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A Playbook for Overcoming Cognitive Bias

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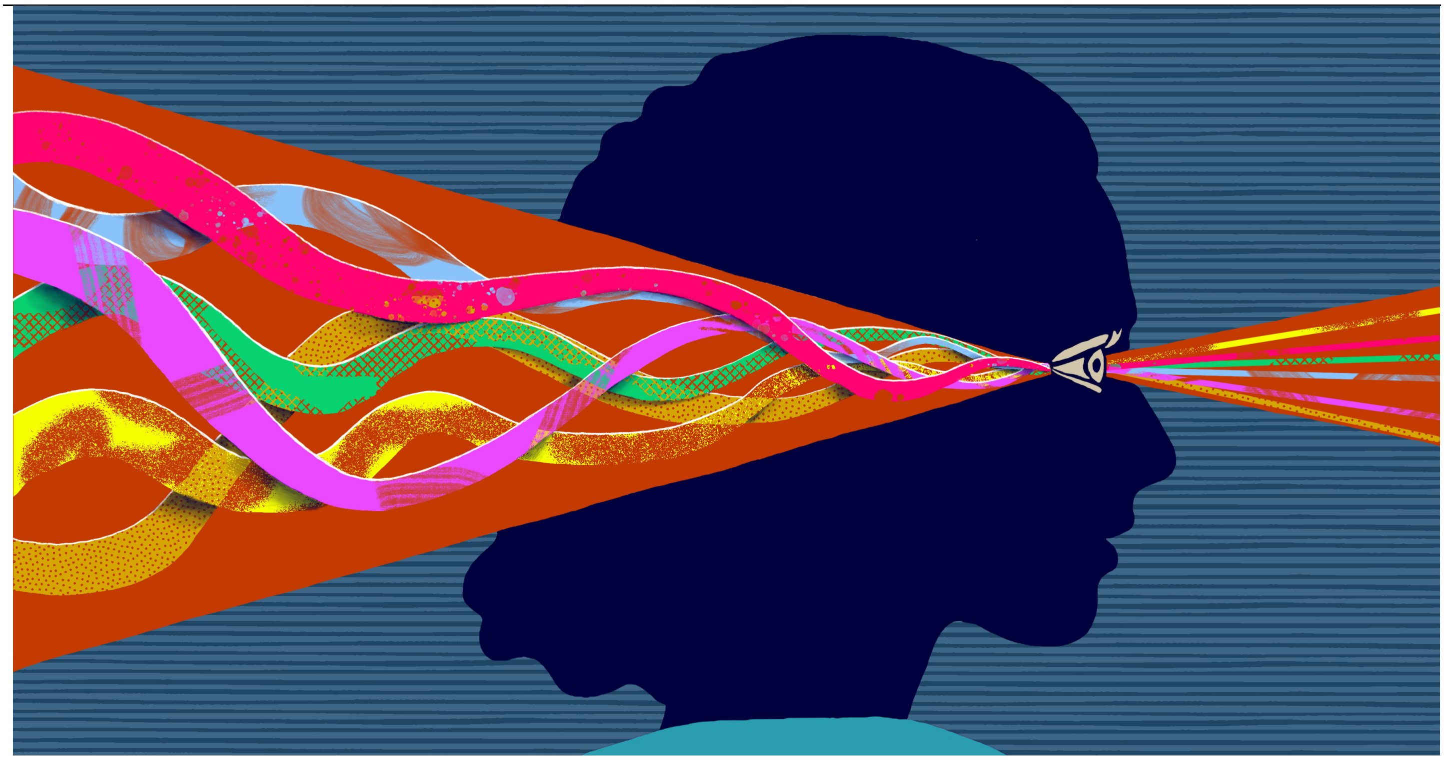

Original Artwork by Gina + Matt.

Cheat Sheet

- **Cognitive bias.** Mental shortcuts can impair the judgment of contract negotiators and put contracts at risk.
- **The long haul.** When contract negotiations take a long time, some lawyers are willing to cut corners and endanger the deal in order to wrap it up faster.
- **Future.** Considerations of compounded risk and reward over time must be made to avoid fallacious negotiations.
- **Playbook.** Biases can be avoided by creating a playbook of strategies to protect contracts from unnecessary risk.

