

**Final Offer Arbitration, Game Theory, and Real Estate**

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### **Abstract**

Final Offer Arbitration, commonly employed in real estate contracts, has been widely studied but primarily in the area of labor disputes. This paper applies the game theoretical models developed in the literature, particularly the work of Brams and Merrill, to the area of real estate, and reviews the results of an experiment in rent determination conducted with real estate professionals. The results of the experiment show consistently sub-optimal behavior by the bidders, which the paper attempts to explicate through ideas developed in the areas of utility theory and mean-variance analysis. The author provides some conclusions designed to assist practitioners.

### **I. Introduction**

Final Offer Arbitration (FOA) is a technique widely used to resolve disputes in real estate. In a survey of 103 brokers at the author's firm 42% had engaged in negotiations governed by FOA, and 16% had done such negotiations five or more times. In FOA (also known as "baseball" arbitration) each party submits an offer to an arbitrator, who must choose the bid that is closer to her perceived "correct" solution.

Oddly enough, the same survey revealed a distinct dichotomy on the reasons that baseball arbitration was regarded as being superior to so-called Conventional Arbitration (CA) in which an arbitrator is allowed complete freedom in selecting an outcome. When asked to choose a reason that FOA

was superior (among those who considered FOA better), 64% chose this statement:

Baseball arbitration is better than conventional arbitration because it makes the parties put forward less extreme positions than conventional arbitration, and therefore causes the parties to converge to a solution.

On the other hand, 26% selected:

Baseball arbitration is better than conventional arbitration because it threatens both parties, and therefore causes the parties to negotiate a settlement rather than run the risk of submitting to the arbitration.

In discussions with professionals that employed these methodologies, it was surprising to see that there was widespread disagreement about the effect of this common procedure on the bidders and arbitrators who employ it.

There has been broad research and publication on the subject of arbitration methodology, with one thread consisting of the application of the principles of game theory to procedures such as CA and FOA. In the pioneering work of Farber (1980) and Brams and Merrill (1983) the authors developed a game-theoretic model of the optimal behavior of two disputants and a neutral arbitrator.

Brams and Merrill derived optimal positions for FOA based upon the assumption (which we follow) that the arbitrator's position can be viewed as a normally distributed random variable. Their model's Nash-equilibrium bidding position implies that the players should bid significantly higher (lower) than from the hypothesized arbitrator mean position. They conclude in their original article and in their subsequent work, including *Negotiation Games* (Brams (2003)) that FOA is not, in fact, a convergent methodology.

## **II. Structure of this paper**

The paper is divided into three parts. It begins with a literature review and a synopsis of the Brams and Merrill model (the BMM). Next we present the results of

an experiment conducted to study the behavior of real estate professionals in mock arbitrations. Finally we look at the BMM in the context of utility theory and mean-variance theory, extending its conclusion and relating it to the experimental results.

All of the mathematical formulae in the paper are in Mathematica syntax. Also, we have generally taken the position of the landlord or maximizer in showing results. This was done only because it is slightly more intuitive to most readers to consider profit or utility maximization rather than cost minimization. The results can be generalized easily to include the minimization case.

### **III. Literature Review**

Research on FOA can be grouped into several areas. First, there is the development of what could be called the *fundamental model* and the solution of that model. This model is presented and developed in two articles that have led to a great deal of additional research. In Farber (1980), he establishes the game-theoretic framework of the FOA process. He provides a model for the expected utilities of the parties, and solves the model for the Nash equilibrium final offers that the parties should employ to optimize their position. He assumes, as do most others and as we follow in this paper, that the arbitrator can be viewed as an exchangeable random variable with a mean and standard deviation.

Brams and Merrill (1983) extended this work by exploring different distributions for the arbitrator random variable. In this article they found that a wide variety of distributions could be employed and solved. In particular unimodal and symmetric distributions (such as the normal) were thoroughly analyzed.

A second area within this research concerns the topic of *risk aversion*, which was incorporated into Farber's model in the form of a utility function. In the interests of defining necessary and sufficient conditions for various distributions, this utility function was not in the Brams and Merrill model.

Farber observes that a risk-averse party will make less extreme offers and will win in the arbitration more often. These results were empirically and mathematically studied by Ashenfelter and Bloom (1984) who examined two sets of arbitrations stemming from NJ municipal labor negotiations, one set settled via CA and the other settled via FOA. In the FOA set, they observe that union offers are accepted more frequently than employers, when symmetrical behavior by the protagonists and fair judgment by the arbitrator would suggest an equal distribution of outcome between the two parties.

