Kluwer Arbitration Blog

Cognitive Errors and Thinking Aids: Rationalising Choice of Law and Arbitration Clauses

Gustavo Moser (Swiss International Law School (SiLS)) · Monday, January 28th, 2019

We often mislead ourselves into believing that, by arriving at a certain contract decision, we have carefully considered all available options, weighed up the pros and cons of each attribute dispassionately, and selected the most favourable outcome, i.e. the one which maximises our welfare in the transaction.

Regretfully, however, we are seldom cognisant of the rational components that form part of our contract decisions. In fact, we are rather often oblivious to the myriad of factors that a bad choice may entail and our 'gut feeling' can frequently lead us astray. Most of the time, we are gathering information that simply justifies our pre-existing beliefs or confirming our choices, rather than helping us to effectively make a decision (*confirmation bias*).

Whilst it is true that some of us can sway towards changes more easily, most of us would prefer remaining in our comfort zone and holding on to what we are most familiar with. Yet being curious and adventurous is part of our evolutionary process. How would this behaviour then play out in the choice of a governing contract law?

Cognitive biases and 'noise'[1)] are errors that can also influence the decision-making process in relation to choosing and applying a governing contract law. While we are all susceptible to such 'threats', we are able to 'outsmart' them through the use of effective systems and controls, frameworks and rules of thumb by which more rational decisions may be achieved, as discussed further below.

Choice of law has been the subject of numerous works and studies worldwide, with a particular and often anachronistic twist on 'searching for the applicable law'. A matter of disquiet for few stakeholders, the focus of these earlier studies was never placed on *how* this choice is made and, more importantly, *why* parties opt for a particular governing contract law.

As surprising as it may sound, negotiators often opt for a law or rules of law that may be the result of a previous experience, such as a successful deal, without further deliberation. Parties may thus simply attribute a 'tag' to this experience and evaluate it according to outcomes achieved in the past. Nonetheless, these evaluations may not always be accurate and can be clouded by emotions, thereby raising a number of questions:

- Are there rational and non-rational elements involved in this choice?

- Does it depend on the context and external stimuli?
- Do emotions and cognitive biases play any role in the choice?
- Can emotions and cognitive biases cloud or enlighten the judgment of these choices? If so, to what extent?
- How can we avoid, control or minimise the effects of these factors?
- How can parties seek to influence and improve choice of governing contract law?

Contemporaneous legal literature[2)] offers a comparative analysis of a number of empirical efforts aimed at investigating how we deal with uncertainty when making choice of law decisions, including shedding light on the above-listed questions. A key factor discussed in legal literature is how parties, negotiators and party advisors may and should execute a cost-benefit analysis in cross-border contracts – by anticipating behaviour, advanced tactics, and possible legal battles. Cognitive errors, however, are likely to play a significant role in the real-life decision-making processes, and this may lead to unwelcome surprises and inefficient decisions.

How can we avoid these errors? It is inevitable that we, first and foremost, understand how biases and 'noise' come to be, i.e. the mental shortcuts that individuals take and assess why this occurs. This is instrumental in better understanding (and possibly anticipating) the risks to which a party, negotiator and party counsel are routinely exposed to in decision-making contexts. In addition, awareness of these risks represents 'warning flags' which signal to contracting parties that they might be falling into a cognitive trap and neglecting a 'better deal'.

Parties should also make use of contract governance structures, i.e. thinking aids to 'debias' and establish an emotional distance from governing contract law decisions. One such mechanism is the use of metrics to achieve more context-specific business decisions. This would involve a list of the most desirable key aspects in a given governing law or rules of law more generally. The list could be categorised by contract type and/or contractor's position (e.g. supplier or buyer), and a system of attribution of points (e.g. 1-5) which would add up to elect the highest value, or provide a ranking which could be compared with a corresponding (pre-existing) list of matching potential governing contract laws. At this point, a decision about the applicable law should have reached a better level of rationality (cognitive errors may however emerge if the lists are too narrowly constrained).

The above structure could work the other way around: by establishing that provisions a, b, and c are undesirable and so if a potential governing law contemplates those factors, it should be eliminated from the pool of choices. A similar mechanism would likewise apply to jurisdiction and arbitration clauses. For example, a list of key factors most appealing in institutional or *ad hoc* arbitrations, or even a mechanism to maximise the expected utility in the choice of the arbitral institution.

To conclude, parties, negotiators, party advisors and adjudicators should make use of contract governance structures to assist them to make more effective, informed and commercially sensible choices. At the same time, such awareness would shield parties, negotiators, party advisors and adjudicators from the cognitive biases and distracting 'noise' that can often cloud rational and efficient outcomes. These structures would be paramount to negotiators – party or party advisor, who will come across a number of considerations (legal and economic) while deciding which law or rules of law should or should not apply to their international contracts. Contract governance structures should, nonetheless, also appeal to adjudicators – in particular judges and arbitrators – who might be called upon to apply or determine the law or rules of law to govern a given cross-

border contract. We hope that these thinking aids will assist stakeholders more generally to better understand what the contract provisions mean(t) and to give commercial effect to the transaction.

References

?1 For Daniel Kahneman, noise equals to randomness or variability within individuals, for which Kahneman attributes the status of an independent source of error along with bias. Kanheman compares noise with arrows that miss the mark randomly, while bias misses the mark consistently.

?2 See, Gustavo Moser, *Rethinking Choice of Law in Cross Border Sales*, Eleven International Publishing, 2018.

This entry was posted on Monday, January 28th, 2019 at 10:15 am and is filed under Arbitration, Choice of Law, Cognitive biases, Rationality
You can follow any responses to this entry through the Comments (RSS) feed. You can leave a

response, or trackback from your own site.