# *Review Essay*

# When Auctions Met Negotiations

*David Lax*

**Guhan Subramanian**. *Negotiauctions: New Dealmaking Strategies for a Competitive Marketplace*. New York: W. W. Norton and Company, 2010. 236 pages. $26.95 (hardcover), ISBN: 039306946X.

## Overlapping Worlds

If you read nothing more of this review, you should know that *Negotiauctions* makes two strong contributions. First, it highlights the close overlap in practice between negotiations and auctions, which are treated as essentially separate activities in the academic literature and in guidance to practitioners. Second, its insightful and detailed study of complex real negotiations, combined with a thoughtful understanding of the relevant academic literature, adds depth and sophistication to the analysis of negotiations.

This sophistication is uncommon in writing by academics on negotiation, who tend to use toy examples, synopses of newspaper articles, or ivory tower imaginings of what a corporate negotiation must be like. *Negotiauctions* will provide valuable guidance to experienced practitioners who need a framework for helping them make important decisions. It will also enable academics studying negotiation and auctions to make their research more relevant to deal makers.

This review will put author Guhan Subramanian's effort in context and then discuss its contents chapter by chapter. I will also note three concerns about the book. The first two reflect shortcomings in his interpretation of some important analytic insights but do not diminish the book's value to practitioners. The third is more a wish than a criticism, as it reflects a sense that this lucidly written book could have gone further prescriptively, which

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would have made it even more valuable to less experienced practitioners and to students.

## Addressing Gaps in the Research

Most academic literature on negotiation addresses two-party cases, often employs game-theoretic or psychological approaches, and presumes that the game is well specified and fixed. The economic/game-theoretic approach typically seeks to predict the outcome that economically rational actors will reach in that carefully specified situation. Psychological studies typically use controlled experiments to see how various manipulations affect negotiating behavior (or responses to questions about negotiation). Some of these studies have identified deviations from economically rational behavior. The auction literature, in turn, is predominantly game-theoretic and predicts optimal bidding behavior under assumptions that are frequently unrealistically strict.

Subramanian rightly notes that while practitioners have found value in some academic insights about negotiation (though less so in the auction literature), three related problems have limited the utility of some models and findings. First, negotiators in many situations (both simple and complex) do not take the elements of the game or its context as fixed. Instead, they may seek to change a host of factors, among them, the parties, the issues being discussed, the interests perceived to be at stake, the no-agreement alternatives or BATNA (Best Alternatives to Negotiated Agreement), as well as the sequence of events and the process orchestration (what information is kept between a subset of parties, what is made public, and the general rules of interaction).[1] Jim Sebenius and I wrote *3-D Negotiation* precisely to provide a prescriptive framework and advice to one party on how to change the elements of the situation to enable better negotiated outcomes (Lax and Sebenius 2006).[2] We refer to this array of moves as changing the "setup."

Second, in situations in which a seller's BATNA in a negotiation with Buyer A is to sell to Buyers B, C (and so on), the process may take on an auction-like dynamic. Specifically, a seller may inform all the potential buyers that they have competition; hence, they must improve their offers if they want to prevail. This dynamic is ignored analytically and prescriptively by game-theoretic and psychological approaches that assume a fixed bilateral negotiation.[3]

Third, rather than following the pristine, uncompromising rules envisioned by academics studying auctions, many auctions involving corporate assets tend to use an auction process to narrow down the field of bidders and then shift into negotiations with one or perhaps two finalists. More generally, the process may be preceded by explicit or implicit negotiations about the rules of the auction. The literature on auctions likewise has little advice for how to conduct an auction that blends into negotiations. When

negotiations blend into auctions and vice versa, the players have many opportunities, to use our language from *3-D Negotiation*, to "set up" the negotiation by influencing the choice of parties, defining the issues, affecting which interests are salient, altering other parties' BATNAs by the negotiation/auction rules that are established, and altering the rules themselves via negotiation.

*Negotiauctions* focuses precisely on the situations in which auctions devolve into negotiation or in which negotiations take on an auction-like dynamic. Although other commentators have noted these situations before, *Negotiauctions* is the first clear and sustained treatment of this important set of phenomena. Its focus is on the subset of corporate transactions, such as the sale of firms or corporate assets, that can have both negotiation-like and auction-like characteristics. In fact, the same analysis offers useful advice to procurement departments thinking about how best to organize the purchase of various goods and services. It is worth noting, of course, that many other situations, such as joint ventures, internal negotiations within companies and governments, bilateral and multilateral treaties, and many interpersonal interactions, are not typically handled via negotiauctions.

