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March 2008 | Volume XXI | Number 3

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## BEHAVIORAL FINANCE: WHAT LESSONS CAN BE LEARNED BY THE INSURANCE CLAIMS PROFESSIONAL

by Andrew S. Kaufman



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Several years ago, I defended a case in which a plaintiff's verdict was returned for \$4.5 million. When I returned to my office after the court session, there was a voice mail waiting for me from the vice president of the insurance company asking that I call him. By the time I called back, he had left for the day. I had never received a call from that particular company after any of the cases I had won and I spent the night contemplating the loss of one of our larger clients. When I reached him the next day, he informed me that in his view he and I were a team and that we all went to verdict with our eyes open and I had properly advised him of the risks. He said that many attorneys would have shied away from a verdict in this situation and that he was grateful that I had not. He said that he wanted to assure me that the verdict would not in any way jeopardize our relationship. For several weeks after that conversation, I reflected on it and how it affected my perspective on trying cases for them in the future. There is a part of the claims professional/trial attorney relationship that favors the settlement of cases because of the fear that the loss of one case could impair the relationship with a client.<sup>1</sup> No doubt, a similar phenomenon is in operation when a claims professional has to account to management when a trial is lost.

Behavioral Finance is a branch of Psychology that studies how individuals make investment decisions in financial markets. Many of its lessons can be applied to the field of Organizational Behavior to evaluate how individuals in a corporate setting respond when faced with risk. The evaluation of claims in a professional liability context is based on the notion that individuals act rationally in considering all available relevant information in their decision-making process. Yet there is a large body of evidence that suggests that decision-making in risk scenarios is not completely rational and is influenced by emotion. The lessons of Behavioral Finance as to how and why emotions can skew the rational decision-making process are instructive, whether it is in the context of the stock market, the gambling table, or the claims department of an insurance carrier.

One area that has been closely studied as part of the discipline of Behavioral Finance involves the concept of irrational risk aversion. Research reflects that for a number of reasons, individuals and corporations, including insurance company claims departments, tolerate less risk than what the profit motive applied logically would dictate. The above vignette is a prime example of something called self-interest bias. Many years ago Descartes described this phenomenon when he said "[m]an is incapable of understanding any argument that interferes with his revenue." Fear of the loss of an account by an attorney or of reputation or job by a claims representative can have a profound effect on claims decisions and in the sense that this is a realistic fear, it is not irrational. Nonetheless, it is irrational in the sense that it is not related to relevant information concerning a particular claim. Recognizing that such fear can be an influential, but irrational emotion, the aware claims executive in the

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vignette above did his best to minimize the effect of this emotion on future decisions made by yours truly. While there are legitimate risks and fears in taking a case to verdict, such as the fact that the downside risk is often limited only by sustainable value and that an adverse verdict greater than policy limits can trigger bad faith and extra contractual damage scenarios, the actual statistical risk alone, including these problematic scenarios, does not fully account for the number and size of settlements in the professional liability claims context. It is the potential fear and embarrassment of reporting an unanticipated loss to one's superior that can, on occasion, create a level of anxiety in the attorney and claims representative that is statistically unjustified. One can imagine how multiple layers of management may serve to magnify this phenomenon.

A remarkably pervasive force in irrational risk aversion is the notion that individuals feel pain of loss twice as much as they derive pleasure from an equal gain. This comes as no surprise to the experienced trial attorney, for whom the details of victories seem to meld together over time, but for whom the details of defeats remain crystal clear and acutely painful. Philip Fisher<sup>2</sup> offers a case study in which there are two six-sided dice, A and B. The six sides of A are 1, 1, 1, 1, 1 and 13, while the six sides of B are 2, 2, 2, 2, 2 and 2. People prefer B, though the value of A (18) is higher than B (12) by a ratio of 3 to 2. While the analogy to a game of chance is not a perfect one, in the claims context, settlement is perceived as a measure providing a level of certainty that avoids the possibility of unpredictable loss, while a verdict raises this possibility. In this situation there is a powerful, but irrational bias toward settlement, which results in a subconscious tendency to place an unjustified significance on negative information.

Feelings of overconfidence in certain situations are also an integral part of human nature. For example 82% of drivers say that they are in the top 30% of drivers in terms of safety.<sup>3</sup> When this overconfidence is coupled with a perception that more information is necessarily better, another phenomenon, studied by students of Behavioral Finance, can be seen in action. In one experiment, horse race handicappers were given 40 pieces of information rather than five. The additional information slightly decreased handicapping accuracy, but doubled the handicappers' reported level of confidence. In the context of claims, efforts to obtain, evaluate and predict the outcome of a claim are sometimes so comprehensive and intense

that perspective as to what is relevant and realistically obtainable prior to trial can be lost. Typically claims are evaluated based on relevant factors such as the quality of the documentation, the effectiveness of the presentation of the various witnesses and the recommendations of experts. There is on occasion a lack of recognition that some of the most important elements relevant in evaluating the risk—namely the identity of the judge, the identity of the jury, and the identity of the adversary—are often not known or obtainable until the time of trial. As a substitute for such critical information, additional less relevant information is frequently compiled and familiarity is substituted for actual knowledge. For example, the venue of the case and generalizations about the jury pool are utilized as a proxy for actual information about the jury yet to be selected. Information that is often required by reporting format, such as strengths and weakness of defenses, may require the attorney to place emphasis on a weakness in what may be a generally strong defense. Plaintiff's demand is certainly a piece of wholly irrelevant, or worse, misleading, information in terms of the evaluation of what a claim is worth. Similarly, extraneous negative information may trigger an instinctive, but irrational response to avoid future unpleasant experiences. A recent unfavorable verdict in an unrelated matter can interfere with the ability of the claims analyst or defense attorney to rationally analyze the likelihood of winning the next case and may exert an insidious influence in the direction of settlement.<sup>4</sup>

Greed and fear are emotions that can cause people to move toward extremes whether it be in investment or claims decisions. If a case is eminently defensible, reasonable demands that make economic sense to accept are sometimes rejected. Consent provisions and the potential deterrent effect of a defense verdict on the plaintiff's bar may account for a portion of this process, but statistics on such cases suggest that there is an additional emotional overlay at work as well. Similarly, there is a tendency to overvalue the settlement value of an indefensible claim rather than suffer a defeat.

