of lines of business, enter into alliances, license technology or products, and agree to associated restrictions on activities inconsistent with those decisions (e.g., non-competition and non-solicitation covenants, exclusivity arrangements, etc.) will generally be accorded the protections of the “business judgment rule.” The business judgment rule reflects courts’ recognition that they are not able to appraise accurately the issues of value and business purpose subsumed within a board’s decision, will presumptively defer to the board’s decision and will not examine the merits of a decision so long as the board is informed and follows a deliberative process in good faith.

The business judgment rule has been articulated by the courts as a “presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”<sup>38</sup> If the business judgment rule is applicable, there is a presumption that the board in making a business decision has acted in accordance with its duties under the rule, and the burden is on the plaintiff to show by a preponderance of the evidence that the directors’ decision was primarily based on gross negligence (generally the absence of an adequately informed decision), self-dealing, fraud, lack of good faith or seeking to perpetuate themselves in office.

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38. *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984).

The “duties” of the board required to be satisfied are generally defined by the courts to include (i) being informed of all the material information reasonably available, (ii) acting in good faith, (iii) not having a conflict of interest, and (iv) making a rational decision that it believes in good faith is in the best interests of the corporation and its stockholders.<sup>39</sup> The keystone of the business judgment rule is the board’s being adequately informed. Counsel should take care to ensure that the board has available to it information about the business justification for the proposed alliance, including the relative value of various alternatives to the alliance, and the implications of the restrictions the company must agree to in order to obtain the benefits of the alliance. Of particular concern are restrictions on the company’s flexibility to pursue other alternatives that, with the passage of time, might appear more attractive than continued participation in the alliance.

## 2. Duties to Alliance and Other Partners.

Where an alliance is predicated entirely on contractual relationships, the parties will generally include broad language in the alliance agreement to the effect that the parties do not intend to form any sort of partnership, joint venture, or other common enterprise and disclaiming any fiduciary relationships, whether that of agent and principal, partners, co-venturers or otherwise. Such language is generally regarded as reliable, as far as it goes,<sup>40</sup> and the only constraints on their activities vis-à-vis each other should be those found in the alliance contract (including any covenants that may be implied at law) and in applicable law generally governing the rights of commercial parties, such as laws against unfair trade practices and the protections available under federal copyright, trademark and patent protections.

Where, however, the parties form a separate entity, whether a

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39. *See id.*

40. *Cf. Coca-Cola Bottling Co. v. Coca-Cola Co.*, 696 F. Supp. 57 (D. Del. 1988) (holding that despite characterization of relationship with bottlers as a “special partnership,” the parties were not partners or joint venturers because the necessary elements of integrated management, risk-sharing, and joint control of ownership of assets were absent).

corporation, general partnership, limited partnership, limited liability partnership or limited liability company, various fiduciary concerns arise with respect to self-dealing transactions between partners and the venture, usurpation of "corporate" opportunities by partners, and the duties of representatives of the partners serving on the governing board of the venture.

The law is reasonably clear that a general partner owes fiduciary duties both to the partnership and to each other partner.<sup>41</sup> It is also reasonably clear that the partnership agreement may be varied by agreement.<sup>42</sup> The willingness of the courts to respect the partners' right to modify traditional concepts of fiduciary duty by contract gives real meaning to the principle of freedom of contract.<sup>43</sup>

The "corporate opportunity" doctrine is an aspect of the duty of loyalty.<sup>44</sup> The purpose of the doctrine is to prevent a fiduciary from appropriating "something for himself that, in all fairness, should belong to the corporation."<sup>45</sup> The corporate opportunity doctrine

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41. See, e.g., *In Re USACafes*, 600 A.2d 43 (Del. Ch. 1991) (explaining the fiduciary duty in the nature of the duty of loyalty owed to limited partnership and limited partners); *Boxer v. Husky*, 429 A.2d 995 (Del. Ch. 1981) (holding that under the Uniform Partnership Act and the Uniform Limited Partnership Act—as adopted in both Delaware and Colorado—general partners owed a fiduciary duty to the limited partners and the duty was comparable to the fiduciary duty owed by corporate directors to shareholders). It is less clear that a limited partner owes fiduciary duties, by analogy to stockholders of a corporation, who usually (though not always) owe no fiduciary duties. Cf. *KE Property Management, Inc. v. 275 Madison Management Corp.*, C.A. No. 12683, 1993 Del. Ch. LEXIS 147, at \*25 (Del. Ch. July 21, 1993) ("to the extent that a partnership agreement empowers a limited partner discretion to take actions affecting the governance of the limited partnership, the limited partner may be subject to the obligations of a fiduciary").

42. See, e.g., DEL. CODE ANN. tit. 6 § 17-1101(d) (codifying the Delaware Revised Uniform Limited Partnership Act and stating that the partnership can be "expanded or restricted by providing in the partnership agreement").

43. See, e.g., *In Re Cencom Cable Income Partners, Consolidated* C.A. No. 14634, 1996 Del. Ch. LEXIS 17, at \*10-11 (Del. Ch. Feb. 15, 1996) (recognizing that the ability to modify fiduciary duties in limited partnerships through contract is provided for in the Delaware Limited Partnership Act).

44. See, e.g., *Science Accessories Corp. v. Summgraphics Corp.*, 425 A.2d 957, 963 (Del. 1980) (describing the doctrine of corporate opportunity); see also Stephen I. Glover, *Joint Ventures and Opportunity Doctrine Problems*, INSIGHTS, Nov. 1995, at 9 (concluding that the corporate opportunities doctrine case law does not provide participants in joint ventures with sufficient guidance on allocating new opportunities).

45. *Equity Corp. v. Milton*, 221 A.2d 494, 497 (Del. 1966).

[W]hen there is presented to a corporate officer a business opportunity which the corporation is financially able to undertake, and which, by its nature, falls into the line of the corporation's business and is of practical advantage to it, or is an opportunity in which the corporation



should be equally applicable to partnerships, subject to the right of the partners to modify those obligations by contract.<sup>46</sup> Parties contemplating a venture and desiring to set forth by contract their agreement regarding the scope of any restrictions on competitive activities would be well advised to disclaim the corporate opportunity doctrine in the governing documents for the venture.

Because of the potential competitive issues that may evolve between alliance participants and (i) the alliance itself and (ii) other participants, it is important that the organizational documents deal with the responsibilities of participants and participant personnel to the alliance. Participants should have a clear understanding at the outset of the alliance of the limitations that they and other participants have (if any) with regard to participation in activities competitive with the alliance either directly or indirectly (e.g., through another alliance). In addition, the organizational documents should clearly define the obligations of participant personnel who are also officers or directors of the alliance with regard to the use of information generated by the alliance. Finally, the negotiation of organizational documents are the best chance that minority participants may have to obtain agreement from dominant or majority participants as to their obligations to the alliance and the minority participants.

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has an actual or expectant interest, the officer is prohibited from permitting his self-interest to be brought into conflict with the corporation's interest and may not take the opportunity for himself. . . . A corollary of the . . . rule is that when a business opportunity comes to a corporate officer, which, because of the nature of the opportunity, is not one which is essential or desirable for his corporation to embrace, being an opportunity in which it has no actual or expectant interest, the officer is entitled to treat the business opportunity as his own and the corporation has no interest in it, provided the officer has not wrongfully embarked the corporation's resources in order to acquire the business opportunity.

