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

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7 | General Discussion

Given that each of the previous chapters already offers critical reflections on the findings as well as the limitations and future directions for research, in this chapter I focus on the overarching conclusions that can be drawn and what these mean for both legal scholarship and legal and banking practice. I first briefly reiterate the goal of this dissertation as well as the key findings of each chapter. Next, I discuss the key contributions of this dissertation, both for academia and for practice. I conclude this discussion by elaborating on avenues for future research that I consider to be promising.

7.1 SUMMARY OF THE KEY FINDINGS

In this dissertation I set out to: “(1) *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.*” To this end, we conducted several studies primarily among legal professionals, but also among bankers and college students. Chapter 2 demonstrated among this latter population that certain decisions can be automatically activated by environmental cues, even when we have previously learned that such decisions will result in negative outcomes. Despite being far removed from legal practice due to the controlled nature of this study as well as the arbitrariness of the decisions, it serves as a demonstration that external factors can automatically affect our decisions in undesirable ways and outside of conscious awareness. Perhaps even more important, this chapter suggests that decision biases might be aggravated when control processes are limited, which is typically the case when operating under stress, when being sleep deprived, or when dealing with strict time constraints. Given that such conditions are not uncommon for legal professionals and financiers, it is possible that these professionals are particularly susceptible to certain biases.

Chapter 3 demonstrated among a sample of bankers that sense-making processes regarding the cause of a company’s financial distress can be affected by similarity bias such that more external causal attributions are made in the case of high degrees of perceived similarity between bankers and entrepreneurs. Moreover, the same bias was found to affect bankers’ trust in the entrepreneur. Interestingly, no significant relationship was found between

perceived similarity and the likelihood of extending credit, suggesting that bankers in the specific context of credit decisions involving distressed assets might overall be less affected by similarity bias than other financiers such as venture capitalists.

Chapter 4 showed that legal professionals can be biased in their assessments of business valuations and business valuers. Specifically, the study showed that the outcome of a deal, the similarity with a valuator, as well as the gender of a valuator can affect legally relevant judgments and evaluations pertaining to valuations and their valuations. Such biases in the context of business valuation risk obscuring the efficient settlement of valuation disputes as well as unfounded trust or distrust in a particular valuation. Indeed, in the context of business failure specifically, biased evaluations of business valuations and valuers risks continuing a business that in reality is no longer economically viable, or alternatively the liquidation of a company that in reality had a solid chance of surviving.

Chapter 5 demonstrated that learning about a company's bankruptcy caused legal professionals to perceive the bankruptcy as more foreseeable and also to evaluate the company director's actions more negatively compared to when these professionals were unaware the company went bankrupt. Additionally, we found that the degree to which legal professionals believe in free will was related to the extent to which they were affected by outcome information, such that those with stronger free will beliefs demonstrated a larger bias in evaluations of directors' decision quality, as well as a larger bias in foreseeability judgments.

Finally, Chapter 6 showed that irrelevant information pertaining to a director's moral character influences mental state attributions, perceptions of a company's outlook, as well as blame and punishment attributions. Thus, in the context of business failure, financiers might be more sceptical of a company's outlook when it is run by a morally bad director versus when it is run by a morally good director, thereby possibly giving insufficient weight to more important information. Likewise, legal professionals might in hindsight unduly hold a director liable for wrongful trading as a result of the director's character. Additionally, in this chapter we put forward a novel account of the folk psychology of intentional action and provided empirical support for the central role of moral character inferences.

In sum, then, this dissertation's primary aim was to investigate whether cognitive biases affect legal professionals' and financiers' judgments in the context of business failure and insolvency, and combined the results summarized above provide ample support for the idea that these professionals can indeed be affected by cognitive biases when making sense of business failure. The second aim was to improve our understanding of the mechanisms underlying these biases and of boundary conditions. Several advances have been made in this dissertation. First, even though Chapter 2 did not investigate sense-making processes of legal professionals or financiers in the context of

business failure, it did further our understanding of how external cues can bias our decisions and the conditions under which such a bias can be aggravated. Specifically, a certain action can be triggered when the associated effect is presented due to the affectively laden bidirectional action-effect associations. Thus, once one has learned that a certain action results in a negative outcome, being presented with a negative cue can trigger that action. Moreover, this study shows that this clearly maladaptive process is probably more likely to occur when control processes aimed at preventing such actions from being activated are minimized.

