Managing Long-Term Business Relationships (1) **Dealing with Price**

This note addresses two common problems:

(1)In many cases, the lofty ideal of "win-win" negotiations is thwarted by the fact that one item - Price - is an elephant, while the other items on the agenda (payment terms, transportation cost, insurance, ...) weigh in as mice. And it is hard to find balanced tradeoffs between an elephant and a mouse.

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(2)Repeated haggling over price is very destructive.

1. Price is an Elephant

For suppliers, any movement in price is likely to have a *significant* impact on profits. Volume is also a very important variable, but it is constrained, by consumer response (in the case of end products) and by derived demand (in the case of an intermediate product). Suppliers often agree to price cuts in the hope that they will result in increased volume or, at the very least, that they will avert a loss in volume. Estimates of volume effects are often biased or inaccurate. Furthermore, these anticipated effects are often too small to justify the magnitude of price cuts under consideration. It is essential therefore to evaluate what volume increase would be needed to break even.

How can they gauge / calibrate what is a "sensible" move?

• Representations by customers???

In some companies, executives stay in a particular position for a very short period, in some cases no more than 2 or 3 years. While offering executives diversity of experience and fast track careers has many advantages, it also entails significant risk. For example, it may take a key account manager two or three years to develop a thorough understanding of the business and build a good working relation with his or her clients. When a new colleague takes over (often without proper briefing from his or her predecessor) he or she not only lacks critical benchmarks but also lacks objective information about prior dealings ... and could become an easy victim of all sorts or representations from clients: "Your predecessor promised an x% price cut in case of"!

• Quantify the impact of your decisions!

- Simulate impact on your profit

If we reduce price by x%, what would be the % reduction in profit? Example: Fixed cost: 10,000,000 € volume: 100,000 units Variable cost: 50 €/unit Total cost/unit: 150 €/unit Price: 170 €/unit Margin: 20 €/unit

A 5% price cut (new price: 161.5 €/unit) reduces the margin to 11.5 €/unit Thus, a 5% price cut results in a margin loss of 42.5%!

- B/E analysis with other variables

Example: "If we reduce price by x%, what increase in volume increase would we need to break even?"

Often, this analysis will reveal that price is the elephant and other variables are mice.

- Estimate impact on other side's profit

This helps to gauge intensity of pressure from /resistance to price movements from the other side

- historical data

Note: even when a benchmark price such as an industry price index may be a biased indicator of price levels, it may still be a good indictor of price changes.

- Even if you are not able to quantify the impact: get a qualitative feel for the impact of a proposed move:
 - Do not expect a linear relationship!

Instead, we should anticipate the following characteristic patterns:



Decreasing marginal benefit

Imagine I want to make my daughter Elisa happy, so I buy her an ice cream. I then want to make Elisa even happier, so I buy her a second ice cream. What can we say about the incremental utility of the second ice cream compared to the first? In general, while incremental benefits may be constant or even increase over some range, they eventually become smaller due to *satiation*¹.



¹ Note that - if we assume free disposal - the utility curve never bends down. More is always better than less - though not necessarily strictly better.

Suppose my boy Jan wants to listen to "Dubstep" on Sunday morning. Dubstep is somewhat like Techno but less the melody, and with even more bass added. To be fully appreciated, Dubstep requires a certain volume (it is appreciated with the stomach rather than with one's ears). Suppose I concede: "OK Jan, one hour". That concession entails a certain cost. Suppose I concede a second hour, on the same Sunday morning. And a third hour. What can we say about the incremental cost of each of those consecutive concessions? In general, while marginal costs may be constant or even decline over some range, they will eventually *increase*. Why? Because we hit some *constraint* (a capacity constraint or, as in the Dubstep example, a psychological threshold, etc.).

- Whether or not a given tool is a suitable instrument to delver value to the other side depends on its "Efficiency Ratio" or "E.R" for short, which is defined as follows:

$$E.R. \equiv \frac{AdditionalBenefitdelivered to the Other Side}{Additional Cost to Us}$$

When a tool is subject to diminishing marginal utility or increasing cost, its Efficiency Ratio declines. This has three important implications for negotiation:

- (1)Beyond a certain point, the E.R. drops below one. Using the tool below this point makes not sense as we would be destroying value.
- (2)Making modest moves using multiple tools is usually better than making a big move using one tool
- (3)Diminishing marginal utility and increasing marginal cost, resulting in declining Efficiency Ratios, provide a conceptual foundation for Homans'Law (more tools means higher total value).
- (4)Contrary to received "academic wisdom", The Belgian Compromise is *not* necessarily inefficient! In fact, agreeing on the 50/50 solution for each of the "issues" may turn out to be rather *efficient* when Efficiency Ratios behave "normally" that is, when due to diminishing marginal utility and increasing marginal cost they are declining monotonically.
- Watch out for "weird" patterns!

