NEGOTIATING RATIONALLY

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along. The J.L. Kellogg Graduate School of Management at Northwestern University continues to be a wonderful place to do work on the topic of negotiation. The interest in negotiation created by Jeanne Brett, the support of Dean Donald Jacobs, the spectacular group of doctoral students, and the creation of the Dispute Resolution Research Center (funded by the Hewlett Foundation) have made Kellogg a truly unique academic environment. In addition, our teaching experience with over ten thousand MBA and executive students at Kellogg has dramatically improved the clarity of our advice. We also had the opportunity to develop cases and ideas under the support of the Newspaper Management Center at Northwestern University (directed by John Lavine).

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We close our acknowledgments by reemphasizing the debt that we owe our colleagues for the critical role that they have played in the development of this book and our perspective on negotiation. Our research group on cognition and rationality in negotiation is simply amazing. We could hope for no better group of collaborators, and we close by dedicating this book to Beta Mannix, Greg Northcraft, Leigh Thompson, Kathleen Valley, and Sally White.

CHAPTER 1

Introduction to Rational Thinking in Negotiation

Everyone negotiates. While many people think of negotiation as something that takes place only between a buyer and a seller or a union and management, in its various forms, negotiation is used every day to resolve differences and allocate resources. It occurs between all sorts of people—colleagues, spouses, children, neighbors, strangers, corporate entities, even nations negotiate. Some negotiations are face-to-face; others take place over time through sequential decisions between competitors. In business, millions of negotiations happen every day, often within the same company.

Think of all the times you negotiate. What could be more central to business than negotiation? And what could be more central to successful negotiation than casting off your illusions about it and, henceforth, negotiating rationally and effectively? This book will teach you how to do just that.

Negotiating rationally means making the best decisions to maximize your interests. However, we are not concerned with "getting to yes." Our work shows that in many cases, no agreement at all is better than "getting to yes.” What we’ve learned from thousands of executives will help you decide when it’s smart to reach an agreement and when it is not.

Negotiating rationally means knowing how to reach the best agreement, not just any agreement. What we’ve learned will help you avoid decisions that leave both you and those you negotiate with worse off.
All executives have pervasive decision-making biases that blind them to opportunities and prevent them from getting as much as they can out of a negotiation. They include the following:

1. Irrationally escalating your commitment to an initial course of action, even when it is no longer the most beneficial choice
2. Assuming your gain must come at the expense of the other party, and missing opportunities for trade-offs that benefit both sides
3. Anchoring your judgments upon irrelevant information, such as an initial offer
4. Being overly affected by the way information is presented to you
5. Relying too much on readily available information, while ignoring more relevant data
6. Failing to consider what you can learn by focusing on the other side’s perspective
7. Being overconfident about attaining outcomes that favor you

Keep these seven factors in mind as you consider the following example.

In 1981 American Airlines introduced its frequent-flier program, arguably the most innovative marketing program in the history of the airline industry. Business fliers (or anyone else who flew frequently) could earn miles for the flights they took and redeem those miles for travel awards. While the incentive plan—designed to encourage loyalty for American—may have seemed like a brilliant marketing strategy, it was a miserable decision from a negotiations standpoint and soon proved disastrous from a marketing and financial standpoint.

Following American’s lead, every airline in the industry soon launched its own frequent-flier program. Increasing the competition further, each company soon offered double miles to their most frequent passengers and even more miles for hotel stays, car rentals, etc. Soon, the benefits required to remain competitive inflated out of control and resulted in tremendous liabilities. By December 1987, when Delta announced that all passengers who charged tickets to their American Express card would get triple miles for all of 1988, analysts estimated that the airlines owed their passengers between $1.5 and $3 billion in free trips. How could the airlines get out of this mess?

One possible answer comes from a similar competitive war that took place in the United States auto industry in 1986. All three U.S. auto companies were engaged in rebate programs designed to increase their sales volume and market share. The rebate each company offered swiftly escalated. As soon as one manufacturer raised its offer, the rest followed, and the profits of all three companies plummeted. Each then added the option of discount financing for their customers as an alternative to a rebate. Again, the competition was fierce. It reached a point where U.S. auto makers were, on the average, losing money on every car sold. It takes no business sense to know that selling more can’t make up for selling at a loss!

How could any one company escape this deadly spiral without losing market share to the other two?