Second, Study 3 contributed to the second aim by zooming in on the specific context of distressed credit and financiers' decision making, demonstrating that bankers appear to be only partially affected by similarity bias. Whereas previous research identified clear similarity biases among early-stage equity investors (e.g., venture capitalists), we found that perceived similarity was related only to causal attributions and perceived trustworthiness, and only indirectly with the ultimate credit decision. Hence, we suggest that certain idiosyncrasies of bankers might, to a degree, protect them from being affected by similarity bias in their credit decisions.

Third, in Chapter 4 a boundary condition was identified regarding the gender bias. Specifically, we found that only men were affected by gender bias in the sense that this group had more trust in the valuator's work when that valuator was also male. Women on the other hand did not show this bias.

Fourth, in Chapter 5 we show advances in understanding the drivers behind hindsight bias. Across two studies we found that those believing stronger in free will demonstrated a stronger hindsight bias in foreseeability judgments as well as a stronger outcome bias in evaluations of a directors' actions. Belief in free will was used as a proxy for people's punitive desires, suggesting that the need to blame and condemn wrongdoers might be an important driver of these biases.

Finally, Chapter 6 furthers our understanding of the role of moral character inferences in mental state ascriptions as well as a range of other judgments such as blame, punishment, and the likelihood a company will fail. This chapter shows that irrelevant and unrelated character information can bias legally relevant judgments such that these are harsher for morally bad directors.

Combined, this dissertation provides evidence for the existence of cognitive biases among legal professionals and financiers when making sense of business failure, as well as furthering our understanding of these biases. Before discussing the broader implications of the findings presented here, a critical reflection on the limitations of the methodology used is warranted.

7.2 LIMITATIONS OF THE METHODS USED

Throughout my undergraduate and graduate studies, I have been trained to conduct experimental research. Initially I was trained in the kind of experimental research described in Chapter 2 (i.e., focussing on behavioural data in a controlled lab environment), and later on in the use of online vignettes. Due to this training and experience, I have come to appreciate both the advantages and disadvantages of the experimental method. A major benefit is that this method allows for causal inferences to be drawn and to isolate a particular effect one is interested in. In the case of hindsight bias for example, using vignettes makes it possible to test whether people answer differently when they are informed on the outcome of a case versus when they are not. In real life, it is impossible to establish with any certainty whether someone is affected by hindsight bias, because we will never know whether someone would have judged differently if outcome information had been absent. The same is true for the effects of moral character inferences. In real life, we can never tell with certainty that someone let character information affect their judgments, because we will never know how that person would have judged had the character of the agent under consideration been different. Using vignettes, we can keep all other factors constant and truly isolate the element we are interested in.

As discussed multiple times throughout this dissertation, the key weakness of using vignettes is the generalizability of the findings to real-world contexts. I aimed to develop vignettes that were detail-rich and realistic, which contributes to the generalizability of the findings (Aguinis & Bradley, 2014). Feedback received from the legal professionals on the vignettes used was generally very positive, and participants responded positively with regard to the realism of the vignettes. However, I also received feedback stating that not enough information was provided in the vignettes to make well-founded judgments. This is understandable as in real-life cases there is typically much more information available. The question then is, to what extent do the findings generalize to real-world contexts?