Warren Buffet the famous investor and corporate guru said that investing is not a situation in which someone with a 160 IQ does better than someone with a 130 IQ. The intelligence to properly evaluate investment or claims decisions is an asset many possess. The ability to exclude emotions is a skill that is more difficult to acquire. Whether in the gambling or investment context, people often treat profit or winnings as found or house money.

This notion is an emotional and artificial construct. From a purely rational perspective there is no difference between any two equivalent sets of money. Similarly in the claims context, the claims professional or defense attorney frequently behaves differently once a plaintiff's demand comes within their authority, as if the decision to authorize settlement for an arbitrarily determined amount makes the obtaining of any further reduction in the settlement amount less critical.

Hindsight or confirmation bias is the attempt to rationalize a prospective decision by using knowledge acquired after the fact. It is the tendency to focus on the outcome rather than the process when determining whether an appropriate decision was made. This phenomenon is often at work when people confuse losing a trial with the discretionary exercise of judgment to try a case to verdict. I recently read an insurance company newsletter in which a claims executive boasted that his claims department had won 94% of the cases they took to verdict during the past year. At first blush, this impressive number seemed to suggest that they had very accurately identified which cases should be tried and could be won. Yet I couldn't help but consider whether it would not have been more profitable for the company to have tried an additional 10 cases and won eight of them. While this would have decreased their win percentage, it would have eliminated settlements in eight cases in which money was paid, at the risk of taking two verdicts that were unlikely to total more than the cost of settlement of the 10 cases. The executive failed to realize that the payment of money by settlement has a real cost. The reference to winning percentage makes sense in sports, where there are only wins and losses, but no settlements. However, the attempted analogy to claims is flawed. The focus on the significance on the winning percentage in a claims context is an indication that hindsight bias is at work.

## RECOMMENDATIONS

1. An emphasis on team philosophy in a claims department permeates through to the claims professional/trial attorney relationship. Efforts should be made to ensure that junior claims personnel feel comfortable providing bad news concerning adverse developments and adverse verdicts. While this may seem counterintuitive, in the long term it will serve your best interests in terms of your agents being willing and able to minimize their own self-interest bias and take appropriate calculated risks on your behalf. While the conventional wisdom is to ask that

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claims people treat the money they pay or place at risk as their own, the best way to remove emotion from their consideration and encourage them to perform in a more economically rational way is to recognize the importance of their decisions, while discouraging them from developing an outlook that would trigger an emotional response.

2. Prepare a written check list of no more than five items that you believe are the most important pieces of information. Once you have evaluated a case based on these items, seek contrary opinion and try to rebut rather than confirm your opinion. If possible, assign someone to take the opposing side. Then ask yourself what it would take to change your mind.
3. While it is important to set reserves and predict outcomes, this process has to be tempered with the recognition that there are variables that may account for a significant portion of the evaluation of a case that, until the trial begins, are beyond the control of the claims department or defense attorney. Developments occasionally occur at trial that make prior information and evaluation irrelevant or even misleading. People tend to focus on bad news, and to minimize the extent of favorable news in

this context. Be flexible and equally open to the possibility that during trial, the case has become more defensible. Recognize that notwithstanding an equivocal or negative evaluation of a case prior to trial, the trial is a dynamic and evolving process and so the evaluation of a claim must become one as well. While a plaintiff's demand may not reflect that a case is proceeding better than expected for the defense, your claims evaluation process should be a flexible apparatus that can accommodate new information relevant to your evaluation. If you have the resources to have someone present to observe the trial, do so. If not, listen openly and carefully to what the trial attorney is reporting. It is not recommended that an observer be present for only portions of the trial unless you are prepared to carefully listen to your attorney's comments on the unobserved balance of the proceedings. It is a mistake to rely on an infrequent observer of a portion of the trial over an attorney who has participated in the complete trial simply because your relationship with the infrequent observer is a close one or because you feel he is generally reliable.

4. To eliminate the effects of confirmation bias, retain a statistician who is not involved in the claims process make suggestions on how to compile statistics from raw data and

recommendations on their significance.


## CONCLUSION

Emotions run high during any type of speculative activity involving large sums of money. To expect individuals to make rational decisions at such times is naive. It is only by raising awareness of how behavior may be influenced by emotions that one's behavior can be modified. The study of Behavioral Finance provides valuable empirical information on how emotions can interfere with rational decision-making and it behooves the claims analyst and defense attorney to incorporate lessons learned in this field in their professional lives.

*The author would like to express his appreciation to David Schiff and Bruce Gordon, for their contributions involving the technical and statistical aspects of this article.*

## FOOTNOTES

- 1) The different nature of the relationship between a plaintiff and his attorney results in a self-interest bias that is far more limited in scope and extent as it operates in relation to the particular case, but does not affect the balance of cases the plaintiff has with multiple other clients.
- 2) *Common Stocks and Uncommon Profits and Other Writings* (John Wiley and Sons, 1996).
- 3) For more information on Behavioral Finance see <http://www.tilsonfunds.com/TilsonBehavioralFinance.pdf>.
- 4) See *Behavioral Investing, A Practitioner's Guide to Behavioral Finance*, Montier J. (Wiley, 2007).



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