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# CONTINGENT AGREEMENTS: AGREEING TO DISAGREE ABOUT THE FUTURE

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*"That won't happen." "Yes, it will." "No, it won't." "Will too." "Will not."*

Negotiators generally find no shortage of things about which to disagree. For example, negotiators seeking to resolve a dispute often have sharply differing perceptions of the past. What happened? Whose decisions and actions caused the effects in question? How does their conduct compare with expectations or duties? In some circumstances, settlement is impossible without resolution of these backward-looking questions. A significant component of classical dispute resolution theory suggests that one might overcome impasse by shifting the focus of conversations toward the future.[1] Sometimes, however, the shift to a forward-looking exploration merely provides fertile, new grounds for disagreement. Rather than arguing about what happened, the negotiators argue about what will happen. A wholesaler asserts that demand for the product will skyrocket in the future, and the retailer suspects otherwise. A defendant points to the relatively minor and temporary injuries caused in a car crash, but the victim fears that currently undetected injuries may manifest themselves down the road. Instinct may suggest that one negotiator will need to persuade the other about the likelihood of future uncertain events. Instead, genuinely held disagreements about the future present an important opportunity for negotiators to discover an attractive trade. The vehicle for capturing this potential is the contingent agreement.

Structurally, a contingent agreement is one in which the parties identify the universe of possible future conditions and agree to take on different obligations in each of those conditions. The simplest contingent deals are those in which the future has only two possible relevant conditions. *X* will

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1. *See, e.g.*, JAMES J. ALFINI ET AL., MEDIATION THEORY AND PRACTICE 128-129 (2001); CARRIE MENKEL-MEADOW, MEDIATION, xxix (2000); JOSEPH STULBERG, TAKING CHARGE: MANAGING CONFLICT 101 (1987).

happen, or it will not. If *X* happens, the terms of our deal are ABC; otherwise, we will do DEF. If I think *X* is unlikely to happen, I will be happy to give you terms you prefer for ABC, in exchange for terms I favor for DEF. Believing that she will get the work finished on time, an author signs a lucrative book contract with a very harsh penalty for late completion. Buyer loves Seller's house, but really wants a property with off-street parking. Seller firmly expects that the city council will approve a variance required for construction of a new garage, but Buyer is less confident about the likelihood of getting approval. Buyer agrees to purchase the property from Seller at a reduced price, with a substantial additional payment to Seller if the City Council grants a variance within the next twelve months. Negotiators can craft attractive trades by establishing obligations that are contingent on a future uncertain event that affects each side's valuation of the agreement.

Contingent agreements can also include variable terms, pegged to some benchmark to be measured in the future. I think interest rates will increase over the next few months, and you think they will go down. If I am loaning you money today, we will each be happy to agree to a deal with a floating interest rate. A school board is nervous about the future level of state funding to the districts, while the teachers' union is optimistic. The teachers' union agrees to a wage and benefit increase tied to a particular line in next year's state budget. The plaintiff believes that he may suffer long-term health effects of exposure to the defendant's product, while the defendant believes no significant health risks exist. The defendant agrees to pay specified medical monitoring expenses for the plaintiff and to assume any future medical costs associated with exposure.[2] Parties to a joint venture agree to final, binding resolution of their intellectual property dispute by an appointed arbitrator.[3] Without the possibility of contingent agreements, uncertainty regarding future conditions can make distributive decisions (for example, who gets how much money) difficult. By linking the allocation of resources to an externally

2. Such an agreement raises certain risks related to the precision with which the triggering event is defined. Which tests are necessary for monitoring? The plaintiff may want many more tests than the defendant considers appropriate. Even more significantly, who will determine whether the need for particular medical treatment was caused by exposure?

3. An arbitrator's award is a measurable, external variable to be fixed in the future, on which the parties might agree to base the terms of their agreement. In this sense, arbitration agreements are a form of contingent agreement. *See* Max H. Bazerman & James J. Gillispie, *Betting on the Future: The Virtues of Contingent Contracts*, HARV. BUS. REV. Sept.-Oct. 1999, at 155, 157; DAVID A. LAX & JAMES K. SEBENIUS, THE MANAGER AS NEGOTIATOR 96 (1986). In some sense, parties may also purposefully agree to a currently ambiguous term in a contract, with an understanding that in future conditions a non-party will interpret the term. *See* Christopher Honeyman, *In Defense of Ambiguity*, 3 NEGOT. J. 81 (1987) (describing the pragmatic considerations of including ambiguous language in agreements—for example, a labor agreement permitting termination only for "just cause").

measurable variable, negotiators can sometimes overcome otherwise paralyzing disagreements about the future.

