APPENDIX 12B*

NEGOTIATION AND RISK MANAGEMENT IN THE REAL ESTATE CONTRACTING PROCESS

APPENDIX OUTLINE

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Introduction

Negotiation is the process whereby two or more parties arrive *voluntarily* at a mutual *agreement* concerning issues in which the parties have (real or perceived) conflicting interests. Though the parties' interests conflict in some respects, they may coincide as well in other respects, and it is the parties' common interest in reaching an agreement that fundamentally underlies the possibility of success in the negotiation. Notionally, one can say that if the parties' common interest in an agreement exceeds their conflicting interests over specific issues, then the negotiation *should* be successful, though its success is still not assured, for human perceptions and behaviors are never perfect. It is not always clear at the outset of a negotiation whether agreement is in fact desirable, so one key purpose of negotiation is information gathering and discovery. This purpose can be served even when the negotiation fails to produce an agreement.

In real estate, the agreement typically concerns the terms and conditions of a property sale or lease transaction, although it may also involve a range of other agreements, such as contracts in the areas of brokerage agency, property management, or building construction, legal representation, and so forth. Successful negotiation in complex commercial real estate deals typically requires the use of: (1) **analytical skills** in ascertaining and quantifying the principal parties' true interests and objectives and the tradeoffs among the various issues of concern to the various parties; (2) **communication skills** in helping the parties to see the relevant facts and motivating them to achieve the desirable outcome; and (3) **entrepreneurial creativity** in developing multiple options for addressing the issues and getting others to cooperate to reach an agreement. This appendix will provide an overview of the topic of negotiation as it is understood by practicing professionals and academics.

Several successful approaches to negotiation exist, when "success" is defined as achieving the objectives of the negotiator. Successful strategies range from the cooperative, open, and creative to the ruthless and dishonest. The personalities involved and the negotiator's specific circumstances may determine the style the negotiator selects for a given encounter. It is not uncommon for ethical considerations to enter into judgments and decisions regarding negotiation techniques. Our position, in line with that of most business practitioners, is that unethical negotiating techniques, such as deliberate deception, are not only wrong but usually less successful in the long run.

In this appendix, we will first describe the two alternative negotiation "philosophies," known as win-lose and win-win. We will then describe the process of negotiation, highlighting some widely used "tricks of the trade" for getting negotiations to a successful conclusion. The final section introduces the concept of "**risk management**," and shows how risks may be managed through the negotiation process. This last section provides a number of examples of how negotiators can identify multiple options for addressing specific risks that arise in typical real estate deals.

12B.1. Underlying Negotiation Philosophies: Two Views

12B.1.1 The Competitive Approach: I Win if You Lose (Win-Lose)

Perhaps the first serious scholars of negotiation were in Asia. The Japanese and Chinese have traditionally viewed negotiation as a military type of exercise. Famous Asian authors have suggested that study of the military metaphor will enhance one's skills at negotiating. Most Japanese business students study *The Book of Five Rings* by Miyamoto Musashi, written originally in 1663–1665. Musashi places emphasis on patience, respect (formality), knowing your enemy (language, culture, training), practice (repetition), mental alertness, and concentration. The philosophies of Zen (meditation and life as a process, self reliance) and Buddhism (seeking enlightenment and understanding, and eliminating ego) are key elements in most Japanese management and negotiating strategies. The "**win-lose**" philosophy of negotiation is sometimes referred to as the "Asian philosophy."

When viewed as a military or competitive exercise, negotiation usually becomes one of "win-lose." For example, to the extent the tenant can get the owner to lower the rent, the tenant wins and the landlord loses. The current deal is the most important deal, and the only one to concentrate on at present. If the adversary falls for a bluff and is misled, that is their problem. The opponent is an adversary, and domination (market control) is important.

Clearly, such an approach would violate the professional code of conduct of most American trade associations, but this view of negotiation is not strictly Asian, nor do all Asians follow such an approach. Many well-known Americans espouse similar win-lose approaches to negotiation, such as Robert J. Ringer (*Winning Through Intimidation*) and Donald J. Trump (*The Art of the Deal*).

Most simple contract negotiations that are concerned with only *one* attribute of interest to both parties, such as the price of a piece of property, are essentially "win-lose" negotiations by nature. Such negotiations are rare in real life because most often there is more than one attribute of interest, such as "How fast can the job be done?" or "How fast can we close?" and so on. For example, the tenant who argues the landlord down to a rock-bottom rent will subsequently have to "live with" that landlord (and be dependent on various services the landlord will provide to the tenant) over the course of the lease term. Not only is there often more than one attribute of interest (including some that are not directly "on the table," such as the landlord's subsequent service provision in the case of the lease negotiation example), but often there is the prospect of subsequent deals that may be of interest to do with the same opposite party. To continue our lease negotiation example, the tenant may want to negotiate with the landlord at the end of the current lease for a possible renewal.

12B.1.2 The Ally, Mutual Gains, or Cooperative Approach: We All Can Win (Win-Win)

The other general approach, and one that has become viewed as American in style, is known as a "**win-win**" approach. Almost all the materials being distributed by American academic authors/lecturers advocate this approach. Americans and academics seem to favor this approach, probably partly because it seems to be more consistent with the Judeo-Christian tradition of Western societies. But the win-win philosophy not only seems more ethical to the typical Westerner, but it is also quite efficient at getting results that are most satisfactory in the long run, especially where on going relationships must exist between the parties (as is typical in commercial real estate deals). The win-win approach strives for mutual gains and balanced benefits across both sides of the deal. This approach requires cooperation. Mutual gains approaches are associated with authors/lecturers such as Fisher and Ury (1981). Here, the negotiators assume that they will have to deal with the "opposite party" ("adversary" in the win-lose philosophy) again, so they strive for long-term relationship building. Essential elements of this approach include trust and honesty, as well as empathy for the other party. This approach also assumes that each party is "logical," as defined by rational and objective thinking patterns. Therefore, the win-win philosophy stresses the importance of **interest-based bargaining**, rather than **positional bargaining**. Interest-based bargaining focuses on the underlying interests or goals of the parties, rather than on specific positions to achieve those interests or goals. (The idea is that there may be more than one way, more than one specific position, that will achieve the same underlying goal or interest.) Such a negotiation approach based on trust and honesty is also known as "**principled negotiation**."

Much of the written material on using win-win approaches is based on the development of creative alternatives to difficult negotiating problems. The most sought-after lecturers have a myriad of funny and entertaining stories to make the point that one must always be seeking ways out of stalemate positions ("stuckness"). Sometimes, this can be done by redefining, again and again, the real objectives and interests of each party and the problems they perceive at hand. Thus, the method is based on developing strong continual and clear communication, separating people from positions and problems, not allowing personalities or egos to get in the way, finding interests behind positions, and using **creativity** in developing options.

12B.1.3 Principled Negotiation and Efficiency: The Concept of Pareto Improvement

Although many negotiation styles exist, a "principled negotiation" style that presumes honesty tends to be the most efficient in terms of the time and effort required to reach agreement, and the range and quality of agreements that it tends to make possible. Also, when we recall that the purpose of negotiation is not necessarily or uniquely to achieve agreement, but rather also to obtain and discover information, the principled approach is clearly better suited to achieving this second purpose of negotiation.

