Privatization in Germany: Lessons from a Third Side Case Study

Mark Young

As Germany (re-) unified itself in the months and years following the fall of the Berlin Wall in 1989, and as east German companies were privatized, the usual process was for the nationally organized "Treuhandanstalt" (Trust Agency or THA), as formal owner of all former assets of the German Democratic Republic (GDR), to sell off companies by negotiating directly with western German or foreign buyers. The companies themselves (management and employees) were only rarely included in the discussions or even consulted. This usually resulted in fruitless and acrimonious negotiations between buyer and seller, as both were far removed from and ignorant of the realities "on the ground". The consequences for those affected (the company) were dire. In a very few cases, however, company management or even employees managed to get involved (classic "third side" activity) and thus deescalate the conflict and improve the outcome. One such scenario was that of the Agricultural Machinery GmbH in Leipzig (AMG), a loss-making entity in a troubled industry, with little initial outlook for economic success.

Drawing on personal experience, the author of this chapter looks more closely at this unusual three-sided management buyout transaction, and uncovers "lessons learned" from a third side perspective.

The Initial Two-sided Negotiation

The Treuhandanstalt corporatized and sold off about 12,500 companies in the period 1991 through 1994. It had serious difficulty finding credible bidders for many of these: The companies were vastly overstaffed and inefficient, plant and equipment was obsolete, dependence on eastern markets meant sales forecasts were bleak, and property claim and environmental liabilities brought considerable acquisition risks for the purchaser.

The Agricultural Machinery GmbH in Leipzig was no exception. This industrial enterprise had once employed 2,000 people: Now 600 were left, and those greatly feared for their jobs. The pre-privatization general manager of AMG, Mr. [FIRST NAME] Schaefer, had managed to retain his job, and had put forward a business plan which envisioned utilizing his considerable Russian contacts to rebuild the company's once-dominant position with customers in states of the former Soviet Union. However, without a substantial injection of fresh capital and western know-how, especially in the area of manufacturing cost control, it seemed likely that these ambitious plans were doomed to fail.

After a concerted marketing effort on behalf of AMG, the THA managed to interest Machina AB, a leading Swedish producer of similar equipment, in acquiring the company. Machina saw a good potential fit between its own operations and those of AMG, and viewed the company as an ideal springboard for potential expansion into eastern Europe. Within a few weeks, an acquisition team led by Mr. [FIRST NAME] Hegström was dispatched to Berlin to conduct takeover negotiations with the THA.

An additional difficulty with this particular privatization lay in the fact that AMG was located on a large and valuable piece of land in the center of Leipzig. With property values soaring in such prime locations, the THA was understandably sensitive about selling off companies who owned such assets too cheaply, and was always on its guard against property developers masquerading as industrial buyers. The often-justified fear was that companies like AMG would be acquired for an inadequate purchase price, only to be shut down a short time later so that the land could be redeveloped for unrelated but much more lucrative purposes.

Machina's managers were made aware of this problem and assured the THA that they had no particular interest in property development--the main focus would be on developing the agricultural machinery business of AMG. After a few weeks' discussions with the THA, the Machina team took the unusual step of traveling to Leipzig to meet with AMG management, introduce their concept and ask for the confidential data they would need for their evaluation of the company.

The discussions there did not go well: Machina management instinctively distrusted Mr. Schäfer for his Communist background and apparent mismanagement of AMG to date, and Mr. Schäfer doubted the sincerity and competence of his visitors, surmising (as had the THA) that the latter only sought to acquire the AMG brand name, in order to acquuire the property then lay off all 600 workers, including (especially) Mr. Schäfer. Furthermore, Mr. Schäfer had full confidence in his business plan, and did not believe he needed outside help to save the company.

Following several inconclusive rounds of negotiations in Berlin, negotiations reached a stalemate. Independent property valuations showed that the property on which AMG was located had a market value many times higher than the price offered by Machina. AMG flatly refused to open its books for Machina, so that the buyers were unable and unwilling to make a more binding (and higher) offer. Entreaties from the AMG supervisory board went unheeded: Mr. Schäfer's personal pride was on the line, and the THA saw no reason to force the issue.

