

BAR BULLETIN



This is a reprint from the King County Bar Association Bar Bulletin

February 2018

Time Is Money

The Sunk-Cost Fallacy – Why More Discovery May Backfire

By Hon. Kim Prochnau (Ret.)

In economics, a sunk cost is any cost that has already been paid and cannot be recovered. The sunk-cost fallacy is a mistake in reasoning in which the sunk costs of an activity are considered when deciding whether to continue the activity. This is sometimes called “throwing good money after bad,” because the money and time spent have already been lost and will not be recovered, no matter what you do now.

The sunk-cost fallacy makes it more likely that a person or an organization continues with an activity in which they have already invested money, time or effort. The greater the size of the sunk investment, the more people tend to invest further, even when the return on added investment appears not to be worthwhile.

This may be why parties continue to litigate a dispute concerning homeowner assessments or a boundary dispute even though the attorney fees may dwarf the amount of the claim.¹ It is also why conducting more discovery in a lawsuit may backfire. The more time, money and energy spent on conducting discovery, the harder it may be for the client (and lawyer) to settle the case.

A common reaction of clients in evaluating a settlement offer is, “I can’t settle now — I have too much money invested in the case!” This, even though the client is unlikely to recover all incurred fees and costs.

Even where there is a fee-shifting provision in the contract, governing documents or law, the judge or arbitrator will normally award fees incurred only on the

successful claims — your client will not be reimbursed for the work expended on any unsuccessful claims. Moreover, the judge or arbitrator may discount the fees expended on the successful claims based on his or her views of the time and expenses that are reasonable.²

Why More Discovery May Lead to Less Light and More Noise

Exhaustive discovery also increases the chances that the clients (and sometimes the lawyers) may become more entrenched in their positions and may make it more difficult to settle. We tend to think of discovery as a search for the truth that will lead the parties to more reasoned positions and effectuate a fair settlement. However, not only does more discovery mean more sunk costs, but it may perversely impede settlement by making the parties’ positions more intractable.

Several psychological phenomena are responsible. In addition to clients (and attorneys!) mistakenly factoring in the costs of discovery already incurred in the evaluation of a settlement offer, research has shown that people tend to interpret new evidence as confirmation of their existing beliefs or theories, particularly where such beliefs are emotionally charged. This is sometimes referred to as “confirmation” or “my side” bias.

An early research study illustrates this phenomenon. Researchers first identified the subjects as either being in favor or opposed to capital punishment. The subjects were all given two fictitious studies. The first study tended to show

capital punishment was a deterrent to serious crime inasmuch that those states that enacted capital punishment experienced a decrease in the crime rate. The second study showed capital punishment to be associated with higher crime rates, again focusing on those states that had abolished the death penalty.

Although the fictitious studies were carefully constructed to employ the same methodology, the pro-capital punishment subjects discounted the study showing an increase in crime and overemphasized the study tending to show a decrease in crime while the subjects opposed to capital punishment came to the opposite conclusion. Even though objectively the two studies tended to cancel each other out, many of the subjects became even more convinced of the merits of their opinion after being exposed to the two studies.

Exhaustive discovery may also lead to overconfidence. Research has shown that the more information acquired, even if irrelevant, the more likely a person will believe that they can predict the outcome of an event. In a study of the NFL draft, researchers found that professional teams place too much value on early picks, in large part because smart scouts delude themselves into thinking that they can forecast the next superstar. The more information teams acquire about players, the more overconfident they will feel about their ability to make fine distinctions — even though a professional football player’s career is highly variable and subject to unforeseeable injuries.

We know that it is difficult to predict how a judge or arbitrator will view the

evidence and law, and even more so to predict how a jury will evaluate a case. The more witnesses who are deposed, and the more paper generated in discovery, the more overconfident you and your client are likely to be as to your ability to predict the outcome at trial — even if much of the discovery is irrelevant.

Remediation

To avoid “sunk costs,” consider provisions for early mediation in the initial documents such as the real estate contract or covenants. For example, the contract could provide that discovery disputes be submitted to a mediator for decision. Homeowner associations could avoid expensive discovery requests by posting relevant documents such as minutes of board meetings on a private

website accessible by the homeowners. Not only would this lessen attorneys’ fees incurred in assembling these documents in response to discovery, but the greater transparency tends to dispel any notions that there is a “smoking gun” to be found through discovery.

Should a dispute proceed to litigation a lawyer is well advised, at the very least, to have another attorney in their firm look at the case with fresh eyes. (Although if your firm has sunk significant time and costs into the case, your partner may also suffer from “sunk-cost” fallacy.)

An even more effective solution is to use a third-party neutral to help you evaluate the evidence and law objectively, before the client sinks money and time into expensive discovery. A good neutral can also suggest alternatives to

protracted litigation that meet the needs of all parties.

While a sunk cost can seem like a frustrating position to be in, it doesn’t have to be a total waste. Using other tools such as mediation or early neutral evaluation can make the most of a challenging situation. ■

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¹ Other emotional factors affect the resolution of property disputes, particularly the tendency to accord a higher value to property already in one’s possession, i.e., “the endowment effect.”

² A group of experienced real estate attorneys was recently informally polled by the author. They unanimously stated that they have rarely, if ever, been awarded all incurred fees by a judge or arbitrator.