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LAW v. TRUST

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ABSTRACT

The special concept of trust does not provide a distinct justification for mandatory legal rules. Although regulation might lead parties to decide to rely on others, it does not produce the sort of transaction-cost-reducing "trust" that should matter for public policy -- that is, trust based on altruism, norms, personal relationships, and social capital. Moreover, using mandatory rules to increase trust may have precisely the opposite effect of increasing distrust and undermining trust-creation devices. Thus, trust provides an additional argument in favor of enforcing contracts.

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Trust is a kind of social glue that lets people interact at low transaction costs.[1] Trusting people cooperate because it is in their nature or because they have been socialized to do it, not because some costly structure has been set up to ensure reliability. This implies that trust increases social wealth by permitting more investment in production.[2] It is logical to consider, then, whether legal rules can contribute to trust. This article concludes that trust does not provide a distinct justification for mandatory legal rules -- that is, for regulation that supersedes contracts.[3] Although regulation might lead parties to decide to rely on others, it does not produce the welfare-increasing "trust" that makes costly constraints unnecessary. Moreover, this article shows that using mandatory rules to increase trust in any form may have precisely the opposite effect.

This conclusion implies that a contractarian approach to law does not depend on a narrow "economic" view of man. Because one who is trusting or trustworthy might be said not to be acting as a "rational" self-maximizer,[4] it has been said that the economic

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[1] This notion was popularized in Francis Fukuyama, *Trust: The Social Virtues and the Creation Of Prosperity* (1995) (describing trust as a lubricant that reduces transaction costs and mitigates free rider problems). *See also* Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate law,* Georgetown Working Paper no. 241403, available at http://papers.ssrn.com/paper.taf?abstract_id=241403 (August 2000) at 21; James S. Coleman, FOUNDATIONS OF SOCIAL THEORY, 301 (1990) (discussing "social capital," which facilitates social interaction and therefore productivity); *id.* at 97 (noting that the placement of trust allows trustor and trustee to get resources at lower cost); Eric Posner, LAW AND SOCIAL NORMS, 54 (noting that trust relationship allows parties to exploit surplus unobtainable through contract because of information costs); Stephen M. Bainbridge, *Corporate Decisionmaking and the Moral Rights of Employees: Participatory Management and Natural Law* 43 VILL. L. REV. 741, 789 (1998) (discussing trust as "a lubricant to reduce social friction" without investing resources in contracting and enforcement).

[2] *See* Stephen Knack and Philip Keefer, *Does Social Capital Have An Economic Payoff? A Cross-Country Investigation,* 112 Q. J. ECON. 1252 (1997) (showing that trust and civic norms are associated with higher economic performance in cross-country comparison); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert W. Vishny, *Trust in Large Organizations,* 87 AM. ECON. REV. 333 (1997) (showing data indicating that in societies where there is more trust government is more efficient, big firms have larger shares of the economy, and economic performance is enhanced); Paul J. Zak & Stephen Knack, *Trust and Growth,* September 18, 1998, http://papers.ssrn.com/paper.taf?ABSTRACT_ID=136961 (discussing factors such as institutions and social distance that affect trust in societies and showing how more trust increases societies' rates of investment and growth). Zak & Knack, *supra* at 11, define "trust" broadly to include the "aggregate time that agents do not spend in verifying other's actions." They examine the effects of legal and other institutions that reduce individual agents' verification costs irrespective of whether these institutions entail even higher costs. Although these institutions may be positively correlated with growth, it is not clear whether the success of the institutions is correlated with underlying factors related to trust in the narrower sense used in the present paper.

[3] This article focuses on the effects of mandatory rules rather on the enforcement of private contracts. As discussed below in Part III, although contracts themselves do not create "trust" in the sense that term is used here, legal enforcement of contracts is more conducive to the development of trust than are mandatory rules that supersede contracts. Moreover, as discussed in Part V(A), rules that supersede contracts can create opportunities for distrust. This is consistent with theories and data showing that government institutions that support contract and property rights can promote trust. *See, e.g.,* Knack & Keefer, *supra* note 2 at 1276 (showing correlation between trust and the security of property rights as measured by the risks of repudiation of government contracts and of expropriation of assets).

[4] This is actually an unduly restrictive view of economics. *See infra* text accompanying note 33.

view is inconsistent with trust.[5] But expanding the model of human behavior makes mandatory rules even less defensible because contracts let parties avoid the trust-reducing effects of legal regulation.[6]

This article begins in Part I by defining trust. "Trust" differs from the *decision to rely*. It refers to the willingness to make oneself vulnerable to another without costly external constraints. Because trust is socially valuable, society should encourage it. Law relates only to the external constraints that lead to the decision to rely rather than to trust.

Parts II-IV of the article discuss various ways "trust" has been conceived in the literature with a view to analyzing how these concepts relate to law. Part II discusses "strong-form" trust, or the willingness to rely on another even in the absence of binding external constraints. Part III discusses "semi-strong" form trust that arises from privately imposed constraints but in the absence of mandatory legal rules that attempt to eliminate the risk of disappointment. Part IV discusses "weak-form" reliance on others produced by mandatory legal rules.

Part V shows how law can actually decrease trust by introducing grounds for distrust and by undermining the trust-creation devices discussed earlier in the article. In particular, regulation gives parties a weapon that they might use opportunistically, thereby increasing the risk of distrust. In other words, law *substitutes for* rather than *complements* trust.

Part VI applies the analysis to the important context of the Internet, and particularly Internet privacy. It shows that the calls for more regulation in this area are misguided, at least to the extent that they rely on the need to instill trust in electronic commerce vendors. Part VII contains concluding remarks.

I. DEFINING TRUST: TRUST AND VULNERABILITY

The implications of trust for law can be viewed from two different perspectives. Trust can be seen as simply a *decision* by one person to give power over his person or property to another in exchange for a return promise. Niklas Luhmann says that this decision is significant regardless of the reason for it because it encourages people to deal with each other and foregoes the extra costs of reducing or eliminating the risk.[7] Luhmann says that we place trust when the harm from breach of trust may be greater than

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[5] *See* Blair & Stout, *supra* note 1 at 19, 27; Tamar Frankel, *Trusting and Non-Trusting: Comparing Benefits, Cost and Risk*, Boston University School of Law Working Paper 99-12 at __ (1999); Lawrence E. Mitchell, *Trust and Team Production in Post-Capitalist Society*, 24 J. Corp. L. 869, ___ (1999).

[6] Blair & Stout, *supra* note 1 at 55, 85, claim that trust supports anti-contractarian theory because contractual constraints may reduce trust. However, my point is not that contractual constraints necessarily beat no constraints, but that the parties ought to be able to choose what, if any, constraints should apply to their relationship. Moreover, as indicated in *supra* note 3 and discussed in subpart V(A), even if contractual constraints are less conducive to trust than no such constraints, they may invite more trust than mandatory regulation.

[7] *See* Niklas Luhmann, TRUST AND POWER, 79, 93-4 (1979).

the benefit that would accrue assuming entrustment is warranted.[8] More precisely, reliance can be said to result when the probability-adjusted gain from relying exceeds the probability-adjusted loss from the breach by the one who is relied on -- that is, if PG x G > PL x L.[9] One who leaves his car keys with a parking attendant expects to gain from placing the car under someone's protection rather than exposing it to the hazards of the street, and from saving the costs of searching for and walking to and from the self-parked space. The car owner's anticipated losses include the attendant's stealing the car, banging it up or stripping the gears. Even a somewhat unreliable attendant may produce anticipated gains if, for example, there is a high probability of theft off the street.

Trust also can be viewed in the special sense of reliance on one who is *not* subject to costly constraints and irrespective of the risk of breach. Thus, Luhmann at one point describes trust as a kind of "suspension of external refutation" that ignores the risk of disappointment.[10] Trust in this sense permits interaction with lower transaction costs. Law clearly can produce a decision to *rely* by enforcing contracts or imposing mandatory constraints that affect the parties' risk calculation. This article shows, however, that law cannot produce *trust*.

The decision to rely obviously relates to what is generally referred to as "trustworthiness," or the likelihood that the person relied on will honor his promise.[11] Like one who trusts, the one who is trustworthy in the sense discussed in this article behaves non-calculatively and honors his promise even in the absence of constraints such as repeat dealings.[12] Trustworthiness, like trust, has the welfare-increasing attribute of reducing transaction costs. Although both concepts refer to non-calculative, potentially welfare-increasing, behavior, they are not necessarily reciprocal. One may trust another who is behaving calculatively, or rely in the calculative sense on a non-calculative, or "trustworthy," person.[13]

Barney & Hansen's distinction between "weak form," "semi-strong form" and "strong form" trust[14] captures these views of trust by differentiating the decision to rely

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[8] *Id*. at 24

[9] This formula is similar to that in Coleman, *supra* note 1 at ___. *See also* Ben-Ner & Putterman, this volume (relying on a similar calculation).

[10] *See* Luhmann, *supra* note 7 at 79.

[11] *See* Ben-ner and Putterman, this volume (discussing interaction between trustworthiness and trust).

[12] *See* Mitchell, this volume (defining trust as involving non-calculative behavior). Compare Russell Hardin, *Trustworthiness*, 107 ETHICS 26 (October 1996) (characterizing trustworthiness as based on self-interest in making commitments, supporting institutions or maintaining relations with particular people).

[13] In contrast, Blair & Stout, *supra* note 1 at 11-12, define trust to include the expectation that the trusted actor will behave "trustworthily" because of legal and market sanctions, fear of reputational loss and retaliation, or because of an "internalized" desire to behave trustworthily. Thus, the definition seems to include only trust based on some sort of calculation by the trustor.

[14] J.B. Barney & M.H. Hansen, *Trustworthiness As a Source of Competitive Advantage*, 15 STRAT. MGT. J. 175 (1994).

according to the parties' vulnerability to the risk of disappointment. Strong-form, or "principled," trust arises, in Barney & Hansen's view, even where the trustor is technically free to breach but "opportunistic behavior would violate values, principles, and standards of behavior that have been internalized by parties to an exchange."[15] Trust in this form, which is the focus of the article, arises only when the trustee is not bound by external constraints to honor his promise.[16] By contrast, semi-strong-form trust arises where the trustor is protected by structures the parties have set up but is still vulnerable to the risk of disappointment if those structures prove inadequate.[17] What Barney & Hansen call weak-form "trust" exposes the relying party to very little risk because of legal or other constraints on the other's conduct.[18] Similarly, Luhmann ascribes important functions to law and institutions in producing "trust," mostly by reducing the need for information about the promisor's reliability.[19] However, because this decision to rely involves none of the vulnerability this article associates with trust, it will be referred to here as weak-form "reliance."

These categories are useful in connecting concepts of trust with social welfare. Trust theorists assert that trust in the sense of willingness to be vulnerable to another improves social welfare by reducing friction in society.[20] The corollary is that the law should encourage this type of trust.[21] This includes not only strong-form trust, but also semi-strong-form trust arising from incomplete external constraints that leave enough vulnerability for trust to develop. As discussed below in Part III, the trade-off for this vulnerability is the sort of reduced friction or transaction costs that is attributed to trust.

This social welfare analysis, in turn, helps evaluate the role of law. As discussed below in Part II, law is irrelevant to the socially valuable, or strong-form, trust. Although law does relate to semi-strong-form trust and weak-form reliance in the sense of providing constraints that produce reliance, "trust" theories add nothing to the standard law-and-economics analysis of whether these legal constraints are socially valuable in reducing transaction costs.[22] In short, "trust" provides no distinct rationale for law.