They evaluated and rejected the idea that the arbitrators were biased, instead concluding that the union side consistently sub-optimized their bids and therefore prevailed more often. Various explanations for this have been put forward by Ashenfelter and Bloom (in this and in subsequent work in 1991) and by Brams and Merrill.

The sub-optimizing behavior (in the sense that union "victories" in FOA lead to lower wage increases than in CA) could result from a structurally different approach by union officials from the approach adopted by representatives of employers. In Brams and Merrill (1991) they suggest a "bonus" formulation for winning. This internal bonus can be used to explain the consistently sub-optimal bidding by the unions, which (however) results in their winning 69% of their FOA arbitrations. The basic concept is that unions derive greater utility from victory (perhaps based upon their constituents' reactions) than do representatives of municipal employers.

Kilgour (1994) makes the point that the zero sum nature of the game fails when the bargainers have utility functions that are not linearly related, for example when one party is fundamentally more risk averse than the other. He goes on to prove that the more risk-averse party will tend to make less extreme offers, and to win more frequently than the more risk-neutral party. He reviews both the data from municipal union negotiations and from Major League Baseball, and finds it paradoxical that management bids more conservatively and wins more often in baseball, but management bids more aggressively and wins less often in union

negotiations. Several researchers have commented that the anomalous nature of baseball players (who have overcome enormous odds to get to the major leagues and are paid enormous salaries) might make them effectively risk seekers in their salary negotiations. Faurot and McAllister (1992) hypothesize that more risk averse players might avoid arbitration, while more risk-seeking players go to the end of the process. He is somewhat disappointed however, that a consistent attitude toward risk on the part of players is difficult to reconcile with the empirical data.

Marburger and Scoggins (1996) find evidence that more marginal baseball players are less likely to engage in FOA, and suggest that the MLB results show the self-selection that comes from players with better historical results and therefore less risk of "input substitution." Thus, some players exhibit risk averse behavior and others exhibit risk seeking behavior, based upon their historical performance.

Throughout the literature on negotiation there is a concept of the contract zone—that range of overlapping outcomes that each party finds superior to impasse. Dickinson (2004) shows that the more risk aversion that players have, the broader their contract zones become, and therefore the more likely that they reach a negotiated settlement.

On a separate track, several researches have attempted to determine whether in practice (either in experiments or in documented cases such as described above) CA and FOA differ markedly in their convergence. For example, Ashenfelter et al. (1992) achieved some surprising results when testing CA against FOA. Their data suggested strongly that baseball players are less likely to come to a negotiated solution when FOA is employed than when CA is employed, which is directly contradictory to the conventional wisdom. They also found no strong evidence of risk averse, sub-optimizing behavior under FOA.

Of particular interest to real estate practitioners is the work of Ashenfelter and Dahl (2005) in which they analyze the data from arbitrations under the New

Jersey Fire and Police Arbitration Act over a longer sample horizon than their initial analysis. They find that this longer sample shows a consistent dampening of the asymmetrical result that dominated their 1984 analysis, and they attempt to explain this by analyzing the changing role of *expert agents* in the outcome of bargaining and arbitration. They conclude that expert agents improve the probability of winning for the side that hires them, both by influencing the decisions of arbitrators and by moderating overconfidence on the part of their clients. The spread of the use of such agents in their sample explains the gradual equilibration of outcome between management and labor. However, they also conclude that this advantage over time has transformed into a classic prisoner's dilemma situation, in which parties almost universally employ agents, thereby neutralizing the benefit to both parties.

#### IV. Basic model

Farber and Brams and Merrill's model both consisted of three steps: a) defining a payoff function for the problem that states the expected outcome to the participants; b) determining a maximum point for that function and c) determining whether that maximum point is locally or globally maximum.

A key to constructing such a payoff function is determining the manner in which the arbitrator is hypothesized to behave (the arbitrator function). While Brams and Merrill studied a wide variety of arbitrator distributions, this paper will focus exclusively on a very tractable and perhaps the most logical distribution, the normal. This requires us to follow the assumption that both parties have similar information about the arbitrator's function, and so we can assume that both parties know the mean and the standard deviation of the arbitrator's position. Real estate, with its well-established databases on comparable transactions, is a good example of a field in which the normality assumption should hold.

