WHITE PAPER

PERCEPTUAL BIASES IN THE ASSESSMENT OF "REASONABLENESS" IN DUE DILIGENCE AND RELIANCE

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DUE DILIGENCE

The term "due diligence" is not defined in statutes or regulations. Instead, it is a term of art that is part of the regulatory, judicial, scholarly and practical lexicon. While not "black letter," the following five-part definition "due diligence" reflects the general legal and industry understanding of its meaning: Due diligence is the [1] process and practice of using [2] reasonable efforts [3] appropriate in the context [4] to investigate (or reasonably rely upon others regarding) the material aspects of a proposed transaction [5] so that a reasonable person could make an informed decision regarding the transaction. Frequently encountered in analyses of due diligence issues is also the concept of reliance, which refers to relying on other parties or information as an alternative to or a part of the process of conducting independent due diligence.

Regardless of transactional context (that is, whether the transaction is a securities offering, negotiated transaction or other setting), the standard for due diligence and reliance is always reasonableness measured by what "a prudent man [in a similar context] in the management of his own property"[1] would have done. However, each situation is temporally, positionally, transactionally and situationally unique, and what is reasonable in one context may or may not be in another.[2]

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[1] 15 U.S.C. § 77k(c).

[2] *See, e.g.*, American Bar Association Comm. on Federal Regulation of Securities, Report of Task Force on Sellers' Due Diligence and Similar Defenses Under the Federal Securities Laws, 48 BUS. LAW. 1185, 1232 (1993) ("Reasonableness is meaningless except in a specific factual context"); Escott v. BarChris Const. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968) at 697 ("It is impossible to lay down a rigid rule suitable for every case defining the extent" of due diligence); "Adoption of Integrated Disclosure System," Securities Act Release No. 33-6383, 1982 WL 90370, (Mar. 3, 1982) at *35 ("The important point is that each subject person should evaluate the surrounding facts, including the extent of his prior relationship with the registrant, and utilize techniques of investigation appropriate to the circumstances of the offering.... Judicial interpretations of Section 11 have confirmed the principle that what constitutes reasonable investigation and reasonable ground for belief depends upon the circumstances of each registration. The prospect of continued flexible application of that standard by the courts should provide assurance to subject persons that they will not incur unreasonable investigative burdens."); *See also*, National Association of Securities Dealers Notice to Members: 03-71, *Non-Conventional Investments: NASD Reminds Members of Obligations When Selling Non-Conventional Investments* (Nov. 2003) (the "type of due diligence investigation that is appropriate will vary."); SEC Advisory Committee Report at 327 ("Although the Committee believes that ideally it would be desirable to have absolute certainty in the application of [disclosure and related due diligence] concepts, it is its view that such a goal is illusory and unrealistic. [These concepts are] judgmental in nature and it is not possible to translate this into a numerical formula. The Committee's advice to the [SEC] is to avoid this quest for certainty and to continue consideration…. on a case-by-case basis as disclosure problems are identified."). While the Committee rejected the notion of rigid definitions and checklists, it did conclude that it would be advisable for the SEC to adopt a rule setting

Reasonableness, therefore, must be judged flexibly according to a "sliding scale"[3] that considers context. Without a proper appreciation for and consideration of the context in which the practitioner conducted its due diligence investigation or made its reliance decision, one cannot fairly determine the reasonableness of what was done or left undone.

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This white paper briefly examines perceptual bias risk and explains how it can affect the determination of reasonableness if not anticipated and controlled for.

PERCEPTUAL BIASES GENERALLY

Perceptual biases are mental errors caused by simplified information processing strategies.[5] A decision maker may believe that he or she is evaluating information accurately and making objective decisions, but perceptual biases can undermine both the analytical process and its results. This is because in making decisions about complex situations, humans often use short-hand techniques, referred to as "heuristics," to facilitate those decisions.[6] Heuristics are the genesis of perceptual bias and, if not controlled, can lead to unsound decisions regarding the nature of a reasonable investigation, the exercise of reasonable care or the reasonableness of reliance.

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out several non-exclusive, contextually oriented factors, courts might consider in assessing the issue of reasonableness as it relates to the due diligence defense.