Machina threatened to withdraw from negotiations, and the team returned to Sweden to confer with top management. The THA, with no reasonable alternative in sight for the company, was worried about its weak negotiating position. If a solution were not found soon, the THA would be forced to liquidate the company, letting all 600 employees go, and market the land as an undeveloped property.

Problems

This initial negotiation situation was unrewarding for all parties. The fundamental problem that overshadowed the discussion was lack of trust. Three particular factors inhibited communication and doomed the negotiators to failure even before they began their discussions.

First, the value of the property proved to be a nearly insurmountable obstacle to any serious effort to sell AMG to an industrial buyer such as Machina. While the company, valued as a "going concern", certainly could not command a high purchase price, the THA was politically obliged to ensure that it was adequately compensated for the land on which AMG's offices and factories stood, and thus to make price demands well out of any range these buyers could consider.

The seeming intransigence on the investor side of the table on this issue in reinforced the THA's suspicion that here, once again, was an investor looking to buy valuable eal estate cheaply. This led to an unwillingness to cooperate on a second issue: the provision of sensitive information such as detailed financial statements and an outline of current and proposed business strategy. The Machina negotiators required this type of data if they were to submit a detailed and binding bid.

Third, even after several rounds of negotiation, it was increasingly unclear just what each party's ultimate objectives were. At AMG, Mr. Schäfer was driven by the fate of his company, but also by his personal pride, confidence in his own abilities and individual political objectives. The THA wanted to privatize the company but was saddled by inconsistent and mutually exclusive price requirements. The buyers had a fundamental interest in contributing intellectual and financial capital to grow the business, but could not further develop that interest without adequate information.

Even if these conflicting objectives could be made coherent and quantifiable, it is clear that they were unlikely to be met. Both buyer and seller, while behaving rationally from their individual perspectives[1], achieved little in their initial discussions, despite their best efforts at rational negotiating. A deal that should have produced mutual advantage was not reached: Most of the potential gains from negotiation remained on the table. Most worrying was the effect that these negotiations were likely to have on the company itself, as management and employees stood to lose their jobs.

Negotiation Results

Happily, the final results of this negotiation turned out far better than might have been anticipated midway in the process. The crucial difference pivoted on an initiative undertaken by a newly mobilized management of AMG, working together with its employees. At the urging of this new negotiation team, discussions were restarted with some substantive new ideas on the table.

The management team proposed a classic "management buyout" or "MBO", an arrangement under which management and employees together would acquire the shares of AMG themselves, without the assistance of Machina or any other Western investor. To finance this acquisition, Mr. Schäfer then pulled a "rabbit out of a hat": a fourth party willing to buy the property for unrelated development, relocating AMG to leased facilities at the edge of town.

This fourth party, RSI GmbH ("RSI"), was an experienced property developer well known to Mr. Schäfer, one who had long been looking for property in Leipzig that was not subject to pending property claims.[2] A few well-placed phone calls were made, and RSI soon proposed to buy the lot at fair market value, correctly calculating that rezoning and redevelopment would still yield a healthy profit for them in the medium term. They were more than willing to find and offer a smaller and far more suitable lot of land at the edge of town on which AMG could continue operations in leased facilities.

This idea broke the logjam of the property problem. The unsolicited involvement of the AMG management/employee team thus changed the dynamics of the negotiation first in terms of substance and then, following this, also of process. With the property issue settled, Machina decided to reopen discussions. Now both Machina and AMG management found that the other two obstacles to trust could also be breached, and that they could talk to one another after all. Once institutional problems had been solved, the negotiators could tackle their interpersonal problems as well. After some frosty initial discussions, they found that they had much in common.

As he regarded Mr. Schäfer across the table, Mr. Hegström began to understand him better. This was a man who had just been through a period of profound political and economic change, and who now found himself cut down at the height of his career through circumstances beyond his control. While he still held the old values of a communitarian society dear, he was now mostly driven by pride and a desperate determination to maintain personal control of the company even in very disadvantageous circumstances.

It also became clear to Mr. Schäfer that Mr. Hegström was in a very different situation. A younger manager, completely inexperienced in this unfamiliar culture and business market, he was under intense pressure to succeed in this new venture. While he would soon realize how little he knew about the established ways of doing business in eastern Germany, he was reasonably confident of the institutional support of his parent company and of the political authorities in Berlin. He had money, industry expertise and Western economic training to offer and he was committed to making the project work in order to please his superiors.