There is much to like about this book. Its strength lies in the depth in which it analyzes actual situations as negotiauctions. Subramanian is at his best when he analyzes in meaningful detail, for example, the negotiation over the television rights for the TV series *Frasier* after it had achieved major commercial success, an auction held by investment bankers for the telecommunications company Cable and Wireless America, the Federal government's Troubled Asset Relief Program auctions of distressed securities, the sale of *New York* magazine, the purchase of a home on Martha's Vineyard, the sale of NCS HealthCare, the acquisition of ABN AMRO by a consortium of banks, the purchase of Boston's John Hancock Tower for a stunningly low price, the sale of Toys "R" Us through the use of club bidding by private equity firms, and the sale of Qwest to Verizon. These are compelling, detailed, real-world cases, not toy examples or contrived ones. Rather, Subramanian has studied many of these situations in depth, often interviewing protagonists to get a sense of the key choices they faced, and he has used these cases to develop his framework and prescriptions.

He begins by looking at negotiations and auctions separately, illuminating familiar concepts of negotiation analysis — the BATNA and corresponding reservation value, the zone of possible agreement, and the negotiator's dilemma. He also uses the Cable and Wireless and *Frasier* cases to illustrate various value-claiming tactics. Subramanian then considers when one should negotiate and when one should run an auction, and he provides a useful framework for distinguishing under what conditions one setup is better than the other. He also identifies key characteristics of the buyers (number, strength of BATNAs, visibility, and heterogeneity in

valuations), the sellers (tolerance for risk and delay), the asset (ease of specification, potential for value creation, importance of relationship and service), and the context (need for transparency or secrecy) that make either a negotiation or an auction more desirable. Such characteristics also inform what kind of auction design makes sense if an auction is deemed to be the appropriate process for concluding a transaction. Subramanian's framework and its underlying logic will provide significant benefit to deal makers thinking about how to organize or participate in a transaction.

He next addresses the problem of how to bid in an auction. He begins with the clearest explanation for lay people of the often-misunderstood winner's curse that I have seen. When bidding for an asset about which the parties have neither special knowledge nor differential economics, each party will form its valuation based upon the same data and same economics. Because there is randomness in any valuation process, at random, some bidders with the same information will value it more highly. The winning bidder will have valued it the highest, of course, but because he has no special reason to value it more highly than the others, he should know that he has likely overvalued the asset and lost money. Initial bids should anticipate this risk and thus be lower. (Many bidders in real situations fail to do so at considerable cost.)

The final part of Subramanian's separate treatment of negotiations and auctions is to look at the limitations of existing theory. It is in this section that he is not always at his strongest. For example, he issues a rather sweeping criticism of the experimental study of negotiations by psychologists. First, he notes that such studies tend to use undergraduates unmotivated by incentives as subjects. Indeed, the lack of proper motivation among subjects is a real concern. Second, he notes that we should be cautious in assuming that the results of a simplistic negotiation exercise translate into the real world of high-stakes negotiations with motivated players. He is correct in saying that experimental researchers who are unfamiliar with actual corporate negotiations may lack clear judgment about whether their experimental manipulations bear much relationship to the construct they claim to be testing.

I sympathize with this general view, as do others, but Subramanian has not invoked strong enough evidence to be persuasive. For example, he criticizes a well-known study by psychologist Ellen Langer that suggests that people are more likely to assent to a request when given a reason (even a nonsensical one), arguing that the sample size was small. In an end note, however, he concedes that the results have been replicated in studies with larger subject pools. He also speculates that the result might be different if the request were more costly to grant. While that is certainly plausible, he only offers anecdotal evidence to support his argument.

Later, he asserts that one cannot design an experiment that captures the complexity of a situation in which one buyer (say a Wal-Mart buyer)

is negotiating in parallel with a number of sellers (but the number may not be known to the sellers). I believe that the specific setting he describes is one that could easily be studied sensibly in a carefully designed, controlled experiment. While I emphatically agree with Subramanian that the external validity of many experimental studies on negotiation is quite weak because the studies omit essential features of actual negotiations, I believe that a more nuanced argument is likely to be more persuasive.