*Id.* See also *Broz v. Cellular Info. Sys., Inc.*, 673 A.2d 148, 154-55 (Del. 1996); *Guth v. Loft*, 5 A.2d 503 (Del. 1939).

46. See, e.g., *Universal Studios, Inc. v. Viacom, Inc.*, 705 A.2d 579, 593 (Del. Ch. 1997) (discussing duties imposed by the parties' contractual agreement); *U.S. West, Inc. v. Time Warner Inc.*, C.A. No. 14555, 1996 Del. Ch. LEXIS 55 (Del. Ch. June 6, 1996) (dealing with a claim challenging managing general partner's acquisition of competing corporation as breach of duty of loyalty; although "corporate opportunity" doctrine was generally applicable to limited partnerships due to the similarity of the fiduciary duties, opportunity in question did not belong to the partnership).

### C. *Avoiding Deadlock*

As noted above, counsel should seek in the alliance agreement to provide clear allocations of decision making authority for most aspects of an alliance. To the extent that shared decision making is crucial to the success of most ventures, the parties must leave certain decisions (generally the most significant decisions) for joint determination. Disputes will arise and deadlock is always possible.

The creation of dispute resolution processes and techniques, as well as the implications of failure to resolve disputes, are best addressed at the time of the alliance's creation rather than when issues arise and relations are strained. Trying to address these issues when the parties are in substantial dispute with respect to various aspects of their business and one party is dependent upon the other for key functions is extremely difficult. If extended deadlock would permit either or both parties to terminate the alliance, exercise buy/sell options, or otherwise impose a disproportionate hardship on one party, the other party may perceive a tactical advantage in permitting (or arranging) for deadlock, counting on the risk and consequences of deadlock to encourage the other party to make concessions during the life of the alliance. The other party should explore possible deadlock resolution mechanisms with that party prior to entering into the alliance, if for no other reason than to see what life would be like partnered with a company so inclined to exercise its economic power.

Effective dispute resolution requires, to the extent practicable, that disputes be resolved as quickly as possible, without formal litigation (and arbitration for this purpose can be considered litigation) and with a minimum of damage to the relationship. The parties should strive to create procedures, such as escalation through operational and management levels ("up the food chain") and mediation, that force each party's personnel to discuss the dispute with their counterparts at the other party and preclude litigation until deadlock has been reached at the highest management levels. The parties may choose to create a joint operating committee for the alliance (regardless of whether the alliance otherwise has a formal structure) with a rotating (yearly) chairmanship having certain powers to break a deadlock.

If arbitration is a preferred final resort, the parties should consider the possible merits of short-form "baseball" arbitration,

where the arbitrator is required to pick one party's position. Such an approach would tend to encourage parties to take more reasonable positions than "traditional" arbitration, where the arbitrators are essentially unconstrained in their choice of outcomes and may be inclined to "cut the baby in half," a possibility which would tend to reward those who take unreasonable positions. Where traditional binding arbitration is utilized, the parties should recognize that the arbitrators are better able to resolve contract interpretation issues than purely business disagreements.

#### *D. Reasonable Exit Strategies*

Circumstances change and the needs of the parties change. Even the best alliances terminate at some point. Like pre-nuptial agreements, termination is a topic that most business people would prefer to avoid during their initial courtship, but really should not. The parties should carefully consider and specify: (i) under what circumstances may a party terminate; (ii) whether the entire relationship will terminate or only certain aspects (product-by-product, geographically) and (iii) what are the costs and consequences of termination (e.g., what rights, licenses and obligations cease, survive or arise upon termination). Termination should not necessarily be easy, but should be fair and reasonable to the parties.

Most every alliance agreement will specify some outside date at which the alliance will, unless extended by the parties, terminate. The parties should aim for this time period to be long enough to give the alliance time to accomplish its goals. If the alliance is intended to achieve identifiable milestones during its development, extension of the alliance may be automatic upon achievement of designated milestones by certain dates.

The alliance agreement also generally will provide that the alliance may be terminated by one party in the event of repeated material breaches of the agreement by the other party. Given the long-term nature of an alliance and the need for the parties to cooperate, no alliance agreement should permit "hair-trigger" termination, but should provide adequate dispute resolution mechanisms and remedies short of termination for relatively immaterial breaches, for which some scale of liquidated damages may

be sufficient, or even for material breaches that cannot be cured, but that are innocent and compensable by payment of damages to the injured party.

Many alliance agreements provide that either or both parties may terminate the alliance in the event it or the other party experiences a change of control. The motivations here vary. The party experiencing the change in control may desire the flexibility to be acquired by a company that cannot (or will not) abide by the restrictions in the alliance agreement. This is often the case in exclusive marketing alliance agreements, where the exclusivity obligation of the acquired company cannot be permitted to "pollute" the other businesses of the buyer. Similarly, the other party may not be interested in doing business with the acquiror, either because it is a competitor or is otherwise an unattractive alliance partner.

The parties may agree that they will each have relative freedom to terminate participation in the alliance, subject to advance notice requirements and settlement of the respective obligations of the parties. The non-terminating party would expect full reimbursement of the financial investment it has made in the alliance and the terminating party to relinquish any claims it may have in alliance work product, which may or may not be appropriate given the parties' relative contributions to the alliance.

Reciprocal buy/sell and put/call options represent both termination techniques and liquidity vehicles for venture participants. In a buy/sell arrangement, one of the parties establishes a price for a unit of equity and the other party must either buy the selling interest or sell its own interest at that unit price. Should there be three or more participants, the procedures of the buy/sell arrangement become more complex. Buy-sell provisions often contain an auction provision, under which the second participant states that it is willing to buy, but only at a price slightly higher (e.g., 3%) than the price named by the first participant. The first participant then has the opportunity to respond by indicating whether it wants to buy or sell. If it wants to buy, it must raise the price by the same amount again (e.g., 3%). This process continues until one party agrees to sell. In certain circumstances, the parties may desire the venture to have first right to purchase a tendered interest, in order to avoid disruption of the other parties' relative percentage interests.

Although buy/sell arrangements are facially neutral, they are very sensitive in operation to the number of parties and the relative financial resources of the parties. Too often one sees buy/sell options that, in practice, given the relative size and resources of the parties, can have only one result: sale of the smaller company's stake to the larger company. Techniques to mitigate the effects of disparate resources can include providing for an extended period during which the smaller party may attempt to find financing for the purchase, providing for the larger party to finance the purchase, providing for a minimum buy-out price, and specifying a date several years out prior to which the buy/sell option may not be exercised.

To the extent a proposed equity investment is "staged" over a period of time or by achievement of specified milestones, termination of the alliance may also terminate the obligation to make the investment. Under those circumstances, the investor may desire the right to accelerate its investment, if the investee otherwise appears to be an attractive investment at the negotiated price, even at the risk of having to forego some of its preferential control rights discussed above. Similarly, depending on the circumstances of termination, the investee may want the right to call the remaining investment, but may have to agree to a corresponding put right for the investor, which may be unattractive.

Depending on the form of the alliance, termination may require liquidation or sale of the alliance, which raises the issue whether either party, due to the circumstances surrounding termination, should be prohibited from purchasing assets of the venture. One study found that of ventures that were terminated, more than 75% were acquired by one of the partners.<sup>47</sup> In addition to the self-dealing concerns and concerns about rewarding a guilty party, termination of the venture may result in one or both parties losing rights to valuable intellectual property. In short, there is no substitute for careful delineation in the alliance agreement of who has what rights in the assets of the alliance upon termination.