Example: Customers' willingness to pay for an innovation usually changes over time, following a typical S-shaped pattern:

first: low because they are don't perceive the value then: increased willingness to pay as they learn about the benefits ultimately: decreases as they learn about the supplier's cost

2. Repeated haggling over price is destructive

Many buyers relentlessly pressure suppliers on a single item: price. To extract lower prices, buyers not only threaten to shift volume to alternative suppliers ("I have another offer ..."), but on occasion actually carry out these threats. In some cases this is done merely for "demonstration purposes", *i.e.* to lend greater credibility to future threats. In The Game too, there is an ominous reminder of this practice: "[...] two years ago Geigy-Awaki cut the share of its main supplier of connectors from 60% to a token 5%."

Since bargaining power rests on two main pillars – alternatives and information - defensive measures available to suppliers are essentially variations of those two main themes (make a realistic assessment of the buyer's threat potential to avoid caving in to empty threats, build in switching costs, bringing in additional parties, ...). These – very important – issues are not dealt with here. Instead, this note focuses on how two business partners who wish to collaborate in a constructive manner might avoid the destructive effects of repeated haggling over price.

- Isolate price
 - Adding more mice typically won't solve the "elephant problem": it remains impossible to find balanced tradeoffs between an elephant and mice
 - Since adding won't work, we'll try a different sort of negotiation arithmetic: *subtracting*.
 - As long as the elephant is part of the picture, mice look really small, *i.e.* any benefits from playing with other items appear trivial compared to the impact of price. Therefore, removing price is necessary to ensure that the benefits of playing with mice are perceived to be worthwhile.

• Change the metric

The key objective is to *sterilize* price by agreeing on a *formula*, and thus replace repeated confrontation over price/unit by *routine*.

Note: Since getting off to a good start is of the utmost importance to establish a collaborative relationship, it is essential to isolate and sterilize price right *from the beginning*.

Example: risk-revenue sharing in the civil aircraft industry

- Pratt & Whitney's PW 2000 program (*e.g.* setting price for turbine blades)
- How to set the price of aircraft engines and other key components and subassemblies (nacelles, avionics, landing gear, ...), given the volatility of the market for aircraft?

Other advantages of this approach this approach include (Fokker example):

- *Unfreeze* an existing situation: eliminate an unfavorable anchor (precedent) cf. Igor Stravinsky
- Identify *alternative benchmarks* that are more favorable
- Bring in additional parties (allies!) to the negotiation
- Divide: Slice up the elephant!

GB example:

"Are you prepared to work with us as a responsible partner for the future and cut your price across the board by 3%, yes or no?"

"Across the board"???? NO! "Divide" price by product line, by region, etc.

What dimension of price do you / does your counterpart care about?

- Level

- Delta relative to competitors? (Most Favored Customer clause)
- Delta relative to other suppliers? (Meet The Competition / Last Look provisions, Right of First Refusal clauses Note: in startups, JV's etc.: will scare off competing offers! See the story of Wayne Huizinga in his two-stage buyout of the Miami Dolphins from the Robbie children in Co-opetion by Adam Brandenburger and Barry Nalebuff)
- Tie to an index of a supplier's key cost driver
- Tie to a benchmark for a substitute (e.g. oil/natural gas), a complement, ...
- Volatility of price over time?
- Achieve a rate of change over time (e.g. programmed reductions)
- Lock in a particular outcome over time (avoid "nibbling", "drift", ...)

• Design focused tools

Example: "x% of your products are found DAO. We are unhappy about that. Clearly, your quality control procedures are inadequate. In fact, in identifying DOA units we are doing the quality control job for you. In light of this, your price is simply too high."

The solution is *not* to lower price. It is too blunt a tool. And it is bad for both sides:

- Buyer: lowering price may create the wrong incentives for the seller: if price is lowered, the buyer may get even more DOA components!
- Seller: Needs to maintain decent price and *not* want to move to a lower price level for all products!

