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SIGNATURE RESOLUTION

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Predictably irrational

WHAT BEHAVIORAL ECONOMICS TELLS US ABOUT DECISION-MAKING AT MEDIATION

Behavioral economics is an emerging field that draws from a variety of disciplines to better understand how people make economic decisions. Behavioral economists use scientific methods to analyze the psychological, cognitive, emotional, cultural and social factors that impact our decision making. Many of the findings in this field have been revolutionary, radically changing our views about human behavior. For example, while we think of ourselves as being rational actors, social scientists have demonstrated time and again that we are in fact highly irrational decision makers prone to making "mistakes." Further, we are generally unaware of these irrational tendencies. Perhaps most importantly, certain irrational thinking is predictable. We can identify and anticipate it before it happens. In mediation, understanding predictably irrational behavior can be a helpful tool.

Decisional errors: Let's Not Make a Deal

In 2008, a group of researchers published the results of a major study that reviewed some 40,000 civil cases in the State of California to determine whether the parties who engaged in settlement negotiations made the right decision. (*Let's Not Make A Deal: An Empirical Study of Decision Making in Unsuccessful Settlement Negotiations*, Randall L. Kiser, Martin A. Asher, and Blakeley B. McShane, Journal of Empirical Legal Studies, September 2008, Volume 5, number 3.) The authors revealed that more than 60% of the time the plaintiff would have fared better by accepting the last offer from the defense rather than going to trial. The average loss was over $40,000, which did not include the added litigation expenses, time, energy, and emotional costs of going through trial. That number has likely increased over the years. The study also showed that while defendants make mistakes less frequently, the cost of their mistakes is much higher.

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What is clear is that parties are prone to making mistakes when it comes to deciding whether to settle their cases. But why?

Economic theory meets psychology

Decisional errors can be due to a number of factors. Sometimes there is a lack of reliable or accurate information upon which to base a decision. Sometimes the decision maker is simply not that knowledgeable about the subject matter of the decision. But there are other, hidden factors that probably lead to some of these mistakes. Behavioral economics can add some insight.

In classical economic theory, people are thought to be rational actors who assess facts objectively, evaluate their options accurately, and make rational choices among alternatives in order to maximize their known preferences. "Rational Choice Theory" has long been the basis for micro- and macro-economic modeling. For example, Adam Smith's "Wealth of Nations" discusses the "invisible hand" of capitalism where economic growth is driven by individual, rational actors who make self-interested decisions in a way that benefits the economy.

Starting in the 1950s, a group of psychologists and economists began to question the rational decision-making model. This movement would eventually lead to a new field called Behavioral Economics.

Social scientist Herbert Simon (who later won a Nobel prize) introduced the concept of "bounded rationality" as an alternative to Rational Choice Theory. According to Simon, in the real world, the criteria for Rational Choice Theory are almost never met. When individuals make decisions, their ability to make the optimal choice is hindered by various factors including cognitive limitations, time constraints, and inaccurate or incomplete information. Decision-makers act as "satisficers," seeking a satisfactory solution rather than an optimal one.

In the 1970s, psychologists Amos Tversky and Daniel Kahneman (who also won a Nobel prize) published a series of articles that expanded on Simon's concept of limited rationality. In "Judgment Under Uncertainty: Heuristics and Biases" and "Prospect Theory: An Analysis of Decision Under Risk," Tversky and Kahneman showed how people have certain biases and utilize certain "heuristics" (i.e., mental shortcuts) to make decisions that do not comport with purely rational models.

Risk aversion

Since the 1970s, a number of other notable psychologists have added to the field of Behavioral Economics. University of Chicago economist Richard Thaler, a former colleague of Tversky and Kahneman and himself a Nobel prize recipient, has published widely about irrational judgment, including on something known as the "endowment effect" which explains how people are more risk averse regarding potential losses than gains.

Duke University's Dan Ariely is another popular author who has conducted several studies and experiments showing how people make irrational decisions. His book "Predictably Irrational" offers a host of interesting examples of people acting irrationally with alarming consistency. One of Ariely's most robust findings is that people do not place absolute "value" on things, but rather, determine value in context. Among other things, he explains how "free" offers, price setting, and markdowns help vendors ratchet up sales.

In 2011, Daniel Kahneman published a book called "Thinking Fast and Slow." In it, Kahneman used the body of work that he and Tversky generated as well as more recent studies to explain the dual nature of decision making. According to Kahneman, our decisions are the result of two modes of thought.

"System 1" is responsible for our fast, instinctive and emotional decisions. This system is operated by the primitive, reptilian aspect of our brain known as the limbic system.

In contrast, "System 2" involves a slower, more deliberative, and more logical mode of thinking which is controlled by our prefrontal cortex. Homo Sapiens has the most developed System 2 among the animal kingdom, which explains why we are able to do so many complicated, complex tasks.

While the systems are interrelated, our judgments and decisions often reflect which of the two are "in control." Among other things, Kahneman has demonstrated how our decisions are often highly irrational, particularly when System 1 is running the show.