Several factors contribute to the efficiency of the principled approach, including (1) the separation of ego from the process, (2) the ability to gather useful information, not just from external sources and research, but also from the one with whom an agreement is sought, and (3) the increased speed of information exchange when trust and honesty are present. This does not mean that principled negotiation will always produce the best result from the perspective of either party. Obviously, there is always the possibility that one party will exploit the trust and honesty of the opposite party, to their own benefit and to the detriment of the principled party. Thus, there is some risk in using principled approaches to negotiation in the absence of a practical mechanism to enforce honest communication or to verify the factuality of claims. However, people (both as individuals and as "business communities") tend to have **long memories** concerning negotiation behavior. Most business communities are pretty small, so if you plan to be around in the same career for very long, you will almost certainly come across the same people again and again in a variety of different specific situations. When you have been in a position to take advantage of someone at one point in time, the shoe may be on the other foot at another point in time and they may be then in a position to take advantage of you.

Sometimes agreements can be reached that improve the position of at least one party without harming the position of any other party to the negotiation. When all such agreements have been made, so that no further agreements can be made without requiring at least one party to sacrifice some net benefit, then the agreement is said to be "Pareto optimal" (named after an Italian economist). Obviously, a Pareto optimal agreement is "ideal" in some sense, because it maximizes welfare without harming the distribution of welfare across the parties (i.e., "nobody loses"). Such agreements are the most satisfactory to all sides, and tend to be the most enduring. The related concept of "**Pareto improvements**" refers to agreements that move the negotiations closer to Pareto optimality. It is relatively easy to achieve Pareto improvements using the "win-win" philosophy and "principled negotiation," provided all sides are able to quantify the monetary value to them of the various issues under negotiation. Usually, one party will care more about a given issue than the other parties, so that a system of compensations (possibly involving "side-payments") can be set up to allow all parties to be "made whole."

"Pareto optimality" or "Pareto improvements" are academic terms that you will not hear in the world of business practice. The more common term in business might simply be, "to avoid leaving **anything on the table**," which means, "Don't fail to make all the Pareto improvements that are possible."

	Profits Assuming Contractor Is Paid $5,000,000:	
Pareto Improvement Example	**Building complete in 6 months**	**Building complete in 12 months**
Contractor's profit	$1,000,000	$2,000,000
Developer's profit	$3,000,000	$1,000,000

As a simple example of Pareto improvements in real estate negotiation, consider the case where two issues are being negotiated between a developer and a construction contractor. The issues on the table are the time within which the project will be completed and the price the developer will pay the contractor to do the job. The normal construction cost (contractor's price) for the project under consideration would be $5,000,000, with completion in 12 months. The construction contractor wants as high a price as he can get for the project,

other things being equal, but he also wants the flexibility to finish the project in as long as 12 months from now, because of prior scheduling commitments he has on other projects. If he has to complete the project within the 6-month window desired by the developer, it will cost the contractor more, due to rescheduling his other projects and/ or the need to hire outside subcontractors and rent additional equipment. The contractor is able to quantify that the additional costs to him of a commitment to finish in six months instead of 12 months is $1,000,000. On the other hand, the developer is able to quantify that the project is worth an additional $2,000,000 to him if it is completed within six months instead of 12 months, due to the jump he will get on the market ahead of his other competitors.

Because both parties are able to quantify their interests on these issues, and because the benefit of the earlier completion is worth more to the developer than the additional cost this would impose on the contractor, a Pareto optimal solution can be found. For example, the developer could agree to pay the contractor $6,000,000 instead of $5,000,000 in return for the contractor agreeing to complete the project within six months. In fact, any agreement in which the developer agreed to pay the contractor any amount between $6,000,000 and $7,000,000 would be a Pareto improvement over the standard contract terms ($5,000,000 price with a 12-month completion date) because any such agreement would leave both parties at least as well off as they would be under the standard terms, with at least one party better off.

Note in the above example that it would have been difficult to achieve the Pareto improvement without a spirit of trust and sharing of information between the parties. Through the exchange of information about preferences (and an ability to quantify the dollar magnitude of the costs and benefits), the parties are able to craft an agreement that is probably more enduring and which maintains the greatest respect between the parties, and which therefore is more likely to result in the parties having an interest in doing business together again in the future.

Note also, however, that it was not necessarily in each party's interest to completely reveal all of their relevant information, **unless they knew for certain that the other party was also revealing everything**. This is seen in the fact that, within the $6,000,000 to $7,000,000 construction price window (holding the construction time-table fixed at six months), every dollar of higher price makes the contractor better off and the developer worse off. Movements **within** this window (as distinct from movements **toward** this window from outside, such as from the original $5,000,000/12-month deal) are not Pareto optimal, because one side loses. Thus, for example, if the developer claimed that the profit difference between the six-month and 12-month time frames was only $1,000,000, he could argue that he could not afford to pay more than $6,000,000 for the 6-month commitment. On the other hand, if the contractor was similarly deceptive and claimed that the additional cost of the six-month commitment was $2,000,000 instead of $1,000,000, then he could argue that he required a price of at least $7,000,000 to make the six-month commitment. With such deceptive claims, it is possible that no Pareto improving solution would be agreed upon, and the parties would end up with the standard $5,000,000, 12-month contract, thereby "leaving money on the table." This is why trust and honesty are so important and why "principled negotiation" can pay off in the bottom line of the parties' profits.

One side can attempt to use a principled approach, even when the other side is not. William Ury's book *Getting Past No* concentrates on dealing with just such problems. He emphasizes the need to "disarm" the other side by agreeing with them whenever possible (avoiding confrontational phrases like those that begin with the conjunction "but") and providing a face saving way for them to reach agreement, even when they have boxed themselves into a corner with colleagues or others by claims they will need to modify.

12B.1.4 Factors Influencing the Degree of Cooperation Versus Competition in Negotiation Styles

Several factors tend to make one or the other of these basic negotiation philosophies more likely to be used. Here we will discuss two major such factors: the ethical/cultural orientation of the parties, and the complexity of the considerations in the deal.

Ethics are an important consideration in selecting a negotiating style, and various cultures, societies, or religious orientations differ vastly in what they consider ethical. For example, presenting a misleading picture of a situation would be considered unethical by many business people. Most Americans consider predatory pricing unethical, but most Japanese consider gaining market share good business, and low prices are an acceptable strategy. On the other hand, the Japanese have historically consider leveraged buyouts or mass lay-offs to be unethical, but some Americans may view these as sound business practices. Never assume that ethics are universal.

Musashi's *The Book of Five Rings,* suggests taking advantage of an enemy's vulnerability during a weak moment or when the enemy is in a precarious position. Musashi suggests that an enemy may rise again and that one should not hesitate to act swiftly. In contrast to this view is that of a Chinese author/philosopher, Sun Tzu, who wrote *The Art of War* over 2,500 years ago. Sun Tzu suggests that when an enemy is in a precarious position and knows he has lost, this is the time to bring the enemy into your camp and begin to forge a new ally, thereby enlarging your forces and power.

Playing upon or **framing** the discussion to emphasize another's insecurity is a way of looking for vulnerability, similar to Musashi's perspective. Mershulim Riklis, an American born in Israel, cowrote *The Magic of Mergers*, in which he emphasized finding out what others really want (including ego gratification) as well as playing on their insecurities. For example, if in the course of negotiations to attempt to buy out another corporation, through prior research or subtle comments from the target firm president, one discovers that the real concern of the president is his daughter's secure role in the future of the firm, then Riklis might suggest emphasizing the important role envisioned for the daughter in the future of the firm in the course of negotiations. If this emphasis upon the daughter is based on realistic expectations and plans, then most businesspeople would consider this approach ethical. If this emphasis upon the daughter is merely a superficial bluff intended only to move your offer to the front of the potential suitor list, many people would consider it unethical.