Contingent agreements also present an opportunity to create favorable incentives. Some negotiated deals involve no future relationship between the negotiators and are self-executing. Buying a trinket in a marketplace involves a simple exchange of money for goods. In more complex circumstances, however, ongoing relationships exist and implementation of the agreement takes place over time. When the negotiated deal involves more than a simple, one-time exchange, parties' behavior *after* the agreement is relevant. Contingent agreements can help to create incentives for parties to behave well after the terms of the deal are fixed. A company may agree to tie a sales executive's compensation to sales performance, thus promoting sales-maximizing behavior out of the executive after the deal is signed. The health ministry of a developing country approaches a prospective donor, seeking support for particular health sector programs. Both the prospective donor and the developing country want to see multiple sources of funding. They agree to a matching program under which the donor will contribute an amount equal to the funds the ministry secures from other sources, giving the ministry officials added incentive to garner resources. In some contingent deals, one party can affect the likelihood of the contingent trigger—the salesman can make more sales calls, the ministry officials can approach more donors. Contingent agreements can affect parties' behavior after the agreement.

Precisely because contingent agreements can affect parties' behaviors, some contingent agreements risk creating conditions of moral hazard. Moral hazard is a condition in which one party, under the terms of an agreement, may undetectably or uncontrollably behave in a way that is adverse to the other party.[4] How quickly do you take the speed bumps when you are driving a rental car? Moral hazard suggests that many drivers will drive more cautiously over the bumps if they are driving their own cars because they consider the long-term effects of their driving behavior. Athletes' contracts often contain contingent incentive clauses. If the athlete scores a certain number of points, for example, he or she receives additional money. Moral hazard arises when, toward the end of the season, a team notices that the athlete is only a few points away from the triggering contingent event. Will the team structure its play to enable the athlete to achieve the statistical goal? If an agent's contract provides for a thirty percent commission on sales this

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4. *See* ROBERT H. MNOOKIN ET AL., BEYOND WINNING: NEGOTIATING TO CREATE VALUE IN DEALS AND DISPUTES 26 (2000) (defining moral hazard as "[t]he problem created when a contract shifts risk from one party to another party and information asymmetries permit the non-riskbearer to behave adversely under the contract without detection or consequence.").

year, but only a ten percent commission in future years, the agent will have an incentive to push deals into the current year—even if the deal he or she could have struck next year would have been on terms more favorable to the company. Negotiators crafting a contingent agreement should foresee the possibility of moral hazard and, where appropriate, structure incentives and disclosures to minimize the incentive for subsequent adverse behavior.

One challenge in crafting a contingent agreement is identifying the boundaries of future possible conditions with sufficient clarity to know what obligations attach. A married couple might agree, "If the weather is nice tomorrow, we'll hike. Otherwise, we'll go shopping." The next morning, when it is cloudy but not raining, the spouse who wants to hike is likely to declare it "nice," while the person preferring to shop will argue the opposite. Rather than peg future obligations on something difficult to define with precision—the weather, the economy, one's health, political stability—wise contingent deals depend on easily-measured external variables. Did the airport weather station register precipitation in the past twenty-four hours? Did the unemployment rate for the state increase last month? Did the lab results show a drop in the level of LDLs in your blood? Did the local elections take place on the pre-specified date? Answering such questions is relatively reliable and costless.

Challenges akin to ambiguous contingent triggers arise when the variable being measured is under the interpretive control of one party. For example, a mid-level executive may not want to have her bonus tied to the performance of the business unit as a whole if she has concerns that the company may subsequently adopt accounting methods that shift credit from her unit to another unit.[5] Contingent agreements containing unambiguous, external triggers are less likely to produce post-agreement disagreements.

Crafting contingent deals also raises considerable questions about strategic disclosure.[6] Without any disclosure regarding forecasts and preferences, negotiators will not spot the possibility for a contingent agreement. Such disclosures, however, inevitably produce a risk of exploitation. Assume that I am virtually certain that *X* will happen, and you are virtually certain that *X* will not happen. If I begin our negotiations by declaring that I am "virtually certain *X* will happen," you may have an

5. *See also* LAX & SEBENIUS, *supra* note 3, at 97 (describing a union's reluctance to tie wages to a company's profit margin).

6. For more on strategic disclosure and the tactical considerations raised by information exchange in negotiation, see HOWARD RAIFFA, THE ART AND SCIENCE OF NEGOTIATION 44-65 (1982); G. RICHARD SHELL, BARGAINING FOR ADVANTAGE: NEGOTIATION STRATEGIES FOR REASONABLE PEOPLE 132-55 (1999); MNOOKIN ET AL., *supra* note 4, at 11-43; LAX & SEBENIUS, *supra* note 3, at 29-45.

incentive to misstate your actual forecast. Rather than tell me that you are virtually certain of the opposite, you may tell me that you think there is "a decent chance" that *X* will not happen. You then may have an opportunity to demand a more favorable premium for being the party to take on the apparently greater risk. Contingent agreements are not different from most other aspects of bargaining; this presents opportunities both for mutually beneficial value creation and for one-sided efforts to skew value distribution.

