RECENT DEVELOPMENTS IN SECURITIES LAW

BEHAVIORAL ECONOMICS AND THE PRACTICE OF LAW

ROBERT C. PORT

Gaslowitz Frankel LLC
303 Peachtree Street, NE
Suite 4500
Atlanta, Georgia 30308
(404) 892-9797
http://www.gadisputes.com/
rport@gadisputes.com

<u>BEHAVIORAL ECONOMICS AND THE PRACTICE OF LAW</u>

By:

Robert C. Port, Esq.[1]
Gaslowitz Frankel LLC
Atlanta, GA

Behavioral economics is the study of how people make decisions. In particular, behavioral economics studies how individual, social, cognitive, and emotional biases influence economic decisions. Although these insights have significant application to how people make decisions regarding investing, they have application for a broad range of decision making. This paper considers these insights as they might apply to the practice of law.

This research demonstrates that decision-making is often not as rational as traditional economic theory would predict. Traditional economic theory – think Adam Smith, *The Wealth of Nations* – makes two basic assumptions. First, that the person making choices either knows or has assessed all the information relevant to making the choice. Second, that the person is rational, and makes choices that are logical and consistent based on that person's desires. This is often referred to as "utility theory."

The problem with utility theory is its limited application in real-world situations. It describes how people ***should*** make decisions, rather than how they ***actually*** make decisions. Real-life decision-making usually employs a variety of cognitive "rules-of-

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[1] Robert Port is a partner with the Atlanta law firm of **Gaslowitz Frankel LLC**. He has over 30 years of experience in civil litigation, arbitration, and mediation. The firm represents individuals, companies, banks, investors, and fiduciaries in disputes involving wills, estates, trusts, guardianships, closely held businesses, and securities and investment fraud. Robert also has expertise in representing investors harmed by the misconduct of their stockbroker, investment advisor, insurance agent, or other trusted advisor.

Robert earned his JD with Honors from the University of North Carolina at Chapel Hill, is AV rated by Martindale-Hubbell, and has been repeatedly selected as a Georgia Super Lawyer. He is the Editor of *Georgia Business Litigation*, a one-volume, comprehensive guide to subjects that business litigators often encounter in their practices, published by American Law Media (ALM). He also publishes and lectures on investing, securities litigation, and arbitration, including articles in both legal and general interest publications. He has been interviewed and quoted by a variety of media outlets, including the Wall Street Journal, The Atlanta Business Chronicle, and the Atlanta Journal-Constitution, and the Daily Report.

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thumb," called heuristics. Heuristics are unconscious short cuts by which our minds make decisions, sometimes instantaneously, rather than the thoughtful, logical, or rational approach that traditional economic theory suggests.[2]

One impact of behavioral economic theories has been to help clarify the proofs and defenses in securities class action litigation. In Basic Inc. v. Levinson, 108 S.Ct. 978 (1988), the Supreme Court upheld the validity of the "fraud-on-the-market" presumption. That presumption provided that class action investors could satisfy the reliance requirement for proving stock fraud premised on a material misrepresentation, because the price of the stock they had purchased or sold occurred in an "efficient market," one which reflected all public, material information, including material misrepresentations.

In its subsequent holding in Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398 (2014), the Court held that defendants can defeat Basic presumption at the class certification stage by introducing evidence that the alleged misrepresentation did not affect the stock price. Of particular note is the concurrence by Justices Thomas, Alito, and Scalia, which channels behavioral economic theories by stating that the Basic presumption is based on "a questionable understanding of disputed economic theory and flawed intuitions about investor behavior." 134 S. Ct. at 2420. The concurrence further observed:

> Basic based the presumption of reliance on two factual assumptions. The first assumption was that, in a "well-developed market," public statements are generally "reflected" in the market price of securities. 485 U.S., at 247, 108 S.Ct. 978. The second was that investors in such markets transact "in reliance on the integrity of that price." Ibid. In other words, the Court created a presumption that a plaintiff had met the two-part, fraud-on-the-market version of the reliance requirement because, in the Court's view, "common sense and probability" suggested that each of those parts *would* be met. Id., at 246, 108 S.Ct. 978.
>
> In reality, both of the Court's key assumptions are highly contestable and do not provide the necessary support for Basic's presumption of reliance. The first assumption—that public statements are "reflected" in the market price—was grounded in an economic theory that has garnered substantial criticism since Basic. The second assumption—that investors categorically rely on the integrity of the market price—is simply wrong.

