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Negotiation – Interview Assignment

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Note: Details of this case, including the names of individuals, have been omitted or changed to protect the confidentiality of the data.

I interviewed Carol, who is the Vice President of Transactions at a real estate firm. Her firm specializes in building and managing low-income housing developments and in applying for tax credits with the relevant state's housing agency. Carol's department does a ton of preliminary work that is needed to plan the developments. She handles paperwork for the state housing agencies, forms partnerships for every deal, and makes financial projections to take to investors.

The partnership agreements that Carol uses are over 200 pages long for each development. As a result, it can take a very long time to fully negotiate these agreements. Carol's firm usually has a big advantage in these negotiations, however, because her firm is a leader in the industry and so they have an information advantage over almost everyone they partner with.

Carol recently negotiated a deal with a Georgia non-profit to start a low-income housing development. Her firm partners with local non-profits frequently because they have local knowledge and expertise. These local non-profits are also very attractive to the state housing agency that issues low-income housing tax credits. Deals are more likely to be awarded tax credits when they include a local non-profit as a partner.

Carol had never worked with this non-profit before. One of her big priorities was to develop a continuing relationship.

Carol began negotiating with the Georgia non-profit in August. At that time, the parties signed a letter of intent to memorialize their understanding. That letter of intent was only three pages long. Since then, the parties have gone back and forth updating a more formal partnership agreement. Carol's firm agreed to be the general contractor, property manager, and tax credit investor for the development, while the Georgia non-profit would be the developer.

After months of talks, the parties were close to an agreement. But, the Georgia non-profit was still hung up on one business point. All of the profits from the deal were scheduled to go to Carol's firm, with the exception of a developer's fee that would go to the Georgia non-profit. The Georgia non-profit was worried that this might cause the IRS to withdraw their status as a 501(c)(3) corporation because they might be seen as a tool for Carol's for-profit firm. However, Carol was reluctant to make the change that the Georgia non-profit requested because she did not want to lose the business point that she had secured in earlier negotiations. Her firm was better off not making the change.

Both sides were assisted by counsel. The representative of the Georgia non-profit wanted to set up a conference call with the lawyers present to discuss this last business point. However, Carol avoided contacting her legal counsel whenever possible to cut down on expenses. Instead, she had a member of her team draft a detailed memo concerning the latest guidance from the IRS on the issue. Carol also wanted to avoid having the lawyers present because she finds that parties never want to back down from their positions when the lawyers show up. Rather, she wanted to focus on the real goals instead of talking about each side's justification for their position.

Carol's research on the issue led her to the discovery that the point of contention within the IRS guidance was not really an issue at all. She confirmed this with her counsel and the Georgia non-profit accepted the proposed deal structure as-is.

Almost all of this negotiation occurred via email correspondence. There was never a teleconference with both sides and their counsel present. Both parties saved on legal expenses and came to an agreement.

Carol said that the critical factor that caused the negotiation to turn out as it did was the fact that she wanted a continued relationship with the Georgia non-profit. She said that she would have held her ground more throughout the negotiations if this was a one-time deal.

Carol was satisfied with the outcome of the negotiations. Her firm landed another deal that will be profitable. So long as the firm can make money on a deal, she wants to make sure everything continues moving forward.

Carol was somewhat less satisfied with the process of the negotiations because she always wants deals to move faster than they do. With some partners, she finds that she must do a lot of hand holding and negotiating moves very slowly. Other partners are much more independent, but they want to question every term in the 200-page agreement. Carol was happy that this partner was very independent and didn't feel a need to pick apart every little detail in the agreement.

Insights from the Negotiation

As I mentioned earlier, Carol's firm has a strong information advantage over almost everyone they do business with. Her firm was one of the pioneers of the industry and now has over 20 years of experience. Additionally, her firm participates in many different areas of the

development process, from the tax credit application, to the actual construction of the building, to the management of the building during the 15-year compliance period.

Strategy of the Georgia Non-Profit

The Georgia non-profit, consequently, did not have a list of great alternatives to choosing Carol's firm. Obviously, they could have walked away from a deal. They could not possibly have proceeded alone in their endeavor to build a low-income housing development in their community because they did not have the technical knowledge or resources to do so. I think that their BATNA would have been to find a different real estate company (or, more likely, two or three real estate companies) that could substitute all of the capabilities that Carol's company has.