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[15] *Id.* at 179.

[16] *See* Luhmann, *supra* note 7 at __; Posner, *supra* note 1 at 34 (discussing trust as excluding the possibility of legal enforcement).

[17] *See* Barney & Hansen, *supra* note 14 at 178. This is generally what Oliver Williamson refers to as calculative behavior, which he distinguishes from trust. *See* Oliver Williamson, *Calculativeness, Trust, and Economic Organization*, 36 J.L. & Econ. 453 (1993). This article is generally consistent with Williamson's distinction, except that it admits a broader potential for trust. *See infra* text accompanying note 53.

[18] *Id.* at 177.

[19] *See* Luhmann, *supra* note 7 at 35, 50-51.

[20] *See supra* note 1 and accompanying text.

[21] I assume for the sake of argument that more trust is a worthwhile objective of social policy. Trust may, however, be inefficient in some contexts. *See* Russell Hardin, *Distrust*, this volume.

[22] *See generally*, Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & Econ. 1 (1960) (showing that legal rules assigning property rights are irrelevant in the absence of transaction costs).

II. LAW AND STRONG-FORM TRUST

As discussed in Part I, any useful trust-based theory of law must relate to trust in the distinct sense of an inherent tendency to cooperate. This Part analyzes various theories of strong-form trust and shows that law is irrelevant to all of these theories. Section A discusses trust that arises because of the parties' disposition to trust or be trustworthy. Section B discusses trust that arises in personal relationships. Section C discusses self-enforcing norms of trust and trustworthiness. Section D discusses trust that is associated with what has been called "social capital."

A. DISPOSITION TO TRUST

Some people are more disposed to trust and be trustworthy than others. The inherently trusting person may place trust without regard to whether PG x G > PL x L. The trustworthy person performs a promise even if the expense of doing so is not balanced by the gains, such as developing a reputation for trustworthiness. Thus, Diego Gambetta, after asking whether trust is simply "a result of cooperation otherwise secured" by devices such as coercion and pre-commitment,[23] concludes that the evolution of cooperation depends on a "disposition toward conditional trust,"[24] or a willingness to believe in trustworthiness.[25] This disposition is important because information about reliability may be hard to get.[26] Distrust may be hard to invalidate through experience and deters the additional dealings that would provide the necessary information.[27] Although Gambetta concludes that it is therefore "rational to trust trust and distrust distrust,"[28] he does not clarify why individuals will end up acting in a socially rational way. Thus, Gambetta's view reduces to the simple fact that some people start with a disposition to trust.[29]

The disposition to trust may be difficult to identify in practice because it results from an unobservable decision-making process rather than an observable outcome. It may be unclear whether the trustor was willing to ignore possible negative outcomes or viewed the costs of placing trust as outweighed by probability-discounted gains (i.e., PG > PL). The two may merge where one becomes disposed to trust because of favorable

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[23] *See* Diego Gambetta, *Can We Trust?,* in TRUST: MAKING AND BREAKING COOPERATIVE RELATIONS at 225 (Diego Gambetta ed., 1988).

[24] *Id.* at 228.

[25] *Id.*

[26] *Id.* at 233.

[27] *Id.* at 234.

[28] *Id. See also* Hardin, *supra* note 21 (noting that trust may be more productive in the long run than distrust, although distrust is easier to establish in the short run).

[29] Social scientists have developed scales for differentiating "high-trust" and "low-trust" individuals. *See* Julian B. Rotter, *A New Scale for the Measurement of Interpersonal Trust*, 35 J. PERSONALITY 651 (1967); Toshio Yamagishi, *The Provision of a Sanctioning System as A Public Good*, 51 J. PERSONALITY & SOC. PSYCH. 110 (1986).

prior experiences.[30]

The disposition to trust or be trustworthy arguably resembles altruism, since the trustor and trustee confer a benefit on society by increasing the amount of trust.[31] By contrast, weak and semi-strong forms of trust involve a reasonable expectation of gain, and the types of strong-form trust discussed below arise because the trustee and trustor face emotional costs from distrust or untrustworthiness or expect reciprocation. It has been said that "a society of self-interest makes trust difficult if not impossible."[32] Because economics is based on a model of rational self-maximization, it seems to follow that trust stands outside of economics. However, the rational choice model of economics does not exclude altruism. As Gary Becker pointed out in his Nobel lecture, his economic approach "assumes that individuals maximize welfare *as they conceive it*, whether they be selfish, altruistic, loyal, spiteful, or masochistic."[33] Thus, by trusting we may be increasing our utility. As Becker might say, we have a "taste" for trust.[34] Moreover, it may be difficult to distinguish altruism from long-run self-interest. For example, Robert Frank notes that emotions such as trustworthiness may serve our long-run self-interest by acting as a commitment device.[35]

Whatever its origins, the disposition to trust is one of several factors that together produce the decision to rely. In other words, one disposed to trust would not necessarily ignore costs and benefits, but rather simply would not be rigidly governed by them. One may, for example, choose to pay up to a certain amount for something that, as a practical matter, he may take for free, but over that amount may be overcome by the temptation to cheat.[36] Barney & Hansen observe that even "strong form trustworthy" people have a

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[30] *See* Partha Dasgupta, *Trust as a Commodity*, in Gambetta, *supra* note 23 at 49; Russell Hardin, *The Street Level Epistemology of Trust*, 21 POLITICS & SOC. 505 (December 1993) at 516-17.

[31] *See* Jane Mansbridge, *Altruistic Trust*, in DEMOCRACY AND TRUST, (Mark E. Warren, ed. 1999) at 290.

[32] *See* Lawrence E. Mitchell, STACKED DECK: A STORY OF SELFISHNESS IN AMERICA, 205 (1998).

[33] See Gary Becker, ACCOUNTING FOR TASTES, 139 (1996). For similar views, see Kenneth Arrow, THE LIMITS OF ORGANIZATION, 17 (1974) (stating that "rationality, after all, has to do with means and ends and their relation. It does not specify what those ends are"); Stephen M. Bainbridge, *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 CORN. L. REV. 8, 871 (1997).

[34] *See generally* Becker, *supra* note 33 (discussing the role of tastes in economic analysis). It has been suggested that altruism may be selfish, or "impure," in the more restrictive sense that the actor gets a "warm glow" from behaving altruistically. *See* James Andreoni, *Impure Altruism And Donations To Public Goods: A Theory Of Warm-Glow Giving* 100 Econ J 464 (1990). But in practice it will be difficult or impossible to distinguish such behavior from "pure" altruism, particularly if altruism is integrated in the utility function.

[35] *See* Robert H. Frank, PASSIONS WITHIN REASON: THE STRATEGIC ROLE OF THE EMOTIONS (1988).

[36] *See* Yongmin Chen, *Promises, Trust, and Contracts*, 16 J. L. ECON. & ORG. 209, 215 (2000) (observing that people have a value "x" below which they are willing to forsake selfish gains). A recent

"Faustian" price at which they "will abandon their values, principles and standards of behavior, and act in opportunistic ways.'[37]

This relationship between the disposition to trust and other reliance-producing conditions is evident in the work of Morton Deutsch. He sees trust as depending on players' attitudes, and presents experimental data supporting this view.[38] People who have a mutually cooperative attitude establish trust even if the immediate situation does not encourage it.[39] More individualistically inclined people respond more to situational factors in deciding whether to deal with each other.[40] Competitive people are less inclined to be trusting than those who are merely individualistic because the latter are subject to greater social constraints on uncooperative behavior.[41]

The disposition to trust is particularly important in long-term open-ended relationships like business firms given the costs of constructing fully effective constraints. Several commentators have proposed theories of trust in firms that rely on workers and managers somehow acquiring dispositions to trust and be trustworthy. For example, Tyler and Degoey show how firms can create a social bond with their workers based on respect, expressions of benevolent motives, and support that encourages people unquestioningly to contribute efforts to the firm.[42] Tyler & Degoey contrast their theory with those emphasizing calculating self-benefits from acting cooperatively.[43] Tyler & DeGoey present data showing that workers respond favorably to employers' assurances rather than to such "instrumental" motives as their dependence on the job.[44] The authors argue that this shows that non-calculative trust is important in commercial as well as personal relationships.[45] Bruce Chapman's theory of trust in firms similarly relies on

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example concerns Stephen King's decision to make an unencrypted version of part of his book available for downloading for a dollar, paid on the honor system. King observed: 'I reserve the right to cease publication if a lot of people steal the story; but I just don't believe that will happen. I mean, we're talking a buck a pop here, right?" *King To Follow E-Book Success With Honor-System Experiment*, E-Commerce Law Weekly, June 19, 2000, available on http://www.law.com.

[37] *See* Barney & Hansen, *supra* note 14 at 179, n. 3. Although people may *say* that they make decisions, including decisions to be trustworthy, at all costs, this can be regarded as a form of signaling or symbolic speech rather than an indication of true preferences. *See* Eric A. Posner, *The Strategic Basis of Principled Behavior: A Critique of the Incommensurability Thesis*, 146 U. Pa. L. Rev. 1185 (1998).

[38] *See* Morton Deutsch, *Trust and Suspicion*, 2 J. CONFLICT RESOL. 278 (1958).

[39] *Id.* at 271-72.

[40] *Id.* at 272.

[41] *Id.* at 275.

[42] Tom R. Tyler & Peter Degoey, *Trust in Organizational Authorities: The Influence of Motive Attributions on Willingness to Accept Decisions*, in TRUST IN ORGANIZATIONS: FRONTIERS OF THEORY AND RESEARCH, 331 (Roderick M. Kramer & Tom R. Tyler eds., 1995).

[43] *Id.* at 332, 338, 344 (referring to Dasgupta's theory).

[44] *Id.* at 345.

[45] *Id.* at 346-47.

managers' dispositions to be trustworthy.[46] Chapman asserts that trust in firms cannot depend on parties' self-interested actions[47] or on managers' reputations.[48] Rather, managers must become trustworthy by seeming to be blindly loyal.[49] Employees will not trust managers as long as the latter seem to be rationally choosing to act, rather than acting out of "what they are.'[50]

Assuming the validity of these theories,[51] the important question for present purposes concerns the role of law in producing this disposition. Mandatory regulation that forces people to attend to others' interests cannot produce the disposition to trust or be trustworthy. Legal constraints may increase the probability that one will perform as promised, but not one's willingness to perform in the absence of constraints or to make oneself vulnerable to the risk of non-performance. If managers are disposed to be trustworthy and shareholders and workers are disposed to trust then there is no need for law. Law may dispose one party to *rely on* another because the other is subject to legal constraints. But this has nothing to do with the distinct concept of *trust*. Although law may be socially valuable in this sense to the extent that people are *not* disposed to trust, its justification must be sought other than from theories of trust.

Legal coercion might be said to cause a disposition to trust that is based on one's favorable experiences in relying on others.[52] These experiences might reveal information that favorably bears on the decision to rely, such as peoples' willingness to obey the law even if punishment is not severe and detection is imperfect. But legal coercion subtracts as well as adds information. Even if regulation enables people to learn that others are trustworthy, it also reduces their ability to learn how others will act when they are *not*

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[46] Bruce Chapman, *Trust, Economic Rationality And The Fiduciary Obligation,* 43 U. TORONTO L. REV. 547 (1993).

[47] *Id.* at 553

[48] *Id.* at 583

[49] *Id.* at 587.

