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Dealing With ‘Selective Perception’ and Bad-Faith Allegations in Commercial Settlement Discussions

BY MICHAEL McILWRATH

Mel Brooks reportedly said, “Tragedy is when I cut my finger. Comedy is when you walk into an open sewer and die.”

Experienced litigators know too well that the same reasoning can be applied to perceptions of good and bad faith in disputes. Because a party inevitably will view its own position as fair or at least sensibly advanced, the inexorable conclusion is that a far-off position taken by the other side can only be explained as unrealistic or even bad faith. How else to account for outrageous demands or denials of reality in the face of one’s own reasonableness?

That question is at the center of “International Dispute Negotiation,” a full-day simulation of an international commercial dispute held regularly for the past four years at the author’s employer, GE Oil & Gas in Florence, Italy. The course’s goals include helping managers and front-line employees better quantify the cost or value of disputes, and identify and overcome impediments to resolution.

Not surprisingly, the course reveals the biggest and usually only impediment to resolution is a significant divergence in valuation—that is, the number each party is willing to accept as a fair value or an accurate estimate of what a judge or arbitrator will award. What has been surprising, however, is how easily participants will conclude the other side is acting in bad faith when all participants share similar professional backgrounds, have access to the same information about the dispute, and even started out on the same side in the negotiations.

Indeed, it’s amazing at how quickly, consistently, and radically participants’ val-

uations change when they take up a role on the opposite side.

To follow Mel Brooks’ definition about comedy and tragedy, whether a party will

NEGOTIATION

perceive the other as unrealistic or as acting in bad faith depends far more on where the party sits than on access to or awareness of the underlying facts.

SETTLING A CATASTROPHE

The course starts with teams of four to five participants playing different roles on a British-led international consortium, with the common task of preparing for settlement negotiations with an Italian equipment supplier the consortium blames for a “catastrophic explosion” at its Egyptian project site—one that the supplier later will refer to as a mere “equipment failure.”

Through a detailed claim statement sent by its lawyer, the consortium—which is referred to in this article as the Claimant—has informed the supplier of \$66 million in losses. These consist of \$600,000 in damage to the equipment itself, more than \$3 million in project costs that can no longer be recouped, and about \$62 million in business lost after the project’s cancellation. Counsel for the consortium has invited the supplier to attend a meeting in Cairo, with a warning about litigation that will follow unless an acceptable settlement can be reached.

Always a challenge in any complex dispute, valuation in the international context must address the additional uncertainties of legal and cultural differences injected into the mix of factors to be con-

sidered. In considering all possible factors, the Claimant groups are asked to provide their (1) opening offer in negotiations, which cannot be more than the \$66 million already demanded, (2) settlement goal, and (3) best alternative to a negotiated agreement, better known as “Batna,” which in the training’s context is the point at which arbitration under the contract’s dispute resolution clause becomes the preferred option.

The results of this preliminary goal-setting session, from a simulation held with 30 participants in May in Florence, Italy, are set out in Table 1 at the top of the next page, with the overall averages in the left column in millions of Euros.

Although the numbers vary greatly among the groups, the Claimants’ expectations run uniformly high in seeking all out-of-pocket costs plus several million dollars of loss-of-business damages. These expectations remain high until the claim is answered, which occurs when the groups

Valuation in international cases must address additional legal and cultural uncertainties.

are divided and at least two participants from each Claimant group move to form a Respondent team. Both Claimants and the newly formed Respondent teams receive a copy of a four-page detailed letter from the Respondent’s counsel raising a number of defenses, including information about events leading up to the “explosion” that

(continued on next page)

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Table 1: Claimant Opening Offers, Settlement Goals, and Batna Based on Unanswered Claim

	Avg	Group						
		1	2	3	4	5	6	7
Opening offer	42.47	62.3	40	32	20	66.0	17.0	60
Settlement goal	13.36	34.0	22	12	6	6.5	6.0	7
Batna	4.30	6.0	7	6	5	2.5	2.17	2

(continued from previous page)

suggests the possibility of the Claimant’s contributory negligence.

The Respondent’s letter has the predictable effect of immediately lowering the Claimant team valuations. The impact is even more pronounced among Respondent teams, however, where valuations drop to levels irreconcilably below Claimant assessments.