Lee Iacocca, the CEO and chairman of Chrysler, came up with a solution. He told the press that all three companies’ programs were scheduled to expire in the near future and Chrysler had no plans to continue; however, if either of the other two continued their programs, Iacocca would meet or beat any promotion offered. What was his message to Ford and GM? Chrysler was proposing a cease-fire if the others cooperated, but threatening to retaliate if they continued to fight. Ford and GM got the message, and the rebate/financing program stopped.

What if United or American Airlines had made an announcement like Iacocca’s before Delta announced triple miles? Delta would most likely have realized there was nothing to gain by the triple-mile promotion. Yet, the airlines failed to negotiate rationally because, unlike Iacocca, they did not consider the possible decisions of their competitors. Iacocca developed a negotiation strategy that explicitly attempted to manage his competitor’s decisions. In contrast, the airlines ignored the decisions of their competitors, and airline debt went up significantly, with some estimates placing it as high as $12 billion. Mark Lacek, director of business-travel marketing at Northwest Airlines lamented the triple-mileage promotions in 1988: “It’s suicide marketing. Insanity.” According to Fortune, “In the annals of marketing devices run amok, few can compare to the airlines’ wildly popular frequent flier plans.”
You will find that this book analyzes why many executives make mistakes like the airlines did, how some—like the auto companies—avoid disastrous pitfalls, and, most important, how you can solve your own negotiating problems. From big negotiations between companies to tough personal ones between you and a colleague or someone you love, we'll help you learn to solve them rationally—and more effectively. We will guide you through a variety of thought processes to minimize the type of "competitive irrationality" just described in the airline example.

Now let's be honest. There are lots of books on negotiation. Some are smart; some are not. Our book, however, is not based solely on our academic experience—it's based on our working with and observing closely thousands of executives and bringing together information from similar studies done with working executives who must make countless decisions involving negotiations every day.

This book is not ivory-tower theory. It is information from the trenches for use by real managers who want to be more effective. (If you are interested in learning more about the theory behind the studies, however, the endnotes will refer you to the right sources.)

Many bright and successful people make mistakes in negotiation. And no book can make you a flawless negotiator. However, a clearer understanding of rational negotiation will make you a far more effective one. To that end, we introduce two strategies to increase your effectiveness. The first helps you see the common mistakes made in negotiation. The second identifies ways to eliminate those mistakes and offers a straightforward framework to help you become a more rational negotiator.

The aspect of negotiation that an executive can control most directly is how s/he makes decisions. The parties, the issues, and the negotiation environment are often beyond your control. Rather than seeking to change them, you must improve your ability to make effective, more rational decisions—to negotiate smarter.

There are psychological limits to a negotiator's effectiveness. A psychological perspective is also required to best anticipate the likely decisions and subsequent behavior of the other party. In the following chapters, we will show you how various factors—such as how you structure problems, process information, frame the situation, and evaluate alternatives—can influence your judgment.

Negotiation is challenging and exciting. It should also be one of the most honed and effective tools in your arsenal. The ideas presented in this book will go a long way toward putting you on a level with the best negotiators we've seen.
Thinking Rationally about Negotiation

In the first section of this book, we described how and why managers can make irrational decisions in a negotiation. Now we look at how managers should make decisions in a world where many people don't always behave rationally. To negotiate rationally, you must understand what makes you sometimes think irrationally, while anticipating similar irrationality from your opponents.

In this chapter we examine the two critical components of a rational negotiation process. First, an effective manager must objectively evaluate each party's alternatives to a negotiated agreement, interests, and priorities. Together, these three sets of information determine a negotiation's structure. Second, an effective manager must understand the integrative and distributive components of negotiation, in order to enlarge the pie of available resources and increase his or her share. We also draw upon the information from the first section of the book to outline prescriptions to prevent you from making the common mistakes that interfere with the development of a rational negotiation strategy.

INFORMATION TO ASSESS IN A NEGOTIATION

ALTERNATIVES TO A NEGOTIATED AGREEMENT

Before you begin any important negotiation, you should consider the potential consequences of failing to reach an agreement. You need to determine your Best Alternative To a Negotiated Agreement (BATNA). This is critical because your BATNA determines...
the lowest value acceptable to you for a negotiated agreement; if the parties cannot reach agreement, they settle for their BATNAs. Thus, any agreement that is of higher value than your BATNA is better than an impasse.