The solution is a *focused* tool to address a specific concern.

Note: What sort of compensation usually works best, compensation in kind (e.g. replacement of DOA items) or in cash (credit for DOA items)?

• Make the "mice" bigger!

Price is the issue ... as long as there is no other issue! Therefore: Highlight the relevance of other – submerged or latent – concerns. Ask: "What if not?"

- Play with other variables (mice) to:
 - Nurture the relationship
 - Create more value (fine tune to get efficiency gains)
 - Create proper incentives
 - Lock in an competitive advantage (asymmetry) relative to rivals
 - Signal / screen information
 - Strengthen your future bargaining position

Managing Long-Term Business Relationships (2) Avoiding Mutual misunderstanding

In The Game, the System performs a number of consistency checks to validate your agreement. In real life, we need to be careful about validating our agreement as well. We have to make sure that there is a *genuine consensus*, not just a document where parties "agree" on the same – hopelessly broad and vague – language.

The following court case aptly illustrates the problem:

FRIGALIMENT IMPORTING CO. v. B.N.S. INTERNATIONAL SALES CORP. Southern District Of New York, 190 F. Supp. 116 (1960)

FRIENDLY, CIRCUIT JUDGE: The issue is, what is chicken?

Plaintiff says 'chicken' means a young chicken, suitable for broiling and frying. Defendant says 'chicken' means any bird of that genus that meets contract specifications on weight and quality.

Parties entered into a contract of 100,000 lbs. of "chicken" from New York to Switzerland. Plaintiff expected to get 100,000 lbs. of chicken suitable for roasting. Defendant shipped stewing chicken.

Clearly, there was no consensus: the word "chicken" had a different meaning for both parties. Dictionaries give both meanings. To establish whether trade usage attached some "objective" meaning to the word "chicken" when used by professionals in the industry, the Court heard the following expert witnesses:

Strasser, resident buyer in New York for a large chain of Swiss cooperatives, testified that 'on chicken I would definitely understand a broiler.'

Niesielowski testified that 'chicken' meant 'the male species of the poultry industry. That could be a broiler, a fryer or a roaster', but not a stewing chicken

However, defendant's witness Weininger, who operates a chicken eviscerating plant in New Jersey, testified: "Chicken is everything except a goose, a duck, and a turkey".

In the absence of established trade usage, the Court sought to identify – and retain – that meaning of the word "chicken" that was consistent with the other terms and conditions of the contract. Plaintiff argued that since the market price for stewing chicken was 30 c/lb., no professional would enter in a contract to buy stewing chicken at 33 c/lb. Ergo "chicken" meant a roaster, a fryer or a broiler. Defendant replied that the contract price of 33 c/lb. was well below the market price for broilers of 35-37 c/lb. Therefore, "chicken" could not mean "broiler", but meant *any* chicken.

Etc. etc. etc.

Unfortunately, when businesspeople negotiate "deals", mutual misunderstanding is all too common. Both parties *believe* they have reached an agreement. But they have not. And it is only later, when they have acted upon this "agreement" that the absence of a genuine consensus comes to light. As the "chicken" case illustrates, Courts then face an almost impossible task to sort our the ensuing mess. Invariably, parties accuse each other of acting in bad faith. In reality, there was no bad faith on either side – just *sloppiness*.

Conclusion: be wary of "brilliant" deals that fit on the back of an envelope – particularly when these deals have been negotiated by the "Big Chiefs" in person. In negotiation, "details" often matter more than "the big picture". And it is generally advisable to leave negotiation to the "little Indians" – including these pesky lawyers, who waste everybody's time discussing countless trivialities (such as defining "chicken")!

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Managing Long-Term Business Relationships (3) Repeated Dealings: Harmony or Conflict?

Casual observation tells us that repeated dealings are not necessarily more harmonious than one-shot negotiations. Internal negotiations (e.g. between two divisions of the same company, within an academic department) are often very nasty. Many executives spend most of their time negotiating within their own organization. Often they report that these internal negotiations are much nastier than the negotiations with their clients or their suppliers. Several structural characteristics of internal negotiations contribute to a more confrontational process:

- 1. Availability of arbitration Conventional arbitration produces the "freezing effect" (parties maintain extreme positions). In contrast, pendulum arbitration may swing it!
- 2. The presence of an audience/public
- 3. Transparency

• Sloane vs. Dependable experiment: Stories are the "lubricant" of the negotiation process. When things become transparent, it is harder to tell stories - and therefore harder to make concessions or other conciliatory moves without loss of face.

