Making sense of business failure: a social psychological perspective on financial and legal judgments in the context of insolvency

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1 The Psychology of Making Sense of Business Failure

An Introduction

1.1 Setting the Stage

In many instances, people's assessments of the causes of failures or adverse events, as well as subsequent judgments of responsibility and blame, have direct and important implications. Think for example of currently pressing issues such as immigration and climate change. In these cases, widely differing opinions exist regarding who or what is to blame and what should be done to solve these issues. Some suggest that many current societal issues (e.g., intolerance, social unrest, crime rates) are for an important part the result of the relatively uncontrolled immigration Europe has seen over the past decades and particularly in the past few years. In contrast, others consider the same problems to be primarily the result of xenophobic and nationalist sentiments and therefore believe immigration is not a problem at all. Rather, according to this group, the solution is not to put an end to immigration, but instead to adopt a more tolerant stance towards immigrants and embrace cultural differences and foster inter-cultural interaction and inclusion.

A similar conflict in causal attributions and proposed solutions can be found in the climate change debate. Most people are certain that recent climate change can be ascribed to human activity and therefore can be stopped (or at least slowed down) by limiting human-caused emissions of greenhouse gases (e.g., CO_2). In contrast, a growing minority is more sceptical about the causes of climate change and therefore consider it to be bad policy to allocate large sums of money to reducing CO_2 emissions, particularly when this would be at the expense of addressing other societal needs (e.g., education, housing, health care).

As a final example, think of the public's perception of the causes of the global financial crisis. That catastrophic event has frequently been portrayed as being primarily the fault of greedy Wall Street bankers. Indeed, a Google search for Lewis Ranieri (a former vice president of investment bank Salomon Brothers and the 'father' of mortgage-backed securities) brings one to an article by TIME magazine titled "25 People to Blame for the Financial Crisis" with an attached poll titled "Who Deserves the Most Blame?"[1] Preventing future

1 TIME magazine. "25 People to Blame for the Financial Crisis. Retrieved on 5 December 2019, from: http://content.time.com/time/specials/packages/article/0,28804,1877351_1877350_1877339,00.html

financial crises could therefore be achieved by simply getting rid of the bad apples and thus firing and possibly even jailing the responsible managers and traders, right? As appealing as such relatively simple explanations and solutions might sound, one can question whether it really was that simple. To what extent was the global financial crisis perhaps also the result of financial deregulations and the lack of adequate government supervision? And to what extent were consumers themselves to blame for taking on increasing amounts of debt to finance their (sometimes multiple) houses and lifestyles? Or how about the numerous investors who invested in financial products they did not really understand? Despite the appeal of 'silver bullets' typically put forward by the general public, reality is usually more complex, and dire situations more often than not result from a complex interplay of a multitude of factors.

I present these examples to illustrate that people's perceptions of the causes of certain societal issues determine their beliefs regarding who or what is to blame and what a suitable solution ought to be. In pressing issues such as immigration, climate change, and the functioning of the global financial system, people's sentiments can dominate public debates and even result in public uproar and (violent) demonstrations, as we have recently seen in the Netherlands from workers in both the agricultural and building industries in response to climate saving measures. Hence, the conclusions people reach after having tried to make sense of adverse events are important. But how can it be that people's perceptions of events such as in the examples used differ by such large margins? How do people go about making sense of adverse events in the first place? To what extent are people actually able to accurately and objectively analyse the causes of highly complex events? That is, to what extent might emotions, feelings of moral outrage, and perhaps even unconscious factors cloud people's judgments of sensitive events?

Understanding how sense-making processes might go awry due to certain psychological influences is not only important when it comes to highly visible debates that receive a lot of public scrutiny. Indeed, the implications of causal attributions and related judgments have perhaps even more direct and concrete implications in the legal domain. That is, in legal decision making, sense-making processes surrounding legal transgressions play a key role in determining legal blame, liability, and punishment. For example, to determine the appropriate legal sentences in criminal cases, judges need to determine whether a defendant knowingly or even purposefully committed a certain crime and whether there are any exculpatory circumstances. Likewise, in civil cases, judges need to determine whether or not there is a causal link between a tortfeasor's actions and the damages suffered by the plaintiff in order to determine whether compensatory damages have to be paid. Moreover, judges need to assess to what extent a certain adverse event could reasonably have been foreseen, as judges can reduce the amount of compensatory damages awarded to the plaintiff if they believe part of the damages incurred could not have reasonably been foreseen by the tortfeasor. In sum, causal attributions

specifically and sense-making processes more generally play a key role in the legal discourse and have direct implications for legal rulings.