[50] *Id.* at 584. In other words, as in Robert Frank's theory discussed *supra* text accompanying note 35, managers use emotions as a commitment device.

[51] It is not clear why workers would believe managers' assurances rather than assume that they are being played for suckers. Cynthia Hardy, Nelson Phillips, & Tom Lawrence, *Distinguishing Trust and Power in Itnerorganizational Relations: Forms and Facades of Trust*, in TRUST WITHIN AND BETWEEN ORGANIZATIONS: CONCEPTUAL ISSUES AND EMPIRICAL APPLICATIONS, 64 (Christel Lane & Reinhard Bachmann eds. 1998), show how management may signal trustworthiness in order to secure union cooperation in a plant closure that is actually an exercise of employer power rather than a genuine promise of reciprocation. Even if workers are generally disposed to trust, the business firm setting is likely to mute this dis position. Experiments show that the subjects' altruism, or "other regarding preferences" (ORP), were *less* in the agency setting than other studies have seen outside the agency setting. *See* Jennifer Arlen, Matthew Spitzer and Eric Talley, *Endowment Effects, Other-Regarding Preferences, and Corporate Law*, USC Olin Working Paper No. 00-2 (April 21, 2000) (hypothesizing that "[t]he agency context . . . might mute ORPs because subjects generally are less inclined to display ORPs towards profit-maximizing nonnatural persons (as compared with other-regarding organizations like the Red Cross)").

[52] *See* Hardin, *supra* note 30.

subject to legal constraints.

B. PERSONAL TRUST

People may be trusting or trustworthy in specific relationships. Family members or close friends may eschew calculation of probabilities as inconsistent with the intimate bond between them. Oliver Williamson asserts that this form of trust is the only one that is distinct from conventional transaction cost theory.[53] As discussed in this Part, that may not be the case. On the other hand, even parties to personal relationships may only appear to eschew calculation while expecting payoffs in the form of reciprocal behavior from their partners.

For present purposes it is enough to note that regulation cannot produce personal trust. The parties rely on each other because of the underlying legal constraint, not because of any trust-like vulnerability. For example, a husband and wife may believe each other because each knows the other will be subject to legal penalties for lying, but this is not personal trust even if it arises in a personal relationship because the need for costly penalties suggests that trust is unavailable to eliminate friction in the relationship.

A possible argument for law in this context is that, by reducing the risk of relying on others, regulation starts relationships in which trust can eventually develop. This appears to be supported by Lewicki & Bunker's three-stage model of trust.[54] The first stage involves calculation of risk based on such factors as punishment, rewards and reputation. The parties enter the second stage based on knowledge of their past behavior. This stage is less fragile than the first because the parties tend to place deviations from complete trustworthiness in the context of past trustworthiness. In the third stage the parties identify with each other and reach a mutual understanding comparable to personal trust. In this model, regulation might "seed" relationships that ultimately develop into strong-form trust.

The problem with this rationale is that it cannot account for the eventual development of trust in the relationship. In other words, it is not clear why the sorts of relationships that regulation "seeds" are more likely to develop trust than those created without regulation. Indeed, the correlation would seem to be negative since regulation-induced relationships begin in the shadow of coercion. Moreover, as discussed below,[55] regulation may actually frustrate the development of personal trust.

C. NORMS

Trust may arise from a social norm – that is, a rule that is imposed by social conventions rather than by centralized lawmakers and that is enforced by extralegal sanctions. Under this norm, people operate under an honor system where they make themselves vulnerable to others and are trustworthy without strictly calculating costs and benefits, including the effects of legal penalties. Acting pursuant to this norm resembles the disposition to trust except that violations are punished by social disapprobation and

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[53] *See* Williamson, *supra* note 17.

[54] *See* Roy J. Lewicki & Barbara Benedict Bunker, *Developing and Maintaining Trust in Work Relationships*, in KRAMER & TYLER, *supra* note 42, at 114.

[55] *See infra* subpart V(B)(2).

ostracism and by psychological sanctions of shame or guilt.[56]

Norms have been described as a form of social ordering that arises outside the legal system.[57] Law may even be irrelevant to norms because the parties are not even aware of it.[58] But law also may operate together with norms.[59] Law can, among other things, have expressive effects that create or change norms;[60] interact with norms by changing the "social meaning" of behavior;[61] provide a focal point that facilitates social punishment of deviators or changes individuals' preferences by offering opportunities for "Pareto self-improvement;"[62] express a social consensus or clarify the behavior that internalized norms discipline;[63] or change behavior by altering what it signals about the actor.[64]

This literature often seems to reach beyond data and theory in explaining law's effects on human behavior.[65] Moreover, merely noting that a law *can* have these effects does not justify it.[66] Indeed, law's norm-influencing effects may be perverse.[67] Thus, the

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[56] For discussions of mechanisms for enforcing norms, *see* Robert C. Ellickson, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES, 207-29 (1991); Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1259-60 (1999) (distinguishing between an internalized norm and enforcement based on conscious calculation of costs and benefits); Richard H. McAdams, *The Origin, Development, And Regulation of Norms*, 96 MICH. L. REV. 338 (1997).

[57] A leading statement of this idea is Ellickson, *supra* note 56. *See also* Robert Sugden, THE ECONOMICS OF RIGHTS, CO-OPERATION AND WELFARE (1986); Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. Legal Stud. 115 (1992); McAdams, *supra* note 56.

[58] *See* Ellickson, *supra* note 56 at 49, 70, 144-47 (discussing evidence of ignorance of the law).

[59] See Lawrence Lessig, *The New Chicago School*, 27 J. Legal Stud. 661 (1998).

[60] *See* Cass R. Sunstein, *On the Expressive Function of Law*, 144 U. PA. L. REV. 2021 (1996).

[61] Lawrence Lessig, *Social Meaning and Social Norms*, 144 U. PA. L. REV. 2181 (1996); Lawrence Lessig, *The Regulation of Social Meaning*, 62 U. CHI. L. REV. 943 (1995).

[62] *See* Robert Cooter, *Expressive Law & Economics*, 27 J. Leg. Stud. 585 (1998).

[63] *See* McAdams, *supra* note 56 at 386.

[64] See Eric A. Posner, *Symbols, Signals, and Social Norms in Politics and the Law*, 27 J. Leg. Stud. 765 (1998).

[65] For a skeptical view of law and norms, *see* Robert E. Scott, *The Limits Of Behavioral Theories Of Law And Social Norms*, UVA Law School, Law & Economics Research Paper No. 18 (August 2000), forthcoming, VA. L. Rev.

[66] *See generally* Matthew D. Adler, *Expressive Theories of Law: A Skeptical Overview*, 148 U. PA. L. Rev. 1363 (2000).

[67] *See* Lessig, *supra* note 58; McAdams, *supra* note 58; Richard H. Pildes, *The Unintended Cultural Consequences of Public Policy*, 89 MICH. L. REV. 936 (1991); Sunstein, *supra* note 58; Cooter,

literature on norms seems to provide at least as many arguments for as against regulation.

Assuming mandatory legal rules can have some role in norm-creation generally, they are irrelevant to the *trust* norm. This norm is based on the trustor's *vulnerability*, and therefore is fundamentally inconsistent with legal coercion.

The law might help establish a *trustworthiness* norm, and thereby make promises more reliable. It has been argued that, by penalizing disloyal behavior, the law expresses a social consensus concerning the type of conduct that constitutes cheating, and so concretizes the behavior that invokes emotional sanctions for violating internalized norms against cheating.[68] But there is reason to be skeptical that law can have this effect.[69] Moreover, legal penalties that help establish an anti-"cheating" norm might be perverse because the norm would be overbroad and would deter socially beneficial selfish behavior.[70] And even if the law influences the trustworthiness norm, it is not clear that it does so through coercion. Some commentators argue that judges create or strengthen norms of trust through morally-tinged language in judicial opinions.[71] Under this reasoning, fiduciaries could opt out of *liability* and still be subject to the fiduciary norm defined by judicial *language*. Thus, judges might issue stern warning tickets but preserve the vulnerability and freedom from coercion that is essential to trust.

Blair and Stout make an alternative argument for the importance of judicial moralizing that emphasizes the role of binding fiduciary rules.[72] They theorize that fiduciary law "frames" corporate managers' roles as either self-interested (low-trust) or other-regarding (high-trust). Judicial language that communicates the fiduciary norm determines the directors' relationship with the firm and thereby defines their

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supra note 62; Posner, *supra* note 64.

[68] *See* Eisenberg, *supra* note 56; Simon Deakin & Frank Wilkinson: *Contract Law and the Economics of Interorganizational Trust*, 153-54, in Lane & Bachmann, *supra* note 51 (arguing that, because regulation may influence the development of trust norms, we should not look merely at law's coercive effect to assess its overall impact).

[69] *See* Market Street Assoc. v. Frey, 941 F. 2d 588, 595 (7th Cir. 1991)(Posner, J., stating that "[i]t would be quixotic as well as presumptuous for judges to undertake through contract law to raise the ethical standards of the nation's business people").

[70] *See* Bainbridge, *supra* note 33 at 867-68 (criticizing as indeterminate proposal for legal enforcement of social norms against cheating).

[71] *See* Eisenberg, *supra* note 56 at 1270-71 (arguing that it is the law's influence in changing norms and not liability that affects the behavior of directors and other corporate actors); Robert W. Hillman, *Business Partners as Fiduciaries: Reflections on the Limits of Doctrine* (unpublished ms) (noting that Judge Cardozo's famous opinion in *Meinhard v. Salmon* simply expresses a business ethic, and showing the difference between the language of *Meinhard v. Salmon* and how it has been applied in the courts); Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work*, 44 UCLA L. REV. 1009 (1997) (showing the distinction between legal rules and judicial statements of norms in Delaware management buyout cases). For an article supporting the holding and not simply the language of *Meinhard*, *see* Nicholas L. Georgakopoulos, *Meinhard v. Salmon and the Economics of Honor*, 1999 Colum. Bus. L. Rev. 137.

[72] *See* Blair & Stout, *supra* note 1.

preferences.[73] Blair & Stout argue that, since contract law encourages parties to be self-interested while fiduciary law encourages them to be other-regarding, a relationship cannot properly be described as both fiduciary and contractual.[74] Allowing corporations to opt out of managerial fiduciary duties would cause managers to slip into a self-interested stance, leaving firms with managers who are governed neither by external nor internal constraints.[75] Thus, Blair & Stout argue that fiduciary duties, to be effective, must be binding. But Blair & Stout do not show why judicial language concerning fiduciaries' other-regarding nature must be linked with liability in order to define fiduciaries' social roles. Indeed, mandatory liability might be counterproductive by forcing managers to completely opt out of their fiduciary role solely in order to avoid liability.[76] Moreover, as Blair & Stout acknowledge,[77] reciprocity theory suggests that liability may have the opposite effect of discouraging trustworthiness.[78]

In short, legal coercion does not help develop norms of trustworthiness or of trust. Moreover, as discussed below,[79] regulation impedes development of trust norms by interfering with opportunities to be genuinely trusting or trustworthy.

D. SOCIAL CAPITAL

"Social capital" is used here to describe the social forces that support decisions to trust without the need to establish costly transaction-specific constraints. James Coleman discusses various sources of social capital, including organizations,[80] business firms,[81]

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[73] *Id.* at 66, 70-72.