Now consider another example. Imagine a real estate negotiation in which a corporate office is seeking to expand into the region. The expanding corporation meets with a leasing agent representing a local developer. The corporation must have space quickly in order to conduct a pressing business deal already in progress. The leasing agent knows that the market is fairly weak and that many rental concessions are being provided to local firms that expand or relocate. Should the leasing agent (1) sign a great lease for the developer at or above market rent with fewer than typical concessions? (2) provide the corporation with the same rental concessions as most other local tenants? or (3) try to determine if the new corporate tenant will likely need more space in the future, and relate the concessions to the importance of a solid long-term relationship?

Is this an ethical question, or merely one of negotiating style and philosophy? Course (1) would be an example of the strict application of the "win-lose" philosophy. Course (3) would probably be the route taken by most American business practitioners, and is basically consistent with the "win-win" philosophy. This illustrates the fact that the type of negotiation style will often reflect the consideration of whether one is dealing with a potentially long-term relationship with a growing tenant. The leasing agent that treats this deal as if it were the only deal that will ever happen and takes advantage of the corporate tenant to the maximum degree tolerated is using a competitive and exploitative (win-lose) style, which may maximize his or her benefit in the short run but possibly not in the longer run. In any case, in the absence of the use of deception or misinformation, most people would probably agree that this is a question of business style rather than ethics. In the real world, the out-of-town tenant would in any case probably have hired a local tenant representative to equalize the knowledge of the local market.

12B.2. THE PROCESS OF NEGOTIATION

12B.2.1 The First Step: Preparation

The first, and some would argue most important, step in successful negotiation is preparation. In some lines of business, the preparation is almost continual. It begins long before any specific or formal talks begin and continues after all meetings with follow-up monitoring and post-negotiation confirming communication. Research and analysis are the key to good preparation.

Preparation before negotiation requires that the critical deal points, which cannot be compromised, be clearly known, as well as those areas where there is room to give. These items might be referred to as developing an agenda. A good negotiator will have also tried to develop as many likely positions which another party is likely to use, as well as responses to each. The fewer surprises the better.

"Posturing" refers to the presentation of positions which are generally extreme in their demands. This is a typical place to begin, but one must be careful that the extreme positions are not so insulting that the negotiation breaks down before it begins. Another approach, as advocated by the "win-win" authors, is to start by stating your *interests* with less specifics on absolute positions and more emphasis on tradeoffs (which if revealed can allow for greater total welfare among all parties).

12B.2.2 In the Thick of It: How to Continue

When stalemates occur, a good negotiator is creative. The win-win advocates suggest continuing to give options or choices, with as minimal an increment in position as possible, and with emphasis on continually re-stating objectives, needs, and tradeoffs (if the deal has more than one parameter of interest). The win-lose advocates may suggest patience when a stalemate occurs.

Games. Competitive negotiators sometimes engage in games, such as the "bad guy/good guy" routine (also called "bad cop/good cop"). Usually, the principal will act as the good guy, and the agent, sometimes an attorney, will act as the bad guy fronting the negotiation process. This is a favorite American routine. This routine sets up various closing plays. For example, the adversary who also has an attorney for protection, through frustration finally calls the other principal directly (they say against their attorney's advice) and negotiates with the more "reasonable" player in the process. Attorneys then become the scapegoats, and the deal finally closes, after the attorneys are brought together (the deal already having been worked out) once more. There are several variations on this theme, such as making the deal seem final, contingent only on a behind-the-scenes boss. The adversary, having thought they had a deal, now finds several new "minor" concessions being requested before "final" approval is possible.

When one has been attacked in the process of negotiation, William Ury suggests "going to the balcony" which means pause and don't react and then try to search out what interests are really being revealed in the attack. Ury goes on to suggest that one should try and "disarm" the attacker by surprising them. This occurs by agreeing with them whenever possible, not getting defensive, and then reframing further questions to seek out common interest that might be dealt with through an agreement.

"**Claiming behavior**" refers to an attempt by one negotiating party to claim contractual agreement or commitment on an individual issue where the other party has presented an attractive position, even though the overall negotiation is not finished, and the attractive position may only have been offered as part of a larger deal. In effect, the claiming party ignores the conditions that were (perhaps not explicitly) attached to the attractive offer. The party claiming the position of the other will often continue to act as if this issue is now closed, with agreement reached, and continue to seek other issues on which a claim might be sought. Such an approach is seldom efficient and could backfire in a complex issue negotiation unless the other party is extremely submissive.

Another type of game that is sometimes played is what is called "**power games**." For example, one party may insist on controlling the meeting location, planning the seating arrangements, and so forth. The response to such games may depend on whether the negotiator believes such details will help or hinder the substantive communication which must take place in a successful negotiation, or whether they are mere symbols that do not have substantive impact in and of themselves. Another important point is whether such behavior is a sign of strength or weakness in the opposite party. This may be a function of culture. What is viewed from one cultural perspective as mere meaningless symbolism or posturing may be important and meaningful etiquette in another culture. Most win-lose advocates believe

controlling the entire environment and every aspect of visual communication is important. In contrast, win-win advocates tend to advise flexibility in such matters.

Bluffing: Know Your BATNA! Although **bluffing** is sometimes used successfully by experienced negotiators, it is a risky strategy. Most negotiation experts advise avoidance of excessive or extreme bluffing. For example, a good rule is to never state that a position or offer is "final," unless it really is. This is one of the quickest ways to end a negotiation process. Of course, sometimes it does make sense to make a true final offer, for that very reason. Making an explicit "final offer" can increase one's power and avoid wasting time in negotiations that drag on.

In order to know if one can or should rationally risk making an explicitly stated "final offer," one must know one's **BATNA (Best Alternative To a Negotiated Agreement)**. The BATNA is the best you can do if the negotiation fails altogether to reach an agreement. The BATNA may be an alternative deal, a formal legal proceeding, abandonment of the project, or some continuation of the status quo. By explicitly stating a "final offer," the opposite party may assume that a good BATNA has become available to you. If in fact no good BATNA exists, then they may call your bluff. Indeed, part of the basic preparation to any negotiation is to analyze and understand what is your BATNA.

Getting It Done: The Decision-Making Process. Experienced negotiators will often avoid and cut off games before they begin. This may be done by first **negotiating the process of negotiation**. For example, a negotiator may simply state that before any issues are discussed, they want to know all of the concerns and issues which the other party is going to raise. They may also state that agreement is first sought on the principle that there will be no other issues raised, other than the list developed together, before the issues are discussed directly. One may also seek to negotiate some of these issues in lump sum package form in order to simplify the negotiation, as well as to discover inherent tradeoffs among issues. In some cases, it may be helpful to agree first upon a formal process by which agreements will be made, especially if there are more than two parties to the negotiation. (For example, will all the parties agree in advance that certain issues can be decided by majority or supermajority decision rather than unanimous consent?) This is a little bit like adopting a "constitution" for the negotiation.

