Case Study: Mediating the Fallout From a Failed Business Deal - Between the Rock and the Hard Case

By Shawn Ladd

After I completed the Harvard Negotiation Institute's course on *Mediating Disputes*, faculty member and Boston Law Collaborative founder, David Hoffman, kindly invited me to observe a commercial mediation. This case highlights some of the strategic and emotional dilemmas that mediators confront. I have removed any information that might identify the parties.

The mediation arose over a failed business acquisition. By the time the buyer and seller came to mediation, the business had been sold to a third party. Both parties were disappointed and angry, and they had already been through litigation and appeal.

The buyer, having failed in his efforts to acquire the business, was demanding return of his $5.0 million deposit, plus accrued interest. The seller, notwithstanding having sold the business to a third party, was claiming the full $5.0 million as liquidated damages, plus actual damages of $3.0 million. The third-party purchaser was threatening patent litigation.

The Seller

Core Consulting was a relatively small IT services firm that had some success marketing specialized software to doctors' offices. The owner had bankrupted Core by defending it from a patent infringement suit. Core's remaining assets were now in the hands of its creditors, who were facing a considerable write-down, even once those remaining assets were sold. They engaged Steve, a lawyer and business agent, to dispose of the assets.

The Buyer

Rock was a veteran software engineer and self-styled "legendary entrepreneur." In his view, Core Consulting's personnel were first-rate and its intellectual property portfolio was good. Furthermore, he had faced down the same patent owners who had sued Core, and was confident that his software patents were strong enough to cover Core's application. With his management expertise and his intellectual property, he could revive the firm for a profit. Rock approached Steve, and they began talks on the purchase and sale of Core's remaining assets.

Rock and Steve settled on a price of $18 million. They signed a purchase and sale agreement (PSA), with a clause stating that the creditors would pay all taxes up to the closing date. Rock moved into an office at Core's premises and began to reorganize the remaining staff. As Rock learned more about the position of Core's creditors and other potential buyers' lack of interest, he reopened the PSA and forfeited his $1 million deposit as liquidated damages. But, after months of talks, he was able to conclude a new deal at only $13 million, effectively saving $4 million in the process.

From the creditors' perspective, they had just lost another $4 million and several months during which they might have found another buyer. They accepted the new purchase price. Rock, however, had been "running the place" for nearly a year, and so they stipulated that the buyer would be responsible for taxes and utilities, with no pro-rating at closing. This time, the creditors asked Steve to insist that Rock deposit $5.0 million, or 38 percent of the purchase price, into escrow.

One week prior to closing, Rock's lawyers discovered that the city had filed a lien over $4,300 in unpaid local income taxes, effective four months prior. Not wanting to upset the closing, Core's creditors promptly paid the full amount due, but were unable to collect documentary proof that the lien had been lifted until two days after scheduled closing.

At the closing meeting, Rock asked Steve if the creditors would also transfer their interest in an unexpired commercial lease on space that Core wasn't using. Steve said no. In Steve's words, he "didn't appreciate Rock trying to take another nibble at closing, especially after driving the price down $5 million and dragging the process out for months." In response, Rock refused to close and claiming that, without a document proving that the city's lien had been lifted, the creditors could not convey proper title and were therefore in breach of the agreement. Rock demanded the refund of his deposit. Steve refused, stating that the creditors had been ready and willing to convey everything they had promised at the appointed time. Steve said that once the creditors obtained the certificate two days later, he renewed their offer to close at $13 million, but Rock wasn't interested. Rock claimed that Steve never offered him another opportunity to close.

In the subsequent weeks, Rock took legal action against the creditors, demanding both a transfer of Core Consulting's assets and the return of his deposit. Regardless, Rock began to think that he may have overreached. To deter anyone else from taking the deal that he had rejected, he filed an order of *lis pendens*, warning any third party who may be considering the property that its rights would be subject to the outcome of his suit.

Nevertheless, word spread that the transaction had not been consummated. Another firm, Arbay LLC, offered the creditors $18 million. By this point, the creditors were exasperated with Rock and gladly accepted Arbay's offer. They asked Arbay for only $1 million in deposit, substantially less than the amount to which Rock had agreed. Arbay was only too happy to close quickly. As it happened, the sole owner of Arbay LLC, and now Core, was a partner in the firm that had sued Rock for patent infringement. He immediately joined Core's creditors in their defense against Rock, and also stood ready to reopen patent litigation against him.

When Rock's case reached trial, the court sided with the creditors on the issue of specific performance. Core's assets were now Arbay's and would not be transferred to Rock. Furthermore, the court ruled that the seller had been ready to close as per the PSA on the closing date; it was the buyer who had breached the agreement, when Rock refused to close. However, the court was silent on the disposition of the $5 million

deposit. Rock appealed, but the decision was upheld. The parties made ready to litigate over damages and the disposition of the $5 million in escrow.