134 S. Ct. at 2420 (emphasis in original).[3]

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[2] See generally, Kahneman, Daniel, Thinking, Fast and Slow.

[3] As suggested examples of why it is inaccurate to assume investors rely on the market price in making their decisions, "[b]ehavioral-economics researchers have . . . identified numerous types of trading activity - some rational and some not - where traders may not rely on the accuracy of the market price. These traders may range from value investors seeking stocks they believe are

The concurrence thus captures the basis premise of behavioral economics: Contrary to traditional economic theory, we do not always make the best economic choice among different alternatives, that we do not consistently understand or implement probability when making decisions, that our assessment of the probability of future expected events is flawed, that we act impulsively and with unconscious biases, and that we act without complete information.

In short, behavioral economics reveals that we are "predictably irrational."[4] In 2017, economist Richard Thaler was awarded the Nobel Memorial Prize in Economic Sciences for his contributions to behavioral economics and his pioneering work in establishing that people act unpredictably or irrationally in ways that defy economic theory.[5]

Behavioral Economic Concepts As Applied To The Legal Profession

Behavioral economists have identified a number of common themes in decision making, many of which have application to the practice of law. Some of these are:

Anchoring

Anchoring describes the effect that exposure to a recent number, or exposure to certain environments, affect decision-making. The concept of anchoring focuses on our tendency to attach or "anchor" our thoughts to a reference point – even though that reference point may have no logical relevance to the decision at hand. Daniel Kahneman describes anchoring as "one of the most reliable and robust results of experimental psychology."[6]

To illustrate this bias, in a well-known experiment, subjects are asked to write down the last few digits of their Social Security number and then guess the number of

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mispriced, to momentum traders to money managers engaging in herding behavior. The natural argument, then, is that it makes little sense to assume that all investors have relied on the market price and thus, indirectly, on any misrepresentation." Korsmo, Charles R., "Market Efficiency and Fraud on The Market: The Danger Of Halliburton," 18 Lewis & Clark L. Rev. 827 (2014).

[4] Ariely, Dan, Predictably Irrational: The Hidden Forces That Shape Our Decisions.

[5] "Nobel in Economics Is Awarded to Richard Thaler," New York Times, (Oct. 9, 2017) https://www.nytimes.com/2017/10/09/business/nobel-economics-richard-thaler.html (Last viewed January 16, 2018) (Thaler "showed that people depart from rationality in consistent ways, so their behavior can still be anticipated and modeled.")

[6] Kahneman, Daniel, Thinking, Fast and Slow, p.119.

marbles in a jar. Subjects with higher Social Security numbers invariably guess that there are a higher number of marbles in the jar.[7]

As a consequence, the starting point at the beginning of the decision-making process has a very real effect on the final result. In a negotiation, anchoring efforts should occur early in the process, before the other party has an opportunity to anchor based on their own decision-making processes or other experiences.

Consider the following which might be anchor points for your client:

- The first offer made in a negotiation.
- The amount of damages set forth in a complaint.
- Litigation costs already incurred.
- Media reports of similar verdicts or settlements.
- Lawyer advertising as to verdicts and settlements achieved.
- The sale of a similar property or business.
- The highest perceived prior value of a property or business.
- Conducting a meeting in a cheap coffee shop might create mental associations that help you negotiate a lower price, whereas meeting in an expensive restaurant might have the opposite effect.

Overconfidence

Human beings have a tendency to overestimate their own skills and predictions for success. We overestimate the probabilities of good things happening, and (unless we are always pessimistic) discount the probabilities of failure or loss. (The clinically depressed actually have been shown to have accurate assessments, the rest of us are too optimistic. That’s depressing.)

Experts and highly educated people – such as attorneys – are more prone to this bias than laypeople, since their education gives them the (over)confidence to believe they are right. Thus, a lawyer might be too confident in their ability to convince the court that adverse case law is distinguishable.

