Negotiation

Decision-Making and Communication Strategies That Deliver Results

A Newsletter from
Harvard Business School Publishing
and the Program on Negotiation
at Harvard Law School

ARTICLE REPRINT NO. N0501C

Don’t Like Surprises? Hedge Your Bets with Contingent Agreements

BY LAWRENCE SUSSKIND

For a complete list of Harvard Business School Publishing newsletters:
http://newsletters.harvardbusinessonline.org

For reprint and subscription information for *Negotiaion*:
Call 800-988-0866 *or* 617-783-7500
http://negotiation.harvardbusinessonline.org

For customized and quantity orders of reprints:
Call 617-783-7626 *Fax* 617-783-7658

For permission to copy or republish:
Call 617-783-7587

Don't Like Surprises? Hedge Your Bets with Contingent Agreements

No one can predict the future. But you can protect your accord by using contingent agreements that anticipate potential changes.

BY LAWRENCE SUSSKIND

A TOWN GOVERNMENT and a private fuel-oil company have a standing contract that they have renewed for several years in a row. The contract is again up for renewal, and the town manager is under pressure from a substantial portion of the citizenry to reduce the city's heating costs and avoid tax increases. The city's fuel-oil consumption has remained relatively stable during the past five years, yet costs have shot up almost 60%. As a longtime client, the town feels it should get some protection from the sudden price jumps.

The town manager hits on the idea of asking the company to provide a guaranteed annual price-increase cap of 10% in exchange for agreed-upon delivery dates and amounts for the life of the contract. With a price cap in place, the town would not have to increase its fuel-oil budget by more than a certain amount each year. Although the town might have to pay a slightly higher per-gallon cost over the life of the contract in exchange for the consumption guarantee, this could be a reasonable tradeoff. The fuel-oil company has never agreed to a price cap for a municipal customer, but it ultimately agrees to the manager's requests for fear of losing the city's business and facing negative publicity.

The price cap proposed by the town manager is a type of *contingent agreement,* in which a range of "If this happens, then we do this or that" promises are added to a negotiated contract to reduce risk in the face of real-life uncertainty about the future. Whenever negotiators strike a deal, both sides must make forecasts and assumptions. Will current conditions remain the same or change after the agreement is signed? Will the other side hold up its end of the bargain? By including contingent incentives or penalties in a contract, you can protect yourself from the risk that your negotiating partner will renege on a commitment as well as improve the prospects of compliance.

Some argue that contingencies unnecessarily complicate business contracts and other kinds of agreements. It's true that contingent agreements can add new complexities to negotiations; but, with a little preparation, the benefits will far outweigh the costs.

When to use contingent agreements

Negotiators can use contingent agreements for several reasons:

- To make commitments more self-enforcing.
- To manage technical disagreements.
- To avoid the need to reconvene.
- To reduce the chances of future litigation.

Make a commitment self-enforcing.

In negotiating agreements of all kinds, it's a good idea to seek protection against *predictable surprises*—broad changes that may occur through no fault or effort on the part of either side, such as fluctuations in market demand, prices, laws, policies, or technological innovations. When all the different "futures" are spelled out clearly at the time the contract is signed, contingent agreements have a useful self-enforcing quality: they can increase the durability of contracts by eliminating the need to reconvene or renegotiate whenever predictable surprises occur.

Contingencies often create incentives for compliance as well as penalties for noncompliance. Professional athletes negotiate with their team owners for contractual performance bonuses. When hiring a contractor to build an expensive addition onto your house, you might add a contingency into the deal to reward the contractor with a prenegotiated bonus if his team beats a certain deadline. Cities often ask developers to post a bond equal to the amount it would take to complete all the public services associated with an approved plan. The city doesn't liquidate the bond until the developer has met all its commitments.

Insurance also can be viewed as a type of contingent agreement because it increases the security of contractual arrangements in an ever-changing world. A company invited to build a plant in an area highly susceptible to hurricane damage might want to ask the local government to purchase an insurance policy that would protect the company against a future disaster in return for its efforts to facilitate economic development.

Resolve technical disagreements.