Even though legal professionals are most likely more appreciative of the innate complexity of the causes and circumstances surrounding legal and moral transgressions, one can wonder to what extent their judgments might still be affected by the same emotions, feelings of moral outrage, and unconscious factors that tend to affect the general public. It goes without saying that it is of vital importance for elements such as procedural justice, legal certainty, and ultimately people's human rights and the public's trust in the legal justice system that legal professionals in general and legal decision makers in particular can and do accurately and objectively analyse legal cases, free of unwanted psychological influences (e.g., emotions, unconscious bias, logical fallacies).

Before discussing both classic and more recent research in psychological science that provide ground for why legal professionals might in fact be subject to certain psychological processes that affect their sense-making processes and legal judgments in ways that deviate from the rational ideal, I will first demarcate the specific legal context that is the focus of this dissertation. After having discussed the legal context and the psychological processes that might influence legal reasoning, I will end this introduction by synthesizing this dissertation's primary goals and by briefly introducing each of the subsequent chapters that contribute to these goals.

1.2 Defining the Legal Context: Business Failure and Insolvency Law

The legal context of this dissertation is that of business failure and insolvency law. For lawyers, specializing in restructuring and insolvency is known to offer an interesting career path due to the diversity of the work (e.g., restructuring distressed businesses, negotiating with stakeholders, negotiating complex transactions, conducting liability investigations) and its combination of different legal fields, such as contract law, liability law, financial law, corporate law, property law, etc. For psychologists, the same holds true in that many different psychological phenomena, theories, and insights can be applied to the context of business failure and insolvency law. Given the endless number of examples of situations that legal professionals can encounter in the context of corporate insolvency in which psychological phenomena may play an important role, I will limit myself to illustrating only those situations that will be dealt with in the remainder of this dissertation. It is therefore important to note that the topics discussed here are in that sense not exhaustive.

When a company has become insolvent, three courses of action can be differentiated. First, an insolvency lawyer (or trustee or insolvency practitioner, depending on the jurisdiction) needs to assess whether it is possible to restructure the business in such a way that it can continue to exist in its current form.

The business would then be 'rescued' and liquidation would be avoided. Second, when restructuring efforts have failed or were deemed unfeasible, an insolvency lawyer needs to assess how the company can be liquidated in an orderly fashion and whether certain assets can be transferred as a 'going concern' to a new legal entity, either owned by the same shareholders or under new ownership. Finally, an insolvency lawyer can (and sometimes has to, such as under Dutch law) investigate the causes of the company becoming insolvent, as directors can be held personally liable when a company's demise, and hence the damages suffered by creditors, is for an important part the result of 'mismanagement' on behalf of those directors. I will first zoom in on this latter element and discuss which key judgments need to be made in such investigations. I will then describe lawmakers' recent shift towards business rescue (as opposed to liquidation) and the investigations and judgments that are becoming increasingly important as a result.

1.2.1 Directors' liability in case of insolvency

Under Dutch law, trustees (i.e., insolvency lawyers appointed by a bankruptcy judge to govern the administration of an insolvent estate) are under the legal obligation to conduct an investigation into the causes of a company's bankruptcy. It is the trustee's duty to investigate whether any irregularities can be identified as the cause of a company's failure and/or or whether fraud has been committed (Article 68(2) Dutch Bankruptcy Act). In case a trustee comes to the conclusion that mismanagement by a particular director or board of directors is an important cause of a company's downfall, the director(s) can be held personally liable for any deficit in the company's estate (Article 2:138/248(2) DCC). Hence, trustees need to investigate a company's management's conduct in hindsight, and assess whether key business decisions were reasonable in light of the circumstances at the time those decisions were made, or whether these were in fact gross misjudgments that can be labelled as negligence and/or mismanagement. In this light, trustees need to determine to what extent the unwanted consequences of such key business decisions were in fact foreseeable and whether a causal link exists between directors' mismanagement and their company's bankruptcy.

Crucially, as will elaborately be discussed in Chapter 5 of this dissertation, judging in hindsight while being aware of the negative consequences of certain actions makes it particularly difficult to accurately and objectively assess those actions. It is rather difficult for people to go back in time, as it were, and truly view a certain decision in light of the circumstances at that moment in time and thus mentally undo or at least ignore any knowledge they have of how a certain course of action ultimately resulted in bankruptcy. Trustees therefore risk judging business decisions too harshly and unjustly putting forward liability claims against directors. As a consequence, directors may face a ban

on taking on any leadership positions for up to five years. Moreover, being held liable for a company's downfall can have detrimental effects on a director's personal well-being (Jenkins, Wiklund, & Brundin, 2014; Kesteren, Adriaanse, & Rest, 2017; Ucbasaran, Shepherd, Lockett, & Lyon, 2013). Moreover, reputations are at risk and creditor claims on the bankrupt estate in some cases far exceed insurance coverage and can therefore lead to dire financial circumstances in the private sphere. Therefore, an accurate assessment of a director's conduct in relation to the company's insolvency is paramount.