• Disclosing payoffs of the different parties under existing and alternative configurations unleashes the "Unholy Trinity": Greed. Envy and Fear!

4. No alternative partners

Imagine North Korea makes a bluntly worded - and outlandish - proposal to South Korea. What is South Korea supposed to do? Negotiate a deal with Zimbabwe? The absence of alternative partners to deal with not only results in more extreme proposals, but also in more extreme behavior! Examples readily come to mind (*e.g.* behavior of partners before and after they are married ...).

5. "Qualitative issues" often become "elephants".

I strongly recommend to quantify outcomes: measure all costs and benefits of decisions in terms of *money*. Insisting on "policies" or invoking a "fundamental point of principle" results in donkey-like behavior (as in academic departments). When "principles are translated into euros" parties tend to move away from a "principled" (*i.e.* dogmatic) negotiation stance and engage in a more pragmatic conversation. Conversely, in settings where outcomes are inherently is hard to quantify (as in family negotiations) highly rigid - and destructive behavior - are to be expected.

6. Repeated dealings often make matters worse! (cf. infra)

Repeated Interaction, Reciprocity and Cooperation: Lessons from Axelrod's Computer Tournament

Theory predicts more cooperative behavior long-term relationships because of the *shadow of the future*: in contrast to a one-shot game, opportunistic behavior is discouraged by the fact an aggrieved party can retaliate. This is the basic idea behind the so-called *Folk Theorem* in game theory, which roughly states that in repeated games, *any* "policeable" outcome - including a cooperative outcome - can be an equilibrium ².

Policing bad behavior to "educate" one's counterpart is also a key factor explaining the success of Tit-for-Tat (TFT) as well as other "provocable" strategies in Axelrod's computer tournament for the Repeated Prisoner's Dilemma³.

		Player B	
		Cooperate	Defect
Player A	Cooperate	3, 3	0, 5
	Defect	5,0	1, 1



Note: The payoffs to player A are listed first

- These payoffs can be interpreted as follows:
 - 3 is the *Reward* for mutual cooperation
 - 5 is the *Temptation* to get more through defection
 - 0 is the *Sucker* payoff
 - 1 is the *Punishment* payoff for mutual defection

TFT is an extremely simple strategy that starts off cooperatively and subsequently mechanically reciprocates its counterpart's previous move. While it did well in Axelrod's first two tournaments, it fared very poorly in later tournaments that introduced "noise" as well the capability of more nuanced responses instead of a binary Cooperate / Defect response. Successful strategies shared key characteristics. They were *nice*, *provokable*, *forgiving* and *clear*.

 $^{^2}$ A major conundrum for game theorists has been how cooperative behavior can be sustained between purely rational and opportunistic players in a finitely repeated Prisoner's Dilemma when the endpoint is *known*. As shown in D. Kreps and R. Wilson, 'Reputation and Imperfect Information', *Journal of Economic Theory* 27 (1982), pp. 253-279 and in D. Kreps, P. Milgrom, J. Roberts and R. Wilson, Rational Cooperation in the Finitely Repeated Prisoner's Dilemma, *Journal of Economic Theory* 27 (1982), pp. 245-252 (for the mathematically inclined only), cooperative behavior may be sustained by *uncertainty about the other side's type* (or, roughly, character). While this very deep insight seems counterintuitive at first glance, it does have very useful practical implications (to be developed in a separate note).

³ Findings from Axelrod's (and later) computer tournaments are discussed in greater detail in a separate note, *Cooperation: Beyond Tit-For-Tat*

• <u>Nice</u>

A Perhaps the most striking finding of the computer tournaments was that 'Nice Guys finish First'. A "Nice" strategy never initiates defection. That is, a nice strategy:

- Starts off on a good footing

- Resists the temptation to get more through an occasional sneak defection

Axelrod's advice: avoid the short run temptation to 'get a jump' on the other side. Attempts at exploitation don't pay.

