The Challenges of Dispute Resolution

Tom Mazetta owns and operates Spreads, Inc., a small laundry and dry-cleaning company that serves a few New York hotels by picking up, cleaning, and returning linens and towels daily. One day, as Tom is unloading stacks of freshly cleaned sheets at the Big Apple Hotel, he loses his balance and falls off the loading dock, breaking his arm and knocking his head on the concrete pavement. Tom is taken to the hospital, where they set his arm and tell him that he has suffered a mild concussion. He is kept overnight for observation and released the next day. He stops working for a month. Although his son fills in for him, business drops off significantly. When Tom returns to work, his arm is not completely healed. Moreover, he is having some trouble focusing his eyes and now has occasional but severe headaches. His doctor is unsure whether Tom's neurological symptoms will improve over time or become permanent. Spreads, Inc. has no disability plan or disability insurance.

Tom thinks he slipped on a newspaper that someone left on the loading dock. Hotel employees often eat their lunch there, and Tom has long

been annoyed by their habit of leaving trash and newspapers scattered around. In fact, Tom almost lost his footing once before on a discarded newspaper, and he spoke with the hotel manager twice about the hazard on the loading dock. Each time, the manager assured Tom that he was aware of the problem and would "take care of it." Nothing appeared to change, however, and Tom recalls that on the day of his accident the loading dock looked particularly messy.

Shortly after returning to work, Tom calls Jennifer Savin, a lawyer who was highly recommended by a family friend. Tom is angry about the damage to his business and worried about the long-term effects of his injuries, which he blames entirely on the hotel's failure to maintain the loading dock properly. Not only should the trash have been removed daily, he believes, but the loading area should have had safety railings, at least on the stairs. Jennifer listens and asks questions. Who saw the accident happen? When did he complain to the hotel manager and what was the manager's name? What have his out-of-pocket medical expenses been? What were his lost profits and earnings? Who were his doctors? Jennifer explains that although it is clear that Tom has sustained injuries, the case will turn on whether the hotel's negligence caused those injuries.

After reviewing his records, Jennifer agrees to represent Tom on a one-third contingent fee. Although her legal fees will only be paid out of any recovery, she explains that Tom will be responsible for out-of-pocket costs, such as court fees, expert witness fees, discovery expenses, and so on. She provides him with preliminary advice about the strength of his potential lawsuit, the probable costs of the litigation, and how she proposes to approach the case. Jennifer writes to the hotel, threatening to file suit and asking for a meeting to discuss "Tom Mazetta's injuries and his potential claim." She suggests that his claim may be worth up to $150,000. The hotel refers the case to its insurance company. The insurance carrier appoints an adjuster to conduct a preliminary assessment of the value of the claim. The adjuster interviews the hotel manager who was on duty the day of the accident and reviews the accident report the manager filled out after Tom's injury. The adjuster contacts Jennifer and asks permission to have a doctor examine Tom and review his medical records to determine what injuries he has sustained.

The adjuster then files a report with the insurance company describing the situation and recommending a reserve for the case—the amount of funds the company should set aside to cover the likely expenses of settlement or trial. Jennifer and Tom, of course, do not know what this reserve amount is. Tom and Jennifer then receive the following letter from the insurance company's attorney:

> Our review of Mr. Mazetta's medical condition and records fails to show that his alleged injuries are as serious as you claimed in your letter. According to the assessment of our medical expert, Dr. Henry Huo, Mr. Mazetta's eyesight is not impaired and there is no medical evidence of a permanent injury of any sort. Moreover, we see nothing to suggest that a court would hold the hotel liable.
>
> We have conducted a thorough investigation of the facts surrounding the incident at the Big Apple Hotel. We are confident that Mr. Mazetta's injuries were caused by his own failure to use due care in unloading his goods at the hotel, in particular his decision to carry tall stacks of pressed laundry himself rather than follow the usual practice of having an assistant help him. We find nothing to indicate that the hotel is responsible for his injuries. Although Mr. Mazetta claims that he slipped on a newspaper that an unnamed hotel employee left on the loading dock, we find no evidence to support this claim.

The insurance company offers to pay "unreimbursed medical expenses up to $5,000 as a good-faith gesture to resolve this matter." Outraged by the insurance company's offer, Tom schedules a meeting with Jennifer to discuss what to do next.

A DEFINITION OF LEGAL DISPUTES

Tom's dispute is a classic tort action in the making. He has sustained injuries that he believes were caused by the hotel's negligence, and he wants compensation. The hotel doesn't want to talk about it. Their insurance company offers a pittance. Tom has hired a lawyer, who prepares to file litigation against the hotel if it refuses to acknowledge responsibility for Tom's losses.

Disputes proceed in stages from the moment a grievance is perceived, through the initial communication between the parties about that grievance, to a resolution of some sort.[1] Many conflicts do not rise (or sink,

depending on your point of view) to the level of legal disputes for the simple reason that neither party has any possibility of asserting a legally cognizable claim against the other. Some disputes are too trivial to fall within a court's purview. An angry spouse cannot invoke a court's jurisdiction to resolve an argument over who should wash the dishes or walk the dog. Other disputes, such as those between countries, are far from trivial but do not result in a legal claim because no court could easily assert jurisdiction.

These are not the sort of disputes we are concerned with here. Instead, we focus on those situations in which at least one party believes that it has a legal claim to relief. But even within this narrower set of disputes, many cases never wind up in the formal legal system. When someone accidentally knocks over his neighbor's mailbox while backing out of his driveway, he may negotiate briefly about whether to repair or replace it and then settle on how best to make his neighbor whole. Neither side files a legal claim or even contemplates one, even though such a claim might be made.

Of all the grievances that turn into disputes, therefore, only a fraction involve a legally cognizable claim, and only a fraction of a fraction result in a formal complaint being filed. Furthermore, only a fraction of a fraction of a fraction are ever actually tried in court. How likely is it, then, that Tom's case will ultimately be decided by a judge and jury in a full-blown civil court proceeding? Not very. In most jurisdictions, for most sorts of civil cases, at least 80 percent of cases filed—and often 95 percent or more—are resolved without adjudication.[2]

Given that so many cases settle, what is the challenge? One problem, although comparatively unusual, is that some cases do not settle that should. A more common problem is that cases settle late—with unnecessarily high transaction costs. In extreme cases, litigation may turn into a lose-lose proposition.

One striking example of a dispute run amok involves Art Buchwald—the writer and Hollywood producer. The story starts when Buchwald wrote a two-and-a-half-page treatment for a story called "King for a Day." Buchwald and his partner, Alain Bernheim, submitted the treatment to Paramount Pictures pursuant to contracts providing that Buchwald would produce any film based on the story idea and that Buchwald and Bernheim would share the profits.

In 1989 Buchwald and Bernheim sued Paramount for breach of contract. They claimed that the studio had based Eddie Murphy's film *Coming to America* on their treatment but had failed to pay them. After three years of litigation, a trial judge awarded Buchwald $150,000 and Bernheim $750,000. Both sides claimed victory. The plaintiffs argued that they had won a respectable judgment—nearly $1 million—against Paramount, which had spent nearly $3 million defending the suit. Paramount claimed that the $900,000 judgment was only a fraction of the plaintiffs' original demand of $6.2 million. Moreover, although Buchwald had been awarded $150,000, his legal fees exceeded $2.5 million. In the end, Buchwald and Bernheim did not have to pay the full amount of their legal fees because their lawyer was paid on a contingency basis. But because Buchwald's out-of-pocket expenses exceeded $200,000, he had no net recovery.

In reality, of course, both parties lost. Their process for resolving their dispute was so inefficient that fighting the battle cost six times more than the amount awarded. As Buchwald has written, "When I got involved, I expected to be in a business dispute that I assumed would be resolved early in the game for a minimal sum of money and, hopefully, an apology . . . One of the discoveries of a suit such as this is that it makes you hurt deeply, and you don't forgive easily . . . Do not count on any money in a lawsuit—this is as true if you win as if you lose."[3]

WHY MOST CASES SETTLE

Fortunately, the *Buchwald* case is hardly typical. In most circumstances, powerful economic incentives operating on the litigants are sufficient to motivate settlement. If lawyers on both sides can help their clients understand the opportunities and risks of litigation, a very basic model demonstrates why settlement usually makes sense.

Evaluating the Case: the Lawyer's Role

At the most basic level, Tom and the hotel—like Buchwald and Paramount—are arguing about legal rights and obligations. When parties negotiate over these sorts of issues, they do so knowing that if the negotiations fail, the aggrieved party can ask a court to vindicate his legal

rights and to force the other party to live up to his legal obligations. Tom and Jennifer believe that the hotel has failed to take due care and that as a result Tom was injured. The insurance company asserts that Tom contributed to his own injuries by acting carelessly. Each has expectations about what would happen in court if they ended up there. But how do those forecasts affect their negotiations outside of court? How does the law factor into their informal negotiations?

At this point, the hotel's insurance company has offered only $5,000 to Tom. Tom's decision to litigate or settle requires that he compare the value of any proposed settlement to the expected value of having his case adjudicated in court.

Lawyers spend much of their time and energy helping their clients make such comparisons: it is a primary reason why disputants hire lawyers. To help Tom decide whether to litigate or settle, Jennifer will have to assess, and presumably discuss with Tom, four basic issues:

- ***Substantive endowments:*** What laws apply to the case, and how do they affect the value of proceeding with litigation?
- ***Procedural endowments:*** What legal procedures apply, and how are they likely to affect the value of litigation?
- ***Transaction costs:*** What expenses will Tom and the hotel incur if they pursue litigation, and how should that affect their decision to settle?
- ***Risk preferences:*** What are the client's risk preferences, and how will these affect the decision to litigate or settle?[4]

SUBSTANTIVE ENDOWMENTS

Every negotiation over a legal dispute turns in part on the substantive rights that underlie the parties' claims. The law determines whether Tom has a cause of action against the hotel for negligent construction or maintenance of the loading dock, and legal rules define what Tom must prove to prevail on such a claim. This is true in any dispute. If, for example, a reporter and a football player are alone in the locker room after a game and the reporter falsely accuses the player of accepting a bribe to throw the game, the football player cannot sue. But if that same reporter falsely accuses the football player of the same act in an article

published on the front page of the city newspaper, the player may have a defamation case.

In Tom's case, tort law provides the basic legal standards that a court would apply to accidental injury. In New York, a plaintiff in a slip-and-fall case must establish that the property owner either created the condition that caused the accident or had actual or constructive notice of the condition. Here, Tom claims that the hotel's employees caused his injuries by leaving behind a newspaper and that the hotel had notice of the trash because of his conversations with the manager.

But, as all first-year law students quickly learn, Tom's own actions may compromise his claim. Jurisdictions differ in how they treat behavior by a plaintiff that could have contributed to his injuries. In some states, even if a defendant is proven negligent, a plaintiff may be barred from recovering any losses whatsoever if the plaintiff was "contributorily negligent"—that is, if he too acted without sufficient care. In many states, including New York, this rule has been replaced with the doctrine of comparative negligence—a plaintiff's recovery is reduced in proportion to his own fault.[5]

The insurance company's letter indicates that the Big Apple Hotel blames Tom for carrying too many sheets by himself, which caused him to lose his balance. Tom sees it differently. He does not always use an assistant; he thought he was acting reasonably on the day in question; and he believes that there should have been a railing to break his fall. Obviously, Jennifer will need to draw on her understanding of the facts and her knowledge of the applicable legal rules to assess the value of Tom's claim.

In addition to her knowledge of the law and legal procedures, Jennifer will be able to fill Tom in on how legal norms and processes are usually translated into actual practice in a given jurisdiction—how the "law in action" typically works. For example, Jennifer may know the range of local verdicts in similar cases, how the big insurance companies in New York operate, and the settlement practices of the hotel's insurance company. She may know how insurance companies set the amount of their reserves, and she may have a fair guess as to how the insurance adjuster evaluated Tom's case. Such knowledge will be of great value to Tom as he considers whether to litigate or settle.

PROCEDURAL ENDOWMENTS

The law that a judge would apply is not the only factor that will affect Tom's negotiation. The likely trial outcome also depends on the court's rules of procedure, which govern how litigation unfolds. At trial, for example, procedural questions—such as which party has the burden of proving damages, causation, or negligence—can greatly affect the outcome. Rules of evidence similarly can affect the expected outcome by making particular kinds of proof relevant or irrelevant. Rules governing pretrial procedure such as discovery, pretrial motions, and pleas can also make a significant difference. If a plaintiff has the right to engage in extensive discovery, his attorney might uncover information to bolster an otherwise weak case. Without such procedural rights, even a deserving plaintiff may be unable to satisfy the requirements for proceeding to trial.

These different procedural endowments, and their likely effect on what would happen in court, must be factored into Tom's negotiation with the hotel. Jennifer knows that, as the plaintiff, Tom will have the burden of proving the hotel's negligence, and Jennifer will be concerned with how she can meet that burden. Obviously, Tom can testify. But who else witnessed the accident? Who might testify about the condition of the loading dock? Will the hotel manager confirm that Tom had made previous complaints? Are there any records to that effect? Jennifer explains that the hotel will have the burden of demonstrating Tom's comparative negligence. What records are there suggesting how big Tom's load was on that day? What evidence might she develop to rebut the claim that Tom was negligent?

TRANSACTION COSTS

The expected transaction costs of securing final adjudication are the third critical element of each party's assessment. A plaintiff must subtract from any possible recovery his likely costs of going to trial.[6] Similarly, a defendant must consider not only the amount of any possible judgment but also the costs of defense. What legal fees will each side incur? What court costs? How might the lawsuit affect each party's ability

to operate its business efficiently? For example, if the hotel's managers and staff are spending time in depositions rather than running the hotel, how much will that interfere with their work and to what extent will the hotel's business suffer? What emotional or psychological costs could litigation have on each party? Only by understanding the costs of litigating can the parties know the net expected value of proceeding to court, and work with that expected value at the negotiation table.

In Tom's case, Jennifer explains that litigation could get fairly expensive. Both sides might hire medical experts to testify about Tom's concussion and its likely future effects. Jennifer would have to depose various hotel employees to try to establish a pattern of leaving trash on the loading dock. If the hotel contests the case vigorously, the litigation might drag on for a long time.

RISK PREFERENCES

Risk preferences also can affect how a party decides whether to settle or proceed to trial. Suppose that a person faces a coin toss in which he has a 50 percent chance of winning $100 and a 50 percent chance of receiving nothing. The coin toss has an expected value of $50. If the person is risk neutral, he will view a 50 percent chance of winning $100 as equivalent to receiving $50 up front. If he is risk averse, he will accept less than the expected value up front—say, $48—in order to avoid the possibility of receiving nothing. Litigants tend to be risk averse because so often the stakes are very large, but a particular disputant may in fact be a risk-preferrer. A gambler, for example, might prefer the chance of winning $100 to the certainty of receiving $55. He would prefer to gamble on getting it all, rather than settle for a lesser amount, even if the lesser amount is more than the expected value.

How do risk preferences affect negotiation? To the extent that both parties are risk averse, the zone of possible agreement is broadened because each would be prepared to accept less or pay more than the net expected value in order to avoid the gamble of going to court. Other things being equal, this should make it easier to settle the case. On the other hand, to the extent that one or both parties are risk-preferrers, the opposite might well be true.[7]

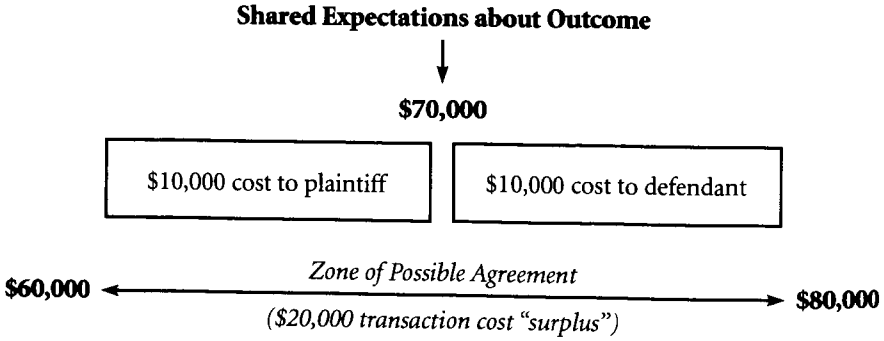

Figure 5

The Basic Model

This simple model—based on substantive endowments, procedural endowments, transaction costs, and risk preferences—explains why most legal disputes are settled and not adjudicated.[8] When the parties have similar expectations about the opportunities and risks of proceeding to trial, settlement saves the transaction costs that would be spent securing a formal adjudication. In essence, these savings are a surplus that can be divided between the parties through settlement.

To understand how transaction costs can create such a surplus, let us simplify Tom's case. Assume that both sides know that if Tom goes to court a judge will award him $70,000. This is a highly unrealistic assumption, as we'll show shortly, but for now let's assume that both sides can know this in advance. Assume further that Tom and the hotel will each have to pay $10,000 in otherwise avoidable transaction costs if the case goes to court. What will their negotiation be about?