One specific ground for directors' liability in case of insolvency is that of wrongful/fraudulent trading, as defined under UK law (Insolvency Act 1986, Section 214), among others. Although differences exist across jurisdictions in terms of specific duties bestowed upon directors in the vicinity of insolvency (see for an overview INSOL International, 2017), the central theme is that directors ought to be reluctant to take on any new debt when their company is approaching insolvency as they risk not being able to pay back those debts, thereby damaging their creditors as a result. Under Dutch law, directors need to comply with the so-called Beklamel norm,[2] which states that directors face personal liability in tort under Article 6:162 DCC when "a director has entered into an agreement on behalf of the company, even though (s)he knew or should reasonably have known that the company would not, or at least not within reasonable time, be able to fulfil its obligations under this agreement and would not provide for sufficient assets against which recourse could be taken" (INSOL International, 2017, p. 714). In light of such laws and regulations, trustees and/or insolvency practitioners need to determine in hindsight how likely it was that a company was going to become insolvent at the time the company took on new debt and whether directors ought to have known they would not be able to fulfil their contractual duties following these new agreements. Considering such judgments also need to be made in hindsight, the same worry arises as described earlier. That is, to what extent might legal professionals be affected in their judgments by their knowledge of how a particular company's fate ultimately unfolded (i.e., insolvency)? Can it be that the likelihood of failure is overstated in hindsight?

In addition to assessing the likelihood of insolvency, trustees need to assess the responsible directors' mental states at the time of incurring new debt to be able to dissociate between wrongful trading and fraudulent trading. Specifically, when a director incurs debt with the purpose of damaging creditors, this constitutes fraudulent trading. In contrast, taking on new debt while 'merely' failing to appreciate the company's dire financial state and resulting inability to pay back those debts constitutes wrongful trading (also called negligent trading). Hence, in addition to determining the likelihood of insolvency, legal professionals need to assess directors' mental states in the sense that they need to assess whether a director acted intentionally, knowingly, recklessly, or

2 Dutch Supreme Court 6 October 1989, NJ 1990, 286, (Beklamel).

'merely' negligently. Indeed, even in the absence of an intent to defraud creditors, it matters whether a director did not know but should have known about his/her company's dire financial situation and gloomy prospects, or whether that same director incurred debts knowing full well (s)he would not be able to offer recourse. Chapter 6 of this dissertation deals with the question whether or not legal professionals are affected by extra-legal factors when determining (in hindsight) a company's likelihood of insolvency and directors' mental states.

To summarize, following a company's insolvency, legal professionals typically conduct investigations into the causes of a company's downfall and under Dutch law are even obliged to do so. Such investigations typically centre around the conduct of a company's directors who may face personal liability for any deficit of the bankrupt estate if it can reasonably be established that they are to be blamed for their company's downfall (e.g., due to mismanagement). Hence, in hindsight, legal professionals need to make sense of a company's demise and the role played by its management. As argued in section 3 of this introduction (and more in depth in Chapters 5 and 6), a range of psychological factors make it difficult to accurately analyse the past when an individual is fully aware of how certain key business decisions ultimately turned out.

1.2.2 A shift towards business rescue

In recent years, a shift has occurred in both Dutch and EU insolvency law in that these now show an increased focus on restructuring and business rescue instead of liquidation (Boon & Madaus, 2017). Specifically, similar to Chapter 11 proceedings in the US in which debt restructurings allow businesses to continue as a going concern, other countries are adopting laws and regulations with the aim of providing businesses with a second chance. For example, the UK has its so-called "scheme of arrangements" (Companies Act, 2006) in which the court arranges debt restructurings and forms agreements between shareholders and creditors with the goal of facilitating a fresh start. Similar procedures are found in for example Australia (Corporations Act, 2001) and South Africa (Companies Act, 2008). Likewise, the European Committee is actively working on harmonizing its nation states' bankruptcy laws with the purpose of enabling business rescues to run more smoothly. A thorough analysis of the reasons for this shift falls outside the scope of this dissertation, but in essence it is believed that much economic value is lost in case of liquidation and that this can be prevented by identifying business failure at an early stage when sufficient time and resources are still available to restructure a business, thereby preventing insolvency and unnecessary (job) losses.

As a result of the shift towards business rescue, insolvency practitioners and other legal professionals are confronted with several key issues in pre-

insolvency arrangements. First, the causes of a company's decline need to be determined as this has direct consequences for perceptions regarding the company's viability. For example, if a company showed substantial decline as a result of mismanagement but the company itself has ample opportunity for growth and a sound business model, changing senior management might suffice to turn the company around. In contrast, if a business suffered significant losses due to an outdated business model, industry wide issues, or general economic turmoil, administrators will probably be more sceptical about the company's viability. In that case, continuation of the business would require a major strategic overhaul which might prove difficult.