• Provokable

There is a difference between being nice and being naive. Strategies that are not sufficiently provokable are mercilessly exploited. Defections that remain unanswered will almost invariably invite further defections. TFT always and immediately responds to a defection. Its objective is not to "get even", however. Instead, it aims to educate its counterpart that there is only one way to get along with TFT, and that is to cooperate.

Communication errors, inadvertent mistakes, random disturbances and other errors usually referred to as "noise" pose significant challenges for strategies that aim to elicit cooperation. Does an observed defection reflect a deliberate choice, or is it merely the result of some innocent mistake? In a noisy environment, TFT does poorly since a single error can trigger a vendetta. The solution to the noise problem is *not* to "wait and see". Delaying one's response to ascertain whether an observed defection is intentional or not (1) invites exploitation from opportunistic players (2) allows a bad situation to get worse, and (3) reduces the effectiveness of feedback. Instead, effective strategies *always* respond and respond *immediately*. However, they take advantage of the nuanced response capability to respond *mildly*⁴. Thus, an appropriate response is not "an eye for an eye" (i.e. get even), but the weakest response that is adequate to signal that future defections won't pay (e.g. break their knee caps).

• Forgiving

Forgiveness is the propensity of a strategy to cooperate after the other player has defected. It is a critical character trait when interacting with players that are not 'nice', since it helps to restore mutual cooperation after a defection has occurred5.

The fact that TFT is very forgiving largely explains its success over other strategies that are also 'nice' and 'provokable'. Confronted with defection, TFT does not overreact but retaliates with restraint. TFT does not hold a grudge. As soon as the other player resumes cooperation, TFT is willing to do the same. TFT is 'patient': it does not give up too quickly on players that seem unresponsive at first.

In a noisy environment, TFT dose poorly as it is does nothing to break out of a conflict spiral. Reciprocity still works in a noisy environment, provided we incorporate a *unilateral peace overture* after observing a string of mutual defections. However, "prudent" peace overtures are doomed to fail. Success requires both *staying power* and *boldness*. People - unlike TFT - *do* hold a grudge. And they will be

⁴ And as we will see below, they are also more forgiving than TFT.

⁵ Forgiveness is critical even when both players are nice, when there is a significant risk that they may misread each other's moves. Often, actual situations can be compared to a game that is played in a 'noisy' environment, resulting in frequent communication errors. Alternatively, as in many business settings, the players' moves are inherently ambiguous or difficult to interpret. In such cases erroneous perceptions resulting from random 'noise' or 'coding errors' may trigger retaliation even when both players are in fact 'nice'.

inclined to write off a "mousy" peace overture as noise. Thus, we should (1) make a bold move that unmistakably signals our desire for peace, and (2) 'stave the course' even when our initiative does not meet with immediate success.

• <u>Clear</u>

TFT doesn't try to be too clever. TFT is so transparent that even the most obtuse of partners can't help 'catching on' sooner or later. By giving immediate and consistent feedback, TFT clearly signals what will happen in the future: predictably, cooperation will be reciprocated while defection will provoke retaliation.

Confrontation in Long-Term Business Dealings: What Goes Wrong?

In reality, however, repeated business dealings often result in *confrontational* relationships ⁶. This is what many executives experience in real life - and what many negotiating teams experience in The Game.

Why?

(1) Dissatisfaction with early outcomes

It is important to distinguish two cases:

• The outcome is "not hygienic" (i.e. it is not better than a party's best no deal alternative).

Here, the "victorious" party made a fundamental mistake. A fundamental objective in negotiation is to make sure the other side walks away with a smile on their face. This requires (in addition to a constructive process) a "hygienic" outcome, that is, an outcome that makes them better off that they would be under the best of their no-deal alternatives. If that is not the case, the "victorious" party simply pushed its counterpart too far - and will pay for it in later negotiations.

• The outcome is "unbalanced".

Some parties complain that they make less money than:

- their counterpart (envy! Cf. the story of a Russian farmer⁷)
- similar companies (are they *really* similar?)

(2) Process mistakes: "C'est le ton qui fait la chanson"

"Ambitious" ≠ "aggressive"! Novices are the barking dogs that don't bite. They are argumentative, aggressive and arrogant, even as their demands are lacking in ambition. In contrast, wily old foxes are ambitious without being aggressive. They recognize that it makes no sense to add an emotional cost on top of the economic cost of complying with their requests.

cf. Fisher and Ury:

"Separate the People from the Problem" ???