Under these assumptions, Tom is better off settling if he receives any amount greater than $60,000 ($70,000 minus $10,000). The hotel is better off settling as long as they don't have to pay more than $80,000 ($70,000 plus $10,000). Therefore, *any* settlement between $60,000 and $80,000 would make both parties better off than having the case tried. In essence, they have a $20,000 surplus to divide (see Figure 5). If they settle for $70,000, each saves its own costs. (One or the other may try to hold out for a more favorable settlement, however, and they could end

up playing a game of chicken. Tom might say, "I won't take anything less than $75,000. Otherwise I'll go to trial." Although the hotel would be better off paying $75,000 than going to trial, if it knew that Tom would only end up with $60,000 if the case were tried, it might not find his threat very credible.)

Why Some Cases Shouldn't Settle

Of course, some cases *shouldn't* settle: those rare cases in which a party's interests can be served only by a complete victory, either in court or by capitulation of the other disputant. Sometimes a party's interest in public vindication is so strong that it cannot be met without adjudication, and that interest may outweigh whatever tangible settlement options the other party can offer. Sometimes a party has a strong desire to create a lasting legal precedent in a certain area and is using litigation as a means to that end. In civil rights litigation, for example, test cases may be brought to challenge or create legal doctrine. Or in a patent dispute, a company may need to demonstrate the validity of its intellectual property to protect its core business. In such cases, the defendant may not be able to offer anything that would be better for the plaintiffs than litigating to judgment.

Sometimes a party may refuse to settle a case because it wants to establish a reputation that will deter future litigation. For example, for several years Ford Motor Company has made one take-it-or-leave-it offer to plaintiffs, correlated to Ford's valuation of the plaintiff's claim. If the offer is rejected, Ford litigates.[9] The company would rather defend those lawsuits and establish a reputation for being willing to fight than overpay for frivolous claims. Over time, the company believes its strategy will pay off with lower total legal expenses and payments.

Finally, some cases don't settle because one or both parties is using the suit for larger strategic or corporate ends. In some corporate takeover situations, for example, the target company will file a lawsuit in an attempt to deflect or defend against a hostile takeover bid. The goal is not so much to win the battle as to win the larger war for control of the company. The suit itself may be over some relatively insignificant thing, but the target company uses the suit to drop the share price and block the takeover. The parties aren't likely to settle in such instances.

LITIGATION DYNAMICS

The basic economic model of litigation and settlement explains why most cases settle: if the parties' expectations about the value of going to court converge, why bother actually taking the case to trial? And most cases *do* settle, as we have noted. But the settlement process is typically very inefficient, for two reasons.

First, even when cases settle, they often settle late rather than early, and this leads to unnecessarily high transaction costs. Legal disputes become trench warfare rather than exercises in problem-solving. Each side takes extreme positions and refuses to compromise, even though each side knows that ultimately a settlement is likely. Time is wasted, relationships are damaged, and in the end the case is still settled on the courthouse steps. By that point the parties have already spent a great deal on the dispute resolution process.

Second, the settlements reached in the litigation process typically ignore the possibility of finding value-creating trades other than saving transaction costs. Although the litigation game includes the evaluation of the legal opportunities and risks, it does not usually incorporate a broad consideration of the parties' interests, resources, and capabilities. As a consequence, the parties may never discover possible trades that could have left both sides better off.

The Distributive Challenges

The distributive aspects of bargaining often preoccupy disputing parties. The litigation game is complex and fluid. The two sides seldom have perfectly convergent expectations about the value of going to court, and each is constantly trying to influence the other's perceptions of that value through moves and countermoves in the litigation process. Because successfully shaping such perceptions can confer real distributive benefits, the parties may escalate the conflict and ultimately become locked into an adversarial and destructive dynamic that neither can then easily change unilaterally. The result is a war of attrition rather than a search for ways to resolve differences efficiently. Here we explore these strategic complexities that can often keep litigants from creative problem-solving.

UNCERTAINTY ABOUT THE OUTCOME OF LITIGATION: "WHAT'S THE CASE REALLY WORTH?"

The first complication is that litigants cannot know with certainty what a court will do in a given case. Unlike our simple example with Tom, in most cases neither side is sure about what the plaintiff would actually receive if the case proceeded to trial. But even with such uncertainty the parties can have similar assessments of the probability distribution of possible outcomes. For example, before the trial neither side can know with certainty that a jury will find the Big Apple Hotel negligent. But they might nevertheless agree on the probabilities.

Consider the simple example illustrated in Figure 6. Both Tom and the hotel expect that there is a 30 percent chance of the jury deciding that the hotel was not negligent, which would lead to no payment ($0) by the hotel. They also agree that there is a 70 percent chance of the defendant being found negligent and paying $100,000. They share expectations about the case, and thus they should agree that the value of the outcome is $70,000, not considering transaction costs. (Multiply each probability by its associated outcome and then add the results. Thirty percent multiplied by zero is zero; 70 percent multiplied by $100,000 is $70,000. Thus, the expected outcome is $70,000.) The expected value is simply the sum of possible outcomes, each weighted by the odds that a particular outcome will in fact be the result.

Of course, often the parties do *not* perceive the relevant probabilities identically. Instead, each has his own expectations about the likelihood and consequences of various trial events occurring, and each has a private estimate of the value of the expected outcome. The parties' differing

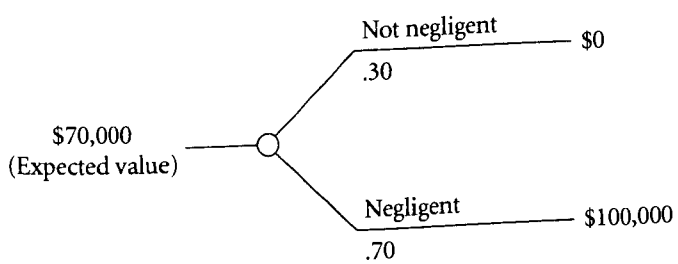

Figure 6

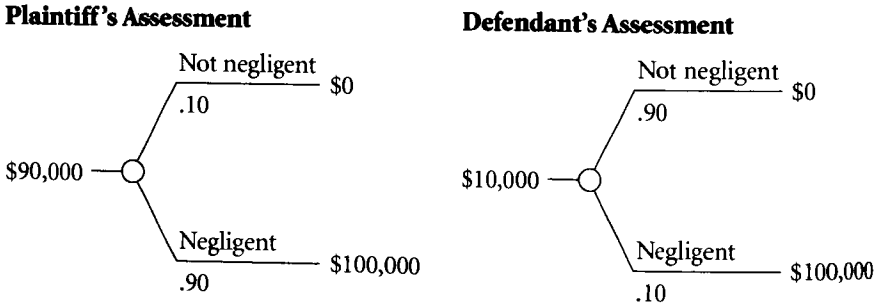

Figure 7

decision trees could look something like Figure 7. There, each party has a different assessment of the probability that the hotel will be found negligent. Although in this example their expectations about damages are similar, their sense of the value of the expected outcome differs dramatically: Tom thinks the case is worth $90,000, and the hotel thinks the case is worth only $10,000.

In most cases, this sort of decision tree will have many branches and sub-branches. Will the hotel be found negligent? Will Tom be found contributorily negligent? If so, what is the comparative negligence of the two parties? What is the range of possible damages? What is the probability of each award? For the parties to reach convergent expectations about a trial outcome, they will need to discuss their differing answers to these questions and figure out ways to bridge the gaps between them.

The parties may have divergent expectations for a number of reasons. First, they may know different facts. Tom may know the name of a person who observed how careless the hotel's employees were with trash around the loading dock. The insurance company lawyer, at least initially, may not know about this potential witness. Of course, before the trial takes place, through discovery and disclosure, this should become common knowledge. But in some circumstances one or both parties may hold private information that influences their expectations about litigation. Second, and more commonly, the parties may have different interpretations or perceptions of the same facts. Third, they may have different assessments of the relevant law and how it would be applied to the facts. Finally, especially with respect to damages, a jury has a great

deal of discretion. The outcome can turn on the jury's subjective impressions of the people involved in the case.

In Tom's case, consider the following uncertainties, about which the parties may have very different views. Is Tom lying about the existence of a newspaper on the loading dock? Whether he is lying or not, is a jury likely to believe him? Will he be a credible witness? What about Tom's conversations with the hotel manager, alerting him to the recurring problem of trash on the loading dock? Suppose the manager denies that such conversations ever occurred. Who will the jury believe, Tom or the manager? How will the manager fare as a witness? And what medical expenses is Tom likely to incur in the future? What damages for pain and suffering is a jury likely to give Tom if they find in his favor? Because the range of possible outcomes is very broad and there is no easy way to assess the odds of particular outcomes, opposing counsel can reach very different conclusions about the expected value of the case.

INFLUENCING PERCEPTIONS IN A DYNAMIC GAME: "YOUR CASE IS A DOG"

Litigation does not simply involve the dispassionate assessment by each party of a fixed set of facts under a given legal regime. Instead, it is a dynamic process in which counsel for each side is constantly trying to shape the other party's perception of what might happen at trial. The odds are not fixed at the outset. Because of moves and countermoves during the pretrial process, an astute lawyer may be able to improve her client's chances of winning: new documents may be discovered; a partial summary judgment motion may be granted throwing out part of the case; careful questioning during a deposition may undermine a witness's credibility; a persuasive expert witness may be hired.

In addition to working to change the odds, each side tries to influence the other's *perceptions* of the likely outcome, and what might be an acceptable settlement. Puffing and exaggeration are commonplace. Parties stake out extreme positions, hoping to signal their confidence and expectations. Lawyers will often attack and belittle the other side's case, trying to shift the other side's subjective assessment of the litigation. These litigation moves are a common part of the negotiation process.

Changing the other side's perceptions of its litigation alternative has important distributive consequences. Imagine that Tom's lawsuit against

the Big Apple Hotel proceeds to the discovery phase and that Jennifer uncovers a document in the hotel's files showing that the original blueprints for the construction of the loading dock called for a reinforced safety railing. In all likelihood she will bring this information with her to her next negotiation with the hotel and wave it in front of the other side's attorney, hoping to influence the hotel's perception of Tom's likelihood of success should the case go before a jury. Will she succeed? Who knows? But most likely she will try.

We cannot overstate the importance of these dynamics. Lawyers and clients constantly base their negotiation strategies on the possibility that a litigation move will change the value, or the perceived value, of the case at hand. The litigation process can become all-consuming, with lawyers and clients focusing exclusively on influencing the possible outcome of the case and ignoring what it will cost in real dollars to do so. Moreover, the fluid nature of the game makes the process of valuing the net expected outcome of a legal dispute very difficult. Litigation is not a game where you know the odds—where you pay a dollar to flip a coin for the chance at two dollars. Instead, it is a game that often feels—at least to clients—as if you must pay some undisclosed and uncertain amount in order to have some undisclosed and uncertain odds of winning an uncertain prize.

INFLUENCING TRANSACTION COSTS: "WE CAN HURT YOU WORSE THAN YOU CAN HURT US"

As we have seen, a party's reservation value in a legal dispute depends, in part, on the transaction costs that the party thinks he is likely to incur if he proceeds with litigation.[10] If the other side can change these costs, it can alter the perceived net value of going to court.

Some transaction costs are fixed, such as the filing fee a court imposes for initiating a claim. But many transaction costs are linked to the parties' behavior. For example, various litigation expenses—including attorney's fees, deposition costs, discovery burdens, and other out-of-pocket expenses—can vary widely depending on what the other side chooses to do. This can be critically important. In litigation, one party may be able to impose substantial transaction costs on the other at very little cost to itself. In discovery, for example, it might cost Attorney A very little to send Attorney B a long list of written interrogatories, but it may take At-

torney B hours of work to answer them. Of course, Attorney B could retaliate with a similar list, thereby imposing costs on Attorney A. But at the start of a lawsuit neither side knows what choices each side will make along the way, and how those choices will affect transaction costs.

The result may be a war of attrition. The goal is to impose such a great burden that the other side gives in, but the reality can be that both sides stagger under the weight of mounting transaction costs that lead ultimately to a lose-lose outcome. Although starting the war in hopes of winning it might be a rational move for either side, the collective outcome is irrational.

The temptation to wear the other side down may be especially great when the parties face different costs or have different resources. An elegant experiment conducted by Richard Zeckhauser illustrates what can happen.[11] Zeckhauser asked subjects to divide $2 between them. In the event they failed to agree on a split, neither party would receive any money. To no one's surprise, in this version of the game virtually all of the pairs hastened to split the $2 evenly. But in a second version of the game, the subjects again were asked to divide the $2, but for every minute that elapsed one party was taxed five cents while the other party was taxed ten cents. In this situation, most people intuit that the bargainer taxed five cents a minute has a degree of leverage over his counterpart by virtue of these asymmetrical costs. And while many pairs in this version will quickly agree to split the $2 evenly, many more do not. Often, the bargainer taxed five cents a minute will try to exploit his apparent leverage by asking for *more* than $1. What is fascinating about Zeckhauser's results in this version of the game is that the party with the purported leverage typically does *worse* on average than when the parties face symmetrical costs or no costs at all. The attempt to exploit asymmetrical costs often induces stubbornness by the other side, and *both* sides typically end up with much less than $1.

This is precisely what happens in some legal disputes. The party that believes it can absorb costs better, or impose more costs on the other side, or both, attempts to use this leverage in the distributive aspects of the bargain. This is a rational strategic move when the other party has limited resources and will be forced to capitulate. But often it leads to irrational stalemates and protracted conflict, and both sides ultimately lose.

INFLUENCING PERCEPTIONS OF WILLPOWER: "WE'LL FIGHT TO THE BITTER END"

Because of the dynamic nature of litigation, both parties to a legal dispute often wonder about the strength of will on the other side. How committed is the other side to pursuing the litigation? Is the other side bluffing, or will it really press forward if it doesn't receive a more favorable settlement offer?

Barbara Tuchman has observed that "an offer of peace terms by one belligerent will always give an impression of a weakening of purpose and will to victory. The other party, sensing weakness, will be less disposed to accept terms. This is one reason why ending a war is always more difficult than starting one."[12] As with war, so with litigation. Lawyers are often reluctant to initiate settlement talks. Each side waits for the other to blink, for neither side wants their move to create an inference that they think their own case is weak. Jeffrey Rubin relates a wonderful example of this dynamic that occurred in a world champion chess match between Bobby Fischer and Boris Spassky.

> As one of the early games in the match was drawing near a close, it became clear that neither Fischer nor Spassky had even the slightest chance of winning. Each had been reduced to a king and pawn, and neither had the board position necessary to queen his pawn. Yet, despite the clear inevitability of a draw, neither player gave even the slightest sign of relenting. The two great chess experts stubbornly refused to show any awareness of each other's presence in the room, not to mention across the board . . . The moves dragged on, the referee apparently becoming increasingly impatient about the behavior of the two players, whose game was so obviously headed for a draw.
>
> Why would neither propose the compromise solution under these circumstances? Apparently because to do so would have been to signal less self-assurance than was shown by one's adversary, thereby possibly weakening one's position in the games that were to come.[13]

Both sides felt stuck. Although both would benefit from a compromise, neither wanted to be the first to propose it.

"We'll fight to the bitter end" is a common litigation battle cry, even though both sides know that settlement at some point is likely. Litigants often want to appear willing to spend what it takes, wait as long as it

takes, and suffer as much as it takes in order to win. By sending such signals, each hopes that the other will reassess its estimate of the likelihood of success at trial and thus reevaluate what it is willing to pay or receive in settlement.

This is not all shadowboxing. A party may have several good reasons to doubt the other side's willpower. Perhaps the client on the other side is not really willing to go to court and would rather settle the case quickly and be done with it. Does he have the stomach for litigation, or will he fold on the courthouse steps? If the other client's resolve seems weak, a party may be encouraged to press forward with litigation in hopes of intimidating the other client into settling on the cheap. Other reasons to press ahead may center on the attorney. "Mary Beth doesn't really want to try this case," a litigator might muse about his adversary. "She's never had trial experience in a matter like this. And it's summer time. She'll want an August vacation. And she's up for partner in her firm soon, so she won't want to risk a big loss in court. We can press ahead, and eventually she'll make concessions to avoid going to court." In Tom's case, the hotel might think, "Jennifer is working on a contingency fee. She has already incurred a lot of expenses. Eventually she'll want to settle this case rather than risk receiving nothing in court. We should hold out."

PREPARING FOR A TRIAL THAT NEVER TAKES PLACE: "WE'LL SEE YOU IN COURT"

In litigation it can sometimes seem as if each side is frantically preparing for a trial that will never take place. One side drafts a complaint, files motions, takes depositions, goes through document production and discovery, prepares for trial—all with full knowledge that it will probably settle the case. *And each side knows this.* It is like an arms race: each side builds up an arsenal, hoping never to use it. Each needs the arsenal to signal a readiness for battle. But each would also benefit if both sides could agree to reduce the weapons stockpile. The problem is that neither side wants to disarm first.

