# 30
# Negotiating the Deal

## INTRODUCTION

The previous chapters have focused largely on analysis and design, the things you can do in the confines of your own office, team, or company. With this chapter the narrative opens outward to consider the impact of counterparties in a negotiation, competing bidders, the constituencies with whom one must communicate, and the organizations to be integrated; this chapter and those following are where the rubber of analysis meets the road of behavior. These chapters teach that it remains important to *think like an investor* but that this thinking can be enriched in important ways with an understanding of the effect of human behavior on decision making.

This chapter turns specifically to the challenge of negotiating the merger agreement. Here, the practitioner needs to manage the tug of at least four kinds of polarities; none of these is an "either/or" choice; instead, one has to find a balance between the poles:

1. ***Analysis versus negotiation.*** It would be simple to assume that the analysis is behind you. But in practice, valuation and due diligence research are ongoing processes of refinement up to the consummation of the deal. The merger negotiation process is a *learning* process in which new information is revealed and must be analyzed in real time. There is no bright line that separates the analytic phase from the negotiation phase; they are linked.
2. ***Rationality versus behavioral "stuff."*** Much of the writing on M&A presumes that once you have an estimate of values and understand the incentives, the negotiation outcome will follow. This view assumes a rational actor, who lets the economic terms of the proposal speak for themselves. Yet M&A practitioners tell a richer story: *How* you present ideas has a big influence on their reception. Thus, when you enter the negotiation phase of deal development, it helps to take the perspective of a behavioralist to understand the actions of others and to anticipate the impact on others of your own actions.
3. ***Strategic versus tactical views of negotiation.*** Strategic motivations for a deal should drive negotiating strategy. Strategy lends discipline to one's participation in the talks. But strategy defines *positions* that can become ends in themselves, when in fact it is one's *interests* that really matter[1]—the dark side of strategy is inflexibility. At the other extreme is the view of negotiations as purely an exercise in bargaining tactics. We know that tactics, the moves by which you implement your strategy, can have a large influence on outcomes. But tactics devoid

of strategy may be little more than opportunism. Best practitioners manage both strategy and tactics.

4. ***Principles versus context.*** The world is messy. Each new merger negotiation presents new challenges and opportunities for lying, strategic misrepresentation, threats, and posturing of all sorts. While adaptation to circumstances is generally a virtue in business, not all adaptations are worth making. One should enter negotiations with a clear internal understanding of the principles that will guide one's own conduct, principles informed by ethical reflection. Here the guidance of ethical analysis sketched in Chapter 2 may help frame one's negotiating principles.

Howard Raiffa, one of the earliest scholars in negotiation, wrote, "It is my belief that many disputes could be more efficiently reconciled if the negotiators were more skillful." (1982, page 2) This chapter aims to enlarge the discussion of M&A deal design with insights about how skillful bargaining can affect outcomes. These insights are relevant to a range of negotiations in M&A, including the terms of an agreement (i.e., between buyer and seller), the financing (with a creditor), social issues (with the target CEO), and antitrust clearance (with the government).

## THE RELEVANCE OF NEGOTIATION PROCESS

That bargaining process affects outcomes of negotiations is consistent with a set of findings I obtained from my observation of 161 simulated merger negotiations (Bruner 1992a,b). One of the objects of the research was to examine the extent to which the bargaining outcomes conformed to predictions based on rational expectations, or whether other factors influenced the results.

If rationality strictly determined negotiation outcomes, then it should be true that deals get done if the terms meet the minimum requirements of each side. The buyer and the target enter negotiation with a privately known opening bid or ask price, and a *reservation price*[2] beyond which they will abandon negotiations. For each side, the range from opening to reservation represents the price range of an acceptable deal. If the price ranges of the two sides overlap, there exists a *zone of potential agreement (ZOPA)*—this is the range between the reservation prices. If rationality governs, deal prices should settle in the ZOPA; alternatively, if the price ranges do not overlap there should be no deal.

My study limited the negotiators to discussing price and form of payment, and then adjusted for different values attached to different forms of payment, so that the results could be boiled down to one metric: price. The findings suggest that behavioral considerations influence rational decision making.

- ***Something more than plain rationality.*** *Ex ante* reservation prices[3] explain two-thirds of the outcomes. As shown in Exhibit 30.1, 67 percent of the deals either settled where a ZOPA existed, or did not settle where a ZOPA did not exist. In the social sciences, a factor that explains two-thirds of the outcomes is very strong. But the unexplained part is equally interesting: 25 percent settled even though no ZOPA existed—this means that one or both parties agreed to terms that were worse than their reservation prices; 8 percent did not settle

**EXHIBIT 30.1** Results of a Simulated Negotiation: Distribution of Number of Negotiations Partitioned by Settlement and Existence of Zone of Potential Agreement (ZOPA)

| | Settled | Did Not Settle | Row Total |
|---|---|---|---|
| ZOPA existed | 85 cases (52.8%) | 13 cases (8.1%) | 98 (60.9%) |
| ZOPA did not exist | 40 (24.9%) | 23 14.3% | 63 (39.2%) |
| Column total | 125 (77.6%) | 36 (22.4%) | 161 (100%) |

*Note:* Percentages may not sum to 100 because of rounding.
*Source:* Bruner (1992a), page 12.

even though a ZOPA did exist—in these cases, the parties could have (should have) come to terms, but did not. Thus, in one-third of the cases, the negotiators did not reach an outcome that was economically rational in light of their *ex ante* reservation prices.