An important aspect of this process is to make sure one understands the **decision process** of the other party in advance of the beginning of the negotiation. In particular, it is important to know who (specifically, which individuals, acting in which capacity) has the official authority to make the final decision on behalf of the opposite party. It will normally be important to negotiate directly with that individual, if at all possible. If the final decision authority rests with a board or committee with whom it is not practical to negotiate, then it is important to be satisfied that the individual staff member or representative of the decision-making body, who is conducting the negotiation, has sufficient influence over the decision-making body so that agreement is highly likely.

Another key problem, which often slows down negotiations, is that the number of issues being addressed is too numerous to deal with separately in an efficient manner. Integrative negotiation is an approach where both parties agree to lay out positions on *all* issues, without committing to any positions (avoid claiming behaviors). Then, the parties agree to move toward a total package rather than dealing solely with any one issue separately. This type of approach should theoretically make the potential tradeoffs between the values placed on each issue by each party more obvious and make it much easier to move towards a parieto optimality type of settlement. Rarely, it might make sense to deal with issues individually. This might arise because of limited authority of the negotiating parties on specific issues, but it also limits the ability to seek tradeoffs among issues.

12B.2.3 The Letter of Intent or Understanding

An efficient way to proceed (for many real estate related contracts) once a fairly general agreement is reached (especially purchase contracts) is through the use of a letter of intent.

The **letter of intent** lays out a set of general positions and issues which are to be resolved before a final contract is to be finalized. This represents a unilateral offer from one party to another. Generally, the letter of intent shows one party that the other party is serious, and indicates the important issues requiring further discussion. It can save a lot of time and legal expense, because unresolved issues that are less important can be worked out pending general acceptance by the other party. But, if it appears that the parties are too far apart to likely reach agreement, then the time and trouble of developing a formal contract has been avoided. Letters of intent are often written in such a manner as to indicate the party is serious, but clearly not bound to follow through on the contract. In this sense, the letter of intent serves as a feeling out of the other party. If a letter of intent is accepted, this may be followed by a **memorandum of understanding** before a final written contract is completed.

The memorandum of understanding generally provides that neither party will not pursue any other parties for this deal until a definitive contract is consummated, or until it becomes clear that the conditions and time frame set forth cannot be worked out. In this context, a memorandum of understanding is like a temporary option, often without the financial commitment of most options. Usually, the time frame for completing a final contract is rather brief (i.e., 30 or 60 days), but it could take several months depending on the complexity of the contract.

12B.2.4 Finalizing the Deal

Always be prepared to walk away from a deal if a reasonable BATNA exists. Sunk costs in terms of legal fees, research, and time spent analyzing and negotiating are irrelevant. One cannot afford to become emotionally attached to the completion of the deal or let ego interfere with sound business judgment. All honest businesspeople will admit, however, that this is a very difficult challenge.

Looking back, every deal could be done a little better. However, it may not be worth having gone any further or spent any more time trying to improve the deal. As negotiation seems to be nearing agreement, continually compare expected benefits to expected costs of further effort and stop if the expected costs exceed the expected benefits. Never lose sight of your real objectives separate from the process of the negotiation and never let ego overpower economic rationality.

12B.3. TRICKS OF THE TRADE: OTHER TECHNIQUES AND CONSIDERATIONS IN SUCCESSFUL NEGOTIATION

At the beginning of this appendix, we suggested that successful negotiation involves three major ingredients: knowledge, communication, and creativity. In this section, we elaborate on this and present some specific rules of thumb or traits that have been found to work well in negotiation.

12B.3.1 Information and Knowledge Are Power

Three types of knowledge are important in negotiation: (1) knowledge of your self, (2) knowledge of your opposite party, and (3) knowledge of the relevant environment. These three types of knowledge enable you to put together options creatively, which can often break a deadlock and bring a successful conclusion.

Knowledge of your opposite party is emphasized in the oriental school of negotiation. The point is made that power comes from knowing an adversary. This includes their culture, language, religious, and business customs. Here, the Japanese and Europeans are said to be far superior to the "naive" and English-only-speaking Americans. (While there is no rigorous or empirical evidence that Americans are less successful negotiators than foreigners, it is clearly a disadvantage when you do not speak your opponent's language and they do speak yours.) Most successful strategies emphasize that one must find out **what an adversary really**

wants, as well as how they usually go about getting it. Knowledge of what competitive firms have offered, as well as how they approach similar clients, is extremely useful. All approaches suggest asking many questions, especially those questions that cannot be answered by a "yes" or "no." This holds even if the answers are known. In answering the questions, the other side may reveal new information. Intensive listening is important, with subtle probing questions.

Knowledge of yourself, your own side in the negotiation, is equally important. What are your underlying objectives and interests, and why? What are your alternatives to this negotiation (your "BATNA")? What are the differing interests involved in the various principal parties, agents, and constituents that make up or influence your side? Even if you do not achieve an agreement through these negotiations, what information would you like to learn about your opposite party? How will your side reach a decision in this negotiation process?

Finally, knowledge of the relevant environment can often mean the difference between successful negotiation and failure, or more subtly, between a negotiation which appears to be successful at first, but leaves you with an agreement which in the long run proves to be less advantageous than you thought. The relevant environment differs in each case but typically involves knowledge of the local political environment as well as the local economy and real estate markets. Knowledge of the financial environment and capital markets is also often of vital importance. The legal and regulatory environment can also provide surprises or opportunities which can determine success or failure, both in the short run of the negotiation itself and in the long run of the underlying project or strategy you are trying to implement.

12B.3.2 The Role of Communication Skills in Negotiation

Communication skills are often crucial in successful negotiations. Understanding and empathizing with the person to whom you are trying to communicate underlies successful communication. Psychologists and communications specialists raise a number of specific suggestions that often arise in business negotiation settings.

The Importance of Voice Tone. To the extent that direct face-to-face or phone negotiation occurs, negotiators should be sensitive to **voice tone** and practice the use (or preventing subconscious use) of such communication. Tone can signal agreement and cooperation or distrust and confrontation, even with the same word. In English, a soothing and quiet tone tends to indicate empathy or active listening. Many of the same words have as many as five different meanings in Chinese depending simply on the intonation. Similarly, English can be spoken in loud or quiet, soothing or agitated ways to indicate our feelings. A good negotiator is conscious of the probable interpretations of the tone of voice used based on how others have reacted to similar intonations.

Framing Is the Art of Tactful Communication. Typically, negotiators spend much of their time in defensive postures and a useless pattern of accusation-reaction-accusation, with much of the emphasis on proving that the other party is not negotiating in good faith. Many people are either so ego-driven or insecure that defensive reactions and hostile counterattacks happen almost automatically. One way to minimize this nonproductive use of time is to be careful to craft one's statements so that the issue and interest is emphasized without personally attacking the other party. For example, rather than ask on your return trip to the mechanic, "Why didn't you fix my car right the first time?" one could simply state "There still seems to be a problem ... could you please drive the car and tell me what you think." In the latter approach, one does not force the other party to be defensive, and respect is still shown for the skills of the other, yet the point is clearly made that some remedy for a prior problem is still required. Most of the time, such positive framing will create greater and faster cooperation than confrontational approaches.[1]

[1]Do not confuse framing as a lack of directness on the part of the negotiator. Framing does not mean hiding the truth behind a position. It does, however, mean holding back on useless truths and unneeded commentary unrelated to the business at hand.