Sometimes the threat of litigation, or its actual initiation, is necessary to bring a recalcitrant party to the negotiating table. Similarly, the use of formal discovery may prompt essential disclosures. At the same time, once initiated, litigation often takes on a life of its own. Even if two par-

ties share the same expectations about the value of proceeding to court, they might never discover that convergence because each side is so busy trying to out-maneuver the other. Each party might begin by stating an extreme position in order to signal great confidence and strength of will. The parties are likely then to make litigation moves to shape each other's perception of the value of going to court, while continuing to huff and bluff about their own assessment of that value. Their behavior will tend to be more radical and antagonizing than candid, in order to secure any possible distributive advantage. And in the process they are unlikely to discover that their expectations about the litigation alternative are similar.

Because each party wants to appear confident to preserve the credibility of their threat to litigate, each side faces a dilemma: Should I be the first to disclose my true assessment of my case? Lawyers and clients in litigation fear that unilateral disclosure risks exploitation. "If I admit the weaknesses in my case, they'll take advantage of those honest assessments without acknowledging the holes in their own argument." Neither side wants to look weak to the other. To admit doubt about one's case seems tantamount to handing money to the other side. As a result, each side holds its cards close to the chest, blathers loudly about the strength of its hand, and possibly bets more on the outcome than its case was worth to begin with.

One of the causes of this behavior is what Jeffrey Rubin has called "over-commitment and entrapment."[14] To illustrate this phenomenon, consider an ingenious game called "The Dollar Auction."[15]

We now play the game for $20 as follows: A $20 bill is auctioned off to the highest bidder, where the initial bid has to be at least $1 and the increments must also be in dollar amounts. The twist in the game is that the *second*-highest bidder is also required to pay the auctioneer the amount of his bid, even though that bidder receives nothing in return. For example, if the high bid is $15, the winner gets a $20 bill for $15, netting $5 profit. If the second-highest bid is $14, however, that bidder pays the auctioneer but gets nothing.

We've played this game with hundreds of lawyers, law students, and executives. The opening bid is often for a small amount—two or three dollars. In almost all cases, however, a competition ensues and the bids escalate. By the time the bidding gets above $10, there are typically only

two bidders left, and the auctioneer knows that he's in the money. But to the amazement of the audience, the bidding typically climbs above $20. Consider the predicament where one person has bid $20 and the other $19. The low bidder figures "I'm better off winning at $21 (for a net loss of $1) than being the second-highest bidder (for a loss of $19)." But as soon as he bids $21, the tables are turned, and the other bidder, using the same reasoning, may raise the bid again.

We have sold a $20 bill for as much as $150, and we've never seen an auctioneer lose money. The game poses some striking analogies to litigation. If no fee-shifting mechanism is in place, each litigant pays her own legal fees regardless of who wins the case, just as each bidder must pay her final bid regardless of whether she wins the $20 bill or not. Like bidders in the auction game, each litigant may try to outspend the other to improve her chances of winning. And, as in the auction game, litigants can become trapped in a competitive dynamic where they don't want to lose, even if winning no longer pays.

INCENTIVE PROBLEMS IN THE LAWYER-CLIENT RELATIONSHIP: "YOU CAN'T PAY THE RENT WITH ONE-THIRD OF AN APOLOGY"

The principal-agent relationship can make it harder to settle lawsuits and harder to create value in cases that do settle. To find value-creating trades, an attorney needs to know his client's interests, resources, and capabilities. Many litigators don't think to ask for or learn about these things. Instead, a lawyer's conversation with her client may focus exclusively on the opportunities and risks of litigation.

As we noted in Chapter 3, exchanging information can be expensive. Because a lawyer *can* pursue litigation without much information about his client's interests, it may not seem necessary to either a lawyer or his client to spend time talking through these basic building blocks of value creation. But without this information, the lawyer's hands will be tied at the negotiating table. The lawyer likely will focus on distributive bargaining about the expected value of going to court rather than on finding ways to make trades to meet the interests of both sides.

In addition, a lawyer's fee arrangement may create the wrong kind of incentive. Clients sometimes complain that their cases won't settle—or settle late—because their lawyers benefit financially by spending more time on the matter. What is a transaction cost for a client is often income

for a lawyer. Large corporate law firms typically litigate on an hourly basis. Whether consciously or unconsciously, attorneys may do unnecessary legal research, file too many motions, take too many depositions, or otherwise raise transaction costs for their own benefit. Not all such behavior is venal. Out of a legitimate desire to gain a competitive advantage for his client and to reduce uncertainty by leaving no stone unturned, a litigator paid by the hour may see each additional investment of time and effort as worthwhile. Nevertheless, when there are hourly fee lawyers on both sides of a dispute, the risks of protracted conflict are great, especially if both clients have deep pockets and the stakes are high.

In tort cases, where the plaintiff's lawyer works on a contingency fee basis while the defense attorney is paid by the hour, the two attorneys' incentives are quite different. Whereas the plaintiff's attorney may be motivated to complete the litigation quickly and at low cost in order to maximize his return on his time investment, the defense lawyer may have an incentive to drag the litigation out as long as possible to increase his own fees. Sometimes the defendant heartily approves of this foot-dragging in hopes of exploiting the weakness inherent in the contingency fee structure to pressure the plaintiff's attorney into settling at low cost. And some clients take the position that they would rather pay their lawyer than the other side.

Contingency fees also can dissuade lawyers from seeking certain kinds of value-creating trades and cause cases to drag on longer than they otherwise might. As one plaintiff's attorney told us, "You can't pay the rent with one-third of an apology." Jennifer, for example, might not reap much reward if Tom drops his suit because he and the hotel have agreed to move his laundry services in-house. Her contingency arrangement with Tom anticipates a cash settlement of his dispute. Given this, what incentive does she have to search for such a resolution?

Principal-agent problems within a client's organization may also inhibit settlement. The manager responsible for a case may want vindication to protect his own career. Or a manager in charge of a given office or division may want to delay settlement until after he has transferred so that it will not be on his watch. Such buck-passing is equally common when government agencies are accused of wrongdoing. When no one within an agency wants to stick his neck out and accept responsibility, the government may end up taking a very tough negotiating stance.

The Value-Creating Opportunities

As our exploration of the distributive challenges demonstrates, when two lawyers negotiate over the expected value of going to court, they often behave as though a dollar more for one is a dollar less for the other. Sometimes this is true. But there are value-creating opportunities in dispute resolution, even if the negotiations focus entirely on determining the net expected outcome of litigation. Resolving legal disputes is not a purely distributive activity.

REDUCING TRANSACTION COSTS

In addition to managing the litigation process, problem-solving lawyers help their clients manage the negotiation process in a way that minimizes transaction costs. They become process architects. This notion is not intuitive. Much popular thinking about negotiation focuses on the substance of a settlement—the terms and conditions, dollars and cents, who gets what and when—rather than on the process by which disputes are resolved. Yet in every negotiation, parties participate in *some* kind of process. Lawyers can help design a process in which a dispute can be resolved in a value-creating way and at lower cost to the parties.

For example, much has been written about the inefficiency and high cost of discovery. To reduce these costs, various attempts have been made to promote expedited information exchange, by which parties turn over critical information to each other, without the need for discovery. The Federal Rules of Civil Procedure were recently modified to mandate disclosure (without a discovery request) of documents and witnesses relevant to "disputed facts alleged with particularity in the pleadings."[16] Quite apart from what the rules may require, the parties to a dispute can, by agreement, reciprocally trade information without protracted interrogatories, depositions, and document requests.

As process architects, lawyers can also explore alternative forums for dispute resolution. Formal litigation in a courtroom is one method of dispute resolution, but many other possibilities—including mediation, arbitration, or a minitrial—may lead to a fair outcome with less delay and lower transaction costs. And within each of these options, there are opportunities for creative process design. We have found that to the extent lawyers ever *do* think about process design, they often see their

choice as deciding between various alternative process options, such as mediation versus litigation. But sometimes customizing a dispute-resolution process may be even more beneficial. For example, neutral experts can be used to reduce technical or legal uncertainties to a more manageable level, or mediation and arbitration can be combined.[17]

We do not suggest that lawyers should discard entirely the option of litigation or the traditional discovery processes that go with it. For alternative processes to work, lawyers must be confident that using them will not naively sacrifice their clients' needs and interests. This means that lawyers will inevitably incorporate process design in and around existing dispute resolution mechanisms, tailoring the mix of procedures to the particular client.

TRADING ON DIFFERENCES

In addition to saving transaction costs, settlements can create value by trading on differences in risk or time preferences. Even though a court might award lump-sum monetary damages, lawyers sometimes trade on these differences through structured payments. For example, a settlement might provide for a monthly payment for the life of the plaintiff.

Through a settlement, the parties can often do things that a court would never order. For example, a doctor's apology to a patient may mean a great deal and go some distance in repairing the relationship.[18] The parties might also find trades that have little or no relation to the issues at stake in the original dispute. For example, two public utility companies were involved in litigation over the terms of a long-term contract in which one corporation was selling power to the other. By broadening the scope of settlement discussions, the parties found a variety of trades and joint activities—unrelated to the dispute—that created a great deal of value and made it easier to resolve the lawsuit as well. Dispute resolution can be used as a catalyst for making new deals that go beyond the original litigation.

To return to Tom's case against the Big Apple Hotel, Tom has long thought that Big Apple's practice of contracting month by month for laundry services makes no sense, and that if he had a few large and dedicated customers who arranged for one- or two-year contracts, he could

lower the cost of providing services. He has also tossed around the idea of operating laundry facilities *inside* the hotels, to eliminate the time and expense of picking up and delivering the linens. Although there would be an initial investment of capital to buy and install laundry machines, Tom thinks that in the long run he could save the hotels money by managing staff on-site.

Are Tom and the hotel likely to discuss this business idea in the course of negotiations over a tort claim? Not very. Jennifer might not know anything about Tom's business idea. Although she knows his narrow financial interest in being compensated for his injuries, she may not have considered his broader financial interest in doing business with the hotel in the future. How important is the Big Apple Hotel to Tom's business? What would the effect of litigation be on his relationship with the hotel? And can Tom and the hotel explore the possibility of future, creative business deals if they are also litigating about Tom's injuries? Most often litigating lawyers would not even consider talking about such ideas, nor would they advise their clients to do so. And yet such a trade would broaden the scope of the negotiation and bring to the table resources and capabilities that the parties could exploit.

Our Example Continued

Tom and his lawyer are now embroiled in litigation with the Big Apple Hotel. Jennifer continues to make progress before the judge. Discovery is unfolding, and she has found several internal reports indicating that the hotel's manager knew that employees had a habit of leaving trash in public areas of the hotel, including the loading dock. Jennifer is looking forward to deposing the hotel manager about Tom's complaints to him. Although she has not found a witness who saw trash on the day in question, Jennifer is confident that she can build a case that the presence of discarded food and trash on the loading dock was a recurring and well-known problem.

Eventually Jennifer and the insurance company's attorney begin to negotiate in earnest. Although the hotel raises its initial offer to $10,000, if both lawyers follow the usual script, they may deadlock. Jennifer will express confidence in her client's case and demand a high settlement figure.

By asking for the moon, she hopes to anchor the hotel's thinking. The insurance company lawyer will shrug his shoulders and say, "Well, we have nothing left to talk about." Or he might attack Jennifer's arguments and try to discredit her reasoning. Either side may walk away from the negotiation table, hoping to signal a willingness to fight it out in court.

Of course, Jennifer could take a different—and more problem-solving—approach. Rather than accept or reject the defense attorney's offer, Jennifer might have the following conversation:

JENNIFER: Thank you for your $10,000 offer; we will certainly consider it, although based on what I currently understand about Tom's case, I don't think it's realistic. Rather than counter with a higher demand and haggle, I propose that you and I try to come to some shared understanding of what this case is worth—what the court's most likely to do if we litigate and the opportunities and risks we each face. If we can't agree, at least we'll be able to explain to our clients where our differences are.

DEFENSE: Well, I told you already, I think this case is worth no more than $10,000 to us.

JENNIFER: Right, I understand that, but I'd like to know *why.* I'm sure you've thought about all sorts of variables—whether you'll be found negligent, whether Tom was contributorily negligent, what damages would be, etc.

DEFENSE: Yes, of course we have. And I'm very confident about that $10,000 number.

JENNIFER: Well, your assessment may turn out to be right and mine may be wrong, but for now at least I think it would be useful to just get a sense of how we both think about the case.

What is Jennifer trying to do? She's trying to negotiate with the defense attorney over the *process* of their negotiations. She knows that the hotel has arrived at a $10,000 figure somehow, and she signals that she's willing to listen to their logic even if she doesn't agree with it. More important, she has framed arriving at convergent expectations about the value of litigation as a shared problem—and has flagged that although they might not converge yet, at least they will be better able to explain their negotiations to their clients if they try to understand where the other side is coming from.

As the negotiation unfolds, Jennifer may have to make many such process moves. In particular, she may want to propose that Tom and the

hotel agree to a limited discovery regime that will save transaction costs. Maybe the two sides can agree to refer the case to a medical expert for a neutral assessment of the value of Tom's injuries, thereby largely eliminating disagreements about damages, regardless of who is found to have caused them. Through creative process suggestions like these, Jennifer can try to reduce the transaction costs of reaching a settlement.

For now, imagine that Jennifer explains that she thinks the case is worth $72,000, and she explains the logic that she used to arrive at that number. Tom has incurred $9,000 in medical expenses. In the three months after the accident his business lost $34,000 because he could not work—several of his major clients went elsewhere for service. In total, that makes for $43,000 in actual losses. Jennifer considers an additional $47,000 a conservative estimate of his future medical expenses, pain and suffering, and future harm to his business. She then discounts this total of $90,000 by 20 percent because of her estimate of Tom's comparative fault.

While admitting that there's some chance she could prove that the hotel was negligent, the attorney for the insurance company originally rejects her figure because he thinks that a jury would find that Tom was at least 50 percent responsible. He also doubts Jennifer's ability to prove future damages to the business now that Tom is back at work. He counters with an offer of $35,000. Jennifer disagrees with his reasoning, but she suggests that there may be ways to bridge the gap or processes through which they could test their conflicting assumptions about how these issues would play out in court.

Jennifer also wants to introduce the idea of finding value-creating trades outside the immediate scope of the dispute. She might try to do this in a conversation with the insurance company lawyer—after first talking with Tom about what his interests actually are.

JENNIFER: The other thing I'd like to suggest is that you and I make some time to put this litigation to one side and talk about whether our clients may be able to make some kind of broader deal here. I know that Tom and the hotel have done business together for quite some time, so it would probably be worth talking through their business interests and whether there are things we could do apart from settling this litigation to find ways to make them both money.

Tom's Interests	Big Apple Hotel's Interests
About the dispute:	*About the dispute:*
• Be treated fairly	• Not pay more than a fair amount
• Not spend unnecessary time and money on litigation	• Not spend unnecessary time and money on litigation
• Get cash up front to cover his medical bills	• Pay only for losses actually incurred
• Be guaranteed that if his medical problems continue, he will be compensated in the future	• Get the dispute over and done with
Outside the dispute:	*Outside the dispute:*
• Retain his good reputation	• Minimize adverse publicity
• Have the hotel resume using Spreads, Inc., for its laundry needs	• Get skilled, efficient laundry service that is tailored to the hotel's special needs
• Expand his business	• Decrease the cost of laundry services
• Repair his personal relationship with the owner of the hotel, who was a friend of his father	• Repair the personal relationship between the owner of the hotel and Tom's family

Box 7

DEFENSE: Well, I'm not sure the hotel's owners are too pleased with Tom after he started this lawsuit. They've been using another laundry service for the last few months.

JENNIFER: I understand. Still, would you mind setting aside some time to talk about whether they might have *any* business interests that could lead to some fruitful discussion between them? In fact, it might be useful to set up a four-way meeting.

DEFENSE: I'm not so sure. Let me talk to my client about it.

Although the defense attorney is initially skeptical about the idea, Jennifer gently persuades him to allocate some time to talk about interests, resources, and capabilities that might be broader than those immediately implicated by the litigation over Tom's accident. She acknowl-

edges that they might *not* find any value-creating trades, but she frames their task as one of exploration and invites the other side to join in.

At a later meeting, they discuss the parties' interests that are not immediately apparent from the face of the lawsuit. Jennifer leads the way, consistently encouraging the other lawyer to think broadly about what his client wants. They discuss their clients' needs and interests.

Jennifer brings these lists back to Tom, and they discuss some ways in which Tom could imagine meeting the hotel's needs, and vice versa. Tom is curious about what special laundry needs the hotel has, and also about what cost-cutting measures they are considering. Maybe they would be interested in his idea of bringing laundry services on-site at the big hotels. Jennifer and Tom agree that he should meet with the hotel owner at some point to discuss what trades they could make to turn their dispute into a deal.

CONCLUSION

This brief example shows that lawyers and clients have an opportunity to create value in legal dispute resolution. By minimizing transaction costs, lawyers can benefit clients even in a negotiation that focuses narrowly on the expected value of the litigation. And by coming up with trades relating to differences between the parties' interests, resources, and capabilities, lawyers can turn even seemingly intractable disputes into productive deals. The opportunities are there—but lawyers and clients need to know how to look for them.

The core of most legal dispute resolution is assessing and shaping both sides' perceptions of the expected value of proceeding to court. Because the expected value—and each side's perception of it—is not fixed, the temptation to engage in hard bargaining to seek distributive advantage can be formidable. And lawyers are often quite skilled at hard-bargaining tactics and tricks and may be most comfortable negotiating in that style.