With regard to what Subramanian calls "negotiation theory," I agree with his assertion that the notion of a BATNA is simplistic in the context of sophisticated deal making. If I negotiate in parallel with three separate suppliers, what is my BATNA, for instance? And how should I set my reservation value in each of the negotiations? Game theorists and negotiation analysts such as Howard Raiffa have grappled with such issues, but Subramanian is correct to question the value in complex settings of simple, even simplistic, notions about BATNAs.

## Negotiauctions and the Negotiator's Dilemma

I must, however, take strong issue with his characterization of the negotiators' dilemma. In the interest of full disclosure, I should note that Jim Sebenius and I coined this term and it has become common currency (Lax and Sebenius 1986). It is a central element of negotiation analysis, but it has sometimes been misunderstood as seems the case here. Let me sketch its key elements as succinctly as possible. (Readers who wish a fuller exposition can consult *The Manager as Negotiator.*):

1. Value can be created in a purely price-driven deal if the minimum a seller is willing to accept is less than the maximum a buyer is willing to pay and the parties agree to a price in that range.
2. Value also can be enhanced in a multi-issue case if the parties can trade on different preferences, expectations, tolerances for risk, time horizons, and the like.
3. Realization of both kinds of value depends on awareness of how such interests overlap and differ.
4. This awareness need not be shared, however. In fact, if an omniscient negotiator is paired with one who is naive, the former can discern a value-maximizing deal and get the lion's share himself.
5. Thus, the negotiator's dilemma: disclosure of information is essential to value creation, but it also leaves one vulnerable to exploitation if the other party is withholding. Both parties have an incentive to withhold information and if both do so, there is a chance that they will reach impasse or fail to find value-creating trades.

The concept is more nuanced than that, of course, but Jim and I — and many others — have written extensively about managing the negotiator's dilemma. Indeed, that was the title of one of the central chapters in our original book. Nevertheless, some early readers somehow assumed that we were contending that hard tactics (particularly, nondisclosure of real interests) would and should drive out collaborative moves. That was hardly the point, as should have been abundantly clear from all the examples of successful deal making we provided.

Subramanian, however, seems to have reached the opposite conclusion, namely, that we asserted that collaborative moves would always trump competitive ones, at least in situations with high stakes. Specifically, he writes, "One of the unstated but core assumptions in the negotiator's dilemma is that the parties will make a deal" (page 109).[4] We make no such assumption. Quite the contrary! If parties fail to disclose their true preferences, they risk impasse or at least suboptimal deals. When that happens, it is costly for the parties and perhaps for other stakeholders, as well. The good news for all of us is that seasoned negotiators often successfully manage the inherent tension between disclosing and concealing information, and more broadly, between creating and claiming value.

Subramanian maintains that deal makers are less likely to mask their preferences or otherwise choose value-claiming tactics when the stakes are high, but he presents no direct evidence for this statement. For better or worse, it is not consistent with my own experience as an advisor in corporate transactions, or as an investment and merchant banker.[5]

Indeed, we can see a version of the negotiator's dilemma dynamic at work in an extraordinarily high-stakes negotiation over the rescue of Lehman Brothers. United States Treasury Secretary Hank Paulson assembled a group of key bank chief executives and apparently told them, "Not one penny will come from the government." Other participants took this to be a bargaining tactic. Bank of America's CEO Ken Lewis subsequently called Paulson and told him that without government help, the bank would not do the deal. Paulson told him there would be no such aid but that he wanted to discuss other options, but that afternoon Lewis entered negotiations to buy Merrill Lynch instead. The government's refusal to admit it was willing to extend financing, an apparent value-claiming move intended to extract better terms from the bank, instead drove it off.[6] As a result, Lehman fell, and the rest, as they say, is history.

That is just one illustration of the negotiators' dilemma. When it comes to bilateral corporate deal making, it is not hard to find examples of needless stalemates or suboptimal agreements. Subramanian would have been on firmer ground if he had limited his claim to the negotiauction context, in which case he makes a plausible argument that at the extreme, in an auction-like setting with many bidders, the equilibrium strategy will

involve value creating on the part of the bidders and value claiming on the part of the seller.