This initial empathy for one another laid the foundation for the building of trust, and for convincing each party that he might have something to gain from negotiation. Both came to realize that their values and goals were more likely to be met if the two could manage to reach agreement. But how were they to put the discussions on a more productive track? How did they manage to create the open conversation necessary for true problem solving?

As in most tense negotiation situations, these negotiators found that procedure is likely to anticipate substance. Mr. Hegström began by proposing small but symbolically significant trust-building measures to change the tenor of the conversation. On his second visit, instead of making a canned presentation to Mr Schäfer in English, he decided to first demonstrate his interest in the welfare of the employees (Mr. Schäfer's main commitment and concern) by speaking to them by means of a translator in German, and by learning more about the existing business before making any new proposals.

Mr. Hegström further allayed justified suspicions of defection (buying up the company only to liquidate it and eliminate it as a competitor) by revealing moderately important confidential information about his own company in the presence of Mr. Schäfer. He shared some of his vision for the future and the Treuhandanstalt officials were also present to demonstrate commitment to implementing his plan if the bid were successful. This not only showed his competence in the industry and gave some indication of the value he wass prepared to add to AMG, but also obliged Mr. Schäfer to reciprocate with trust-building measures of his own.

Mr. Schäfer responded by offeing some information, primarily on the skill profiles of the employees, thus demonstrating that they would bring unexpected value to the transaction, value which would be lost to Machina in the event of a liquidation. Protected by a confidentiality agreement monitored by the THA, he also indicated his own vision and plans for the company, checking carefully for Mr. Hegström's reaction to see whether there might be any basis for cooperation. All of these measures entailed only limited risk to each party, with plenty of room to withdraw from the negotiation if cooperative moves were not reciprocated.

Results were most encouraging. The two parties came to see that they had much more in common than they realized and that what they brought to the table was highly complementary. Mr. Schäfer realized, for instance, that the Scandinavian culture of Mr. Hegström was nearly as communitarian as his own, so that there were, already, shared commitments to build on. Mr. Hegström was able to envision a meaningful role for Mr. Schäfer in the new company, one which would not compromise Machina corporate objectives.

The two parties brought very different assets to the deal. Mr. Hegström managed to turn weaknesses--his lack of knowledge about eastern markets and his inability to pay for the Leipzig property--into a strength through an alliance with Mr. Schäfer and his partner RSI. Mr. Schäfer recognized that his personal plans were far more likely to succeed if backed by fresh capital and western know-how from Machina. The two learned that they had, in short, much to offer each other.

The result was a creative revision of an initially unsuccessful MBO proposal which had been tabled months earlier by AMG management and employees. Far from fighting this form of competition, Machina instead proposed to join forces with management, offering to buy a 51 percent share in the new (propertyless) AMG, with 49 percent reserved for old (Mr.Schäfer) and new (Mr. Hegström) management and employees, effectively giving all players an equity stake in the new venture. In a particularly creative forward-looking addendum, AMG employees and management were given the option to buy out Mr. Hegström's share if revenue and profit targets were met over a period of several years.

In this way, the company was successfully privatized. By thinking jointly about AMG, and viewing it not only as a struggling small machinery company but rather as a vehicle to access not only the eastern German but also the much bigger markets in Russia and the Ukraine, and by bringing other products from Machina's diversified businesses to this new joint venture, the two parties together laid the foundations for a credible business plan, one that the THA could happily endorse as it relinquished control of the company.

Seven years later, in 2001, the scale of the result has surprised everyone. Today's AMG, relocated in new facilities at the edge of Leipzig, is a slightly smaller operation (520 employees) but one that is, despite continuing industry challenges, now firmly in the black. Mr. Schäfer has retired (after five years) on the money raised by selling his shares to Machina, and was replaced from within by his deputy. Mr. Hegström has moved on to other higher responsibilities within Machina, selling his 24 percent share in AMG to AMG employees under the terms stipulated in the privatization contract.