Contingent agreements may affect negotiators' perceptions of "winning" and "losing." Classical negotiation advice counsels negotiators to conceive of negotiations in terms other than win-lose, pointing to the risk that competitive behavior may cloud opportunities for joint gains.[7] In one respect, contingent agreements may present an opportunity for negotiators to avoid the necessity of identifying a winner. Rather than forcing one side to concede on its forecast, contingent agreements permit (in fact, require) both sides to maintain their conflicting predictions about the future. At the time of the agreement, therefore, each side can declare "victory," to the extent such a declaration is important. On the other hand, contingent agreements have the nature of a wager or a bet. Unless one counts the sheer joy of gambling as a victory, *both* sides cannot win a wager. The contingent event either happens or it does not. Either way, one side may be disappointed.[8] In some organizational cultures, failure is punished more harshly than success is rewarded. A negotiator fearful of identifiable failure (for example, a wager that visibly did not pay off) may forgo an elegant contingent agreement in favor of a less efficient non-contingent deal. Elegantly structured contingent deals may help to reduce the risk of visibly "losing." For example, if the plaintiff fears that a jury may award him nothing, and a defendant fears a runaway jury award of millions, the two could agree to a small guaranteed recovery in exchange for a cap on the maximum recovery.[9] The losing party at trial will then be grateful

7. Perhaps the most widely cited authority for this proposition is GETTING TO YES: NEGOTIATING AGREEMENT WITHOUT GIVING IN by ROGER FISHER ET AL. (2d ed. 1991). While the authors of GETTING TO YES do not label it so, many describe a particular stance toward negotiation as "win-win." The label is problematic, but widely recognized.

8. This assertion is modestly overbroad. Recently, on a business trip with a colleague, we were dashing between gates, trying to make a flight. My colleague expressed confidence that we would make it, while I was convinced we would not. We placed a small wager on our fate. We made the gate with seconds to spare, and as we boarded the plane, I handed over the $1 wager I had lost. I was not in the least disappointed to have been wrong in my prediction. The nature of my position in the wager, however, was uncommon in that I was sure to experience some measure of success in either event.

9. For more on high-low agreements, see Samuel R. Gross & Kent D. Syverud, *Don't Try: Civil Jury Verdicts in a System Geared to Settlement*, 44 UCLA L. REV. 1, 61 (1996); Chris Guthrie, *Better Settle Than Sorry: The Regret Aversion Theory of Litigation Behavior*, 1999 U. ILL. L. REV. 43 (1999).

to have made the contingent agreement, and the winner's regret will be dampened by having won a favorable verdict.

Given that two people virtually never agree entirely on the likely shape of the future, why aren't *all* deals contingent? Part of the answer lies in the transaction costs associated with identifying differences and crafting elegant contingent agreements. Two parties crafting the terms of a joint venture cannot imagine that they will plan for every possible contingency. At some point, they will agree to resolve future uncertainties when/if they arise. Even in circumstances without trust or a structural incentive for cooperation, the contingent stakes may simply be too low to justify the effort of crafting and implementing the deal. The value captured simply may not outweigh the cost of crafting a contingent deal to capture it.

A final, often overlooked, factor dissuading parties from crafting contingent deals is that parties place some value on certainty and finality. Particularly for negotiators embroiled in a dispute, achieving resolution may have an inherent value independent of the terms of the deal. Many disputants find it emotionally costly to carry around uncertainty. A contingent agreement does not represent complete finality, as at least some of the terms are yet to be determined. Uncertainty also can be costly for economic reasons. A company with an uncertain liability or benefit on its books faces considerable challenges in planning appropriate reserves of money, for example. If a company has a large collection of similar contingent agreements, it may be able to spread the risks and allocate money accurately in the aggregate. Similarly, some circumstances may permit parties to manage risks through the use of hedging instruments such as futures or options. Such allocations are not generally available to all individual negotiators, potentially making contingent agreements less attractive. For a contingent agreement to be appropriate in a given context, therefore, the perceived benefit it captures for each negotiator must exceed the transaction costs of discovering and implementing the agreement.

Negotiators arguing about the past sometimes "agree to disagree," preferring instead to focus on what they will do moving forward. Negotiators with differing perceptions of the future should similarly agree to disagree—using contingent agreements to capture the potential benefits of their differences.