By way of illustration, imagine a company selling an attractive division. It has identified a number of interested buyers, has gotten indicative bids from a number of bidders, and told the bidders that it would negotiate with the top two. In calculating an indicative bid, the buyers have to consider the likely bids of other buyers, with the goal of putting enough value in the bid to be selected as a negotiating partner. That creates an incentive for the buyer to learn as much as it can about the seller's interests. That way it can offer a deal structure that adds value unique to the buyer on top of merely a price offer. Each potential buyer will attempt to do likewise. There has to be sufficient competition, of course: not too little so that the buyers do not feel they need to stretch and not so much that they do not see the exercise as worth the effort. If so, the buyers will have to move from the claim strategy to the create strategy. The seller will likely remain in the claim mode. In a negotiauction in which the seller can dictate the process to the buyers, Subramanian argues, the equilibrium strategy is likely to be (create, claim) rather than (claim, claim).[7]

Subramanian provides a real-world example in which KPMG played off Microsoft and Netscape in its desire for browser technology. To overcome its weaker browser technology, Microsoft learned about KPMG's interests and used its broader business capabilities and deep pockets to create value for KPMG. As Subramanian notes, the company followed the create strategy. Thus, Microsoft and KPMG chose the (create, claim) strategy.

Another interesting aspect of that negotiauction, which Subramanian does not point out, is that the other negotiauction bidder (Netscape) did not follow the value-creating strategy. He could have explored more deeply why players do not always choose what he labels the equilibrium strategy in this setting. He does, however, describe a meeting between top auction theorists and top investment bankers who sought ways in which auction theory could help investment bankers. His conclusion that conventional auction theory has little practical advice to offer deal makers squares with my own experience.

## Defining Negotiauction Moves

Subramanian next turns to negotiauctions and the real payoff of the book. He defines negotiauctions and identifies three mutually exclusive and collectively exhaustive classes of moves and devotes a chapter to each:

1 *setup moves*[8] that establish terms of entry into a negotiauction situation;

2 *rearranging moves* that reconfigure the assets, the parties, or both in a way that is designed to create value in the deal; and

3 *shutdown moves*, which are designed to eliminate competition on your side of the table.

In the chapter on setup moves, Subramanian explains that a bidder who is considering entering an auction should recognize that he/she adds value to the seller and can, in many circumstances, ask for compensation prior to entry. That compensation may be in specifying rules for the auction or in some cases actually getting paid — when a party is a stalking horse to create competition for a likely buyer, for example, that party can reasonably ask to be paid for its time and opportunity cost if it loses the bid.

Subramanian correctly points out that these moves have to be made at the outset. Once the bidder has joined the negotiauction, his/her leverage is dissipated. He illustrates a number of fascinating setup moves using several examples (the purchase of the Martha's Vineyard home, the acquisition of NCS HealthCare, and the management buyout of Kerzner International). Subramanian notes that he has observed many setup moves over the course of his research. It would have been instructive for all of his audiences to read descriptions of other setup moves. It would have been extremely valuable to read Subramanian's rough rules describing which setup moves are appropriate to which situations.

In the chapter on "rearranging" moves, Subramanian describes the formation of bidding consortia in the private equity bid for Toys "R" Us and as well among three European banks to purchase ABN AMRO bank. The most interesting example in this chapter involves Normandy Capital's moves in advance of the 2009 auction for the John Hancock Tower. In 2008, Normandy began purchasing a controlling share of a class of debt in Hancock at roughly 40 cents on the dollar because that class of debt could, according to the "terms of public sale," be used as a bidding currency at face value. Thus, given its ownership, Normandy could easily outbid any other bidders and so they did not even try. Arguably, Normandy acquired this prize property for a song as a result of its rearranging moves. Here again, it would be useful to read about more rearranging moves and then to ponder what rearranging moves are appropriate for which situations.

Shutdown moves are moves by the buyer (in corporate transactions or vendors in a purchasing context) designed to end the negotiauction or eliminate negotiation with any other parties. Some succeed, and as illustrated in the chapter, some fail or even worse, ignite a bigger bidding war than might have happened otherwise. Subramanian offers some examples, but less experienced practitioners might have appreciated more examples of shutdown moves and guidance on how to think about what to do and when.[9]

In voicing such concerns, I am undoubtedly revealing my own sense of the value of this topic. My concerns should not obscure the fact that by treating negotiations and auctions together, and developing approaches for

their linkage, Subramanian has almost single-handedly opened up a valuable field for theoretical inquiry with considerable practical implications. *Negotiauctions* will be especially valuable for academics because its case studies highlight the dynamics of *real* negotiations. Until now, too many researchers have lacked sophistication when it comes to complex business transactions, and as a result, much of their work has had limited practical value.