First, we state the Brams and Merrill payoff function. Let **a** be the bid of the minimizing party and **b** be the bid of the maximizing party. The payoff ( $g[a,b]$  in Figure 1) will be:

$$g[a_-, b_-] := a F\left[\frac{a+b}{2}\right] + b \left(1 - F\left[\frac{a+b}{2}\right]\right) \quad \text{Figure 1}$$

Where F is the CDF for the normal distribution, as in Figure 2:

$$F[x_-] := \int_{-\infty}^x \frac{1}{\sigma \sqrt{2\pi}} e^{-\frac{1}{2} \left(\frac{t-\mu}{\sigma}\right)^2} dt \quad \text{Figure 2}$$

The  $\mu$  and  $\sigma$  are the assumed mean and standard deviation of the arbitrator's (normal) preference function.

The payoff function basically states that the expected outcome of the arbitration starts with the probability that the arbitrator's choice is above or below the midpoint of the two bids. The probability that the arbitrator will choose a position below is multiplied by **a**'s bid, and one-minus that probability is multiplied times **b**'s bid. The sum of the two is the expected outcome.

Using some realistic parameters, we can graph the BMM. We assume that FOA is being employed for a real estate rent arbitration. Based upon the analysis of transaction comparables, we assume that the arbitrator's choices will center around a mean rent of \$40 with a standard deviation of \$10. These mean and standard deviation assumptions will be used throughout the balance of the article.

Figure 3 graphs the expected outcome of the arbitration. It shows the characteristic saddle shape of a Nash-equilibrium problem.

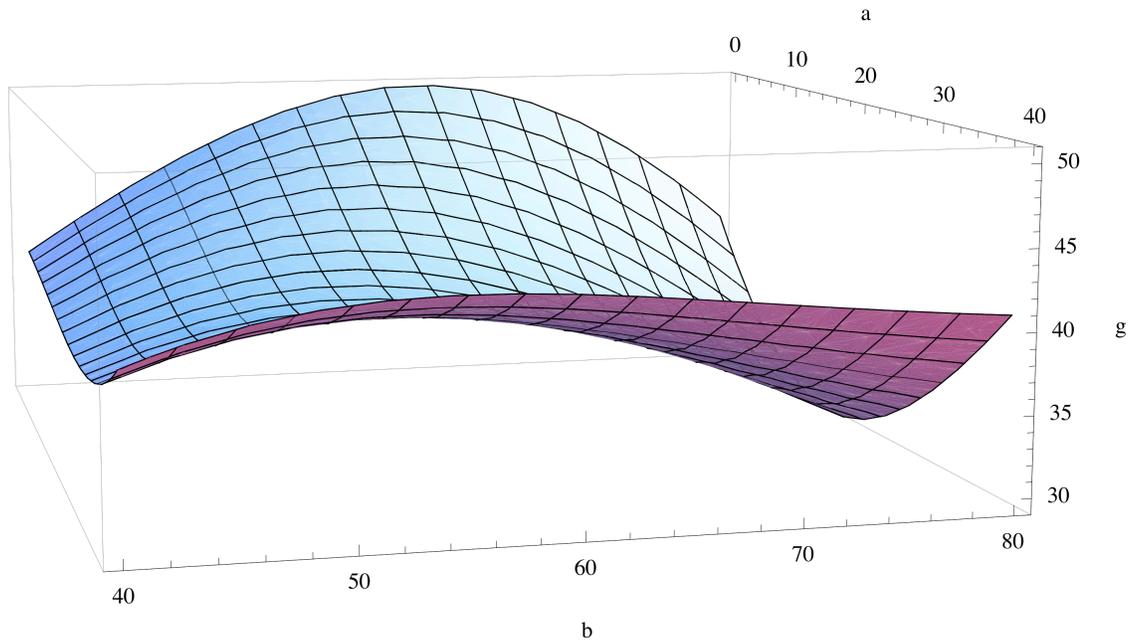


Figure 3

By taking the first derivative of the payoff function **g** and with a little algebraic manipulation, it can be determined that the optimal bids (with **a** being the minimizer and **b** being the maximizer) are as in Figures 4 and 5:

$$\mathbf{a} = \mu - \sqrt{\frac{\pi}{2}} \sigma \quad \text{Figure 4}$$

$$\mathbf{b} = \mu + \sqrt{\frac{\pi}{2}} \sigma \quad \text{Figure 5}$$

By taking second derivatives it can be determined that these optima are global for each of the players. These results indicate optimal bids of approximately

\$52.50 for the landlord and \$27.50 for the tenant, which as Brams points out, is hardly a convergent outcome.