Knowing that the court would consider whether the parties had attempted mediation when scheduling a trial, the creditors' attorneys proposed mediation. They agreed to engage David Hoffman to mediate the dispute. David scheduled an initial session and asked for each side to submit to him a confidential brief.

Rock appeared for himself at the mediation, along with his lawyer Bob, who had worked on the suit and its appeal (but not the PSA), and his lawyer Brad, a family friend who normally handled real estate cases. For the creditors, there was Steve, who had been negotiating with Rock since the outset; Sam, whom the creditors had engaged to defend against Rock's suit and its appeal, and a third lawyer.

I noted at the time that David immediately established a friendly rapport with both parties. He reminded them that he had worked constructively with attorneys on both sides of this case, and made sure that everybody in the room knew each other. He reassured them that the power to conclude an agreement, or to resume litigating, rested entirely in their hands. He would ask a few questions with them together, and then perhaps meet with each of them separately.

The parties consented and David began a joint discussion. Both David and I were genuinely puzzled about why the transaction had not closed, either on the appointed day or shortly thereafter. When David asked the question, Rock revealed that he had relied on advice from his attorney at the time that the tax taking was a fatal flaw.

David asked the creditors' attorneys how sure they were that a court would agree that a deposit of 38 percent of the purchase price ($5 million) represented a reasonable estimate of damages likely to occur in a breach. (Rock's case hinged on whether the non-refundable deposit constituted a "penalty," prohibited under applicable law.) The creditors' attorneys said that the courts would see a well-informed buyer, a well-informed seller, and a PSA that speaks for itself; they would surely not overturn any aspect of the agreement. But David had subtly reminded both sides to consider the weaknesses, not just the strong points, in their own cases; the cost and uncertainty of further litigation; and the likelihood of collecting on any award. Having opened up a little in front of each other, even Rock's side could agree in principle that the creditors were entitled to recoup actual damages, if any existed.

Even if the issue is strictly distributional, it's still worth proposing direct talks.

It was already apparent that there was no chance of a productive business relationship between these parties. Core and its assets had been disposed of. Both side's experiences had left them frustrated and suspicious, and their perceptions of the other's motives and style had further undermined clear communication.

The creditors' attorneys considered Rock an opportunistic nuisance: constitutionally incapable of keeping his word and executing an agreement, and quick to

take baseless and wasteful legal action when thwarted. Rock held a grudge against the creditors for their counsel's arrogant and condescending tone toward him in negotiations, and for depriving him of possession of a business that he had helped to preserve – a business that had been sold for a profit that should rightfully have been his. He was at once indignant that creditors had demanded such a large deposit, and embarrassed that he had agreed to it, thereby placing himself in this vulnerable position. The final straw: the creditors had ultimately sold the property to, and joined legal forces with, a longtime business rival who openly set out to embarrass him.

David let both parties vent their frustrations. They now had a shared understanding that litigation would result in the payment of at least actual damages from Rock to the creditors. It would also entail additional time and cost. They were ready to bargain, but David saw a risk that they could start to swap nickel-and-dime proposals, which might prematurely lead them to abandon mediation. The creditors' attorneys would perceive a lowball offer as yet one more of Rock's time-wasters. Rock would view a lowball counteroffer from the creditors as an additional insult. David therefore set out to prime both parties, urging them to make big moves early and forego the preliminary dance steps.

I noticed that Steve, who had been dealing with Rock for years, and Brad (Rock's "lawyer buddy") exhibited more open body language and facial expression, and spoke less defensively, especially to each other. David noticed the same thing. To make sure both parties "owned" the process, to increase the credibility of their respective offers, and to keep the more irritable characters at bay, David asked the parties to consider delegating Brad and Steve to work with him.

David then announced that we would resume in caucus, and sat first with the creditors' attorneys. He asked them, "So, how far do you think Rock will take this?" In their view, Rock made a serious business mistake when he failed to close, and he knew it. He had overestimated his leverage in the transaction and in the courts: no judge would return the whole $5 million plus interest to him. But they also knew he was stubborn and emotionally invested in the fight. Their clients wanted complete closure and no further liability. For that, they were prepared to part with some of the escrowed funds today.

Alas, it had to be shuttle talks.

David repeated that he saw an opening for one person from each party to work with him. He asked if Steve would represent the creditors. Sam, who seemed as stubborn, if not as demonstrative, as Rock, did not support this, "because Steve doesn't have the authority to settle the case." David dropped the proposal. I reminded myself that, ultimately, it is up to the parties to decide how much or how little they will rely on the mediator.