Liquidation of the alliance would normally return each participant's original assets, with the remaining assets (if any) to be shared proportionally. This method must, of course, eliminate all of

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47. See Bleeker & Ernst, *supra* note 5, at 130.

the liabilities of the alliance. This is particularly effective where it is contemplated that goodwill might not develop if the alliance is not successful or where one of the parties is essential to the alliance and the others are not.

It may be very important to provide a “cooling off” period during which none of the termination arrangements are available to cause the parties to attempt to make the alliance work. This may also be true for “calls” where there may be a period of time when the venture is worth very little and then significantly gains value.

Not every exit strategy necessarily requires termination of the alliance. If the alliance includes a minority equity investment by one party in the other, the investee may be willing to permit the investor to monetize its investment without termination of the alliance. In this regard, the interests of the investor and the investee are not materially different from those of parties to any equity financing arrangement, such as a venture capital financing. The investor is concerned about liquidity, specifically the ability to sell when and to whom desired, the availability of a liquid (i.e., public) market for the securities and, if necessary, the right to require the investee to register resales of the investor’s shares under federal and state securities laws. The investee’s concerns are the stability of the market for its stock, the disruption and expense associated with registering shares for resale, and the possibility that the chosen purchaser for the shares might be objectionable to the investee. The only issue that is particularly unique is the possible loss of the validation (or “marquee”) benefits associated with the investor’s investment in the company, although there may be circumstances where the validation benefits have been realized and the investee now perceives the continued investment as an adverse characteristic and would encourage disposition of the investor’s stake.

#### *E. Liability Allocation*

Certain activities may expose the bank to unacceptable risks, even though they could be conducted within the bank. Common examples are real estate holdings, which may include not only foreclosed properties but the bank’s own facilities. Claims that result from the ownership or operation of properties or other businesses

outside the scope of the bank's core business may be moved outside the bank to protect the institution.

Although limited partners enjoy limited liability, a limited partnership is not likely to be a suitable format for a business alliance because all of the participants desire to be involved in the business. Generally, in a partnership all of the partners are liable for the debts of the partnership. On the other hand, shareholders of a corporation are generally not liable for the debts of the corporation. Liability in the partnership alliance, however, can be easily avoided by having each participant create its own wholly owned corporation to serve as the alliance partner of a general partnership. This shields each participant and its assets from liability for the alliance's obligations while maintaining the tax benefits of a partnership.

If a separate entity is not being formed, a technology firm will generally want to limit its risk. A technology firm will often be unwilling or unable to accept potentially unlimited risk for a product sold at a relatively modest unit price. Relative bargaining strengths of the participants will, of course, play a role in risk allocation. The use of interim testing, phased introductions, third party insurance or other devices can allow the parties to quantify, limit and address the liabilities and risks associated with a particular technology, product or service.<sup>48</sup>

#### F. *Bank Regulatory Concerns*

On the one hand, limitations on permissible activities, the form, and level of permissible equity investments, and flexibility regarding operational control will limit a firm's choice of alliance structure. Many regulatory barriers have become increasingly flexible, however, because of the rapid pace of technological innovation. The financial services industry today is experiencing the most accommodating regulatory environment in decades. Regulators seem prepared to approve virtually any type of relationship between a financial institution and a technology company if the objective is to allow the financial institution to take advantage of the technological

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48. See John L. Douglas, *Structuring Relationships Between Banks and Technology Companies: Pitfalls from the Perspective of the Banking Lawyer*, 2 ELEC. BANKING L. & COM. REP. 1 (1998).

proWess of the company to further its banking and related businesses.

The array of permissible structural alternatives for non-banking activities and investments by banking organization is vast, and the regulatory framework can be incredibly complex. The basic alternatives revolve around a few simple variables: will the activities/investment be housed in the bank or out of the bank; if out of the bank, in a holding company subsidiary or in a bank subsidiary; and will the activities/investment be controlling or non-controlling or jointly controlled?

### 1. Contract Issues

Perhaps the most straightforward form of alliance is simply a contractual arrangement, such as a joint development or licensing agreement, marketing agreement or outsourcing agreement. There are certain statutory and regulatory provisions to keep in mind in the contracting area.

Contractual arrangements entered into by a bank and a third party may create regulatory oversight. The Bank Service Corporation Act has a relatively peculiar provision stating as follows:

[W]henver a bank that is regularly examined by an appropriate Federal banking agency, or any subsidiary or affiliate of such bank that is subject to examination by that agency, causes to be performed for itself, by contract or otherwise, any services authorized under this chapter, whether on or off its premises –

(1) such performance shall be subject to regulation and examination by such agency to the same extent as if such services were being performed by the bank itself on its own premises, and

(2) the bank shall notify such agency of the existence of the service relationship within thirty days after the making of such service contract or the performance of the service, whichever comes first.<sup>49</sup>

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49. 12 U.S.C. § 1867(c) (1994).



Although not all contracts with non-bank providers are subject to this provision, to the extent that a bank has contracted out its back-office processing, customer service operations, or other banking functions to a third party, the bank regulators will want to have the right to examine the activities to assure that they are being conducted properly and appropriately.

In an Interpretive Letter, the OCC stated that the right under the Bank Service Corporation Act to oversee these nonbank providers of services is “probably narrower” than the authority to examine a bank and its subsidiaries. It went on to state that it was probably only the “performance” of the services that would be subject to examination and regulation.<sup>50</sup>

The Federal Deposit Insurance Corporation (FDIC) also has the right, under the Federal Deposit Insurance Corporation Improvements Act of 1991 (FDICIA), to address contracts. Under section 30 of the Federal Deposit Insurance Act (FDI Act), a bank may not enter into a written or oral contract with any person to provide goods, products, or services to or for the benefit of such bank “if the performance of the contract would adversely affect the safety and soundness of the institution.”<sup>51</sup> The FDIC is given the authority to promulgate regulations implementing the prohibition of the statute. Although regulations were proposed, the FDIC had a difficult time defining the types of contracts that fell within the prohibition. While the regulation was withdrawn, apparently because “the existence of adverse contracts has decreased considerably since the proposed rule was issued for comment, and because of overwhelmingly negative comments received,”<sup>52</sup> the lingering power of the FDIC to address these adverse contracts by order must be respected.

Certain contractual structures in the marketing arena raise some special concerns.

*Percentage Leases.* Banks are generally able to rent lobby space to non-bank providers of services, either on a flat fee basis or a

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50. OCC Interpretive Letter (July 26, 1989) (unpublished), *available in* LEXIS, Banking Library, ALLOCC File (addressing the scope of the OCC’s oversight with respect to CHIPS—the Clearing House Interbank Payments System—and SWIFT—Society for Worldwide Financial Telecommunications).

51. 12 U.S.C. § 1831g (1994).

52. *See* Contracts Adverse to Safety and Soundness of Insured Depository Institutions, 60 Fed. Reg. 24,296, 24,303 (1995).

percentage rent basis. This arrangement allows a bank to provide, through a third party, additional products and services to its customers on its premises, and to benefit financially through the arrangement. It may solidify customer relationships, allow the more productive use of retail floor space, and provide an additional source of fee income.

The leasing arrangements are useful in areas where the investment to create a fully competitive product is too high for the banking organization, where regulatory constraints prohibit or impede the offering of the product directly, or where a third party provider has significant marketplace advantages over the bank. Accordingly, leasing arrangements have been used with securities, insurance, travel agencies, and various other businesses.

