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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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Summary

The starting point of this dissertation was the observation that (1) financiers and legal professionals need to make several important judgments when faced with an insolvent business and (2) that humans in general are notoriously susceptible to cognitive biases when faced with complex problems under certainty and time restraints. The main question therefore was:

To what extent do these professionals succumb to the effects of cognitive biases when making sense of business failure?

Moreover, in addition to investigating the existence of several biases in financial and legal reasoning, this dissertation sought to further our understanding of the mechanisms underlying these biases and whether certain boundary conditions exist. In light of the importance of ensuring fair trials and safeguarding people's trust in the legal system, as well as in light of the severe consequences for individuals (e.g., company directors) if they are held liable for damages, it is important to know whether biases can cloud financial and legal professionals' judgments and if so how this works.

To answer these two questions, several studies were conducted among legal professionals, financial professionals, and college students. In the latter population, it was demonstrated (Chapter 2) that under certain conditions, negative environmental cues can automatically trigger decisions that have previously been learned to 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, as well as that such biased decision making might be aggravated when self-control processes are minimized. Among a sample of bankers (Chapter 3), it was demonstrated that sense-making processes regarding the cause of a company's financial distress can be affected by similarity bias to the extent 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. Among a sample of legal professionals, it was been demonstrated in Chapter 4 that this group 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 all affect legally relevant judgments and evaluations pertaining to valuers and their valuations. These 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, which can then lead to suboptimal decisions to insolvent companies. In Chapter 5 it was demonstrated that learning about a company's bankruptcy causes legal professionals to perceive the bankruptcy as more foreseeable and that they evaluate the company director's actions more negatively compared to when these professionals are unaware the company went bankrupt. Additionally, we found that the degree to which legal professionals believe in free will is related to the extent to which they are affected by outcome information, to the extent that those with stronger free will beliefs demonstrate 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. Furthermore, this chapter put forward a novel account of the folk psychology of intentional action and provides empirical support for the central role of moral character inferences.

Combined, these results provide ample support for the idea that legal and financial professionals can be affected by cognitive biases when making sense of business failure. Additionally, the research in this dissertation has shed more light on the underpinnings of a number of biases. For example, a new insight is that believing in free will is associated with hindsight bias, suggesting that people's innate desire to punish wrongdoers might cause people to perceive past events in such a way that it is coherent with their moral intuitions. Additionally, this dissertation has drawn further attention to the role that moral character inferences have on legally relevant judgments.

A central theme of the research described in this dissertation is that motivated reasoning processes play an important role in legal and financial judgments. In short, motivated reasoning implies that people's initial moral intuitions guide their subsequent sense-making processes in such a way that people are unconsciously motivated to arrive at a conclusion that is coherent with their initial reaction/intuition. I believe that this is where this dissertation makes an important contribution to the field of legal scholarship. Research pertaining to motivated reasoning processes has only recently started gaining popularity in the psychological literature and therefore has not yet penetrated the field of legal scholarship, let alone legal practice. Despite its importance, knowledge of cognitive biases in general and of motivated moral reasoning in particular is largely absent among financiers and legal professionals. There-

fore, in the discussion section of this dissertation I argue that much work still needs to be done to first of all raise awareness of these key psychological insights among practitioners. Additionally, I argue that substantial improvements can be made in insolvency investigations as well as judicial investigations to limit the effects biases can have. Finally, I put forward a hypothesis pertaining to a change in mindset regarding business failure. Specifically, I hypothesize that normalizing business failure might help overcome some of the biases in sense-making processes stemming from moral intuitions.