- ***Creativity plays a role.*** Unlike the rigid assumptions of mathematical game theory, bargainers tend to concoct unexpected solutions. The paramount example of this is the use of earnouts and other contingent terms of payment that are used to bridge significant differences in outlooks by the two negotiating sides. The two sides had very different expectations about the future in the negotiation problem for this study. As a result, buyers and targets attached very different values to earnouts and other contingent payments. Thus, buyers believed they were giving away little value in the form of earnouts, whereas targets believed that earnout features were highly valuable. This finding is consistent with the role of contingent payments in bridging the differences between sides in a negotiation.[4]
- ***Buying with abandonment.*** The buyers in merger negotiations tend to abandon their reservation prices much more readily than do targets. Some 44 percent of buyers settled on terms worse than their reservation prices (this is a large departure from economic rationality); only 14 percent of targets did so. Also, where one side abandoned the reservation price and the other did not, the abandoner gave up significant middle ground between the two sides. This finding is consistent with the review of announcement returns in Chapter 3 and of the departures from win-win deal zones in Chapter 21: Buyers destroy value more readily than targets.
- ***Taking ZOPA.*** Buyers give more (and targets take more) of the middle ground. Especially where a ZOPA did not exist beforehand, the buyer tended to give away more value (beyond its reservation) than did the target.
- ***Beliefs, values, and aspirations.*** These vary across negotiators and were found to have a significant influence on outcomes. The more the seller wants to settle, the lower is the buyer's payment. The more optimistic the buyer is, the higher will be the settlement price. The more pessimistic the target is, the lower will be the settlement price. These results are broadly similar to previous research.[5]

- *Tactics pay.* Tactics such as "*anchoring*," offering many proposed deals, and simply sticking with the negotiations have a significant influence on outcomes. Anchoring tends to carve up the middle ground to the anchorer's advantage. Making successive offers[6] tends to result in settlements in the counterparty's favor. And giving the negotiations plenty of time increases the odds of settling.
- *Bad stuff happens.* My debriefing of teams in laboratory simulations of merger negotiations suggests that some kinds of conduct contribute materially to negotiation failures and/or the agreement to irrational deals. These include misrepresentation of facts and opinions; threats and ultimatums; cross-cultural misunderstandings; verbal abuse; reneging on agreement; stonewalling on information; spying; offers of favors, bribes, and other forms of influence; team infighting; emotional outbursts; walking out.

## BEHAVIORAL FINANCE

What makes the findings reported in the previous section so interesting is that they depart somewhat from the predictions of "rational choice," a paradigm that prevails widely in economics and the other social sciences. Rational choice (or "rationality" for short) presumes that individuals are self-interested, that they prefer more wealth as opposed to less, and generally that their preferences are transitive (if you like A better than B, and B better than C, you will like A better than C). The rational decision maker is guided by outcomes and chooses the best. As the economist Jon Elster put it, "To act rationally is to do as well for oneself as one can."[7]

Rationality is an attractive foundation in the social sciences for two reasons. First, it simplifies the world greatly and opens up a number of important and intuitively appealing economic insights. Even the proponents of behavioral theories acknowledge the fundamental tractability of rationalism. Charles Plott (1986) wrote that the real issue is not whether the rational choice paradigm is "true or false, but rather whether the magnitude of error in predicting market phenomena is acceptable. . . . Market models based on rational choice principles . . . do a pretty good job." (Page S302)

Nevertheless, other researchers in behavioral finance point to disorderly patterns in markets that are not consistent with rationality:

- *Market volatility: manias, panics, and crashes.* Periodically, securities markets detach themselves from reality. There is no explanation for why or when these will occur, though some work by Robert Shiller (1995) points to "herd mentality" in which investors crowd together and follow trends. The herd mentality is founded on waves of information cascading through the securities market, followed by conversation among investors. More generally, securities prices seem to change not only because of changes in economic fundamentals, but also because of changes in investor sentiment or psychology. Shiller suggests that "prices change in substantial measure because the investing public en masse capriciously changes its mind." (1989, page 1)
- *Winner's curse.* In the classic barroom game, someone auctions a jar full of pennies. It is highly probable that the winner will pay more than the value of the jar and pennies. This is the *winner's curse*, a phenomenon first identified

by Capen, Clapp, and Campbell (1971) in their analysis of bidding for oil leases. Oil companies who win auctions of lease rights on oil lands tend to overpay; whether or not they actually lose money on the bidding, the winners will almost always be disappointed that the asset is worth less than they thought. In short, winning buyers tend to make outlying assessments that drive their estimates of value for the target. Capen et al. (1971) warn that "he who bids on a parcel what he thinks it is worth, will, in the long run, be taken for a cleaning."[8] The winner's curse is hugely important in M&A, and has been offered as a possible explanation for the poor returns to buyers; see, for instance, Roll (1986) and Varaiya and Ferris (1987). This phenomenon is revisited in the next chapter.

