The Put-Up-Or-Shut-Up Strategy in Business Negotiations

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INTRODUCTION

In forming various kinds of business organizations or relationships it is often necessary to ask which participant will bear the risk associated with a contingent adverse outcome. Who is to be held responsible, and in what way, if events turn out badly? In many such situations, it may turn out that one person will be in a position where she must "put-up-or-shut-up" and thus will wind up bearing the risk. The "put-up-or-shut-up" strategy may be used as a negotiation technique or *ploy*, but it is also a *solution* to certain kinds of problems that arise when establishing business relationships. The solution has characteristics, both desirable and undesirable, that are of theoretical interest as well as of practical importance. The desirable characteristics are that the solution (a) may close a gap by eliminating problems of honesty and of differences in perception as to the venture's expected costs and returns, and (b) may tend to align incentives of participants with different claims or expectations. The undesirable characteristics are that (a) the person who is subjected to the risk may be less capable than other participants of bearing it, and (b) the incentives may turn out to be perverse if they create or exaggerate conflicts among the participants.

The "put-up-or-shut-up" ploy and solution can be found in many contexts. This Article will examine two of those. The first involves planning for the additional capital needs of a real estate development syndication. To set the stage for the "put-up-or-shut-up" discussion in this context, the Article will examine in some detail the additional capital problem, which is an interesting, important, and often ignored aspect of business planning. The second context involves the over-budget problem in motion picture production. The discussion of the ploy and solution in the real estate and motion picture settings is broadly applicable to contingent payments, including bonuses and other such com-

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pensation to executives and other providers of services. These are briefly discussed at the conclusion of the Article.

I. Additional Capital in Real Estate Development Syndication

The problem of raising additional capital presents special difficulties when the venture is small and when, as a result, any additional capital needs most likely must be met by existing investors. The problem can arise in any business setting,[1] but the real estate development syndication offers the best opportunity for clear illustration of the "put-up-or-shut-up" solution.

Suppose that a real estate promoter proposes to develop a shopping center; that the promoter estimates that she will need $10,000,000 to build the facility and to sustain it until rental receipts are sufficient to cover all outlays; and that she has arranged to borrow $9,000,000 and seeks to raise the remaining $1,000,000 from 40 investors (at $25,000 each), who will become limited partners in a partnership in which the promoter will be the sole general partner. Before committing themselves, the investors should ask themselves what will happen if, because of misfortune or mismanagement, the promoter runs out of money before the rents begin to cover required outlays.

It will be helpful to make the potential problem more concrete. Suppose that the investors envision the following scenario: There are delays in construction due to bad weather (beyond allowances made by the promoter); there are cost overruns due to geological problems; and rental deposits are not generated at the expected rate. All the money has been spent. The lender threatens to foreclose and sell the project at a public auction. It is anticipated that if this happens the proceeds will be $9,500,000, but the selling expenses will be $500,000, so the investors will be left with nothing.[2] The expected selling price of $9,500,000

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[1] *See* W. Klein, Business Organization and Finance 75-79 (1980).

[2] The problem is most serious when the value of the equity investment has declined. If the investment value has risen, the promoter may be able to borrow to meet cash-flow needs. Moreover, the existing investors may be more willing to supply additional funds than they would be in a disappointing venture. As will be demonstrated in the discussion that follows in the text, where the project has declined in value, and if new funds entitle contributors to participation in the equity of the firm at the same rate as the initial funds (as opposed to the present reduced value of the initial funds), then those partners who do contribute subsidize those who do not. *See infra* text accompanying notes 3-8. When the project has increased in value, those partners who are unable to contribute their pro rata share will sacrifice value to those who do contribute, if the same participation formula is used. In either case, the people who seem to be the losers

suggests that the equity interest of each investor is worth $12,500, or half the initial investment of $25,000 — if, and only if, liquidation can be avoided. Otherwise the equity is worthless. Suppose further that the promoter now says that if she can raise an additional $500,000 she will be able to complete the project to the point where it will sustain itself. The project will then be worth $10,000,000, as initially projected, and the interest of each investor will be worth $25,000. In other words, if the promoter's present projections are accepted, and if each investor advances an additional $12,500, the project will be saved and each will have an investment worth $25,000. If the money is not raised, however, the interest of each will be worth nothing. Assume further that it is an all-or-nothing proposition. Unless the full $500,000 can be raised, eventual liquidation and the loss of all that was invested is virtually inevitable. So, if each investor puts up the additional $12,500, they all gain $12,500 (winding up with a $25,000 investment for their additional $12,500). If any investor refuses to put up her share then all is lost. The scenario is simplified and overdrawn but it is nonetheless a reasonable representation of a grim reality that can be encountered by investors.