Divergence is caused by the following simple fact; each player has to make an offer that balances her increased payoff amount against the decreased probability of succeeding in the FOA. In a normal distribution there is a great deal of probability clustered near the mean, and this increased probability slopes away rapidly on each side of the mean.

It is interesting to note that these are the optimal solutions based upon the assumption that the other party is bidding in a purely rational and informed way with no risk aversion or risk seeking. If the opposite party is risk averse or unaware of her optimum bid, then the best strategy changes. Figure 6 shows the fact that foreknowledge of the minimizing bidder's position makes the best strategy for **b** to make a bid that becomes more extreme as the **a** bidder moves away from the optimal position in either direction. Using the arbitrator's position from the numerical example above, the graph's x-axis depicts a range of **a** bids from 0 to the mean; the y-axis shows the best bid for **b** at the corresponding **a** bid.

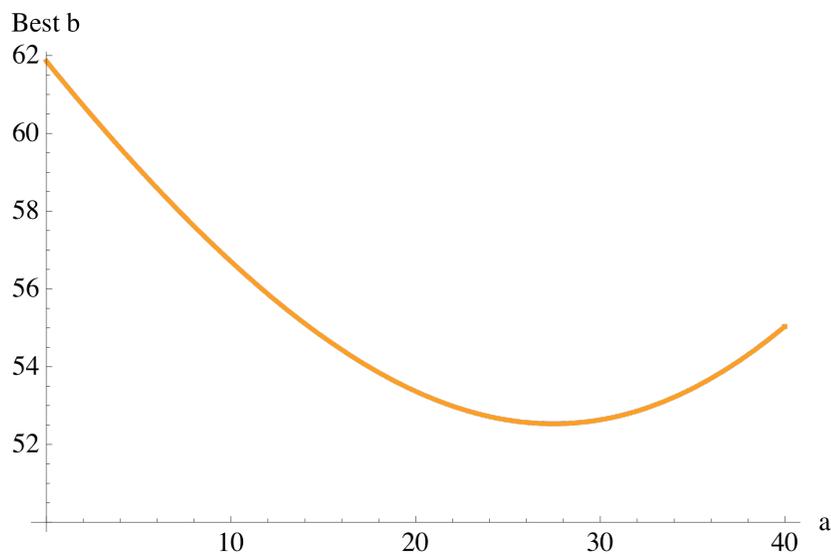


Figure 6

This graph clearly illustrates the tactical fact observed in the literature that a known risk-averse minimizing party should cause the maximizing party to increase his or her bid.

## **V. Description of the experiment**

To explore the implications of this research on real estate the following behavioral economics experiment was conducted. Three groups of approximately twenty real estate brokers (all from a firm that typically represents tenants) were each asked to rapidly evaluate comparable transaction data and either submit a bid or act as the arbitrator.

Each broker did three evaluations: one in the role of arbitrator, tenant, and landlord. As well as changing roles in each round, the players also changed markets, so that their evaluation of the comparable data was *de novo* in each round.

When the participants were requested to serve in the arbitrator role, they were not asked to consider the position of the tenant and the landlord, but instead to produce a fair assessment of the market. This matches the “black box” or random variable concept of arbitrator behavior that has been widely employed in the literature. This also allows us to consider both the participants’ view of the market (when they act as an arbitrator) as well as their strategy as tenant or landlord when they serve in those roles.

The participants were told only that the exercise was designed to improve understanding of the FOA process.

## **VI. Results of the experiment**

Table 1 summarizes the result of the experiment.

		Market			
Role (Landlord, Arbitrator Tenant)		Chicago	Washington	New York	Orange County
A	Average submission	\$30.86	\$47.55	\$102.03	\$33.75
	Standard deviation	3.99	4.41	12.85	4.11
LL	Average submission	\$33.61	\$49.48	\$106.40	\$35.27
	Standard deviation	4.21	5.01	13.77	4.66
T	Average submission	\$28.92	\$43.86	\$89.71	\$30.43
	Standard deviation	2.91	2.88	12.32	1.24
Average across all		\$31.18	\$47.01	\$99.23	\$33.15
Standard deviation across all		4.22	4.81	14.77	4.18
<i>Total number of submissions: 201</i>					

Table 1

The general ordering of the results is consistent with expectations, with the average “arbitrator” position consistently between average “landlord” and average “tenant” submissions. Population standard deviations were between ten and fifteen percent of the rent—which might be considered surprisingly low.