So, the Georgia non-profit did not have a great BATNA. What is more is that they would have struggled to determine their baseline, or what they would expect in a perfect world. Virtually all deals in low-income housing are private deals. Therefore, the Georgia non-profit would have struggled to find research on fair terms for a non-profit developer. Additionally, they couldn't shop around for the best terms. These negotiations began in August with a signed LOI signaling their intent to do business with Carol's firm.

From there, the Georgia non-profit would have to adjust their somewhat amorphous baseline for transaction costs and risk aversion. When they began the "final" negotiation, the Georgia non-profit had already sunk months of time and effort into the proposed deal. These additional transaction costs effectively raised their reservation price by making their BATNA less attractive. If at all possible, they would prefer to close with Carol's firm instead of incurring those expenses again negotiating with a different party. Additionally, closing the final negotiation with Carol would make their deal absolutely certain because the signed partnership

agreement would be a binding contract. Risk aversion makes a certain deal more attractive than an uncertain one, and so this would also lead the Georgia non-profit to favor a deal with Carol's firm (and again raise their reservation price).

The Georgia non-profit would not have come up with a specific number as their reservation price because this deal was so qualitative in nature. They were more concerned about their rights and obligations in the agreement, such as what payments they had to guarantee and what consent rights they were provided. The bottom line is that they were willing to make whatever concessions were necessary so long as (1) the development got built for their community, (2) they were fairly compensated for their efforts, and (3) their risk of being recharacterized by the IRS was extremely low.

Strategy of Carol's Firm

Carol's firm had many alternatives to doing this deal with the Georgia non-profit. For example, they could have built a development all by themselves. They also could have partnered with a different non-profit. They participate in dozens of developments every year and have many firms that they can partner with.

Her firm was able to set a very accurate baseline because they have records of literally hundreds of deals that they have done. In this negotiation, they would not have offered the Georgia non-profit any payments above and beyond the developer's fee. Extra fees are reserved for special partners who bring something different to the table.

As with the Georgia non-profit, Carol's firm had to adjust their baseline for transaction costs and risk aversion. Carol had also invested months of time and effort into the deal and a certain payday was more preferable than a breakdown in communication.

Carol's firm certainly did have a specific number in mind for their reservation price and they also likely had several qualitative positions too. The bottom line is that they were willing to make some concessions so long as (1) they made an equal or greater amount of money than they would pursuing a different development and (2) they had the prospect of doing future business with this developer.

Power of Carol's Firm

In theory, Carol's firm should choose to do a deal whenever they can make a profit. However, they have a long track record of making a large profit and are a big player in the industry capable of sourcing deals all over the country. As discussed above, this gives Carol's firm the better alternatives and thus a stronger reservation price. They can credibly threaten to walk away, change the bargaining zone in their favor, and take more of the cooperative surplus for themselves.

The Georgia non-profit's perception of Carol's firm's BATNA and reservation point were also important. They had little to no knowledge on how to price this deal. With specific numbers in hand, Carol's firm could make a highly credible offer of terms used in past lucrative deals. Because the Georgia non-profit has such a small amount of information, they would likely be unable to distinguish those bad terms from more favorable ones.

Carol's firm also used patience strategically. The low-income housing industry revolves around deadlines. Carol knew in August when the LOI was signed that both parties would have to reach an agreement by the end of the year to meet certain deadlines for the tax credit application. As the parties negotiated, they both incurred the cost of lost time and the cost of negotiating. These costs made the Georgia non-profit less and less likely to walk away from a

deal as time passed by. Carol could have just waited until the deadline and the Georgia non-profit would likely have had to make every concession asked of them. However, that is not an effective method of building trust or generating future business. Rather, Carol chose to make some concessions and came to an agreement ahead of schedule.

The only limiting factor on the use of power by Carol's firm was their desire to continue doing business with the Georgia non-profit in the future. The low-income housing industry consists of a few large and specialized firms with tremendous leverage. Smaller players must make do with smaller margins because they are at the mercy of the larger players to give them business. This environment is unlikely to change given the high cost of entrance; new entrants must spend a lot of money on planning developments, filing applications with the state housing agency, and forming legal entities. Such an endeavor is cost-prohibitive for most aspiring competitors in the space.