Under partnership law, assuming that the partnership agreement is silent as to the problem, the general partner cannot compel the limited partners to contribute additional capital,[3] nor can she (without the unanimous consent of all the partners) raise additional equity capital[4] from the present limited partners[5] or from new investors.[6] Given this legal posture and the practical problem that it creates, one might suppose that lawyers drafting limited partnership agreements for the kinds of situations contemplated in the present hypothetical would provide some mechanism for raising new equity capital from existing or new

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may be better off than they would be if the new funds could not be obtained at all, and their initial investments were lost. *Id.*

[3] *See* U.L.P.A. § 17(1) (1969). In a general partnership, since decisions are made by majority vote, U.P.A. § 18(h) (1969), and since the partners are jointly liable for all legitimate partnership debts, U.P.A. § 15 (1969), the majority can borrow money or incur other obligations for the partnership and thereby draw on the credit of all the partners. *See* A. BROMBERG, CRANE AND BROMBERG ON PARTNERSHIP 366-67 (1968).

[4] It is assumed that because of the very high ratio of existing debt to equity no additional funds could be raised by borrowing.

[5] The sale of any new equity interest would reduce the equity share of existing partners. This is the kind of fundamental change in the partnership relationship that cannot be made unless all the partners agree. *Cf.* A. BROMBERG, *supra* note 3, at 276 (agent's authority does not bind the partnership if the change is fundamental).

[6] *See* U.L.P.A. § 25(1)(b) (1969).

investors. Often lawyers do not and perhaps one reason is that the solutions are all objectionable for one reason or another. One approach sometimes used is to grant to the general partner authority to seek additional funds from the existing partners, with new money coming in, in effect, at the same value as the old money, with the interests of noncontributing partners "diluted" accordingly. In the situation hypothesized, this solution is not likely to work because it fails adequately to compensate the contributing partners. To illustrate this point, suppose that half of the limited partners decline to contribute and the other half are asked to contribute $25,000 each in order to pick up the slack. By hypothesis, the total value of the partnership interests will be $1,000,000. Half of that value comes from the existing equity (assuming that liquidation can be avoided) and half comes from the new money. Under the formula suggested in this paragraph, the new money receives one third of the equity while the original money receives two thirds. This is because the original contribution or old money is still counted under the formula as $1,000,000 (rather than its present value of $500,000) and the new money counts for its face amount of $500,000. Thus, a person who contributes an additional $25,000 winds up, by virtue of that contribution, with a new interest worth $16,667.[7] The total value of her original interest ($16,667[8]) plus the new interest ($16,667) is $33,333. Since the outcome if the funds are not raised is a worthless investment, there is a sound economic incentive for contributing the $25,000 (even though half of the investors contribute nothing). By contributing $25,000, an investor generates an investment worth $33,333, producing a gain of $8,333 (compared with the worthless investment that the investor will have if the additional $500,000 is not raised). On the other hand, the alternative of refusing to contribute leaves the investor with $26,667, assuming the other investors are induced to contribute. In other words, if others can be counted on to contribute, the choice is between hanging on to one's $25,000 by refusing to contribute and winding up with that plus $16,667 (the value of the original investment) for a total wealth of $41,447 or contributing the $25,000 and winding up with a total wealth of $33,333. Anyone who notes that $41,447 is greater than $33,333 will want to be among the

[7] By hypothesis, 20 of the original 40 partners contribute $500,000. For this contribution they receive a one-third interest in the total equity in the project. The total equity is worth $1,000,000, one third of that is worth $333,333 and the pro rata share allocable to each of the 20 contributors is $16,667.

[8] The total value of the original interests is, under the formula, two thirds of the total value of $666,667. There are 40 shares, each of which will be worth $16,667.

group of noncontributors. Altruism, a sense of fairness, or social or economic pressures might induce sufficient contributions, but the outcome will be unfair and it is certainly not one that people would choose if they could bargain over the matter at the outset.

A more sensible solution might be to give the general partner authority to borrow or to raise additional equity capital on the most favorable terms she can find, either from insiders or from outsiders (possibly contingent on the consent of a majority of the partners). If the venture had been organized initially as a corporation, that option presumably would be available without special agreement (disregarding preemptive rights and assuming that the decision to raise the funds was made in good faith).[9] This solution also has serious drawbacks. If the need for additional funds has arisen as a result of mismanagement or misfortune causing a decline in the value of the equity, the likelihood of borrowing is very small; the leverage would simply be too high. At the same time, outsiders with potential equity funds will be hard to find, for several reasons. First, the promoter probably will have drawn on all her sources in putting together the initial $1,000,000. The "search" cost for additional funds will reach high levels. More important, potential investors will be skeptical of the project's value. They will wonder why the existing investors are not putting up the funds, and they will be on their guard and will want to do some careful, costly investigation. As a result, they are likely to be willing to invest only at a price that the insiders will consider unreasonable.