[74] *Id.* at 56-58. Blair & Stout also observe that since "contractarian theory is rooted in economic analysis," and since neoclassical economics treats preferences as given, contractarian theory cannot cause people to adopt a different, other-regarding, preference function. *Id.* at 58-59. However, the law and economics literature now incorporates a variety of approaches to preferences. More importantly, regardless of how "economic analysis" is construed, the present article shows that it is mandatory regulation, and not private ordering, that is incompatible with theories of trust.

[75] *Id.* at 60-62.

[76] *See infra* text accompanying note 162.

[77] *See id.* at 73-74.

[78] *See infra* note 176 and accompanying text.

[79] *See infra* subpart V(B)(3).

[80] *See* Coleman, *supra* note 1 at 312-13. For leading works on the role of associations in creating social capital, *see* Putnam, *supra* note 84 (concluding that social capital is declining in the U.S. because of reduction in associational activity); Robert D. Putnam, MAKING DEMOCRACY WORK (1993) (explaining differences in economic success and government efficacy between northern and southern Italy in terms of associational activity).

[81] *Id.* at 313.

trust norms,[82] and ideology, such as religious beliefs that are hospitable to a trusting atmosphere.[83] Some of these sources create what Robert Putnam calls "thick" trust, which is based on specific relationships and expectations of reciprocity, while others create "thin" trust, which is based on the general social fabric.[84] It might be said that social capital exists only in private organizations or small groups.[85] But religious and ethical values may contribute to "spontaneous sociability," or people's willingness to form new associations.[86] This sociability permits trust to spread beyond close-knit family structures or small communities[87] and contributes to the growth of large organizations such as business associations.[88]

How might law affect the creation of social capital? One possible story is that legal sanctions for untrustworthy conduct make people more willing to rely on strangers, which increases "sociability." But this just restates the arguments about how legal sanctions dispose people to *rely on* others by affecting their probability assessments.[89] Trust arises in these settings only in the absence of coercion. We may trust others to some extent because our religion teaches us to do so or because the others are in our groups, but not because we know the others are coerced into being reliable. Law's role, at most, is to pick up where social capital leaves off. But, as shown below, law must be regarded as a substitute for rather than complement of social capital because it undermines the institutions that create it. [90]

III. SEMI-STRONG FORM TRUST

The decision to rely occurs in some situations because the parties have voluntarily

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[82] *Id.* at 114, 310-11. See subpart II(C).

[83] *Id.* at 319-21 (noting the role of ideology in religious schools). The link between non-hierarchical Protestant religions and trust is explored in Fukuyama, *supra* note 1; Putnam, *supra* note 80. La Porta, et al, *supra* note 2, find empirical support for this link in a cross-country comparison. For a more general description of mechanisms for creating cooperation in society, *see* Jon Elster, THE CEMENT OF SOCIETY: A STUDY OF SOCIAL ORDER (1989).

[84] *See* Robert D. Putnam, BOWLING ALONE, 136 (2000).

[85] *See* Bainbridge, *supra* note 1 at 803. *Cf.* Ellickson, *supra* note 57 at 177-82 (concluding that welfare-maximizing cooperation norms arise only in "close-knit" groups).

[86] *See* Fukuyama, *supra* note 1 at 26. *See also* Francis Fukuyama, THE GREAT DISRUPTION (1999) (noting that trust grows from shared norms of honesty and reciprocity (*id.* at 51) and discussing the cultural and religious bases of trust (*id.* at 240-41); Francis Fukuyama (this volume) (noting that social capital is norms and values that promote cooperation and serves as the basis of trust).

[87] *See* Fukuyama, *supra* note 1. The reliance on families in a low-trust society is humorously illustrated in Ian Fleming's "From Russia with Love," in which a Turkish intelligence agent employs only his many sons.

[88] *See id.* at 36, 47-8; 62-3, 226 (linking growth of industry to trust).

[89] *See supra* text accompanying notes__.

[90] *See infra* subpart VI(B)(4).

taken on constraints that assure performance. These may include contractual obligations and incentive devices that align the parties' incentives and interests, or "hostages" that the hostage-giver must forfeit in the event of non-performance.[91] "Semi-strong-form" trust refers here to trust that operates in the vulnerability left by the risk that these privately assumed constraints may prove to be insufficient.[92] By contrast, under weak-form "trust" discussed in the next subpart, the law supplies an additional, uncontracted-for constraint to protect against disappointment. As with other forms of trust, the payoff is reduced transaction costs, in this case from the parties' ability to design constraints to fit their transactions rather than being forced to accept one-size-fits-all mandatory rules.

The constraints associated with semi-strong-form trust include the bonding and monitoring devices discussed in the agency cost literature.[93] A principal will delegate power to an agent when the costs of these constraints, together with expected residual loss, are less than the benefits of delegation. For example, individuals and firms can bond future performance by investing time and money in developing a reputation that would be devalued by acts of disloyalty.[94] The bond is self-enforcing in that misconduct diminishes the value of trustee's reputation according to the public's perception of the seriousness of the conduct.[95] Once reputational or other constraints are in place the parties seem to "trust" each other. However, the investment in reputation, or in detailed contracting until less formal reputational constraints are in place,[96] differentiates these transactions from the frictionless world of strong-form trust.

So pervasive are the privately ordered constraints discussed above that Oliver Williamson believes that what has been referred to here as strong-form trust has little meaning in commercial relationships.[97] In Williamson's view, people design institutions to provide reasonable assurances of performance, and then adjust what they are willing to pay to reflect these assurances.[98] Thus, trust in commercial relationships is simply

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[91] *See* Oliver Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 AM . ECON. REV. 519 (1983).

[92] *See infra* text accompanying notes__.

[93] *See* Michael Jensen & William Meckling, *Theory of the Firm: Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 8 (1976).

[94] See Benjamin Klein & Keith B. Ieffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615 (1981); Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297 (1978).

[95] *See* Jonathan M. Karpoff & John R. Lott, Jr., *The Reputational Penalty Firms Bear from Committing Criminal Fraud*, 36 J.L. & ECON. 757 (1993).

[96] *See* Laura Poppo & Todd R. Zenger, *Substitutes or Complements? Exploring the Relationship Between Formal Contracts and Relational Governance*, http://papers.ssrn.com/paper.taf?abstract_id=223518 (April 27, 2000) (studying the relationship between explicit contracts and informal controls).

[97] Williamson, *supra* note 17.

[98] As to the tradeoff of price and safeguards, *see id.* at 467-69.

calculated risk.[99] Partha Dasgupta similarly concludes that the decision to rely is based on an expectation that the other will be punished for untrustworthiness[100] and on the other's incentives,[101] particularly including his investment in reputation.[102]

Private constraints may, however, be compatible with trust. As long as people are not completely constrained by law, there is room for vulnerability and therefore trust. To be sure, detailed contracts, like legal regulation, may "crowd out" trust.[103] However, as discussed below, mandatory constraints only exacerbate this problem.[104] Thus, crowding out supports relying on strong-form trust rather than contractual constraints, but *not* replacing private ordering with mandatory rules.

Semi-strong form trust is particularly important in firms. Shareholders, workers and others who contract in and with the firm may *decide to rely* on managers because of market and contractual structures that help ensure that managers act in their interests. These include incentive compensation, governance devices such as monitoring boards, shareholder voting, and efficient securities markets.[105] David Kreps' theory of corporate culture[106] is an example of semi-strong-form trust in firms. Kreps notes that firms can post self-enforcing reputational bonds[107] that are valuable because firms last longer than their individual agents and their owners seek to maintain the firm's value to maximize the sale price of their shares.[108] The firm bases its reputation on a "culture" that guides the sorts of transactions the firm is likely to engage in,[109] and that the firm can readily communicate to customers, suppliers, executives and employees.[110] In order to make

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[99] *See id.* at 463 (noting that it is redundant or misleading to use trust to describe commercial exchange with safeguards and that "calculative trust is a contradiction in terms").

[100] *See* Dasgupta, *supra* note 30 at 52.

[101] *Id.* at 54

[102] *Id*. at 62

[103] *See infra* text accompanying note 165.

[104] *See infra* text accompanying note 167.

[105] *See generally* Frank H. Easterbrook & Daniel R. Fischel, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991); Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1 (1990).

[106] David M Kreps, *Corporate Culture and Economic Theory*, in PERSPECTIVES ON POSITIVE POLITICAL ECONOMY 100-3 (James Alt & Kenneth Shepsle eds 1990).

[107] *Id.* at 110 (noting that a reputational bond is better than cash bond because it is self-enforcing).

[108] *Id* at 108-09. *See also* Larry E. Ribstein, *Ethical Rules, Agency Costs and Law Firm Structure*, 84 VA. L. REV. 1707 (1998) (discussing the role of reputational bonding in law firms).

[109] *See* Kreps, *supra* note 106 at 128.

[110] *Id* at 125-26. The communication of the firm's culture can be understood in terms of Eric Posner's signaling theory. *See* Posner, *supra* note 37. Managers may make absolute statements about the

favorable contracts with workers and others, the firm has an interest in motivating its agents to preserve a culture of trustworthiness. Kreps' theory thus explains corporate "trust" in Williamsonian calculative terms.

Semi-strong-form constraints like that emphasized by Kreps do not provide a distinct rationale for law. The law might reduce the costs of the *decision to rely* through its well-understood transaction-cost-reducing function -- i.e., by providing standard forms and enforcing the parties' contracts. But this does not involve resorting to special concepts of "trust."

To the extent that the decision to rely on private ordering involves the distinct vulnerability associated with trust, law is irrelevant. Shareholders, workers and others may trust in the sense of making themselves vulnerable to the risk of breach of faith rather than insisting on mandatory backup rules. Trust does not emerge from legal coercion.

IV. WEAK-FORM RELIANCE: LAW INSTEAD OF TRUST

What Barney & Hansen call weak-form "trust"[111] is not "trust" at all in the sense discussed in this article because it wholly replaces vulnerability with constraints. Mandatory legal rules make it easier to rely on promises because they remove any risk of disappointment resulting from limited foresight and knowledge in the ex ante design of constraints. This does not, in itself, justify mandatory rules, however, because it is not self-evident why the law should remove vulnerability rather than simply allowing the parties to take it into account in determining the price. Calling the decision to rely one to "trust" does not change this conclusion.

An example of "trust"-based arguments for mandatory rules is Tamar Frankel's article on the need for regulation to engender trust, focusing on regulation of the financial services industry.[112] Responding to Langbein's theory of trust law as contract,[113] Frankel asserts the need for fiduciary law,[114] saying that, without "a legal infrastructure," markets "cannot exist."[115] Law's "backing" permits the development of a "trusting commons."[116] Contracts alone are insufficient, she says, because they may offer less than absolute

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firm's culture of trustworthiness because if they confessed to any self-interest employees, communities, and others would tend to over-discount the reliability of the firm's promises. *See also* Ben-Ner & Putterman, *supra* note 9 at [19] (discussing how firms induce trust through such devices as culture and contributions to charity).

111 *See supra* text accompanying note__.

112 *See* Frankel, *supra* note 5.

113 *See* John H. Langbein, *The Contractarian Basis of the Law of Trusts,* 105 YALE L. REV. 625 (1995).

114 *See* Frankel, *supra* note 5 at 26.

115 *Id.* at 30.

