WOOLLY WAYS
NEGOTIATION

Teaching Note

A transactional negotiation involving integrative and distributive elements, Woolly Ways involves Wise Wool's potential purchase of AllSheep. WiseWool is a large and well established privately held company that manufactures and sells wool and wool blend clothing products. AllSheep is a newer company that hit the market with high style and high priced wool shoes, and more recently introduced a small line of "base layer" undergarments and athletic wear. AllSheep's customer base of younger urban buyers is attractive to WiseWool.

Prior to this negotiation, WiseWool had agreed to purchase AllSheep for $36 million and had agreed on most of the usual terms. The senior attorneys were called away for various reasons and "highly competent associates" were assigned to negotiate two remaining items: the amount of the purchase price "hold back" to be held in escrow in case of certain circumstances, and a possible "Purchase Price Adjustment." The proposal for a holdback was agreed upon in principle, but the amount was not. While the parties had not determined whether there should be a PPA at all, both accepted that any PPA would be based on changes in cash balances, quarterly revenues, and debt incurred since the date of the letter of intent.

With regard to each term, the parties' confidential information sets up opportunities to exploit different preferences and valuations.

As to the escrow holdback:

- AllSheep would of course prefer $0 escrow; each founder would receive $9 million immediately. However, because AllSheep is confident of its "reps and warranties", it would agree to an escrow of up to $8 million of the $36 million purchase price. That would still yield each founder $7 million immediately.
- WiseWool's CEO doesn't think a holdback (or a PPA) is important. They think the $36 million purchase price was a bargain and don't want to hold up the closing. However, the lawyer wouldn't recommend an escrow holdback of less than $1 million on the theory that if AllSheep won't agree to that it would be a cause for suspicion.
- Both parties' confidential information references the idea that Representation and Warranties Insurance ("RWI") is available and could likely be purchased for about $1 million. The attorney would recommend obtaining RWI if AllSheep won't agree to at least a $3 million holdback.

Clearly, there's a large ZOPA on the escrow amount, theoretically from $0 to $8 million based on the WiseWool CEO's instructions, or $1 million to $8 million, based on the lawyer's advice.

As to the PPA issue:

- WiseWool is aware of risks attached to wool prices, damages to inventory, and sheep blights, and thus would value PPA reductions if Allsheep's cash balances or inventory values dip significantly, or if it takes on a significant additional debt. However, Wise Wool isn't concerned about a PPA in the event of a dip in AllSheep's monthly sale revenues because it is confident of future sales under its management. In the end, WiseWool would do the deal without a PPA.

- AllSheep would be comfortable including a downward PPA adjustment provision because its assets are retaining value. However, they would greatly value an upward PPA adjustment in part due to "seller's remorse" (they think the $36 million was too much of a bargain), and because they just landed two enormous contracts with military manufacturers that should result in doubling monthly revenues over the next four years. Ideally, AllSheep would like a PPA that lasts four years and increases based on increases (over those provided to support the purchase price) in monthly revenues for its current products. But if need be, a deal is a deal, and they would go forward with no PPAs.

Once again there's a ZOPA: both parties would go forward without any PPA. If AllSheep insists on a PPA that goes up as well as down, WiseWool could just say no. While AllSheep doesn't know it, here's no reason for AllSheep to accept downward only PPAs (though they wouldn't necessarily object). Of course, AllSheep's information about its new contracts is not known to WiseWool. Whether AllSheep should reveal it is an interesting question. On the one hand, WiseWool shouldn't mind paying more to get more. But from a distributive point of view, AllSheep would be better off NOT revealing these contracts, and framing the idea of both upward and downward PPAs as "only fair" or "what's good for the goose is good for the gander."

This parties' instructions do not articulate which of the terms is more important to them, and how the value of a holdback compares to the value of PPA adjustments. This can lead to a good class discussion about the importance of asking your client how they would value a tradeoff. How does WiseWool weigh the value a $ holdback against a downward PPA adjustment? How does AllSheep weigh the value of an upward PPA adjustment against a higher $ escrow holdback?

Another interesting question is how a party's resistance or response to a proposed term will be interpreted. If AllSheep resists any escrow, or any downward PPA, they may (legitimately) raise concerns for WiseWool – what does AllSheep know about their business that they aren't revealing? Negotiators are wise to consider how their positions will be interpreted.

Confession: this problem was developed for a law firm negotiation workshop, less than a year before this teaching note was written. Thus, I've only taught it once. Having said that, it worked well: generated a wide range of results and a robust discussion, with a particular focus on the value of information.