Insiders, those who are already investors, may seem to be a better source of the additional equity funds. Their information costs are likely to be much lower. But if they are not obligated to invest, the insiders may be willing to invest only on the same terms that would be available from an outsider. There is no reason to assume that they will refrain from driving a hard bargain, and the bargain they may be able to insist

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[9] In the absence of bad faith, the sale at a fair price of new shares of stock by a corporation is permissible despite objection by a minority shareholder who claims that she lacks sufficient funds to buy those shares. The new shares can be sold either to existing shareholders or to outsiders. *See, e.g.*, Bellows v. Porter, 201 F.2d 429 (8th Cir. 1953); Hyman v. Velsicol Corp., 342 Ill. App. 489, 97 N.E.2d 122 (1951); Maguire v. Osborne, 338 Pa. 121, 130 A.2d 157 (1957); *see also* Katzowitz v. Sidler, 24 N.Y.2d 512, 249 N.E.2d 359, 301 N.Y.S.2d 470 (1969) (protecting a minority shareholder from issuance of low price stock rights in a plan with no business justification, when the objective and effect was to take unfair advantage of the minority shareholder). In *Katzowitz*, the court observed that normally a shareholder is protected by the opportunity to sell the rights, but that this is not an adequate protection in the case of a close corporation with only a very limited market for its shares.

upon will be strongly influenced by the availability of funds from outsiders. Yet, even in partnerships with many partners who are mostly strangers to one another, there may be some feeling of involvement in a common cause, with an implicit promise to cooperate, to refrain from pushing others to the wall, and generally to treat others as one would treat one's good friends. If so, and assuming that the price outsiders would be willing to pay would seem unreasonably low to insiders, then if some existing partners insist on essentially the same price for any new funds that they contribute, the noncontributing partners are likely to feel aggrieved. Moreover, the less knowledgeable partners may want to wait to see what the more knowledgeable partners do, with the result that the process of finding the right amount of money from each partner may be difficult and time consuming. Similar problems may arise with other approaches such as use of the present fair market value of the project to determine the share of the new money[10] or "penalty"

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[10] Thus, in our example, if 20 partners contributed $25,000 each, for a total of $500,000, then assuming a fair market value of $500,000 for the period before the new contribution and a corresponding value of $1,000,000 after the contribution of new money, the new money would receive half of the new equity. The half would be worth $500,000, which is equal to the amount paid. The original interests would be worth $500,000, or $12,500 each. No one would gain or lose as a result of the new contribution. Lawyers and business people often describe the outcome as one in which the original interests are "diluted." It is clear, however, that there is no financial dilution by virtue of raising the new money. The original interests were diluted in value by the misfortunes of the venture, not by the contribution of the new money. There is, of course, a dilution in voting power, but in most instances this is of little significance. *But see* Note, *Freezing Out Minority Shareholders*, 41 VA. L. REV. 77 (1955), discussing the role of preemptive rights in protecting minority shareholders of ordinary business corporations from dilution of their voting rights. It is a simple proposition stemming from basic concepts of fiduciary obligation that people in control of a business should not be allowed to sell new equity interests solely for the sake of extending their powers. *See* W. CARY & M. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 1096-1101 (5th ed. unabr. 1980). Apart from problems suggested in the text, a solution in which the sharing of equity is determined by reference to the fair market value of the existing equity requires a determination of the amount of that fair market value. That determination is likely to be speculative and uncertain, especially, as here, when the leverage is extremely high and when, as a result, any variation in the estimated total value of the project is highly magnified when translated into a value for the equity.

Note that as the value of the equity declines, the debtor's risk of loss rises and the debt's expected return declines. Thus, the equity does not sustain the full amount of any loss in the project's value. Correspondingly, as new equity funds are added, the value of the debt rises and the value of the equity does not rise by the full amount of the contributed funds. Hence, even if the present equity owners could continue without the new money, the fair market value of their equity may be less for purposes of determining the cost of raising new equity funds than for purposes of determining the dilution.[11] These solutions[12] may work well in particular instances, but they all create the risk that some investors will feel aggrieved or, even worse, that the money will not be raised.

Keeping in mind the difficulties of the various solutions thus far suggested, let us reexamine the problem from the perspective of an investor who has been approached by a promoter seeking funds. The concern of the investor is that the promoter may run out of money, which would most likely be a result of the promoter's mismanagement, miscalculation, or both. (Even the effects of bad weather can be predicted and planned for, and insurance can be obtained to protect against the "unpredictable.") Thus, the problem is one that the promoter has the power to avoid. It is also one about which the promoter may have some inclination to be dishonest or at least disingenuous. With these thoughts in mind, the investor might lead the promoter into the following kind of dialogue:

I (investor): I'm worried about what happens if we run out of money.

P (promoter): I assure you that there is no cause for concern.

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amount a buyer willing to continue with the present leverage might pay for it.

[11] The phrase " 'penalty' dilution" is used to refer to provisions that encourage new contributions by allocating to the new money a greater share of the equity than that which would be allocated by comparing the value of the new money with the present value of the existing equity. Such provisions may take either of two forms. In one form the agreement among the partners (or other investors) requires contribution by the partners of an additional sum called for by the general partner (perhaps subject to some limit), and goes on to provide that the remedy for breach of the obligation to contribute is dilution of one's equity interest under a formula. In the other form, the partners agree that if new money is needed they will be allowed to contribute pro rata and that the new equity's share of the total equity will be determined by the same formula. The formula will be designed to penalize the noncontributing partners. For example, the formula might provide that the new money will count for four times the original money. Thus, in the example in the text, the new money ($500,000) would receive 80 percent of the equity. A contribution of $12,500 of new money would result in an investment worth $20,000 while the value of each of the initial 40 interests would be $5,000. Obviously, partners who are unable to contribute new money will suffer. The intended effect is to force people to contribute and many investors object to such a future contingent obligation.