Relations between management and employees and with the Swedish parent are excellent, and the two companies have completely reconfigured their product development, work flow and operational logistics to capture economies of scale all through their businesses. AMG's old sugar beet harvester product line has been phased out and replaced by new Machina tools, all developed and assembled in Leipzig for both eastern and western markets. AMG is thus now an integral and valued part of Machina and a going concern in its own right.

In the meantime, on the old AMG lot in downtown Leipzig, RSI has built a new "Business Innovation Center", a technological office park for internet-related service companies, surrounded by attractive apartment complexes and public space. The company reports good profits from this activity, and is proud of the contribution it has made to the civic and industrial life of Leipzig.

Most importantly, company managers and employees achieved their goals. They not only averted bankruptcy, but also provided the impetus for a "new" AMG, one that can gainfully employ them and give them new career perspectives in Germany and an equity share in the new company they have helped to create. They transformed a negotiation failure into a business success.

Lessons for the Third Side

This case is a particularly good illustration of the power that the Third Side can wield in negotiations. By mobilizing and effectively coordinating forces external to the original conflict but deeply affected by its outcome, intervenors such as Mr. Schäfer can fundamentally alter both the substance and the process of the negotiation. By changing the rules of the game, such players create outcomes that are successful measured not only by the criteria of the original discussion but also in terms of object of a new and more ambitious vision. The AMG experience yields many lessons of which four stand out:

1. Third-siders can be varied and can play many roles, if effectively coordinated.

As is often the case, the Third Side was but monolithic. In the AMG case, the"Third Side" was an uneasy coalition of disparate parties brought together by the initiative of one man, Mr. Schäfer. They were held together by the realization that that alliance could--at least for the time being--best serve all their individual interests. That idea enabled them to negotiate as a unified force in conversation with the traditional first and second sides. In addition, an eleventh third side role was played, that of "horizon widener"[3]. The creativity of the third side team led by Schäfer enabled the negotiators to redefine the problem and thus discover the unexpected solution.

AMG management, in the person of Mr. Schäfer, was the initiator and creator of the Third Side in this situation (in classic Third Side parlance, he was the "bridge-builder"). He found the courage to stop functioning as an obstructionist, and instead to introduce himself as a third party to the negotiation table. He articulated interests separate from those of the other two parties and designed an innovative proposal allowing a successful outcome for all three sets of interests.

It was not easy for Mr. Schäfer to gain a seat at the negotiation table. His hand was significantly strengthened, however, by the inclusion on his team of representatives of the (nonmanagement) employee body of AMG. Schäfer's judicious sharing of information with his employees went a long way towards overcoming the traditional distrust prevalent in Germany[4] between management and employees. In this way, Schäfer expanded his base beyond the personal, making it clear to the THA that he represented not only the interests of a few but of all 600 employees, with a formal legitimacy which the THA had to take seriously. The political pressure reated by such a unified approach cannot be overestimated.

The critical addition to the Third Side team, however, was the inclusion of RSI. This personal contact of Mr. Schäfer not only expanded the number of those working towards a solution but also solved a substantive problem. By putting forward a "yesable" proposition about the property, the

Schäfer/RSI team, functioning as Provider, immediately changed the dynamics of the situation. With the creation of this innovative new option for the THA, stalled discussions were effectively jump-started.

RSI's interests, quite coincidentally, were far better served by joining this Third Side coalition than they would have been by pursuing them via the THA. The THA was able to serve, in Third Side parlance, as a Referee, determining and enforcing rules for this difficult part of the overall privatization efforts. Straight property deals were not politically popular at the THA, and it was not public knowledge that this piece of property might become available. Only the unique joint solving of both the property and the industrial problem at AMG was likely to meet an affirmative response from the rule-making land-owner. That unique solution was possible only through the joint efforts of this particular Third Side team.

However, even with Schäfer's new stance, the third side team was incomplete. Although he did not want to admit it, he simply lacked the capital, management expertise and market contacts to make even his revised business plan work. He desperately needed the expertise that Machina, and specifically Hegström, had to offer. Although the initial proposal excluded Hegström, Schäfer gradually learned from the more open negotiation process just how much extra value this further party could add to his team. And so, quite rationally, he invited him to be a full equity partner. He recognized, however reluctantly, the value to be gained from what Hegström had to offer as Teacher.