The Importance of Nonverbal Communication. Win-lose advocates tend to place greater weight on **nonverbal communication** as signs of strength or weakness. Nonverbal communication includes gestures, facial expressions, eye contact, body positioning, as well as dress and accessories. Examples of attitudes *assumed* to be communicated by most psychologists through nonverbal means would include the following:

1. Nervous and Insecure
   - cigarette smoking
   - fidgeting in chair
   - avoiding eye contact
   - perspiring abnormally
   - dry throat or excessive throat clearing
2. Confident and Self-Assured
   - firm hand shake
   - direct eye contact
   - hands together in back while standing
   - standing straight
   - patient and even voice tone
   - little unnecessary movement

Much of real estate negotiation occurs through written contracts—often exchanged via the mail, e-mail, or fax machine—or through telephone contact. As a result, in some cases, nonverbal communication may not be as important as the other types of communication.

Patronizing Behaviors, Dress, and Pacing. Generally, most people feel most comfortable with other people whom they regard as "similar" to themselves. This is a basic subconscious human trait.

From this, it follows that if the objective of a negotiator is to develop trust and comfort, then appearance and behavioral actions that convey such "similarity" can play a useful role. Conscious communication for this objective would include selecting a similar level of dress, using appropriate language or expression, using the same level of vocabulary, smoking or not smoking, driving the appropriate type of car, and so on. The point is to increase the other side's comfort level by saying, "I am like you." (In some cases, where the other party suffers from some insecurity, the point may be more: "I am like you want to be.") An extreme form of imitation is called "pacing," in which one mimics the actions, dress, and mannerisms of another party in order to gain their trust. A negotiator must be careful not to use such an approach so blatantly as to seem to "patronize" the other party, however, or the approach may backfire. The best guard against excessive mimicking or **patronizing** behavior is sincere human concern, understanding, and empathy for the other person.

Often, the appearance of self-confidence can be useful in achieving one's negotiation objectives. Self-confidence is illustrated in many ways, including body language (i.e., level of relaxation or tension, posture, voice tone, loudness, eye contact). Body language and tone of voice reveal a person's security level.

12B.3.3 Avoid Conflicts of Interest Within the Sides

Negotiations inherently involve conflicts of interest "across the table," that is, between the two (or more) "sides," or "parties," in the negotiation, otherwise there would be nothing to negotiate. But in complex deals, it is usually the case that **within each side** are two or more individuals or entities. Most typically, even in relatively simple deals, the "principal parties" (ultimate decision makers) on each side will be represented by their "agents," such as brokers and attorneys. It gets even more complicated if there are partners involving more than one principal party within a side, or if the principal party is a large corporation or institution that has multiple constituents (e.g., different classes of investors, different branches of the corporate management, and so forth). This raises the possibility that in addition to the conflicts of interest across the table, there may be conflicts of interest **within** one or more

sides of the table. This raises a new level of complexity in the negotiation. Such complexity can make the negotiation much more difficult, because it can make it difficult to get one or more sides to agree to anything, because they do not even agree about their own interests. On the other hand, sometimes conflicts of interest within a side can be exploited, especially if one side has no internal conflict while the other side does. Although the strategy is risky, it may be possible to use conflict within the opposite side to obtain a more favorable agreement. (Such strategy is risky because it can easily backfire, either by unifying the other side, or simply killing the negotiation altogether.)

In general, a good rule is to avoid to the extent possible conflicts of interest within a side (especially if it is **your** side!). One type of relationship in which this issue is most ubiquitous is between the principal party and their negotiation agents in the form of their representative brokers and attorneys. It is important to structure this relationship so that the agents' interests coincide with those of the principal. Some mechanisms which are commonly employed to accomplish such interest alignment include contingent and proportional compensation of the agent. That is, the agent may be compensated only if the negotiation is "successful," and/or the agent's compensation may be greater the "more successful" is the negotiation. In such cases, it is important that the definition of "success" be **clearly defined and objectively measurable**. If the employment is based on a contingent event, the definition of the required event must be clear. For example, if the broker is to be compensated for an agreement reached within three months, the definition of "agreement reached" must be clear. Does this mean a signed contract of sale, or a closed sale? The principal needs also to consider the balance between pressure placed on differing objectives. A ubiquitous case is the balance between time pressure and price pressure placed on the agent. If the agent loses all prospect of compensation after some point in time, but stands to gain little extra compensation no matter what the agreed sale price is, then the agent's personal incentive is clearly to strike a deal at almost any price (at least in the short run, and ignore the fiduciary responsibility).

12B.3.4 Multiple Issue Negotiation and Agent Principal Communication

We previously noted that most real world negotiations involve multiple issues. This is more of a concern in the larger and more sophisticated commercial real estate deals, where there may be quite a number of separate issues. This makes it important in the preparation for any negotiation for each principal party to try to explicitly identify all the issues that they are concerned about, and to the extent possible to quantify the tradeoffs among these issues. (Recall the simple example of the developer and the construction contractor, and the tradeoff there between time and price.) But it is not only necessary that the principal parties perform this exercise, the agents representing the principals must also be informed of these tradeoffs. Furthermore, to avoid **agency problems**, in some cases it will be desirable for the agents' own compensation to also reflect the principal's tradeoffs among the multiple issues. Without clear communication between the principal and agent regarding multiple issues and tradeoffs, the agent will have to constantly stop the negotiation process to communicate with the principal about the changing choice set. Although negotiators often use the strategy of "checking with the principal" as a ploy to delay an otherwise uncomfortable position, such behavior tends only to waste valuable time.

Multiple issue negotiation cases (as used in an academic negotiation class) often rely on a **point system** to make explicit the "**equal utility positions**" for the principal in the case. For example, to return to our developer/contractor example, each party would assign a number of points to each combination of construction price and time-to-complete the project. More points imply more value or "utility." For example, the developer might say that the 12-month/$5 million contract is worth zero points to him, while a 6-month/$5 million contract is worth 10 points, a 6-month/$6 million contract is worth five points, and so forth. The agent is instructed to come up with a contract for the developer to sign that obtains the highest number of points he can possibly negotiate. The agent's compensation might be based on the number of "value points" in the agreed contract. Real-life negotiators seldom use point systems to develop explicit indifference combinations; rather, they often

consider the minimums and maximums within an acceptable set of preferences over multiple issues. Nevertheless, using a point system would not be a bad idea for many agents who represent principals because this exercise forces a principal to consider the tradeoffs that may occur over a range of key issues. Unfortunately, once the situation includes more than four or five issues, the number of tradeoffs becomes too numerous to create explicit and equally attractive combinations. The only other alternative is simply to discuss (brainstorm) and speculate upon all the possible scenarios that might have to be dealt with in advance, and try and develop responses that are acceptable to the principals. This is a critical part of negotiation preparation.

12B.3.5 Patience Is Important

Patience does not mean wasting time, but it does mean respecting the other party and listening to what they have to say, as well as how they say it. Americans are typically considered very impatient. It would not surprise most non-Americans if an American commented some two minutes after sitting down to talk, "Well, let's forget about this chit-chat, and get down to business!" Efficient use of time is often defined by many Americans as getting done quickly. Others may emphasize the end result as being the most important measure of whether time was efficiently used or not.

Listening is probably the most important negotiating tool, but listening and thinking about what has been said, both directly and indirectly requires patience and practice. Listening is the ideal way to gather information quickly because it requires no new research.