[12] For other variations, see 4B BENDER'S FORMS FOR THE CONSOLIDATED LAWS OF NEW YORK, Partnership Law § 10, Forms 62 & 69 (1975); J. MULDER & M. VOLZ, THE DRAFTING OF PARTNERSHIP AGREEMENTS 65-66 (1955); J. RABKINS & M. JOHNSON, 1 CURRENT LEGAL FORMS WITH TAX ANALYSIS, Form 1.30 (1981). None of the solutions provided in these forms seems to avoid the problems discussed in the text. For further discussion, see Coleman & Weatherbie, *Special Problems in Limited Partnership Planning*, 30 SW. L.J. 887, 909-11 (1976); Comment, *Drafting Problems of Partnership Agreements*, 40 CALIF. L. REV. 67, 73-76 (1952).

I: But what if you are unable to find tenants?

P: That's no problem. I know the market. There are all sorts of people out there desperate for what we will be offering.

I: Are you sure? What experience do you have?

P: I'm absolutely certain. I've been in this business for twenty-five years and I have thoroughly surveyed the market. And as I told you, I am investing not only my time but my own money as well.

I: What if the construction is delayed by bad weather?

P: I've made all allowances for that. The average number of rainy days in the period in which we will be building is fourteen and in my budget I have allowed for a delay of thirty days.

I: Are you confident that the general contractor knows how to deliver on schedule?

P: Certainly. She's one of the best in the business. I've dealt with her before and I've never had a problem. Besides, I'll be watching the whole thing carefully myself.

I: Well, it sure sounds good. What you're telling me is that if I trust your judgment I have nothing to worry about.

P: Right.

I: I want you to know that I do trust you, but just to give me some peace of mind (and to give me a better basis for recommending this investment to those friends of mine I mentioned to you), why don't you agree that if we run out of money you will lend the needed funds to the partnership without interest?

P: Now wait a minute. Why should I take that risk?

I: What risk? You just told me that there is none and that I should trust you. Do you trust yourself? If so, you should not hesitate to supply the guarantee I am seeking. You have told me there is no risk and now all I am asking is that you put-up-or-shut-up.

P: You're absolutely right. I agree.

I (to herself): Gotcha.

P (to herself): This tightwad has more brains than I gave her credit for. But I was prepared to give up on this issue at the outset and it's all factored into the terms of the deal anyway.

End of dialogue.

The "put-up-or-shut-up" ploy works in this scenario. Even if the promoter had had some doubts, she has been put in a position in which she cannot admit them. And if she was lying, she has been forced to live with her lie. Not only has the ploy worked, the problem (from the perspective of the investor) has been solved (assuming that the promoter has the necessary funds to back the guarantee). Indeed, sophisticated, reputable promoters will have had experience with the problem, will appreciate the message of the ploy, and often will include in their initial proposals the kind of agreement extracted by the investor in our dialogue. Such promoters will then be able to use that element of the proposal as a selling point.

From the investor's perspective the "put-up-or-shut-up" solution yields at least three potential benefits with corresponding potential costs. First, the solution bridges a gap in perceptions. The investor may doubt the promoter's honesty or candor. The solution eliminates the basis for this concern. Putting aside questions of honesty, the solution capitalizes on a difference in perception between the confident, optimistic promoter and the cautious, worried investor. The investor perceives that there is a significant danger of running out of money, while the promoter perceives that the danger is minimal. When the promoter solves the investor's problem by agreeing to lend the money, she believes she is giving up very little. At the same time, the investor thinks that she is getting something of substantial value. In a sense, the investor gets something for nothing. Of course, if the promoter was misrepresenting the degree of risk, then she really is giving something up, but, depending on the degree to which she failed to anticipate the ploy, she may be unable to extract something else from the bargain in return.

Second, the promoter's incentives will be changed, at least to the extent that the promoter thinks that there is some risk. She will have an added incentive beyond those created by other features of the bargain, such as a share of the profits, or by a concern for her reputation, to exercise skill and care in planning and managing the project. These incentives may tend to align the promoter's interest more closely with those of the investor. To the extent that that happens, conflict of interest will be reduced. Unfortunately, the incentives could turn out to be perverse. Some risks may be worth taking in the investor's interests (for example, turning down a present rental opportunity in the expectation of a higher rent from some other prospect). The promoter may be induced by her fear of the consequences of running out of money to incur avoidance costs or avoid taking chances[13] to a greater degree than the investor's calculus of the appropriate trade-off between risk and return would dictate. Moreover, if the promoter runs out of money and is forced to lend money to the partnership, she may become excessively concerned with generating immediate returns to repay the loan at the expense of long run gains. It may be possible to mitigate such perverse

[13] For example, she may incur costs by hiring engineering or geological services or by declining to hold out for higher rents.

incentives by allowing the promoter some reasonable, though perhaps below market, interest on the loaned funds. The interest payment may be a method of fine-tuning the agreement to optimize incentives.

