

Experiment #1: Right of First Refusal

Many contracts, including collective bargaining agreements in major professional sports, allow the incumbent firm the right to retain an agent (player) by matching the best offer made to that player in bidding for his services. This is referred to as the right of first refusal (ROFR). See the attached excerpts from section 6 of the NBA Collective Bargaining Agreement (<http://www.nbpa.com/cba/cba.html>) for an example of such a clause.

In this experiment, you will be playing the role of a firm holding the right of first refusal (the INCUMBENT), a rival firm competing for the services of the agent (the RIVAL), or the agent herself (the PLAYER). The goal of this exercise is to study the impact of clauses like the right of first refusal on bargaining outcomes.

Incumbent (ROFR) firm:

Your contract with a valuable member of your firm (the player) is about to expire. As a result of the unique talents this particular individual possesses, you estimate that the incremental revenues that agent brings to your firm above the next best alternative is on the order of \$10 million per year.

Restricted Free Agency

Phase I

Under the terms of your existing agreement with the player, you have the right to initially negotiate with her prior to the expiry of the contract. While these negotiations cover all sorts of items, your offer is can consist of a bottom-line total compensation in dollars to be offered to that individual in the coming year. We'll assume that multi-year deals are not possible.

The incumbent and the player should briefly meet to talk about the terms of the offer sheet. At the conclusion of this meeting, the INCUMBENT fills out the offer sheet and presents it to the PLAYER.

The PLAYER must then make a decision whether to accept or reject this offer. If she accepts, the contract is made and the negotiation ends. If the player rejects, proceed to phase II.

However, **the initial offer remains on the table throughout the game, and the player can still accept it in any later phase.**

Phase II

In this phase, the PLAYER is negotiating with the RIVAL. The player is as valuable to the rival as to the incumbent, therefore if the rival firm hires the player, it earns \$10 million less the cost of the player's salary.

The rival and the player should briefly meet to talk about the terms of the offer sheet. At the conclusion of this meeting, the RIVAL can decide whether to fill out an offer sheet and present it to the player or not. If the RIVAL fills out an offer sheet, it incurs an up-front negotiation expense cost of \$500,000. This cost is NOT RECOVERABLE. It is incurred regardless of the outcome of the game. If the rival chooses not to fill out an offer sheet, then no expense is incurred.

If the player is presented with an offer sheet, the agent is free to accept or reject the offer. In either case, we proceed to phase III---the right of first refusal phase. If not offer is made, the game also proceeds to phase III.

Phase III

If the rival firm has filled out an offer sheet and the agent has accepted, the incumbent firm, by right of first refusal, is free to match this offer or not. If the incumbent chooses to match, then the agent is retained by the incumbent for the terms given by the rival's offer sheet. If the incumbent chooses not to match, the agent is hired by the rival firm at the terms of the offer sheet.

In the event that either the agent has rejected the offer or the rival has declined to make an offer, the incumbent can negotiate one last time. At the conclusion of this negotiation, the INCUMBENT can choose to fill out a new offer sheet.

The PLAYER can then accept the original offer sheet of the incumbent (from Phase I), the new offer sheet (if one was presented) in Phase III, or reject both offers and sit out a year.

Payoffs:

As the player, your payoffs are the amount of total compensation you negotiate. If you sit out a year, you earn \$0.

As an incumbent, your payoffs are \$10 million less salary costs if you hire the player. You earn \$0 if you do not hire the player.

As a rival, your payoffs are \$10 million less salary costs if you hire the player. You earn \$0 if you do not hire the player. In addition, if you filled out an offer sheet in Phase II, regardless of whether you hired the player or not, you incur an additional cost of \$500,000.

In every case, your job is to maximize payoffs.

A Variation: Unrestricted Free Agency

Now suppose that the right of first refusal is removed from the agreement. In this case, the game proceeds as follows:

- Phase I is identical
- Phase II is identical except that if a player accepts the rival's offer, the game ends and the rival hires the player.
- Phase III differs from the earlier game: The incumbent has no opportunity to match the rival's offer nor to make a new offer. In Phase III, the player simply decides whether to accept or reject the incumbent's phase I offer if he or she has not previously accepted an offer.

Payoffs are determined identically in the variation.

NBA Free Agency – Details

You will play 4 rounds of this game. Games 1 and 2 are under restricted free agency, 3 and 4 under unrestricted. You will alternate roles (Player or Incumbent) after each game. So if Team A is matched with team B, the order of play is:

Game	Type	Incumbent Team	Player
1	Restricted FA	A	B
2	Restricted FA	B	A
3	Unrestricted FA	A	B
4	Unrestricted FA	B	A

Your earnings are the total value gained (salary in the case of the player), \$10mm – salary if incumbent and 0 each if no deal. Divide this number by 10,000 to determine the number of ecus earned.