Most people enter into negotiations with a general target or at least some idea of what they want; however, many executives don’t specifically establish their own or their opponent’s reservation price. A reservation price is the point at which you are indifferent to whether a negotiation reaches agreement or ends in an impasse. It’s closely related to your BATNA. For example, rather than buying a new car from a particular dealer, one alternative you could consider is to use mass transit. Alternatively, your BATNA could be to buy the same car from another dealer, with your reservation price being the price offered by the second dealer. While it’s easier to assess the value to you of the second price offered than to put a “price” on using mass transit, it’s critical in either situation to determine the value of your BATNA. By thinking about your BATNA, you can rationally assess the highest price you are willing to pay before you would prefer an impasse. If you make an offer near your reservation price and it’s rejected, you know that any further concession to reach an agreement is unacceptable to you. Remember the goal of negotiating is not to reach just any agreement, but to reach an agreement that is better for you than what you would get without one.

While it may seem obvious that you should know your alternatives when negotiating, most people don’t take this rational step. One common example of this is an event we have come to refer to as the Sunday night real-estate call. Since many open houses are held on Sundays, negotiation instructors often receive telephone calls on Sunday nights from friends, friends of friends, friends of relatives, etc., that sound something like this:

Hello, Maggie. You don’t know me, but we have a mutual friend—Sarah. I looked at a house this afternoon, and was telling Sarah about it. The house is absolutely wonderful. I love it! The asking price was $249,000. The kitchen has really interesting wooden cabinets . . . (fifteen minute of needless detail on the house) . . . Anyway, I offered $222,000 earlier this evening, and they countered at $237,000. I was telling Sarah about this, and she suggested that I call you to figure out what I should do next. What do you recommend?

We don’t like getting these calls. They are no-win situations for us. If our advice leads to a higher price than the caller had hoped for, he or she is unimpressed with our expertise. If our advice leads to losing the house to another buyer, the caller will be angry at us—especially since the house is so wonderful. Unfortunately, getting the lowest possible price often requires running the risk of losing the house to another buyer. In fact, any strategy other than accepting the other party’s offer means some risk of impasse.

So what advice can we give our caller? We say that he or she has already violated the most important rule of buying houses (or making any other important exchange, with the possible exception of mate selection): “Fall in love with three, not with one.” To make a well-informed decision, a buyer must first think about what would happen if he or she did not buy the house. How attractive is the next best option? To the extent that the buyer loves only this house and has to have it, any bargaining position is weakened.

Falling in love with one house (or car, or company) prevents you from thinking clearly and rationally about your best alternative and compromises your competitive edge in the negotiation. If you have an alternative, you are better able to risk losing the first house by waiting for the other party to make a concession. An alternative strengthens your position.

Prescription 1: Assess what you will do if you don’t reach an agreement with your current negotiation opponent.

While executives rarely think rationally about their own alternatives to a negotiated agreement, we noted in Chapter 7 that it is even rarer for them to think about their opponent’s decisions on alternatives. However, by considering the other party’s circumstances and likely alternatives to an agreement, you can get wealth of information about how far they will move before actually walking away from the negotiating table. For example, the seller of a house who has already purchased another one will act very differently than a seller who is just testing the residential market. Knowing this can give a potential buyer a distinct advantage.

Unfortunately, it can be difficult to assess the other party’s alternatives. Despite this, managers should always know their own
BATNA and make their best estimates of an opponent's BATNA.

**Prescription 2:** Assess what your current negotiation opponent will do if they do not reach an agreement with you.

**The Interests of the Parties**

A complete analysis of a negotiation includes identifying the interests of all parties. Roger Fisher and Bill Ury emphasized the importance of distinguishing between underlying interests and positions. A position is the stated requirement that one side demands from the other. An interest is what each side really desires, even if it is not publicly stated. Sometimes focusing on interests helps identify more useful solutions. Consider the following example:

Prior to the Camp David agreement between Israel and Egypt, both parties described their interests as ownership over the Sinai. In trying to negotiate the control of the Sinai Peninsula, it appeared that the two sides had directly opposing goals. Egypt wanted the return of the Sinai in its entirety, while Israel, which had occupied the territory since the 1967 war, refused. Efforts at compromise failed; neither side found the proposal of splitting the Sinai acceptable. Therefore, a solution wasn’t possible if the negotiation remained focused on the stated positions of each side, namely control over the Sinai.

However, the negotiation was resolved when both parties gained a better understanding of their underlying interests: land ownership for Egypt and military security for Israel.