The OCC approved percentage lease arrangements in December 1983, noting that leasing excess space “was merely an incident to the banking business,” and stating that the bank should be able to spread expenses and operating costs by renting excess space to a variety of tenants without restriction. The OCC recognized that it was possible to structure a lease arrangement so that the bank might be construed as entering into a joint venture or partnership with the non-bank provider, which would raise other issues and could even be impermissible. Such concerns could arise if the lease rate were unusually high or the terms and conditions of the lease gave the bank effective control over the operations of the lessee. Accordingly, the OCC indicated that national banks should contract on terms and conditions customary in the field of commercial leasing.<sup>53</sup>

Based on the OCC guidance, the OCC has permitted lease arrangements with insurance agencies, securities brokers and investment advisors, and indeed has stated that a national bank may enter a percentage lease with any business.<sup>54</sup> Accordingly, a bank may

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53. OCC Interpretive Letter 274, *Percentage Leasing on National Bank Premises to Insurance Agent Does Not Create Partnership*, [1983-1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,438 (Dec. 2, 1983). The OCC also indicated that certain terms ought to be incorporated in the arrangement, including: (i) language specifically negating the creation of a joint venture or partnership; (ii) language expressly stating that the bank would not be liable for the debts or liabilities of the lessee; (iii) separate identification of the non-banking company, with disclosures to avoid customer confusion; (iv) appropriate advertising, indicating the separate and independent ownership and operation of the business; and (v) an arm's length lessor-lessee relationship. *See id.*

54. *See* OCC No Objection Letter 87-8, *Leasing Branch Office Space to Corporation Offering Residential and Commercial Real Estate Brokerage and Consulting Services*,

enter an arrangement with essentially any retail organization in order to expand the products and services offered to its customers.

Somewhat ironically, banks are entering lease arrangements with other businesses as lessees, in order to gain access to the customers of other businesses. The most prevalent example is the grocery store branch, where the bank will typically lease a modest amount of space and establish a branch operation. The in-store branch operates not only as a convenience for existing bank customers, it provides a meaningful opportunity to attract new customers. Essentially the same principles that permit a bank to sub-lease space to non-bank businesses also permit a bank to lease space from non-bank businesses.

*Dual Employees.* Banks have expanded on the lease arrangement by coupling the lease with provisions where the bank and non-bank entity share employees. These employees may be either back-office employees, involved in clerical or administrative functions, or they may be sales agents or representatives offering the products and services to customers.<sup>55</sup>

The dual employee relationships raise a series of concerns regarding separateness of the businesses of the lessee and the bank. Written contracts, specifically stating duties, responsibilities, control and compensation, are required. The bank should have no duty or obligation to monitor or control the employees while engaging in their duties on behalf of the lessee. None of the bank's other employees should be providing services to the lessee. If the employee is to engage in activities on the bank's premises, the activities must be limited to those that would be permissible for the national bank. However, it should be noted that the OCC has also stated that a national bank employee can also act as agent for another entity, even if the activity is impermissible, so long as the bank receives no share of the profits resulting from the employee's activities on behalf of another, and the activity does not constitute an unsafe and unsound banking practice.<sup>56</sup>

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[1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,037 (Nov. 17, 1987).

55. See INVEST Securities Brokerage Program, 4-3 O.C.C. Q.J. 67 (Sept. 1985) [hereinafter INVEST Letter].

56. See Letter from Ford Barrett, OCC Assistant Chief Counsel, to Max Repermeiner (July 23, 1982) (on file with authors).

The other federal banking agencies have taken positions with respect to leases and employee sharing that are fairly consistent with the OCC statements. The FDIC has cautioned regarding the need for adequate contractual limitations on liability to avoid concerns regarding the bank's exposure to the activity.

States have expressed concern about leasing and employee sharing, particularly in the insurance area. A number of states have anti-affiliation statutes, prohibiting in various forms the combination of banking and insurance agency activities.<sup>57</sup> Certain of these states have viewed the leasing and employee sharing arrangements as attempts to circumvent the anti-affiliation laws.

*Sales of Customer Lists or Referral Fees.* Although a bank may be precluded from engaging in an activity directly, banks have historically been able to act as a finder or referral source for a fee, and have been able to sell customer lists and other information. Such arrangements can allow access to the customer base in exchange for additional fee income, providing advantages to the bank without any capital investment.

The OCC has stated that a national bank may act as a finder for companies offering financial and non-financial products or services.<sup>58</sup> While the bank must limit its activities to those of a "finder," and may not become involved in negotiating the actual sale of the product or service, it does allow the bank to participate to some degree in an activity that may be otherwise prohibited.

Banks have used the authority to act as finder in merger and acquisition transactions, real estate transactions and other service functions. The OCC permitted a national bank to act as a finder in informing its customers of automobile club memberships, assisting them in filling out applications, and otherwise facilitating the matching of the bank's customers with the automobile club.<sup>59</sup>

Banks can sell or lease their customer lists to non-bank providers, who in turn will solicit the bank's customers, typically by

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57. See, e.g., GA. CODE ANN. § 33-3-23 (1998) (restricting insurance transactions by lending institutions and bank holding companies).

58. See OCC Interpretive Rule on Finder Activities, 12 C.F.R. § 7.7200 (1998).

59. See OCC No Objection Letter 89-02, *National Bank Offering Automobile Club Membership Program to Its Customers*, [1989-1990 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,014 (Apr. 17, 1989).

mail or by telephone. The OCC allows such activities so long as there are no tie-in arrangements with the non-bank provider. The OCC is concerned that customers will believe that they might be forced to acquire the non-bank product or service as a condition to obtaining some service from the bank or in exchange for more favorable treatment from the bank.

Similar to the sale of the customer list, banks are permitted to include promotional materials from non-bank providers in mailings to their customers. These "statement stuffers" allow banks to capitalize on their customer relationships, hopefully in an appropriate manner. Banks, of course, will want to review and approve the materials sent, and will be rightfully concerned regarding the nature of the product or service offered. Banks may be compensated either on a flat fee basis or on some basis relative to the success of the solicitation.<sup>60</sup>

## 2. Minority Equity Investment Issues

Investing in equity securities of an alliance partner (or any other person) through the bank is difficult. National banks in general are precluded from owning common or preferred stock for investment purposes,<sup>61</sup> and state banks may not make any minority equity investment impermissible for national banks.<sup>62</sup> There are three avenues for minority equity investments, however, that may be available: through a bank holding company, through an operating subsidiary of a national bank, or through an SBIC.

*Minority Investments under the BHCA.* Section 4(c)(6) of the Bank Holding Company Act of 1956, as amended (BHCA),<sup>63</sup> allows a bank holding company to acquire shares of a company engaged in non-bank activities without approval of the Federal Reserve Board (Board) so long as the ownership interest is less than 5% of the voting shares

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60. See OCC Interpretive Letter 339, *Bank May Market Tour Packages to Its Customers*, [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,509 (May 16, 1985).

