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# Elmtree House

The following case study is mostly make-believe; one might speak of it as an "armchair" case. It involves a colleague of mine—I'll call him Steve—who, as a professor of business, was quite knowledgeable about finance but not a practitioner of the art and science of negotiation.

Steve was on the governing board of Elmtree House, a halfway house for young men and women ages eighteen to twenty-five who needed the support of a sympathetic group and professional guidance to ease their transition from mental institutions back to society. Many of the residents had had nervous breakdowns, or were borderline schizophrenics, or were recovering from unfortunate experiences with drugs. Located on the outskirts of Boston in the industrial city of Somerville, Elmtree House accommodated about twenty residents. The neighborhood was in a transition stage; some said that it would deteriorate further, others that it was on the way up. In any case, it did not provide an ideal recuperative setting because of its agitated atmosphere. Although the house was small and quite run down, the lot itself was extensive, consisting of a full acre of ground. Its once-magnificent stand of elm trees had succumbed to disease.

The governing board, through a subcommittee, had once investigated the possibility of moving Elmtree from Somerville to a quieter, semiresidential community. Other suitable houses were located in the nearby cities of Brookline, Medford, and Allston, but the financial aspects were prohibitive and the idea of moving was reluctantly dropped.

Some months later, a Mr. Wilson approached Elmtree's director, Mrs. Peters, who lived in the house with her husband and child. Wilson indicated that his firm, a combined architectural and developmental contractor, might be interested in buying the Elmtree

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property. This was out of the blue. No public announcement had ever been made that Elmtree House was interested in a move. Mrs. Peters responded that the thought had never occurred to her, but that if the price were right, the governing board might just consider it. Wilson gave Mrs. Peters his card and said that he would like to pursue the topic further if there were a chance for a deal.

The governing board asked Steve to follow up on this promising lead. The other board members were prominent individuals in clinical psychology, medicine, vocational guidance, and the clergy; none besides Steve had any feeling for business negotiations of this kind, and since they fully trusted Steve, they essentially gave him carte blanche to negotiate. Of course, no legal transaction could be consummated without the board's formal approval.[1]

Steve sought my advice on how he should approach Mr. Wilson, and we decided that an informal phone call was in order. Steve accepted an invitation to discuss possibilities over cocktails at a nearby hotel. He decided not to talk about any money matters at that first meeting—just to sound out Wilson and find out what he might have in mind. He insisted, I think rightly, in paying his own bill. I assured him that he also did rightly in not even hinting to Wilson that the governing board was looking for other locations.

Based on that first meeting, as well as on some probing into Wilson's business affiliations, Steve ascertained that Wilson was a legitimate businessman of decent reputation. Steve thought that Wilson's company wanted the Elmtree property as a possible site for a condominium. Wilson wished to talk money matters right away, but Steve needed a couple of weeks to prepare for negotiations. He used the excuse that he needed the approval of the governing board before he could proceed to serious negotiations.[2]

During the next twelve days, Steve did a number of things. First,

1. When telling this story in class, I stop at this point and ask the students what advice they would give Steve; I then tell them what he actually did. I repeat this at critical junctures throughout the case study.

2. Queries for students: Are such strategic misrepresentations of the truth an acceptable mode of behavior? Given that Steve has two weeks to prepare (about fifteen working hours), what should he do?

Students are surprisingly tough in their responses to this case study. They generally suggest that Steve invent all sorts of stories because such misrepresentations would seem to be in the interests of a good cause and because the students identify with the housing plight of the residents of Elmtree House. I purposely chose this setting to stir these emotional feelings.



he tried to ascertain Elmtree's *reservation price* or walkaway price—that is, the minimum price that Elmtree House, the seller, could accept. The reservation price was difficult to determine, since it depended on the availability of alternative sites to relocate. Steve learned that of the other sites that had previously been located, the one in Brookline was no longer available but the other two, in Medford and in Allston, were still possibilities—for the right price. Steve talked with the owners of those sites and found out that the Medford property could be had for about $175,000 and the Allston property for about $235,000.[3]

Steve decided that Elmtree House would need at least $220,000 before a move to Medford could be undertaken and that it would need $275,000 to justify a move to Allston. These figures took into account the cost of moving, minor repairs, insurance, and a small sum for risk aversion. The Allston site (needing $275,000) was much better than the Medford site (needing $220,000), which in turn was better than the site at Elmtree. So Steve decided that his reservation price would be $220,000. He would take nothing less, and hope to get more—possibly enough more to justify the Allston alternative. This bit of research took about six hours, or a couple of evenings' work.