In the caucus with Rock, the entrepreneur directly asked David for his evaluation of the case. David reviewed the creditors' actual damages claims, point by point, and identified the eligible costs that could be established with some certainty. These totaled about $1.8 million.

On their claim for liquidated damages (the $5 million deposit), David described how a judge in the relevant court would likely view such circumstances: Rock had breached the PSA in failing to close, but 38 percent of the purchase price seemed a high before-the-fact estimate of damages likely to arise from a breach. David noted that there were no examples of a deposit that large being upheld, but there were also very few case-law examples of refunded deposits.

David and Rock's lawyers began a traditional risk analysis of the case. Rock was uncomfortable with that approach, and just waved them away from the whiteboard: "That's not how I think about things." David emphasized that any offer must have a rationale, grounded within the four corners of the case, to be credible. Rock, having accepted that the creditors would get at least their actual costs, suggested conceding $1.2 million. This meant that Rock was demanding a total cash payment from the creditors of $3.8 million.

In contrast to the creditors' attorneys, Rock readily agreed to have Brad act as his spokesman to the other party. Rock said, "Dealing with those guys just upsets me, especially Sam." This was a welcome glimmer of self-awareness. Brad knew both sides of the case, and how the other side was likely to react. Rock and Bob trusted him.

Priming the parties on their initial offers helps.

Brad accompanied David to meet the creditors' lawyers. Brad spoke frankly and directly to them. He shared his professional assessment of how the parties would fare in court and grounded his offer in their cost estimation framework. To commiserate a little, he also asked them to imagine "what it took to get a guy like Rock to part with $1.2 million." To my surprise, the creditors' attorneys gently nodded their heads.

Brad withdrew and David resumed with the creditors' attorneys. He asked, "What had you been thinking Rock would offer?" Their guesses were *well below* the actual offer. David seized on their "reverse sticker shock" and urged them to respond proportionately.

When David reviewed their case with them again, the creditors' attorneys recognized the futility of trying to collect any money beyond what was already in escrow. However, they were bullish about their liquidated damages defense and hanging on to the $5 million deposit. They floated a figure: they would return to Rock $900,000 plus accrued interest. To me, their lowball offer would bring mediation to a sudden stop, but David didn't even have to intervene. Steve's eyes noticeably widened. With evident effort at delicacy and self-restraint, he said, "Guys, that is *not* gonna be a good counter offer." They agreed to make a larger concession: $1.35 million plus accrued interest.

Sam, rather than Steve, went with David to present the creditors' first counteroffer. Rock and Brad had taken a break, so only Bob was present. Bob was non-committal. With Sam and Bob both present, David acknowledged that there was still a gap between their positions, but commended both parties for "making big steps and really sticking your necks out." He urged them not to downshift their efforts in the next round.

Getting past the emotional resistance to considering alternatives.

Next, David met again with Rock and Bob. Brad had been called away. This made Rock, always visibly antsy, even more uncomfortable and it was affecting his thinking. He said, "I don't know where we go from here. We're too far apart." David reassured him that the process was unfolding normally: "You knew they wouldn't accept your first offer, and they knew that you wouldn't accept theirs." Bob said to David, "This has been our problem all along. Rock can't decide on a number that he can say 'yes' to!"

To help Rock to relax and reengage, David recounted a hypothetical scenario:

"Imagine that, three years from now - after a trial, an appeal, perhaps a retrial - someone were to ask you: 'Knowing what you know now, would you have turned down an offer of, say, $2.5 million?'"

David sat quietly and gave Rock time to think. Rock admitted he might well look back wishing he had taken the check. But he was still conflicted, and clung to his point: "I still think a judge would have a hard time letting them keep 38 percent of the purchase price."

"Maybe," David said. "But *what if* the judge asks you, 'Why did you agree to put $5 million down?'"

"I'd have to say I took bad advice, both about how much to put down, and about whether to close."

"So *what if* the judge asks, 'Why aren't you trying to collect from the advisors who served you badly, then?'"

That struck a nerve. To relieve his discomfort, Rock reverted to how the creditors' lawyers had been contemptuous and unprofessional. David knew Rock needed to feel exculpated a little.

"You were trying to do the prudent thing, based on your lawyers' advice. That's completely understandable. However, if you go back to litigation, bear in mind that the creditors won't concede that the deposit included any element of penalty, and a judge could interpret their statements that suggest otherwise benignly. So, would you continue to litigate if $2.5 million were on the table?"

Unfortunately, in Rock's mind, any further concession on his part would feel like defeat and expose him to further loss of face.

Let them go? Or get in the hole with them?
The mediator's proposal:

By this time, the day was three-quarters over. The creditors' team was open but unmotivated; they were comfortable with their BATNA and expected that Rock would not counteroffer. Rock was trapped in an emotional dilemma: his liability for actual

damages was clear; his BATNA on liquidated damages was uncertain; but he could not, in his own eyes, "back down."