61. See 12 U.S.C. § 24 (1994).

62. See *id.* § 1831a.

63. See *id.* § 1841 *et seq.* The BHCA generally imposes strict limits on the ability of a bank holding company to engage in activities, either directly or through a subsidiary, by limiting the activities of a bank holding company to those of banking or of managing or controlling banks or so closely related to the business of banking or of managing or controlling banks as to be a proper incident thereto. See *id.* § 1843(c).

of the company.<sup>64</sup> This leeway investment authority allows a bank holding company to make smaller equity investments in companies.<sup>65</sup>

Because the Board does not want to allow these minority investments to become a substitute for more active or controlling investments, it has traditionally imposed two additional limitations. First, the minority investment must be passive, and may not be used in a way that allows the investing bank holding company to participate actively in the business. When a group of 20 bank holding companies each proposed to invest in 5% of the outstanding voting shares of an insurance entity with the intent of participating in certain underwriting and related activities, the Board determined that the BHCA section 4(c)(6) exemption was not available. It went on to state that the exemption was only available for passive investments.<sup>66</sup>

Second, the investment, regardless of how structured, cannot give the investor effective control over the company or permit it to exercise a controlling interest over the management or policies of the company. Various bank holding companies have attempted to expand the limits of permissible investments under the BHCA, and have attempted to stretch the less than 5% voting share exemption to its fullest (and beyond).

One common structure was to combine the less than 5% voting interests with large non-voting interests, contractual provisions granting control or options, warrants or other interests that provided strong assurances of compliance with the will of the investor. The Board has indicated that many of these provisions can create effective control or, at the least, may amount to impermissible controlling influence over management and policies.<sup>67</sup>

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64. *Id.* § 1843(c)(6).

65. *See, e.g.*, NationsBank Corp., 80 Fed. Res. Bull. 154 (1994) (involving debt financing combined with warrants to acquire 24.9% of the borrower's voting shares).

66. 12 C.F.R. § 225.137 (1998); *see also* FRB Interpretive Letter 4-338.2 (January 22, 1986), *available in* LEXIS, Bankng Library, ALLFED File; Insurance Underwriting—Investment in Nonbank Company, 4 Fed. Res. Reg .Service 4-600.1 (1986).

67. *See* Policy Statement on Nonvoting Equity Investments by Bank Holding Companies, 12 C.F.R. § 225.143 (1998); Statement of Policy on Nonvoting Equity Investments by Bank Holding Companies, 68 Fed. Res. Bull. 413 (1982) [hereinafter Nonvoting Equity Investments]; Michael S. Helfer and Russell J. Bruemmer, *Interstate Nonvoting Equity Agreements and "Control" Under the BHCA*, 39 BUS. LAW. 383 (1984); Letter from FRB to Richard S. Simmons, (July 8, 1982) (on file with Board) (discussing investment proposal of Chemical New York Corp. and Florida National Banks of

The earliest statements from the Board related to non-voting equity investments by bank holding companies in other banks or bank holding companies. Often described as "stake out" investments, these investments were intended to give the investing bank holding company an effective leg up on subsequent acquisitions when interstate banking became legal and the acquisition could finally be consummated. In a policy statement issued in 1982, the Board stated that a less than 5% voting interest, when combined with an investment in non-voting securities of less than 25% of the total equity, could be consistent with the BHCA. However, the Board warned that restrictions on the ability of the acquiree to sell or transfer shares or assets of its subsidiaries or otherwise restrict the rights of the owners of the shares of the acquiree could result in impermissible control. The Board indicated that various covenants or contractual provisions could not impermissibly limit the existing management's control over operations, policies, or business decisions. The Board also indicated that contractual provisions that substantially hindered the acquisition of the target by a third party would be disfavored.<sup>68</sup>

On the other hand, the Board has indicated that if the total equity investment remains below 25%, if any shares must be sold in a public offering of wide distribution, and if the target can terminate the agreement on reasonable terms and conditions, the arrangement is more likely to be acceptable. The Board indicated that each such arrangement must be evaluated individually, and requested that parties contemplating such arrangements should first consult with the Board.

The ability to use the minority investment provisions of the BHCA while following the Federal Reserve's guidelines for nonvoting equity investments provides significant advantages in certain

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Florida).

68. See 12 C.F.R. § 225.143; Nonvoting Equity Investments, *supra* note 67. Other items that the Board has indicated may be impermissible include: (i) the acquisition of shares which are non-voting only in the hands of the bank holding company, and which become voting when transferred to a third party (the Board indicated that the ability to control the transfer of voting shares may constitute control over those shares); (ii) contractual provisions limiting discretion with respect to normal management decisions, such as sale of assets, dividends, mergers or acquisitions, or the like; (iii) entering into a merger agreement with an unusually long period for consummation, without providing a mechanism for the target to terminate the agreement; and (iv) agreements giving control over the selection of directors, the voting of shares or other corporate matters, or requiring that the target consult with the investor prior to taking certain significant actions. See *id.*

situations. While the bank holding company cannot take too active a role in the business, the ability to make an investment and participate in its growth can be very useful.<sup>69</sup>

*Bank Operating Subsidiaries.* The bank operating subsidiary, in spite of the apparent restrictions that appear from the OCC's operating subsidiary regulations,<sup>70</sup> is an extraordinarily useful vehicle for structuring arrangements with non-bank providers.<sup>71</sup> Although the regulations would appear to require that a bank own not less than 50% of the subsidiary,<sup>72</sup> no such limitation is recognized in actual practice. The OCC has approved a number of arrangements in the past through operating subsidiaries where the operating subsidiary's investment was less than 50%.<sup>73</sup> The principal determination of permissibility relates to the nature of the activity itself.

The determining criteria are: first, whether the activity is

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69. See FRB Interpretive Letter (Nov. 25, 1986), available in LEXIS, Banking Library, ALLFED File (approving, subject to conditions, Sumitomo's acquisition of a 24.9% nonvoting interest in Goldman Sachs, subject to numerous restrictions on common activities).

70. See 12 C.F.R. pt. 5 (1998).

71. Although the OCC's regulations speak in terms of subsidiary corporations, the OCC has approved banks' participation in an operating subsidiary structured as a limited liability company, and has allowed banks to be limited partners in a partnership. The OCC cannot approve a bank becoming a general partner in a partnership, due to concerns relating to the unlimited liability of a partner, see *Merchants National Bank v. Wehrman*, 202 U.S. 295 (1906), but has allowed banks to establish a corporate subsidiary to serve as the general partner of a partnership.

72. See 12 C.F.R. § 5.34(d)(2) (1998). Prior to 1997, the regulation required that the parent bank own at least 80% of the voting stock of the subsidiary.

73. See, e.g., OCC Interpretive Letter 697, *Approves Indirect Ownership of 25% of a State Chartered Trust Co.*, [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,012 (Nov. 15, 1995) (approving 25% shareholder interest in trust company); OCC Interpretive Letter 689, *A National Bank Was Authorized to Hold a 60 Percent Share, Through an Operating Subsidiary, in a Limited Liability Company That Processed Credit Card Sales Transactions for Merchants*, [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-004 (Aug. 9, 1995) (addressing proposed 60% interest in LLC); OCC Interpretive Letter 517, *Banks Permitted to Establish Operating Subsidiary to form Partnership with Affiliate of Investment Bank*, [1990-1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,228 (Aug. 16, 1990) (approving 17% interest as general partner of one partnership, 17% interest as limited partner in another partnership); OCC Interpretive Letter 516, *Subsidiary Permitted to be General Partner in Joint Venture Providing Information Analysis and Execution Services*, [1990-1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,220 (July 12, 1990) (discussing 17% interest as general partner with four other partners); OCC Interpretive Letter 381, *Bank Subsidiary's Participation in Computer Processing and Automated Teller Machine Network Partnership*, [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,605 (May 5, 1987) (allowing 33 1/3% interest as general partner).



permissible; second, whether the bank can limit the activities of the investee company to those permissible for national banks; third, whether the bank's liability is limited from both an accounting and a legal perspective; and fourth, whether the investment is convenient or useful to the bank in carrying out its business, and not merely a passive investment unrelated to that bank's banking business.