Second, irrespective of the causes of a company's decline, it needs to be established what a company's future outlook is. If restructured, will the company be able to survive and hence represent a higher economic value than if the company were to be liquidated?

Third, following directly from the second point, a comparison needs to be made between a company's liquidation value and its value as a going concern. As a result, valuation issues are becoming increasingly common. A too optimistic going concern valuation risks continuation of that business while in reality it has very little chance of surviving, which might then result in further losses for creditors. Alternatively, a too pessimistic valuation risks liquidation while in reality the company would have had a solid chance to survive and thrive. But to what extent are legal professionals able to determine the accuracy and quality of the work of business valuators? Might it be that legal professionals are affected by unwanted psychological factors when evaluating a company's outlook and the work of business valuators? Chapter 4 of this dissertation deals with this question.

In addition to legal professionals, in many circumstances financiers also need to determine the causes of a company's decline and its future outlook. For example, when evaluating the options of liquidation versus restructuring, creditors (e.g., banks) often need to determine whether they are willing to take a 'hair-cut' (i.e., a write-down on their claims against the company) to reduce the company's debt burden and/or whether they are willing to extend further credit to finance a turnaround or whether to use their legal right to terminate financing. Commercial banking contracts include this type of clauses to protect against the debtor's insolvency. Similar to legal professionals, financiers' decisions will be based for an important part on their perceptions of the causes of a business' decline and its future outlook, as well as their perceptions of the role of the management. Given the complexity of making sense of the past and predicting the future, could financiers also be affected by certain psychological processes that causes them to make suboptimal decisions? Chapter 3 of this dissertation deals with this question.

1.2.3 Summarizing the legal context

When companies face substantial decline or have even become insolvent, both legal professionals and third parties such as financiers need to make consequential judgments and decisions that will, for an important part, determine the fate of that company and its directors. Pre-insolvency, the focus of their judgments is primarily forward-looking and will ultimately be used to assess whether it makes economic sense to avoid liquidation. In contrast, post-insolvency these judgments will centre around the causes of a company's downfall and in particular the roles played by the company's directors. In both pre-insolvency and post-insolvency situations, legal professionals and financiers are faced with a highly complex task that involves taking innumerable different factors and uncertainties into account. To what extent is it realistic to expect humans, and even highly trained experts, to be able to make sense of such a complex event as a company's demise in an objective and unbiased manner? Is it not far more likely that such sense-making processes are riddled by psychological factors that obfuscate the objective assessment of a company's history and likely future? As alluded to several times in this introduction, advances in psychological science suggest it is likely that a wide range of psychological processes tend to affect people's perceptions and predictions in such instances. The next section of this introduction discusses this point in more detail.

1.3 The Unconscious Mind and its Flaws

The workings of the unconscious mind have fascinated philosophers and scientists alike ever since the time of the ancient Greeks (e.g., Plato and Aristotle). In more modern history, it was Sigmund Freud (founding father of psychoanalysis) who popularized the unconscious mind in psychological science (e.g., Freud, 1989) and who attributed a prominent role of the unconscious in human cognition and motivation. Even though Freud's theories have largely been discredited, psychological science has seen a continued interest in the role of the unconscious brain (e.g., Bargh & Chartrand, 1999; Bargh, Lee-Chai, Barndollar, Gollwitzer, & Trötschel, 2001; Hassin, Uleman, & Bargh, 2005). Even though there are some who consider the conscious will to be an illusion altogether (e.g., Lamme, 2011; Wegner, 2002), in general dual-process models are considered more mainstream, which typically allocate some functionality to both conscious and unconscious processes (for reviews, see for example Osman, 2004; Pennycook, 2017). A full history and overview of the science surrounding the role of the unconscious in human cognition and behaviour would be well beyond the scope of this dissertation. The key take-away for now is that an important part of our thoughts, feelings, and actions are influenced by factors outside of conscious awareness and control.

Despite the widespread acknowledgement within psychological science of the significant role our unconscious mind plays in the way we make sense of the world and in the way we form judgments and make decisions, this notion has not yet fully reached other disciplines. For example, economic models typically still rely on the human concept of the *homo economicus*. This model, which is central to for example game theory, typically portrays humans as perfectly rational agents who are self-interested and who pursue their goals and interests in an optimal manner. However, most modern economists acknowledge this portrayal is inaccurate and that economic models fare better when taking at least some degree of human irrationality into account.