As was the case much of the literature cited above, the bidders in the experiment consistently sub-optimized. Across the four markets the average tenant position was arbitrator mean minus .77 standard deviations, and the landlord position was arbitrator mean plus .46 standard deviations, which in either case is less aggressive than the BMM solution of mean  $\pm$  1.25 standard deviations.

Since the participants were directed to produce a pure estimate of market rent when functioning as the arbitrator, the mean and standard deviation of the arbitrator positions can to some extent be used as benchmarks. It is noteworthy that the landlord and tenant positions taken were generally within one standard deviation from the mean of the arbitrator position taken by the group.

One interesting result was the asymmetry between the positions taken when the participants played landlord versus tenant. As pointed out by Ashenfelter et al. (1992) a Nash equilibrium model such as Farber or Brams and Merrill should result in a bids that are symmetrical around the mean. In fact, the magnitude of difference between tenant position and arbitrator position was higher than the difference between landlord position and arbitrator position. This might be because of the fact that the brokers in the experiment typically represent tenants, which might lead them to be more comfortable taking slightly more aggressive positions as a tenant than as a landlord.

However, t-tests and bootstrap analysis of the data show that the null hypothesis that the populations were drawn from the same distribution could not be ruled out at any of the standard levels of significance ( $p$  values ranged from approximately .59 to .81).

Although the results do not provide much support for symmetrical behavior, they do suggest that the bidders, whether acting in the role of landlord or tenant, were consistently risk averse. This is consistent with much of the literature, but differs from the experimental results of Ashenfelter *et al* whose experiment produced some bids that were less extreme than the anticipated risk neutral and others that were more extreme.

## **VII. Risk aversion, utility theory and mean-variance analysis**

### **A. Risk Aversion**

Why would the players consistently choose sub-optimal strategies? There are at least two fundamental approaches in economics to modeling the propensity for

individuals to be risk averse. One is based upon general utility theory; the second upon mean-variance analysis as pioneered and refined by Harry Markowitz (Markowitz (1987)).

In utility theory one assumes that every individual maximizes expected utility, subject to a function that maps the outcome of an uncertain event into a utility for the individual. These utility functions are generally speaking increasing and concave, illustrating the fact that increasing amounts of wealth have smaller and smaller levels of utility to an individual. A commonly employed class of utility function—the negative exponential—is depicted in Figure 7. See for example Gollier (2001) p. 27 for a review of utility functions and their behavior:

$$U_a[w_, \gamma_] := -e^{-\gamma w}$$

Figure 7

In this function,  $w$  represents wealth and  $\gamma$  represents the degree of risk aversion. This function can be imposed onto the BMM payoff function as in Figure 8 (see both Farber (1980) and Kilgour (1994)):

$$g2[a_, b_] := U[a, \gamma] F\left[\frac{a+b}{2}\right] + U[b, \gamma] \left(1 - F\left[\frac{a+b}{2}\right]\right)$$

Figure 8

In Kilgour's 1994 article "Game-Theoretic Properties of Final-Offer Arbitration" his primary concern is to assess the effect of two different utility functions (one for each player) on the results of the game play. Our goal is to categorize the level of risk aversion necessary to cause the maximizing bidder to sub-optimize her bid.

In order to show graphically how risk aversion changes the bidding, we normalize the initial payoff function of Figure 1 and the utility-adjusted function in Figure 8 and graph the results for parameterized version of the utility function in Figure 7. The normalization procedure is from Korsan (1994). As seen in Figure 9, a positive value of the risk aversion parameter causes the outcome of the bid to shift to the left. A consequence of this shift is that the optimal bid will be lower for the maximizing, risk averse player.