[3] *See, e.g*., FHFA v. Nomura, 68 F. Supp 3d 439, 468 ("As these factors suggest, there is a 'sliding scale' in the diligence required of parties, with heavier demands of those with more central roles and greater access to the information and expertise needed to confirm the accuracy of the registration statement."); In re: WorldCom Sec. Litig., 346 F. Supp. 2d at 675 ("Feit [referring to Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544 (E.D.N.Y. 1971)] insists that '[w]hat constitutes 'reasonable investigation' and a 'reasonable ground to believe' will vary with the degree of involvement of the individual, his expertise, and his access to the pertinent information and data."). *See also*, Sjostrom/Brandeis at 550.

[4] "Adoption of Integrated Disclosure System," Release No. 6383, 1982 WL 90370 (Mar. 3, 1982) at *35.

[5] GREGORY S. PARNELL, TERRY A. BRESNICK, STEVEN N. TANI, ERIC R. JOHNSON, HANDBOOK OF DECISION ANALYSIS (John Wiley & Sons, 2013).

[6] *See generally,* DR. RON HOWARD, STRATEGIC DECISION AND RISK MANAGEMENT (Stanford University, 2006); *see also*, Peter McNamee and John Celona, *Encoding a Probability Distribution*" DECISION ANALYSIS FOR THE PROFESSIONAL, (USA: SmartOrg, Inc., 2008), 322–326 and B. Fink, *The Psychology of Negotiation: Common Tricks Your Brain Plays on You*, https://www.axial.net/forum/cognitive-biases-deals/. *See also*, L. BURKE FILES, DUE DILIGENCE FOR THE FINANCIAL PROFESSIONAL (Aegis Journal LLC, 2010) at 9 ("Heuristics are cognitive strategies people use to simplify assessments or judgments of probability. We use heuristics to filter information from noise so that we can make quick perceptions and judgments…. While useful, heuristics can lead to systematic errors when applied, because they rely on information that is subject to many biases as it is sampled and categories. These inferences or filters we use, and the preconceived notions we have, are biases.") and *Id*. at 6 ("We must remove the presumption that investing is riskless, or that all risks are, or can be, known.").

Such biases are many, but the ones most frequently encountered in the context of due diligence and reliance are "hindsight bias" (judging a matter based on information learned after the fact) and "outcome bias" (judging a matter based on the outcome of the matter to which it related). These biases typically are unconscious, and therefore are more dangerous.

PERCEPTUAL BIAS RISK IN ASSESSING REASONABLENESS

Reasonableness decisions, especially those regarding due diligence and reliance, must be made based on information known or reasonably knowable at the time. Substituting heuristics for rigorous, objective and contextually specific analysis can lead to errant reasoning and faulty conclusions. Thus, to properly assess whether a party's due diligence or its reliance was reasonable, one must avoid judging the quality of the process and its execution by the outcome of a transaction or based on information learned after the investigation was conducted or the decision to rely was made.

As the Federal District Court for the Northern District of California stated in *Software Toolworks*:

> "Plaintiffs' contention that had the [defendants] done more they would have revealed the problems, is unpersuasive. The Court cannot evaluate [a defendant's] due diligence defense with the benefit of hindsight. The overall investigation performed here was reasonable under the circumstances at the time of the investigation."[7]

Reaching a similar conclusion, the Central District of California held that the measure of due diligence is reasonableness not perfection:

> "It is clear, then, that the diligence conducted must be reasonable, not perfect. In re Software Toolworks, Inc. Sec. Litig., 789 F. Supp. 1489, 1496–98 (N.D.Cal.1992) ("Toolworks I"), *aff'd in part and rev'd in part*,38 F.3d 1078 (9th Cir.1994), *amended* 50 F.3d at 615 (9th Cir.1995). Without the benefit of hindsight, the Court must determine whether '[t]he overall investigation ... was reasonable under the circumstances at the time of the investigation.' *Id*. at 1498 n. 14. To the extent that the underlying facts are undisputed, the adequacy of the diligence may be appropriately decided on summary judgment."[8]

Moreover, as one commentator has stated: "due diligence should not be put on a disproportionately high pedestal."[9] Due diligence is not a guarantee of a good investment outcome[10] nor is the outcome of the transaction, whatever it ultimately might be, indicative of the reasonableness of the due diligence investigation or any element of reliance in the

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[7] *In re* Software Toolworks, Inc. Sec. Litig., 789 F. Supp. 1489, 1496–98 (N.D.Cal.1992), *aff'd in part and rev'd in part*,38 F.3d 1078 (9th Cir.1994), amended 50 F.3d at 615 (9th Cir.1995., 789 F. Supp. at 1498.