The rival is a bot with the following rules:

1. Roll a 20 sided die (d20) to determine rival's response. Here is a website with a virtual 20 sided die <http://www.brockjones.com/dieroller/dice.htm>

Restricted Free Agency: If die = 1-19, no offer. If die = 20, rival offers \$9.5 million

Unrestricted Free Agency: If incumbent offer \geq 9.5 million then no rival offer. If incumbent offers $<$ 9.5 million in salary, then: If die = 1-10, rival offers incumbent salary + 500k (up to a max of 9.5 million). If die = 11-19, rival offers incumbent salary + 100k. If die = 20, then no rival offer.

Phase I: Offer Sheet – Incumbent Firm

The incumbent firm offers the agent a total compensation of \$ _____ million.

Signature of agent: _____

Phase II: Offer Sheet – Rival Firm

The rival firm offers the agent a total compensation of \$ _____ million.

Signature of agent: _____

Phase III: Offer Sheet – Incumbent Firm

The incumbent firm offers the agent a total compensation of \$ _____ million.

Signature of agent: _____

Problem Set 1

Problem-solving questions:

1. Assume that negotiations always take the form of a take-it-or-leave-it offer by the firm followed by an acceptance or rejection from the agent. Note that in case of rejection, the offer remains on the table. Draw the game tree for the version of the game where there is no right of first refusal.
2. What is the equilibrium to this game?
3. Now show how the game tree changes with the addition of the right of first refusal.
4. How does the equilibrium change with the addition of a right of first refusal?

Discussion questions:

5. How valuable is the right of first refusal clause in a contract? Do you think this is appreciated by those entering into it? Is there some way the agent can change the system to undermine the power of this clause? Does it promote competition?

Excerpts from Section 6 of the NBA Collective Bargaining Agreement:

b) When a Restricted Free Agent receives an offer to sign a Player Contract from a Team (the "New Team") other than the ROFR Team, which he desires to accept, he shall give to the ROFR Team a completed certificate substantially in the form of Exhibit G annexed hereto (the "Offer Sheet"), signed by the Restricted Free Agent and the New Team, which shall have attached to it a Uniform Player Contract separately specifying: (i) the "Principal Terms" (as defined in Subsection 6(c) below) of the New Team's offer; and (ii) any non-Principal Terms of the New Team's offer that the ROFR Team is not required to match (as specified in Subsection 6(c) below) but which would be included in the player's Player Contract with the New Team if the ROFR Team does not exercise its Right of First Refusal. The Offer Sheet must be for a Player Contract with a term of more than two NBA seasons (not including any Option Year). In order to extend an Offer Sheet, the New Team must have Room for the player's Player Contract at the time the Offer Sheet is signed. The ROFR Team, upon receipt of the Offer Sheet, may exercise its Right of First Refusal, which shall have the consequences hereinafter set forth below in this Section 6.

(c) The Principal Terms of an Offer Sheet shall not include any Non-Cash Compensation. In addition, the Principal Terms of an Offer Sheet are only:

(i) the fixed and specified Cash Compensation that the New Team will pay or lend to the Restricted Free Agent and/or his designees as a signing bonus, Current Cash Compensation, and/or Deferred Cash Compensation in specified installments on specified dates;

(ii) Incentive Compensation payable in cash; provided, however, that the only elements of such Incentive Compensation that shall be included in the Principal Terms are the following: (A) bonuses that qualify as Likely Bonuses based upon the performance of the Team extending the Offer Sheet and the ROFR Team; and (B) generally recognized league honors to be agreed upon by the Players Association and the NBA; and

(iii) Any allowable amendments to the terms contained in the Uniform Player Contract (e.g., Cash Compensation protection, Early Termination Options, assignment bonuses).

(d) If, within fifteen (15) days from the date it receives an Offer Sheet, the ROFR Team gives to the Restricted Free Agent a "First Refusal Exercise Notice" substantially in the form of Exhibit H annexed hereto, such Restricted Free Agent and the ROFR Team shall be deemed to have entered into a Player Contract containing all the Principal Terms included in the Uniform Player Contract attached to the Offer Sheet.

(e) If the ROFR Team does not give the First Refusal Exercise Notice within the aforementioned fifteen (15) day period, the player and the New Team shall be deemed to have entered into a Player Contract containing all of the terms and conditions included in the Uniform Player Contract attached to the Offer Sheet.