This chapter has identified two problems with the status quo. The first is that when both sides hire attack dogs, both sides end up in a bloody mess. Litigation becomes expensive and wasteful, and the parties are unlikely to resolve their differences quickly, cheaply, or in a way that maintains a working relationship. The second problem is that the tradi-

tional approach to legal disputes does not provide an opportunity for finding trades that are mutually beneficial. Although not all legal disputes have immense value-creating potential, many do. And if lawyers get stuck in a hard-bargaining mode, they are unlikely to find value where it is available.

The Challenges of Deal-Making

Textile Corporation, a manufacturer with worldwide operations, decides to sell an unoccupied brick building that was a mill in the nineteenth century. This property, which is situated next to a stream in the heart of the Berkshires in western Massachusetts, is listed with the local realtor for $3.5 million. David Dirks is interested in buying the building and the surrounding parcel of land in order to convert it into a shopping center. David is betting that the architectural distinction of the building, its beautiful site, and tourist flow into the Berkshires will make this a lucrative investment.

After viewing the property several times with the listing real estate broker, and after having his architect and contractor examine the site, David meets with Victoria Leigh, a vice-president of Textile Corporation, on July 1. David tells Victoria that he hopes to convert the old factory building into a stylish shopping mall, that he is confident he can secure a mortgage to finance the project, and that he would like to consummate the sale by October 1. After viewing pictures of similar projects David has developed, Victoria expresses approval of David's plan and offers the support of Textile Corporation, which has a good relationship with town residents and local businesses, in helping David obtain regulatory approval for the project.

After a few hours of negotiating, David and Victoria agree on a price of $2,985,000. David hands Victoria a $10,000 check and calls it a good-faith deposit. Victoria looks him in the eye, shakes hands, and says, "We have a deal at $2.9 million with an October 1 closing. Have your lawyer send over the formal contract."

A DEFINITION OF LEGAL DEAL-MAKING

In the broadest sense, deals can be defined as economic agreements between two or more parties.[1] This definition encompasses virtually all voluntary exchange. It includes transactions over standardized products with fixed prices—like purchasing food at a supermarket, buying a newspaper from a street vendor, or paying for dinner at a restaurant—as well as transfers of more ephemeral or intangible assets, such as a lease, in which a new property right is created, carved up, or allocated. Corporate mergers, home sales, employment contracts, joint ventures, intellectual property licensing, strategic alliances, and long-term supply contracts between manufacturers and distributors are all complex deals.

For purposes of negotiation, what differentiates deal-making from the resolution of legal disputes? In deal-making, neither party has a pre-existing legal claim against the other. The alternative to an agreement is to go elsewhere in the market, not to court. Suppose Ted walks into Anne's Office Supply and asks how much Anne charges for 8 ½″ × 11″ white paper that can be used in Ted's ink-jet printer. Anne says a package of 500 sheets costs $9. Ted takes out two twenties and a ten, lays the money on the counter, and asks, "Will you sell me six packages for $50?" If Anne says no, Ted has no legal claim against Anne. He must simply look for another vendor who will accept his offer.

Suppose Anne says yes, takes Ted's money, rings up the sale, and gives Ted the six packages. This is what is known as a spot-market transaction: concluded on the spot. Before the exchange takes place—before the time when, literally, Anne accepts the cash and hands over the paper—neither buyer nor seller is legally bound to consummate the sale. As soon as the transaction is complete, Ted owes Anne nothing (he has already paid in full), and Anne has no obligations to sell other office supplies to Ted. But even in this simple deal, the law provides background rules that

shape the transaction and impose limits on what the parties can agree to. Law constitutes a framework within which private ordering takes place. For example, although Anne may not have made explicit promises about the paper's suitability for use with an ink-jet printer, the Uniform Commercial Code may furnish such a warranty.[2] Law is thus relevant to deal-making negotiations even when its role may not be immediately obvious.

Even some transactions creating complex legal obligations are completed without lawyers. Consider an apartment lease negotiation between a landlord and tenant. The property right must be defined with precision—which apartment, how many spaces in the garage, and who has easements burdening the land. A landlord might warrant that the apartment is habitable under state law or promise to make certain repairs before the tenant takes possession. Despite the complexity of these arrangements, parties frequently execute residential leases without the assistance of lawyers. In some states, lawyers are no longer typically involved even in the purchase and sale of residential real estate.

In this chapter we focus primarily on deal-making in which lawyers *are* involved in the process of creating legal obligations concerning the exchange or allocation of assets and services between two or more parties. Lawyers tend to become involved in deal-making when the assets to be transferred are idiosyncratic or difficult to define; when the parties make promises or representations that extend over time; and when the value of the parties' agreement hinges in part on external contingencies, such as securing regulatory approval. More generally, lawyers tend to be involved in deal-making when the risks associated with a transaction are not well known or when there is no standard method for allocating those risks.[3]

THE LAWYER'S ROLE IN DEAL-MAKING

Many deals originate as broad agreements-in-principle, in which clients establish price, delivery dates, and financing arrangements. Two corporate CEOs, for example, may agree to merge their companies, or a borrower and lender may agree on the amount and interest rate of a loan. Lawyers rarely play a central role in this stage of the negotiation, al-

though some clients want their lawyer to be responsible for negotiating everything. In the more typical case, lawyers get involved in deal-making negotiations when the time comes to identify and allocate bundles of risks and to make binding legal commitments to the other party.

Identifying Risks

Lawyers typically enter deal-making when the parties want to specify their obligations to each other in precise written terms.[4] Lawyers then bear primary responsibility for translating into legally recognizable concepts the parties' preliminary understanding of their deal.[5] In addition, legal drafting involves identifying and allocating ancillary risks that the clients may not have considered but that can have significant distributive consequences.

David Dirks and Victoria Leigh did not have lawyers present at the time they shook hands on their deal. When each later consults with an attorney, both lawyers will probably ask questions about a range of risks and contingencies, some of which may cause the parties to reconsider the deal's value. David's lawyer, for example, might be concerned about whether the property can be used as a shopping center without a zoning variance. Does David want the right to defer the purchase until all zoning requirements are secured? What if it appears that the zoning board will not approve this use of the property? Does he want out of the deal? Similarly, David's lawyer might wonder about the present condition of the property. Does he want a right to inspect? What happens if the inspection reveals structural defects? Or if David learns that the conversion will be more costly than he originally contemplated? Or if the land is unsuitable for some other reason, such as environmental contamination?

As the conversation progresses, David's lawyer will also ask about a variety of smaller, subsidiary issues. For example, what exactly is being sold? Are the old machines and lighting fixtures in the mill included in the purchase price or must the seller remove them before the closing? David's lawyer might ask about the dimensions of the property. Without a survey of the land, David may not have an accurate impression of its boundaries. Should the purchase price be reduced if the parcel is smaller

than both sides believed? David's lawyer presumably will continue to ask questions until he feels confident that his client understands what exactly is being purchased.

David's lawyer will also be concerned about a variety of things that could go wrong: risks of nature, such as the possibility that a flood or fire may destroy the property before the closing; regulatory risks, such as the possibility that the zoning board will deny a variance; economic risks, such as substantial changes in interest rates. Lawyers often try to anticipate and address these sorts of exogenous contingencies—outside the control of either party.

There are also endogenous risks, created by the possibility of strategic behavior by the other party.[6] Recall the lemons problem. In putting the deal together, Victoria may try to mislead David about the condition of the property if she knows something about it that would be difficult for David to discover. Lawyers seek to design contractual provisions that guard against the lemons problem and make such precontractual opportunism less likely.

Similarly, in almost every deal in which the parties have a continuing relationship, there will be the potential for moral hazard. The moral hazard problem concerns postcontractual opportunism.[7] One person may pursue his private interests at the other's expense *after* the contract is signed. Recall, for example, that Victoria suggested that she could help David get any necessary variance from the town's zoning board and could find prospective tenants. Absent incentives built into the contract, David has little assurance that Victoria will use her best efforts to help him after he buys the property. Victoria could take her money and run. David's lawyer would want to consider incentives, either positive or negative, to dampen these hazards.

As these examples suggest, clients—much to their disappointment and, at times, surprise—occasionally find that setting a deal's basic terms does not resolve all the thorniest distributive issues connected with the deal. Suppose, for example, that the parties agreed that the $2.9 million purchase price would be paid with stock in David's publicly traded corporation.[8] The parties may never have considered when the value of David's stock should be assessed, even though this might significantly affect the number of shares that Textile Corporation receives. Should the stock price be set on the day of the purchase and sale agreement or on the day

of the closing? If the latter, what if David behaves in a way that artificially raises the stock price between the P&S and the closing, so that Textile Corporation will receive fewer shares for the land?

Such valuation issues can be very nettlesome and risk serious conflict later. Consider *Questrom v. Federated.*[9] Allen Questrom was lured away from Nieman Marcus in 1990 to become CEO of Federated Corporation, a retail clothing giant then on the brink of bankruptcy. In addition to a $2 million signing bonus and a salary of $1.2 million for a guaranteed five years, his employment agreement also provided for a bonus that was to be based on any increase in Federated's "equity value" during the specified five-year period. When it came time to determine the bonus in 1995, the relationship collapsed and the parties ended up in litigation. Questrom's expert claimed that Federated's value in 1995 was $6 billion, thus entitling him to a $63 million bonus, while the investment bank hired by the company (and initially accepted by Questrom) valued Federated at $4 billion, entitling him to $16 million. Questrom lost his case on summary judgment on February 4, 2000. One lesson is clear: after a contract is signed, if it later becomes clear that the stakes are high, one or both parties to an agreement may have an incentive to search for ambiguity and construe in his own favor a valuation method specified in the contract.[10] One of a lawyer's central roles in deal-making is to help her client understand these types of risks.

Allocating Risks and Dampening Strategic Opportunism

After identifying the risks inherent in a deal, a lawyer must consider what might be done to protect his client. There are several contractual and noncontractual ways to constrain risk.

CONTRACTUAL MEANS: THE LAWYER'S TOOLBOX

Lawyers use a variety of contractual tools for dealing with risks, uncertainties, and strategic opportunism.[11] The toolbox includes:

- Representations and warranties
- Covenants
- Conditions
- Remedies

Representations and Warranties

On the lack of encumbrances: "The property agreed to be sold shall be conveyed free and clear of all encumbrances, easements, restrictions, taxes, assessments or special assessments, and building restrictions or covenants, with the following exceptions _____. Seller represents and warrants there are no other encumbrances, etc."

On the existence of tenancies: "The sale and transfer of possession of property shall be subject to existing tenancies of property as described in Schedule __, which is attached and incorporated by reference. The seller represents and warrants there are no other tenancies."

On the corporation's standing: "The seller represents and warrants that __ and __ are corporations duly organized and existing in good standing under the laws of the States of __, __, and __, respectively. Each Corporation has the corporate power to own its properties and assets and to carry on its business as now being conducted, and is duly qualified to do business and is in good standing in every jurisdiction in which the nature of its business makes such qualification necessary."

Box 8

A *representation* is a detailed statement of fact about the subject of a transaction. A *warranty* is a promise that a fact is true. A representation might describe the merchandise to be shipped, and a warranty would state that it is in good condition. In deals involving the transfer of goods, a representation helps the buyer acquire knowledge about the seller's product. For this reason, most warranties and representations are made by the seller.[12] In our example, David would want Textile Corporation to make as many representations as possible—on evidence of title, on lack of encumbrances, on the existence of tenancies, on relevant zoning ordinances, and on the corporation's standing to complete the transaction.

Covenants are promises to perform or refrain from performing certain actions. An affirmative covenant might require a board of directors to submit a plan for shareholder approval. A negative covenant might contain a promise not to pay dividends prior to closing.[13] Both parties are likely to include covenants in their agreement. Because of moral

Covenants

A promise not to reduce the value of the land: "Seller shall not demolish any of the structures on the premises or cut any trees on the property without first obtaining the express written consent of purchaser. Should Seller demolish structures or cut trees on the property without the prior written consent of purchaser, purchaser shall have the right to terminate this contract, at purchaser's option, on written notice to seller. On such termination, Seller shall refund to purchaser the deposit provided for above, and this contract shall be null and void."

A promise to apply for financing: "Part of the purchase price shall be paid by mortgage money borrowed from an established lender on a note secured by a first mortgage on the property in the principal amount of $___. Buyer shall promptly apply for the mortgage loan and use his best efforts to obtain a mortgage commitment. Buyer shall supply all necessary information and fees requested by the lender. The commitment for the mortgage loan must be received by Buyer no later than ___ [date]. Buyer shall notify Seller whether the commitment has been received by that date."

Box 9

hazard, David might worry that Textile Corporation will take some action prior to the closing that diminishes the value of the property. To deal with this, he will seek a covenant by which Textile Corporation promises not to destroy or reduce the value of its land prior to the closing date. Similarly, if consummation of the deal is conditioned on obtaining financing, Textile Corporation might require David to undertake certain commitments to obtain financing within a specified time.

Conditions are exit options. They are statements which, if not satisfied, "relieve a party of its obligation to complete the transaction."[14] For example, Textile Corporation may place a condition in the contract that David must receive his mortgage financing by August 1. Parties seeking exit options will want to expand the number of terms that operate as conditions.

Finally, contracts can provide for customized *remedies* in the event of nonsatisfaction. This tailors the remedies the parties receive should

Conditions

On relevant zoning ordinances: "This contract and the sale provided for are expressly conditioned on zoning of property for __ [state desired zoning]. Purchaser shall apply forthwith to the __ [name of zoning authority] of __ [city or county], __ [state], for such zoning, and shall pursue the application with diligence and in good faith. If the application is denied on or before __ [date], or if no action has been taken on the application by the zoning authority on or before __ [date], this contract shall be of no further force or effect and shall be rescinded and terminated. All costs of the undertaking to secure zoning shall be borne by purchaser."

A general condition to guarantee exit options: Buyer's obligation to close is expressly conditioned on the satisfaction of each of the conditions set forth in this __ [Article or Section or as the case may be]. Each condition may be waived in whole or in part by buyer on written notice to seller."

Box 10

some term or condition not be met and ensures that the deal can then go forward rather than derailing into litigation over damages. For example, the parties may specify a sliding scale to adjust the purchase price should the property be different than anticipated. Similarly, they may build in liquidated damages clauses, triggered if certain promises are broken.

THE PROBLEM OF INCOMPLETE CONTRACTS

Regardless of how well a lawyer employs the provisions in her toolbox, no contract can specify the full range of risks in a deal or the host of future contingencies for which it might be important to have done some planning. Contracts are inevitably incomplete.

Consider a simple example. Lee Strickland was planning for a six-month sabbatical in London. He faced a quandary. On the one hand, he couldn't justify the sabbatical if he didn't rent out his house. On the other hand, how could he be sure that his tenant wouldn't damage his beautifully furnished home, which he cherished?

One way to address Lee's problem would be to write a very detailed contract specifying the level of care any prospective tenant would need to maintain. For example, Lee might insist that the tenant wax the floors every two weeks, dust every week, and keep her feet off his sofa. Lee might set out a long list of requirements, such as no eating in the library or no playing the stereo system above level 5 to save the speakers. But this list could be endless. Leaving to one side how Lee could ever monitor compliance, there's no way that he could detail all of the rules that would be required to ensure a level of care to his satisfaction.

Contracts may be incomplete in two ways. They may be *obligationally incomplete* in that they do not fully specify the parties' obligations to one another, or they may be *contingently incomplete* in that they fail to realize the potential gains from trade under a range of economically relevant contingencies. A *complete* contract, in contrast, would specify the parties' obligations in a manner that rendered compliance more attractive than breach over the range of economically-relevant contingencies.[15]

Just because a contract is silent with respect to a particular contingency does not mean it is incomplete in this economic sense.[16] Even without an explicit contract term, an agreement may still allocate a relevant risk because the default rules—that is, the background provisions created by contract law—clearly protect one side or the other. When drafting an agreement to implement a deal, a lawyer must always decide how much detail to include and which contingencies to cover explicitly with a contractual provision. Indeed, for tactical reasons, a lawyer might choose *not* to raise a particular risk because the background rule is favorable to his client.

But most contracts are incomplete by the economist's definition, for one of several reasons. First, deal-makers by nature are not perfectly rational. No one can predict the future; even sophisticated parties may not be able to foresee all the relevant contingencies in a deal.[17] Second, even if a risk is identified that is not clearly allocated under the default rules, parties might rationally decide not to address the risk in their contract. The transaction costs of negotiating a provision for some contingencies may outweigh the expected benefits.[18] The parties might view the risk as very remote. They might decide that rather than deal with it now, they can wait, see if it materializes, and negotiate about it later if necessary.

In short, it is impossible to provide for all contingencies, and it may be inefficient to try. Lawyers may ill serve their clients by trying to plan for every eventuality. In Lee's case, the absurdity of doing so is obvious. On the other hand, sometimes lawyers and clients throw up their hands in despair and prefer to create only bare-bones contracts in the belief that cooperative business partners will resolve all future disputes amicably. This solution can be equally unwise. Deals can and should channel the incentives of deal-makers in a direction that gives the deal the best chance of working out in the long run. While there are limits to what contracts can accomplish, through sensible planning many risks can be constrained by contract.[19] The mark of a good business lawyer is knowing when to press for certainty and when to leave terms for ad hoc resolution down the road.