Arguably, two key developments can be accredited for the increased acceptance in economics and other social sciences of the limitations imposed on human rationality. First, Nobel laureate Herbert A. Simon introduced the concept of *bounded rationality*, which in essence proposes that boundaries exist for human rationality due to humans' limited cognitive capacities, time constraints, and the limited information typically available concerning a particular decision problem (Simon, 1957). Second, and perhaps even more impactful, psychologists Amos Tversky and Daniel Kahneman (the latter of whom also received the Nobel Prize in Economic Sciences in 2002) developed their *Prospect Theory* and further popularized the notions of *heuristics and biases* (e.g., Kahneman, 2011; Kahneman & Tversky, 1979). Combined, these concepts challenged the traditional rational choice theory by demonstrating that people frequently deviate from the rational ideal in a non-random, systematic fashion. In a nutshell, heuristics are mental shortcuts or 'rules-of-thumb' that under ideal circumstances allow mental processes to operate quicker, thereby facilitating fast judgments and decision making. Indeed, the unconscious processing of information in general is not problematic in and of itself, quite the contrary. However, under certain circumstances those same heuristics can lead judgments astray.

In their landmark paper, Tversky and Kahneman provided several examples of how heuristics and biases operate (Tversky & Kahneman, 1974). They listed three heuristics that are involved in judgments concerning the probability of events and related predictions. Specifically, they discussed the representativeness heuristic, availability heuristic, and the adjustment and anchoring heuristic. As an illustration, I will briefly discuss the representativeness heuristic. In short, this heuristic is used when people make judgments concerning the probability that a certain event (A) caused another event (B). For such judgments, people assess to what extent A is representative of B. For example, when considering the likelihood that a series of random coin tosses (assuming a fair coin) will produce a particular sequence of heads and tails, people judge the sequence H-T-H-T-T-H to be more probable than the sequence H-H-H-T-T-T, even though both have the same probability of occurring. People believe that the former sequence is more representative of a random sequence than the latter and therefore overestimate its probability of being true. Even

though the heuristic of using information regarding whether an event (A) is stereotypical of some broader phenomenon (B) can be useful to inform probability estimates, that same heuristic can bias our judgments when other pieces of information, such as the statistical probability of a certain event, are given insufficient weight or are even ignored.

Applied to the context of business failure and insolvency, legal professionals and financiers might for example be confronted with a particular director of a now insolvent business who they perceive to be, or perhaps is even known to be, a highly narcissistic person who greatly values his social status. He might run a tight ship and not appreciate his staff questioning his authority and vision. Moreover, this director is very materialistic and spends most of his wealth on lavish homes and exclusive cars. Now, how representative would people consider this director to be of someone who mismanages his company? Or of someone who is likely to commit fraud or to cut corners to benefit his own company at the expense of creditors? Might it be that at least some legal professionals and financiers will overestimate the probability that this director has been involved in fraudulent actions or mismanagement because that director fits their image or preconception of the way immoral and incompetent directors typically are? Chapter 6 of this dissertation takes this discussion further.

Another striking example of a cognitive bias is the well-known framing effect (Tversky & Kahneman, 1981), which suggests that people's aversion to incurring losses is typically stronger than their motivation to acquire gains of the same magnitude. In their classic demonstration of this effect, Tversky and Kahneman presented participants with a scenario describing an anticipated outbreak of a rare disease expected to kill 600 people. Participants were asked to choose between two alternative courses of action to combat the disease. The first option was presented as a certainty (i.e., 400 people will die), whereas the second option was presented as a probability (i.e., 1/3 probability that nobody will die, 2/3 probability that all 600 will die). Importantly, for half of the participants, these two alternatives were framed in terms of how many people would die (see above), whereas for the other half the same options were framed in terms of how many lives would be saved (i.e., "200 people will be saved" for option 1 and "1/3 probability that everyone will be saved, 2/3 probability that no people will be saved" for option 2). Thus, participants were presented with exactly the same alternatives, only the way these were *framed* differed. The results showed that when the two alternatives were framed in terms of lives saved, the majority (72%) opted for the option providing certainty (i.e., 200 lives will be saved). When the alternatives were framed in terms of lives lost, the majority (78%) opted for the risky alternative (i.e., 1/3 probability that nobody will die, 2/3 probability that all 600 will die). Hence, people's preferences shift from risk aversion to risk taking when the frame shifts from gains to losses.

Since Tversky and Kahneman's initial work, a whole field of research focused on cognitive biases emerged, resulting in the identification of many different biases to which humans can succumb. Tversky and Kahneman's work even resulted in the emergence of an entire new academic discipline, behavioural economics, which deals with how economic decisions specifically are affected by (unconscious) psychological factors, among others. Given that the subsequent chapters of this dissertation discuss a range of different biases in depth, I will refrain from providing more examples or evidence at this stage. For now, it is important to realize that ample evidence exists for the role our unconsciousness plays in our judgments and decisions and that these unconscious influences can bias our judgments in systematic and undesirable ways.