Third, the investor will have gained the obvious advantage of shifting a risk to the promoter. At first blush this may seem to the investor to be an unalloyed benefit, but the promoter is likely to extract a price if she perceives the risk to be significant. Putting aside the possibility of differences in perception, if the investor is better situated to bear the risk than is the promoter, and if the risk is borne by the promoter, the subjective expected cost rises. The size of the pie shrinks and one expects that to that extent the loss will come out of the investor's slice or the promoter's slice or partly from each. This observation implies, of course, that risk should be borne by the person best able to bear it.[14]

Plainly, the solution will be a good one at times when there is a significant and sincere difference in perceptions, when the incentive effects are benign and when the promoter is the better risk bearer. In other situations, the incentives may be perverse, or the promoter may be the inferior risk bearer, or both. The solution may be a bad one on both of these counts or on the balance of them. But if the difference in perceptions is great, the ploy may work and that bad solution may be adopted.

The foregoing discussion glosses several problems that will be considered in more detail later but deserve mention at this point. First, in the case of a typical real estate promoter and group of investors, the effect of the solution on incentives probably would be attenuated because the promoter is likely to think that the risk of running out of money is small. Given that frame of mind, the promoter's acceptance of the risk is not likely to have much effect on her behavior. This will be true to some degree in all such situations because for the ploy to work there must be a likelihood of genuine difference in perception of risk and low perception of risk means low incentive effects. In other situations, the level of risk perceived by the more optimistic party still may be high enough to affect behavior. In the most common situations, however, the

[14] Disregarding differences in perception as to the degree of risk, the best risk-bearer will be the one who is least risk averse. Risk aversion is partly a function of one's temperament and partly a function of one's wealth. Promoters are likely to be more optimistic, and therefore less risk averse, than investors. On the other hand, the amount involved may be large in relation to the promoter's total wealth while it would be much smaller in relation to each individual investor's wealth, which will tend to make the investors the better risk-bearers. This kind of observation suggests that some sort of compromise might be sensible, such as a provision for a loan by the promoter with subsequent full or partial shifting of liability to the investors.

risk may seem to the person rendering the service to be small because that person's perception of risk is largely dependent on her effort or diligence. To the extent that the risk is perceived to be a function of future behavior within the control of the person who bears the risk, the ploy is likely to be effective and the incentive effects powerful.

Second, the discussion of the real estate promoter and the investor has barely adumbrated the possibility that a price might be extracted by the promoter in return for agreeing to accept the risk. The ability to extract some such price will depend on the perception of both parties as to the degree of the risk and as to the degree to which the other party wishes to avoid that risk. The possibility of some price being paid for accepting the risk changes the calculus of benefit to the two parties in ways that make the analysis complex.

Third, the thought that a price might be extracted for accepting risk suggests further analytic problems arising from the possibility that the transacting parties may lie about their perception of the risk. For example, in the real estate scenario, an investor might think that the risk of running out of money is low but might lie about her perception and then agree to accept the risk in return for favorable treatment on some other aspect of the deal. When there are many investors, that possibility is not realistic. Many investors are a necessary condition in generating the additional capital problem.

Fourth, we have not explored solutions involving the shifting of risk to a third person — to someone willing to act for a price as guarantor and monitor of the principal performer of services. This possibility is best examined in the context of motion picture production.

II. The Overbudget Problem in Motion Picture Production

As with real estate development, motion picture production is an enterprise with a limited, relatively short duration and a well-defined project. One of the important attributes of such a venture is that it is possible to specify a budget and a timetable. This reduces problems of control that participants confront in economic ventures with a longer expected duration and some vaguely defined objectives. The budget becomes part of the contract or set of contracts. The parties accept the budget as a part of their deal. As with any other contract provision, in order to give contractual meaning to this term of the contract, one must know what happens if the budget is exceeded. This section examines this question, and its relevance to the "put-up-or-shut-up" strategy, by focusing on the producer and the studio in a deal in which the studio is to provide financing and distribution for a film project that has been developed by the producer. This deal concerns a two-part transaction in contrast to a multi-party transaction involved in the real estate development scenario. In the real estate development example, it is unrealistic to imagine that the investors will accept the risk of running over budget. In addition, difficulty of communication among the investors limits the possibilities for a bargaining process to resolve the over-budget problem after it arises. Those attributes are altered when we shift to a two-party transaction. At the same time, strategic lying becomes a more realistic problem.

Suppose that a producer, *P*, has invested her time in finding a story, developing an outline for the film, and lining up some key performers to create a viable film-production project. She calculates that she will need $10 million for the project (including the fee for her own services) and seeks these funds from a major studio, *S*. It is understood that if the studio supplies the funds, it will also act as the film's distributor. Assuming that *S* likes the project and is inclined to back it, a complex contract will be required. The contract will call for a budget and a schedule. One of the issues to be determined is what happens if the film runs over budget. Assume that *P* and *S* have agreed on and signed up a writer, a director, and the key performers. While this eliminates an important control issue, control over other aspects of the production remains a matter of serious concern. *S* will have some considerable additional powers of control (including the power to take over the production if it runs over budget), but the prime authority and responsibility to control production will be *P*'s. Consequently, it is reasonable that responsibility for exceeding the budget, except when the cause is a natural disaster or something of that sort,[15] will be *P*'s.