Cognitive biases

One area of Behavioral Economics that has generated significant literature is related to "cognitive biases." A cognitive bias is a systematic deviation from objective, rational judgment. Although there are a number of cognitive biases, there are a few that are particularly relevant to decision-making at mediation.

Optimism bias

Optimism bias is a cognitive bias that causes people to believe they are less likely to experience a negative outcome or more likely to experience a positive outcome than they actually are. It explains why, when something really bad happens, people say, "I never saw that coming."

While it is important, indeed necessary, to be optimistic when representing clients in litigated matters, it is equally important to be realistic.

One way to address optimism bias is to "test" the reliability of your expectations. You can do this by gathering accurate data. How many slip-and-fall cases result in favorable plaintiff verdicts? How many wrongful death verdicts exceed five million dollars? What are carriers typically paying in settlement for a particular type of injury or loss?

You should also engage in an honest assessment of the circumstances of your case. Are you *really* going to be able to get the treating doctor to support a medical damages case? How effective

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is your opposing counsel likely to be in front of a jury? Is your client likeable and convincing? Is your venue "plaintiff-friendly"?

Confirmation bias

Confirmation bias is the tendency of people to search for, interpret and recall information in a way that supports their pre-existing beliefs. This cognitive bias is probably the most prevalent and most dangerous.

When you take in a case, you do so in part because you believe you can accomplish a favorable result for your client. From that point on, you begin to acquire information about the case. As you learn about your case, you are incorporating this new information into your case plan. You are digesting it. You are interpreting it. You are deciding how it affects your prospects for a successful outcome.

Confirmation bias is the hidden force that will cause you to view this information more favorably than you should. It will cause you to ignore certain harmful evidence. It will cause you to see evidence more favorably than you should. And it will generally leave you with a distorted impression of your case. Again, while it is important to be positive and optimistic about your case, it is just as important to see the "warts" on your case. Indeed, it may be more important to see the bad stuff so you can make sound decisions about settlement and, if the case does not settle, be prepared to address those issues at trial.

The best way to address confirmation bias is to run your case by someone who has no interest in the outcome or at least someone with no preconceived beliefs about your case. When doing this, do your best not to "taint" your listener's views. Don't spin or advocate a position, but just tell the story as a reporter might. Don't go out of your way to highlight the good stuff. And definitely don't hide the bad stuff. You might give an overview of the case and then start revealing specific information about the case to see how the new information is perceived in the context of the overall case. The key here is to try to get objective input, not input that is shaped by an agenda. Sometimes your mediator will be the best source for this input. Focus groups are also great for this purpose.

Anchoring effect

The "Anchoring effect" is the tendency of a participant in negotiation to place too much emphasis on the initial position or positions of other participants when making subsequent moves. For example, plaintiffs will often start with an unreasonably high demand, hoping to permanently change the defense's assessment of the value of the case. Defendants will do the same. The idea is that any subsequent position will look more reasonable when compared to the initial, extreme position.

There are a couple of things to know about anchoring. First, it works and it works both ways. Studies have shown that people can be significantly swayed in their judgment based on initial numbers.

In "Predictably Irrational," Dan Ariely discusses an experiment he did where he asked the participants to think about the last two numbers in their social security number. He then asked the participants how much they would be willing to pay for a particular product. Those in the top 20% of social security numbers were willing to pay 3 times what those in the bottom 20% were willing to pay. While the social security numbers were irrelevant to the value of the product, the participants had been conditioned in a way that substantially altered their subsequent judgment. Examples of the Anchoring Effect abound in the scientific literature.

Second, while anchoring can be effective, it can also create problems in getting to a final resolution. For example, if the case is reasonably valued somewhere between $500,000 and $600,000, starting your demand at $5 million will probably require you to move a lot to get to settlement. How do you do that? If you make a big move early, you may send a message that you really don't believe in your case. If you make a big move late, your opponent might sense that momentum has shifted and be emboldened. Bracketing and mediator proposals are two techniques that can help address this concern, but it is a very real concern.

Heuristics

A "heuristic" is a mental shortcut that people use to make decisions under conditions of uncertainty. There are a number of heuristics that help explain irrational decision-making in the context of personal injury mediations.

Sunk-costs fallacy

In economic decision-making, a sunk cost is a cost that has already been incurred and cannot be recovered. For example, if you are trying to decide whether to build a commercial building based on current economic conditions, the money you have already spent for architectural plans or permit approvals cannot be recovered if the project does not go forward. These costs are distinct from prospective costs that you will incur if you go forward with the building project.

In the context of mediation, the money that plaintiff's counsel has spent to prosecute the case is a sunk cost. Generally speaking, those costs will not be reimbursed to the lawyer if the case does not proceed or if the outcome is not a success. This can cause counsel to make a mistake about how or whether to proceed.