Given the abundance of evidence for the existence of cognitive biases in people's judgments and decisions that has accumulated over the years, has the legal domain, for which such findings are clearly worrisome, paid much attention to the effects that cognitive biases might have on their reasoning? My answer to this question is: insufficiently, as I argue in the next section.

1.3.1 Cognitive biases in legal reasoning

In the beginning of the last century, legal realism emerged as a new movement that opposed the more traditional doctrine of legal positivism. Whereas legal positivists suggest, in a nutshell, that legal reasoning follows a structured and mechanical approach in which correct decisions can be deduced from predetermined legal rules (e.g., Hart, 1958), legal realists suggest in contrast that legal reasoning and decision making is much less mechanistic and that courts "[…] decide not primarily because of law, but based (roughly speaking) on their sense of what would be 'fair' on the facts of the case" (Leiter, 2003. p. 50). Moreover, realists have argued that "legal rules and reasons figure simply as post-hoc rationalizations for decisions reached on the basis of non-legal considerations" (Leiter, 2003, p. 50, see also Green, 2005). Thus, even though concepts like bounded rationality and heuristics and biases had yet to see the light of day at the time the legal realism movement emerged, there was already some acknowledgment of the idea that judicial decision making might not be perfectly deduced from the law and that it could be influenced by, for example, moral considerations.

Following the doctrine of legal realism, research has been conducted on factors that might (unconsciously) affect legal reasoning and decision making; these will be discussed in subsequent chapters. As an illustration, an important concern has been to what extent courts are able to accurately judge in hindsight in an unbiased manner, thereby recognizing the risk of being affected by hindsight bias. In short, hindsight bias refers to the risk of exaggerating the foreseeability of certain events in hindsight, resulting from people's knowledge

of how a certain course of events ultimately unfolded (Fischhoff, 1975). Thus, what might have been hard to predict in foresight, might in hindsight appear as though it was in fact easily foreseeable. Considering that legal decision making happens almost without exception after the fact, hindsight bias clearly risks causing unfair judgments and in parties unduly being held liable for damages that could not realistically have been foreseen (e.g., Helm, Wistrich, & Rachlinski, 2016; Rachlinski, 1998). Chapter 5 of this dissertation deals with the question whether legal professionals succumb to hindsight bias when evaluating a director's liability in relation to insolvency and whether some might be more susceptible to this bias than others.

Despite the promising work being done in recent years on the cross-section of law and psychology, one could argue that this interdisciplinary field is still in its infancy and that many open questions remain. For example, as will be discussed in Chapter 5, several limitations exist in the literature that make it difficult to generalize previous findings regarding hindsight bias to the specific context of business failure and directors' liability. For example, the literature on hindsight bias among legal professionals is rather scarce and has shown mixed results, which might be due to the low statistical power previous research suffered from. Moreover, the majority of research on hindsight bias has been conducted on 'jury eligible participants', which is a relevant population for jurisdictions that have a jury system (e.g., the United States), but less so for jurisdictions that do not (e.g. the Netherlands, Germany, and many other EU countries). Moreover, in the case of directors' liability, other legal professionals such as trustees, insolvency lawyers, and insolvency practitioners play a more prominent role as they most often lead the investigations into directors' conduct. I therefore believe it to be important to conduct high-powered research on this topic to complement previous work and investigate whether this specific group of legal professionals is affected by hindsight bias.

The same limitations regarding the current state of the literature hold true for other psychological phenomena studied in this dissertation. Indeed, to date only a single study has investigated whether legal professionals (in this case judges) can be affected by extra-legal factors when determining a person's mental state at the time a crucial decision was made (Kneer & Bourgeois-Gironde, 2017). Moreover, no research has yet tested whether moral character inferences specifically can bias legal professionals' judgments of mental states and other relevant legal judgments in the context of insolvency (Chapter 6). Likewise, when it comes to financial decisions made by either legal professionals or bankers, very little work has been done in the context of business failure and how financial judgments in this specific context might differ from investment or credit decision under better circumstances (Chapter 3). Finally, considering the shift towards business rescue is a recent development, no research has yet been devoted to how legal professionals might perceive and evaluate business valuations in this context, and how this might lead to further conflict (Chapter 4).