Assume that *P* has a net worth of $3 million and that the possibility of the film going over budget by $1 million or more is significant, but the possibility of it going over by more than $3 million is negligible. Is it realistic to suppose that *P* and *S* might reach an agreement under

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[15] *See, e.g.*, CBS Theatrical Films Production, *Definition of Net Profits,* in THE NEW ECONOMIC GAME: MONEY AND MOVIES, THE SIXTH ANNUAL UCLA ENTERTAINMENT SYMPOSIUM 592 (G. Stiffelman, C. Cuddy & M. Lauer eds. 1981):

> [E]xcess costs incurred due solely to force majeure (other than weather), new (as opposed to redone) scenes, written direction from an executive officer of Producer over the written objection of Participant, and retroactive increases to scale personnel under collective bargaining agreements (which were not reasonably foreseeable in the Approved Picture Budget) are excluded from the overbudget computation.

Id. at 607.

which costs in excess of the $10 million budget will be borne by *P*, subject to some right of recoupment out of returns from ultimate revenues from the film's exhibition and from ancillary sources? Ordinarily the answer is no for several reasons. First, the resources of *S* are far greater than those of *P*. *S* can far more easily afford to spend and lose an additional $3 million, or whatever other sum is needed, than can *P*; it is much better able to bear the risk. If *S* insisted that *P* bear the risk, *P* would want to be compensated for doing so and the amount of compensation that *P* would require would be far greater than the amount *S* would be willing to pay (or greater than the amount *S* would be willing to accept to take the risk). Second, *S* should worry about perverse incentives. To some extent the incentives arising from imposing the burden of going over budget on *P* would be good ones: she would be worried about costs and would seek to keep them under control. The danger of *P* being too stingy or too miserly can be alleviated by allowing for waiver; that is, by permitting *P* to add items to the budget during production with *S*'s consent, a process comparable to a change order in a construction contract. There will remain some danger, however, that out of fear of her personal exposure to risk, *P* will order shoddy sets, or refuse to reshoot scenes.

Placing the risk on *P* is a "put-up-or-shut-up" ploy to the extent that *P* is responsible for setting the budget. If she sets the budget by herself and then accepts the risk, *P* would simply be required to live with the consequences of her implicit representations that the film could be produced within the budget. By the same token, to the extent that *S* imposes a budget on *P*, the "put-up-or-shut-up" ploy loses its force, but even if *S* does play a major or dominant role in setting the budget, *P* will be required to accept it, and, at least implicitly, to represent that she can live with it. In any event, *S* will want to create an incentive for *P* to respect the budget. We have seen that requiring *P* to meet all the overbudget expenses out of her own pocket is not likely to be regarded as an acceptable solution.

A. *The Overbudget Penalty*

A more plausible outcome, and one that is in fact common in motion picture production/finance/distribution agreements, is to impose an overbudget penalty of some sort. Thus, *P*'s compensation is likely to consist in part of a fixed fee payable in large part as the film is produced.[16] Part of the fixed fee may be deferred until the film is com-

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[16] *See, e.g.*, ABC Motion Pictures, Inc., *Producer Contracts,* in THE NEW ECO-

pleted or until it produces profits. In addition, *P* is likely to be entitled to compensation in the form of a share in net profits.[17] Either of the deferred types of compensation can be reduced according to a formula taking account of the amount by which the project has gone over budget.[18] The deferred compensation could be reduced, for example, by ten cents, or by ten dollars, for every dollar over budget, or by any other amount that *P* and *S* agree upon.[19] Thus, the overbudget penalty can be finely tuned to achieve the proper balance of risk bearing and the appropriate incentives. Given the "put-up-or-shut-up" concept, *P* will be hard pressed to deny the appropriateness of some such provision.

B. The Completion Guarantor

Another possibility sometimes used in the motion picture industry to deal with the overbudget problem is the use of a third-party guarantor called a completion guarantor. The completion guarantor is obligated either to supply the money to complete the film if it goes over budget or, if the project is abandoned, to make the investors whole.[20] Use of a

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NOMIC GAME: MONEY AND MOVIES, THE SIXTH ANNUAL UCLA ENTERTAINMENT SYMPOSIUM 528, 533-34 (G. Stiffelman, C. Cuddy & M. Lauer eds. 1981).

[17] *Id.* at 533-34; ABC Motion Pictures, Inc., *Definition of Net Profits*, in THE NEW ECONOMIC GAME: MONEY AND MOVIES: THE SIXTH ANNUAL UCLA ENTERTAINMENT SYMPOSIUM 558-73 (G. Stiffelman, C. Cuddy & M. Lauer eds. 1981).

