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Excerpt
More Information

Introduction

Back in 2009 when I was starting my doctoral studies, I sat through my first ever law and economics seminar. Two of the field's founding fathers – Polinsky and Shavell – were presenting their proposal to abolish product liability.[1] A heated debate over the outcomes ensued in the room: how abolishing liability could affect access to justice or distribution. But I was still stuck on the logic, namely, how Polinsky and Shavell treated reputation as an alternative to the legal system. Manufacturers, their argument went, will invest in the quality and safety of their products even without the threat of legal liability, simply because they care about maintaining their reputation. And in markets where these nonlegal (reputational) forces are strong enough, it is not cost-effective to keep a costly adjudication system merely for the sake of an incremental contribution to deterrence. Reputation serves as justification for reducing legal intervention. A quick search revealed that such reputation-instead-of-litigation logic is actually prevalent in economic analysis across various legal fields. I then realized what was bothering me about the logic, and found my academic calling.

At the heart of the argument lies an implicit assumption that the legal system and the nonlegal system are independent of each other. Law and economics scholars were assuming that we can remove the law – remove the background threat of litigation – and the market forces will continue to function just the same. But in reality the strength of market forces is (among other things) a function of the existing legal system. If we remove the background threat of litigation, reputational sanctions may become more strident.

This book represents the culmination of my efforts in the decade that has passed since that law and economics seminar to better understand the

[1] Mitchell Polinsky & Steven Shavell, *The Uneasy Case for Product Liability*, 123 Harv. L. Rev. 1437 (2010).

interactions between legal and reputational systems. The book makes three major contributions, along the following dimensions: how reputation works, how the law interacts with reputation, and how a social planner can harness these interactions.

First, the book shows that *nonlegal systems of control are costly too (just less transparently so)*. Legal scholars are usually aware of the costs of legal systems, and can relatively easily quantify them. But the costs of nonlegal systems are less transparent to us, and we tend to underplay them.[2] This is especially true for reputational systems, where the legal literature suffers from an "indefensible optimism about the actual operation of information markets."[3] The legal and economic literature often treat reputation as a straightforward, binary process: if you misbehave, your future business opportunities diminish; if you behave well, your future business opportunities flourish. This book draws from an emerging interdisciplinary body of research to show that in reality reputation is rather inherently noisy. Market players often lack the incentives and information needed to accurately update their willingness to do business with the company in question. As a result, the market systematically overreacts to certain types of behaviors, and underreacts to others. Stakeholders may stop doing business with perfectly fine companies or ignore warning signals and continue doing business with rotten companies.

Second, *Law and Reputation* fleshes out how *the effectiveness of nonlegal systems is affected by the legal system*, and vice versa. Reputational sanctioning does not operate in a vacuum. The same bad news that ignites an initial market reaction may also get the legal system involved in litigation or regulatory investigations. Then, in the process of determining whether to impose legal sanctions, the legal system produces as a by-product information on the behavior of the parties to the dispute: what top managers knew about the problem, when they knew it, whether they could have stopped it, and so forth. This information is available to outside observers and affects the way that these third parties treat the parties to the dispute. In other words, the legal system provides better information to the public for them to base reputational judgments on. Law and reputation are not independent of each other, but rather complement each other.

Finally, recognizing the informational role that the law plays in facilitating reputational sanctions carries important policy implications. On

2 John C. P. Goldberg & Benjamin C. Zipursky, *The Easy Case for Products Liability Law: A Response to Professors Polinsky and Shavell*, 123 Harv. L. Rev. 1919, 1929 (2010) (criticizing the conventional approach for not running market systems of control through the same wringer as it does legal systems).

3 Cass R. Sunstein, On Rumors 22 (2009).

a general level, the book calls for a more cautious approach to advocating for nonintervention. Scaling back litigation or regulation may have the unintended consequences of raising the costs of nonlegal sanctions. On a more specific level, the book uses the reputational framework to reevaluate key doctrines according to how they contribute to the quality and quantity of information produced. In the process we get to revisit timely questions such as the desirability of the recent wave of mandatory arbitration provisions, the proper scope of the judicial review of the Securities and Exchange Commission's (SEC) actions, and whether to assess director liability individually or collectively.

The broad focus of this book is *diffusion of information*. Business law scholars tend to rely on classical economics and agency theory, and this focus has hindered them from grappling with informational issues: market players are assumed either to have information or not to have it. *Law and Reputation* shifts our focus to questions such as how information is diffused (contrary to popular belief, information does not fall on individuals like manna from heaven), what is the role of information intermediaries such as mass media, and what types of messages are perceived as being more credible than others. For example, the book conducts content analyses of prizewinning investigative reports, showing how and how much these impactful media stories relied on information coming from the legal system.