By serving as an "inside third sider" on the ground in Leipzig, Hegström also played a vital bridge-building role between Machina and the AMG management/employee team. Without forsaking his responsibilities as chief negotiator for the second side, Hegström became, even before the deal was done, a part of the AMG family, earning the trust of his co-managers and employees. As interests were redefined, he came to see himself also as a Provider, uniquely able to help meet their needs. His innovative share option proposal helped to institutionalize that transitional role: Under its terms, Hegström moved from manager to co-investor to coach, gradually allowing others within the company to take the helm.

The skillful coordination of these previously unrelated parties was, of course, critical. While interests in this situation did not diverge to the extent that mediation was required, something was needed to hold the parties together. Initially, that force seems to have been the strength of Schäfer's personality, but the ongoing institutionalization of communication (company-wide meetings, the offering of share options to employees) were also important in melding the Third Side into a potent unified force for change.

All four parties--Schäfer, the AMG employees, Hegström and RSI--were critical to the success of the Third Side fundamentally redefining and redirecting the negotiations previously conducted only between Machina and the THA. The new coordinated effort, initiated and pursued by Mr. Schäfer, made the solution to everyone's problem possible. What created the impetus to get that coalition-building process started? How did managers and employees break out of the traditionally passive role assigned to them and find the courage to voice and pursue their interests?

2. Necessity can drive passive bystanders to act.

There was, in this situation, very little precedent for the engagement of a Third Side and there were many obstacles to change. Most THA privatizations were conducted centrally in Berlin, with little need for involvement by and virtually no information provided to the companies in question. MBO proposals were rare; company managers seeking to initiate them hardly knew where to start and their attempts were likely to be hopeless.

In addition, the entire THA privatization effort was embedded in a culture that did not encouraged initiative and nonconformism. The German experience of 1933-89, especially in the East, was one of hierarchy and rules, with swift and severe punishment for any who dared to step out of line. As both perpetrators and victims, most actors in this culture had learned the elements of hierarchical power, imposing authority when they had it and keeping their heads down when they did not. Those in the latter category knew to wait for instructions from above and to expect support from their rule givers.

This system broke down after the fall of the Berlin Wall. As managers and workers in the east began to realize that the support that had always been provided in exchange for compliance was no longer forthcoming, they began to question the validity of the rules in general. Seeing little to lose in rousing themselves from traditional passivity, some of them were emboldened to take their fate in their own hands.

In short, necessity gave birth to third side initiatives like the one at AMG. It was, indeed, a mobilizing force. Disquieted by rumors of failing privatization negotiations and imminent bankruptcy, employees and management at AMG moved to hold company-wide meetings and to seek professional advice in support of their nascent idea of a buyout. In this way, they were able to coordinate half-formed ideas and write a serious business plan and privatization proposal.

Another side of the effort was public. Three times in the course of the negotiations with Machina, employee leaders bused several hundred AMG workers, friends and sympathizers to Berlin to demonstrate outside THA headquarters. Interviews were held with the press to mobilize public support and to increase the political pressure on the THA to take the MBO proposal seriously. AMG management/employee team used the press to serve as a further "equalizing" element of the Third Side. With public opinion bearing Witness to what was occurring, the first and second sides were forced to respect norms of fairness.

The RSI offer to buy the land was made public as well, and communicated through separate channels to the city, which had its own interest in a speedy and appropriate redevelopment of the downtown area. As ideas were externalized--placed in the public sphere--soon proved to be too powerful to ignore.

3. Third-Siders can help with substance as well as process.

In general, negotiation practitioners have found that substance follows process: The best way to start building trust in a tense negotiation situation is to seek agreement on minor process issues first, saving the more difficult questions of substance for discussions in an improved climate. By showing that they can propose and then comply with fair rules of procedure, negotiators gradually earn the confidence and respect of their opponents, factors necessary to resolve difficult substantive questions when these come to the table.

While this phenomenon held true in this case, it is interesting to note that, at least initially, substance led process. It was the creative, unsolicited and substantive proposal to solve the property issue through the introduction of RSI as an additional investor that first changed the course of the privatization negotiations in a material way.[5] Only then did the individuals involved in the negotiation adopt a Third Side perspective and begin a truly open conversation with one another.