Other Means of Dampening Strategic Opportunism

Lee was clearly unhappy with a contractual solution to his problem. He couldn't detail the tenant's rules of conduct completely, and even if he could, such a contract would not offer him much reassurance. After all, a contract only provides for relief after the damage is already done. Lee didn't want *any* damage to his home—he wanted to prevent, deter, and preempt a loss, not remedy it through compensation. Suing his tenant for breach of contract after he returned from sabbatical was not what Lee had in mind. It would be a hassle, and it was unlikely to restore his home to its original state. So how could Lee best protect his home?

Legal promises are often a second-best solution, given the transaction costs and delay involved in enforcing those promises in court.[20] Thus, business lawyers must structure the business incentives of the contracting parties so that each partner will want to comply for reasons that are independent of the legal enforceability of the contractual promises they have made. Several mechanisms, besides the threat of going to court after the damage is done, can increase the parties' incentive to comply with the terms of the deal. These include:

- Hostage-taking
- Reciprocal exchange

- Early warning mechanisms
- The prospect of future deals
- Compensation mechanisms

HOSTAGE-TAKING

This is a common means of aligning incentives. A hostage is an asset that is forfeited by a party who doesn't honor his contract or agreement. A hostage raises the cost of noncompliance and may therefore motivate that party to honor his obligations.[21] In a lease, the most common hostage is a security deposit from the tenant.

A hostage was not a perfect solution to Lee's problem, however. A normal security deposit wouldn't be sufficient to assure Lee that the tenant would take care of his home. He was planning to rent the house for $3,000 a month for six months, for a total of $18,000. One month's rent as security deposit would not do much to protect Lee's antiques and valuable photograph collection. He could, of course, ask for a very large security deposit—say $50,000. This would increase the likelihood that the tenant would be careful with Lee's belongings. But this approach raises two problems. First, in Lee's home state, security deposits cannot, by law, be greater than one month's rent. Second, even if a tenant *could* agree to such a large deposit, this hostage might create its *own* incentive problems.

The most effective hostage is one that is valuable to the giver but not very valuable to the receiver. To see why, consider the potential incentive problems if the tenant gave Lee a large cash deposit. Because the hostage would be inherently valuable, an unscrupulous landlord would have an incentive to behave opportunistically at the end of the lease—to keep more of the money than is justified. He could claim that modest wear on the carpet or marks on the walls required him to spend the security deposit to recarpet or repaint the entire house. To reduce the risk of opportunism on either side, a better deal would involve a hostage that is valuable to the tenant—such as a piece of treasured memorabilia or an object of sentimental value—but not to Lee. Of course, the tenant would need to show credibly that losing the nonpecuniary hostage would be sufficiently undesirable to create the deterrence Lee hopes to achieve. In Oliver Williamson's classic (if sexist) analogy, a king who wants to guarantee his promise to another sovereign is better off offering his ugly

daughter as a hostage than his beautiful daughter—not because the king loves the ugly princess any less (which he doesn't) but because the other sovereign will be less tempted to keep her after the promise is fulfilled.[22]

What sort of hostage might Lee take—perhaps in addition to a one-month security deposit—that could help reassure him? Reputation is a common nonpecuniary hostage. Imagine that Lee and a prospective tenant know many people in common. In addition to being able to get more information about the tenant's character by contacting these references, the tenant's reputation may be held as a hostage, provided Lee could damage it if the tenant was irresponsible. Better yet, suppose Lee finds a tenant who is about to start work in a major law firm in Lee's town and that Lee knows well several partners for whom the tenant will be working. Assuming the tenant is concerned about her reputation, this may be a more effective hostage than a large cash security deposit.

RECIPROCAL EXCHANGE

The reciprocal nature of some transactions automatically provides both parties with a means to guarantee the other's behavior. This occurs in situations where the parties buy and sell reciprocally "some specialized product, or product requiring a specialized input," from each other.[23] As Paul Rubin has explained, "If a manager of Firm B is in a position of buying some specialized input from Firm S and is afraid that S will behave opportunistically, he should look for something for B to sell to S which will make it possible for Firm B to also behave opportunistically."[24] In other words, the parties mutually create a situation akin to a bilateral monopoly, in which each side can exploit the other.

To take advantage of reciprocal exchange, Lee might look for a tenant who has a home in the city where Lee intends to take his sabbatical. They might swap houses, as in some time-share arrangements. So long as their homes are of roughly similar value, this might reassure Lee that his house will be safe—after all, each side can exploit the other, and thus each side will have an incentive not to do so.

EARLY WARNING MECHANISMS

A third means of dampening strategic opportunism without contemplating court enforcement is to build in monitoring and early warning mechanisms. Thus, Lee might require as a condition of the lease that his

tenant employ his housekeeper during the six-month sabbatical. This would serve two functions. First, it would guarantee to Lee that someone was doing basic cleaning and maintenance in a way that he approved of. More important, however, this would provide Lee with an inside source of information on the condition of his house. Each week his housekeeper would be able to inspect the premises and report to Lee if there were any problems. And *knowing* this, his tenant might be less likely to cause problems in the first place.

THE PROSPECT OF FUTURE DEALS

In commercial relationships, both parties to a deal may want to do business with each other again. Neither party wants to lose the profit it would earn from future transactions.[25] Suppose that apart from his sabbatical, Lee went away for two months every summer and typically left his house vacant. If Lee found a tenant who came to his city every summer, both parties might have a substantial interest in future dealings.

At some point, however, there may be no prospect of further dealings. There is no shadow of the future in what game theorists call the "last round" of a series of transactions. Moreover, if it is known in advance when the relationship ends, there is a risk of unraveling. If a supplier knows that its December shipment will be the last shipment it will ever deliver to a particular manufacturer, and if the manufacturer must always pay in advance, the supplier may take advantage of this opportunity to ship inferior goods in December, since no future profits will be forfeited.[26] But the manufacturer, anticipating this problem in December, can also behave opportunistically: he can cancel the December shipment as soon as the November shipment arrives. Why pay for the December goods and then get an inferior product? Knowing that the manufacturer is likely to think this way, the supplier will in turn be tempted to ship inferior products in November. But the manufacturer, anticipating such opportunism, will be tempted to terminate the relationship in October. And so on.

As L. G. Telser observes, "If there is a last period known to both parties, then no self-enforcing agreement will be feasible."[27] Given appropriate assumptions, it is possible to demonstrate mathematically that unraveling should occur.[28] The unraveling effect is undoubtedly less extreme in practice than in theory, but it does seem clear that as the

shadow of the future shortens, the incentive to behave opportunistically increases.

COMPENSATION MECHANISMS

Deal-making often involves arrangements where one party is providing services over time that benefit the other. As we suggested in the principal-agent context, while perfection may not be possible, some compensation mechanisms can better constrain opportunism, and better align incentives, than others. The examples that follow illustrate the effective use of incentive terms. Lawyers should be sensitive to these issues when they help to structure deals.

Incentive terms can address a host of problems. For example, they can be used when parties have different time horizons. Consider the possible contractual relations between a movie distributor (like Paramount, Universal, or Fox) and a local theater that will exhibit a movie.[29] At the extreme, the exhibitor could pay a fixed rental fee for the right to screen the movie for a given period and keep all the revenue itself. Or, at the other extreme, the exhibitor could charge the distributor a flat rental fee to screen the movie, with the distributor receiving all the revenue from ticket sales. As Victor Goldberg has shown, parties typically avoid these extremes. Instead, they divide the revenues in a manner that takes account of the fact that both parties can influence how successful the movie's run is, although the period in which each makes its effort differs.

A distributor's effort is concentrated shortly before the movie is released, and after release the exhibitor takes over advertising. The exhibitor has an incentive later to market the movie locally. The sharing formula reflects this difference in timing. As Goldberg observes, "Since the selling effort of the distributor is more heavily front-loaded, a constant profit-sharing formula would give the Exhibitor a poor return on its marketing efforts in the later stages of a film's run. It would be inclined to terminate a run early, since it would bear nearly all incremental marketing costs [of a longer run while reaping] only a portion of the gains."[30] Distribution contracts respond to this asymmetry by reducing the distributor's share of profits over time.

Incentive terms can also address situations in which the parties have different risk preferences. Consider the problem of incentive alignment

with respect to executive compensation. Shareholders want executives to behave in a way that maximizes the value of the enterprise—for a publicly traded company this would be reflected in the share price. To the extent that a substantial part of an executive's total compensation depends on an increase in the stock price, his incentives will be better aligned with those of the shareholders. Providing a lower base salary and more stock options would obviously be better in this regard than a fixed salary arrangement. On the other hand, tying compensation too closely to short-term profits may lead an executive to focus too much on short-term gains at the expense of investments that could provide long-term profits.[31]

Finally, incentive terms can be used to constrain opportunistic behavior by one of the parties to *an ongoing venture.* Consider a negotiation in which a new long-distance telephone service provider is contracting with a broker that will solicit customers to switch from their current long-distance provider to the new company. The broker is to receive a commission based on the telephone bills incurred by the customers whom he induces to switch. But the service provider is worried that under this arrangement the broker has an incentive simply to copy names out of the phone book and to submit them to the provider as customers who authorized a change in service. Of course, the broker will protest that it would never engage in such behavior and may even promise not to do so in the contract. But that might not be enough. The parties might also need a mechanism that enables them to determine relatively cheaply whether a customer has authorized service changes, perhaps by obtaining from each customer a signed letter of authorization or some other kind of proof. But even this might not be enough. After all, these forms of proof can be faked. What should the lawyers do?

The service provider wants to give the broker the greatest possible incentive to submit only the names of customers who actually authorized a switch in service. This can be achieved by using a sliding commission rate. Because customers who did not authorize a switch in service will likely terminate their service after incurring one or two months of charges, the service provider can offer commissions that increase incrementally with each month that the customer remains with the company. Thus, the broker may collect nothing in the first month, 2 percent in the second month, 5 percent in the third month, and 15 percent

for every month thereafter. By structuring compensation in this way, the broker has an incentive to sign over customers who will stay on the service—that is, legitimate customers.

Managing the Commitment Process

In addition to allocating risks and dampening strategic opportunism, a lawyer performs another critical function in deal-making: managing the commitment process. Consider the real estate deal between David and Victoria. Suppose that four days after meeting with his lawyer, David found an alternative site that was an even more attractive investment opportunity than Victoria's mill. Imagine that he wanted to get out of his agreement with Textile Corporation, if he has one. If he were to call his lawyer and ask whether his handshake created a legal contract, his lawyer would reply that nearly every state requires that contracts for the sale of land be in writing. Therefore, neither David nor Textile Corporation would be bound by their preliminary agreement.

Lawyers are expert in managing and crafting enforceable legal obligations and in specifying when obligations are *not* meant to be enforceable. Typically, most deals progress from an initial stage of exploratory negotiations—when the parties prefer not to be bound—to later stages in which the parties, having made financial and emotional investments in the deal, prefer to be committed. Between these poles lie intermediate stages of legal commitment that may create uncertainty for clients. Clients may not understand the legal obligations that attach to agreements-in-principle, memoranda of understanding, or purchase-and-sale agreements.[32] More important, they may only vaguely understand what degree of legal commitment—at any moment in time—best meets their interests.

Lawyers have a range of mechanisms to meet clients' differing preferences toward commitment. Buyers, for example, often want a free option to buy at a specified price for a period of time, during which they can investigate the subject of the purchase. Because such buyers prefer to delay binding commitments until the very last moment in the process, their lawyers may seek to provide them with a condition that gives them an easy exit prior to closing. In our example, David's lawyer might draft an inspection clause so broad that David could find the property unaccept-

able for almost any reason. Sellers, on the other hand, will usually seek to nail down the buyer's escape hatch as early as possible, because they may forgo opportunities to sell elsewhere if their property is kept out of the market for too long. They will want conditions to be narrowly drawn and have short deadlines.

Lawyers often work hard to clarify whether a commitment is meant to be binding. For example, they will often insert explicit language into agreements-in-principle or term sheets indicating that no one is bound by that document and that only a formal signed contract, yet to be written, will create legal obligations. Sometimes, however, lawyers will intentionally create ambiguity about whether an agreement-in-principle is meant to be enforceable. Parties, of course, often honor commitments even if they are not legally enforceable, and there may be reputational costs to breaking one's word.[33] In addition, fear that a court *might* enforce such a preliminary agreement may augment the sense of psychological commitment or moral obligation to complete the deal. For the lawyer, the point is to be purposeful.

Deal-making is like a dance in which the parties begin across the room from each other and end in a tight embrace. Lawyers choreograph this dance by creating small steps, or micro-commitments, that move the parties closer together. These small commitments—such as initial deposits (sometimes called "earnest money") or agreements-in-principle—pave the way for ultimate commitments by allowing both parties to learn more about each other (thus correcting any information asymmetries) and by signaling that both parties are serious enough about the deal to invest resources. The lawyer's role as a risk manager facilitates this process. By identifying and allocating risks, lawyers essentially provide insurance to their clients. Clients may find it easier to agree to a deal after the lawyer has approved how the risks are allocated.

There is substantial interplay, therefore, between the lawyer's two roles—as risk allocator and as commitment manager. On the one hand, lawyers may withhold or forestall commitment until they understand how the allocation of certain risks will affect the value of a deal for their clients. Similarly, their ability to plan for the most relevant contingencies enables them to shepherd reluctant or hesitant clients through the commitment-making process.

CLOSING THE DEAL

So far we have explored how lawyers help their clients structure deal terms to reduce opportunism over the life of a deal. But opportunism persists, including opportunism at the bargaining table. Like dispute resolution, deal-making has both value-creating opportunities and distributive elements. And often deal-making ends up being wasteful or inefficient because the parties engage in hard bargaining to secure distributive advantage, spend more time than is necessary, over-lawyer the deal terms, or blow up a deal unnecessarily. Here we explore some of these opportunities and pitfalls in making deals.

Value-Creating Opportunities at the Bargaining Table

Lawyers often say that whereas dispute resolution and litigation are primarily distributive, deal-making is a value-creating enterprise. Parties to a deal are looking for trades that make one or both better off; otherwise they wouldn't do the deal. When lawyers get involved in deal-making, they can help their clients discover those differences in resources, relative valuations, forecasts about the future, risk preferences, and time preferences that create the potential for gains from trade.

TRADING BETWEEN TERMS

The possibility of trades between terms unravels a puzzle inherent in the structure of all deals. In looking at any one provision—be it a price term or a representation—we can confidently predict how each party would prefer to have that term adjusted. With respect to any one term, bargaining is distributive. For example, if David and Victoria—or their lawyers—focused exclusively on the term regarding the date by which David had to secure financing, David would undoubtedly want it to be later and Victoria would want it to be earlier. But because deals involve bundles of terms, each of which can affect the balance of risk and return, negotiators can trade among terms, swapping relatively inexpensive terms for more valuable provisions. Thus, David might agree to secure financing by August 1 in return for a more favorable promise from Victoria on some other term.

If a lawyer understands his client's interests, resources, and capabilities, he can structure a deal to maximize its value for his client by securing advantageous provisions on the terms that matter most to his client while yielding a bit on those terms that are relatively more important to the other side. This is not as easy as it sounds. It requires effective communication between the lawyer and the client, and a great deal of trust. It may be very difficult for the client to ever have a nuanced sense of how the wording of different provisions may affect the degree of legal risk. Likewise, a lawyer may not be able to fully explain the opportunities and risks of making trades between various legal terms.

CREATIVE FINANCING

Financing arrangements—that is, the terms that govern the allocation of the cash flows generated from a particular venture—can create value by drawing on the different interests of the two parties.

Consider David's options for raising money to complete the sale. Assume that David can seek a mortgage from a bank (debt financing), pay the purchase price in net cash reserves, or turn to a business associate or colleague to form a partnership in return for equity share. This is a simple choice between debt and two forms of equity financing. If David can earn 11 percent return on the property and borrow money at 9 percent, he will reap a 2 percent surplus on every dollar he borrows. This will free up David's cash reserves to make other investments that also might yield more return than the interest payable on the mortgage. In addition, debt financing is attractive because interest payments are usually tax-deductible. But if interest rates are too high, David might well be advised to invite equity participation—minimizing the cost of funds now in exchange for spinning off future cash flows to a partner.

This is the stuff of real estate finance, and it involves complex decisions about what type of investment will maximize the cash flows generated from the project.[34] Of course, financing arrangements are not limited to a simple choice between debt and equity but can be devised in a variety of ways. In every case, however, each of the parties—lender, borrower, equity investor—wants more return for less risk. All have a mutual interest in maximizing the cash flows from the project, but—as our first tension suggests—each is in competition with the other for a larger

slice of the pie. Throughout the financing process, lawyers can help their clients understand the advantages and disadvantages of different options and the various risks each poses.

Common Pitfalls

Deal-making is not all about value creation, of course. Although two clients may have reached an agreement in principle, inevitably there will still be distributive issues to address at the bargaining table. In haggling over legal terms, the lawyers on each side may try to capture more of the as-yet unallocated gains from trade and push the other side as close as possible to its reservation point. Neither side may know how far it can push the other before the deal risks falling apart.