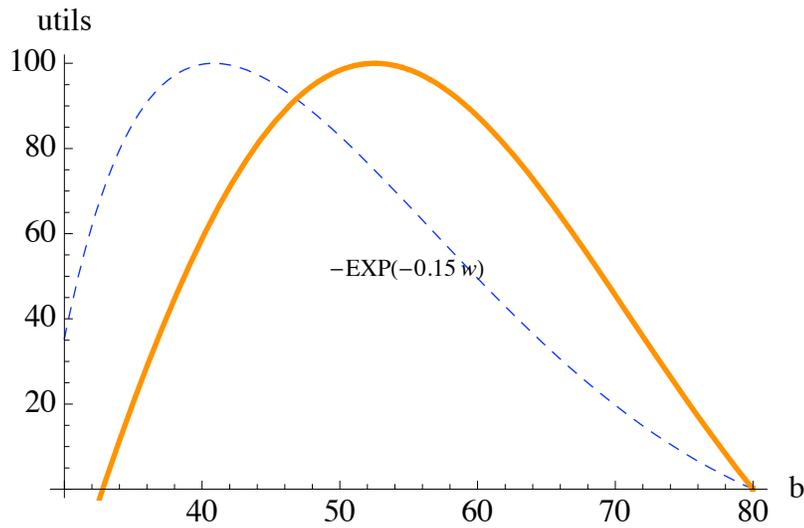


Figure 9

How much risk aversion ( $\gamma$ ) does it take to account for the deviation from optimality seen in the experiment? For simplicity, we will examine the maximizing case only. The results are presented in Table 2. The BMM calculations are based upon the mean and standard deviation of the arbitrators in the experiment, and the results are evaluated at the optimal point (Figure 4) for the minimizing bidder.

Market	BMM "Optimal" Bid (arbitrator mean / standard deviation)	Average Experimental Bid (Landlord)	Risk Aversion Parameter Required
CHI	<b>36.0</b> (30.9/4.1)	<b>33.6</b>	<b>.12</b>
DC	<b>53.2</b> (47.6/4.5)	<b>49.5</b>	<b>.18</b>
NY	<b>118.7</b> (102.0/13/3)	<b>106.4</b>	<b>.07</b>
OC	<b>39.2</b> (33.8/4.3)	<b>35.3</b>	<b>.22</b>
		<b>Average</b>	<b>.15</b>

Table 2

While there is insufficient data to draw strong conclusions about the consistency of the parameters, their difference is relatively small.

How would this utility function change the overall shape of the result for the maximizing bidder across all  $a$  bids? To show this, we use the function in Figure 8 and the utility function in Figure 7, parameterized at approximately the average value in Table 2. The resulting graph is only meaningful for the maximizing bidder, since the minimizing bidder's utility curve will look different from the utility curve for the maximizer (for example it will likely be decreasing).

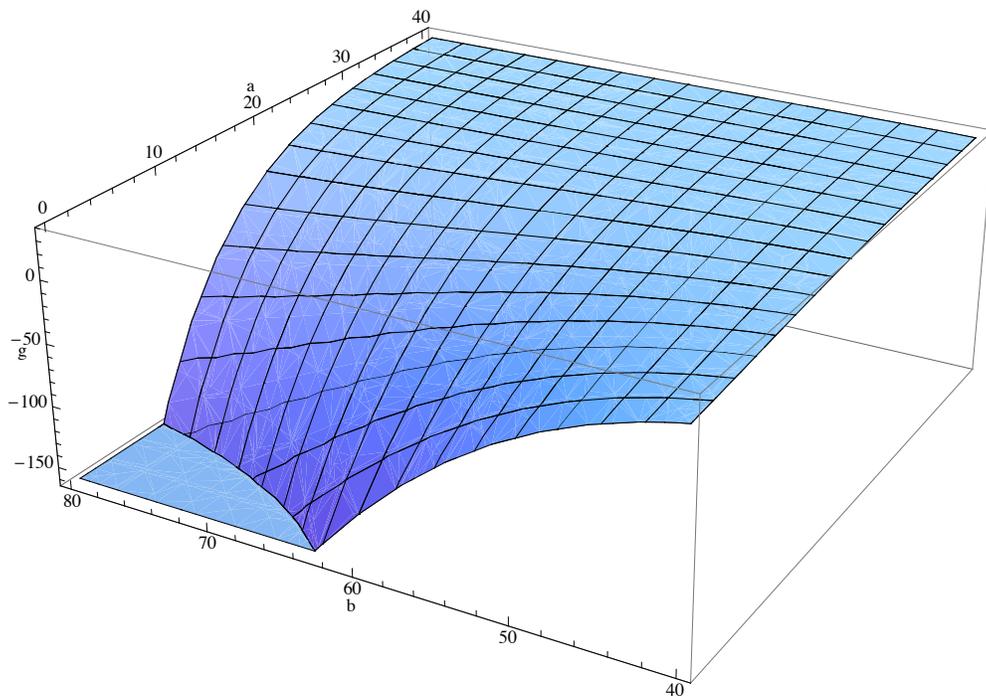


Figure 10

Figure 10 illustrates a number of interesting points. First, when the minimizing bidder chooses a bid between the mean and her optimal bid (i.e. between approximately 27.5 and 40), the bid of the maximizer is largely irrelevant when it comes to expected outcome. Second, when the maximizer chooses a bid between the mean and her optimal bid (i.e. between 40 and approximately