Cognitive biases are an inescapable part of being human, and this can negatively affect an in-house counsel's performance during a negotiation. However, taking its effects into account confers great advantages.

As advisors to companies, NGOs, governments, and the like, it behooves negotiating lawyers to study the impact of human irrationality in decision-making and spot it when it happens to others. The effects of cognitive bias become more pronounced with higher stakes and longer-term negotiations, as more will hinge on human intuition with every decision. Creating a "negotiation playbook" to address cognitive bias can help in-house lawyers avoid pitfalls that may occur.

Large enterprises that value consistency and transparency may wish to automate certain negotiations to minimize the risks of cognitive bias. For organizations that have less contractual risk, or that value speed, integrating an enterprise-wide approach may not be the best approach. Regardless, the ability to recognize cognitive biases is a skill that will help in-house counsel serve their organization.

Cognitive bias

A cognitive bias is, in essence, a systematic error in thinking arising from mental shortcuts, known as heuristics, that are endemic to most human beings. Situations arise which can exacerbate one's mental shortcuts to the point that it impairs one's judgment. The study of these cognitive biases ended up giving rise to a branch of science known as behavioral economics, which studies the economic impacts of human irrationality, be they stemming from psychological, cognitive, emotional, cultural, or social influences.

Sunk cost fallacy

The amount of discretion a lawyer has for executive decision-making during a negotiation often falls to their client. While the idea of having the ability to walk away from a deal sounds inviting, it is rarely the case that one may do so in reality. The deal may simply be too important. For example, a sales team with an ax to grind may be far more powerful in the eyes of executive leadership than a lone lawyer appearing to cry wolf about the future risk of certain contractual terms. Politics and human emotion go hand in glove in frustrating a negotiator's goals.

This issue leads us to the sunk cost fallacy, which arises when people believe their existing investments justify further investment and cost. In the case of the negotiating counsel, it is when counsel feels pressure from internal and external forces to continue to agree to term because "we've come too far and negotiated too long to walk away."

Say a sales team pressures a legal team to cave on a term or condition that gives the lawyer pause. Add in pressurizing factors that this negotiation has been going on for a long time and a large percentage of the sales team's P&L depends on closing this deal. What then? Surely one can't walk away from the deal. In such a moment, the wisest action is to learn from that scenario rather than try to prevent it after the fact and plan for its reoccurrence. Mitigation may be your most realistic tactic. However, while you might lose that battle, you don't have to completely capitulate your wisdom to the aggression of outside factors.

To address the sunk cost fallacy, a negotiation playbook is needed to outline clear limits and guidelines regarding how much leeway a negotiator has before walking away. Some deals must be stopped to save the company from risks, be they financial, reputational, or perhaps even political. Knowing what risks are red flags, and when to pull the ripcord, may save the company great pain and loss in the long run and help decision-making.

Decision fatigue

Another dangerous and common issue is what is known as decision fatigue. In one study, Israeli judges were observed throughout a working day to determine the likelihood they would grant paroles. Individuals seeking parole who had their appointment with the judges early in the morning tended to receive parole nearly 70 percent of the time, while prisoners who appeared much later in the day were paroled less than 10 percent of the time. This same group was also more likely to grant paroles after a meal.

Decision fatigue leaves one vulnerable to poor decisions and may lead a negotiator to assent to terms one would not normally if one were less fatigued or irritated. As many negotiators have experienced, a redlined contract offers an endless source of psychological drain. Every time you must decide to say yes to one term and no to another, you're using a finite resource until, as a negotiator, your mental fuel runs out.

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A negotiator's patience and mental will has limits. A crafty counterparty may seize on that fatigue to soften up their opponent. The counterparty could table the really important terms and conditions until later in the negotiation. Unless one has a larger team of negotiators to share the burden, the fatigue developed by slogging through nominal terms before getting to the meat of the contract will work against an inexperienced negotiator.