In addition to limitations in the scientific literature, there is also work to be done when it comes to bridging the gap between science and practice. Specifically, despite advances made in the fields of law and psychology, practitioners are, in my personal experience, typically unaware of these advances and on occasion even deny being affected by unconscious biases altogether. For example, when giving seminars and workshops to legal professionals, I observe that only a small minority is aware of the seminal work by Tversky and Kahneman and that they typically succumb to the 'bias blind spot', i.e. the tendency to recognize or acknowledge biases in others but not in oneself. Moreover, there have been cases at the Dutch commercial court in which the risk of hindsight bias was explicitly mentioned but cast aside by the court relatively easily.[3] Appreciating the somewhat anecdotal nature of the above, it might be that in some jurisdictions or areas of law the possible effects of cognitive biases are more widely acknowledged. There is evidence that at least in some jurisdictions courts have recognized the risk of biased legal judgments and have attempted to adapt and limit the effect these biases might have on their rulings (for a comprehensive and critical review of such adaptations, see Rachlinski, 2000).

In sum, although important work has been conducted on the cross-section of psychology and legal scholarship, more work is needed. Adopting a behavioural sciences approach to studying legal problems is still relatively new and it is therefore not surprising that many open questions remain (for reviews on the developments of behavioural science within legal scholarship, see for example Engel, 2013; Rachlinski, 2000b, 2011; Ulen, 2014). Nonetheless, it is promising to see the increasing attention for this emerging field and the explicit calls that have been made for the further integration of insights from psychological science to legal scholarship (e.g., Jolls, Sunstein, & Thaler, 1998; Ulen, 2014). With this dissertation I aim to answer these calls and contribute to the growing field of empirical legal science.

1.4 Aims of this Dissertation

To reiterate the state of the literature as discussed in the previous section, little research has been aimed at the psychological processes affecting legal professionals' judgments, the research thus far has occasionally shown mixed results, and it typically suffers from low statistical power. Moreover, when it comes to research specifically within the context of business failure and directors' liability, hardly any research has been conducted among legal professionals. Finally, there is still a bridge to cross between academia and legal practice when it comes to informing legal practitioners on advances in the field of bias

3 Case against Fortis N.V. (ECLI:NL:PHR:2013:172) and the case against Meavita (ECLI:NL:GHAMS:2015:4454)

research applied to the legal context. In light of this latter point, furthering our understanding of the mechanisms underlying certain cognitive biases as well as important boundary conditions will be valuable when developing debiasing protocols.

This dissertation aims to attend to the issues raised above. Put succinctly:

> *The primary goal of this dissertation is (1) to investigate whether cognitive biases affect legal professionals' and financiers' judgments in the context of business failure and insolvency, and (2) to improve our understanding of the mechanisms underlying these biases and of boundary conditions.*

In this dissertation, I aim to translate existing knowledge of certain biases to the context of business failure and insolvency, while making theoretical advances by investigating the underlying mechanisms and boundary conditions of these biases. The next, and final, section of this introduction will provide a brief overview of the core questions addressed in each chapter.

1.5 Overview of Chapters

The following chapters vary somewhat in terms of focus; some have a more applied focus (Chapter 4) whereas others are more theoretical (Chapter 2 and Chapter 6), and yet others are a mixture of applied and theoretical advances (Chapter 3, Chapter 5). Despite the clear goal of this dissertation as set out in the prior section, for several reasons it might not always be directly clear to the reader how some chapters contribute to achieving this goal. The first reason relates to my own perspective on this dissertation and the second reason is a reflection of the learning process throughout the past four yours.

Regarding the former, my perspective on this dissertation is that it is more akin to a portfolio of the papers I have written in the past four years (i.e., a collection of individual and independent research projects) that combined contribute to this dissertation's primary aim as stated above, rather than a set of chronological and clearly interconnected chapters. The chapters can therefore be read independently and in any order. This approach also explains why I included the research described in Chapter 2 in this dissertation, which I expect will be somewhat technical for those without a background in cognitive psychology. Yet, I do consider the key messages of Chapter 2 to be intriguing and I elaborate on what legal scholars and practitioners can take away from this chapter.

The latter reason for why some chapters might initially feel somewhat removed from the overarching theme of business failure and insolvency relates to the chosen target audience which, for some chapters, is not directly legal scholars or practitioners. I experienced challenges in conducting interdisciplinary research when it comes to choosing a target audience and writing up the

findings accordingly. Specifically, I attempted to conduct research that is both relevant to legal scholarship and practice, as well as for psychological science. As a result, some chapters contain both applied elements such as demonstrating certain biases in legal and financial judgments, while at the same time they incorporate theoretical elements aimed at increasing our understanding of these psychological phenomena. The difficulty of my endeavours is related to determining who the target audience will be and which approach – applied versus theoretical – should receive prominence. For example, a paper targeted at legal scholars and practitioners to advance psychological theorizing may well be received with scepticism, as I have experienced, as the audience is, in general, more interested in the legal context and concrete legal implications than in learning about abstract psychological theory. In contrast, when writing a paper targeted towards psychologists, focusing on the applied element results in this community sometimes questioning the paper's contribution. This group will be less interested in the applied legal context and would rather see advances being made in psychological theories.