[18] *See, e.g.*, ABC Motion Pictures, Inc., *Definition of Net Profits*, *supra* note 17, at 568:

> 3. "Overbudget Charge." If the Negative Cost (excluding this subparagraph 3) shall exceed the Budgeted Negative Cost of the Picture by seven and one-half percent (7½%) or more, then, as additional consideration for the increased risk incurred by ABCMP as a result of the additional investment in the Picture, there shall be added to the sums described hereinabove, for purposes of determining Negative Cost hereunder, an additional amount equal to the amount by which the Negative Cost (excluding this subparagraph 3) exceeds one hundred seven and one-half percent (107-½%) of the budgeted cost. For purposes of this subparagraph 3, the Negative Cost shall not include costs incurred solely by reason of force majeure events (including currency fluctuations, but not including weather), union increases which were not capable of being reflected in the budget, and overbudget costs incurred at the written request of an executive officer of ABCMP.

[19] *S* will want to be sure that the agreed upon amount is sufficiently within the boundaries of reason that it will be treated as "liquidated damages" rather than as a "penalty" for purposes of the rule of contract law under which "penalties" are unenforceable.

[20] *See* Completion Bond Company, Inc., Form Contract of Guarantee (copy on file

completion guarantor reflects a combination of (a) an unwillingness of the source of finance (especially a group of financiers with less resources than those of a major studio) to bear the overbudget risk, and (b) a perception on the part of *S* that the "put-up-or-shut-up" solution is not sufficiently effective to protect it against a significant risk — in other words, a perception that the producer doesn't have enough "put-up."

The completion guarantor is likely to perform functions that otherwise would be performed, or hired elsewhere, by the financier. Like most other insurers, the completion guarantor will investigate the nature of the risk by investigating the record and present condition of the producer. In many cases, it will monitor the producer's performance by observing the progress of the production and the fidelity to budget and schedule. The guarantor will be prepared to take over production, as permitted under its contract, if the producer's performance is deficient.

In addition, the completion guarantor may assume the role of "tough guy" if the project does go over budget or falls behind schedule. Consider again the example of *P*, a producer, and *S*, a major studio. Once *P* and *S* have entered into the agreement for production, they are likely to feel more like co-venturers than adversaries. *S*'s representatives may develop considerable sympathy for *P* and her problems. Their own reputations may depend on the film's success and in the face of production difficulties, they may be inclined, in a desperate effort to protect themselves, to take risks that would be unwise for the studio. Thus, if *P* goes overbudget, they may be reluctant to exercise *S*'s takeover rights. The top executives of *S* may be unaware of, or unable to control, this tendency. By bringing in a completion guarantor, those top executives in effect buy protection for *S* against the potentially costly consequences of such human frailty.

C. *Strategic Lying*

Again, think of *P*, a producer, and *S*, a major studio. Imagine them worrying about how to estimate the risk of going over budget and about how that risk should be allocated. Both *P* and *S* may have any of a

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at U.C. Davis Law Review office). The completion guarantor has three options if the film goes over budget: advance funds for completion; take over production and complete the production under its direction; or pay off the investors. As one would expect, the set of contracts defining the guarantee obligation gives the guarantor the power to monitor the production from day to day, and to protect itself at any stage, by takeover if necessary. *See also* PRACTISING LAW INSTITUTE, *Completion Bonds*, in LEGAL AND BUSINESS PROBLEMS OF FINANCING MOTION PICTURES, No. 110, 339 (1979).

wide variety of perceptions of the actual degree of risk. *P* or *S* may claim that the risk is high and expect to be compensated dearly for taking it. On the other hand, either claim may be made falsely, with a true perception of the risk at variance with the claimed perception. *P* or *S* may or may not believe the other and may or may not believe that the other believes its own claim. The degree of risk may be at any of an infinite variety of levels on a spectrum between very low and very high. It would be impossible to examine all possible combinations. It does seem useful, however, to examine two possibilities that suggest the nature of the process and some of the problems that can be encountered.

Imagine that *S* thinks that the risk of going over budget is relatively low because of the character of the director and the principal performers and the nature of the script. *P* also thinks the risk is low, but she claims that it is high. She does this because she knows that *S* is likely to insist on a tough overbudget penalty and believes that if *S* is convinced that the risk of going over budget is high she will be able to extract concessions elsewhere in the contract in return for accepting such a provision. Now return to *S*. First, assume that *S* believes that *P* is lying. *S* may simply call *P*'s bluff and give her nothing. This may not be a costless strategy, however. It could cause strain in the relationship. (After all, lying is not nice and is inconsistent with the relationship of trust that helps to make joint ventures successful.) Alternatively, suppose that *S* believes that *P* is telling the truth but that she is mistaken. *S* may conclude that it cannot afford to give *P* what she has demanded; that nonetheless, *P*'s demand is reasonable from her perspective; and that therefore a deal cannot be struck. Even if *P*, in the face of *S*'s refusal to meet her demands, abandons her demands for concessions elsewhere in the contract, *S* might be reluctant to enter into an agreement with her for fear that *P* would be the kind of unhappy participant who is likely to cause trouble in the future. Also, *S* might be worried that *P*'s concern with going over budget would make her too conservative in her decisions.