Sunk costs can lead to a "sunk cost fallacy" when they cause the decision maker to pursue a course of action that would otherwise not make sense. If my chances of prevailing at trial are slim and I need to spend another $100,000 to get through trial, looking forward, the option to proceed to trial is probably not a good one. But if I allow the fact that I have already "sunk" money into the case to influence my decisions, I may reject settlement and proceed to trial anyway.

There are a variety of psychological reasons for the sunk-cost fallacy. People are particularly averse to losses. At least in the moment, deciding not to proceed to trial or taking a smaller settlement than expected may feel like a "loss" even when

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it is not. There is also a "status quo" bias where people prefer to maintain their course. People do not like to change their minds. In addition, people are generally hard wired to avoid "waste." Walking away from sunk costs feels like you have wasted money (and sometimes you may have).

The most important thing to remember about the sunk-cost fallacy is that your evaluation of potential outcomes will likely be colored by the amount of money you have invested in the case. You will look at the exact case differently based on how much you have spent. While it may be emotionally easier to reject settlement and proceed to trial in the moment, in the end, that decision could prove financially disastrous. As they say, sometimes it is best to "cut bait" and avoid "throwing good money at bad." Just being aware of this phenomenon can help you avoid a big mistake.

Availability heuristic

The "availability heuristic" is the tendency of people to make judgments about the likelihood of a particular event or outcome based on how easy it is to recall a seemingly similar example or instance. This can be particularly misleading given how our minds selectively store and recall information. For example, after the terrorist attacks on 9/11, Americans tended to overestimate the risk associated with acts of terrorism versus other risks. We could all vividly recall the images of that dreadful day, which made the risk of a future attack seem more likely. In fact, the risk of an attack was no more likely the day after 9/11 than the day before. If anything, the risk was probably diminished (due to increased vigilance).

In the context of mediation, the participants each have their own experiences and information to recall. Plaintiff's counsel might be influenced by the "availability" of a memory about a particularly successful trial result. News of great verdicts abound. Every month, if not every week, you read about some spectacular result. The poor results rarely make the headlines. Because the pro-plaintiff results come to mind more readily, the decision maker develops a distorted expectation about her own case.

Representative heuristic

A similar though distinct heuristic is known as the "representative heuristic." This is the tendency of decision makers to group things together based on the degree to which they resemble each other, and then draw certain inferences based purely on the fact that the two things belong to the same group.

The representative heuristic can be misleading in that the feature or characteristic that causes you to group two things together may be irrelevant to your projection. For example, if you have in your mind a "representative" instance of a traumatic brain-injury verdict, say a $20 million verdict, and your case is a traumatic brain-injury case, you might conclude your case will generate a similarly big verdict based exclusively on the outcome of the representative case. You may ignore other factors or information that show the representative case is not a good indicator of the likely outcome in your case, or not similar to your case at all.

The key to avoiding a mistake related to the representative heuristic is to avoid unreliable or inaccurate comparisons. In personal injury cases, for example, outcomes are notoriously varied. There is no single representative result for your particular case. Verdicts will differ based on things like the venue, the judge, the attractiveness of your client, and even the time of year. If you are going to evaluate your case based on other cases, be sure you are comparing "apples to apples," and not deluding yourself about the similarities in your case and some other case you have in mind.

Affect heuristic

The "affect heuristic" is the tendency to make decisions based on one's current emotions. While everyone knows that emotions can disrupt rational thought, the affect heuristic involves a different concept. This is not clouded thinking. This is what you might think of colloquially as a "gut feeling."

An example of the affect heuristic is found in the negative correlation between projections of risk and potential benefit. When the potential benefit is perceived to be high, people will assess the risk to be lower even when the actual risk is the same. This is why, for example, perfectly rational smokers evaluate the risk associated with smoking differently than non-smokers. For the smoker, the positive association with smoking causes him or her to downgrade the risk. For the non-smoker, particularly the non-smoker with a strong emotional aversion to smoking, the risk associated with smoking is perceived to be much higher. The emotional "gut" feeling about the activity colors the judgment of the decision makers. People also tend to assess risk differently depending on whether they feel "happy" or "sad."

In evaluating your case, you should be aware that your judgment will be impacted by your emotions. If you are excited about the prospect of a "record breaking" verdict, you will probably underestimate the risk. If you are "scared" about trial, you may overestimate the chances of a bad outcome. While it is extremely hard to control one's emotions, just being aware of your emotions can help you make a better decision.

Conclusion

Behavioral economists have produced a wealth of data to show we are not as rational as we think. In fact, we are highly irrational and we don't even know it. Anyone responsible for making decisions under conditions of uncertainty should take note. Our emotions can cause us to make rash decisions in the heat of the moment. Our optimism and confirmation biases cause us to see our cases more favorably than we should. And because of the way our memory works and how we associate people and activities to make predictions, we often expect outcomes that we should not.

The good news is that most people behave irrationally in a way that is predictable. Being aware of this behavior

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can help you avoid mistakes, and to recognize what is happening on the other end of the bargaining table. This should give you a leg up in negotiating your case, and help you better choose which cases to settle and which cases try.

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