NEGOTIATING RATIONALLY

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To Beta Mannix, Greg Northcraft,
Leigh Thompson, Kathleen Valley, and Sally White,
who have been excellent
colleagues and friends

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PART THREE
Simplifying Complex Negotiations

Preface

Whether you run a corporation, buy a used car, or sometimes disagree with a colleague or your spouse, you need to know how to negotiate. As recently as ten years ago, however, negotiation courses were rarely taught in management schools or executive education programs; now, they're some of the most sought-after courses across the country. At the J.L. Kellogg Graduate School of Management at Northwestern University, negotiation is the most popular course in both our MBA and executive programs. Current and future managers want to know how to get better results in negotiation—they want to know how to negotiate more rationally.

A large number of diverse researchers have studied negotiation, and their work has profoundly affected this book. In addition, we've devoted our own research and teaching over the last decade to helping managers and executives make more rational decisions and attain far stronger outcomes. We've had over ten thousand participants in our programs, and they've helped us understand the changing social and organizational environment they face today and target the problems they must deal with.

We analyzed both how these professionals negotiate rationally and the common reasons why they don't and found amazing consistency in the errors that bright executives make. We've summarized why managers make these errors, and how you can avoid them to become a more rational negotiator—not just while you read the book, but for the rest of your life.

Why is negotiation attracting such attention? Why have negotiation courses become so popular in the last decade? One answer is that recent social and economic changes have made good negotiating skills not just more important, but more difficult to master. Consider the major trends of the past twenty years and how they affect your professional life:

1. *Workforce Mobility.* Unlike past generations, employees these days frequently change jobs. Long-term commitment between employer and employee is rare. White-collar workers often view a job as simply one stepping-stone in an upwardly mobile career; the next step may or may not be with the same organization. These new models of employment require that employees actively negotiate their position in an organization.

2. *Corporate Restructuring.* The 1980s brought on the era of corporate restructuring. Mergers, acquisitions, downsizing, and joint ventures created thousands of new corporate arrangements. Career survival in such an environment depends on good negotiation skills.

3. *Diversified Workforce.* By the year 2000, seventy percent of the entering workforce will be composed of females, minorities, and immigrants. This high diversity will require managers to work with peers, subordinates, and superiors who have very different goals, motivations, and cultural backgrounds. Negotiating sucessfully will be more complex, and good negotiation skills will be critical levers for workplace and workforce productivity.

4. *Service-Sector Economy.* The U.S. has shifted from a manufacturing-based to a service-based economy. Service-sector negotiations are, on average, harder than manufacturing-based negotiations. Buyers and sellers must agree on more ambiguous outcomes. This requires more complex negotiations.

5. *Renegotiation.* The U.S.'s economic decline, and the resulting devastation to organizations affected by it, makes renegotiation more important. When a company is failing, bankruptcy often becomes a more attractive option than fulfilling its obligations to shareholders and/or creditors. Renegotiations also occur between nations, an example being the continual renegotiation of Third World debt.

6. *Global Marketplace.* Twenty years ago, American managers faced a simpler environment. Global competition wasn't a serious threat, and managers could negotiate on their own terms. But, as the industrial leadership of the United States erodes, more and more American managers are negotiating with foreign counterparts who negotiate quite differently than they do.

It seems inevitable that each of these trends will be here for the foreseeable future, making keen negotiation skills a critical tool for the successful executive of the 1990s.

* * *

In the first chapter of this book, we describe our overall perspective. We specify what negotiating rationally is and why you need this skill. The rest of the book is organized in three sections:

In the first, we answer the question: if you and your opponent don't negotiate rationally, what errors can you expect? What can you do to eliminate them? We provide examples that let you audit your own decision processes in two-party negotiation.

In the second, we outline general frameworks for thinking more rationally about negotiation. We focus on one particular negotiation to guide you through the necessary steps you must take to evaluate when and how to reach an agreement, and when to walk away—in both cases, producing outcomes that are in your best interest.

In the third, we go beyond the standard two-party negotiation and look at the variety of settings and contexts in which executives must rationally negotiate with multiple opponents, issues, and constraints. Some factors we consider are expertise, emotion and fairness, multiple parties, negotiating through third parties, competitive bidding, and negotiating through action.

Finally, we close with advice on how to negotiate with irrational opponents and how to make all that you've learned about rational negotiation an integral part of your behavior.

Acknowledgments

We started developing our framework for thinking rationally in negotiation over a decade ago. Throughout this process, we were guided by the research and writings of Howard Raiffa, Danny Kahneman, and Amos Tversky. There is no way that we can present the research on which these ideas are based to adequately recognize the contributions of our coauthors, whose ideas are now so intertwined with our own, we often fail to fully recognize their unique contribution. Our associations with Jeanne Brett, Jack Brittain, John Carroll, Tina Diekmann, Vandra Huber, George Loewenstein, Beta Mannix, Keith Murnighan, Greg Northcraft, Robin Pinkley, Jeff Polzer, Harris Sondak, Leigh Thompson, Tom Tripp, Kathleen Valley, and Sally White have influenced every idea in this book and have informed and shaped our research and broadened our perspective. Finally, we owe an intellectual debt to a number of negotiation scholars who have helped to create the field of negotiations. These include the timeless classic of Richard Walton and Robert McKersie, as well as the more recent writings of Tom Kochan, Harry Katz, Roy Lewicki, Dean Pruitt, Larry Susskind, and Jeff Rubin.

Every sentence, every paragraph, and every chapter in this book has been rewritten more times than we care to remember. Authors are notorious for being nervous about what editors will do to their ideas. Our experience with editors has been wonderful. Every time Claire Buisseret, Bob Wallace, Nancy Vergara, Val Poirier, and especially Pam Jiranek and John Lavine touched the manuscript, we were delighted to see how much better our ideas could be expressed. Editing is an important talent, and we have been fortunate to be surrounded by wonderful editors. In addition, our pharmaceutical case in Part II also benefited from the expertise of Gene Watkins, Jon Tanja, and Ed Zajac.

A number of excellent institutions have also helped this project 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).

We were supported by the J. Jay Gerber and J.L. Kellogg Distinguished Professorships. Our research has also benefited from the support of research grants provided by the National Science Foundation, National Institute for Dispute Resolution, the Fund for Research in Dispute Resolution, Northwestern University Research Grants Committee, and Eller Center for the Study of the Private Market Economy (Arizona). This book was begun while Max was a fellow at the Center for Advanced Study in the Behavioral Sciences, a wonderful place to start a writing project. His funding there was partially provided by the Russell Sage Foundation and the National Science Foundation.

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."[1] 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 chair 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.[2] Mark Lacek, director of business-travel marketing at Northwest Airlines lamented the triple-mileage promotions in 1988: "It's suicide marketing. Insanity."[3] According to *Fortune,* "In the annals of marketing devices run amok, few can compare to the airlines' wildly popular frequent flier plans."[4]

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 as a negotiator and limit your effectiveness.

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.

PART ONE

Common Mistakes in Negotiation