- *Loss aversion.* People view value asymmetrically: the utility of gaining a dollar is less than the disutility of giving one up—this is "*loss aversion.*" This is the outgrowth of pathbreaking research by Kahneman and Tversky (1984), and led to a better understanding of two related phenomena of great importance in M&A: *endowment effect*, in which people tend to ask more in selling an asset than they would offer to buy it, and *status quo bias*, in which people tend to stick with their current situation because the disadvantages of changing seem larger than the advantages.

There are numerous other examples of departure from what economic rationality would predict.[9] These findings imply that economics shares the decision-making stage with other considerations. Skills of bidding and bargaining may matter more than theory presently allows. To the extent this is true, you should not believe that your economic analysis of an M&A transaction will dictate the final result. Perhaps Stewart Myers said it best in commenting on the Bendix/Martin-Marietta takeover fight:

> *And it finally came to me that, in mergers, the ratio of "noise" to "signal" is very high, and that the noise is a helluva lot more fun. . . . They're idiosyncratic things that happen in a particular case, once people get into it, and once people start trying to win . . . the lesson about noise and signal is really very important. If we pose the problem of valuing a merger candidate, what you want to do is find the signal and avoid the noise. The great danger is that you start out trying to be rational and end up as a noisemaker. . . . People start out trying to be rational but they end up making mistakes in the analysis; they end up getting carried away in the heat of the battle, and they lose the kind of rationality, the kind of power, that financial analysis can bring to this kind of a problem. As Pogo used to say, "We've met the enemy and he is us."*[10]

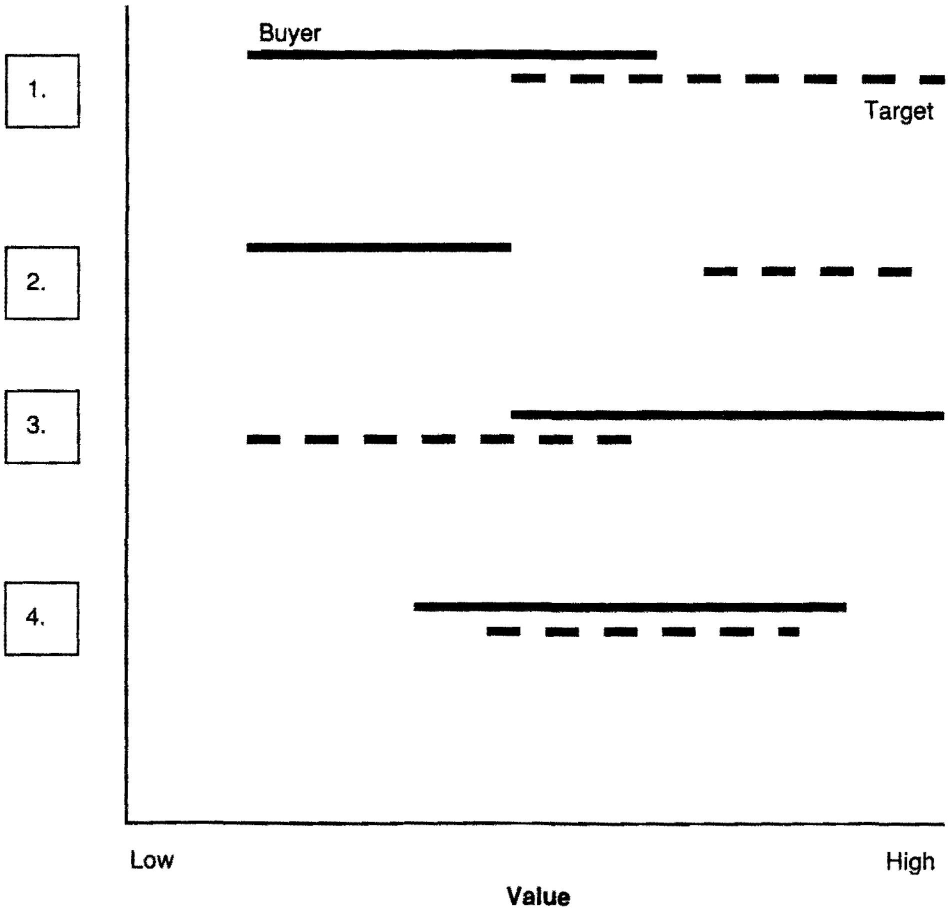
## INFLUENCING BARGAINING OUTCOMES: AN OVERVIEW OF THE CHALLENGE

From an economic standpoint alone, the bargaining problem can be summarized with value ranges and ZOPA. Exhibit 30.2 gives some examples. In the first example (1), the range of the buyer is lower than the range of the seller, but they overlap, producing the ZOPA. The buyer's range is lower typically because of the seller's great

**EXHIBIT 30.2** Find the ZOPA: Four Distributions of Buyer and Target Negotiation Ranges

The following figure presents four cases of the distribution of the bargaining ranges of the buyer (solid line) and target (dashed line):

1. The buyer has a lower bargaining range than the target, perhaps reflecting pessimism, anchoring, or risk aversion on the part of the buyer, and optimism, anchoring, or better information on the part of the target. This kind of positioning of buyer and target is commonly observed in M&A negotiation. The ZOPA is bounded by the region of overlap between the two negotiation ranges.
2. In this case, the buyer and target are positioned in the classic low/high pattern, but there is no ZOPA, because the reservation price of the buyer is below the reservation price of the target.
3. Occasionally one observes buyers with a *higher* bargaining range than the target has. This may be due to special synergies or greater optimism. The likelihood of settlement should be high in this case.
4. Occasionally one observes that the bargaining range of one side *completely surrounds* the bargaining range of the other. The likelihood of settlement should be high in this case as well.