**Prescription 3:** Assess the true issues in the negotiation.

**The Relative Importance of Each Party’s Interests**

While managers often have several interests in a negotiation, it is important to estimate how important each is to you. Effective trade-offs can then be accomplished by conceding less important issues to gain on more important issues. In the Israel-Egypt dispute, Egypt cared more about ownership of the land, while Israel cared more about the security that the land provided. The solution at Camp David that emerged traded off these two principal issues: Israel returned the Sinai to Egypt in exchange for assurances of a demilitarized zone and new Israeli air bases.

**Prescription 4:** Assess how important each issue is to you.

Although you may often find you don’t have enough information to assess your opponent’s true preferences, it’s important to recognize this deficiency. It helps clarify what you need to learn during the negotiation. As each party tries to persuade the other, you can learn many critical pieces of information. Too often, the negotiation isn’t used as an opportunity to improve the quality and quantity of information you have about the opposition. Knowing what information you’re missing keeps you from making the errors described earlier. It is far better to realize that the other side has some valuable information that you don’t know than to make uninformed assumptions.

Alternatives, interests, and their relative importance provide the building blocks for analyzing the distributive and integrative aspects of a negotiation. Assessing this information before entering any important negotiation prepares you to analyze the two primary tasks of negotiation: integration, or the enlargement of the pie of available resources, and distribution, the claiming of the pie. Richard Walton and Robert McKersie first suggested the critical need to think simultaneously about these two dimensions of the negotiation problem in the context of labor relations, and much of the analysis in this chapter is an application and extension of their earlier work.

**Prescription 5:** Assess how important each issue is to your opponent.
THE DISTRIBUTIVE AND INTEGRATIVE DIMENSIONS OF NEGOTIATION

THE DISTRIBUTIVE DIMENSION OF NEGOTIATION AND THE BARGAINING ZONE

All negotiation involves the distribution of outcomes. A single-issue negotiation is purely distributive. One party’s gain is the other party’s loss. Consider a case in which Company Y (the buyer) is interested in acquiring Company X (the seller). What Company X doesn’t know is that while Company Y would like to buy Company X for $18 million, it considers Company X to be worth $30 million (the value of Company Y’s BATNA) and would rather pay any price under $30 million than lose the opportunity. What Company Y doesn’t know is that while Company X would like to sell the firm to Company Y for $35 million, Company X would rather sell the firm at any price above $20 million (the value of Company X’s BATNA) than keep it.

Ben Franklin spoke to this issue: “Trades would not take place unless it were advantageous to the parties concerned. Of course, it is better to strike as good a bargain as one’s bargaining position permits. The worst outcome is when, by overreaching greed, no bargain is struck, and a trade that could have been advantageous to both parties does not come off at all.” On the other hand, if the sale is to take place, the seller would prefer the highest and the buyer the lowest price possible. The challenge is to identify where the two price ranges overlap, if at all.

During the discussions that follow this case, we are often asked by our students whether it is better to be tough or soft in the negotiation. Suppose a typical soft negotiator sells the target company for $22 million. He or she can at least claim to have gotten a better outcome than those who didn’t reach an agreement. The typical tough negotiator, who sells Company X for $28 million, will argue that the only way to succeed is to take a tough stand. (Notice that this only works against a soft Company Y negotiator who is willing to pay the $28 million.) Then there are those who reached an impasse. Why didn’t they find the $10 million of joint gain possible by reaching an agreement? Why didn’t they listen to Ben Franklin’s advice? When both parties adopt a tough strategy and assume that the other will cave in, confident that only the tough survive, the result is usually an impasse.

So, is it better to be tough or soft? We propose that it’s better to be rational. There are times to be tough and there are times to be soft; the rational manager evaluates each negotiation and create a strategy that fits the particular context. There is no one-size-fits-all strategy that will guarantee success. Think about your BATNA and your opponent’s BATNA, and make your best assessment of the bargaining zone, the range of settlements within which it is better for both parties to agree than not to agree. The bargaining zone for the transfer of Company X can be diagrammed as follows:

<table>
<thead>
<tr>
<th>Company Y’s Payment to Company X</th>
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<tr>
<td>$18 million</td>
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$\textbf{Y}_T = \text{Company Y’s target price, the price it would be happy to pay:}\$18\text{ million}$

$\textbf{X}_R = \text{Company X’s reservation price, at which Company X is indifferent between keeping or selling the company:}\$20\text{ million}$

$\textbf{Y}_R = \text{Company Y’s reservation price, at which Company Y is indifferent between buying or not buying the company:}\$30\text{ million}$

$\textbf{X}_T = \text{Company X’s target price, the price it would be happy to accept:}\$35\text{ million}$

The bargaining zone framework organizes the distributive aspect of a negotiation by showing the overlap, if any, of each side’s acceptable price ranges. In the diagram above, the endpoints of this zone are the two reservation prices. Thus, there is a set of agreements that both parties prefer over impasse, which in this case consists of all values between $20 million and $30 million. When the reservation prices of two parties overlap, both parties can benefit by reaching agreement. Conversely, when the reservation prices don’t overlap, there is a negative bargaining zone and no settlement that will be acceptable to both parties.