Three possibilities exist. First, it could be that for whatever reason, the findings do not generalize at all and legal professionals and financiers in real life are hardly affected by cognitive biases. Second, it could be that the effects found in this dissertation generalize perfectly and that the effect sizes are roughly the same in real life. Finally, it could be that the effect sizes observed in this dissertation are actually on the conservative side and that in real life cognitive biases pose a much bigger problem than one might expect based on our findings. It is perhaps hard to make a convincing argument in favour of any of these three hypotheses, but in light of the abundance of evidence for the existence of cognitive biases across a wide range of domains, I personally consider the first hypothesis unlikely. Given that the biases studied in this dissertation rely to some degree on moral intuitions or emotions in

general, it could be argued that such underlying processes might be stronger in a real-world context, based on the assumption that emotions will be experienced stronger in real life than when using online vignettes.

All in all, I trust the studies in this dissertation offer unique insights into how legal professionals and bankers can be biased in their judgments, while appreciating the limitations of the methods used and the benefits of complementing these findings in the future with additional research using different methods.

7.3 IMPLICATIONS FOR PSYCHOLOGICAL SCIENCE AND LEGAL SCHOLARSHIP

A challenging aspect of this dissertation has been to conduct research that will ultimately provide useful insights for practitioners, while at the same time contribute to the academic fields of psychological science and legal scholarship. Balancing between practically and theoretically oriented research proved quite a challenge. In the next section I discuss the implications for practice, so I will first briefly reflect on this dissertation's contribution to the academic literature.

For psychological science, the key contributions of this dissertation lie not so much in the demonstration of biases in judgments and decisions, as there is already overwhelming evidence for this phenomenon, but they can be found elsewhere. First, an important contribution is that certain biases were demonstrated in ecologically valid samples of legal professionals and bankers. That is, much criticism has recently hit the field of psychological science (in particular social psychology) in the aftermath of fraudulent research and the failure to replicate key findings (for an overview, see Shrout & Rodgers, 2018). Moreover, criticisms have been expressed regarding the generalizability of findings when using WEIRD samples (Western, Educated, Industrialized, Rich, and Democratic; Henrich, Heine, & Norenzayan, 2010). Even though this dissertation did not systematically test for differences between WEIRD and non-WEIRD samples, several studies were conducted among professionals from across the globe and thus also included people from non-WEIRD societies. Therefore, the studies presented in this dissertation contribute to the field of psychological science by demonstrating that the biases studied in this dissertation can also be found when using more ecologically valid samples from diverse backgrounds.

The second contribution of this dissertation for psychological science is the advances made in terms of understanding the drivers behind particular biases and what boundary conditions might be, as described in section 7.1. Despite the fact that psychologists have been studying cognitive biases for several decades, there is still work to be done when it comes to fully understanding the underlying mechanisms and the circumstances under which biases might be attenuated or aggravated in practice. For example, as discussed in Chapter 3 the topic of financial decision making in the context of financial

distress is highly understudied as well as the extent to which different types of financiers might be affected by biases in this context. Likewise, Chapter 5 discussed the limitations of the current literature when it comes to hindsight bias among legal professionals (i.e., limited research attention, mixed results, low statistical power) and the mechanisms driving the different types of hindsight bias that are currently not yet fully understood. As a final example, in Chapter 6 we discussed the state of the literature when it comes to asymmetries in mental state attributions, put forward a novel theory to account for the existing data, and presented new empirical evidence for the central role of moral character inferences.