For another illustration, suppose that *S* believes the risk of going over budget is low, even with little or no overbudget penalty on *P*, but lies and says that it considers the risk to be high. *P* thinks the risk is high and truthfully says so (simply because she is honest). *S* lies about the risk in order to induce *P* to accept other onerous provisions, or a reduced fixed fee, in return for foregoing any significant overbudget penalty. In this situation, assuming that *P* believes *S* and is willing to make concessions, *S* will gain by the concessions and, if it is right about the risk, is not likely to lose much in the way of performance. *P* already believes that the risk is high and her concern with her reputation probably will be sufficient to provide adequate incentive to stay within the budget. In any event, *S* believes that the risk is low even without an overbudget penalty so a penalty is not needed as an incentive. *S* gets something for nothing. Is this too good for *S* to be true? Probably it is. A critical assumption is that *P* will believe *S*. But any person like *P* who is reasonably intelligent or experienced, or is represented by someone with these qualities, will realize that *S* has little to lose by lying. People like *P* will tend to assume that, or act as if, *S* is lying. To the extent that this is true, one worries about what happens in a situation in which *S* truly believes that the risk is high.

All of this merely adumbrates the problems of strategic lying. It might seem that the lesson of it is that people should not reveal their own estimations of risk and should disregard the representations of others. Unfortunately, this view ignores the need to adopt an agreement that allocates risk in a way that provides appropriate incentives. But one cannot determine what provisions are needed to accomplish this objective without knowing the true perception of the participants about the degree of risk. Thus, lying, and even the possibility of lying, may impede the process of drafting the soundest possible agreement.

D. Enforcement

Suppose that *P* and *S* adopt an agreement with a stiff overbudget penalty, that *P* is halfway though the production of the motion picture, and that *P* now foresees that she is going to wind up $2 million over budget. She goes to *S* and asks for a waiver of the overbudget penalty. In some circumstances, *S* may have no reasonable alternative but to grant the waiver. Replacement of *P* midway through the production may be extremely costly. If *P* knows that, and knows that *S* knows it, she can threaten, however subtly and politely, that if the waiver is not granted her performance will deteriorate. Carrying out such a threat might impair *P*'s reputation and might therefore be costly to her in the long run. That possibility might reduce the force of her threat. But a demand for waiver of an overbudget penalty is different from, say, a simple demand for more money. The former allows more scope for finding some legitimate entitlement, some rational basis — for instance, for attributing the overbudget problem to circumstances beyond *P*'s control. To the extent that *P* can generate (however disingenuously) such a basis for her request for a waiver into a grievance, the grievance can be used to excuse a decline in effort or efficiency and thereby to preserve reputation. In short, as all experienced business lawyers know, contracts for personal services are often difficult to enforce, and *S* may wind up with less than it bargained for. If *S* is a sophisticated consumer of such services, it will, of course, be aware of this possible outcome and will take account of it in the bargaining process. To this extent, *S* may not be victimized. Rather, both *S* and *P* are disadvantaged by their inability to reach an agreement that would be mutually beneficial if it could be enforced.

III. Other Applications and Conclusion

We have examined the "put-up-or-shut-up" ploy and solution in the context of the real estate development syndication and motion picture production. While those may be specialized areas of economic activity, they are good vehicles for discussion and the discussion is relevant to more common situations in which the ploy and solution can be used. One of these is the basic employment relationship. A brief examination of that situation will serve as a recapitulation of the basic themes of this discussion as well as a demonstration of its broader applicability.

Suppose that an employer, *E*, negotiates to hire a chief executive officer, *C*. *C* represents that she will do an outstanding job and that her efforts will substantially improve the profits of *E*. *E* is in a position to suggest that *C* accept some share of those increased profits as part of her compensation package, in lieu of high fixed compensation. *C* can scarcely deny the value of the contingent compensation. Assuming she accepts it, the solution will produce the three previously described benefits. First, if *C* is more optimistic about her ability to improve profits than is *E*, it will help to close any gap between *E* and *C*. If, for example, *C* becomes entitled to ten percent of profits, and if she thinks that those profits will be $2 million, while *E* thinks that they will be $1 million, *C* will think that she is getting twice as much as *E* thinks it is giving. Second, as a result of the contingent compensation, *C*'s incentives may be more closely aligned with those of *E* than they would be with only fixed compensation, though there is a risk of going too far and creating incentives inimical to *E*'s. Finally, *E* will have reduced its own exposure to risk of loss by agreeing to pay contingent rather than fixed compensation, though possibly at excessive cost if *C* is highly risk averse. The same principles apply to all employment relationships and to the compensation provisions of real estate syndicators, and promoters, and movie producers.[21]

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[21] The principles can also be applied to earn-out provisions used in connection with the purchase and sale of a business. For a description of such provisions, see Gunther, *Contingent Pay-outs in Mergers and Acquisitions*, J. ACCT., June 1968, at 33.