Meanwhile Steve's wife, Mary, contacted several realtors looking for alternate properties. There were a few nibbles, but nothing definite turned up.

*What next?*

Steve next investigated what Elmtree House would bring if sold on the open market. By examining the sale prices of houses in the vicinity and by talking to local realtors and real estate experts, he learned that the Elmtree property was probably worth only about $125,000. He felt that if sold without Wilson in the picture, the house would go for between $110,000 and $145,000 (with probability one-half), and it was just as likely to go below $110,000 as above $145,000. How disappointing! This took another four hours of research time.

3. These were not firm figures, but Steve's assessed distributions of these amounts were tightly distributed about these central values; each judgmental distribution had a standard deviation of about $15,000. This means that *roughly* Steve would give 2-to-1 odds that the actual selling price of the Medford property would be within $15,000 of $175,000 and 19-to-1 odds that the actual selling price would be within $30,000 of $175,000. Analogously for Allston.

*What next?*

What was the story from Wilson's perspective? It was difficult for us to make judgments about the buyer's *reservation price*—that is, the maximum price that Wilson would be willing to offer before he definitely would break off negotiations, not temporarily for strategic purposes, but permanently. Neither Steve nor I had any expertise in the matter. We went for advice to a number of real estate experts (some at the Harvard Business School) and we also queried two contractors in the Boston area. Our experts did not agree with one another, but they all took our question about reservation price seriously, and we were convinced that they understood our problem. A lot, we were told, depended on the intention of the developers. How high a structure would they be permitted to build on the site? Were they buying up other land as well? Steve found out that the answer to the latter question was yes. The matter turned out to be much more involved than Steve or I had imagined it would be. After ten hours of his time and five hours of my time, we decided that we were hopelessly vague about our assessment of Wilson's reservation price. Figure 1 shows Steve's assessed probability density function—all things considered—of Wilson's *RP* (reservation price). As of two days before the start of real negotiations, Steve would have bet even money that Wilson's *RP* lay in the interval from $250,000 (the lower quartile) to $475,000 (the upper quartile).[4]

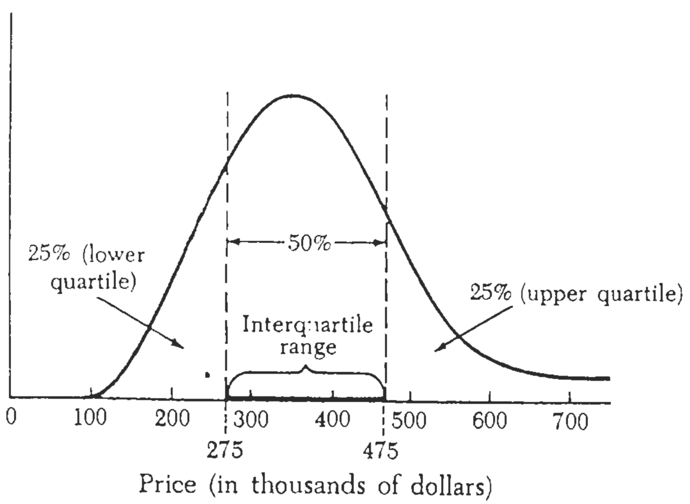


Figure 1. Steve's probability assessment of Wilson's reservation price for Elmtree House. (Vertical scale is such that the area under the probability density function is 1.00.)





After all this preparation, Steve and I discussed his negotiation strategy. It had already been decided that the meeting would be at a hotel suite to which Wilson's company had access. Steve and I had no objection to this venue; the dining room of Elmtree House would have been too hectic, and his own university office inappropriate.

Feeling that he needed someone at the discussions to advise him on legal details, Steve decided to invite Harry Jones, a Boston lawyer and former member of Elmtree House's governing board. Jones agreed to participate, and Steve reserved two hours to brief him prior to the meeting.[5]

We also thought it might be a good idea for Steve to bring along Mrs. Peters. She was the person who was most knowledgeable about Elmtree House, and perhaps an appeal to Wilson's social conscience might help. It was agreed that Steve alone would talk about money matters. Mrs. Peters would be coached to talk about the important social role of halfway houses and to argue that it did not make sense for Elmtree House to move unless there would be substantial improvement in the surrounding amenities: "You know how hard it is on kids to move from one neighborhood to another. Just think how severe the effects will be on the young residents of Elmtree House." Mrs. Peters actually did have conflicting feelings about moving, and it would be easy for her to marshal arguments against a move.