Over the years, the OCC has permitted banks to form operating subsidiaries to engage in and carry out permissible activities. As long as the ownership is incidental to the banking business of the bank, and not a "speculative" investment of the bank, the prohibitions of section 16 of the Glass-Steagall Act contained in 12 USC 24(Seventh) relating to stock ownership do not apply. This view is consistent with an interpretive ruling of the OCC issued in 1966, declaring that section 16 was not intended to prohibit, and did not impair, the ability of national banks to "acquire and hold stock in corporations as an incident to and to facilitate the banks' conduct of their banking business."<sup>74</sup> This analysis applies to minority stock purchases just as it applies to wholly owned operating subsidiaries. We note that in that same year, the OCC permitted a bank to acquire a minority interest in a credit card clearinghouse owned by a number of institutions.<sup>75</sup>

The OCC has authorized similar arrangements for a wide variety of activities, including equity investments in a corporation operating a point of sale and ATM network;<sup>76</sup> in a corporation providing advice on the government securities market;<sup>77</sup> in a corporation affiliated with a captive insurer;<sup>78</sup> in a corporation providing services to participants in government securities markets;<sup>79</sup>

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74. 12 C.F.R. § 7.10 (1966).

75. See Letter of James J. Saxon, Comptroller of the Currency (October 12, 1966) (on file with OCC).

76. See OCC Interpretive Letter (Nov. 9, 1992), available in 1992 WL 486340 (discussing permissibility for national bank to invest or hold stock in particular company).

77. See OCC Interpretive Letter 543, *Membership in Corporation of Primary Dealers in Government Securities*, [1990-1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,255 (Feb. 13, 1991).

78. See OCC Interpretive Letter 554, *National Bank Purchasing Shares of Stock in a Company Affiliated with an Industry Captive Insurance Company, When Such Purchase is a Condition Precedent to the Obtaining of Insurance of the Captive*, [1991-1992 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,301 (May 7, 1990).

79. See OCC Interpretive Letter 421, *National Bank Investment in the Government Securities Clearing Corporation*, [1988-1989 Transfer Binder] Fed. Banking L. Rep.

and in a state chartered trust company.<sup>80</sup>

The second requirement is that the bank has the ability to limit the investee company to bank-permissible activities. In past letters, this requirement has been addressed in a number of ways. For instance, in partnerships, the partnership agreement can provide that the national bank retains a veto over new activities, and this is a common requirement for partnerships.<sup>81</sup> While minority shareholders in a corporation do not possess a veto power as a matter of corporate law, there are other ways, principally by contract, of assuring that the corporation does not engage in impermissible activities. A common requirement is that the articles of incorporation or bylaws limit the activities to those permissible for national banks.<sup>82</sup> The OCC recently indicated that restricting activities through a shareholders' agreement could also satisfy this requirement.

Banks normally satisfy the third requirement, that of limiting liability, through using the corporate structure for their operating subsidiaries. The corporate structure generally insulates the bank from liability or loss beyond its investment in the shares of the subsidiary.<sup>83</sup>

Further, as minority investments in operating subsidiaries are generally unconsolidated subsidiaries of the banks, the investment in the operating subsidiary would be reported under the equity method of accounting. This generally provides that losses in the subsidiary are limited to the amount of the investment (including extensions of credit or guarantees, if any, if shown on the investor's books).<sup>84</sup>

The final requirement, that the investment must be convenient or useful to the bank in carrying out its business, and not merely a

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(CCH) ¶ 85,645 (Mar. 14, 1988).

80. See OCC Interpretive Letter 697, *supra* note 70, at 81,012.

81. See, e.g., OCC Interpretive Letter 625, *National Bank Permitted to Establish Wholly-Owned Subsidiary to Participate, as a General Partner, in a Proposed General Partnership with an Insurance Company Subsidiary to Offer Investment Products*, [1993-1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,507 (July 1, 1993).

82. See, e.g., OCC Interpretive Letter, (Jan. 4, 1983) available in 1983 WL 145686 (stating that national bank may be member of corporation to operate ATM switch network).

83. See, e.g., 1 WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS, § 25 (rev. perm. ed. 1990).

84. See generally Accounting Principles Board, Op. 18, § 19 (1971) (discussing equity method of accounting for investments in common stock).

passive investment unrelated to that bank's banking business, requires that a distinction be drawn between investments consistent with the bank's business and plans, as opposed to investments made because they are good investments. The OCC generally will require the bank present the business reasons driving the bank to carry out its businesses through the subsidiary.

The revisions to the OCC operating subsidiary regulations indicate that the OCC will consider applications to engage in activities that, while closely related to or incidental to the business of banking, might not be permissible for national banks. Zions First National Bank applied in early 1997 for authority to engage in the underwriting of municipal revenue bonds, a power long sought by national banks, but otherwise impermissible. On December 11, 1997, the Comptroller approved the request, making an important statement regarding the inherent flexibility of the national bank charter.<sup>85</sup>

In June 1995, the OCC approved requests by BankAmerica Corporation and NationsBank Corporation to establish operating subsidiaries that in turn would acquire MECA.<sup>86</sup> MECA, using its "Managing Your Money" software program as the basis for offering home banking services, had entered several licensing and distribution agreements with banks. The banks proposed to acquire MECA, convert its ownership to a limited liability company, and continue the activities of MECA related to home banking and financial management services.

The OCC in its approval analyzed the intent and purpose behind its requirements relating to data processing and related services associated with banking, financial or other related economic data. The OCC had little trouble with the home banking, financial management, financial planning, investment analysis, tax estimation, and the other components of the software provided by MECA. Nor did the OCC have a problem with the ancillary services related to the foregoing, including providing checks and other financial forms. The OCC pointed to a number of prior approvals relating to such services. The OCC also noted that its prior ruling allowed a national bank to use

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85. See OCC Conditional Approval 262 (Dec. 11, 1997), available in LEXIS, Banking Library, ALLOCC File (expressing Comptroller's decision on the application by Zion's First National Bank, SLC, Utah to commence new activities in an operating subsidiary).

86. See OCC Interpretive Letter 677, *supra* note 28.

data processing equipment and technology to perform for itself or others these financial services related to the business of banking.

Of particular interest in the approval was a discussion of the ability to market the software to individuals or entities that were not financial institutions and were not customers of either of the acquiring institutions. The OCC noted that as most of the software in question was financially related, it could permissibly be marketed to non-customers. With respect to non-financial products that might have been or might be developed, the OCC viewed them as permissible "by-products" of the financial and banking products which the banks were intimately involved in developing with MECA.

The request to the OCC asked for the ability to use MECA's excess capacity in equipment, personnel, and facilities for the production and distribution of some software products that might be non-financial in nature. The OCC noted that approximately 25% of the total units, and 7% of the total revenue, were non-financial in nature. The OCC indicated that this excess capacity would diminish over time. The OCC determined that this was a permissible use of the excess capacity, pointing to earlier letters allowing marketing of records management systems manuals and supply and purchasing manuals as part of permissible data processing activities, allowing the acquisition of equipment with excess capacity, and allowing the resale of excess long lines telecommunications capacity. The OCC analogized the use and sale of the excess capacity to the ability of a national bank to lease excess real property to other businesses.