52.5), the outcomes are essentially similar. However, when the minimizer and the maximizer both make extreme bids, the results for the maximizer become dramatically worse. The conclusion of this graph, simply stated, is that in an environment in which the maximizer is risk averse (specifically in the case of exponential utility and with a relatively significant level of risk aversion), then the expected utility function doesn't serve as an unambiguous indicator of the appropriate game theoretical position. What it does show, however, is the dangerousness of choosing a bid that significantly exceeds the BMM maximum.

## B. Mean-Variance Analysis

Some additional insight can be gained by looking at an issue that is not extensively addressed in the literature on FOA. What is the variance of the outcome, and how does that variance change with different plays of the game?

In the case of a discrete random variable  $X$ , the definition of the variance is as a summation of a product. The first term in the product is the squared difference between the discrete value (in this case  $X$  can either be  $\mathbf{a}$  or  $\mathbf{b}$ ) and expected value. The second term is the probability that  $X$  will take on that value. Brams and Merrill provide the expected value function ( $g[a,b]$ ) and the probability that either  $\mathbf{a}$  or  $\mathbf{b}$  will be selected, and so the variance of the BMM can be written as in Figure 11:

$$v[a_, b_] := (a - g[a, b])^2 F\left[\frac{a+b}{2}\right] + (b - g[a, b])^2 \left(1 - F\left[\frac{a+b}{2}\right]\right)$$

Figure 11

Following the ideas of mean-variance analysis (normally applied to portfolio problems) this equation makes it possible to project bids into expectation-standard deviation space. In order to graph this in two dimensions, we set the  $\mathbf{a}$  bid to the theoretical optimum and graph the expected outcome of the  $\mathbf{b}$  bid against the standard deviation (the square root of  $v[a,b]$  above) in Figure 12:

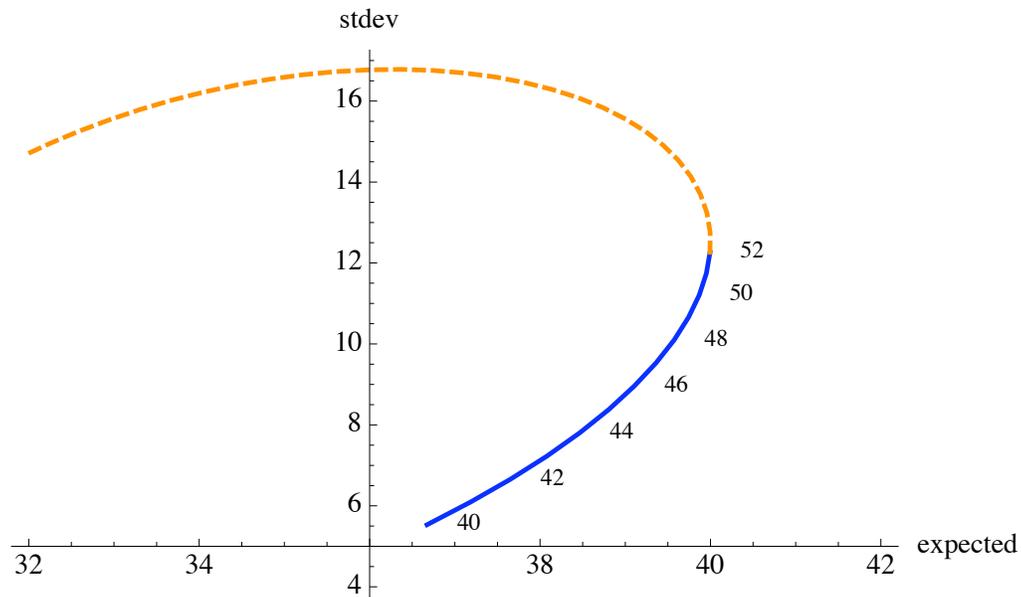


Figure 12

The labels represent the **b** bids up to (approximately) the optimal. This illustrates two points. First, between the mean and the optimal value, there are rational combinations of return and risk that a bidder might choose based upon her utility. Second, bids in the range from the mean up to the optimal bid *dominate* all bids above the optimal bid, in the sense that in every case an equivalent level of expected return can be achieved with a lower level of variance. This range represents an efficient set, in the vocabulary of Markowitz mean-variance analysis.