This chapter proceeds in three parts. The first provides an overview of the main themes and questions that motivate each chapter The second explains the methodology – how I approached the questions. The third clarifies the scope of inquiry and original contributions, by juxtaposing my arguments with the extant related literature.

OVERVIEW

The book lays out the theory of law and reputation (Chapters 1–2), applies the theory to specific legal fields (Chapters 3–6), and offers big-picture policy implications (Chapters 7–8).

Chapter 1 starts with the basic questions of what reputation is and why it is noisy. Why do similar behaviors lead to different reputational outcomes? Everyday experience and systematic empirical evidence tell us that not all bad news is created equal. Some companies and businessmen emerge from failures unscathed while others go bankrupt. To better understand why the market reacts negatively to some bad news but not to others, we need to break the process of reputational sanctioning into its different components, and reveal how noisy it is.

The first component is those who dispense reputational sanctions (the company stakeholders: consumers, workers, investors, and so on). Stakeholders often do not have enough information to judge correctly what happened and how it happened. Even when stakeholders do have information, many times they ignore it or process it imperfectly due to well-documented behavioral biases such as focusing too much on available and salient issues. The second component of reputational sanctioning is intermediaries who disseminate information on corporate behavior, such as mass media or corporate watchdogs. These intermediaries have incentives to cater to their audiences' biases. They tend to exaggerate certain criticisms and downplay others, as a function of what sells newspapers or attracts donors and volunteers. Finally, those who are sanctioned – the companies themselves – invest heavily in distorting the information environment with tactics such as smokescreens and scapegoating.

Evidence is thus mounting that the market, when left alone, has trouble calibrating reputational sanctions/rewards correctly. But in reality the market is rarely left alone. In reality reputation operates in the shadow of the law.

This is where Chapter 2 enters, explaining how the law affects reputation. If you read only one chapter of this book (a pity), read this one, as it contains the core elements of the arguments that appear throughout. The law affects reputation in various ways. First, it reveals new damning information about the misbehavior of powerful players in society. The legal system confers fact-generating powers on litigants, judges, and investigators. As a result, the legal system often gives stakeholders access to facts that they were not privy to when they initially reacted. Think, for example, of internal email communications exposed during the discovery stage, showing how top managers knew but did not stop the misconduct. The law can also affect stakeholders' beliefs without producing any new information, simply by shaping the saliency, credibility, and framing of issues in stakeholders' minds.

In particular, the law shapes the scope and tone of media coverage. Chapter 2 presents evidence gathered by interviewing forty investigative reporters, going over members-only databases of reporters' tip sheets and how-to manuals, comparing course syllabi in leading communication schools, and conducting content analysis of prizewinning investigative projects from the past twenty years. The triangulation of these methods yields a clear conclusion: in today's world, legal sources – court documents, regulatory reports, freedom-of-information requests – are the single most important source of investigative reporting. The law facilitates effective media scrutiny, which in turn facilitates effective reputational deterrence.

Chapter 2 then provides a blueprint to applying the law-and-reputation framework to specific legal fields and situations. The key insight is that information flows from the courtroom to the court of public opinion in counterintuitive ways, which need to be taken into account before applying the theory. Not every legal dispute affects reputation. And when they do, they do not necessarily hurt it – some actually improve the disputants' reputation. For example, judicial scolding sometimes helps a defendant company recover its lost reputation, by creating scapegoating dynamics (singling out an individual manager for opprobrium). Thus, companies often lose the legal battle but win the reputational battle, and vice versa.

Chapter 3 starts the applications part of the book with the most natural candidate: fiduciary duty litigation in corporate law. Directors of publicly traded companies are more likely to get struck by lightning than pay legal fines for mismanaging their company. Acknowledging this curious feature of corporate law – the lack of direct sanctions – has led corporate legal scholars to look at the law's indirect effects on nonlegal sanctions and rewards. But so far most accounts have dealt only with how corporate litigation shapes *morals*. Under the prevalent approach, judges who scold misbehaving managers make directors internalize better norms of behavior (framing effects) or behave better out of fear of social disapproval from their peers (shaming effects). The problem with existing accounts is that they focus solely on what judges say rather than on what relevant audiences – the directors themselves, their peers, and the public at large – actually hear. Analyses of the content of media coverage and law firm memos show that in reality moral rebukes often get lost in translation and do not reach their presumed audiences.