optimism about the company and the buyer's reticent tendency (i.e., with less than perfect information, the buyer suspects that the range in which the intrinsic value of the target is to be found will be less than the target claims). The second example (2) shows no overlap; the two parties have no common ground. In simulated merger negotiations, I have observed the final two examples: in which the buyer has a higher bargaining range than the seller (3), and where one side's range completely surrounds the other side's (4). Psychology intervenes in these neat diagrams through the length and positioning of the negotiation ranges. For instance, the treatment of uncertainty and intangible values may vary dramatically among decision makers.

### Uncertainty

Chapter 9 argues that valuation ranges should embrace the range of one's certainty to an acceptable level of confidence. Ultimately, we cannot observe intrinsic value; we can only estimate it. The triangulation process that produces the valuation range is best regarded as choosing a range within a probability distribution that trades off *confidence* that the range likely embraces the true intrinsic value of the firm and *efficiency* of the estimated mean. For instance, by setting the range between zero and infinity we could achieve nearly 100 percent confidence that the range embraces the intrinsic value, but such a range would be useless. We settle for less than 100 percent confidence in order to improve our decision making.

The need for confidence and efficiency will matter to executives in various ways. Psychology can influence this *trade-off.*

### Conversion of Multiple Dimensions into a Deal

It would take a heroic effort to reduce the entire assessment of the deal to a single dollar figure. For instance, the sole owner of a target firm may want to structure a deal in a way that takes into account her regret about selling, her self-esteem over the firm she built, her care for the employees she will be leaving behind, and so on. The conversion of intangible concerns such as these into a handshake on price will vary across decision makers—psychology will influence this conversion.

In short, if psychology enters the bargaining process in ways such as these, the practitioner should learn to manage both the economics and the psychology of deal making. To "manage" means to blend both perspectives in a way that promotes successful outcomes such as those outlined in Chapter 1. This includes understanding how one's own actions might affect other party's perception of confidence and efficiency and conversion of multiple dimensions. It also includes recognizing when the counterparty is trying to affect *your* thinking, and how to guard against it. The following sections lend some practical advice on how to work on both realities and perceptions in a negotiation.

## PRACTICAL ADVICE: HOW TO PREPARE FOR A NEGOTIATION

Sound prenegotiation homework helps the deal maker anticipate and respond to the other side's tactics and unusual behavior that might otherwise influence or derail the negotiations. Economic and strategic analyses provide vital foundations with which to use, or defend against, behavioral influences.

### Assess Buyer and Target Strategy

Assessment of the current strategic position and alternative strategic actions for buyer and target would include mapping the strategic strengths, weaknesses, opportunities, threats, and goals of the buyer and target, studying their goals, and exploring the alternative strategic actions and tactics they might use to pursue their goals. Tools of strategic analysis outlined in Chapter 6 may be useful at this stage.

### Value the Target

Use a variety of approaches outlined in Chapter 9. Most of these approaches assume to some degree that the market and its pricing of assets are rational. Sensitivity analysis assumes great importance in negotiation, for the problem is rarely a binary, go/no-go decision, but rather an arbitrage process across different bundles of attributes. The purpose of the sensitivity analysis should be to identify key value drivers and gain some sense of the elasticity of value with respect to small changes in assumptions. While it may help to have negotiation goals, negotiators should never prepare to bargain from point estimates of value, but rather from ranges.

### Explore Your Best Alternative to a Negotiated Agreement (BATNA)

*BATNA* defines your reservation price and therefore defines one end of your negotiation range. Lax and Sebenius (1986, page 48) note that "alternatives limit the bargaining range." If negotiations can deliver only a deal that is worse than the BATNA, then the rational deal doer should walk away or should try to shape the counterparty's perception of BATNA relative to this deal—in short, change the reservation price. Also, clarity about your own BATNA is the first defense against attempts by the counterparty to change your reservation price.

### Determine Asking Price and Reservation Price

Refine the strategic and valuation analyses until you converge upon an opening offer or asking price and a reservation price—these are different numbers drawn from different perspectives on the deal. The reservation price becomes an important discipline on one's conduct of negotiations and should be abandoned only with care; obviously, new information may surface in the negotiations that might cause you to revise your reservation price, but the whole point of having one is to limit the impact of psychological tactics, such as anchoring. Because of anchoring, the opening price is important as an influence on the final outcome: Raiffa (1982) found in experiments that the midpoint between the opening and asking prices is a fair predictor of the settlement price for value negotiators, as long as it falls within the ZOPA.

### Identify Relevant Players and Their Interests

A "position" is a demand or requirement expressed straightforwardly—an example would be the line drawn in the sand, which becomes a boundary for future conduct. "Interests" are the real aims standing behind the positions. Interests for negotiators in an M&A transaction range across economics (get rich), politics (retain control), and psychology (preserve self-esteem or "face"). Fisher and Ury (1981) urge negotiators to focus on interests rather than positions; Lax and Sebenius (1986) argue that focusing on interests enhances creativity and breaks deadlocks, but that it may be more useful to focus on positions when ideological differences make agreement difficult. Also, it is important to assess actual or potential competitors in the negotiation. One must identify who they are and what their strategy might help for advance thinking on how to present oneself as the best partner for the target.