Table 2 below, from the same May 2004 session, shows the parties’ valuations following receipt of the detailed claim response from Respondent’s counsel. It is evident at this stage, which is just before face-to-face negotiations are set to begin, that valuations are not only far apart but across the Claimant and Respondent teams there is an expectation that the other side agrees with their own assessment.

Table 2’s Column 1 (far left) provides the Claimants’ revised estimates of their

losses. Taking into account the potential difficulties introduced by the Respondent’s

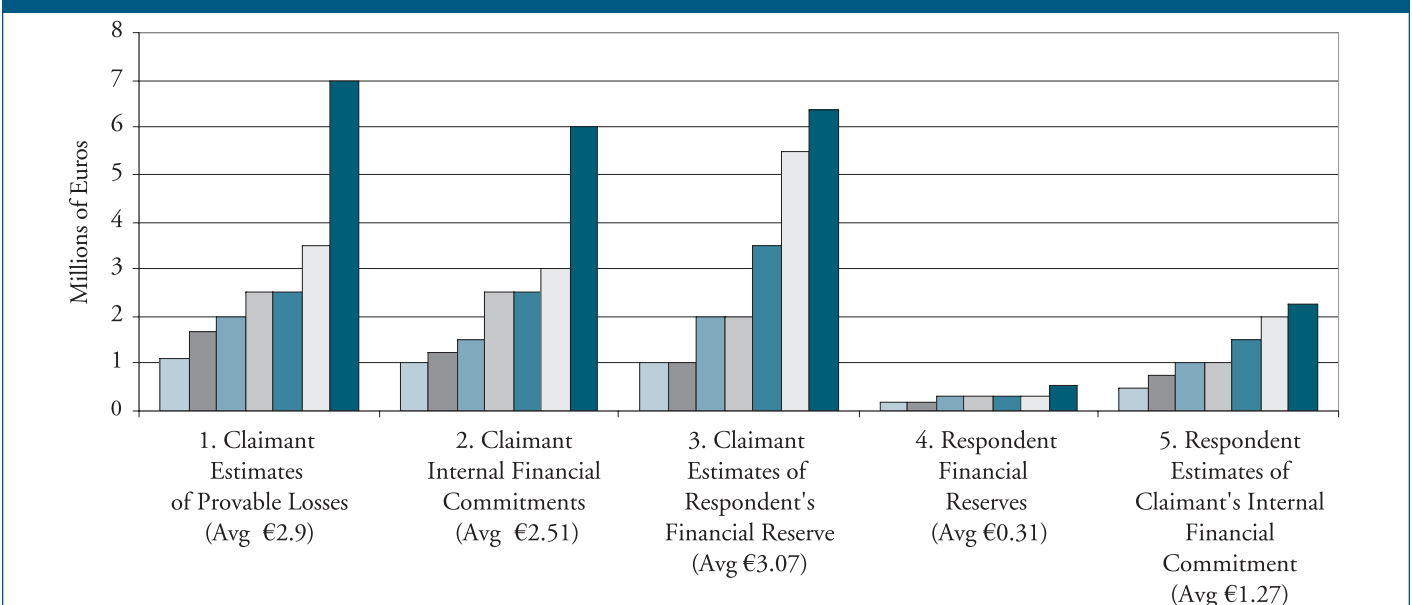
Participants may be receiving the same information but filtering it in a way that best fits their interests.

counsel, the Claimants now believe they can prove an average of only €2.9 million in damages, compared with an earlier aver-

age settlement goal of nearly €13.4 million and a Batna of €4.3 million. They have promised their management to recover between 75% and 100% of these provable losses (Column 2). This internal commitment roughly tracks what they believe to be the Respondent’s valuation of the dispute (Column 3, middle). The Claimants, obviously, have comfortably set their settlement goals for an amount they perceive to be within the Respondent’s reasonable valuation of litigation risk.

If only life was so easy. The Respondents, as the chart above shows, no longer value the dispute at levels even approaching what the Claimants have predicted, and have set aside financial reserves to cover a potential adverse judgment that range from 50% down to just 3% (Column 4) of what they would need to settle within the different Claimant groups’ financial expectations. The reserves are an

Table 2: Reaction to Detailed Claim Response—Claimant and Respondent Loss Estimates and Perceptions of Opposing Party's Valuations



even smaller fraction of the Batna the same participants had established when they were on the Claimant teams (Table 1).