116 *Id.* at 31.

protection,[117] and thereby indicate that the trustee will be less than fully trustworthy.[118] According to Frankel, if the law does not provide absolute trustworthiness, the parties must rely on detailed contracts,[119] trustors face an "unknowable and unpredictable future,"[120] investments will become illiquid because of the risk of runs,[121] and investors "will put their money in gold and other unproductive goods, and hide it under the mattress."[122]

This argument assumes that investors will fully understand the uncertainty they face and for that reason will be reluctant to invest.[123] The victims of distrust therefore are not individual investors but rather markets that lose productive investments because of inadequate legal protection. There is a large literature on cross-country comparison of investor protection and implications for designing securities markets in emerging economies.[124] Although market actors have incentives to create and to rely on market intermediaries such as bond rating agencies, their incentives may be suboptimal because individual investors and firms do not capture all of the benefits from improving an entire market.[125] This argument might justify some mandatory laws, assuming the social costs of these laws do not outweigh benefits, including increasing the general level of

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[117] *See id.* at 26-7 (asserting that fiduciary duties are based on property rights rather than contract damages); 32 (stating that weaker contract approach encourages mistrust through such rules as efficient breach; no duty to speak, and damages rather than accounting for profits).

[118] *Id.*

[119] *Id.* at 33.

[120] *Id.*

[121] *Id.* at 29.

[122] *Id.* at 34.

[123] Lawrence Mitchell makes a rather surprising argument about an alternative investor response to distrust -- that it causes shareholders to be reluctant to invest in individual stocks. *See* Lawrence E. Mitchell, *Fairness and Trust in Corporate Law,* 43 Duke L.J. 425, 480 (1993). In other words, distrust leads to diversification. If this is so, then distrust explains the capital assets pricing model, although it is not clear what this explanation adds. But given distrust, the increase in diversification may be an entirely salutary development reflecting the growth of diversification devices, including index mutual funds.

[124] *See, e.g.,* Bernard S. Black, *The Legal and Industrial Preconditions for Strong Securities Markets,* 48 UCLA L. REV. ___ (2000); Bernard S. Black, *The Core Institutions that Support Strong Securities Markets,* 55 BUS. LAW. 1565 (2000); Bernard S. Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law,* 109 HARV. L. REV. 1911 (1996); Florencio Lopez de Silanes, Andrei Shleifer & Robert Vishny, *Legal Determinants of External Finance,* 52 J. FIN. 1131 (1997); Rafael La Porta, Florencio Lopez de Silanes, Andrei Shleifer & Robert Vishny, *Law and Finance,* 106 J. POL. ECON. 1113 (1998); Rafael La Porta, Florencio Lopez de Silanes and Andrei Shleifer, *Corporate Ownership Around the World,* 54 J. FIN. 471 (1999); Florencio Lopez de Silanes, Andrei Shleifer & Robert Vishny, *Agency Problems and Dividend Policies Around the World,* 55 J. FIN. 1 (2000).

[125] Similarly, in assessing evidence of the effectiveness of the securities laws, one would not expect these laws to have increased risk-adjusted returns. *See* Frank Easterbrook & Daniel Fischel, *Mandatory Disclosure and the Protection of Investors,* 70 VA. L. REV. 669 (1984).

investment.[126]

The important point for present purposes is that a special concept of "trust" does nothing to advance this analysis. On their face the above arguments point to no reason why the law should ensure that investors must be able to rely unhesitatingly on firms. In particular, "trust" does not support more stringent regulation in an already strong securities market such as that in the U.S., particularly in view of the potential trust-reduction consequences of such regulation discussed below in Part V. For example, government might induce more people to invest by requiring all issuers to offer money-back guarantees rather than merely full disclosure, but mandating these guarantees obviously would entail substantial costs, including limiting the range of available investments. "Trust" in this sense is no more than a shorthand for other arguments for regulation. Only trust in the sense discussed in this article deserves special consideration because of its potential for reducing friction in society. Arguments like Frankel's implicitly assume that investors lack trust, so that markets need regulatory "backing." But this approach precludes any opportunity for genuine trust and trustworthiness by ensuring that everybody acts under legal coercion.

This analysis applies to theories of trust within firms that several legal commentators have proposed. Lawrence Mitchell opened this line of analysis by criticizing the fairness test in corporate law, which allows insiders who have participated in conflicting interests transactions to escape liability if they can prove that the transactions were fair.[127] Mitchell suggests requiring the fiduciary at least to obtain the best possible price, and not merely a fair price, in "vertical conflict" situations where the fiduciary's interest competes with those of the firm as a whole.[128] Mitchell sees such strict law as necessary because investors would not "entrust [their] money to people who you were told had the power, practical ability, and legal right to take some of it for themselves."[129] Mitchell's later writing criticizes Williamson's calculative trust model because of its emphasis on self-interest.[130] Mitchell asserts that permitting parties to act in their self-interest destroys the "culture" of trust[131] by leading shareholders to be more suspicious of management's motives, and managers therefore to trust shareholders less.[132] If the law instead forces managers to consider shareholders' interests, shareholders will be

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[126] *See* Frankel, this volume (discussing a cost-benefit approach to regulation that increases regulation when investor verification costs are high).

[127] *See* Mitchell, *supra* note 123. The focus on shareholders is somewhat ironic since in the communitarian framework shareholder primacy and wealth maximization is the great evil to be redressed. *See, e.g.*, Allan A. Kennedy, THE END OF SHAREHOLDER VALUE (2000).

[128] *Id.* at 485.

[129] *Id.* at 491.

[130] *See* Lawrence E. Mitchell, *Trust. Contract. Process.* in PROGRESSIVE CORPORATE LAW (Lawrence E. Mitchell, ed 1995) at 185.

[131] *See* Mitchell, *supra* note 130 at 187.

[132] *Id.* at 203-204 (noting that the risk of misuse of power causes fear); 206 (wrong of breach of trust is less ability to trust, encouraging more monitoring and litgation and therefore manager distrust); 208 (narrow interpretation of duties forces shareholders to be wary and therefore to do more monitoring).

more prone to tolerate managers' errors, thereby stopping this cycle of mistrust.[133]

William Bratton, like Mitchell, sees law as necessary for "backstopping" trust.[134] Bratton says that, "corporate law stabilizes the atmosphere of trust" by providing a guarantee.[135] Although Bratton notes that reputation helps enforce cooperation,[136] he asserts that this is not enough because "rational actors do not bring norms of honor to the ordering of their affairs."[137] Rational actors cannot make credible commitments because, given their narrow economic view, they will always be assumed to act in their immediate self-interest.[138] According to Bratton, fiduciary law provides the necessary constraints for the "trust-based" firm, including punishment, observability and verifiability, and communication of standards.[139]

Marleen O'Connor argues for mandatory fiduciary duties of directors to workers as a way of supporting "goodwill trust" in the corporation.[140] According to O'Connor, fiduciary duties, by fostering cooperation between workers and managers[141] and promoting "moral commitment" and "we-feelings" among workers and managers, would encourage effort and therefore efficiency.[142] O'Connor says that legal reform is necessary to change the workers' role in corporate governance.[143]

These theories do not establish a trust-based rationale for legal coercion. To be sure, corporate managers may need to demonstrate the firm's benign attitude to shareholders and workers in order to induce the latter to reciprocate. Managers might

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[133] *Id.* at __. Tamar Frankel also notes how fiduciary regulation can reduce reliance on lawyers, detailed contracting and litigation that is prevalent under a contract regime. *See* Frankel, *supra* note 5 at __. As discussed below in subpart V(A), there are strong reasons to believe that, rather than supporting trust, legal remedies will spawn shareholder opportunism which will give rise to distrust.

[134] *See* William W. Bratton, *Game Theory and the Restoration of Honor to Corporate Law's Duty of Loyalty,* in Mitchell, *supra* note 130 at 139.

[135] *Id.* at 145.

[136] *See* Bratton, *supra* note 134 at 166.

[137] Bratton, *supra* note 134 at 141, 151-52.

[138] *Id.* at 167.

[139] *Id.* at 168

[140] *See* Marleen A. O'Connor, *Promoting Economic Justice in Plant Closings: Exploring the Fiduciary/Contract Law Distinction to Enforce Implicit Employment Agreements,* in Mitchell, *supra* note 130 at 219.

[141] *Id.* at 234.

[142] *Id.* at 223-24. It is worth nothing in passing that there is little evidence for the proposition that reform of management/employee relationships along more cooperative lines increases efficiency. *See* Bainbridge, *supra* note 33.

[143] *See* O'Connor, *supra* note 140 at 235-36

achieve this result by adopting a pre-commitment strategy, as by genuinely transforming themselves emotionally as Robert Frank has argued.[144] But it is far from clear how the theories make the leap from there to mandatory legal rules. Rules that punish managers for breaches *prevent* them from demonstrating their genuine commitment to the workers and innate trustworthiness. Although law may usefully provide a substitute constraint that induces shareholders or workers to *rely* on managers, this has nothing to do with *trust*.

The above rationales for trust-based regulation are best understood in light of the corporate "communitarian" theories these writers espouse.[145] These theorists want to remake the corporation by elevating workers' role.[146] Trust would arise after law reshapes the world into a communitarian mold. However, it is not clear why changing the power structure would increase trust in firms. Rather, putting the workers in charge simply creates a new incentive structure with different but equal opportunities for distrust to arise among workers and between workers and managers.[147]

The only way mandatory rules might create trust in firms or elsewhere is by changing peoples' preferences. As discussed above, Blair & Stout have argued that law might make people more other-regarding and less self-interested, applying their arguments explicitly in the firm context.[148] However, there is little logical and no empirical support for this theory.[149] Indeed, as discussed below, mandatory rules are more likely to move preferences in the opposite direction.[150]

V. TRUST-BASED ARGUMENTS AGAINST LAW

The discussion so far indicates that law has nothing to do with trust. This leaves open the possibility that law complements trust in the sense that mandatory legal rules may be necessary to the extent that trust is lacking. But, as this Part discusses, law actually may undermine trust, and therefore serve as a substitute rather than a complement. Subpart A shows that regulation may increase the potential for distrust.

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[144] *See supra* text accompanying note 35.

[145] Corporate communitarian ideology is perhaps best represented by the collection of essays in Mitchell, *supra* note 130.

[146] *See generally* David Millon, *Communitarianism in Corporate Law: Foundations and Law Reform Strategies*, in Mitchell, *supra* note 130. For excellent critiques of communitarianism, *see* Bainbridge, *supra* note 1; Bainbridge, *supra* note 33. Communitarianism looks similar to "team production" theory, which also emphasizes cooperation among corporate factions. However, team production purports to be a description of how firms actually operate and therefore does not in itself seem to call for reshaping by strong mandatory rules. *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 25 J. CORP. L. 751 (1999). *See generally*, SYMPOSIUM: TEAM PRODUCTION IN BUSINESS ORGANIZATIONS, 24 J. CORP. L. 743 (1999).

[147] *See* Bainbridge, *supra* note 1.

[148] *See supra* text accompanying note 73.

[149] *See supra* text accompanying notes 76 - 78.

[150] *See infra* text accompanying note 165.

Subpart B shows how regulation can frustrate the trust-creation mechanisms discussed in Part I, including norms, personal trust, social capital and private associations.

A. REGULATION AND DISTRUST

A broad and strict duty that ignores ex ante expectations in order to protect the parties from ex post disappointment also may give them opportunities to get more than they bargained for. It follows that imposing extra duties to reduce the parties' vulnerability to the risk of disappointment may increase their vulnerability to opportunistic litigation.[151] This, in turn, increases the need for devices to deal with the new vulnerability. Regulation thereby may increase the friction and attendant transaction costs that trust is supposed to reduce. Some productive transactions might be lost if these devices are not feasible. The following subsections illustrate these effects of regulation.