### Anticipate Trade-Offs

Having identified the interests of the players, it is possible to take a further important step of looking for opportunities to give and take that might advance the attractiveness of the whole deal. I have argued that an M&A deal is a system, a bundle of attributes that can be optimized by looking for valuable exchanges where you sacrifice on some dimension that is less valuable to you in order to gain on another dimension that is very valuable. For instance, the seller of a business might be fixated on winning a very high price but be willing to provide generous financing or take contingent payments in return. Lax and Sebenius (1986, page 86) note that "Tradeoffs are as important to interests as proportions are to recipes. To assess tradeoffs among intangible interests, it is sometimes helpful to imagine services one could buy otherwise to satisfy the same interests."

### Consider Motivations and Aspirations

How motivated the seller and buyer are to do a deal has a significant influence on outcomes. My research found that the greater the desire, the higher the likelihood of settlement. For the two sides the motivation works symmetrically: For the buyer, a strong desire to settle results in higher prices; for the target, it results in lower prices. Classic motivators for the target to sell are financial distress, the need to settle an estate of a deceased owner, and the private belief that current market conditions are ideal and temporary. Overlaid on the motivation to settle are often some private aspirations about price. One can be highly motivated to settle for a high price, but not so motivated at lower prices. Thus, the homework for negotiators is to reflect on the counterparty's motivation at different price levels. This is just speculation, of course, and can usually be informed only through the negotiations themselves.

### Role-Play

Work through possible negotiation scenarios in your mind or with a team to role-play the negotiations: "Suppose I make this move, and the other side responds with

X; then what should I do?" This is a process of thinking several moves ahead, like a master chess player—this is *thinking strategically*.[11] But be very careful not to let these scenarios become scripts—one wants to remain flexible in the face of conditions as they emerge, and not fixed according to some idealized scenario.

### Determine Bargaining Costs

Assess the impact of bargaining costs as you enter the negotiations. It is costly to prepare for an M&A negotiation. One must acquire information about the counterparty. Experts (e.g., in law, accounting, and valuation) must be retained. And not least, the investment in time by the deal designer and the executives to whom he or she reports will be considerable. Termination fees, meant to discourage a change of heart and to compensate the counterparty for these expenses, typically amount to 2 to 4 percent of the total deal value. The effect of these costs is manifold:

- *Entry barrier.* They may discourage some parties from making the effort to strike a deal.
- *Sunk cost; deal frenzy.* Bargaining costs represent some "skin in the game," a commitment that becomes a psychological loss of face if the deal does not go through. They can stimulate a strong desire to complete a deal, even a bad one (deal frenzy). However, one of the basic lessons of economics is to reject sunk costs from one's decision making. One should look forward, not backward, in assessing the attractiveness of an investment opportunity.
- *Strategy.* From the buyer's perspective, it is rational to try to reduce bargaining costs by seeking deadlines, asking for termination fees, and looking for other forms of commitment from the target that mitigate the costs. The target, on the other hand, will try to deepen the buyer's commitment by raising the bargaining costs—of course, this has the effect of raising the entry barrier, so the target may try to discriminate among potential counterparties.

### Check Your Counterparty Reputation

One prenegotiation influence on outcomes is the set of expectations about the negotiator and his or her firm. Practitioners assert that reputation has an influence on the negotiation process and outcomes. One approaches tough negotiators differently than easy ones. Reputation can play a role of anchoring the expectations of the counterparty. For example, consider the case of Hugh McColl, CEO of NationsBank, a U.S. bank that grew rapidly by acquisitions in the 1980s and 1990s. In an interview, he acknowledged to me that some banks would not discuss deals with him because of his reputation as an aggressive restructurer. He said,

> *There have been many cartoons about me and most of them depict me as sort of a savage attacker, tossing hand grenades into parties. . . . Generally speaking, I earned that reputation in the '80s. And it sort of doesn't reflect the warm and cuddly Hugh McColl of today. I got a lot better as time went by. I got a lot more mellow. And . . . but the image never went away. It's an image that's stayed. And arguably it's well earned.*[12]

Reputations are sticky and can have both positive and negative effects. The role of reputation as an influence on merger negotiations has received little research attention. Experimental research in games suggests that players learn from the counterparty's past behavior and adjust their actions accordingly. For instance, the use of bluffs, threats, and ultimatums in the past can elicit a range of defenses and/or the same behavior. The practitioner should be aware that the counterparty's beliefs about the negotiation process and the likely deal are probably affected by the negotiator's reputation even before the talks begin. The thrust of the effort should be to determine the bargainer's reputation for deal making and any implications it may hold for the forthcoming talks.