A third contribution of this dissertation to both psychological science and legal scholarship is the advances made on motivated moral reasoning research. Indeed, a central theme of the discussed findings is that both moral judgments and subsequent motivated reasoning processes can bias our judgments. Specifically, whereas moral and legal judgments should be the result of an unbiased review of the available facts and assessments regarding for example causality, intentionality, and foreseeability, it appears that initial moral reactions can bias sense-making processes in such a way that people are unconsciously motivated to match their final judgments with their initial intuitions (for an excellent review of motivated moral reasoning, see Ditto, Pizarro, & Tannenbaum, 2009). When faced with a company's bankruptcy, legal professionals will in some cases experience some degree of contempt towards the company directors in light of the damages caused to creditors or because of their perceptions of the directors' moral characters. Whatever the source of their moral intuitions, motivated moral reasoning processes would suggest that negative evaluations surrounding company directors will bias the subsequent sense-making processes and insolvency investigations. It is not unlikely that undue attention will be focused on the directors' actions at the expense of external, circumstantial, contextual factors. More weight will be given to arguments and facts that are in line with initial moral intuitions, and information that contradicts this view will be downplayed. Ambiguous information will be explained in ways that are consistent with the professionals' preconceptions and less rigorous judgmental standards will be applied to information consistent with rather than inconsistent with these preconceptions (e.g., Clark, Chen, & Ditto, 2015; Ditto et al., 2009; Sood, 2013). As stressed before in this dissertation, it is important to realize that such biased sense-making of business failure is an unconscious process and does not involve disingenuous lawyers, judges, or bankers *per se*. Rather, those engaging in biased sense-making will do so under the illusion of objectivity (Hughes & Zaki, 2015; Kunda, 1990; Nadler & Mueller, 2017; Sood & Darley, 2012). That is, those involved will most likely be convinced that they have engaged in a careful, rational, and objective analysis of the available evidence and are perhaps even convinced that they have done so in an unbiased manner.

It is clearly worrisome for both legal scholarship and legal practice that motivated moral reasoning underlies the judgments of legal professionals, even when they are convinced they are acting objectively. Fortunately, recent years have seen increased attention to motivated reasoning processes (Clark, Chen, & Ditto, 2015; Ditto et al., 2009; Sood, 2013). However, apart from the occasional paper in a law review (e.g., Haidt, 2013; an excellent paper that deserves more attention), the majority of such work is confined to the psychological literature. In this dissertation I combined insights from motivated cognition, motivated moral reasoning, as well as those derived from the recent increase in attention for the central role of moral character inferences in moral judgments. I hope therefore that this dissertation will contribute to legal scholarship by raising awareness of and providing evidence for the ways in which moral judgments can shape legal professionals' sense-making processes and subsequently bias legal judgments.

7.4 IMPLICATIONS FOR LEGAL PRACTICE

Like me, psychologists might look at some of the findings presented in this dissertation and not be surprised at all. Demonstrating biases in human judgments is interesting and useful (and in my view even fun), but not groundbreaking in light of the abundance of existing evidence. Hence, the fact that legal professionals and financiers are actually human and thus succumb to cognitive biases is no surprise. Still, in my experience legal professionals and even legal scholars generally find it difficult to accept this fact. Acknowledging the anecdotal nature of the following, I frequently encounter legal professionals who publicly deny being affected by unconscious biases. They might be willing to say that people in general can be affected by cognitive biases, but not them as they have been trained to be objective and rational when analysing legal cases. I believe this to be a classic case of 'bias blind spot'. I have also met well-known legal philosophers who were certain that legal professionals might be affected by information about a director's professional reputation, but definitely not by *irrelevant* character information. Chapter 6 of this dissertation suggests otherwise. When giving workshops or lectures attended by legal or financial professionals, I ask them about their familiarity with the notion of biases and heuristics and for example the work of Tversky and Kahneman. Some have read Kahneman's well-known book *Thinking Fast and Slow*, but the vast majority have not and are unaware of the work done in psychology relevant to legal and financial decision making. Based on the assumption that such encounters are not unique, I believe there is still quite a long way to go before legal decision making will be infused with more realism.

What can and should be done to ultimately limit the effects biases can have on legal and financial reasoning and decision making? A proper answer to this question would probably encompass several additional dissertations, which

is why I will refrain from trying to come up with a comprehensive answer. Nonetheless, I will put forward some suggestions that I believe might hold promise and which I have come across during the span of my PhD research. In light of these suggestions, it is important to note that no solid debiasing ‘trick’ currently exists. Any effort to counter the effects of biases will therefore probably require substantial efforts and monetary investments. It therefore becomes relevant to determine how important stakeholders of legal proceedings consider it to be to have ‘bias free’ courts. In criminal law it is more obvious who should carry the burden of improving legal decision making (i.e., the government), but who will bear the additional costs in civil procedures? Thus, some of the suggestions made below might be less realistic than others due to the costs involved. Ultimately it matters what we care about more as a society; is it preventing false positives (assigning blame/liability where in reality there should be none) or false negatives (assuming no blame/liability where this should have been the case)? In case of the former, some suggestions I make below may warrant further investigation.