But maybe they would both rationally appraise a proposal from a neutral third party. David explained the ground rules of a "mediator's proposal" as follows: David would make the same proposal of settlement to each side. After the parties had considered the proposal, he would talk separately and confidentially to each side and find out if they would be willing to settle on those terms. If both parties said yes, David would report, "We have a settlement." If either or both parties declined, David would report, "No settlement."

This process can provide additional incentive to say "yes." In a two-party dispute, if the mediator reports, "We have a settlement," both parties know that they both agreed to a proposal which they genuinely found acceptable. If it's "No agreement," the declining party doesn't know that the other side said "yes," but the accepting party knows that the other side said "no."

Both parties agreed to this process. Both had the same initial question: How would David arrive at a proposal?

Rock wanted more certainty in the value of his BATNA, and how this compared to what the creditors' lawyers would accept. David reiterated the elements of Rock's case that were likely to be upheld. The creditors' lawyers were concerned that the proposal might implicitly challenge their estimate of the value of the case. David assured them that his proposal would be a compromise that, in his opinion, would allow both parties to end the dispute. He would not offer a competing evaluation of the case that the creditors' lawyers would have to explain to their clients.

Meeting first with the creditors' lawyers, David said, "I'm about to put a proposal to you. You are not to convey your reaction until I return. Here it is: Split the escrowed funds, including accrued interest, 50/50, with a release of all claims." David left them and went to Rock.

"Okay, but…."

David presented the same proposal to Rock. Rock said, "Okay, but…" if he were to accept a 50/50 split, he needed reassurance that the agreement would be confidential. He didn't want "those Arbay guys" to even know that the mediation had happened. "They'd sneer at me for caving, then turn around and try to get their paws on my half with another patent litigation."

David returned to the creditors' attorneys. They said, "Okay, but…" they feared that Rock still couldn't take "yes" for an answer; he would once again change his mind and reopen litigation. Their "but" was that no one connected with the sale and related actions could be left vulnerable to subsequent litigation, and that there could be no room for Rock to sabotage implementation of the agreement.

David announced, "We have an agreement!" and drafted a brief Memorandum of

Understanding that responded to the concerns of both parties. It included a confidentiality clause and another that required both parties to revert to David for an interpretation, if they got stuck on any subsequent issues down the road.

Learning Points

This case reinforced four classic negotiating and mediation lessons:

First, parties enter litigation with *overconfidence bias*. Notwithstanding that Rock had clearly overestimated his power in the transaction and in court, he entered clinging to the belief that "a judge has to see it my way, eventually." Notwithstanding that the creditors had collected an unusually large deposit, and then sold the property to a third party at a higher price, their lawyers thought, "We can't fail to collect what it actually cost us, and, because the creditors are still under water, we might get to keep it all." The mediator can encourage parties to imagine the full range of scenarios, and then to temper their overconfidence.

Second, sometimes the parties have not just a simple *bargaining gap* between them, but a profound *perceptual* or *cognitive gap*. If the people involved lack the mindfulness they need to think strategically, talks can spiral into reciprocal indignation and exasperation – even absent an actual legal controversy. If you want to know what respect and rapport are worth, watch what happens in deals where they are not clearly present.

Third, how much is required of the mediator depends on the complexity of this gap. If David hadn't been prepared to offer a mediator's proposal, both parties would have left saying "I knew they would do that." But all he offered was a 50/50 split. Nothing could be simpler. It was within their reach all along.

Fourth, resist the urge to "nibble." If Rock hadn't asked for a last-minute concession at closing, the deal would have gone ahead as agreed. The litigation, appeal, and mediation would have been avoided. The same principle applies in the mediation: nickel-and-dime offers can sabotage the process because each side feels that they are insulting, and they erode the confidence that flexibility will be reciprocated. Shuttle diplomacy (i.e., caucusing with each side separately) and/or a mediator's proposal can help the parties take bolder steps.

Buyer proposes	Seller proposes
Seller drops $3 million claim and refunds $5 million plus accrued interest.	Buyer pays $3 million and drops claim for refund of $5 million.
Mediation begins	
Seller drops $3 million claim, refunds $3.8 million + accrued interest. Seller retains $1.2 million.	
	Seller drops $3 million claim and offers Buyer refund of $1.35 million plus accrued interest. Seller retains $3.65 million
Mediator proposes	
$2.5 million + half of accrued interest	$2.5 million + half of accrued interest
Agreed	

Shawn Ladd mediates disputes and facilitates durable agreements between firms, governments and communities in North America, Latin America, the Caribbean, and in Africa. His practice focuses on mining, oil and gas, forestry, manufacturing, finance and tourism.