## Reflect on Persuasion

M&A negotiation is to some extent a persuasive process. Conger (1998) argues that persuasion is more than just argument; it also depends on emotional connection, common ground, evidence, and credibility. Here is where influence counts. Cialdini (1993) argues that the aura of influence a person brings into a transaction can affect the outcome. Influence is the "dark matter" of deals and is gathered through:

- *Reciprocity.* For instance, giving gifts can create a sense of indebtedness that sways the judgment of the recipient.
- *Commitment and consistency.* For instance, skilled salespeople invite you to try an appliance in your home and then later seek to close the sale. By taking the appliance into your home, you make a (small) commitment that later becomes hard to back away from. Psychologists tell us that humans preserve consistency. Skilled M&A negotiators look to build influence in the negotiations through the establishment of small commitments.
- *Social proof.* The conduct of peers is enormously influential, as parents of all teenagers learn. M&A negotiators can point to other firms in the same industry or similar deals as social proof that suggested terms are appropriate.
- *Familiarity and likability.* Research finds that people tend to agree with people they like and have known. The success of peer-based sales organizations (e.g., Tupperware and Amway) indicates the influence of familiarity and likability. For this reason, some M&A practitioners seek to build personal positive relationships with counterparties or to hire advisers (e.g., lawyers, investment bankers) who already enjoy such relationships. Raiffa (1982) observed that the foundations for bargaining progress were often more effectively prepared in a tavern or restaurant than in the formal bargaining venue.
- *Authority.* Experiments by Stanley Milgram (1974) found that people will defer to authority. Obedience to authority might be heightened through the use of titles, clothing or trappings, and junior staff who give the example of respectful deference.
- *Scarcity.* Small numbers and/or short time can elevate the desire to conclude a deal. Cialdini (1993, page 195) notes, "opportunities seem more valuable to us when they are less available."

## MANAGE THE NEGOTIATION PROCESS PROACTIVELY

The research and practitioner literatures on negotiation offer a range of recommendations for managing the bargaining process.

### Conduct Multi-Issue, Parallel Bargaining, Not Single-Issue, Serial Bargaining

Observing the processes and outcomes of numerous government and business negotiations, Raiffa (1982) concluded that those situations in which multiple issues were negotiated simultaneously and as a package were more likely to avoid deadlock than were the one-issue-at-a-time negotiations. This is because negotiations across many issues simultaneously permit trade-offs that may allow the buyer and target to gain simultaneously. My research found an interdependence between price and terms of payment. Generally, buyers paid more if part of the payment was contingent on future performance. It seems reasonable to speculate that failure to settle would have been higher if the negotiators had been restricted to bargaining on price alone.

### Distinguish Claiming Value from Creating Value

Fisher and Ury (1981) argue that one should focus on ways to expand the pie, rather than on how to slice it. Do not assume that your gains must come from the other side. Look for opportunities to create joint value through effective deal design. This is the idea underpinning the discussion of trade-offs in Chapter 18. Stimulating cooperative behavior is possible in a setting of repeated dealings, such as an annual negotiation over a manufacturing contract. But in the M&A setting, the owner of a target may be a person entering retirement for whom this is a one-and-only opportunity to deal. Lax and Sebenius (1986, pages 164–166) offer a range of cooperation-building approaches, including giving principled justifications for all offers, openly attempting to develop joint gains, making the process into a series of small wins rather than just one gigantic outcome, criticizing "claiming" tactics, and socializing with the counterparty in ways that create trust.

### Look for Trade-Offs

Identifying possible trade-offs is part of the suggested homework for negotiators *before* coming to the table. But *at* the table, an orientation toward trade-offs can get lost in the hurly-burly of discussion. Bazerman and Neale (1992) give a helpful overview of possible tactics with which to identify possible trade-offs. These include sharing information, asking questions, giving away some information (in hopes of gaining some from the other side), making multiple offers simultaneously, searching for postsettlement settlements, and exploiting differences in expectations, risk aversion, and time preference.[13]

## Consider Openness

Raiffa et al. (2002, page 86) describe the virtues of *full open truthful exchange (FOTE)*: "An idealized, collaborative style of deliberation in which they try jointly to solve their problem. . . . They keep no secrets from each other—at least as far as the current negotiations are concerned—and they divulge to each other the truth, nothing but the truth, and the whole truth. (There's the rub—the whole truth.)" They note that many partnerships (and marriages) practice this to great success. Its chief strength is as an antidote to a focus on *claiming* value rather than *creating* value through joint gains. Wessel (1976) offers a code of conduct with which a FOTE strategy is consistent—this is given in Exhibit 30.3. Openness does not absolve the parties from having to struggle with differences in reservation prices, preferences, timing, and power. But it advances the talks quickly to a point where these issues may be engaged, and more importantly, helps the negotiations sail past the minefield of bad stuff that can derail a deal. FOTE may be a risky strategy if only