"Hard on the problem but soft on the people"

 $^{^{6}}$ Note that the Folk Theorem holds that cooperation is *an* - *not the* - equilibrium outcome: there are many more equilibrium outcomes, including confrontational ones.

⁷ After many years, God finally answered the farmer's prayers. "All right, I'll do anything you want for you, but bear in mind that I'll do twice as much for your neighbor." The farmer thought for a while - and poked out one of his own eyes.

• Instead of making amends, parties who behave inappropriately often make matters even worse:

- a major problem is our inability to objectively judge our own behavior doe to the well-known *attribution bias* (successes are attributes to self, failures are attributed to the other side or to external factors such as "the market" ... or "The Game"!)

- presumably in the belief that "offense is the best defense, they blame the other side for their own inappropriate behavior ...

- As Dostoievski, one of the most brilliant students of the human mind, has pointed out, when A hurts B, it is *A who gets angry with B*!

(3) Increased transparency

The seminal work by Kahneman and Tversky (1979, 1986), and Tversky and Kahneman (1981), has shown that we generally prefer a certain gain to an uncertain outcome, even though the latter may have a higher expectation. Our intuition is that it is better to lock in a certain gain than to gamble and run the risk of losing it all: One bird in the hand is better than two in the bush. Thus, if the outcome of a negotiation is perceived as positive as in the picture below, we will prefer the certain benefit associated with the status quo to the uncertainty that comes with upsetting the apple cart.



In contrast, we prefer uncertain alternatives to a known loss, even though their expectation may be worse. We'd rather take a poor gamble and "give it a try" than accept a known loss. When the loser of a bet is offered a chance to play "quitte ou double", he refuses to accept his loss and invariably goes for the gamble.

Kahneman and Tversky have also shown, however, that the same objective reality can be presented either in a positive frame - and elicit risk averse behavior - or in a negative frame - and elicit risk seeking behavior. Is a glass of beer half full, or is it half empty? That is a matter of perception. And this perception can be manipulated *framed* - at will. Suppose you wish to create the perception that the glass is half full. How would you do that? Answer: Put an empty glass next to it. (And now the easy question ...) Whether the frame is positive or negative depends on the *reference point*.

Thus, when both partners in a business relationship are making money and their nodeal alternatives are fraught with uncertainty, the relationship is probably pretty stable. The glue that binds them together is risk aversion. Over time, however, both

© Ingemar Dierickx 2012, Revised 30.07.2019 FOR PERSONAL USE ONLY. DO NOT COPY OR CIRCULATE will continue to explore their no-deal alternatives (at least, they should be encouraged to do so). This is why we must negotiate deals that are "hygienic", *i.e.* we must deliver more value to our counterpart than they could obtain under the best of their alternatives.

A hygienic outcome does not guarantee contentment and stability, however. Suppose our partner, who is making good money - much more than they could make under any other option that is available to them - finds out that we are making *even more* money! Their immediate reaction: "That's unfair!" Or suppose that our partner finds out that other companies that are "similar" make more money than they do. Invariably, whether these other companies are *really* similar or not, this will prompt the same refrain: "That's unfair" ⁸. Increased transparency - the availability information about players' payoffs under existing and alternative configurations - shifts the benchmark by which profits are judged. The resulting negative frame undercuts the stability of the relationship.

Even when our counterpart is making more money than we do, more than "similar companies" do, and of course more than they could do under any of their alternatives, stability of the relationship might still be threatened by a further piece of information: suppose our counterpart learns that *we* could make more money under some alternative business arrangement that would cut them out ...

In short, increased transparency of payoffs unleashes the "Unholy Trinity" of Greed, Envy and Fear, and results in generalized discontentment and chaos. This proposition could easily be tested in your own company: Make everyone's compensation package public! And this proposition *has* been tested in Russia: Glasnost did result in widespread dissatisfaction and chaos.

The obvious recommendation, therefore, is *never to comment on the outcome of a deal*. After the deal is done, when the adrenaline is down, parties may be tempted to comment on the deal: "Now tell me, you've done a good deal, haven't you?" My recommendation: never comment on the outcome; instead, comment (positively) in the *process*.

(4) <u>"Homans Law in Reverse"</u>

Over time, the number of negotiable items on the agenda *shrinks* as more and more items are settled. According to Homans Law, this implies not only that there are fewer opportunities to create value, but also that the process may deteriorate.