1. Managers' fiduciary duties

Imposing broad duties on managers may force them to incur costs to deal with the distrust these duties engender. This was evident when the Delaware supreme court imposed potentially draconian negligence liability on corporate directors in *Smith v. Van Gorkom*.[152] Directors had to protect themselves from the risk of being sued for mistakes that previously were not actionable. In other words, directors could not rely on shareholders not to sue for bad results that occurred although directors performed up to shareholders' ex ante expectations. In *Van Gorkom*'s wake, directors' and officers' liability insurance became more costly and less available.[153] Legislators dealt with the problem by enacting statutes authorizing duty of care opt-out charter provisions.[154] These charter clauses, in turn, created extra contracting and litigation costs, such as uncertainties concerning the scope of the opt-out.[155] This indicates what might happen if courts were to impose even stricter duties on managers, as Mitchell suggests.[156]

2. Duties to non-shareholders

Marleen O'Connor's proposal to expand managers' fiduciary responsibilities to

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[151] *See* Putnam, *supra* note 84 at 147 (noting increase in demand for legal work from "preventive lawyering" because informal understandings are no longer sufficient). Another effect of the distrust that fiduciary duties may cause is diverting the parties' efforts from production to monitoring. *See* Eric Talley, *Taking the "I" out of "Team": Intra-Firm Monitoring and the Content of Fiduciary Duties*, 24 J. CORP. L. 1001 (1999).

[152] 488 A. 2d 858 (1985).

[153] *See* Roberta Romano, *What Went Wrong With Directors' and Officers' Liability Insurance?*, 14 Del. J. Corp. L. 1 (1989) (attributing directors' insurance "crisis" to unpredictability of the application of business judgment rule following *Van Gorkom*).

[154] For a discussion of statutes passed in the wake of *Van Gorkom see* Larry E. Ribstein & Peter V. Letsou, BUSINESS ASSOCIATIONS, 484-86 (3d ed. 1996).

[155] *See, e.g.,* Zirn v. VLI Corp. 621 A.2d 773 (Del. 1993)(holding that Del. G.C.L. §102(b)(7) does not permit opting out of liability for failure to disclose).

[156] *See supra* text accompanying note 128.

embrace workers and other stakeholders as well as shareholders[157] provides another example of how regulation may cause distrust. O'Connor discusses *Charter Township of Ypsilanti v. General Motors Corp.*[158] in which the trial court recognized an implied duty purportedly based on a promise by General Motors to a municipality not to transfer production to another plant seven years after receiving a property tax abatement. The trial court cited the "gross inequity and patent unfairness if General Motors, having lulled the people of the Ypsilanti area into giving up millions of tax dollars which they so desperately need to educate their children and provide basic governmental services, is allowed to simply decide it will desert 4500 workers and their families because it thinks it can make these same cars cheaper somewhere else."[159] Although the appellate court reversed, finding no promise and no reliance, Professor O'Connor agrees with the trial court's basis for imposing liability.[160]

The trial court's holding arguably would enable towns in Ypsilanti's position to more readily rely on new employers who get tax breaks and other concessions not to shut down and stick the town with excess infrastructure and unemployed workers. But this remedy gives municipalities a litigation tool that might give employers grounds for distrust and that therefore might increase the costs of structuring these deals. An employer that decides to locate or expand and seeks local concessions would have to trust the town not to use the negotiations as a basis of liability when the employer seeks to alter its situation. The employer faces unpredictability concerning, among other things, the length of its commitment to the plant. The employer cannot assume that the court will act only to the extent of enforcing the town's reasonable expectations. The employer might attempt contractually to clarify its commitment, but a court may not enforce the contract literally if it believes that a strict duty is warranted. The employer's other possible responses include moving to a state that does not recognize such fiduciary duties, not asking for concessions that might trigger the duty, or simply foregoing the additional plant investment as unprofitable.

3. Joint ventures and close corporations

Joint venturers often write contracts varying standard form fiduciary duties for transactions in which the participants plan to pursue independent as well as joint business objectives. Although bargaining for this sort of selfishness might be in both parties' ex ante interests, strict duties based on abstract notions of "trust" and "honor" might frustrate the deal. To be sure, these duties might reduce the costs involved in a venturer's decision to trust the other as compared with relying solely on specific contract terms because open-ended duties prevent venturers from opportunistically taking advantage of their contractual rights. But the strict duty also may increase the parties' joint costs by enabling an opportunistic venturer to extract damages from the other venturer or to use the threat of litigation to renegotiate the deal.

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[157] *See supra* text accompanying note 140.

[158] (Cir. Ct. Washtenaw County, Mich. Feb. 9, 1993), rev'd Ypsilanti v. General Motors Corp., 506 N.W. 2d 556 (Mich. Ct. App. 1993), discussed in O'Connor, *supra* note 140 at 228-30.

[159] *See* Ypsilanti v. General Motors Corp., 506 N.W. 2d 556, 558 (Mich. Ct. App. 1993) (quoting trial court opinion).

[160] *See* O'Connor, *supra* note 140 at 228-29.

The most famous joint venture fiduciary duty case, *Meinhard v. Salmon*,[161] illustrates the potential for distrust in broad fiduciary duties. The venture involved management of a building for a 20-year term. At the end of the term, the active venturer, Salmon, agreed with the property owner to undertake a much bigger deal that included the subject property without giving Meinhard, the initial financier, an opportunity to join the project. The court held that Salmon breached his fiduciary duty to Meinhard, describing this duty in memorably strong and colorful language. Particularly given the significant difference between the initial and subsequent deals and the fact that Meinhard had recouped his investment many years before, there was ample basis to dispute the court's result. But what matters most for present purposes is how the holding created distrust in later joint ventures.

Venturers may need to respond to the risks inherent in strict fiduciary duties with contractual devices that limit the risk of opportunistic litigation but increase both parties' costs. The parties might be willing to trust their partners with milder fiduciary duties because of the transaction-cost savings from relying on open-ended default fiduciary duties rather than fully specified contracts. But if, consistent with the strong language in *Meinhard*, courts apply fiduciary duties strictly and non-contextually in order to ensure a high level of "honor" and "trust," trustors would face a greater risk of bargain-breaking opportunistic litigation. Venturers may need to respond by specifying their rights and responsibilities and explicitly eliminating any broader duty that might apply to unforeseen cases. This might reduce the value of open-ended fiduciary duties, thereby increasing transaction costs and possibly foreclosing productive ventures. If the courts go further and preclude contractual alteration of fiduciary duties, the parties may have to structure their relationships in non-fiduciary terms, thereby losing all the advantages of fiduciary duties, including the potential norm-enhancing effect of fiduciary language in judicial decisions.[162]

4. Non-competition agreements

The increased risk of opportunism associated with regulation need not relate to litigation. The problem arises whenever regulation creates rights that impede parties' ability to protect themselves from others' opportunism. For example, although non-competition clauses in employment agreements arguably invite employers to treat trapped employees opportunistically,[163] they also protect firms from employees' appropriation of clients or information. Enforcing these clauses lets a software firm, for example, share proprietary information with its employees without being concerned that the employees will start new firms based on the information they learn. This is particularly important for relatively inexperienced employees who have not developed reputations for trustworthiness and who most need the firm's contacts and information. At the same time, employees may be able to rely on established firms' reputations not to abuse their power under non-competition agreements. Thus, non-enforcement of the non-competition clause might leave the employer vulnerable to employee opportunism without providing much

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[161] 249 N.Y. 458, 164 N.E. 545 (1928).

[162] *See supra* text accompanying note 71.

[163] For an alternative criticism of non-competition agreements *see* Ronald Gilson, *The Legal Infrastructure Of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants not to Compete*, 74 N.Y.U. L. REV. 575 (1999) (concluding that such agreements restrict socially productive dissemination of information).

additional protection to employees. The employee may seize on non-enforceability to take more from the relationship than the parties had bargained for. This may force a costly response from the employer, such as restructuring the employee's responsibilities or client contacts.

B. UNDERMINING TRUST-CREATION

In addition to creating opportunities for distrust, regulation can undermine the creation of trust. As discussed in Part II, the distinct concept of trust requires voluntary subjection to risk, or vulnerability. Legal coercion of faithful behavior therefore reduces the opportunities for trust to develop. Thus, legal coercion not only is irrelevant to the creation of trust, but also can cause a substitution of costly legal constraints for relatively friction-free strong-form and semi-strong-form trust. This general point has four main applications: disposition to trust in personal relationships and otherwise; trust norms; reputation and other forms of semi-strong-form trust, and trust-building associations.

1. Disposition to trust

Regulation can impede the development of the sort of "strong-form" trust that arises from a disposition to trust in personal relationships or otherwise.[164] First, regulation decreases the sense of vulnerability that is critical to personal trust. This is supported by theories and evidence that extrinsic motivations such as monetary rewards and regulation "crowd out" parties' intrinsic motivations based on benevolence or trust.[165] Thus, strict tax laws, lower speed limits and higher sanctions for crime and tighter regulation of agents may have perverse effects in discouraging voluntary tax compliance, more responsible driving and compliance with law and less trustworthy agents.[166]

Second, regulation can interfere with the disposition to trust by forcing pre-dispute planning. To be sure, if the parties can trust each other not to cheat, they may be able to trust each other not to sue. But opportunistic use of legal remedies does not carry the same connotation as fraud and therefore tempts even relatively honest actors. Increasing the potential for litigation and administrative complaints increases the need for contracts that minimize the risk of such costly actions. This invites the parties to take an adversarial planning posture that is inconsistent with the nature of personal relationships. These contracts, like the regulation itself, may "crowd out" intrinsic motivations to trust and be trustworthy.[167]

Third, mandatory regulation can reduce the parties' ability to form personal relationships based on strong-form trust by eliminating opportunities to signal readiness

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[164] *See supra* subpart II(A)-(B).

[165] *See* Bruno S. Frey, NOT JUST FOR THE MONEY 8, 17-8 (1997) (noting generally crowding out effect of regulation).

[166] *See id.* at 49-52, 81, 101.

[167] *See* Iris Bohnet, Bruno S. Frey & Steffen Huck, *More Order With Less Law: On Contract Enforcement, Trust, and Crowding*, http://papers.ssrn.com/paper.taf?ABSTRACT_ID=236476 (July 7, 2000) (discussing experimental evidence showing that, if people are allowed to interact in a low-enforcement environment, they became more trustworthy).

to engage in such relationships. Blair & Stout note that participants in close corporations may decline to use detailed contracts in order to signal their willingness to be vulnerable and therefore to be trustworthy, thereby facilitating selection of trustworthy partners.[168] But mandatory rules reduce the opportunities for such signals. The increased need for pre-dispute planning discussed immediately above may further decrease signaling by increasing the cost of vulnerability and therefore of giving the signal.[169]

Fourth, regulation can erode personal trust when disputes arise. Regulation that establishes legal and administrative remedies may interfere with the trust repair process in Lewicki & Bunker's model of the evolution of strong form trust.[170] Lewicki & Bunker assert that breaches of trust in the final, strong-form, stage may be difficult to repair because they carry emotional weight. Instead of the victim's confronting the violator, the latter must admit responsibility, after which the parties renegotiate and the victim accepts reasonable reparations. But in a heavily legalized context, parties submitting to a trust repair process may forego their legal rights by admitting fault or delaying prosecution. Thus, given more law, the parties may be better off standing on their legal rights than trusting their partners.