**EXHIBIT 30.3** Rules of Reason, by Milton Wessel

1. Data will not be withheld because they may be "negative" or "unhelpful."
2. Concealment will not be practiced for concealment's sake.
3. Delay will not be employed as a tactic to avoid an undesired result.
4. Unfair "tricks" designed to mislead will not be employed to win a struggle.
5. Borderline ethical disingenuity will not be practiced.
6. The motivation of adversaries will not unnecessarily or lightly be impugned.
7. An opponent's personal habits and characteristics will not be questioned unless relevant.
8. Wherever possible, opportunity will be left for an opponent's orderly retreat and "exit with honor."
9. Extremism may be countered forcefully and with emotionalism where justified, but will not be fought or matched with extremism.
10. Dogmatism will be avoided.
11. Complex concepts will be simplified as much as possible so as to achieve maximum communication and lay understanding.
12. Effort will be made to identify and isolate subjective considerations involved in reaching technical solutions.
13. Relevant data will be disclosed when ready for analysis and peer review—even to an extremist opposition and without legal obligation.
14. Socially desirable professional disclosure will not be postponed for tactical advantage.
15. Hypothesis, uncertainty, and inadequate knowledge will be stated affirmatively—not conceded only reluctantly or under pressure.
16. Unjustified assumption and off-the-cuff comment will be avoided.
17. Interest in an outcome, relationship to a proponent, and bias, prejudice, and proclivity of any kind will be disclosed voluntarily and as a matter of course.
18. Research and investigation will be conducted appropriate to the problem involved. Although the precise extent of that effort will vary with the nature of the issues, it will be concomitant with stated overall responsibility [for] the solution of the problem.
19. Integrity will always be given first priority.

*Source:* Wessel (1976), presented in Raiffa et al. (2002), page 408.

one of the two sides deals openly—clearly such a strategy requires a fair amount of trust. Raiffa et al. offer a partially open truthful exchange (*POTE*) as an alternative to be considered in setting a negotiating approach.

### Don't Let Stalemates Simmer

Standoffs are among the most challenging obstacles to settlement. By definition, the two sides have dug into their positions, and perhaps by *ex post* reasoning justify them on principle. Brandenburger and Nalebuff (1995) offer a framework that suggests three approaches that may yield progress:

1. ***Changing the rules of the game.*** One can possibly change the constraints that influence the two players.
2. ***Changing the players.*** Sometimes stalemates arise because of the psychological investment the sides feel about their respective positions.
3. ***Changing the value-added.*** Perhaps you can change the perceived value that you bring to the table.

### Master the Tactics

Bazerman and Neale (1992) emphasize that rational negotiation techniques can help one avoid well-documented losing behaviors. My research highlighted the influence of several tactics on negotiation outcomes:

- ***Anchoring.*** Believing there is a value to letting the other side expose its hand first, many negotiators prefer not to be the first party to offer a price. But this exposes the negotiator to a psychological phenomenon called "anchoring." A seller anchors the buyer's thinking by quoting a high asking price; this has the effect of elevating the range of prices within which the buyer believes a deal is possible. Of course, an exorbitantly high asking price can drive the buyer from the negotiation, having destroyed the buyer's belief that the seller is bargaining in good faith. Opening with "Here's my best offer, and that's final" may be a formula for failure. Thaler (1992) emphasizes that "notions of fairness can play a significant role in determining the outcomes of negotiations." (Page 34)
- ***Making offers: number and rate of change.*** My research found that the number of offers extended during a negotiation was associated with a higher likelihood of settlement and a higher final price. The intuition here is that a high number of offers occurs where the negotiations are arduous: The parties are far apart and require a large number of offers to find common ground. The practical implication of this finding is that negotiation is a dance. You take a step, your counterparty takes a step, and so on. It is important to keep stepping for two reasons: Reciprocity keeps the other side at the bargaining table. And continued movement helps build a sense of momentum toward the goal—this helps motivate the two sides to find common ground. On the other hand, don't overdo it. In one's eagerness to keep up the dance, it is possible for one to submit offers in succession without waiting for the counterparty to respond. Don't do this; you are bidding against yourself and will be exploited by an observant counterparty.

## Time Matters

Time invested in the negotiations is a special subset of bargaining costs, but merits special attention. Cross (1969, page 45) argues that "the more distant the agreement, the less its present value." Time bears further consideration for at least three reasons. First, the *length* of time matters. My own research found that the length of time spent in bargaining was associated with a higher likelihood of reaching agreement, and a higher price. I believe these findings tell us about the trade-off between two very important effects: *discovery* and *fatigue*. The impact on likelihood of settlement is straightforward: Given more time (and patience), the two sides are likely to discover *some* set of terms that are mutually satisfactory.

Offsetting the higher creativity associated with more time is the fact that more time allows the two sides to grind each other down with rational arguments or emotional suasion. In the case of M&A, the grinding shows a strong propensity to head in one direction: It is to the seller's advantage and the buyer's disadvantage. My study found that the side more likely to weaken with more time was the buyer—perhaps this is a result of hubris or the winner's curse. Negotiations carried into the wee hours will amplify the fatigue effect. Careful attention to detail, patience, and emotional intelligence, all strain at these times. *Deadlines*, either self-imposed or externally imposed, have an effect similar to ultimatums: They force the hand of the bargainers. The danger arises from stress on the negotiators and therefore provocation of a hasty conclusion to the negotiations. But deadlines are also useful in promoting movement where the two sides have simply been holding firm.