Behavioral economists have identified a variety of cognitive biases that lead to overconfidence. One is she “illusion of control” - the tendency for people to overestimate their ability to control events. Attorneys, for example, might feel that they can control outcomes for situations where they demonstrably do not have complete control, such as a jury’s decision or whether the other party will accept the terms of a business proposal.

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[7] “An Introduction to Behavioral Economics and Negotiations,” ABA Business Law Section, Business Law Today, https://usinesslawtoday.org/2017/11/an-introduction-to-behavioral-economics-and-negotiations/ (Last viewed Jan. 17, 2018).

Another and related bias leading to overconfidence is the "hot-hand" fallacy – the erroneous belief that a person who has experienced success with a random event has a greater of further success in additional attempts. A flipped coin that has landed on heads 10 times in a row still has only a 50/50 chance of landing on heads on the 11th flip. (Though if has landed heads 100 times in a row you might question the fairness of the coin.) And an attorney who has won their last ten cases, or secured the last ten zoning variances, still must recognize that their success or failure on the next case or zoning dispute is not completely assured.

One approach to counter overconfidence is to conduct a "premortem":

> A premortem is the hypothetical opposite of a postmortem. A postmortem in a medical setting allows health professionals and the family to learn what caused a patient's death. Everyone benefits except, of course, the patient. A premortem in a business setting comes at the beginning of a project rather than the end, so that the project can be improved rather than autopsied. Unlike a typical critiquing session, in which project team members are asked what *might* go wrong, the premortem operates on the assumption that the "patient" has died, and so asks what *did* go wrong. The team members' task is to generate plausible reasons for the project's failure.[8]

This strategy for addressing overconfidence involves "prospective hindsight . . . which helps . . . identify risks at the outset."[9] Using this strategy, the lawyer imagines early on in the representation that the desired goal has not been achieved – the case was lost on summary judgment or at trial, or the business deal collapsed – and then works backward from that hypothetical failure to determine what potentially could lead to that negative result.

Planning Fallacy

The "planning fallacy" refers to the tendency for people to consistently underestimate both the time and costs for completing projects. Because human judgment is generally overconfident and optimistic, people tend to underestimate the costs, completion times, and risks of planned actions.

- In a litigation situation, both sides will likely underestimate not only the amount of time needed to reach a conclusion, but also the cost of the litigation process. Litigators are notorious for underestimating the length of a deposition, arguments on a motion, a hearing, or a trial.
- In a deal situation, parties will underestimate the time needed to negotiate and draft the details of the relevant documents.

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[8] Klein, G., "Performing a Project Premortem," Harvard Business Review (Sept. 2007), https://hbr.org/2007/09/performing-a-project-premortem (Last viewed Jan 18, 2018).

[9] Id.

Behavioral economists suggest that the best way of avoiding the planning fallacy is to use a data-driven technique called "reference class forecasting." Essentially, reference class forecasting tries to eliminate the subjective prejudices of the forecaster (the "inside view"), and focuses on reasonably objective data ("the outside view"). For example, when trying to predict the legal fees and expenses of a lawsuit, the analysis would be this:

> First, identify a number of similar lawsuits as your "reference class." The number needs to be of sufficient size to be a good sample.
>
> Second, collect data on the reference class. How long did those lawsuits last from beginning to end? How much were the total legal fees and expenses? You can then develop a range of the variation in total costs, as well as the average cost from that reference class, to determine a baseline estimate.
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> Third, evaluate the effect of concrete differences between your particular case and the reference class cases. For example, have your rates gone up, will discovery be more extensive, will you need a greater number of experts, will motion practice be more robust, etc. Adjust the baseline estimate upward or downward based on these differences.
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> Fourth, actually use the estimate and ignore the inevitable tendency to use your original gut "prediction" about the cost, rather than hard data.[10]

Confirmation Bias

Confirmation bias is the tendency to interpret new facts and experiences in ways that reinforce our pre-existing beliefs. Simply stated, we favor information which confirms our beliefs, while discounting facts that counter those beliefs. As a consequence, confirmation bias causes us to give less weight to information which challenges those beliefs, and we may not even search for conflicting evidence or differing opinions.