What should be Steve's opening gambit? Who should start the bidding first? If Wilson insisted that Steve make the first offer, what should that be? If Wilson opened with $x$ thousand dollars, what should Steve's counteroffer be? How far could this be planned in advance? Were there any obvious traps to be avoided?

Steve and I felt that our probabilistic assessment of Wilson's *RP*

4. One expert thought that there was a reasonable (over 25 percent) probability that Wilson would go as high as $600,000; another thought that the chances of this were minuscule (less than 1 percent). Too bad we couldn't have had them bet with each other and taken a brokerage fee for our entrepreneurial efforts.

5. One colleague of mine suggested that bringing a lawyer to the initial negotiations might have hurt Steve's cause: it indicated too much of a desire to do business and to settle details.

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was so broad that it would be easy to make a mistake by having our first offer fall below his true reservation price. But if we started with a wildly high request like $900,000—way over what we would settle for—it might sour the atmosphere.

Steve decided to try to get Wilson to move first; if that did not work and if he were forced to make the first offer, he would use the round figure of $750,000, but he would try to make that offer appear very flexible and soft. Steve thought about opening with an offer of $400,000 and holding firm for a while, but we felt there was a 40 percent chance that this amount would be below Wilson's *RP*. If Wilson moved first, Steve would not allow him to dwell on his offer but would quickly try to get away from that psychologically low anchor point by promptly retorting with a counteroffer of, say, $750,000.

I told Steve that once two offers are on the table—one for each party—the final point of agreement could reasonably be predicted to fall midway between those two extremes. So if Wilson offered $200,000 and if Steve came back with $400,000, a reasonable bet would be a settlement of $300,000—provided, of course, that that midway figure fell within the potential zone of agreement, the range between Steve's (the seller's) true *RP* and Wilson's (the buyer's) true *RP*. For starters, Steve thought that it would be nice if he could get $350,000 from Wilson, but, of course, Steve realized that his own *RP* was still $220,000.

We talked about the role of time. Should Steve be willing to walk away from the bargaining table if Wilson's most recent offer was above $220,000? I reminded Steve that there is no objective formula for this. He would be confronted with a standard decision problem under uncertainty, and his assessment of Wilson's *RP* could be better evaluated after sounding out Wilson than it could be with present information. The danger in breaking off negotiations—and a lot depends on how they're broken off—was that Wilson might have other opportunities to pursue at the same time.

As it turned out, the first round of negotiations was, in Steve's eyes, a disaster, and afterward he wasn't even sure that there would be a second round. Mrs. Peters performed admirably, but to no avail; it seemed unlikely that Wilson would raise his offer to Elmtree's reservation price. After preliminary pleasantries and some posturing, Wilson said, "Tell me the bare minimum you would accept from us, and I'll see if I can throw in something extra." Steve expected that gambit, and instead of outright misrepresentation he responded, "Why don't you tell us the very maximum that you are willing to pay, and we'll see if we can shave off a bit." Luckily, Wilson was amused at that response. He finally made his opening offer at $125,000, but first bolstered it with a lot of facts about what other property was selling for in that section of Somerville. Steve immediately responded that Elmtree House could always sell their property for more money than Wilson was offering, and that they did not have the faintest intention of moving. They would consider moving only if they could relocate in a much more tranquil environment where real estate values were high. Steve claimed that the trouble of moving could be justified only by a sale price of about $600,000, and Mrs. Peters concurred.[6] Steve chose that $600,000 figure keeping in mind that the mid-point between $150,000 and $600,000 was above his aspiration level of $350,000. Wilson retorted that prices like that were out of the question. The two sides jockeyed around a bit and decided to break off, with hints that they might each do a bit more homework.



Steve and I talked about how we should reassess our judgmental distribution of Wilson's *RP*. Steve had the definite impression that the $600,000 figure was really well above Wilson's *RP*, but I reminded him that Wilson was an expert and that if his *RP* were above $600,000 he would want to lead Steve to think otherwise. We decided to wait a week and then have Steve tell Wilson that Elmtree's board would be willing to come down to $500,000.[7]

Two days later, however, Steve received a call from Wilson, who said that his conscience was bothering him. He had had a dream about Mrs. Peters and the social good she was bringing to this world, and this had persuaded him that, even though it did not make business sense, he should increase his offer to $250,000. Steve could not contain himself and blurted out his first mistake:

6. A student of mine suggested that during negotiations, obvious modifications could have been made to the exterior of Elmtree House to give the impression that the residents indeed had no intention of moving.