## Turn Negotiation into a Corporate Capability

M&A negotiation is an infrequent occurrence for all but the most active serial acquirers, for whom there is enough memory from one negotiation to the next to permit professional learning and development on the job. But for most other professionals, the acquisition and development of negotiation talent as a corporate *capability* must result from a more determined effort. As Raiffa (1982) suggested, the accumulation of *skill* should be a priority. Ertel (1999) outlines four practices of firms that have successfully done this:

1. *Infrastructure.* To help align the priorities of the company and its negotiators, the firm should develop a database and knowledge transfer systems, promote active training, and debrief negotiating teams to encourage sharing of successful practices. Chapter 37 offers more detail on how infrastructure can promote the development of negotiation as a corporate capability.
2. *Evaluation.* The popular saying is, "What you measure is what you get." Best practitioners realize that a good deal is more than a price—indeed, the thrust of this book is to encourage the view of a deal as a system of attributes. To promote good deals, the negotiator must be evaluated against this richer view of M&A deal structure. Ertel highlights other possible bases for evaluation: development of a deeper relationship with the counterparty, constructive communication, win-win outcomes, creativity, and so on.
3. *Deal versus relationship.* Where the buyer is in the market for firms regularly, successful negotiators will understand the importance of each deal for

building a general perception in the market and specific relationships that can help development of future deals—this is a relationship that opens future options.

4. *Okay to walk away.* Best practitioners develop deal cultures based not on closing a high number of deals, but rather on closing *good* deals. This means that the buyer must have the discipline to swallow the cost in time and money of preparing for the negotiations. Generally, such a culture begins with a focus on creating value, a sense of patience and understanding that the firm faces a range of opportunities (expressed in the form of BATNA) and that very few deals are must-haves.

### Bridge a Gap

Contingent payments can bridge a gap between two positions. My research found that contingent payment deals look very different in value to the buyer and seller. This is because the two sides bring differing expectations to the bargaining table. By definition, the value of a contingent payment term depends on (i.e., is contingent upon) the realization of the expectations one has. The greater one's optimism, the more attractive an earnout will seem. Bazerman and Gillespie (1999) wrote, "In effect, contingent contracts allow negotiators to be flexible without feeling that they've been compromised."

### Culture Counts

Practitioners know that best practice in negotiation is always defined relative to the cultures of the two sides. Thus, in cross-border negotiations it pays to learn the principles of the local culture and anticipate their impact on the bargaining. For instance, negotiators from the United States in Asia are often counseled to be patient with delays; to respect age and status; that a direct "no" may be indelicate; that humility is a virtue; and that saving face is important. If you are unfamiliar with the cultural challenges of cross-border negotiation, consult experienced professionals and some of the commercially available guides to dos and don'ts.[14]

### Manage the Politics within Your Own Team

Realistically, negotiating teams are not monolithic. They will harbor differences in attitudes, personalities, aims, and incentives. Lax and Sebenius (1986) note that "Former Secretary of Labor John Dunlop once remarked that any bargain really involves three separate transactions: one across the table and one on each side of it. Making a deal with the 'other' side is normally only part of the process; often the interplay within one's 'own' side is as difficult or even more so." (Page 339) In short, the negotiation team leader is truly stuck in the middle and must find allies within the team. The task of the leader will be to help the team reach alignment so that the members can present a reasonably similar perspective to the counterparty.

## SUMMARY AND CONCLUSIONS

The key lesson of this chapter is that success in M&A is not determined solely by excellent analysis. Analysis remains vitally important, but one must also master the processes of negotiation by which deals are obtained. Analysis provides an important grounding, reflected in the walkaway price and an understanding of economic trade-offs. Mastery of negotiation addresses the behavioral aspects of deal design. This chapter has outlined numerous tactical considerations in pursuit of settlement.

One final caution is necessary. Given the relatively high variance of returns to buyers (summarized in Chapter 3), practitioners are well reminded to perfect the ability *simply to walk away* from an acquisition negotiation that appears to have no profitable prospect. Robert Cizik, former CEO of Cooper Industries and an active acquirer, said, "Acquisitions require tremendous discipline, the courage to walk away from an acquisition opportunity that is attractive in every way except price."

## NOTES

1. The distinction between positions and interests may be illustrated by this comparison: my *position* is that I want a red Ferrari; my *interest* is in having personal transportation.
2. The reservation price is the value to you of your best alternative to a negotiated agreement (BATNA). At prices above the buyer's reservation price, the buyer will walk away; at prices below the target's reservation price, the target will walk away.
3. *Ex ante* means "before"—these are the reservation prices set by the negotiators before bargaining starts.
4. For more on the role of contingent payments in merger negotiations, see Bazerman and Gillespie (1999).
5. See Siegel and Fouraker (1960), Sawyer and Guetzkow (1965), Raiffa (1982), and Kahneman and Tversky (1979).
6. Successive offers occur where one side makes more offers than the other side.
7. Elster (1989), page 28.
8. For an excellent discussion of the winner's curse, and violations of economic rationality generally, see Thaler (1992).
9. Raiffa, Richardson, and Metcalfe (2002, pages 35 and 38), catalog 48 "decision traps" to which most people will commit themselves some of the time.
10. Stewart Myers, "The Evaluation of an Acquisition Target," in *The Revolution in Corporate Finance*, Joel Stern and Donald Chew, eds. (New York: Basil Blackwell, 1986), page 394.
11. The opposite of thinking strategically is to think *myopically* (i.e., to look ahead no further than one move at a time). Myopic negotiation is a formula for disaster.
12. Bruner et al. (2003).
13. These points are drawn from Bazerman and Neale (1992), pages 91–97.
14. For an introduction, see Morrison et al. (1995), a compendium about doing business in various countries of the world.