[8] Int'l Rectifier. No. CV91-3357-RMT (BQRX), 1997 WL 529600 at *11.

[9] Milton H. Cohen, *The Integrated Disclosure System-Unfinished Business*, 40 BUS. LAW. 987, 995 (1985). *See also*, Anna T. Pinedo & David M. Lynn, Frequently Asked Questions About Communications Issues for Issuers and Financial Intermediaries, Morrison & Foerster LLP (2015), http://media.mofo.com/files/Uploads/Images/FAQ_Communications.pdf

[10] L. BURKE FILES, DUE DILIGENCE FOR THE FINANCIAL PROFESSIONAL, (Aegis Journal LLC, 2010) at 6 ("We must remove the presumption that investing is riskless, or that all risks are, or can be, known.").

context presented.[11] Indeed, Professor Barbara Banoff has argued that the benefits of underwriter due diligence (addressing the context of an expedited offering such as a shelf takedown) are far from clear in as much as the offering documents largely are a restatement or incorporation of publicly available information. She concludes that "[d]ue diligence, except perhaps for new issuers or novel securities, does not increase investor welfare by more than its cost."[12]

Even the best due diligence and reliance practices sometimes involve unwanted outcomes, just as poor due diligence and reliance can sometimes involve good outcomes. An objective assessment of reasonableness in due diligence and reliance requires one to focus on the process and its execution, without reference to the outcome of the transaction or information learned after the investigation or incidence of reliance. To do otherwise is to risk the loss of objectivity and clear reasoning.

CONCLUSION

The central question in analyzing the reasonableness of a party's due diligence investigation and/or reliance is whether the process and the practice conducted by the investigator was reasonable in the context, without reference to the outcome of the transaction or after-acquired information. While the temptation to measure reasonableness using such information is understandable, succumbing to hindsight, outcome or other forms of perceptual bias is analytically unsound and intellectually undisciplined. Therefore, in assessing reasonableness one must recognize the danger of perceptual biases and endeavor to control for them.

ABOUT THE AUTHOR

G. M. Lawrence is a prominent transactional and due diligence scholar whose academic work has been cited authoritatively in numerous publications, by the Federal District Court for the Southern District of New York and in pleadings before the Supreme Court of the United States. He also has advised the U.S. Securities and Exchange Commission regarding such matters and has served as a consulting expert in a number of high profile cases.

Professor Lawrence is a member of the adjunct faculty of the Dedman School of Law of Southern Methodist University where he teaches due diligence studies to MBA, JD and LLM candidates, the founder and executive director of the independent Center for Advanced Due Diligence Studies, and managing principal of Applied Research & Analytics, a consulting firm. He also is executive chairman of the investment firm, Pacific Financial Group.

He is the author of the two-volume treatise *Due Diligence in Business Transactions*, a leading work in the field for more than 20 years, and the graduate textbooks *Due Diligence, Reliance and Verification: Law, Standards and Practice*; *Due Diligence: Law, Standards and Practice* and *Due Diligence, a Scholarly Study*. He is co-author of the treatise

[11] *See generally* DR. RON HOWARD, STRATEGIC DECISION AND RISK MANAGEMENT (Stanford University, 2006) at 7. *See also* GREGORY S. PARNELL, TERRY A. BRESNICK, STEVEN N. TANI & ERIC R. JOHNSON, HANDBOOK OF DECISION ANALYSIS (John Wiley & Sons Inc., 2013) at 3.

[12] Barbara A. Banoff, *Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415*, 70 VA. L. REV. 135, 180-81 (1984).

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Previously, Professor Lawrence was a global managing partner with a global law firm where he founded and taught the firm's due diligence training program, managed the firm's investment fund and chaired the technology, media and telecommunications practice. He was a member of the firm's management, strategic planning, compensation and other committees. Professor Lawrence also has served on the board of directors and various committees of public and privately held companies.