Those using a win-lose approach tend to believe that the less said the better. They try to say only what is necessary and no more. If too much is said, not only is new information revealed, but one may end up reminding the opponent about some factors they would have ignored or forgotten about.

With a win-win approach, discussing objectives (interests) and alternatives openly and directly, but without revealing everything (for example, the true limits of what one will accept), is considered the most expedient method. The emphasis is on revealing objectives and interests, encouraging empathy.

12B.3.6 Stay Objective and Know Your True Interests

The win-lose advocates will try to play perception games, acting stronger than they are. The key to any approach here is to remain suspicious and never assume anything. The win-win advocates would suggest that if you think you are being misled, or games are being played, to confront your opponent immediately. On the other hand, win-lose advocates would consider totally ignoring the strategy of an opponent, and side stepping the gamesmanship.

12B.3.7 Know Your Options at All Times

Win-Win advocates like Ury and Fisher emphasize the importance of staying on top of your available options. These may change over time, even during the process of the negotiations, as the environment changes, or you or your opponent changes, or you simply learn new information that makes you realize certain possibilities. The so-called "BATNA" should be constantly re-examined and re-assessed. It will change as the environment changes and your knowledge grows. The better your BATNA, the more negotiating leverage you have (unless your opponent's BATNA has also improved), as it becomes more realistic for you to simply walk way from the table. If your BATNA is very poor, then you have little negotiating leverage (unless your opponent also has a poor BATNA), and revealing the poor quality of your BATNA could be extremely costly to you in the negotiations. Apart from knowledge of your BATNA, creating constructive options is a real skill, which takes practice and experience, as well as fundamental knowledge and preparation. This is where fundamental entrepreneurial talent and ability to analyze and synthesize complex issues can really bear fruit.

12B.3.8 Consider Everything Negotiable

Another rule of thumb advocated by the win-win school is to consider all things potentially negotiable. Do not draw a line arbitrarily around sacrosanct positions. Lateral thinking, the ability to "think out of the box," is part of the creativity which makes successful negotiations. Do not waste time by deciding on final positions to options which have never been presented. This is a common problem for many negotiators. In talking out their options with a fellow colleague, they start by stating all the positions they would not accept. This can be viewed as the antithesis of creative thinking and option building, and does not often make for very successful negotiations.

12B.4. NEGOTIATION IN A RISK MANAGEMENT FRAMEWORK

Objectives sought through negotiation include those that capture gains, secure resources and influence return levels, and those that influence risk levels. For example, in a simple sale, the current price affects future return levels. The higher the price, the lower the returns upon resale, all else held constant. However, many other aspects of a contract of sale could influence the risk of the purchase or investment. For example, will the seller offer nonrecourse financing or require a personal guarantee on the loan? Many successful real estate practitioners have argued that the negotiation process is an ideal place to manage such risks. This is because the negotiation provides a setting to accomplish "**risk shifting**," the passing of the bearing of risk from one party to another. This can be valuable because certain types of risks may be less burdensome or less dangerous, or simply easier to manage, for one party than for another. This section briefly describes a number of real-world examples of using risk management to negotiate real estate contracts.

Risk is generally taken as a given in most academic discussions on the real estate purchase and investment process. Risk is usually defined and analyzed as part of the investment/development process, where economic, financial, business, political, or other sources of risk are considered. Techniques such as sensitivity analysis, simulation, and probability analysis are useful to develop risk-related information. Such analysis can help to understanding the sources of risk and to quantify tradeoffs. Such quantification often leads to adjustments in the expected future cash flow and resale estimates to be more or less conservative, or adjustments in the required rate of return (discount rate) over the period for which the investment returns are discounted. While such analysis is useful, it is not meant to imply that principal parties should be passive recipients of risk. Rather, the principal parties should seek to actively manage risk with the objective of minimizing the cost of risk, or maximizing the value of the transaction.

The examples below emphasize the management of risk, not through passive quantitative analysis, but through risk shifting. As noted, this is the process of accomplishing, **through contractual arrangements** arrived at during the negotiation process, a passing of certain specific risks from one party to another. Anyone involved in the transaction might be affected, including the buyer, seller, landlord, property manager, tenant, and banker. In exchange for accepting additional increments of risk, a party might receive a higher return or be able to accomplish another objective. The examples below are of course not exhaustive. They are presented merely as illustrations of some ways to handle some issues before they become problems. The more one can study and think about such examples, especially through your own actual practice and experience, the easier it will be to be creative in handling unforeseen risk considerations.

12B.4.1 Economic Risk Based on Dependency on Others

Situation: An attractive investment property has inadequate parking. The seller rents an adjacent parcel on a month-to-month basis, for what seems to be below market rent. The broker has indicated the parking lot owner's willingness to continue this relationship.

Problem: Without the adjacent parking lot, there are no parking alternatives. It would be impossible to keep more than half of the tenants with the existing parking. For some reason,

the current property owner has been willing to maintain a risky relationship with a month-to-month lease. How should the investor deal with the situation?

Options: There are at least three major options open to the potential investor, other than walking away from the deal. (1) Make an offer, including price and other terms, contingent on an assignable long-term lease between the parking lot owner and current property owner, at a maximum stated rent level. (2) Make an offer, including price and other terms, contingent on being able to first negotiate a lease directly with the parking lot owner for a minimum length of time and at a maximum rent level, or contingent on being able to purchase the parking lot at an acceptable price. (3) Simply try and negotiate a deal to rent or buy the parking lot before negotiating to buy the rental property.

> *Option (1) forces the seller (or seller's broker) to try to negotiate a lease for the potential buyer. While this option is low risk, it also gives the buyer less control over the terms of the parking lot lease. The benefit of this option is that it may force the seller to reveal some new information, such as a pending increase in the parking lot lease or increasing difficulty in dealing with the parking lot owner.*
>
> *Option (2) gives the buyer more control over the terms of the deal with the parking lot owner, and keeps the option of buying the rental property available for a specified period of time at a reasonable price.*
>
> *Option (3) gives the buyer the maximum negotiating leverage over the rental property owner, if the buyer is successful in first negotiating a deal with the parking lot owner. If fact, this option gives the buyer the ability to drastically reduce the price (and value) of the rental property by controlling the parking lot's future use.*

There are probably other options as well. A choice should be based on one's ethics, as well as one's eagerness to control the terms of the deal or let others do the work of negotiating issues of concern. There is no right or wrong answer here, as long as the buyer has evaluated and protected himself/herself from an untenable situation and managed the risk.

12B.4.2 Management Risks: The Rent Is Paid in Cash

Situation: An old hotel, catering to transients, weekly and monthly tenants, sits on a potentially valuable piece of property. Many of the tenants pay in cash on a week-to-week basis, and the existing owner seldom accepts checks. Sound in structure, antiquated elevators and shared wash rooms would suggest the need to modernize or tear down this hotel. The cash flow of the property is more than adequate to support the current asking price of the property.

Problem: How does an investor manage a property when most of the returns come in cash? Who and how will a buyer manage the property without worrying about skimming?

Options: There are a few options which are available to someone who wants to buy the old hotel in order to control it for long-term investment potential. (1) Plan on managing it personally and with the help of trusted partners or relatives. (2) Explore computer accounting/management software and hardware systems that would provide adequate controls to detect most skimming. If such a system is not cost prohibitive, then the investment may be still worth pursuing. (3) Purchase the property at a lower investment price, with the assumption that skimming will occur. (4) Attempt to get a long-term purchase option on the property.