HARD-BARGAINING TACTICS

Each side may start with an initial draft agreement that is highly partisan in its favor. The prototype is the landlord's lease—a standard form that is extremely skewed in favor of the landlord. Then each lawyer may try to wear the other side down so that the other side will grant valuable concessions on various terms.[35] This is not entirely irrational, of course. As in any negotiation, each side faces great strategic uncertainty and neither party wants to be overly generous initially for fear of giving away more than is necessary to do the deal. Each side may thus dig in to an initial position that claims most of the value of the deal and fight hard to concede little while demanding concessions from the other side. If one party seems to be in the more dominant or powerful position—perhaps because it has greater resources or has a better alternative in the marketplace—it may demand that the deal be structured on its terms and refuse to negotiate over those terms with the weaker party.

When a lawyer says "There can be no deal unless you provide a warranty in the form I've suggested," this creates a basic problem. Is it really true? Or is the lawyer trying to create the perception that the provision is indispensable when it isn't? The lawyer may be playing a game of chicken just to see how important this provision is to you and whether you're willing to risk having the deal blow up over it.

The result may be deadlock. If the lawyers on both sides stake out ex-

treme positions on legal terms, they may argue back and forth without moving the deal forward. Eventually, one or both clients may intervene to get the deal done—particularly if they get impatient with their lawyers for delaying the negotiations.

OVER-LAWYERING

Over-lawyering is a second problem. It can occur in two basic ways. First, lawyers can waste the client's time and money by focusing on small or unlikely risks that do not justify contractual planning. For example, during a merger negotiation, James Freund—then-partner in the New York law firm of Skadden, Arps—was asked by the other side to negotiate a set of clauses that would take effect in the unlikely event that the 1933 Securities Act was repealed.[36] Fortunately or not, there is no limit to the process of identifying risks when creative and smart lawyers are involved. The critical consideration to keep in mind is whether the net expected impact of the risk justifies the cost (in both money and relationships) required to allocate it before the fact.

Another type of over-lawyering is more subtle. It occurs when lawyers insist on creating legally enforceable promises even though the long-term cost of enforcing the promise outweighs the value added. To understand this second type of over-lawyering, consider the factors that bear on the value of a legal promise. In addition to the delay and costs of litigation, there is also the possibility that a reviewing court might come to the *wrong* conclusion.[37] In other words, any estimation of the value of a legal promise must factor in the possibility that when you try to enforce it, the other side might defend the enforcement action vigorously—and win.

For example, in the case of an indemnification provision given by the seller of a business to the buyer, as Ed Bernstein explains, the value of such a promise is not the full dollar amount of the indemnity. "Rather, it is the dollar amount of the indemnity discounted to take into account the time it will take to obtain a judgment, litigation costs, and the risk that the buyer may not prevail if the court errs and denies him a full recovery on a valid claim."[38] Conversely, a seller's representation or warranty may be more "expensive" than it appears because of the risk of having to defend against an opportunistic enforcement action and the possibility of losing that defense.

An estimate of the value of a legal promise must also consider whether the parties' relationship will suffer—and more specifically, whether their expectations of each other's behavior will change—if a variety of state-contingent clauses are proposed. Consider the potential effect on a romantic relationship of asking for a pre-marital agreement. The mere suggestion of a pre-nup implies that at least one party is anticipating breach rather than perfect love.[39] The relational costs of negotiating such an agreement often deter couples from even talking about it.

By analogy, a commercial deal-maker may feel as if he is getting married to his new business partner, and may reassess the relationship if the other side wants to plan systematically for a split-up down the road. The difficulty, of course, is that feigning insult at having to negotiate over contingencies is easy—especially when the other party will truly be at risk if the contingency arises. Moreover, parties who choose not to plan for certain risks may be in denial: they may underestimate the risks to their detriment. To make things more complicated, a client may *believe* that her attorney is over-lawyering but be wrong. Clients often complain that lawyers don't understand business and the sorts of risks that businesspeople take every day. They may sometimes be right. On the other hand, lawyers often complain that their clients don't understand the extent of a legal risk.

In legal deal-making, the best decisions require a combination of legal knowledge and knowledge about the client's business and preferences. Ideally, a well-informed client should decide the extent to which her lawyer seeks protection through contractual provisions. Alternatively, if a lawyer knew enough, it might be appropriate for a client to delegate decision-making authority to her counsel. But either ideal may be very difficult to achieve in practice. It can be very expensive (and sometimes impractical) for the client to become sufficiently informed about the lawyer's area of expertise or for the attorney to learn enough about her client's business to make informed decisions.

We do not wish to overstate the problem of over-lawyering. Because clients often complain that lawyers don't understand the business side of a deal, lawyers must walk a fine line with their clients, identifying and allocating those risks that are important for the client but not spending unnecessary time on risks that are relatively trivial. Moreover, lawyer and

client may not see eye to eye on which risks are which; the lawyer may find some risks important that the client does not, and vice versa.

Our Example Continued

Let's return to the real estate deal between David and Victoria. To complete our example, consider how lawyers could help David and Victoria negotiate about the possibility that hazardous wastes have contaminated Textile Corporation's site.

Assume that David's attorney drafts a contract to send to Victoria. David's lawyer, experienced in real estate transactions, calls to David's attention the possibility that the factory may have contaminated the surrounding water or soil with hazardous wastes. David's attorney advises him that under the Superfund law (CERCLA) he may be held liable for pollution created by previous owners.[40] Moreover, because Superfund liability is strict, joint and several, and retroactive, there is a possibility that David would be stuck with *all* the clean-up costs, should there be any. David, of course, does not know whether the site is contaminated with toxic waste. This was a risk that he and Victoria did not discuss. David thus faces a lemons problem. He is purchasing an asset of unknown quality (in this case, a property burdened by an uncertain amount of liability). What should he do?

Assume that Textile Corporation, having held the land as a passive investment for the past thirty years, is certain that it has done nothing to contaminate the site. But Textile Corporation has never tested the soil and groundwater around the factory. It does not know if, and to what extent, there is on-site contamination. The basic dilemma for David and Victoria, then, is how to manage these uncertainties.

David, of course, wants Victoria to represent that the land is uncontaminated, that Textile Corporation has not deposited waste while it owned the land, and that it has no knowledge of hazardous substances being on the property. David wants these representations to survive the closing, and he may even seek indemnification from Textile Corporation for any Superfund liability connected to the site. He may also seek inspection rights, with an option to rescind and terminate the contract if tests reveal toxic waste contamination. In drafting the agreement, therefore, David's attorney might include language like this:

Seller's Warranty that Soil Is Free of Toxic Waste Contamination
Purchaser, at Purchaser's sole expense, shall have 90 days from the date of this contract within which to secure soil and groundwater tests of the property. Purchaser and any firm or person designated by Purchaser shall have the right to enter on the property to secure samples of soil and groundwater and otherwise test the soil and groundwater within the stated period. Buyer shall indemnify and hold Seller harmless from all liability, claims, losses, damages, costs, and expenses, including attorney fees, arising out of or resulting from the performance of any such inspection and testing.

Seller expressly warrants that the soil and groundwater of the property are free of toxic waste contamination as of the date of the passage of the legal title to the property from Seller to Purchaser.

In the event Purchaser's experts determine within the stated period that the soil and/or the groundwater of the property is or are not free of toxic waste contamination, and a written analytical report by the experts demonstrates conclusively that such is the case, Purchaser may at Purchaser's option rescind and terminate this contract, provided written notice of termination and rescission is given to Seller on or before 120 days from the date of this agreement.

From David's viewpoint, this term obtains the maximum degree of disclosure about the land prior to the actual exchange. If Victoria refused to deliver such a warranty, it might suggest that something is wrong with the property. In addition, this term, as do all representations, "lays the groundwork for indemnification, should it develop after the transaction has been closed that the representation was untrue."[41]

Victoria is likely to think that David's lawyer is asking for too much. She might respond by requiring that David take title to the land on an as-is basis.[42] She might allow David to inspect the land to his satisfaction but insist that no warranties or representations be made about environmental conditions. Before returning the draft to David's lawyer, she might cross out his language and insert the following:

Purchaser's Agreement to Take Property "As Is"
All previous understandings and agreements between the parties are merged in this agreement, which alone fully and completely expresses their agreement, and the same is entered into after full investigation, neither party relying upon any statement, representation, express or implied warranties, guarantees, promises, statements, "setups," representations, or information, not embodied in this agreement, made by the other, or by

> any real estate broker, agent, employee, servant, or other person representing or purporting to represent Seller. Purchaser has inspected the property and is thoroughly acquainted with its condition and takes same "as is," as of the date of this contract, ordinary wear and tear and damage by the elements or casualty excepted. Seller has not made and does not make any representations as to the physical condition, expenses, operation, or any other matter or thing affecting or related to the property, except as specifically set forth in this contract. Purchaser acknowledges that all representations which Seller has made, and upon which Purchaser relied in making this contract, have been included in this contract.

Victoria might claim that the purchase price of $2.9 million contemplated an as-is purchase and that if David wants representations as to quality, the purchase price must be increased. Or Victoria might react with anger (feigned or real) that David is reneging on previously agreed-to terms. The bargainers might reach an impasse on this point.

How can David and Victoria create value when dealing with this risk? Textile Corporation knows more about the past use of the land than David does. Presumably, it is easy—and cheap—for Textile Corporation to indemnify David for any clean-up costs traceable to its own ownership of the land, because it knows it dumped no waste. In exchange for reducing this uncertainty, Textile Corporation can seek a higher price from David or concessions on other deal terms of importance to it. In effect, Textile Corporation can trade what is relatively inexpensive to it for something more valuable.

Victoria's lawyer will likely point out a further wrinkle. In indemnifying David for clean-up costs, Textile Corporation will worry about moral hazard.[43] Because Textile Corporation's warranty will fully insure David, the buyer may not have the strongest incentive to minimize clean-up costs should any arise. In fact, David may even exacerbate the problem—by digging new wells or otherwise disturbing any contaminated area—knowing that any increased harm will be attributed to Textile Corporation. The seller, therefore, might want to cap its total liability to the buyer. The cap will provide incentives for the buyer to minimize clean-up costs should contamination turn up. Similarly, Textile Corporation will seek indemnification from the buyer for any clean-up costs associated with hazards during the buyer's ownership.

A similar problem would arise if David and Victoria tried to create

contractual promises based on what Victoria does or doesn't know about the condition of the land. For example, rather than promise that there are no toxic wastes, Victoria might promise that she *knows* of none. Or she might claim to have no knowledge either way. The parties, of course, would face a distributive issue as to the stringency of the term—David would push for a term that held Victoria responsible more often, Victoria for the opposite. Throughout this negotiation, Victoria's lawyer would be concerned about the ways in which David could abuse the term later. For example, suppose Victoria stated that she knew of no waste. If there *is* waste, it's almost certain that David will allege that Victoria knew of it—even if she didn't. And how will Victoria prove that she *didn't* know? If the burden of proof is on her to do so, she may find it very difficult.

As a result, perhaps Victoria will suggest a different approach. Rather than promise that she knows of no waste, she might turn over all of her records, books, and files to David before the sale. "Here," she might say. "I promise that this is all the information I have about the property. Look for yourself. But once you've inspected, the risk is yours." In that situation, if David later found waste, the burden would be on him to prove that Victoria *hadn't* shown him all the documents and information—a much more difficult task for David.

Carving up these risks and tailoring the contract to them will create value for David and Victoria. Of course, clever trades cannot entirely eliminate distributive conflict. Much of the bargaining about terms in a deal involves attempts—however subtle—to do better for your side. Perhaps the best example occurs when a party fails to comply with an obligation that is a condition for closing, or when new, unanticipated information surfaces. While technically granting one party an out, these developments are often used as the basis for price renegotiation.

Suppose that on inspection David discovers trace lead levels in the groundwater. Assume such levels are not in themselves hazardous and that the law does not require their clean-up. Nevertheless, the possibility that such deposits will increase over time creates a risk that someday David may have a significant environmental clean-up on his hands. David might try to reduce the purchase price by the amount of the cost to clean up the trace amounts of lead. Presumably, Victoria will resist. She may not know whether David is using the trace amounts of lead as a

strategic ploy to reduce the purchase price or whether he is genuinely concerned about future environmental risks. It may, in fact, be some of both.

If Victoria thinks that David is simply bluffing, she may require a term in the contract that the clean-up actually occur. If David does *not* want to clean up the waste and is just trying to decrease the purchase price, he will resist this term—and his real interest will be discovered in the process. By changing the terms of the contract, Victoria can smoke out David's ploy.

CONCLUSION

Our colleague Ronald Gilson has advanced a theory to explain how lawyers create value in business transactions.[44] Gilson asserts that in a world of perfect markets, four ideal conditions would exist:

- The parties to a transaction would have a common time horizon
- They would share future expectations about an asset's risk and return
- Transaction costs would not exist
- All information would be available without cost

According to Gilson, lawyers would play little role in this world. They certainly could not increase the value of a transaction, because investors would do just fine on their own. Prices would accurately reflect value, and bargainers could make deals at no cost.

But this utopia does not exist. The real world is beset with various forms of market failure which increase the cost and difficulty of contracting. Gilson writes that it is precisely these forms of market failure that provide the basis for the lawyer's value-creating role: the lawyers step in to correct these failures at an acceptable cost. Lawyers act as "transaction-cost engineers," devising efficient mechanisms—or deals—to bridge the gap between this hypothetical world of perfect markets and the real world. "Value is created when the transactional structure designed by the business lawyer allows the parties to act, *for that transaction,* as if" the four ideal conditions existed.[45]

As we have seen, business lawyers *may* create value by designing a transactional structure that reduces the parties' mutual fear of strategic

exploitation. Reducing this uncertainty helps the deal go through and adds value to the process. We have also seen, however, how hard-bargaining over representations, warranties, or indemnities may cause a deal to flounder even though both parties would be better off if it were completed. And even if a deal goes through, hard bargaining may impose unnecessary costs.

This dilemma, of course, is present in both deal-making and dispute resolution. In Chapter 6 we turn to several additional reasons that lawyers and clients often end up in adversarial rather than collaborative legal negotiations.

10

Advice for Making Deals

Peter French, age 42, is a vice president of the agrochemical division of a large national company. He has just been offered a new job as executive vice president and chief operating officer (COO) of Montero West Corporation, a moderately sized and publicly traded bioengineering and life sciences company based in Denver, Colorado. Montero West produces agrochemicals, including pesticides and herbicides, as well as genetically engineered seeds, specialty crops, and some pharmaceuticals.

Three months ago Peter was contacted by a headhunter who arranged for him to meet the president and chief executive officer at Montero West, Henry Phills, and a search committee of Montero board members. The Phills family controls a majority of the outstanding shares of Montero West, which was founded by Henry's grandfather. Peter is being considered for second-in-command, with broad day-to-day operating responsibilities. Henry, who is now 60 years old, expects to retire at age 65. Although Peter has been told that there can be no guarantees, Henry and the board have suggested to Peter that when Henry retires Peter would be the prime candidate for CEO.

Henry and Peter have negotiated the key financial terms of Montero's offer. On behalf of the corporation, Henry sent Peter a "nonbinding letter of intent" outlining their understanding, which included the following:

- "You will be Executive Vice President and Chief Operating Officer, reporting directly to the CEO and the Board of Directors."
- "You will be paid a yearly base salary of $475,000, with an additional discretionary annual incentive bonus to be determined by the Board's Compensation Committee."
- "Upon signing, you will receive options to purchase 100,000 shares of Montero West's stock at the current price of $30 per share. Twenty percent of these shares will vest each year over a five-year period."
- "In the discretion of the Board's Compensation Committee, you may also be awarded additional options in the future on an annual basis."
- "You will also receive the company's standard executive benefits package, including disability, life and health insurance, and retirement benefits. The firm also agrees to pay your reasonable relocation expenses."
- "Our agreement will be documented in a written employment contract with a five-year term."

Peter hired Janice Dobson, a partner at a mid-sized Denver law firm, to represent him in negotiating his employment contract. The company referred the matter to Bill Stodds, a partner in the Denver law firm that is Montero West's outside counsel, to handle the contract for Montero West.

REVISITING THE OPPORTUNITIES AND CHALLENGES IN DEAL-MAKING

Our focus in this chapter is on how lawyers can best take a problem-solving approach in negotiating the legal language used to implement deals. In many transactions, as in our example, the clients have already negotiated a preliminary understanding of the basic terms without the

direct involvement of lawyers. Clients bring lawyers into the transaction to create the written documents to formalize the deal.

Why Deals May Be Easier to Negotiate than Disputes

To some extent, problem-solving should be easier in deal-making than in dispute resolution. In deal-making, the parties see the possibility of joint gains and value creation almost by definition. Parties enter deals because they each see themselves as better off doing business together than not. They want the deal to go through, and they want to capture the value of their proposed transaction. Thus, the whole enterprise of deal-making is often oriented toward value creation.