(5) <u>Parties' No-Deal Alternatives as well as their Benchmarks change over time</u>

Parties constantly seek to improve their no-deal alternatives, both through internal development and by seeking new external options. As a result, a deal that was highly satisfactory to both parties when it was concluded may no longer be "hygienic" to one or even both of the parties some time later. The implication of this is that unless parties manage to create more value over time, the relationship is likely to unravel. All too often, negotiators (typically *Western* negotiators) have a static notion of "the

⁸ These complaints have, of course, less to do with fairness than with *envy*. Nevertheless, they do raise a fundamental question: What notion of "fairness" makes sense in the context of negotiation: *Fair outcome or fair process*?

deal", which marks the end of "the negotiation", and the beginning of "implementation". Instead, I strongly recommend viewing negotiation as an *ongoing process of mutual adjustment*. Whenever there is new information, parties should seek to create additional value in a process that Howard Raiffa has called *Post Settlement Settlement*.

(6) Unforeseen events - Scenarios that were not anticipated by the parties

Unforeseen events may dramatically change the way value is shared between both parties – and produce outcomes that are perceived as "unfair". To tray and mitigate the impact of unforeseen events, I recomment:

- negotiating *conditional sharing formulas*
- negotiating the 'Spirit' of the deal

(8) A breakdown of Trust

A breakdown of trust between two teams is often due to (perceived) misrepresentations, a (perceived) failure to honor commitments, poor interpersonal chemistry, as well as a variety of other causes. The following section highlights two interrelated mechanisms that may contribute to a breakdown of trust:

• apprehensiveness about one's ability to detect deception breeds suspicion

• suspicion breeds untrustworthiness

Trust: A key Dimension of Successful Business Dealings

This is a highly complex topic. Amongst the many factors that may contribute to a lack of trust I would like to highlight two:

• A sense of vulnerability

We feel particularly vulnerable - and therefore become distrustful - when we fear that we would be unable to detect cheating by our counterpart. For example, we will be inclined to believe that our counterpart is lying to us if we are fearful that we would not be able to spot his lies if he was lying. Conversely, we will be more trusting if we are confident that if our counterpart were to lie, we would unfailingly spot the lie. This sense of vulnerability also explains why we suffer from paranoia when we deal with people from a different culture, as expressed in the following lines from Rudyard Kipling's poem *The Stranger*:

The Stranger within my gate, He may be true or kind, But he does not talk my talk--I cannot feel his mind. I see the face and the eyes and the mouth, But not the soul behind.

The men of my own stock, They may do ill or well, But they tell the lies I am wanted to, They are used to the lies I tell; And we do not need interpreters When we go to buy or sell. Distrust Breeds Untrustworthiness

The chief lesson I have learned in a long life is that the only way to make a man trustworthy is to trust him; and the surest way to make him untrustworthy is to distrust him and show your distrust.

Henry L. Stimson (1867 - 1950) US Secretary of War, 1911-1913 and 1940-1945

Consider the sequential move game in the diagram below.



All information depicted in the diagram, including the payoffs of both players, is common knowledge. Payoffs are in Euro. The game is played once.

First, A must make a decision, UP or DOWN. Once A's decision is made, it is irrevocable. B observes this decision. If A chooses UP, the game is over and the payoffs to both players are zero. If A chooses DOWN, B gets to make a decision. If B chooses UP, both players get 4. If B chooses DOWN, B gets + 5 and A gets -1.

Game theorists and economists work out the "subgame perfect Nash equilibrium", which is found by backward induction. Suppose B gets the make a choice, what will he choose: UP, which gives him + 4, or DOWN, which nets him +5. Answer: B chooses DOWN. Since B would choose down, A effectively has a choice between -1 or 0. Hence A chooses UP.

The weakness (*fatal*, in my opinion) of this analysis is that it assumes that *all* players B would choose DOWN. This is an extremely dogmatic assumption about human behavior. Undoubtedly, some players B will choose DOWN. But *all of them?* Instead of making such a dogmatic assumption, I believe it is wiser (and more realistic) to accept that we know very little about the choices different people would make. After all, "tous les goûts sont dans la nature" ("different strokes for different folks"): *different people - each for their own reasons - are likely to make different decisions*.

