

Focus | ADR/Collaborative Law

The Endowment Effect and its Impact on Case Valuation

BY CHRISTOPHER NOLLAND

Legal settlement negotiations are often viewed as rational processes where parties weigh risks, rationally calculate outcomes, and arrive at mutually tolerable compromises based on objective criteria. Any experienced mediator or litigator knows this rarely reflects reality.

Clients (including sophisticated businesspeople) may not have the skill sets or temperament to objectively value their case, even with counsel's guidance. Some clients have agendas other than making smart, objective decisions—think of the nightmare family law matters we all have witnessed or heard about. Cognitive biases such as the Sunk Cost Fallacy—the belief that time and money previously invested in the case inform its current value—further impair client and lawyer objectivity.

One powerful behavioral economic cognitive bias is the Endowment Effect, which causes individuals to overvalue what they already possess simply because they own it. In litigation, the “possessions” are legal claims or the value and likelihood of success of their defenses. The Endowment Effect skews logical valuation, inflates expectations, and impedes settlement.

The Endowment Effect

First formally named by economist Richard Thaler in the 1980s (although conceptually referenced by Aristotle), the Endowment Effect describes how people typically assign greater value

to things they own than to equivalent things they do not own. Simply put, if they own something, they believe it is “special” and “above average.”

In the legal world, litigants “own” their claims and defenses. This psychological ownership elicits the Endowment Effect, leading parties to view their positions as more valuable, more correct, and more likely to prevail than any objective analysis would support.

The Adverse Impact on Lawsuit Negotiations

When litigants view their claims as special because of their ownership, several things happen:

- **Overvaluation of Claims.** Plaintiffs reject reasonable offers because their claim is “special”—it is more valuable than those merely “ordinary,” similar claims owned by others. They overrate the strength of their evidence, legal arguments, their experts, or how compelling and convincing their story will be to a jury or appellate court.
- **Loss Aversion.** A settlement feels like a loss. They fear they may have given up a “sure win” of substantial damages in their very special, one-of-a-kind case by settling for too little.
- **Inefficient Outcomes.** The Endowment Effect leads to prolonged litigation, suboptimal results for all involved, and a much worse result than could have been achieved with an earlier settlement based on objective criteria.

How to Mitigate the Impact of the Endowment Effect

Lawyers and mediators can use several strategies to help clients make sound decisions even in the face of the Endowment Effect's powerful influence.

1. **Use Objective Benchmarks.** Utilize precedent, expert opinions, and risk analysis tools to shift focus from subjective belief to empirical, objective criteria. Clients (and lawyers) are more likely to rethink their evaluations when presented with objective guideposts.

2. **Reframe the Narrative.** Instead of presenting settlement as “giving up” a claim, frame it as “gaining certainty,” “saving time, money, stress, and opportunity costs,” “gaining control and self-determination,” and “investing in closure.”

3. **Involve Neutral Voices.** Mediators, retired judges, other lawyers (perhaps with some gray hair), focus groups, or even a mock trial can provide assessments that carry weight.

4. **Discuss Cognitive Bias.** Many clients have never heard of the Endowment Effect. Educating them can help them separate their emotions from objective decision-making.

5. **Ask How Much the Client Would Pay to Buy the Claims.** Logically, one should “sell” their lawsuit claims for any dollar amount above what they would pay to acquire the claims.

6. **Let Time Work.** Time for reflection can allow for more rational think-

ing and permit some of the objective criteria to marinate and “sink in.”

7. **Lawyer Self-Awareness.** Lawyers (especially when on a contingency arrangement) are not immune to the distorting impact of the Endowment Effect. Lawyer, heal yourself. Much like being on an airplane, put on your own oxygen mask before you help your companion passenger with theirs.

8. **Put It In Writing.** Put your case evaluation and the objective criteria which support it in writing to the client. A formal writing underscores how serious your concern is about their misvaluation of the case. Lay out in detail the factual, legal, procedural, evidentiary, appellate, and practical economic challenges with the case, together with your recommendations about settlement. A side benefit to such a writing is protection against a client's future “different recollection” of the real-time advice you gave.

Settlement negotiations are not purely a debate about factual and legal arguments – they are a negotiation between human beings, whose rational decision-making is easily influenced and distorted by powerful psychological forces. One of our jobs as mediators or counsel is to help the client properly value their claims, defenses, and arguments and to make decisions primarily on objective criteria rather than the distorting effects of cognitive biases.

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