A necessary first step I believe is to raise further awareness among financiers, legal practitioners and legal scholars about the effects that biases and motivated reasoning processes can have in financial decision making and legal proceedings. Such awareness is important as without it, no one will be motivated to make an effort to counter the effects of cognitive biases. In light of raising awareness, I also see an essential role for law schools. In addition to the standard curriculum, law schools should offer courses focused on teaching students about psychology (as also suggested by, for example, Haidt, 2013). This way, the new generation of attorneys and judges will enter the workforce knowing full well which factors might threaten their reasoning. Also, if radical changes were required to deal with the effects of biases in legal reasoning, this new generation would probably be more supportive of such changes than the current generation.

One way to counter the risks of cognitive biases clouding insolvency investigations specifically, might be to refrain from conducting such investigations altogether, apart from situations in which there is a clear suspicion of fraud or in cases where a corporate insolvency has such significant societal impact that people will want to know what happened. Such a position has been argued by for example Dutch insolvency law professor Reinout Vriesendorp (Vriesendorp, 2017). Such a measure would likely decrease false positives, but risks increasing false negatives (for thorough reviews of adaptations of courts in response to hindsight bias, see Rachlinski, 1998, 2000a).

Other potential solutions to counter the risk of cognitive biases can be found in the field of forensic science. In forensic investigations, a case manager is appointed who gathers all the relevant information and who liaises with all the relevant stakeholders (e.g., police, prosecutors, crime scene investigators). Given that this case manager is exposed to information that might have biasing effects (e.g., moral character information), it is acknowledged that this

case manager is not able to evaluate the available evidence in an unbiased manner (e.g., comparing fingerprints found at the crime scene with those of suspects). Thus, the case manager filters the available information and only passes on the essential information necessary for a second investigator to conduct the investigation. Such a process has been called “linear sequential unmasking”, which entails that at each step of an investigation, it is determined which information is essential to complete that step and that increasing amounts of information is disclosed at later stages (Dror et al., 2015; Stoel, Berger, Kerkhoff, & Dror, 2014)

Applied to the context of directors’ liability in relation to insolvency, can trustees appointed with the task of conducting an insolvency investigation conduct such an investigation in an unbiased manner given the exposure to a wealth of information with potentially biasing effects? As should be clear by now, this is highly unlikely. Therefore, it might be worthwhile appointing independent investigators or a second trustee who will collaborate with the main trustee (who would then serve as the case manager). This would limit the risk of biases tainting the investigation, but would clearly add significantly to the cost of insolvency investigations. In case limited funds are available in the estate, it might not always be feasible to hire additional investigators. The same applies to bankers’ decision making. They may want to separate the decision making process from the investigation phase and have two separate bankers (or more) appointed to a client: one who interacts with the entrepreneur and (at least) one who is shielded from potentially biasing information such as first impressions of the client. However, not only would this be a costly solution, it would perhaps also, paradoxically, be met with scepticism from clients who probably want the ultimate decision maker to have due regard for their unique circumstances and narrative. The same paradox exists when delegating financial decision making to algorithms. Even though such algorithms are expected to have superior abilities when it comes to predicting a company’s future outlook and thus its credit worthiness in times of distress, people are yet somewhat reluctant to fully rely on algorithms that are unable to communicate their ‘thought process’ (i.e., black box problem). Also, clients will probably be reluctant to have their entire future be dependent on the advice of an algorithm.