Negotiations often get hung up on technical considerations. Suppose that an oil company seeking a permit to build a new refinery promises to keep various environmental disruptions to a minimum. Not surprisingly, local residents worry that the refinery owners won't live up to their commitments and that regulatory agencies will be lax or inefficient in tracking possible violations. What if an accident did occur? Maybe the company would prefer to pay a small fine rather than hold its facility to the highest possible standards. Meanwhile, the oil company might dispute whether the community's informal observations and measurements were valid.

> **Contingent provisions can reduce the risk of technical disagreements that might eventually lead to conflict.**

A contingent agreement could reduce these technical disagreements. If the company is confident that its plant will operate safely and cleanly, why not agree to address the residents' concerns? A "good neighbor" agreement could include detailed monitoring and shutdown provisions beyond those required by law. The oil company might even agree to train and fund local residents in monitoring techniques, thereby avoiding future battles between independent experts. Through contingent provisions, both sides can reduce the risk of technical disagreements that might eventually lead to conflict.

Avoid the need to reconvene.

When one side suspects that the other has failed to live up to contractual promises, it might want to reconvene to discuss the possible breach. Negotiators can avoid such potentially awkward encounters in advance by setting fixed dates to meet and review progress during the life of the contract. It's easier to agree to undertake a joint investigation and sort out what needs to be done at a prescheduled session than at a time when one side is claiming violation of contract terms.

In the construction world, such *partnering agreements*—in which the contractor and the client agree to meet periodically to maintain or improve their working relationship—are quite common. If no effort is made to enhance relationships before problems arise—especially once charges and countercharges have been leveled—it becomes all the more difficult to clarify misunderstandings and build greater trust.

Head off litigation.

To reduce the likelihood of going to court at the first sign of difficulty, consider carefully spelling out informal dispute-handling clauses in your contracts. Typically, such contingencies stipulate that both sides must continue to meet their contractual obligations until a neutral party has investigated any potential violations. Without such measures, contractual charges and countercharges can take on a self-fulfilling quality.

If I think you're not living up to your end of the bargain, I might unilaterally disengage from the contract. Of course, if it turns out that I was mistaken, my contract breach would be reason enough for you to shed your obligations as well.

The advantages of contingent agreements might seem to qualify them as a normal step in any serious negotiation. All too often, however, this is not the case.

Overcoming resistance

By following these steps, you can overcome internal resistance to contingent agreements fairly easily:

Raise red flags.

Don't be afraid to raise concerns during negotiations about things that might possibly go wrong in the future, and point out that such predictable surprises can be handled with contingent agreements. Resist the charge that you're being pessimistic or increasing the odds of trouble simply by looking at what might go wrong. Rather, argue that you are being optimistic: you believe it's possible to make durable agreements that can traverse all kinds of bumps in the road.

Strive for "nearly" self-enforcing agreements.

By including incentives and disincentives, you'll make it more likely that everyone involved will live up to their commitments without the need for messy, expensive enforcement proceedings. Prearranged incentives and penalties for meeting or exceeding contract terms foster not only effective negotiation but also effective implementation.

Accept disagreement.

Don't worry if you and your negotiating partner disagree on what the future may hold. Contingent agreements allow you to sidestep the need to agree on whose forecast is most accurate. First, create one possible scenario that describes what the other side assumes will happen. Next, outline your own scenario of what you think is more likely to happen. Finally, spell out expectations and requirements appropriate to each scenario. Include both scenarios in the contract. In doing so, you'll create an agreement that both sides can live with. Added complexity is a small price to pay, as long as clear triggers and monitoring arrangements state exactly when and why one scenario or another begins.

Broadcast benefits.

To overcome organizational resistance to contingent agreements, you'll have to describe the benefits that balance the costs of complexity. The legal and financial experts who prefer less complexity are just trying to do their jobs. But if you can show them how multiple contingent scenarios can head off potential crises, you can head off their defense of simplicity for its own sake. ✧

Lawrence Susskind is Ford Professor of Urban and Environmental Planning at MIT, visiting professor of law at Harvard Law School, and president of the Consensus Building Institute. He is the lead author of *The Consensus Building Handbook: A Comprehensive Guide to Reaching Agreement* (Sage, 1999). He can be reached at negotiation@hbsp.harvard.edu.