And the Respondent groups do not fare much better in predicting the other side's new valuation of the dispute. Although the Respondent groups are slightly more generous in their efforts to guess the Claimant's financial commitment, they still miss the mark by an average of 50% (Column 5).

BAD START

And now settlement negotiations begin, and with these distant expectations they generally begin badly. As one Claimant participant noted, "We know our claim has problems, but we believe we will recover at least a portion of what we genuinely lost. Although our last offer was \$15 million, we are willing to accept \$2.5 million as settlement, which we view as more than fair under the circumstances and certainly less than [the] Respondent knows [it] will have to pay." For their part, most Respondent teams have now assessed a nearly zero value to the claim and remain willing to settle for a much lower amount, an average of only \$310,000. Clearly, if the Respondent is willing to pay at most \$310,000 and the Claimant will not settle for less than \$2.51 million, then an expectation gap of \$2.2 million, or roughly seven times the Respondent's best offer, must be addressed.

It does not help that the parties' positions, based as they are on technical and legal information provided to both parties, already have begun to crystallize.

WHAT'S THE EXPLANATION?

And herein lies the rub: how to explain the gap, and then address it? In the real world, it would be easy to at least partially blame the different valuations on imperfect access to information, or an imperfect technical or legal capacity to assess it. But in our course, and at this stage of the simulation, both sides are operating from the same information about the underlying dispute and, as noted above, they share similar professional backgrounds.

Instead, what appears to be pushing the parties in different directions is simply their selective perception of the data, i.e., participants may be receiving the same

information but filtering it in a way that best fits their interests, giving greater importance to favorable data and discounting or ignoring what is unfavorable. Information that each participant would in other circumstances treat as arguable opinions or doubtful facts becomes, in the context of taking sides to a dispute, irrefutable truth. Each side is as likely as the other to attribute unrealistic expectations to the other side or, as is often the case, "bad faith" in demanding something that is much more or much less than one deserves.

Do participants themselves realize that just switching sides is the reason for the startling valuation differences? We have not seen this; in fact, even when presenting the stark

The Claimants have comfortably set settlement goals for an amount perceived to be within the respondents' valuation. If only life was so easy.

data above we have difficulty convincing participants that they were selectively interpreting the facts, although most are ready to believe this of the other side. A common reaction was expressed by one recent participant, who said it was "frustrating to suddenly switch sides and experience obstinacy where you feel the situation is clear."

In the face of such tenacity, how is the gap to be closed? In the context of the dispute negotiation course, it almost never is. Once the parties become enamored of their positions and have staked out clear goals and immovable bottom lines, settlement on pure valuation terms is nearly impossible.

So if there can be no agreement based on a fair valuation of the disputed matter, how does the course conclude? Notwith-

standing ferocious and bitter disagreements, most participants over the years have been able to find overriding commercial interests that provide a way for the parties to bury the hatchet and move on to new projects. The rare failure has resulted in the occasional arbitration hearing at the end of the course day, with an award—and legal bill—that is bound to leave both sides feeling they could have done better.

In fact, disappointment with arbitration outcomes has led the program's designers to strongly encourage even the bitterest of opponents to pursue mediation—also held within the course—so that participants can leave the day with a greater sense of accomplishment.

Do the results of this course affect the way GE Oil & Gas conducts its disputes? In reinforcing the company's preference for early settlement, very much so. By providing an opportunity to experience and reflect upon the same dynamics that commonly thwart efforts to settle in the real world, the dispute negotiation course helps managers understand the importance of documenting their contractual rights, encourages early identification of disputes and promotes de-escalation, introduces managers to the basic concepts and benefits of mediation, and helps keep the company's aim—and, to the extent possible, our adversary's aim—on commercial interests rather than the win/lose results of litigation.

The course probably has little impact on how the company conducts itself in those few instances it is unable to avoid going to court or arbitration. But at least when an adversary takes a completely unrealistic position, we know they probably think the same about us.

And that's the tragedy of litigation. 🏠

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