Having tried to balance applied and theoretical contributions in the same paper, I have learned that this approach is suboptimal for the reasons mentioned, and that it may be preferable to adopt a clear focus with a clear target audience. Still, the research discussed in Chapter 5 is an example of a paper where I combined both applied and theoretical contributions and which was therefore challenging to write. Having learned this lesson, for the final research project of this dissertation (Chapter 6), I chose to adopt a more theoretical approach, and this chapter is thus targeted towards experimental philosophers. Despite the variation in foci of the subsequent chapters, each has clear contributions for this dissertation's research goal, and I attempt to highlight these in the overview below as well as in each respective chapter.

The first empirical chapter of this dissertation (Chapter 2) provides an illustration of how decisions can be affected by unconscious factors. Specifically, this chapter shows that once people have learned that a certain behaviour results in either a positive or a negative outcome (resulting in strong mental associations between the action and the effect), presenting people with either positive or negative cues automatically triggers the corresponding action (i.e., the 'positive action' in response to positive cues and the 'negative action' in response to negative cues). The key contribution of this chapter is its demonstration of negative cues being able to trigger actions that people have learned to result in negative outcomes. Previously, it was believed that mental processes geared towards approaching rewards and avoiding punishments would overrule the automatic activation of maladaptive (i.e., negative) behaviours when presented with negative cues. This chapter presents data showing that under certain conditions, such adaptive processes (i.e., those geared towards approaching reward and avoiding punishment) can be bypassed, ultimately resulting in a bias for behaviours that were previously learned to result in negative outcomes when faced with negative cues.

This experimental study was conducted in a controlled environment with college students as subjects and was therefore quite far removed from legal practice. Nonetheless, the implication of this chapter for legal practitioners lies in the study's additional evidence for the notion that certain decisions can be affected by automatic and unconscious processes, even when these decisions have been learned to result in unfavourable outcomes. Moreover, the research in this chapter suggests that under conditions in which certain self-control processes are limited, decision biases can be aggravated. Considering that in the context of business failure and insolvency legal professionals and financiers typically operate under conditions of stress, time pressure, and perhaps even sleep deprivation (i.e., all of which hamper self-control), it is possible that these professionals are particularly prone to biases due to such circumstances.

Chapter 3 focusses on an important stakeholder in insolvency proceedings, being businesses' financiers and in this case bankers, specifically. As discussed, when faced with a company in financial distress, bankers need to assess what the most important causes are of the financial decline (i.e., the company's management or external factors outside management's control) and whether they still have trust in the management's ability to turn the company around. In this chapter, I investigate whether bankers succumb to similarity bias in such a way that they are more likely (1) to attribute the cause of a company's decline to external factors, (2) to trust the entrepreneur's ability to save his company from bankruptcy, and (3) to extend additional credit to finance the turnaround, when they perceive the entrepreneur to be more similar to themselves versus when they perceive the entrepreneur as less similar.

Chapter 4 investigates to what extent cognitive biases can affect legal professionals' evaluations of business valuations. As discussed, business valuations have become increasingly important in the light of the shift in EU and Dutch law towards business rescue. However, legal professionals typically hire business valuators to conduct these valuations as they themselves are not equipped for that task. Given the prominent role of business valuations in key decisions in insolvency proceeding (e.g., whether continuation of a business is economically viable or whether liquidation makes more sense), it is important to understand whether cognitive biases can affect legal professionals' perceptions of such business valuations. Specifically, we investigate whether similarity bias, outcome bias, and gender bias can affect legal professionals' perceptions surrounding business valuations.

Chapter 5 deals specifically with the difficulty of judging in hindsight and tests whether legal professionals succumb to hindsight bias (i.e., retrospectively overstating the foreseeability of events) when evaluating a director's role in a company's bankruptcy. Moreover, in this chapter I investigate whether some legal professionals are more susceptible to hindsight bias than others. More specifically, I test whether believing in free will is related to people's susceptibility to hindsight bias and whether this is likely due to variation in people's need to condemn and punish wrongdoers.

Chapter 6 investigates to what extent legal professionals are influenced by moral character inferences when making judgments relevant for determining wrongful/fraudulent trading. More specifically, we tested whether legal professionals' judgments concerning (1) a director's mental state, (2) the likelihood of company's failure, (3) as well as attributions of blame and punishment are affected in such a way that harsher judgments are made for directors with a morally bad character than for those with a morally good character, even though character information should not have any bearing on these judgments.

Finally, Chapter 7 offers a general discussion of this dissertation's key findings and elaborates on what the findings might mean for legal scholarship and legal practice, as well as giving directions for future research and practice.