Confirmation bias often places undue influence on information gathered early on. A person forms an initial opinion and then evaluates subsequent evidence through that filter so that it confirms the opinion. The "first impression" controls, and then the person has "blinders" on, preventing any realistic assessment of contrary information.

In *Predictably Irrational*, psychologist Daniel Ariely describes an experiment where he asked MIT students to taste-test two types of beer. One is a regular beer, and the other is the same beer, but with balsamic vinegar added. They called this "MIT Beer." As expected, when told in advance that MIT Beer contained vinegar, the students preferred the regular beer. However, when they were not told in advance about the vinegar, the students typically preferred MIT Beer.

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[10] Mauboussin, Michael, Think Twice.

Much of what lawyers do involves direct adversarial situations (litigation, arbitration, mediation), or quasi-adversarial situations, such as M&A deal making. Confirmation bias can cause either or both sides to have an unrealistic view of their chance of success, leading to an inability to objectively evaluate the matter, and resulting in extended litigation or negotiation deadlocks. Some examples:

- Clients often have no ability to recognize the possibility that the fact finder will not find them credible, will not find the facts as the client swears them to be, or otherwise will not see their case as the client sees it.
- A litigation lawyer fails to adjust the case's "theme" he identified early on even when discovery produces evidence challenging that theme or suggesting alternative theme(s).
- A lawyer might discount or wholly ignore the probable effect of negative testimony at a deposition, focusing on the parts of the deposition that support his client's position.
- A business client may be so enamored of the proposed deal that they overestimate the cost savings of a merger, the ease of regulatory approval, or the ability to merge different business cultures into one.

Confirmation bias can be countered by maintaining an objective viewpoint from the start. Also, it is useful seek input and feedback from objective third parties who have no stake in the matter. Any negative information counter to our initial analysis and impressions must be carefully and objectively analyzed, without fear that doing so will cause us to recognize the bias in our own decision-making.

Loss Aversion

Loss aversion is the tendency of people to fear losses more than they desire a gain of similar value. A person viewing himself or herself as losing something places more value on the thing lost than someone who views the transaction as receiving the same thing, even though the economic value of the loss and the gain are the same.

A lawyer who understands these incentives can set up the litigation, or the business negotiation, to increase the chance of reaching a successful result. Loss aversion suggests that rather than trying to achieve a result by threating the adverse party with a loss, the lawyer who can frame the consequences for all parties as a "win-win" to should do better in achieving the result desired by their client.

Hindsight Bias

Another common behavioral tendency is hindsight bias. This describes situations where a person believes, after the fact, that what happened was predictable and completely obvious, when in fact, the event could not have been reasonably predicted. The fact is that "stuff happens," often in ways that are unpredictable and unexplainable, but it won't appear that way after the fact.

Psychologists attribute hindsight bias to our innate need to find order in a chaotic and uncertain world. To do so, we create rationalizations that allow us to believe that unexpected or unpredictable events most certainly could have, and should have, been predicted.

Some clients expect lawyers to have perfect foresight as to the course of negotiations, the way in which a judge or jury will decide a case, or what a government regulator might do. How many times have we heard a disappointed client say "You should have known!", as if we have the perfect foresight of a crystal ball?

To reduce the challenges of disappointment caused by a client's hindsight bias, the lawyer should regularly remind the client of all the variables in the litigation/negotiation decision making process over which the attorney has little or no control:

- The strategies of the adverse party and their counsel;
- The interpretations of law by the court;
- The facts as found by the judge or jury;
- The subjective impressions that each of the players involved have with each other (opposing counsel, opposing party, judge, jury, mediator).

Conclusion

By understanding some of the key heuristics and unconscious tendencies lawyers and their clients use to make their decisions – decisions which are often "predictably irrational" [11] – a lawyer can accomplish two things. First, we can better understand our own decision-making processes and improve them. Second, with that knowledge, we can help our clients make better decisions.

[11] Ariely, Dan, Predictably Irrational: The Hidden Forces That Shape Our Decisions.