*This is an important result, because it shows that a bidder sensitive to both expected outcome and standard deviation of the outcome should only consider bids between the anticipated mean and the optimal.*

In the numerical example above (considering only the efficient set of bids) the standard deviation goes up 226% while the expected value increases by only 9%. This suggests that if expected value and standard deviation are considered together, a bid significantly lower than that suggested by the BMM would be selected.

## VIII. Conclusion and observations

The work of Brams and Merrill and their peers make it clear that optimal play in a FOA game does not cause the bidders to converge to the arbitrator's assumed mean. However, their model does not explicitly take into account risk aversion. As several researchers have observed, risk aversion will cause maximizing parties to bid below the BMM optimal.

The empirical data in this paper supports the idea that bidders in real world settings will tend to sub-optimize. We can provide two possible explanations for sub-optimal bidding found in the empirical study that are supported both by the mathematical exercise and by intuition. First there is the general principle of risk aversion, which causes incremental benefits to be worth progressively less, and therefore causes the player to be unwilling to take a fair bet.

Using a widely studied utility function (the exponential), this paper computes the level of risk aversion necessary to account for the sub-optimal bidding found empirically.

The paper also presents a formula for the variance of the BMM, and makes the observation (drawn from portfolio theory) that expected outcome and the variation in the outcome relate in the following way. While a greater outcome is preferred to a lesser outcome, if two outcomes are the same, the one with lower variation is preferred to the one with greater variation. The choice among these combinations of outcome and variation is made based upon the utility function of the player. However, certain combinations of outcome and variation dominate others. This analysis shows that (for maximizers) bids above the BMM optimal are dominated by those between the mean and the BMM optimal.

One of the problems with this study (and perhaps much of economics) is that it is somewhat unsatisfying to employ mathematical models to study human behavior, when it is clear that human behavior is not algorithmic. Milton Friedman addressed this problem cogently in his seminal essay "The

Methodology of Positive Economics" (in several books, including Friedman (1953)).

In that essay Friedman makes the point that positive economics should be judged in terms of the results of its predictions, not based upon whether the underlying model or analysis precisely maps the actions of those involved. What positive insights can this analysis provide for practitioners?

1. When evaluating the actions of an arbitrator, one should consider both the likely outcome and the variability of that outcome. The brokers in this study computed means of comparable transactions and normalized current and future payments pretty effectively. To go one step further and compute the variability intrinsic in market data is a logical step.
2. Armed with public information on comparables, and with a computation of an arbitrator's expected value and the likely standard deviation around that mean, it becomes possible to quantify the FOA using the BMM model. This can be done easily in Excel and can be used to calibrate bids and expectations of results.
3. The BMM model states that risk neutral bidding will in general produce better results. However, these improved results come with a price in risk. The mean-variance analysis in this paper allows the tradeoffs among different strategies to be depicted and better understood.
4. If it is possible to understand (in advance) what the counter party's attitude toward risk might be, a risk-neutral practitioner can significantly improve her position. Figure 6 shows that foreknowledge of the other party's risk aversion can be intelligently used to increase the aggressiveness of one's bid.
5. It is possible that the benefits of this approach will over time be minimized in classic prisoner's dilemma fashion as found in Ashenfelter and Dahl (2005). Until that happens, the more numerate practitioner has an advantage.

Returning to the original question discussed in the article, we conclude that there is a certain amount of truth to each of the described perspectives on FOA in real estate. While Farber, Brams and Merrill, and their fellow researchers show that FOA is not mathematically convergent, considerations of variability make it clear that it is not unreasonable to bid somewhere between the anticipated mean and the BMM optimal position. This positioning between theoretical optimum and “safe” but sup-optimal bidding is supported both by analyzing the problem through the lens of traditional utility theory and the lens of mean-variance analysis.

It could be argued that this conclusion supports the idea that FOA drives the parties to be more reasonable, even if the process is not technically convergent. There should be no question that the outcome frontier depicted in Figure 10 should give any bidder pause when considering an extreme bid.

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