Second, in deal-making the principals have often reached agreement about the distributive dimensions of many important issues before lawyers are even brought into the negotiation. Peter and Henry, for example, have settled the most conspicuous basic terms of their deal: the salary amount, length of the contract, and so on. Although their lawyers have a great many remaining issues to address, the parties are likely to see those issues as secondary to the substantive core terms that have already been tackled.

Third, in deal-making the parties often anticipate that they will have a future working relationship. Peter and Henry, for example, expect to work together for the next five years. Neither wants the negotiations over Peter's employment agreement to undermine that budding relationship. In cases like this where the shadow of the future is long, clients may be less tempted to behave opportunistically or to push for what could be perceived as unreasonable distributive gain. They are more likely to collaborate to resolve their differences amicably, fairly, and efficiently.[1]

Finally, problem-solving can be easier in deals than in disputes because attorneys often have an economic incentive to get deals done. Transactional lawyers, even if generally paid by the hour, often must significantly discount their fees if a deal falls apart, and they may earn a premium if the deal goes forward. The reality is that some lawyers will be paid only when and if the deal goes through. Unlike a litigator who is paid by the hour and will earn less if there is an early settlement, trans-

actional lawyers often have a strong incentive to reach a negotiated agreement.

The Challenges for Lawyers in Deal-Making

Despite these advantages of deal-making over dispute resolution, negotiating the language of documents that will implement a deal is often difficult. Lawyers face two basic challenges. First, they must communicate with their clients clearly about the risks that might affect the client down the road. Second, they must manage the strategic challenge inherent in all negotiations: what we have called the first tension.

LAWYER-CLIENT COMMUNICATION

Transactional lawyers are experts at thinking about what might possibly go wrong with a deal and how to protect their clients from avoidable risks and unwise commitments. The hard question is what level of risk a client should accept—which risks are important and which less so.

To make wise decisions, a lawyer must learn his client's priorities and preferences, and the client must learn how different legal arrangements may shift risk and affect the value of the transaction. But this kind of learning requires that the lawyer and client communicate effectively and efficiently as the negotiation with the other side unfolds.

Many lawyers and clients don't manage their communication very well. Often lawyers don't probe for their clients' interests deeply enough. Sometimes clients are unsure about their interests and have difficulty setting clear priorities. Moreover, lawyers often find it trying to explain to clients how different legal provisions would affect the probable outcomes should a particular contingency arise in the future. Some subjects and risks may be hard to discuss because they may trigger an emotional reaction in the client. For example, a client may be reluctant to focus on provisions that relate to his being fired for incompetence or to his being terminated in the event of disability. Particularly when a client sees certain risks as remote, lawyers and clients can become frustrated with each other. The lawyer may feel that the client does not take a given risk seriously enough. And the lawyer may fear that even if a client agrees to forgo protective language today, he will still blame the lawyer later if the contingency in fact arises. On the other hand, clients sometimes feel that

their lawyer is making a mountain out of a molehill or simply trying "to cover his own tail."

THE STRATEGIC CHALLENGE

In addition to managing this communication challenge behind the table, lawyers face a strategic challenge across the table in negotiating deal terms. After reaching an agreement in principle on the major terms, one or both clients may wonder "What greater concessions might I have gotten from the other side had I pushed harder?" Some clients are tempted to use the legal phase of negotiations to seek further distributive gains on secondary terms. One or both sides may believe, "Even if my lawyer proposes secondary terms that are highly favorable to my interests, the other side obviously wants this deal—they will ultimately concede rather than walk away." For example, Montero West may think, "Peter is very eager to come work for us—we might have been able to get him to work for less than $475,000. Even if we insist on rather one-sided provisions relating to stock options and termination, he'll still agree to the contract."

The dilemma is compounded because some lawyers—or clients—*are* willing to make concessions if pushed. Deal-making negotiations may thus begin with one or both lawyers trying to assess how sophisticated, smart, and aggressive the other side is in order to decide how much pressure to apply. If the other side looks like a "sucker," or seems overly eager to do the deal, pushing for concessions might make sense. To avoid this dynamic, each lawyer may assume a highly aggressive posture so as not to appear weak or unsure.

As a consequence, negotiations over legal terms in deal-making—like any negotiation—can become highly adversarial. The parties may build one-sided demands into their initial drafts that they really don't care about but hope to concede away later as bargaining chips. On provisions that they do care about, each side may open with an extreme position and concede very slowly in hopes of wearing down the other side. The negotiation may become a game of chicken, where various terms are characterized as deal-breakers or "not subject to negotiation." Each side may try to create the impression that it has less to lose if the deal doesn't go through. Each may believe that the other side will blink first. Neither side learns much about the other's true interests or concerns, and cre-

ative trades to resolve their differences go unexplored. In the end, the lawyers may deadlock, with each side unwilling to back down and yet unsure just how far the other side can be pushed before they walk away from the deal. The clients may need to get involved—often to their annoyance—to get the deal moving again and save the transaction. And sometimes deals still blow up, even when any number of arrangements would have made both sides better off than no deal at all.

PREPARING TO PROBLEM-SOLVE

In deal-making, the challenges behind the table and across the table are clearly related. To minimize the risk of stalemate, lawyers must work with their clients to identify key risks, learn their clients' interests, and draft contractual language to bring to the negotiation table.

Identify Issues and Risks

Lawyers are involved in a variety of kinds of deals, including complex leases, real estate sales, loan agreements, mergers and acquisitions, corporate financing, compensation contracts, partnership agreements, and licensing of intellectual property and patents. Each context has its special risks and opportunities. How can a lawyer best identify the critical issues and risks in a particular transaction?

Probably the most important way that attorneys come to understand these risks is through past experience—working a particular kind of deal repeatedly, perhaps initially with more senior colleagues who can identify typical problems. Experience with a given type of deal can help a lawyer know what the distributive issues are in that context and what value-creating trades are often found. Similarly, experience will help the lawyer identify which risks his client should worry about most.

In addition to calling on their experience, lawyers often identify a transaction's risks by using check lists, form books, and drafts of similar agreements used in the past. By looking at examples of similar deal terms—including the "boilerplate"—a lawyer can usually uncover the risks and concerns that the parties were trying to address through contractual language. And of course there's no point in reinventing the

wheel. Often, looking at forms will give an attorney useful insight into how various risks in a deal can be constrained or allocated.

A third way to identify risks is simply to imagine that a year from now, looking back, you realize that this deal—and the contract that formalized it—was an unmitigated disaster for your client. She lost money, she was victimized by the other side's opportunism, and she would have been better off if she had never done the deal at all. How did this happen? What caused this reversal of fortune, given that today—going into the deal—the terms of the contract seem attractive?

A final, and related, way is to consider the incentives that might operate on the other party in various contexts. How might the other side try to take advantage of your client if they set out to be unscrupulous and strategic? In any deal, each party should ask itself how the other might *already* be acting strategically by withholding information about the quality of the goods to be traded (the lemons problem), or might act strategically in the future by taking advantage of incentives and provisions in the deal (the moral hazard problem). By looking at a deal's terms from the other side's perspective—by asking why the other side is so eager to sign—a lawyer can often spot risks that need to be addressed.[2]

In Peter French's negotiation with Montero West, an experienced lawyer will realize that a critical set of risks relates to what will happen if Peter works for Montero West for fewer than five years. Under what circumstances, and with what consequences, can the company dismiss Peter? What happens if Peter resigns? If an employment contract doesn't explicitly address these issues, background legal standards might provide one side or the other with a breach of contract claim for damages. The parties could litigate such claims, but there would often be a great deal of uncertainty about liability and the amount of damages. For this reason, executive compensation contracts usually contain explicit provisions spelling out the consequences of contract termination by either party.

With top executives, most corporations insist on the right to terminate the employment relationship early, not just for cause if the executive breaches the contract but also without cause if the corporation simply wants to make a change. What remains to be negotiated is what consequences will flow from a dismissal. The convention is that if a cor-

poration terminates an employee for cause, the employee receives little or no severance pay or additional compensation. Executive contracts also provide, however, that if the employer dismisses the executive *without* cause, then the executive will receive severance compensation—spelled out in the contract—in lieu of damages or other claims.

An analogous set of distinctions governs resignation by the employee. Typically, if an executive voluntarily quits, she forfeits her severance package and has no claim against the corporation for future compensation. On the other hand, many executive employment agreements provide that if the executive quits her employment for what constitutes "good reason," she will be entitled to a predefined severance package, which may be the same or may differ from the without-cause termination package.

Not surprisingly, Peter and Henry did not discuss these issues of early termination when they hammered out the basic deal terms. Just as a couple about to marry rarely wants to think about the terms of a potential divorce, businesspeople about to work together rarely enjoy discussing provisions for termination or for allocation of risks if a deal fails.

Nevertheless, Peter's lawyer understands that defining what constitutes "for cause" and "good reason" and the amount of these severance packages is often at the heart of a lawyer's negotiation in such deals. The scope of these definitions will have serious distributive consequences in the event of eventual termination. If Peter is terminated without cause, how long will his salary continue after he's no longer working for Montero? For one year? Two years? Until the end of the five-year term? And what happens to his unexercised stock options? Does he keep only those that are already vested? Or does he also keep those that have been awarded but are not yet vested? Peter's lawyer expects that these issues will be central to negotiations with Montero West.

Understand and Prioritize Your Client's Interests

With these issues in mind, Jan Dobson has her first meeting with Peter. Peter explains that he's excited about the prospect of working at Montero West, that he expects the company to do very well, that he's quite happy with the salary he's been offered, and that he's entirely satis-

fied with the company's fringe benefits package. As he talks, Jan listens and probes for any concerns Peter may have about the transaction. She learns two things of considerable importance. First, a primary reason Peter is taking this job is that he hopes to become the CEO of a publicly-traded company. "That's always been my ambition," Peter says. "If I stayed in my present job, I'd eventually run a division, but I'd never be CEO." Peter explains that in hiring him, Montero's board has made it clear that he is being groomed to be the next CEO. "No promises, but it's mine to lose." Jan asks Peter about what he would do if Montero brought in someone else to become CEO when Henry retires. "If it starts to look like I won't become CEO, I'll go somewhere else," Peter says. "I can't imagine that I'd want to stay at Montero in the number two spot. I'd want the freedom to leave Montero West before the five years are up if someone else is brought in."

Peter describes a second concern. Montero West is a leader in agricultural biotechnology, and therefore it may be a prime target for acquisition by a larger chemical company sometime in the next five years. The Phills family controls a majority of the outstanding stock shares, and so the board of directors can prevent a hostile takeover. But if in the future the family decided it wanted out, the family could use its control to implement a sale. Peter is concerned that he would then be left either without a position or in a position he wouldn't want. "Rather than being CEO of an independent Montero West," Peter explains, "at best I could end up running a division of a larger chemical company. I don't want that."

Jan then raises the issue of the board's firing Peter before the end of his five-year term. "It's not going to happen," Peter says. "I trust Henry Phills completely, and I know we're going to work together well." Notwithstanding Peter's optimism, Jan emphasizes the need to plan for this contingency. She explains the distinction between for-cause and without-cause termination, and she points out that while negotiations over the definition of "cause" may seem dry and technical, there's a great deal at stake. Even though Peter's relations with Henry and the board are now all very friendly, things could change. Henry could die. Board membership could turn over. Relationships could deteriorate. If sometime in the future the company wanted to get rid of Peter, the board might seek to

cut its costs by claiming there was cause for termination. Jan says, "Once the company decides that you're not working out, then there's no more future relationship to worry about. It can be very tempting to play hardball and save a few dollars when the employment relationship is basically over."

Jan explains that most for-cause provisions include language to allow the company to terminate an employee without severance if the employee commits a serious crime, breaches fiduciary duties, or willfully does something that materially harms the company's interests. "I doubt these provisions will cause much trouble," Jan explains. "There are pretty standard clauses we can rely on. The hardest part of these negotiations will be defining whether and when the company can terminate you for not performing well. The question is always what counts as inadequate performance. They'll want a broad provision that allows them to terminate you for cause very easily, and we'll have to push to narrow the language to protect you."

Set Realistic Expectations

Throughout their discussion, Jan tries to help Peter set realistic expectations about the upcoming negotiation. In deal-making, this is a crucial part of the communication challenge behind the table. Rather than avoiding these tough conversations or promising the moon, a lawyer needs to talk straight to her client about what the client can expect and what course of action the lawyer recommends. Clients appreciate candor, and the best way for lawyers to ensure that clients have realistic expectations is to be straightforward, clear, and truthful.

For example, Jan and Peter talk about what severance pay Peter should expect if he was terminated without cause. "If they just fired me without cause," Peter says, "I'd want my whole salary for the rest of the five-year term, and all my options. We should make it expensive for them to fire me without cause." Jan agrees that Peter should get more severance if he's terminated without cause than if he quits. She points out that it's common to award a terminated executive one or two years' salary, but that paying salary through the end of the five-year term (if

more than two years remained) would be unusual for someone at Peter's level in a company of Montero's size. "We could push for that," Jan says. "But I'd recommend against it—I think you should expect no more than a two-year salary severance. Montero isn't going to be happy about paying you a salary long after you've started working for a competitor. Industry standards with respect to options are not so clear. I will certainly press for all of your options vesting immediately if there is termination without cause or you resign for good reason."

Understand Your Client's Priorities

Jan understands that some terms in Peter's employment contract are more important to him than others. Although lawyers sometimes dig in on every term in a contract, Jan knows that searching for trades between terms is the key to creating value in deal-making. She therefore works with Peter to understand the trade-offs Peter would be willing to make between various terms. "You seem pretty concerned about getting a high severance package if they terminate you without cause," she says. "I understand that; I'd feel that way too." Jan and Peter then discuss what Peter's interests are concerning a severance package. Will he be short of cash? How long does he expect that he would have to look for a job? Peter believes he could get a new job fairly quickly. "Which is more important to you—an additional year of severance pay or keeping all of your options?" Jan asks. Peter explains that continuation of his salary would be nice, but he would be most concerned about keeping all of the 100,000 options. "This company has wonderful growth prospects: those options could turn out to be worth millions."

Jan and Peter also talk about the possibility that Montero West may resist giving Peter a severance package if he resigns because he isn't made CEO. She digs to find out what he cares about most. She also explains that she may not be able to get *everything* he wants—which is why she's trying, and will continue to try, to understand how he views the various trade-offs they might make as the negotiations progress.

Peter and Jan talk through a variety of other less central issues as well. Peter is concerned about signing a noncompete clause that would

make it difficult for him to assume an executive position in the same industry later. "I'm obviously not going to do anything wrong like steal the company's trade secrets," Peter says, "but I don't want to sign something ridiculous. Some of the agreements out there are just too broad." Jan assures him that she'll consider this term carefully. Peter also wants to be sure that he receives excellent health insurance coverage for his family—his wife has a hereditary kidney disease and may need dialysis in the future. In the event of termination for any reason, he needs that coverage to continue uninterrupted until he secures a new job.

NEGOTIATING ACROSS THE TABLE

Jan is now nearly ready to complete her preparations and to begin negotiations with the other side. She expects that there may be serious disagreements about a few key provisions in the contract—what constitutes "for cause," for example—but she hopes that they'll be able to resolve these disagreements amicably and efficiently. She also knows that certain value-creating opportunities are commonly exploited in executive compensation agreements. For example, sometimes by deferring compensation—having the corporation pay the employee certain sums after retirement rather than while the employee is actually working—the employee can reduce income tax because presumably he'll be in a lower income tax bracket at a later date. Similarly, sometimes the corporation can save taxes by structuring compensation carefully. For example, although a corporation can deduct from its expenses only $1 million a year in salary for any one employee, it can deduct additional compensation if the money is paid out as bonuses contingent on performance. Jan's goal is to try to tailor the contract to meet the interests of both sides, and in the process create value for her client.

Lead the Way toward Problem-Solving

When the other side in a deal starts a legal negotiation with moves that suggest they intend to be strategic, there's no reason to be confused, surprised, or offended—this is the way the game is often played, and the other side hopes to gain distributive advantages by playing that game better than you can. You have to be prepared to defend against the other

side's distributive moves while leading the way toward a more collaborative approach.

THE FIRST-DRAFT PROBLEM

Often, the first question for deal-making lawyers to negotiate over is who will write the initial draft of the contract. Creating the first draft confers obvious advantages, because it gives the drafter many opportunities to shade the contract language and frame the negotiation in favor of her own client. Each side knows this, and therefore both may jockey for the opportunity to create the first draft.

Jan, for example, knows that there is a wide range of ways to draft a for-cause provision to favor the employer or the employee. She has a stack of executive compensation agreements in her files from past clients, and she pulls several for-cause provisions from them:

> ***PROVISION A:*** The Company may terminate this Agreement in the event of repeated and demonstrable failure on the part of the Executive to perform the material duties of Executive's management position . . . in a competent manner and failure of the Executive to substantially remedy such failure within 30 days of receiving specific written notice of such failure from the Company.[3]
>
> ***PROVISION B:*** Termination for "Cause" shall mean willful and continued failure to substantially perform his duties hereunder, provided, however, that if such cause is reasonably curable, the Company shall not terminate Executive's employment unless the Board first gives notice of its intention to terminate and Executive has not, within 30 days following receipt of such notice, cured such cause.
>
> ***PROVISION C:*** The term "Cause" shall include the willful engaging by Executive in gross misconduct which is materially injurious to the Company. For purposes of this paragraph, no act or failure to act on Executive's part shall be considered "willful" unless done in bad faith and without reasonable belief that such action or omission was in the best interest of the Company.