If Company Y could convince Company X that its offer was
Thinking Rationally About Negotiating

One of the critical pieces of information in a negotiation is the other party’s reservation price. If one side can discover the other’s reservation price without revealing their own, they can push for a resolution that is only marginally acceptable to the other side. Extreme demands won’t work if they are worse than the other side’s BATNA. For example, Company X will not accept $15 million, regardless of Company Y’s persuasiveness. In order to be tough, a manager must first know the bargaining zone. Knowing your opponent’s BATNA allows you to determine whether an offer is conservative, aggressive, or unreasonable.

Any agreement within the bargaining zone of the acquisition creates a joint surplus of $10 million over the value of an impasse. For example, an agreement price of $24 million gives Company X $4 million over the value of their BATNA and gives Company Y $6 million over their BATNA. Thus, when negotiated rationally, distributive agreements can be very profitable for both sides.

While managers often think about a possible settlement price in advance of negotiating, they usually spend too much time thinking about a target price and not enough thinking about the reservation prices and the bargaining zone. It does you no good to demand a price that the other side won’t pay. Focus instead on the maximum price they are willing to pay.

Prescription 6: Assess the bargaining zone.

The Integrative Dimension of Negotiation

Sometimes a more careful assessment of each side’s relative preferences or interests can produce more joint profit than a purely distributive agreement can. This is the basis of integrative negotiation. In Chapter 3, we argued that there is a mind-set we call the mythical fixed-pie that prevents people from making favorable trade-offs. We discussed examples where this attitude destroyed negotiations that could have been mutually profitable. Understanding the underlying issues of a negotiation and their relative importance for both parties allows you to avoid the mythical fixed-pie and make beneficial trade-offs across issues.

This is illustrated in a story told by Mary Parker Follet. Two sisters both wanted a single orange. A compromise, dividing the orange equally, would leave each sister with only half. By trading the rind for the juice, however, one sister got all of the juice she wanted to drink, and the other sister got the rind to bake a cake.

In this very fortunate trade, both parties were able to get exactly what they wanted. This is rarely the case. More commonly, each side gives up something they care less about for something they care more about. But if you have a clear understanding of each side’s interests and their importance, your negotiations can be both successful and rational.

Integrative agreements have a number of important benefits. First, they create better agreements than purely distributive ones. Second, in cases such as the Camp David example, no agreement is possible without finding an integrative agreement. Third, the problem-solving atmosphere of integrative negotiations — finding mutually beneficial trade-offs — and the higher quality agreements that result strengthen the bargaining relationship. But, while the benefits of integrative agreements are clear, managers often fail to find them. As soon as multiple issues surface in a negotiation, look for trade-off opportunities and ways to expand the pie of available resources.

Prescription 7: Assess where the trade-offs exist.

BARRIERS TO RATIONAL NEGOTIATIONS—THE SOLUTION OF ANTICIPATION

This chapter begins to outline a framework for managers to use in thinking about negotiation. It shows that by rationally identifying all the issues and each party’s relative concerns for these issues and by rationally thinking about the bargaining zone, you can better increase the size of the bargaining pie and your share of it. But the prescriptions in this chapter assume that you will follow rational negotiation advice. Remember the biases we discussed in Chapters 2 to 8 that reduce your ability to act rationally. We encourage...
A RATIONAL FRAMEWORK FOR NEGOTIATION

You are the executive vice-president of Northcraft and Northcraft (NN), one of the nation’s leading pharmaceutical companies. Your firm is a leader in over-the-counter (OTC) products (nonprescription medications). You also have a significantly smaller division that manufactures ethical pharmaceuticals (prescription medications). One of your weaknesses is that you lack a large volume presence in the vast OTC analgesic market, which is currently dominated by three product categories: aspirin-related products, acetaminophen-related (Tylenol) products, and ibuprofen-related (Motrin) products. Your analysts heard recently that a reduced-strength version of the prescription drug betaMANNx, sold by Thompson and Company, was approved by the Food and Drug...