2. Trust norms

Strong-form trust can arise from a norm of trustworthiness,[171] which might be established by strong language in judicial decisions.[172] If legal liability backs the norms and judicial language, it removes parties' opportunity to behave according to trusting and trustworthiness norms. Parties will seem to be reliable only because the law forces them be, and believe that they are trusted only because they face these penalties.

One way to describe this phenomenon is that the law changes the "social meaning" of behavior that complies with the norm. Lawrence Lessig has argued that laws against dueling may have changed behavior by changing the meaning of refusing to duel.[173] If dueling is illegal, refusing to duel is not clearly a failure to defend one's honor, but might carry the more favorable connotation of obeying the law and thereby respecting

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[168] *See* Blair & Stout, *supra* note 1 at 80-84. *Cf.* S. Ghoshal and P. Moran. *Bad For Practice: A Critique of the Transaction Cost Theory*, 21 *Academy of Management Review* 13 (1996) (noting that effect of contractual constraints might be to indicate that people are not trusted or trustworthy to behave appropriately without such controls); Kathryn Spier, *Incomplete Contracts and Signaling*, 23 RAND J ECON 432 (1992) (showing how parties can signal their type by refraining from requesting certain types of contract terms, such as labor-management profit sharing, or an injury clause in an athlete's contract). Along the same lines, legal coercion reduces opportunities for sending emotional signals of trustworthiness under Robert Frank's theory of the emotions as a commitment device. *See* Frank, *supra* note 35 at 96-133 (discussing signaling of emotions).

[169] The law's effect may be complicated in this regard by the possibility that increased vulnerability increases the value of the signal when it is given.

[170] *See supra* text accompanying note 54.

[171] *See supra* subpart II(C).

[172] *See supra* text accompanying note 71.

[173] *See* Lessig, *supra* note 61 (discussing how law can affect the social meaning of behavior).

one's obligation to the community. Laws coercing trustworthy behavior also might change social meaning, but more perversely. The existence of legal coercion means that one no longer can clearly demonstrate that he respects his promise regardless of self-interest, but rather can show only that he can be legally coerced into performing. This makes the other party reluctant to trust without costly constraints. In other words, the meaning of the behavior is changed from the connotation associated with voluntary compliance to the connotation associated with coerced compliance. This inhibits the formation of a norm based on voluntary compliance.

Mandatory rules' perverse effect on norms may cause a downward spiral of trust. As the rules undermine the trust norm, trusting people will decline in number, thereby increasing their risk of dealing with those who do not behave according to trust norms.[174] This will provide a disincentive for this behavior, further decreasing the ranks of the trusting,[175] and further increasing the need for mandatory regulation.

The law may have a related effect in deterring reciprocal altruism by signaling that others will behave in a self-maximizing way.[176] Given this signal, people will not trust out of a desire to avoid being seen as "suckers."[177] This, in turn, may make it harder to establish a trust norm, thereby contributing to the downward spiral of trust.

3. Reputation and other semi-strong-form trust

To the extent that law imposes a mandatory constraint, it displaces possibilities for private ordering constraints that are more socially valuable than regulation under the logic of trust theory because they substitute trust for friction. Specifically, as discussed in Part III, parties who rely on semi-strong-form trust are willing to risk disappointment rather than insist on the formal and less tailored remedies mandatory regulation supplies.[178] An example is so-called "discretionary" contracts, such as a mutual fund's promise to support the dollar-a-share price, where the fund's reputation rather than a

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[174] *See* Bainbridge, *supra* note 1 at 803.

[175] This is analogous to the problem of "mismatch" risk discussed in Paul G. Mahoney & Chris William Sanchirio, *Competing Norms and Social Evolution: Is the Fittest Norm Efficient?* U. Va. Law School, Legal Studies Working Paper No. 00-15 (May 1, 2000), http://papers.ssrn.com/paper.taf?abstract_id=229694.

[176] *See* Blair & Stout, *supra* note 1 at 73-4 (noting that increased duties may suggest that breach is common); Ernst Fehr & Simon Gachter, *Cooperation and Punishment in Public Goods Experiments,* 90 Am. Econ. Rev. 980 (2000); Ernst Fehr & Simon Gachter, *Reciprocity and Economics: The Economic Implications of Homo Reciprocans,* 42 Eur. Econ. Rev. 845 (1998); Dan M. Kahan, *Social Influence, Social Meaning, and Deterrence,* 83 VA. L. REV. 349, 352-53, 356-57 (1997); Dan M. Kahan, this volume.

[177] *See* Blair & Stout, *supra* note 1 at 44-45; Peter H. Huang & Ho-Mou Wu, *More Order without More Law: A Theory of Social Norms and Organizational Cultures,* 10 J. LAW, ECON & ORG. 390, 403 (1994) (showing how behavior can be influenced by expectations of corrupt behavior by others).

[178] The general point here is that contracts are less binding, and therefore more conducive to trust, than mandatory rules. By contrast, Blair & Stout argue against contract based on a comparison with the absence of all constraints. *See supra* note 6.

contractual remedy backs the promise.[179] Although the fund operator may forfeit some reputation if it fails to honor its promise, it may nevertheless choose to do so if it is facing a serious liquidity crisis. For similar reasons, a manufacturer may express a hope of remaining in the community without intending to be contractually bound or a fiduciary may undertake to deliver the utmost loyalty and care without intending to be subject to liability for imperfection. Courts would frustrate the valuable flexibility such devices provide by making implicit bargains explicit and holding that the parties' expectations necessarily trigger contractual remedies.

4. Inhibiting private associations

Private associations can contribute to social capital by promoting the willingness to associate.[180] However, regulation can discourage trust-creation by private associations by using these organizations' efforts to increase trust as bases for monitoring obligations.[181] This is part of a general tendency toward emphasizing individual rights at the expense of cooperating in associations.[182]

An important context for this regulatory effect is business associations. The parties to a business relationship may contract for control mechanisms and profit-sharing compensation that provide incentives to monitor efficiently. Courts might decide that these contract terms create an agency or partnership relationship even if the contracting parties did not want to create such a relationship.[183] This might trigger both internal fiduciary duties that apply between principal and agent and vicarious liability to third parties. Firms might avoid the agency liability by forming a limited liability business association such as a limited liability company or corporation, but only at the cost of confirming application of fiduciary duties that apply to this type of relationship.

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[179] *See* Arnoud Boot, Stuart Greenbaum & Anjan Thakor, *Reputation and Discretion in Financial Contracting*, 83 Am Econ Rev 1165 (1993).

[180] *See supra* text accompanying notes__.

[181] Trust can be eroded by regulation other than that related to generating trust. Legal regulation such as anti-discrimination and anti-trust laws can undermine the exclusivity these organizations need in order to create trust. *See* Fukuyama, *supra* note 1 at 315; Bainbridge, *supra* note 33 at __. For articles dealing with the collision between a individual rights and the "civil society" that private groups help create, *see Symposium on Legal and Constitutional Implications of the Calls to Revive Civil Society*, 75 CHICAGO-KENT LAW REVIEW 289 (2000). Exclusivity makes it easier for groups to internalize the benefits of creating social capital. First, in small enough groups, members have incentives to forego short-run self-interest in dealing with other group members because they reasonably expect those others to reciprocate. Second, exclusivity may increase cohesiveness by ensuring that group members share the same values. Consider, for example, Lisa Bernstein's orthodox Jewish diamond dealers. *See* Bernstein, *supra* note 57. Third, the power to exclude is a way for the organization to penalize violations of its rules. *See* Larry E. Ribstein, *Law Partner Expulsion*, 55 BUS. LAW. 845 (2000).

[182] *See* Fukuyama, *supra* note 1; Bainbridge, *supra* note 1 at 803 (decrying "the decline in social trust [that] began when the rich set of mediating institutions famously praised by Tocqueville was caught, like the Romans at Cannae, between the nanny state on one side and judicial hijacking of the state's monopoly on the use of coercive force to advance a hyper-legalistic cult of the autonomous individual on the other" (footnotes omitted)).

[183] *See, e.g.*, Nichols v. Arthur Murray, Inc., 248 Cal. App. 2d 610, 56 Cal.Rptr. 728 (1967) (imposing agency liability on a firm that licensed its name brand).

Although these liability rules may make it easier for third parties to rely on the legal "firm," they do so at the potential cost of encouraging the contracting parties to avoid the contractual monitoring mechanisms that triggered the creation of the agency relationship.[184]

VI. TRUST, LAW AND THE INTERNET

The Internet is an important context for considering the role of regulation in creating trust because it does not yet have a fixed regulatory structure. At first glance it would seem that, since participants deal with other remotely and potentially anonymously, consumers would be reluctant to rely on web merchants without strong legal rules. It is harder for consumers to rely on merchants when they must give up a credit card number and wait for delivery, than when they walk into a brick-and-mortar store and walk out with their goods.

An important trust issue emerging in connection with the Internet is the current debate over Internet privacy. Merchants can acquire valuable marketing information about customers' preferences through techniques such as placing files known as "cookies" on the computers of consumers who visit their websites.[185] Thus, consumers may need protection not only regarding what they buy, but also concerning the information about themselves that they sell or give away.[186]

The current Internet regulatory regime relies on semi-strong form trust -- that is, on self-imposed and contractual constraints. Web merchants can employ many strategies to encourage consumers to rely on them, including third-party control and monitoring by organizations such as Ernst & Young[187] or TRUSTe,[188] reputational bonding, giving

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[184] For a discussion of these tradeoffs, *see* Larry E. Ribstein, *Limited Liability Unlimited*, 24 DEL. J. CORP. L. 407 (1999).

[185] *See generally*, Federal Trade Commission, SELF-REGULATION AND PRIVACY ONLINE: A REPORT TO CONGRESS, 2 (available online at www.ftc.gov) (July 1999).

[186] Note that it is not clear whether this is really a "privacy" issue involving intrusion, or a property rights issue concerning whether marketing information relating to consumers belongs to consumers or to the merchants who extracted it.

[187] For example, a recent advertisement for Ernst & Young touts its verification service as a way for businesses to trust each other and for startups to be trusted by consumers. Ernst & Young's special advertising supplement in the July, 2000 Wired, states in part: "Protect your customers' privacy and transactions or you may be the one who gets burned . . . if your internet customers feel exposed they'll quickly take their business elsewhere. The CyberProcess Certification solutions that we offer, including WebTrust, help you build and maintain their trust. So you can grow your customer base and establish a competitive advantage."

[188] For descriptions of this non-profit organization, *see* FTC Report, *supra* note 185 at 9-10; and www.truste.org. TRUSTe licensees must abide by TRUSTe's policies concerning collection and use of consumer information, subject to TRUSTe's monitoring and auditing of licensees and resolution, reporting and possible referral to the FTC of consumer complaints. Other private organizations sponsoring consumer privacy efforts include those established by the Better Business Bureau and the American Institute of Certified Public Accountants. *See* FTC Report, *supra* note 185 at 10-12. For an analysis approving use of such private lawmaking regimes in Internet and other commercial law areas, *see* Gillian K. Hadfield,

products away to encourage initial transactions, and building communities through vendor-built discussion groups.[189] The industry also has been developing the so-called "P3P" protocol, which would permit a kind of automated contracting where individuals' computers could block access by firms whose privacy policies do not meet user-configured standards.[190]

As is typically the case without strong regulation, people are vulnerable to some risk of disappointment. Firms might not honor their privacy policies and may be able to exploit chinks in users' privacy protection. Users' vulnerability under the current system has been exposed by several widely publicized incidents of well-known Web retailers' breaching their privacy promises.[191] Accordingly, there have been calls for Internet privacy to move from semi-strong-form trust to a regulatory approach. Although the FTC concluded in a preliminary report on Internet privacy that "legislation to address online privacy is not appropriate at this time,"[192] the FTC now seems to be heading away from the self-regulatory approach.[193] Congress is considering several bills that would mandate

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Privatizing Commercial Law: Lessons From the Middle and the Digital Ages, Stanford Law School, John M. Olin Program in Law and Economics Working Paper No. 195 (March, 2000), available at http://papers.ssrn.com/paper.taf?abstract_id=220252.