The agreements set different standards of basic performance for their executives. Provision A is skewed heavily in the executive's favor. It combines strong contract language (such as "repeated and demonstrable failure") with a 30-day notification and cure period. Provision B is also favorable to an executive. It has more moderate language but the same

notification period. Provision C eliminates the notification period but strengthens the basic contractual language by requiring that the executive act in bad faith and without belief that his act was in the best interests of the company.

HOW MUCH TO ASK FOR?

Given the range of possible approaches to this key term (and others) in Peter's contract, Jan sees several problem-solving ways to address the first-draft problem. First, all things being equal, Jan would like to create the first draft. If she does, in order to point the way toward problem-solving she won't just use her draft to stake out a position but will send Montero West a letter accompanying her draft explaining Peter's interests and how Jan designed each of her proposed draft provisions to meet those interests. She may also want to explain what she hypothesized Montero West's interests to be, and how she tried to accommodate those interests in her draft. By linking her draft language to these interests, she can underscore that ultimately both sides are going to have to take the other's concerns into consideration. And she can show that her draft is not merely taken from a form book but is tailored to satisfy her client's specific needs.

The second approach is to negotiate a process with the other side that circumvents the first-draft problem by having an initial discussion with the other side *before* drafts are even exchanged. If the parties discuss their concerns about the various issues involved in a deal, often they can hammer out a framework agreement that identifies the key issues and resolves many of them quite handily. They can then work together to come up with draft language for the more important terms and avoid the duel of drafts that can develop when one side rejects the other's contractual language and advocates for its own.

If Jan does send the first draft, how hard should she push the other side? Should she start with language that is extremely favorable to Peter? Or try to start out with a reasonable solution and stick to it? Our advice is for Jan to produce a document that serves Peter's interests extremely well, can be justified with good reasons, but is *not* unreasonably one-sided. Deal-makers often expect to bargain, to haggle, to make concessions, to reach an agreement somewhere in between the two opening offers. This is a pervasive ethic in the culture of legal negotiation. There-

fore, Jan would be wise to ask for more than she thinks she could live with. At the same time, it is a mistake to begin negotiations with an offer that even the offeror thinks is draconian. The first rounds of a negotiation set the tone for subsequent rounds. By asking for too much, the drafter sends an implicit message that this will be a knock-down-drag-out fight over each and every term.

WHAT IF THE OTHER SIDE STARTS WITH AN EXTREME DRAFT?

Although Jan proposes that she write the first draft, Montero West's lawyer insists that they use the company's "standard" employment agreement as the basis of their negotiations. Jan alerts the other lawyer that her client has special concerns about the termination and severance provisions but says she would be glad to evaluate the company's draft as a starting point.

When Jan receives the draft agreement from Montero West, she reviews it, keeping Peter's concerns in mind. The agreement provides that 20,000 options vest at the end of each year of the five-year contract. The company's draft does not contain a good-reason clause but instead provides that Peter receives no severance package at all should he terminate his employment for any reason. The draft did contain an extremely broad termination-for-cause provision that would give the company broad discretion to fire Peter:

> ***TERMINATION FOR CAUSE:*** Executive's employment with the Company may be terminated for cause if Executive is determined to have (1) acted incompetently or dishonestly or engaged in deliberate misconduct; (2) breached a fiduciary trust for the purpose of gaining personal profit; (3) neglected to perform or inadequately performed assigned duties; or (4) violated any law, rule, or regulation.[4]

This is a common situation for deal-making lawyers. Often the other side will begin the negotiation process with an extremely partisan draft. How should Jan respond? Jan wants to give the company basic information about her client's interests and priorities. She will want to indicate that Peter recognizes that the company should be able to terminate his employment for any reason, but that the termination should be "for cause" only if Peter has done something seriously wrong. She will want to explain her concerns about the breadth and vagueness of Montero's

termination-for-cause provision. For example, what does "acted incompetently" mean? What if Peter makes a business decision that seems sound at the time but ultimately goes awry? Chief operating officers make a huge number of such decisions every day—and many don't work out well. Is that incompetence and cause for dismissal without severance? And what is "inadequately performed assigned duties"? Does that include trivial matters like filing an expense report on time or showing up for a meeting? Similarly, the "violated any law, rule, or regulation" language is very broad. Does this include getting a speeding ticket? Montero's draft seems extreme.

Jan will certainly want to send a revised draft that (a) contains a good-reason clause; (b) narrows the grounds for termination; and (c) explains why these provisions are important to Peter. With respect to the termination-for-cause provision, Jan must make a judgment about how one-sided her proposed revision should be. Should she use Montero's provision as a base and narrow its language by, for example, adding a requirement that misconduct must have a "material effect" on the company's fortunes? Or should she send an entirely new provision, and if so, how extreme should her counterproposal be? Should she send a termination-for-cause provision that requires "repeated failures," written notice, and an opportunity to cure, as in Provision A above? These are matters of judgment.

The key is to respond to an extreme draft in a way that signals an ability to defend yourself but does not provoke further escalation. You want to assert your client's interests but continually demonstrate understanding of the other side's interests as well. And you want to keep pointing the way toward a collaborative process for resolving disagreements.

Explore Value-Creating Trades

Because of the way that Peter prioritizes his concerns, Jan decides to send a new termination-for-cause provision that she thinks is reasonable while at the same time underlining the critical importance of adding a good-reason provision. Jan sends the following language, along with a letter explaining her client's interests and proposing that she and the company's attorney meet:

> ***TERMINATION FOR CAUSE:*** Executive's employment with the Company may be terminated for cause if the Executive is determined to have (1) willfully engaged in fraud, misrepresentation, embezzlement, or other illegal conduct that is materially detrimental to the Company; (2) breached a fiduciary trust for the purpose of gaining personal profit, or (3) repeatedly and demonstrably failed, after adequate written notice, to perform material duties under this agreement.[5]

This protects Peter, but also gives the company what it most likely wants—insurance that if Peter does anything really serious, Montero can terminate Peter.

Jan also sends the following good-reason provision:

> ***TERMINATION BY OFFICER:*** (a) If, during the term of this agreement, the Company's Board newly elects a person other than the Executive to the position of Chief Executive Officer, the Executive shall have the right to resign from the Company and shall receive the severance compensation provided for in Section __ above.
>
> (b) If the company becomes a party to a merger in which it is not the surviving company, or if the Company sells all or substantially all of its assets, or if there should occur a change in control of the Company by virtue of a change or changes in the ownership of its outstanding voting securities, then the Executive shall have the right to resign from the Company within 90 days of receiving notice of such event and shall receive the severance compensation provided for in Section __ above.

She explains why this provision addresses Peter's concerns.

When Jan and Montero's attorney sit down to negotiate, the two lawyers easily agree that in the event of termination for cause Peter will keep only his already vested options and should receive no severance pay. They are also able to agree on Jan's definition of cause.

The severance package poses more difficult problems. Jan asserts that Peter deserves two years' salary and all of his options, vested and nonvested, if Montero terminates him without cause. In Peter's mind, the options are a signing bonus—something he's entitled to unless he is terminated for cause. Bill Stodds, the lawyer for Montero West, disagrees. "It's not a signing bonus," he insists. "It's an incentive plan. The 20 percent each year is designed to keep him at the company and motivate him to perform." He also insists that severance pay be limited to one year: "After all, Peter gets this pay even if he has a new job."

Jan and Bill obviously have different frames on what these shares represent—a signing bonus or an incentive plan. Jan tries to address the difference. "Clearly the company is concerned about aligning Peter's incentives correctly, and treating the options as an incentive plan makes sense for that purpose." But she argues that this reasoning only goes so far. If the company terminates Peter without cause, it's the company's decision to end his employment, through no fault of Peter's. In that scenario, he should receive all the options as part of his severance package. Jan concedes that if Peter leaves *without* good reason, then he should receive no severance package. But if he leaves *with* good reason, Peter and Montero West then share responsibility for his termination. "He wouldn't be leaving on a whim," she says. "He'd be leaving because of a turn of events the board can control: either a new CEO has been brought in or there has been a change in control."

In talking further, the two lawyers explore the possibility of having different severance packages: (1) if Peter is terminated without cause; (2) if he leaves because there is a change in control; and (3) if he leaves because he is not made CEO. Jan suggests that Peter might be willing to accept a shorter period of salary continuation (say, one year) in circumstance 3. Bill accepts this principle and suggests the following compromise: all options vest in each of these situations, with eighteen months' severance pay if Peter is terminated without cause, one year's severance if Peter leaves because of a change in control, but no severance pay if someone else is brought in as CEO. The company is concerned about setting a bad precedent for future employees by paying severance because an executive did not get a promotion. Jan agrees to discuss this proposal with Peter, who indicates that it is acceptable.

RELY ON NORMS

Jan and Montero West also are able to rely on norms—precedents, rules, or generally accepted ways of doing things—to resolve some of their distributive issues.[6] Legal domains vary in the extent to which there are well-structured norms that make it easy to document deals. In some contexts, such as the sale of residential real estate, standardized contracts are widely used and make documentation very quick and easy. In others, the same kind of deal is done over and over—such as a merger and ac-

quisition agreement or a loan agreement. At the other end of the spectrum, some domains are largely norm-free. In new types of deals, for example, there might not yet be a generally accepted method for allocating risks or for correcting particular information asymmetries.

All of this suggests the importance of learning the norms in a particular context. A lawyer should find out how similar deals have been done before. Better yet, she should find out how her counterpart across the table has negotiated such agreements before.[7] Every transaction has its unique aspects, but a business lawyer can't really proclaim outrage at a particular term when in an identical transaction two months prior he asked for and received the same term himself. Moreover, if one party is reluctant to extend a representation that is common in the marketplace, an adept bargainer may demand recompense, contending that a departure from the norm is likely to unsettle expectations or create inefficiency.[8]

In Peter's case, Jan turns to norms to resolve a variety of distributive issues. Jan and the company's lawyer disagree about the provisions related to termination in the event of disability. Jan has proposed that if Peter is unable to perform his duties for 180 straight days—six months—then Montero West can terminate him. The company's lawyer wants 90 consecutive days or any 120 days in an 18-month period. Montero West also proposes that Peter should receive only the payments due him under the company's disability policy—which would amount to approximately 60 percent of his regular salary. Jan disagrees, arguing that the company should make up the difference between the disability plan and Peter's regular salary. They also disagree about whether Peter should accrue options and bonuses while on disability leave.

Eventually Jan turns to norms to resolve this disagreement, which isn't *that* important to Peter in the overall framework of the deal. "Here's one way we could resolve this," she says. "I'm pretty sure that on this term, Peter would be comfortable accepting whatever disability termination provision is in *Henry's* contract. Whatever the company's giving its CEO seems good enough for the COO as well. Why don't we just agree that we'll ask the company to forward each of us a copy of this term from Henry's executive compensation agreement, and we'll base our language on that?"

UNDERSTAND THE LIMITS OF NORMS

Norms will not dispose of every distributive issue. Often there will be competing norms in the marketplace and parties will have to negotiate over which norm applies. And sometimes one side will dislike the dominant norm and seek to use another norm more favorable to that side. Norms won't end negotiations by any means. Nevertheless, being prepared to give *reasons* for what you ask for—to try to persuade the other side through norm-centered argument rather than with pressure tactics—can be helpful.

A second note of caution about norms: just because a norm exists doesn't mean that it is efficient and offers the best solution to your particular problem. Like default rules,[9] some but not all norms may be efficient. But in a world full of strategic interaction and imperfect information, the use of standardized deal terms may have more to do with copy-catting than with efficiency.[10]

Consider a story told to us by an experienced real estate lawyer representing a company that was selling a business in South America. The potential buyer—a large enterprise that frequently buys businesses in Latin America—expressed concern about the possible costs of environmental clean-up. The seller's lawyer proposed that each side procure an environmental report from an independent expert indicating how much it would cost, if anything, to clean up any environmental hazards. Instead of the seller providing an indemnity to the buyer, the parties could simply reduce the purchase price by the average of the two estimates. If the estimates were more than $100,000 apart, the two experts would pick a third expert, whose determination would be binding. The buyer, however, insisted on getting an indemnity, because "that's the way things are always done." The seller's lawyer even pointed out the risks for the buyer of indemnification—surely if a hazard were later discovered, the seller would have an incentive to defend vigorously against a lawsuit on the indemnity provision, driving up transaction costs for both sides. But the buyer was adamant—and the transaction went through with the indemnity.

It's hard to see an efficiency argument for the structure of this transaction, provided the buyer could get detailed and complete information about any possible environmental problems through a report. But the

norm prevailed in the end. This story suggests that there may be circumstances in which norms might leave value on the table, even though they ease the distributive issues somewhat. A lawyer's task is to consider norms within the framework of our basic model of trades based on differences in relative valuations—when a norm stands in the way of a more efficient customized exchange, the lawyers should consider departing from the norm.

Change the Players to Break an Impasse

In addition to using norms, deal-making lawyers often change the players to break a distributive impasse. Since ultimately the clients must live with whatever arrangements their attorneys draft, when the going gets tough deal-making lawyers often turn to their clients for help.

One possible advantage of involving the clients is that it can permit reopening the price term, and this may help resolve distributive issues. Price terms change infrequently in deals because the principals reach an agreement and then turn only the legal matters over to their lawyers. To an economist, this is a puzzle, because the subsequent negotiation between the lawyers often involves the allocation of risks that can significantly impact the overall value of the transaction. Because money terms are generally fungible, we would expect that as the lawyers allocate various risks, the price term would fluctuate as the net present value of the deal changes for each of the parties.

But it is easy to understand why price terms stay fixed. First, a lawyer may not have the authority to revisit the basic deal terms. Second, the lawyer may feel uncomfortable approaching the client to request that the price term be put back in play. Especially in lawyer-client relationships in which the client is sophisticated and views the lawyer as a scribe rather than advisor, the negotiability of the price term may be difficult to raise.

Third, revisiting key deal terms can be highly destabilizing to the clients. The principals may both feel that the deal is done, and when one hears through her attorney that the other side wants to reduce the price term, it may feel as though the other side is trying to renege on its word. This is especially so where the principal doesn't have a good understanding of how important it is to allocate particular risks. The other side may

think you are trying to use a nit-picky clause to squeeze more money out of the deal.

And this can, of course, be true. Still, there are sometimes good reasons to revisit the price term. Doing so can open up a range of trades that might not otherwise be possible if the parties bargained term by term. The price term is a kind of safety valve in the transaction—opening it permits one party to give in on a particular clause in exchange for money when no other kind of trade is feasible.

Look to the Future: Dispute Resolution Provisions

No contract covers every issue, risk, or contingency. In joint ventures, leases, partnerships, and custody arrangements, secondary deals are struck at a later date, as unanticipated circumstances arise. In Peter's case, as in many deals where an on-going relationship is being created, further issues to negotiate will develop over the course of the employment relationship. Against what backdrop will these future negotiations take place? Will the parties be bargaining in the shadow of litigating their disagreements? Or can they create some other dispute resolution mechanism *now,* in their contract, that will lower the transaction costs of resolving disagreements in these future negotiations?

Contractual dispute resolution provisions are increasingly common. Often, alternative dispute resolution clauses provide for arbitration under the auspices of a sponsoring agency, such as the American Arbitration Association. The contract might provide this clause, for example:

> ***ARBITRATION PROVISION:*** Any controversy or claim arising out of or relating to this contract, or the breach thereof, shall be settled by arbitration administered by the American Arbitration Association in accordance with its Commercial Arbitration Rules and judgment on the award rendered by the arbitrator(s) may be entered in any court having jurisdiction thereof.

This provision leaves many issues unanswered. A better provision might make clear that the controversy will be submitted to one arbitrator or to a three-arbitrator panel. In the latter case, each of the parties traditionally chooses one of the arbitrators, and they then select a third neutral to serve as the chair of the panel. If they cannot agree on a third, the AAA might pick that person. In addition, an arbitration clause will

provide for notice to the parties, choice of law, and other technical specifics to make any future use of arbitration as smooth as possible. Some contracts provide for a tiered dispute resolution process that begins with mediation and advances to arbitration. The parties are limited only by their creativity.[11]

CONCLUSION

The key thing for attorneys to remember as they try to close deals is that lawyers are only one part of a larger equation. In most complex deals, the clients share responsibility for making the deal work. Many of the most important provisions are dealt with by the clients, not the lawyers. From the clients' perspective, the attorneys may appear to be negotiating over relatively remote contingencies that have little practical relevance for the deal today. The clients, in short, may not care half as much about the lawyers' work as the lawyers do.

This is not to say that lawyers should defer to their clients' understanding of the importance of various legal provisions nor that lawyers should downplay their own input into the deal-making process. It can simply be helpful to remember that if you can't win on a given distributive issue or risk, the world probably won't come to an end. The deal will most likely go through, and your client will most likely be happy. The risk may never materialize, and even if it does, as long as your client has made an informed choice about it, you have done the best you can.