Before the introduction of RSI, negotiations were in stalemate, a classic prisoners' dilemma in which each party's rational pursuit of his individual interests seemed destined to lead to a collectively calamitous result. However, when the Third Side's "broke the box"[6] of conventional problem solving, circumstances changed dramatically. By separating the property and business issues the management/employee team created an attractive new option. The new possibility suggested an improved process which generated better communication, increased interpersonal trust and then, finally, the eventual overall solution.

4. Third Siders can change the rules of the game.

The situation at AMG seemed fairly clearcut during the initial two-sided negotiation. The company was overstaffed, badly managed and operating in an extremely depressed industry. Nevertheless, the THA had a political obligation to make a "best effort" to sell it at a price that would include the high value ofthe property involved. Machina stood to gain from making the purchase, but not at any price. Returns to both were, even under a best case, likely to be modest.

This set of objectives began to change markedly when the Third Side became involved in the discussions. Once the value of the property was identified and negotiated separately from the value of the business, the negotiators could focus on the latter in a creative way. They were able to recognize the human and corporate potential that the 600 AMG employees could offer if affiliated with the right western partner: New value was imagined, identified and created.

Both the THA and Machina were surprised by the boldness of the Third Side's business projections. They had never considered how much more business the management team was willing to take responsibility for creating, once their concept was recognized and legitimized with shares in the company. They had not considered new products and services designed for (nonagricultural) western markets that AMG could produce, or the value of Machina's ways of doing business.

At of this writing (2001), even those ambitious forecasts have been surpassed. AMG is a clear success in terms of sales, profit, investment and jobs. Moreover, this privatization effirt is also a success measured against a wider set of criteria. The product range and geographic scope of the combined company have been significantly redesigned and expanded. Employees have been trained in new skills and are thus more valuable and more fulfilled in their work. The innovative and attractive redevelopment of the original piece of land has solved a problem for the City of Leipzig, as well as making money for RSI. It is a true Triple Win.

In this negotiation, the Third Side sketched out for the first two a new set of objectives; together the three sides then developed a road map for reaching them. The game played at the end of the negotiation was thus very different from the fairly predictable one embarked on at the start.

Conclusions

While each privatization is--like each conflict situation--unique, many of the third side lessons learned in the case of AMG are clearly transferable. Seven years' hindsight shows us that much was done right in this situation, but also that some things could have been done differently.

The Third Side at AMG certainly taught the other two to think creatively about interests and options, and to view negotiation outcomes in terms of potential rather than existing value. They showed how initiative can pay off and how powerful coordinated bridge-building, teaching, providing, equalizing, witnessing and refereeing can be. They demonstrated that communication is essential to the building of trust and the discovery of value.

Certainly, it seems clear that in future privatization negotiations in Germany or elsewhere company management should be included in the discussions from the start. When this is the case, the parties can work actively to build trust early on, and successfully mine the intellectual capital of all concerned to ensure that all available options to create and sustain value are considered and tested. Conflicts between the parties can be aired and used constructively in the search for a joint solution.
All parties to such a transaction must be given a voice and a responsibility to contribute to the problem-solving effort. This is not only fair, but also leads to better results. In the end, this meets everyone's best interest.

Notes

1. This is true, at least if rationality is defined as utility maximization, as it all too often is in business. Game theory would, in fact, model this outcome as a classic prisoner's dilemma, in which both parties are led to do what is eminently rational from their individual perspective, and yet both lose.

2. AMG's lot was especially valuable as it was one of the few larger pieces of property in the downtown area with a "clean title". Over 50 percent of the land in Leipzig had been expropriated by the Nazis and was now subject to a class action claim put forward by the Jewish Claims Committee, effectively making it unavailable for development.

3. The experience of this case does suggest a widening of the original Third Side model to include this further valuable function which Third Siders can play in order to resolve conflict. There are, I am sure, also others.

4. Codetermination structures in Germany have gone a long way towards strengthening cooperation between management and employees, as "workers' councils" are elected in most companies and must be allowed to participate in most larger business decisions affecting the welfare of the workers. Even so,

communication in companies such as AMG is often far from open, and agendas between management and workers still diverge widely.

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