7. A colleague to whom I recounted this story thought that our assessment of Wilson's *RP* should have been updated during the breaks in the negotiations by going back to the experts we had consulted initially; Steve should have been more aware of information he might have obtained from Wilson that the experts could have used to reassess Wilson's *RP*.

"Now that's more like it!" But then he regained his composure and said that he thought that he could get Elmtree's board to come down to $475,000. They agreed to meet again in a couple of days for what would hopefully be a final round of bargaining.

Following this phone conversation with Wilson, Steve told me that he had inadvertently led Wilson to believe that his $250,000 offer would suffice; but Steve also felt that his offer of $475,000 was coming close to Wilson's *RP*, because this seemed to be the only reason for Wilson's reference to a "final round of bargaining." We talked further about strategy and we revised some probabilistic assessments.

Over the next two days there was more jockeying between the two sides, and Wilson successively yielded from $250,000 to $275,000 to $290,000 and finally to a *firm last offer* of $300,000, whereas Steve went from $475,000 to $425,000 to $400,000, and then—painfully—when Wilson sat fixedly at $300,000, inched down to $350,000. Steve finally broke off by saying that he would have to contact key members of the governing board to see if he could possibly break the $350,000 barrier.

Now, $300,000 not only pierced Steve's *RP* of $220,000 (needed for the Medford move), but also would make it possible for Elmtree House to buy the more desirable Allston property. It had at that point become a question of "gravy." I asked Steve whether he thought Wilson would go over $300,000 and he responded that although it would take some face-saving maneuver, he thought Wilson could be moved up. The problem was, he felt, that if Wilson were involved in other deals and if one of these should turn out badly, Wilson might well decide to wash his hands of Elmtree.

Steve did two things next. He first asked Harry Jones to put in place all but the very final touches on a legal agreement for acquiring the Allston property. Jones reported the next day that all was in order but that it was going to cost $20,000 more than anticipated to do some necessary repair work on the house in order to meet Allston's fire standards. Still, $300,000 would meet those needs. Second, Steve worked with Mrs. Peters to find out what an extra $25,000 or $50,000 would mean to Elmtree House. Mrs. Peters said that half of any extra money should definitely go into the Financial Aid Fund for prospective residents who could not quite afford Elmtree House, and that it could also be used to purchase items on her

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little list of "necessary luxuries": a color television set, an upright piano, new mattresses and dishes, repair of broken furniture, a large freezer so that she could buy meat in bulk, and so on. Her "little list" became increasingly long as her enthusiasm mounted—but $10,000 to $20,000 would suffice to make a fair dent in it, and as Mrs. Peters talked she became even more excited about those fringes than about the move to Allston. She was all for holding out for $350,000.

The next day Steve called Wilson and explained to him that the members of Elmtree's board were divided about accepting $300,000 (that was actually true). "Would it be possible for your company to yield a bit and do, for free, the equivalent of $30,000 or $40,000 worth of repair work on Elmtree's new property if our deal with you goes through? In that case, we could go with the $300,000 offer." Wilson responded that he was delighted that the board was smart enough to accept his magnanimous offer of $300,000. Steve was speechless. Wilson then explained that his company had a firm policy not to entangle itself with side deals involving free contract work. He didn't blame Steve for trying, but his suggestion was out of the question.

"Well then," Steve responded, "it would surely help us if your company could make a tax-free gift to Elmtree House of, say, $40,000, for Elmtree's Financial Aid Fund for needy residents."

"Now that's an idea! Forty grand is too high, but I'll ask our lawyers if we can contribute twenty grand."

"Twenty-five?"

"Okay—twenty-five."

It turned out that for legal reasons Wilson's company paid a straight $325,000 to Elmtree House, but Wilson had succeeded in finding a good face-saving reason for breaking his "firm last offer" of $300,000.

Lest readers think erroneously that it's always wise to bargain tough, I might suggest another perfectly plausible version of this story: Wilson might have backed out of the deal suddenly, at the time when he made his firm last offer of $300,000 and Steve demanded $350,000. An alternative venture competitive with the Elmtree deal might have turned out magnificently profitable for Wilson.