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The potential for expropriation through joint ventures

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Abstract

We examine the potential expropriation of a firm's intellectual capital that results from joint venture agreements when a firm's joint venture partner becomes the target of an acquisition attempt. We find that: (1) non-targeted joint venture partners often suffer losses in value upon the announcement of the acquisition; (2) the magnitude of the loss increases with the R&D intensity of the non-targeted joint venture partner; and (3) average bidder returns are less negative for acquirers if the affected joint venture partners report R&D spending and are in the same line of business as the acquirer. Our estimate of the average loss is \$843 million per firm, roughly 3% of the non-targeted firm's pre-announcement equity value. Our evidence suggests a previously unrecognized merger motive in that joint ventures expose a firm's intellectual capital to the risk of expropriation.

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1. Introduction

The first expropriation of intellectual capital undoubtedly occurred shortly after the first invention. Attempts to prevent such expropriation were surely close behind. Even after laws were adopted to protect intellectual capital, avoiding expropriation has remained an imposing task. Just a year after Eli Whitney

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filed one of the first U.S. patents, 90% of all cotton gins in service were pirated versions. More recent American history abounds with tales of inventors forced to expend more resources defending intellectual capital than developing it (e.g., Dow, Edison, Goodyear, and the Wright brothers).

Current business journals overflow with news of patent infringements.¹ With our growing reliance on intellectual capital, the problem will seemingly only grow worse. In the two decades following 1976, the percentage of intangible or non-physical assets rose from 20% to 80% of the average U.S. firm's total assets (Blair & Wallman, 2001).

Unlike tangible assets, the benefits derived from a firm's intellectual capital can vanish overnight. New technology can supersede high-tech patents or unfounded rumors can undermine the reputation of established brand names. By definition, any intangible asset is difficult to clearly define and therefore difficult to contain and protect. Intangible assets may reside in the collective memories of employees, so it may depart with key employees.² Acquisitions and collaborative alliances also threaten the sanctity of intellectual capital. For example, Berg and Friedman (1978) note that the "acquisition of technical skills and know how" is the most frequently cited rationale for joint ventures; Mody (1993) contends that firms often participate in alliances to gain access to potentially valuable strategic information; and Doz and Hamel (1998) argue that alliances are particularly suited to transferring tacit, collective and embedded skills that would be difficult to learn in any other manner.

Habib and Mella-Barral (2003) contend that joint ventures would not be entered unless they were perceived to be mutually beneficial. Consistent with this argument, joint ventures generally conclude when the partner that most efficiently assimilates the shared information buys out its partner (Bleeke & Ernst, 1995; Hauswald & Hege, 2003; Kogut, 1991). Based on the propensity of joint ventures to end with buyouts Bleeke and Ernst (1995) argue that strategic alliances are generally preludes to a sale. Our intended point is that partnering with another firm in a joint venture exposes the partnering firms to the potential loss of valuable intellectual capital.³

¹ For example, "Judge Sets Court Hearing on BlackBerry Injunction," Wall Street Journal, January 26, 2006, D6 and Ron Winslow, "Will Stent Makers Fight Dentist's Patent Tooth and Nail," Wall Street Journal, January 26, 2006, B1.

² See Scott Thurm, "Companies Struggle to Pass on Knowledge that Workers Acquire," Wall Street Journal, January, 23, 2006, B1.

³ Lazzara (2001) reports the following examples involving the illegal transfer of intellectual capital stored in the brains of an employee to another employer:

- In a case opened in 1997, the Supervisor of Maintenance for PPG attempted to sell Owens-Corning Corp. a customer list, secret fiberglass formulae, videos of machines in operation, and specifics about PPG products and experiments. He even sent a letter listing 19 items of information for sale. The culprit was convicted and sent to prison.
- In December of 1997, the FBI suspected a Deloitte & Touche employee of stealing software after being terminated. The software was worth between \$4 and \$6 million. The ex-employee modified the program by deleting the Deloitte & Touche name, then tried to sell the software to a third party and foreign companies.
- An employee of a Gillette Co. subcontractor stole valuable information and drawings concerning the development of a new shaving system. The employee then disclosed some of the technical drawings to a number of Gillette competitors by fax and e-mail.
- A vice president at Preco Industries Inc., felt he was about to lose his job, so he set out to get some payback ahead of time. He anonymously mailed monthly sales forecasts, along with design and specification information, to four European competitors. Two of the recipients reported the mailings to Preco.
- An employee at Idexx Laboratory Inc. devised a scheme to steal technical data and seven binders containing marketing and other competitive information. The employee discussed the theft in an e-mail to a co-conspirator, which was also inadvertently sent to another Idexx employee.
- An installation Service Manager at Varian Associates Inc., who had signed confidentiality agreements during his tenure, resigned and went on to another company. At his new company, the employee performed the same job he had at Varian. He also downloaded information about Varian service technology from one of its own laptops. He was arrested in 1999.

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