Accordingly, while the OCC imposed the typical conditions (charter limited to bank-permissible activities, the ability of the banks to withdraw if the company engaged in impermissible activities, and no liability on the part of the banks for the debts, liabilities or obligations of the company), the flexibility to actually engage in impermissible activities was not insubstantial.

Other OCC interpretive letters indicate perhaps an even greater willingness to accommodate activities that might otherwise seem to pose problems. In a letter dated August 19, 1996, the OCC indicated that a national bank could act as an Internet service provider in connection with its home banking service.<sup>87</sup> The bank wished to offer

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87. See OCC Interpretive Letter 742, *A National Bank's Subsidiary Could Provide*

home banking services to its customers and believed that it needed to offer an Internet access option for that service. The OCC determined that the Internet access service was incidental to the home banking service, and allowed the bank to provide such service to customers and non-customers alike. The OCC has allowed a bank to design and operate toll booths on a toll road, determining that the collection and transmission of funds was a part of the business of banking, and in connection therewith the bank could design and contract out the building of the toll booths and related devices.<sup>88</sup>

Of potentially more interest and importance is the recent OCC letter approving Integrion Financial Network's acquisition of warrants to acquire shares of common stock of CheckFree Corporation.<sup>89</sup> Integrion, itself the subject of an OCC letter dealing with permissible activities of operating subsidiaries of national banks, entered into a strategic alliance (essentially a servicing alliance, in the terminology used in this article) with CheckFree. In connection with the alliance, Integrion was granted warrants permitting it to acquire approximately 6% of the outstanding stock of CheckFree, and could earn additional warrants permitting it to acquire up to 16% of the outstanding stock. The investment was clearly non-controlling, and although CheckFree engaged in only bank-permissible processing activities, there was no assurance that it would continue to do so.

The OCC addressed the possibility of non-permissible activities by (i) requiring Integrion to monitor the activities of CheckFree, and to advise the OCC when or if CheckFree commenced engaging in impermissible activities; (ii) deferring the determination of how much in the way of impermissible activities would cause the OCC to require Integrion to cease its investment relationship with CheckFree; and (iii) granting Integrion a two year period in which to divest shares of CheckFree if the OCC determined divestiture were to be required due to CheckFree's impermissible activities. The OCC

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*Home Banking Services Through a Direct and Internet Connection to the Bank's Home Banking System and, Non-Bank Customers in the Bank's Service Areas*, [1996-1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-106 (Aug. 19, 1996).

88. See OCC Interpretive Letter 731, *A National Bank Could Contract to Operate an Electronic Toll Collector System*, [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-048 (July 1, 1996).

89. See OCC Conditional Approval 289 (Oct. 2, 1998), available in LEXIS, Banking Library, ALLOCC File.

strongly hinted in the letter that up to 30% of CheckFree's revenues could be derived from impermissible activities before the OCC would require divestiture, but the statement is clearly not a commitment from the OCC.

*Use of SBICs for Minority Investments.* A small business investment company (SBIC) is a permissible investment for a national bank under 12 U.S.C. section 24(seventh). A national bank may invest up to 5% of its capital and surplus in a SBIC.<sup>90</sup> As the BHCA permits bank holding companies to acquire, without approval, shares of the kinds, and in the amounts, eligible for investment by national banks, the Federal Reserve Board allows such investments as well. The Board does limit the amount of investment by a bank holding company to approximately that which a national bank could invest.<sup>91</sup>

### 3. Joint Ventures

Regardless of the nature of the other participants, activities proposed to be conducted through a joint venture structure may be housed in either a bank or bank holding company subsidiary. As a general rule, joint venture-type activity may not be conducted directly in the bank, as the regulatory authorities are concerned about the bank exposing itself to potential liabilities resulting from these ventures.

*BHC Subsidiaries and Joint Ventures.* Of all the possible structures, the bank holding company subsidiary is perhaps the easiest to accommodate to the joint venture. Under section 4 of the BHCA, Federal Reserve Board approval is required regarding voting investments of greater than 5% in any entity; the clear implication is that the investment need not be a majority or controlling investment.<sup>92</sup> Indeed, the Board orders dealing with participating in activities with other entities regularly involve less than majority positions. The Board has approved ventures involving multiple participants structured as partnerships, limited partnerships, corporations, or joint ventures under state law.

The Board does require that the venture limit its activities to

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90. See 15 U.S.C. § 682(b) (1994).

91. See 12 C.F.R. § 225.111 (1998).

92. Cf. 12 U.S.C. § 1843(c)(6) (1994).

those permissible for bank holding companies and their subsidiaries.<sup>93</sup> In fact, the Board has routinely approved joint ventures in virtually every area: data processing, trust activities, investment advisory services, mortgage banking, financing and leasing activities, ATM services, travelers checks, municipal securities brokerage, merchant credit card processing, and holding real property obtained through or in lieu of foreclosure.<sup>94</sup>

The Board will often impose a series of commitments designed to assure that the venture will be kept separate from the activities of the other participants. Such conditions are common in joint ventures with securities firms, for instance, where specific types of management interlocks may be prohibited, joint employees may be restricted, or physical separation of offices may be required. The Board may require a commitment on the part of the bank holding company to divest its interest in the venture on request of the Board.

When a non-bank venturer has control over the venture, the Board has two concerns. First, the Board believes that it has the right to supervise and examine all non-bank subsidiaries of a bank holding company. Such supervision may be seen as intrusive by non-regulated entities. Second, the Board wants to assure that the venture continues to engage only in permissible activities. Accordingly, the Board will reserve the right to examine the activities of the venture, and will in fact do so on a routine basis.

On February 6, 1996, the Board permitted The Royal Bank of Canada to acquire 20% of the voting stock of MECA Software, L.L.C.<sup>95</sup> Royal Bank applied to join BankAmerica Corporation, NationsBank Corporation, Fleet Financial Group, Inc., and First Bank Systems, Inc. as owners of MECA. As discussed above, each of the other banks owned their respective shares of MECA through bank operating subsidiaries; Royal Bank, as a foreign bank, needed the Federal Reserve's approval under Regulation Y.

In addition to its consumer financial software products and related services, which easily fall within the parameters of Regulation

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93. See *id.* § 1843(c)(8); 12 C.F.R. §§ 225.21, 225.123 (1998).

94. See PAULINE B. HELLER, FEDERAL BANK HOLDING COMPANY LAW § 5.03[7] (1986).

95. See Royal Bank of Canada, 82 Fed. Res. Bull. 363, 364 (Apr. 1996).

Y,<sup>96</sup> MECA had also developed and marketed various non-financial software, including games, a computer security program, a medical reference library, and a program providing basic legal forms. Although these activities did not fall within the Regulation Y limitations, the Board permitted MECA to keep, and indeed continue, these activities. MECA and Royal Bank indicated that the revenues from the impermissible activities were small, amounting to approximately 7% of 1994 revenues, that MECA had no intention of developing new non-financial software or to upgrade, enhance or promote its current non-financial programs, and that the non-financial portion of the company's business was expected to diminish over time. Based on the limited nature of the activity, the Board approved the acquisition and did not require the cessation or divestiture of the impermissible activities.

On February 26, 1996, the Board approved an application of *Compagnie Financiere de Paribas* to engage de novo in providing an integrated software program to operators of digital mobile telephone networks to perform billing and account-related services for customer accounts.<sup>97</sup> The software calculates bills based on data provided by the telephone operator, such as date, time, duration, and destination of the call, the customer's service contract, and individual account balances. The company also provides general accounting services, such as recording payments and balances, provides billing and settlement services, and generates various related reports to the operator.