To mitigate decision fatigue in a contract negotiation, an effective technique is to spread out the negotiation over a number of sessions, providing a limited period of time for every debate (for example, no more than three hours per session with frequent breaks for refreshments). If the counterparty works to exacerbate decision fatigue, observe how they are trying to do it. Are they asking to spend long hours negotiating? Or allowing for fewer breaks, or imposing a deadline for the end of negotiations? All these actions are strategies to pressure your side to capitulate on key terms.

If this is a complex agreement, prioritize negotiating terms that are most important to you early in the negotiation. Avoid allowing the negotiation to get mired down by red herrings or low priority terms that have little legal or business consequence but will cause both sides to develop decision fatigue.

Probability blindness

Humans do not naturally see and understand probability despite the cornucopia of resources available, research shows. To see and understand probability requires training and practice. When humans were not living together in sophisticated communities, generally accepted theories state that we used heuristics to survive in the wilderness rather than understanding mathematical probability. That is, a caveman probably did not sit and calculate the movement of a deer before attacking.

In our current world, this blindness to probability tends to harm us and manifest itself in numerous ways. For example, think of how many people drive like maniacs and yet are scared of airplane turbulence, even though the former has a far higher probability of fatality than the latter. Three probability blinding cognitive biases are particularly interesting for contract negotiations: optimism bias, subadditivity effect, and gambler's fallacy.

Optimism bias

Optimism bias causes humans to gravely underestimate the probability of bad outcomes. By allowing a counterparty generous rights to withhold payment, a negotiator for a vendor might be grossly underestimating how badly things could go if the company has to sue the customer.

Subadditivity effect

Subadditivity effect is the human tendency to judge the probability of the whole to be less than the probabilities of the parts. If, in an additive way, one is consistently negotiating to execute a higher number of contracts versus managing overall risk, the risk of the entire contract portfolio will gradually increase and the negotiator will likely not notice.

Gambler's fallacy

Gambler's fallacy is when humans erroneously believe that past events affect future probabilities. For example, flipping a coin and having it land on heads six times in a row does not mean the seventh coin flip to have a higher probability of landing on heads.

Applying these principles to contract negotiations, it's easy to imagine compounded problems. A negotiator will tend to have an optimistic outlook that not a single contract will ever be subject to a civil suit or investigation, even if the negotiated terms were suboptimal. With such an assumption, a negotiator will not see the mounting risks as more and more contracts with more risks are added.

As the negotiator's client company grows more successful, it is likely that the number of contracts in its portfolio increases. As the years go by, and no lawsuit has yet been filed by the negotiator's client nor the counterparties, a negotiator will assume all is well and not change their behavior or style of negotiation. But, quietly and insidiously, the likelihood of risk has increased across the portfolio. Every day that passes with the accumulated risk, the company rolls the dice, like driving long distances without a seatbelt.

According to research, having an outside view will help overcome overly optimistic views from a team embedded in the project, as the optimism bias will not take hold as strongly for an outside team. The outside team could prepare a checklist and think of a "premortem" — a thought experiment that involves running scenarios in which events transpire poorly. A key factor in the success of such a committee is balancing members who are already invested with those who have a more objective perspective. Too many dispassionate opinions, however, would have a committee that would be aloof to on-the-ground concerns such as time sensitivity and P&L.

Hindsight effect

Many negotiators think about one single contract at a time. This is because humans generally ignore the ever-increasing chance of a negative legal event if they can't perceive it. If each executed contract independently bore a one percent chance of having a costly legal consequence throughout its term, then having 99 active contracts at a time versus three active contracts massively increases the overall risk borne by the organization, with the former having a far higher probability of a negative consequence in the near term.

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A negotiator will likely not look back at all the contracts they have negotiated over the last three to five years, for example. Nor is there, by default, a watchdog or contract administrator within the company to oversee said risks as they compile over time. Even if there is a watchdog group within the company, what metrics of risk probability is it applying to the portfolio of executed contracts?

A negotiator will likely not look back at all the contracts they have negotiated over the last three to five years, for example. Nor is there, by default, a watchdog or contract administrator within the company to oversee said risks as they compile over time. Even if there is a watchdog group within the company, what metrics of risk probability is it applying to the portfolio of executed contracts?