All of the above options deal with the management risk in a different way. A creative investor will probably explore and consider all of them.

12B.4.3 Exchange Rate Risk

Situation: A large industrial park property is available. Two tenants are now negotiating with the developer; one is a major Japanese company, the other a Korean company. Either prospect may take the entire building. A 20-year lease is now being negotiated. The asking price for the property seems reasonable. The most attractive financing available is from the Bank of

Tokyo, but it wants the interest rate annually indexed with the yen value of the dollar so that the real yen payment does not change.

Problem: If the rent is paid in dollars and the dollar is devalued against the yen, the mortgage payment will be difficult to make.

Options: (1) Make the purchase contingent on leasing to the Japanese firm, with the rent to be paid primarily in yen. Simultaneously negotiate with the mortgage lender to make the mortgage payments in yen, so that there will be no exchange rate risk, even on a 20-year loan. (2) Make the purchase contingent on a lease, paid in yen or in dollars but with the rent amount indexed to the exchange rate of the dollar to the yen. (3) Examine the feasibility and cost of financially hedging the exchange rate risk (essentially, short-sell dollar-denominated U.S. government bonds and use the short-sale proceeds to invest in yen-denominated Japanese government bonds of similar duration).

Option (1) is the easiest and least complicated. While it does force the developer to sign with a Japanese tenant and there will be the question of default risk, this option makes sense assuming the tenant is financially strong. Otherwise, option (3) might work pretty well.

12B.4.4 Operating Risk: Utility Expenses

Situation: An attractive old residential building with classic architecture and 100% occupancy looks like a good investment. The utilities are paid by the tenant, except for heat. The heating system is an old hot steam system, with a large single oil-fired furnace. Based on current rents and expenses, the cash flow is strong and adequate for a reasonable return at the asking price. The local market is weak, and rental increases in the future will be modest.

Problem: The uncertainty of future heating costs could make this a bad investment. Steam systems are very difficult to replace, and oil prices are likely to escalate faster than most other fuels in the future. Eventually, the fuel system must be converted.

Options: Sometimes utility costs can be shifted to tenants, through proration or putting in separate meters, and rents lowered by a like amount. However, in this case, there is no way to shift the heating costs to the tenants directly, unless the heating system is changed. Alternatives include

(1) Investigate the cost to convert the system to gas (if available) and lower the price by at least that amount, with an ample reserve for uncertain future costs; (2) Investigate the cost to eliminate the system (being careful about asbestos problems) and put heaters, such as electric baseboard units, into each apartment, with the tenants paying their own heat. Rents will have to be lowered by the expected current cost of the heat.

12B.4.5 Vacancy Risk: Keeping Key Tenants

Situation: An office building is for sale, at a reasonable price for the current income. It is 95% occupied, with one large high-credit tenant taking 30% of the building, and the remainder in small tenants with 5% to 10% of the building each. Most of the leases expire over the next three to eight years. The large tenant's lease expires in six months. The vacancy rate is 18% in the local market, and while no new space is planned, the competition for tenants has been vigorous. On a new five-year lease, most tenants are being offered 12 to 18 months free rent, plus moving costs. The long-term potential in this market is solid.

Problem: The potential loss of the large single tenant could drastically reduce the returns on this property. It is critical to keep this tenant, even if rent must be lowered. New tenants will likely not help cash flow for 12 to 18 months, even if they can be found.

Options: There are several ways of dealing with this problem. Deciding which one is best may depend on how strong the seller is financially. (1) Make the purchase contract offer contingent on the seller negotiating a new lease, with minimum acceptable terms and rents. If the seller cannot successfully negotiate such a lease, provide the option of making up the difference directly, or reducing the price by a predetermined formula (i.e., the price is reduced by $10 for every dollar of annual rent below $35). (2) Make the purchase contract include a deposit of part of the price into an escrow account controlled by a third party, with the escrow account funds to be distributed to the seller or back to the buyer within seven months

depending on the outcome of the lease negotiations with the key tenant. The seller may be given the right to negotiate directly with the key tenant, (or other potential tenants) and the distribution back to the buyer or seller may depend on both the rent and term of any lease negotiated. The amount of the escrow account is simply a present value financial calculation, such as the present value of the maximum rent that might be lost if the key tenant moves out (for three or more years) at a discount rate based on alternative market opportunities. (3) Approach the key tenant on the basis of making them an equity participant in the property if purchased (i.e., 10% of all cash flows exceeding a certain amount per year and 20% of the net resale price above a certain level). (4) Make the purchase contract contingent on the seller guaranteeing minimum total rent levels for the next two years, with the difference to be made up by the seller either through deduction from an escrow account or directly from the seller.

12B.4.6 Seller Financing: Refinancing Interest Rate Risk

Situation: The seller is willing to finance 80% of the price of a property at 8.0% interest only while market rates are 11.5%, for a period of three years. The asking price is 20% higher than the market price would be if financed conventionally. The seller argues that the higher price will benefit the buyer by providing more tax shelter. (This type of situation occurs most often when interest rates are high and capital gains taxes are lower than ordinary income tax rates.)

Problem: Three years from now when refinancing is required, rents (and corresponding market value) may not have risen enough to be able to support the mortgage payments.

Options: (1) Lower the price offer to something closer to true market value at conventional financing, with only a slight premium for the benefits of below-market financing for three years. (2) Make the price offer at a premium over the market value, but ask for an extended term before refinancing is required, such as five or more years. (3) Make an offer at a price slightly above market, but make the refinancing requirement contingent on market interest rates (APR) falling to a certain level before refinancing is required or a maximum time period has elapsed or when rents have reached a minimum level.

12B.4.7 Repair Risks: Several Items Need to Be Replaced

Situation: A large flat-top apartment building appears to need a new roof but is otherwise in good condition. The seller said that he has an estimate of $45,000 to fix the roof but shows no written bid. Your roofer has suggested that it might run up to $125,000 to repair the roof in order to "do the job right!"

Problem: The uncertainty over a major repair item, and the fear that if the job is not done right, the problem could resurface.

Options: (1) Make the purchase offer at a price that assumes a $125,000 repair cost. (2) Make the purchase offer at a fair price assuming the roof has already been fixed, and put $125,000 of the price into an escrow account to be used to pay for the roof repair, with the excess going to the seller after the repair is completed. (A time limit will also be needed here for the repair, as well as discussion on any interest accrued, or how many bids are taken and how the roofer will be selected.) (3) Make the purchase offer contingent on the seller repairing the roof before all monies are paid, or even before the closing, using a roofer and materials as approved by the buyer. (4) Make the purchase offer with a price contingent on the average (or minimum plus 10% whichever is larger) of a number of bids from buyer-approved roofers, with inspections and bids to be solicited within 60 days, and closing to occur within 120 days.

12B.4.8 Buyer Requires an Empty Building (no tenants)

Situation: The seller has received an offer of a price about 20% over the market value of his industrial warehouse property but with a contingency that before closing all tenants must vacate the property. Unfortunately, the seller has one tenant with two years left on the lease at a below-market rent. All other tenants have leases that are on a month-to-month basis and require only 60 days, notice to vacate.

Problem: The seller should have anticipated this potential problem when the lease was negotiated with this tenant and inserted a clause that would allow cancellation of the lease if this situation (or others) occurred, with reasonable notice. Now there are few alternatives open to the seller.