If we accept that we really don't know what people might do, the next step is to *calculate a break-even*: what percentage of players B would have to choose DOWN to make us as players A indifferent between UP and DOWN? The answer is found by solving

© Ingemar Dierickx 2012, Revised 30.07.2019 FOR PERSONAL USE ONLY. DO NOT COPY OR CIRCULATE 4 P - (1 - P) = 0which gives us the break-even probability P = 20%.

Thus, if we believe that more than 20% of players B might choose UP, it would on average pay for us as player A to choose DOWN.

The next question, then, is: What do we believe about the population of B players? Will all of them be ruthlessly opportunistic, or are there some of them who might play UP? What might motivate such people to play UP? Suppose we are B. What would we *like* A to do? Of course, A could choose to play it safe - perhaps being worried about what we might do if A were to take a risk and choose DOWN. But then we wouldn't make any money. Only if A does decide to take the risk can we make money. So if we do end up in that comfortable position where we will make money (either + 4 or +5), we owe it to A. How do we say "thank you" to someone who has created that opportunity for us? By stabbing her in the back? Furthermore, unless we assume that A made her choice to move DOWN thoughtlessly, doesn't her decision tell us something? And when someone signals that she trusts us, how do we respond? Of course, we won't naively believe that all players B will reciprocate ... but some might. Will there be enough? That is your judgment call.

The choices people make in the roles of A and B reveal some of their basic character traits. B's choice to play UP evidences *reciprocating* behavior. It conforms to a very powerful social norm: You scratch my back and I'll scratch yours. In contrast, B's choice to play DOWN is a ruthlessly selfish and *opportunistic* choice. While some of people who made this choice invoke a variety of justifications ("A should not have been so stupid", "A needs to be taught a lesson", etc.) most simply claim that it is "rational".

A's choice to play UP reveals a *skeptical* attitude: A expects people to act selfishly and opportunistically. Many of these players are *projecting*: As player B, they themselves chose DOWN. In contrast, A's decision to take a risk and move DOWN reveals a *"trusting"* attitude. The quotation marks indicate that A's decision is not necessarily a naive one: it may be a sober and calculating choice. In fact, the most effective approach to make decisions in these kinds of decision problems is to (1) make a careful assessment of the payoffs, (2) perform a break even calculation (3) make a judgment call about whether or not that break-even probability is likely to be reached in order to make A's choice of DOWN pay off on average. Such a calculating approach may help us maintain this "trusting" attitude even after we've been stung by an opportunistic B. After all, we *knew* this could very well happen. We're just playing the averages. In contrast, if our choice was based on the naive notion that "people will do the right thing", we might be so disappointed when B plays DOWN that we "learn our lesson, once and for all" - and never do it again.

Based on people's choices in the roles of both A and B, we can distinguish 4 distinct profiles:

• "*Nice*" people are "trusting" and reciprocate

• "*Economists*" are skeptical, *i.e.* they believe others are selfish and opportunistic, and see themselves as "rational", *i.e.* they act selfishly and opportunistically.

• "*Martyrs*" have had a good education, were brought in a protected environment, and naively believed that "people are good" - until an economist took advantage of them.

Since then, Martyrs have learned their lesson: Never again! Nevertheless, being good people themselves, they reciprocate when someone creates an opportunity for them. • "Machivellis" are smart. They know that there are all kinds of people out there - including bleeding heart liberals who will do the right thing. But they, of course, will be ruthlessly selfish and opportunistic. Their motto is "There is a sucker born every minute, but it ain't me!"





MBA students are predominantly "Economists" (about 70%). About 25 % are "Nice", and 5% are "Martyrs" (negotiations with fellow MBAs during the Negotiation Analysis class taught them a lesson). There are hardly any Machiavelli's. Surveys (though admittedly rather sketchy ones) of CEOs and Board Members in Europe, the US, Australia and New Zealand shows a markedly different picture: about 70% are Nice, 20-25 % are Economists, and 5-10% are Machiavellis.

While it is dangerous to generalize from such a limited (and possibly biased) sample, I am nevertheless tempted to draw two conclusions:

(1) It is important to be "trusting" (the *calculating* variety!) - and to *maintain* this attitude even after one is stung by an Economist or a Machiavelli.

There are two simple reasons for this:

• When we move up in an organization, it is simply impossible to maintain total control of our own destiny: we must rely on other people

• Martyrs and Economists don't create value.

(2) Reciprocate: "You scratch my back? I'll scratch yours!"