In cases where using additional investigators or advanced algorithms is not an option, it would be beneficial if trustees and financiers would be equipped with a better toolkit when it comes to conducting insolvency investigations. Currently, little guidance exists as to how to conduct such investigations. Generally, lawyers are trained to analyse jurisprudence, not to conduct scientifically sound investigations into bankruptcies. It is therefore not surprising that such investigations can be methodologically flawed and thus allow results to be biased. It would therefore help if attention was paid in law schools to how to conduct sound investigations.

In addition to hiring external investigators or providing training courses and/or guidance to trustees, courts might themselves be able to improve their investigations from a methodological standpoint to limit unwanted psychological effects. As has been convincingly argued by emeritus professor Raimond Giard (e.g., Giard, 2017), the opportunities for methodological improvements in investigations in civil proceedings are plentiful, for example when it comes to substantive truth finding.

A question I find particularly intriguing is what effect it might have when we change our perspective on business failure and start viewing it as normal or even the default, and business success as ‘surprising’ and as the outlier. Many of the discussed biases and processes of motivated moral reasoning have as their starting point a certain degree of moral outrage or negative emotion. Such emotions or outrage are the result of being confronted with a situation that is surprising and/or in violation of people’s innate sense of fairness. Indeed, it has been well established that people have a need to mentally construct the world in a way that is comforting, fair and just, morally predictable and controllable, a world in which people “get what they deserve and deserve what they get” (Clark et al., 2015; Ditto et al., 2009; Lerner, 1980). Given this belief in a just world, and the inherently intuitive and automatic nature of moral judgments, it is not surprising that being confronted with business failure automatically triggers sense-making processes that are partly motivated by the desire to reconstruct this event in such a way that it fits with our worldview. After all, if a business’ failure was the result of corrupt or at least incapable management, that is a coherent story. The directors will be blamed, and perhaps even held liable, and thus get what they deserve. Admitting that a company’s failure was the result of bad luck is highly discomforting and unsatisfying. It implies the same can happen to ourselves. For this reason, people prefer to attribute others’ success to luck and their failure to their own wrongdoing (unless they are part of our in-group, in which case this pattern is reversed), a phenomenon called ‘defensive bias’ or ‘self-serving bias’ (e.g., Miller & Ross, 1975; Thornton, 1984; Tyler & Devinitz, 1981). If their success was a matter of luck, this implies we can be bestowed with the same luck. If their failure was a matter of their own wrongdoing, we can avoid the same fate by simply not making the same mistakes.

One implication of all this might be that if we did not perceive a certain event as being surprising or abnormal, or in violation with our belief in a just world, we may not experience much negative affect when being confronted with that event, nor would we have the need to make sense of that event in a biased and motivated manner. Translated into the context of business failure, what would happen if we would look at business failure as being normal, as something that would not require any explanation because going bankrupt is simply what companies ultimately do? What if we would rather look at a business’ success as something that is out of the ordinary and therefore much more interesting to investigate? Interestingly, statistically speaking business

failure *is* much more likely than success. As mentioned before, typically only 50% of new businesses survives the first five years of trading and after 15 years only 25% still exist (BLS, 2019). In that sense, business failure *is* in fact the norm (see also Verdoes & Verweij, 2018). I find it an intriguing hypothesis that motivated moral reasoning processes (and thus biased perspectives of business failure) might be attenuated when we make such a paradigm shift.

To conclude this dissertation, I have argued that in order to counter the effects of cognitive biases in both financial and legal judgments surrounding business failure, first and foremost it is important to raise more awareness about the psychological influence on the reasoning and sense-making of financial and legal professionals. Next, I have argued that attention should be given to the methods currently used in insolvency investigation and legal proceedings and how these might be improved such that the risk of biases is diminished. Finally, I have put forward a somewhat speculative, yet intriguing (at least in my view) hypothesis concerning the potential benefits of a paradigm shift in our thinking about business failure. All three of these suggestions require substantial further research as currently very little is known about how we can debias our reasoning and judgments. For now, I trust this dissertation will contribute to the goal of understanding if, when, and how human sense-making processes and decision making is affected by cognitive biases and how we can ultimately reduce such biases to make sure that important judgments are as rational and fair as they can be.