[189] *See* Ben-Ner & Putterman, *supra* note 9; Jarvenpaa & Tiller, this volume.

[190] *See* Lawrence Lessig, CODE AND OTHER LAWS OF CYBERSPACE, 160 (1999) (endorsing P3P as giving individuals a kind of automated property right in their information); *Internet Regulation Through Architectural Modification: The Property Rule Structure of Code Solutions*, 112 Harv. L. Rev. 1634 (1999). There has been much debate over the adequacy of P3P and whether it will effectively empower individuals to make choices, or end up forcing individuals either to turn over substantial control of data or stay out of cyberspace. Although a single P3P protocol cannot be configured to suit everybody, the market can produce products that permit more sophisticated customization of privacy preferences. *See, e.g.*, www.anonymizer.com (making available free software that allows anonymous surfing); www.adsubstract.com (offering a cookie customizer that allows users to manage cookies); David P. Hamilton, *Freedom Software Lets You Get Some Privacy While Surfing the Web*, Wall St. J., August 10, 2000 at B1 (discussing software that lets users hide behind alternate identities). For a general discussion of automated contracting and an application to jurisdictional issues involving privacy and other matters, *see*Committee on Cyberspace Law, *Achieving Legal and Business Order in Cyberspace: A Report on Global Jurisdiction Issues Created by the Internet*, 55 BUS. LAW. 1801 (2000).

[191] *See* Rebecca Quick, *On-Line: GeoCities Broke Privacy Pledge, FTC Declares*, Wall St. J. August 14, 1998 at B1 (discussing GeoCities settlement of an FTC complaint that it misrepresented that information on application forms would not be disclosed to third parties); Don Clark, *RealNetworks Will Issue Software Patch To Block Its Program's Spying on Users*, Wall St. J., Nov. 2, 1999 at B8 (discussing RealNetworks Inc. gathering of information about consumers' listening habits without their consent); Michael Moss, *A Web CEO's Elusive Goal: Privacy*, Wall St. J., February 7, 2000 at B1 (discussing how ELoan, despite touting the strength of their privacy policy, tracked information about consumers without their consent); Nick Wingfield, *DoubleClick Moves to Appoint Panel for Privacy Issues*, Wall St. J., May 17, 2000 at B2 (discussing DoubleClick Inc.'s plans to combine databases of people's Web-surfing habits and of users' personal information).

[192] *See* FTC Report, *supra* note 185 at 12.

[193] The FTC in its final privacy report recently advocated a more regulatory approach than in its preliminary report. *See* Federal Trade Commission, *Final Report of the FTC Advisory Committee on Online Access and Security*, May 15, 2000 (available online at www.ftc.gov).

some form of consumer privacy protection.[194] Indeed, it might be said that consumer trust of online merchants, like investors' trust of securities markets,[195] depends on government regulation. Just as unprotected investors might flee those markets and put their money in mattresses,[196] so might wary online consumers resort to brick-and-mortar merchants unless online merchants are tightly regulated.[197] Thus, individuals have been said to have fundamental privacy rights to protection of personal information that should be enforced by mandatory rules.[198]

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[194] *See* Ariana Eunjung Cha, *Key Firms Back Bill On Web Privacy*, Wash. Post, October 4, 2000 at E1.

[195] *See supra* text accompanying notes__.

[196] *See supra* text accompanying note 122 (quoting Tamar Frankel).

[197] *See* Paul M. Schwartz, *Privacy & Democracy in Cyberspace*, 52 Vand. L. Rev. 1609 (1999). *See also* Frankel, *supra* note 5 (noting the privacy problem and the need for trust in this area).

[198] See e.g., Christopher D. Hunter. *Recoding the Architecture of Cyberspace Privacy: Why Self-Regulation and Technology Are Not Enough* (February, 2000); Schwartz, *supra* note 197. The focal point of the debate is the 1980 Organization for Economic Cooperation and Development (OECD) *Guidelines on the Protection of Privacy and Transborder Flows of Personal Data*, which state:

> 1. Collection Limitation Principle: There should be limits on the collection of personal data, and such data should be gathered legally, and with the knowledge or consent of the data subjects.
>
> 2. Data Quality Principle: Personal data should be relevant to the purposes for which they are to be used, and, to the extent necessary for those purposes, should be accurate, complete and kept up-to-date.
>
> 3. Purpose Specification Principle: The purposes for which personal data are collected should be specified not later than at the time of data collection, and all subsequent uses should be limited to those purposes.
>
> 4. Use Limitation Principle: Personal data should not be disclosed, made available or otherwise used for alternative purposes without consent from the data subject or by the authority of law.
>
> 5. Security Safeguards Principle: Personal data should be protected from unauthorized access, destruction, use, modification, or disclosure.
>
> 6. Openness Principle: There should be a general policy of openness about developments in data collection and use. Means should be readily available to ascertain the existence and nature of personal data, the main purpose of their use, and the identity and location of the data controller.
>
> 7. Individual Participation Principle: An individual should be able to contact a data controller about what information the controller has about that person, and be able to correct inaccurate records. If an access request is denied, a reason must be given, and the individual must be able to challenge the denial.
>
> 8. Accountability Principle: A data controller should be accountable for complying with the measures which give effect to the principles stated above.

Yet, as in the other contexts discussed above, trust in the special sense emphasized in this article does not justify regulation. At best, legal regulation can make it easier for consumers to rely on merchants. But it does not necessarily follow that regulation is cost-justified,[199] and use of the word "trust" does not further the argument. Regulation cannot create strong-form trust on the Internet anymore than in other areas.

Legal regulation can, however, create distrust. Under a system designed to enable absolute consumer reliance on merchants' privacy policies, web merchants would be subject to potential liability if, for example, they changed some detail of their privacy policy after obtaining information without getting customer consent, or could not adequately document how they used consumer information. If consumers had legal remedies for violation of privacy policies, the damages would be uncertain and potentially open-ended, particularly given the questions concerning the value of personal information to consumers.[200] Contracts would not necessarily protect merchants because weak-form trust assumes non-contractibility of privacy rights.[201] Accordingly, instead of the current freewheeling and rapidly evolving e-commerce, web merchants would be unwilling to deal with consumers except within a rigid regulatory structure that protects them from liability.

Moreover, regulation inhibits the development of trust. Consumers cannot make themselves vulnerable as trust requires, and merchants cannot show themselves to be genuinely trustworthy, under a system of extensive regulation. Legal regulation also interferes with the role of private organizations in internalizing some of the costs of creating social capital that underlies strong-form trust on the Internet.[202] For example, E-Bay, the online auction firm, provides a way of bringing private buyers and sellers together. The resulting interactions can create reputational information that encourages dealings.[203] Internet service providers such as America Online provide space for online communities.[204] Courts and regulators may undermine these activities by holding that they trigger tort or other liability. For example, E-Bay was sued on the ground that it is, in effect, an auctioneer and therefore liable under a California statute regulating sale of sports memorabilia.[205] Similarly, holding Internet service providers liable for their

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[199] For an argument suggesting that legal regulation may not be cost-justified in this area, based partly on defects with the public law system, *see* Hadfield, *supra* note 188.

[200] *See supra* note __.

[201] Merchants would also face the problem of having these characterized as unenforceable adhesion contracts. This has already emerged in the context of shrinkwrap and clickware licenses. For a collection of the literature on the subject, *see* Mark A. Lemley, *Beyond Preemption: The Law and Policy of Intellectual Property Licensing*, 87 CAL. L. REV. 111, 120 n.20 (1999).

[202] *See supra* subpart II(D).

[203] For a study evidence of the reputational capital effects of EBay auctioneers, *see* Cynthia G. McDonald & Carlos Slawson, Jr., *Reputation in an Internet Auction Market* (available at http://papers.ssrn.com/paper.taf?abstract_id=207448).

[204] *See* Lessig, *supra* note 190at 66 (discussing AOL's role in creating online communities).

[205] *See* Miguel Helft, *Ebay: We're Not Auctioneers*, THE INDUSTRY STANDARD, May 2, 2000. See also Wall St. J. May 31, 2000 at B18.

members' postings[206] would force these firms to internalize the costs of erroneous or defamatory postings although they do not internalize the social benefits of providing an information-exchange mechanism and creating online communities. This could reduce the Internet's potential for creating social capital.[207]

VII. CONCLUDING REMARKS

Trust in society is a potentially useful dimension of public policy debate. But this article has shown that trust must be used with care as a justification for regulation. Even if mandatory regulation might increase weak-form reliance on others, this in itself does not provide any new justification for legal coercion. Strong-form trust provided by altruism, norms, personal relationship, and social capital, and semi-strong trust that permits reliance on private ordering, may be useful policy goals because these forms of trust decrease friction and thereby increase social wealth. But law has no effect on trust in this sense. Indeed, mandatory regulation may actually decrease these forms of trust by creating opportunities for distrust and inhibiting trust-creation. Thus, trust provides another argument in favor of enforcing contracts.

Strong regulation is justified only on the assumption that we live in a Hobbesian world in which short-term self-interest is dominant. This is the world of Terry Gilliam's film "Brazil," awash in law and bureaucracy. Pervasive government signs carry slogans like "trust in haste, repent at leisure" and "don't suspect a friend, report him." Trust in this world is subversive. This is the sort of world that either justifies or results from the strong, mandatory regulation some legal commentators advocate.

These observations bear on trust-creation in contexts such as transition economies or the Internet where questions about the appropriate extent of regulation are most salient. While regulation may induce parties to deal with each other by lowering the risks inherent in these dealings, it also may subvert trust. Moreover, even if regulation is necessary in transition economies, the same considerations obviously do not translate to developed economies. Viewing trust as an increasing function of law may undermine the private structures that developed economies have managed to produce, thereby moving them closer to the transition economies we want to reform.

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[206] The latter possibility was raised in an ISP's settlement of a libel case following a favorable court ruling. See Godfrey v. Demon Internet Ltd., 4 All E.R. 342, 1999, settlement reached March 11, 2000; John T. Aquino, *British Court Concludes ISPs Liable for Bulletin Board Postings*, E-COMMERCE LAW WEEKLY, April 7, 2000.

[207] An analogous problem is presented by regulation of so-called "B2B" firms and sites established among competitors in some industries, including automobile manufacturing and defense contractors, that provide a reliable way for firms to deal with others in the vertical supply chain. *See, e.g.*, Don Tapscot, *Manager's Journal: Virtual Webs Will Revolutionize Business*, Wall St. J., April 24, 2000, at A38. The FTC and the Justice Department are investigating or are being asked to investigate these sites for potential antitrust violations. *See* Andrea Foster, *B2Bs Raise Antitrust Concerns*, THE NATIONAL LAW JOURNAL, May 3, 2000. For an analysis, *see* Richard E. Donovan, *Online "Business-to-Business" Enterprises Raise Antitrust Issues*, Washington Legal Foundation Legal Opinion Letter, vol. 10, no. 15 (August 11, 2000).