ZOEWE'S PLACE
NEGOTIATION

Teaching Note

Once again, this is a straightforward distributive negotiation, with a large ZOPA. I originally developed it for a negotiation workshop series at the business school at the University of Cincinnati. However, I believe that law students would be well served by understanding how the valuations work, and how a bank might view assets acquired in bankruptcy. The problem contains considerable information about the reason the Krugfeld building is particularly valuable to the potential buyer, and why the bank may be willing to sell it for very little.

In summary, Zoewe's owns a large number of movie theaters, primarily in suburban areas. Zoewe's is interested in purchasing the downtown Krugfeld building as a social theater space with café table service. It's targeted at aging baby boomers-empty nesters who might be otherwise inclined to watch movies at home. Studies show they have considerable leisure time and seek more social and entertainment options. Rebranded as Zoewe's Place(s), upscale food and beverages would be served before, after, and during movie classics, recorded theater and concert performances, and some newer movies. Screenings might be punctuated with breaks for food, drink, and conversation, perhaps old-style dancing.

Zoewe's business plan eventually calls for incorporating these into their suburban theaters. However, Zoewe's VP (who authored the plan) very much wants to kick off the venture and generate buzz with the downtown Krugfeld location first.

Zoewe's VP has a total budget of $10,000,000 which leaves a reservation price of up to $4,000,000 - $4,500,000 to purchase the property. $5,000,000 will be required for rehabbing and construction, and an additional $500,000 - $1,000,000 for furnishings (depending on how "classy"). The building is known to be in terrible condition. Certain floors are structurally unsound. From Zoewe's perspective, that's a benefit, not a problem. Research into the building's history revealed that it was originally constructed as a theater with open four to five-story height and wrap-around balconies. Thus, later-added interior floors are not part of the building's structural bones and should be relatively simple to remove, restoring it to a theater. That's part of what kept the construction and fixture cost estimate to $5,000,000. The Sixth/Fourth Bank representative is unaware of this.

While Zoewe's could spend up to $4,500,000, the lower the price the more they have for reconstruction, furnishing, and promotion. Promised city tax abatements and urban revitalization agencies' support should also boost this plan.

Zoewe's VP is worried, given the downtown location, that a well-funded developer might pay a much higher price to develop it as a condominium and/or retail space.

If Zoewe's can't get the Krugfeld building for under $4,500,000, their alternative is to spend $7,500,000 to reconstruct, re-fit, and re-furnish space in one of Zoewe's suburban area multiplexes.

It's known to both parties that the Krugfeld building was listed several years ago for $6,000,000; registry records indicate the owner had purchased it for $4,000,000 some 20 years before. It went into foreclosure a year ago and was bought at foreclosure auction by the mortgagor, Sixth/Fourth Bank, for $2,250,000. More recently, it was listed on the bank's realtor's website for $5,000,000. The tax assessment was $4,000,000, but it was likely based on square footage without considering the building's dilapidated condition.

From Six/Fourth Bank's perspective, their BATNA is bad (expensive) and it has spent just $330,000 on it so far – for tax liens and three years of real estate taxes since the foreclosure (if you don't count the mortgage balance from 20+ years ago). Frankly, even the $330,000 should be considered a sunk cost.

When the developer skipped town and stopped paying real estate taxes or the mortgage, the mortgage balance was $2,000,000 – from 20+ years ago. The city filed a $250,000 lien for back taxes and the bank initiated a foreclosure action. Shortly after you took on this job, the developer (by then in his 80s) died, and his LLC had no significant assets.

The bank had no choice but to bid at a foreclosure auction for $2,250,000, the total of the tax liens and the mortgage balance. However, the actual payment at auction was $0. They just paid off the $250,000 in tax liens as well as annual property taxes of $80,000 for the past year.

At this time, Six/Fourth has been informed that the city's building department plans to condemn the building. They are looking at an estimate of $500,000 to tear it down, or $1,000,000 to complete minimum repairs necessary to satisfy the city's building department. The city is likely to force Sixth/Forth to begin that work very soon. The bank estimates it would take $7,000,000 to completely rebuild the building's interior multi-floor structure and rehab its exterior. The project would take at least a year. Meanwhile, annual real estate taxes are approximately $80,000 and accruing. The VP's boss has directed them to get the property OFF of the bank's asset list, "Never mind the sweet location, it's still an eyesore and a financial sinkhole."

To this writer, the ZOPA is theoretically as wide as $0 (even though the bank might not want to take $0 it would be better for them than keeping the property) up to $4,000,000 - $4,500,000. Diligent inquiry (and in real life, research) by both negotiators is required to make an educated guess as to the other's reservation price and to anchor appropriately. The Six/Fourth's VP should be asking about Zoewe's larger business plan, what value the project might have for their business and the benefits of the downtown location. If they learn of the plan to build a theater and take out interior space, they might see the building's unsound structure as having value. They might lean on the tax assessment and earlier listed prices. That might justify a relatively high anchor initial demand.

On the other hand, Zoewe's negotiator would be wise to ask what the bank actually paid at the foreclosure auction ($250,000, not $2,250,000). If they learn of the imminent condemnation, they might ask what the bank's costs will be. Even if not, they might focus on what the bank would have to do to the building to make it valuable for office or residential developers to purchase. Zoewe's would downplay the tax assessment as likely based on square footage, rather than the actual crumbling condition of the property, etc. Zoewe's might suggest they are aware that no bank wants to hold the foreclosed property for long: that's not their business. This is a crumbling and costly asset the bank likely wants to get off its balance sheet, etc. See if the bank VP disagrees, or how convincingly. That might justify a low anchor for an initial offer.

In other words, information about the other side's perspective/BATNA is critical, as it is in any distributive negotiation. Negotiators are wise to consider what parts of their information NOT to disclose.

From a teaching perspective, the bank's information about the condition of the building raises an ethical issue. As the VP knows, an inspector (in connection with a potential sale to a condo developer) recently determined the building "had been constructed with a large open interior space… and found the interior floors to be structurally inadequate. Put up in slap-dash fashion and never up to code, they would not support the weight or movement loads required for residential or most commercial uses. Realistically, the building's insides would have to be gutted and all new interior floors built for habitation."

This is added to the bank's awareness of the city's building department's intent to condemn the building without immediate, extensive repairs. The city found and reported bricks and mortar crumbling at the chimney, rotting wood on boarded windows, and structurally weak and dangerous interior floors.

The question is: can or should the VP disclose these issues to Zoewe's representative in the negotiations? The bank doesn't how Zoewe's plans to open up the interior space, which makes the building's interior condition a benefit. And Zoewe's is surely not aware of the city's imminent condemnation action.

It's a strategic question as well as an ethical one. Should or could the bank insist on an "as is" provision in the negotiation?