As for those who conduct deals, *Negotiauction*'s greatest value will be for more experienced, high-level practitioners. The categories and moves Subramanian identifies will resonate for them. They will be able to draw on their own deal-making experience to construct appropriate setup, rearranging, and shutdown moves. Those learning the deal-making trade can benefit from *Negotiauctions*, though its value to them (and to experienced practitioners as well) might have been further enhanced by a rearranging move, namely, by extending the solid prescriptions of the setup, rearranging, and shutdown chapters beyond some useful but relatively general statements to make them more specific. Overall, this is a terrific book and sets the stage for more important work. Subramanian is well situated to carry this work forward, and others will be able to do so, as well, thanks to the grounded foundation he has provided.

## NOTES

**1**. Jim Sebenius first observed this (Sebenius 1983), and he and I then extended it substantially (Lax and Sebenius 1986).

**2**. We also explain how to achieve better outcomes within a fixed situation.

**3**. I offered an early approach to thinking about the situation in which one's BATNA is a search among other potential buyers (see Lax 1985).

**4**. Subramanian asserts that as a deal becomes more attractive to Party A when viewed from the perspective of Party B, the more likely Party A is to accept it. In general, it is hard to imagine that this statement is not true in any setting. Note that for a pair of rational decision makers, it could not be otherwise. A rational Party A, by definition, will accept any deal that exceeds its reservation value, properly calculated. Party A may decline a deal whose economics on paper just beat its BATNA, because of concerns including implementation risk, the opportunity cost of management time, more generalized risk aversion, a concern about reputational risk of seeming to have buckled under. This may be why Subramanian notes that deal makers will not accept deals just above their BATNAs, but that observation just reflects a failure to incorporate all of the deal maker's interests when comparing the deal versus the no-deal alternative. If Party B is uncertain about A's reservation value (as is almost always the case), the higher B's offer to A, the greater the probability from B's perspective that it is greater than A's reservation value and thus the greater the probability from B's perspective that A will say yes. If Subramanian's observation that, from Party B's perspective, Party A is more likely to say yes as the incentive for saying yes increases were to have the implications he asserts, he would also have completely rewritten some major results in game theory. There seem to be two causes to his incorrect inference: his argument seems to confuse B's predictions about what A will do with A's actual view of the world. Although his argument is not specified clearly, it appears to confuse (1) strategy choices in the simplified economic models of situations and the incentives decision makers face at the time that they choose strategies with (2) the ultimate outcomes that result from their choices.

**5**. In many corporate transactions, investment bankers are compensated based upon the value of the deal and thus care primarily about whether a deal occurs and much less about the value of the deal to their clients. In situations in which the bankers drive the deal, one might find it easier to get deals done, but because of how incentives are set rather than for the reasons Subramanian describes. Nonetheless, my reflections on my work as an investment and merchant banker and then

as an adviser on corporate transactions are not populated by many visions of excessively cooperative, nonaggressive investment bankers.

**6**. For a detailed account of this stalemate, see http://www.dailyfinance.com/story/why-the-u-s-balked-at-bailout-out-lehman/19399313/?icid=sphere_copyright.

**7**. This argument, which leads to a create, claim equilibrium in negotiauctions, appears to further contradict his earlier argument that the equilibrium strategy in the negotiator's dilemma will involve a create, create strategy choice, at least for corporate deal makers working on deals with high substantive value.

**8**. Subramanian's category of setup moves are a subset of the moves we call setup or deal setup in *3-D Negotiation*. Rearranging moves would typically be part of what we would call moves to establish or change the deal setup.

**9**. There is one additional category of moves that could have benefited from Subramanian's careful study. Skilled deal makers often ask for advice on how to avoid an auction in the first place. I am not sure whether such negotiations are setup moves because they affect the rules of engagement or shutdown moves because they eliminate same-side-of-the-table competition (or both).

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