Options: (1) The seller can accept the offer or counter for a higher price (after attempting to ascertain how badly the buyer needs the property) contingent on being able to buy out the tenant within a certain time period. The price to buy out the tenant's lease may include moving costs as well as a cash settlement equal to the present value of the market rent less the tenant's lease rate for at least the remaining time period. (The maximum of such an offer would be based on how much of the premium price it erodes from the deal. At the extreme, the indifference point would be when all of the excess price premium is being paid to the tenant, less an amount for the time and trouble and costs to reinvest the proceeds for the seller.) (2) Suggest the buyer attempt to buy out the tenant's lease and revise the offer if necessary after a deal has been struck with the tenant. (Here, the seller is hoping that the 20% premium is much less than the maximum offer forthcoming from the buyer and would want to know why the buyer needs the property and how badly he or she needs it.)

12B.4.9 Inflation: Negotiating Alternative Leases

Situation: A single-tenant warehouse near a growing business area has a triple net lease expiring in nine months. The market is fairly strong, and new prospective tenants have also been brought to the owner by several leasing agents. The existing tenant has offered to sign a new lease, but rather than paying a base rent each year adjusted by the change in the CPI, as in the last five-year lease she signed, she wants to pay a flat rent for all of the five years plus all other operating expenses as before. Currently, most economists are forecasting an inflation rate of about 4% for the next four years.

Problem: Inflation rates that affect required yields and market rents are difficult to forecast for any length of time. One might try and rely on the inflation forecasts of others in the market, even though they will probably be wrong. The problem here is a simple one to solve financially, once a reasonable forecast of inflation is known.

Option: The owner can assume an inflation forecast that is consistent with her risk preferences and then calculate the rent payment that will produce the same present value over five years when fixed each year, as opposed to a lower initial rent adjusted by the expected inflation rate. This fixed rental amount, with a slight premium added for the degree of inflation uncertainty, would be the owner's indifference alternative. A number of lease alternatives can be calculated, with expense stops or with fixed increments, where the owner is indifferent between the alternative leases.

12B.4.10 Other Issues: Tie It Up, Then Work It Out

Situation: There are a number of other important issues critical to the success of any real estate purchase contract. Many times, these issues can be resolved, after the parties have agreed on price and financial terms. For example: (1) The small shopping center development needs a traffic light with a turn lane, in order to be successful. (2) The proposed use of the property is not in conformance with zoning, and needs a zoning change. (3) The development requires that septic tanks be installed and the cost is uncertain.

Problem: If a buyer or seller always waits for all of the information that he may eventually want, then he will often lose a deal before they begin. If the price and terms are satisfactory and nonprice issues are at stake, then it always makes sense to try to complete the initial contracting process contingent on the information required, with alternatives clearly spelled out.

Options: This purchase contract is contingent upon (1) the seller obtaining approval for the installation of a traffic light, within a certain number of months, to be paid for by a certain date, etc.; (2) the seller (or buyer) being able to secure approvals for a change of zoning to_, within a certain number of months; (3) that estimates for septic tank installation,

obtained within 30 days, do not exceed X amount of dollars, or else the seller agrees to pay the difference above such an amount.

12B.4.11 Moral Dilemmas Issues: Tenants Are Old and on Social Security While Rents Are Below Market

Situation: An apartment building with 20 units appears to be an attractive investment because five of the units are at rents at least 25% below market and five others are at least 15% below market. The rest of the units are at market rent. It is priced to provide an attractive return if all of the rents are brought to market levels. Upon further investigation, it appears that the five units most below market are occupied by tenants who have been there over 10 years, and with an average age of 79 years, with little other income except social security. The landlord has not felt comfortable imposing the same rent increases on these tenants, as with the new tenants. The five others that are 15% below market have been there an average of seven years and average 79 years in age. All of the older tenants in the property are on month-to-month leases.

Problem: The investment is attractive at market rents. At the current rents, returns are slightly below market. They would be further below market, but the low turnover in this property has resulted in lower maintenance costs to repaint and repair units.

Options: (1) Be a hard-nosed businessperson, buy the property in the name of a trustee, and hire a property manager to raise the rents. (2) Offer to buy the property, but at a price which reflects below market rents for a few years, while providing assurances, either verbally or in writing that rental increases for the older tenants will not increase faster than increases in social security. (While no seller wants to accept a lower than market value offer on their property, written assurances that rents for specified units will be limited while certain tenants remain, may ease the conscious of a seller enough to accept such a deal.) (3) Simply buy the property at close to market value, and accept slightly below market returns for a few years, knowing that in the long run the property will be a good investment.

12B.4.12 Summary of Risk Management

Risk management involves first the analysis and understanding of those factors which are critical to the success or failure of an investment to perform as expected. Recognition and anticipation of risk-related factors are essential for the successful investor. Quantitative financial analysis may help determine which factors are critical or most important. Second, risk management involves the shifting, avoidance, sharing, or acceptance of and planning for risk factors as they are. Last, assumptions used in evaluation of proposed purchase, development, lease, or mortgage terms may be changed (such as discount rates used in calculating present values) as a means of incorporating risks in the final decision.

12B.5. SUMMARY

How you handle negotiations, from the collection of information about the relevant opposite party and environment, to the execution of clear and well-planned communication with both the opposite party and between principals and agents, to the creative development of entrepreneurial options within the negotiation process, will go a long way to determining how successful you are as a real estate business professional. Most professionals stress the "win-win" philosophy of negotiation and the importance of preparation ("doing your homework"). When a negotiator seeks to satisfy their own principal's objectives by simultaneously satisfying the objectives of the other side, they are seeking Pareto optimality, which is a good general objective in most negotiations. Good negotiators understand the process of negotiations as well as the interests of all involved parties. Negotiation also provides an excellent opportunity for risk management. Understanding what is risky involves careful research, analysis, and preparation. Shifting or accepting risk (pricing risk) is accomplished through the contracting process.

KEY TERMS

negotiation
win-lose
win-win
interest-based bargaining
positional bargaining
principled negotiation
Pareto improvement
negotiation games
good guy/bad guy
claiming behavior
power games
bluffing
BATNA
negotiating the process of negotiation
decision process
letter of intent
memorandum of understanding
voice tone
framing
nonverbal communication
patronizing
conflict of interest
multi-issue negotiation
agency problem
equal utility position
risk management

STUDY QUESTIONS

1. Define "negotiation."
2. Describe the dominant characteristics of a "win-win," mutual gains or principled negotiation approach versus a "win-lose" or power negotiation approach.
3. Why does principled negotiation tend to be more efficient than other approaches?
4. Describe secure versus insecure voice tone and body language patterns.
5. Describe the characteristics in common of all successful negotiators. What is the most important skill during negotiation?
6. What is meant by risk management in negotiation? Who might be involved in risk management?
7. Provide some solutions to the risks present in the following issues, from the perspective of a buyer of property:
   a. Three parcels must be acquired from different owners in order to develop a proposed property.
   b. The property may not meet ADA requirements, but you still want to buy the property if the investment numbers can work.
   c. The zoning on the property is uncertain and may constrain future property uses.
   d. Mortgage interest rates are starting to climb reducing the potential property cash flow.
   e. The negotiation has many complicated issues, and time is of the essence.

Negotiation References

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