Part of the services performed consist of customer identification and account information and the generation of certain reports used by the operator to detect fraud. While these functions would be performed only in connection with the data processing and billing services, they are not within the list of "banking, financial or economic" information described in Regulation Y. The Board, however, allowed the company to engage in these activities, describing them as a "relatively small part" of the operation of the company, "incidental" to the primary billing and account functions to be provided to the telephone operator.

Interestingly, and perhaps significantly, Paribas owns a

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96. See 12 CFR § 225.1-200 (1998).

97. See *Compagnie Financiere de Paribas*, 83 Fed. Res. Bull. 348 (Feb. 1996).



majority of France Telecom, the French national telephone operating company, and owns 49.9% of Financiere Sema, a French investment company that in turn owns 41.6% of Sema Group PLC, which developed the software. It was not stated whether Sema offered the product overseas. Sema proposed to establish the company as a wholly-owned U.S.-based subsidiary to sell the software described in the proposal.

The MECA and Paribas orders are extremely significant. The limited authority to retain or engage in some modest non-financial activities provides important "real world" opportunities for financial institutions to participate more directly in the technological revolution that will surely transform banking over the coming years.

The Board is occasionally concerned where the participants in joint ventures are very large or the activities are to be extensive, that the venture may result in an undue concentration of resources. In Deutsche Bank/Fiat Credit,<sup>98</sup> such a joint venture was disapproved, even though the venture was strictly limited to otherwise permissible activities. On the other hand, the Board recently approved a joint venture between Wells Fargo and Nikko Securities,<sup>99</sup> relating to trust and investment management services, and earlier approved a joint venture between Citicorp and Harrison Credit Corp.,<sup>100</sup> a large company engaged in the manufacture of farm equipment.

Finally, the Board has on occasion determined that a bank holding company should limit its exposure to a joint venture, and has disapproved certain ventures where it has determined that the investment in a single venture or group of ventures is too great.<sup>101</sup>

*Bank Service Corporations.* Banks also have found that the bank service corporation may be a useful vehicle for participating in joint ventures with other bank and non-bank parties.<sup>102</sup> Recently banks

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98. See Deutche Bank AG, 67 Fed. Res. Bull. 449 (1981).

99. See Wells Fargo & Co., 76 Fed. Res. Bull. 465 (1990).

100. See Citicorp, 69 Fed. Res. Bull. 648 (1983).

101. See Maryland National Corp., 65 Fed. Res. Bull. 271 (1979) (denying application of bank holding company requesting permission for subsidiary to form joint venture with General Electric Credit Corp. for purpose of leasing personal and real property).

102. A bank may not invest more than 10% of its capital in a bank service corporation, and may not invest more than 5% of its assets in all service corporations. See 12 U.S.C. § 1861(b) (1994). For this purpose, "invest" includes both equity investments and extensions of credit. See *id.*

have used bank service corporations to engage in merchant credit card processing, trust activities and mortgage banking activities.<sup>103</sup>

There are three basic types of bank service corporations: (i) the “back office” corporation, performing check sorting, posting and similar services for depository institutions, and for which no approval is required; (ii) the “bank permissible” corporation, engaging only in activities which the parent bank could engage, for which the approval of the bank’s primary federal regulator is required; and (iii) the “4(c)(8)” corporation, engaging in BHCA permissible activities, and for which the approval of the Federal Reserve Board is required.<sup>104</sup> Although the list of bank permissible and 4(c)(8) activities is virtually identical, there are occasions when it is easier and more appropriate to go to the Federal Reserve than the OCC, particularly when there are a number of bank participants operating under a number of different charters, and the venture will operate on a broad geographic basis.

Under the statute, a bank service corporation may only be owned by one or more insured depository institutions. Even the participation of a non-banking subsidiary of a bank holding company in the direct ownership of a bank service corporation will destroy the character of the entity and may call into question the ability of the bank to participate through its service corporation. Accordingly, just as with the national bank operating subsidiaries, banks will structure the service corporation as a wholly owned subsidiary, or as a subsidiary owned solely by banks, and the operating subsidiary will then participate as a venturer in the venture, either as a partner in a partnership, shareholder in a corporation, or in some other similar capacity.

#### G. *Antitrust Concerns*

Federal and state antitrust laws may place limitations on parties’ other alliance activities, such as territorial and product-market

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103. See, e.g., OCC Interpretive Letter 697, *A National Bank Was Able to Establish an Operating Subsidiary to Serve as General Partner in a Partnership That Will Own a Trust Company*, [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-012 (Nov. 15, 1995).

104. See 12 U.S.C. § 1861 *et seq.*

allocations, exclusive dealing arrangements and concerted refusals to deal. While neither the Department of Justice nor the Federal Trade Commission has issued universal guidelines or policy statements regarding the antitrust treatment of joint ventures, it is clear from the agencies' enforcement activities that the agencies are willing to consider efficiency justifications for joint ventures. Participants should be aware that any horizontal agreements (agreements among rivals) regarding price, the lowering of output or quality, allocation of customers or territories, and agreements not to deal with certain buyers except on advantageous terms may receive a quick invalidation from the court. Some courts will also look to see if there is a less restrictive alternative than a joint venture with anti-competitive effects. Exclusive dealing concerns are at the core of the Department of Justice claims against VISA and MasterCard.<sup>105</sup> Although antitrust issues are not within scope of this article, they are of vital importance and must be considered in planning any alliance.

## V. CONCLUSION

Other things being equal, most financial services executives and their counsel would prefer not to enter alliances, with their complexity and potential for loss of control of strategic assets. The trouble is that other things are not equal now among competitors (in terms of marketing savvy, technical know-how or share of wallet) and they are not likely to be equal in the future. The competitive forces unleashed by deregulation and the revolution in information and communications technology are here to stay and we have to deal with them. This being the case, it is incumbent on the executive managements and counsel of firms that want to survive to master all of the available competitive tools at their disposal and to use them to best effect.

This article has summarized a number of legal and business issues that interested parties may study as they consider the use of alliances to achieve their strategic goals. In our opinion, a necessary

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105. See Lisa Fickenscher, *Justice Dept. Probe Grows to Include Debit Cards*, AM. BANKER, Feb. 1, 1999, at 1; see also Lisa Fickenscher, *American Express: We Hit Pay Dirt With Global Card Distribution Push*, AM. BANKER, Feb. 9, 1999, at 1.

next step in this process is to consider carefully what it is that is fundamental to the firm's success. The primary obstacle to successful participation in alliances, as discussed above, involves the issue of control in various contexts. We believe that serious consideration of alliances requires that participant managements and their counsel narrow the control concern to the absolutely essential; in other words, that they ask themselves; "What is it about us, exactly, of which we fear the loss of control?" As noted above, bankers already are participants in a number of alliances; expanding their use requires a refinement of our understanding of where the line must be drawn between what we are willing to share and what must be ours alone.

While the "fundamental asset" determination may differ between financial institutions, we would suggest one particular asset that "trumps" all others: the relationship of a bank with its customers. As noted above, this "trusted institution" relationship is at the foundation of a bank's franchise and is an asset unique to each institution. After that crucial asset, we believe successful competitors in the future will view virtually everything else as "negotiable." While not all of everything else will be the subject of alliances, those institutions that best figure out how to trade through alliances for what they cannot do themselves in a superior manner will do the most to shore up their relationships with customers.