Imagine a scenario in which a negotiator consistently allowed a counterparty to insert terms that permits them to sue the negotiator's client many times above the value of the contract itself, and the governing law allows such a term. While it is possible that not a single contract is ever litigated, with enough contracts and enough risks present, something is bound to blow up.

There is the specter of a Black Swan event, in which an outlier event, which carries extreme risk, occurs. This event is retroactively justified by the hindsight effect — another common cognitive bias, which provides explanations after the fact of why the event was predictable. Blame is then thrown around without the hurt party really understanding why this phenomenon occurred in the first place. This was a risk creep, a situation in which a company's overall contractual risk increased over time but was invisible to all concerned parties. Hindsight, as they say, is 20/20, though not particularly useful if a costly legal catastrophe has already occurred.

Hyperbolic discounting

Sales teams and other stakeholders tend to exacerbate hyperbolic discounting, a particular cognitive bias. This is an ever-present human tendency to take a reward today rather than a much greater reward in the future.

Explaining to a sales team that contract negotiations ground to a halt because the counterparty introduced key risks into the contract is a near impossible task. Factor in commissions and the fact that a salesperson's job is on the line, and you have a potential recipe for disaster.

Having a whole team with that same mentality multiples the problem. Sales teams are incentivized to deliver in the near term and count their commissions with quarterly figures. They have neither the luxury nor bandwidth to propose questions of long-term risk. The sales team is rarely penalized directly for accepting risks long term, only for failing to "make their numbers" for a short reporting period.

Overcoming cognitive biases in contract negotiation

Moving from being a transactional negotiator concerned with getting one contract to execution to becoming a more systemic negotiator who sees the larger enterprise-wide risks and rewards is the first step to overcoming cognitive biases.

A negotiation playbook can counteract hyperbolic discounting, probability bias, and other cognitive fallacies. By using the playbook's strategies, one implements a "trip wire" to allow long-term logical, algorithmic thinking and planning to overcome "heat of the moment" decision making. The playbook should include a set of terms that are ideal positions and non-ideal but acceptable compromises.

An overarching contract negotiation playbook can provide anchors and guardrails. A playbook will require approval by one or more executives within the organization. This jointly created playbook will serve as guidelines for all negotiations of a certain type and has buy-in from the stakeholders, who will be less likely to contradict the strategy they helped create and support.

In such a case, deviations from the playbook would go to predetermined decision-makers within the organization who have the executive authority and expertise to proceed if the negotiators do not. Human intervention in the application of the playbook should only be used in instances that are unprecedented in the life of the company, as the playbook should be based on collective knowledge and experience of the company's legal team. The value of a playbook is not only in its ability to mitigate the power cognitive biases and psychological pressures, but it also serves as a risk mitigation strategy for an entire contract portfolio.

Whether one takes a standing or ad hoc human committee approach or the more algorithmic and mechanical playbook approach, having a clear, objective weighted scoring system for a contract's risk factor can be a way to further mitigate cognitive biases from creeping into decision-making. By assigning an objective, predetermined risk value to certain changes in contractual terms, a legal team may be able to quickly diagnose the contract's overall risk factor. For example, an unfavorable Limitation of Liability clause would have far more weight for a certain type of contract than changing the governing law between similar jurisdictions.

More math means more logic and less emotion. It gives a legal reviewer a chance to step back and look at the whole contract as a snapshot of risk. It may even be able to build a "contract portfolio risk index" to see if there is a systemic drift toward more risk.

EXAMPLE: accepting 10 times the value of the contract = -200 points or -20 points per multiple of the value of the contract

EXAMPLE: changing the default State [Virginia] to [Maryland] = -10 points.

In the end, managing risks while factoring in human cognitive biases is a difficult task and a tough balancing act. Sales and legal need to work together to understand the visceral urgencies of the other side and come together to present a united front to the counterparties in every negotiation. Depending on the size and risk appetite of your organization, automating certain decisions and making systemic strategic calculations can serve the client well and streamline successful negotiations for the long term.

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