In effect, the main function of corporate law is not to shape moral beliefs (finger-wagging theory) but rather to shape factual beliefs (information–production theory). By shifting the focus to information production, we get a fresh perspective on much-debated features of Delaware corporate law, such as the increased reliance on open-ended standards and the liberal use of shareholders' inspection rights, both being doctrines that boost the amount and quality of information production.

Chapter 4 shifts our attention from private litigation to public enforcement, within the context of the SEC's settlement practices, which became the center of national debate in the wake of the 2008 financial crisis. While the existing debate revolves around the amount of money being paid or admissions being collected, the reputational framework offers an alternative way to measure the effectiveness of SEC enforcement. The real problem with SEC settlements is not that the SEC leaves money on the table, but rather that the SEC leaves information on the table. Both the SEC and big-firm defendants have incentives to settle quickly and for high amounts, in exchange for limiting the public release of damning information. Such information–underproduction dynamics are good for both parties but bad for society at large. The reputational framework helps us identify solutions, like evaluating the proper scope of the judicial review of SEC actions.

Chapter 5 switches focus from reputational sanctions to reputational rewards. Why do business companies donate to charity? One possibility is that charitable donations serve as a signaling device: by sacrificing profits in the public interest the company conveys messages about its fundamentals. Think, for example, of cash donations as a handicap: when we observe a company substantially increasing its cash donations, we infer that the firm's insiders perceive its future to be good enough to spend these ultra-discretionary funds. In other words, corporate philanthropy is not so much about gaining a reputation for being nice, but rather about gaining a reputation for being financially sound. But corporate philanthropy is not just about signaling or goodwill, and is not unequivocally good for the company. Corporate managers have both the will and the means to strategically select the levels and targets of corporate charity in order to entrench themselves at the expense of shareholders and society at large. Donations to directors' pet charities can co-opt board independence requirements. And donations to certain educational charities can bypass money-in-politics restrictions.

The theoretical arguments on how philanthropy can be good (signaling) or bad (co-optation) for the company strengthen the case for introducing some form of mandatory disclosure. In fact, corporate philanthropy practices around the world serve as a great laboratory to test the reputational theory of the law: they provide a counterfactual, namely, an environment beyond the shadow of the law. In the United States, for example, there is no legal intervention in corporate niceness – not even a requirement to disclose how much or to whom you donate. The regulatory vacuum leads to a "cheap talk" reputation environment: companies get credit for being socially responsible regardless of their actions. Enron, for instance, won numerous accolades for corporate social responsibility in the years leading up to its collapse. By contrast, in countries that introduce some form of standardized, subject-to-legal-liability mandatory reporting, reputation rewarding becomes more accurate. Two opposite experiences in the United Kingdom and Israel illustrate. Israel enacted in 2003 mandatory disclosure of corporate philanthropy, while the United Kingdom dropped its mandatory disclosure requirement in 2013. The chapter uses evidence from these semi-natural experiments to show that the shadow of the law affects both actual behaviors (how much and to whom companies donate) and perceptions (stock price reactions).

Chapter 6 takes the theory outside of its comfort zone, applying it to regulatory behavior. Can judicial review effectively check regulators' behaviors? The answer largely depends on how regulators behave – what motivates them. If, as in traditional economic theory, regulators mostly maximize their narrow self-interest, then there is little that judicial review can do to stop regulatory capture. Judges may invalidate specific regulatory decisions after the fact, but they cannot overcome the inherent advantages that special interests enjoy in the way of offering lucrative future business opportunities or campaign financing. If, however, regulators care not just about material incentives, but also about their reputation, then judicial review can shape regulators' behavior indirectly, by providing information on how regulators behave. Regardless of whether courts intervene and strike down specific regulatory decisions or not, the process of litigation can generate reputational pressures that propel the regulators to change their behavior. Judicial review mitigates the risks of regulatory capture not so much through modifying regulators' material incentives, as through shaping the public's perceptions of regulators.

A burgeoning political science literature empirically documents how regulators proactively react to what the media writes about them. If the media agenda dictates regulatory behavior, then a key question becomes what shapes the media agenda. Here as well, a large part of the answer is litigation. In administrative litigation, for example, regulators are required to provide detailed explanations for why they decided the way they did, and judges provide their own, hard-look assessment of the regulator's competence and integrity. Still, public litigation is limited in its ability to effect change through reputational pressure, for reasons that include the legal doctrine and the (low) saliency of issues. This is why in many instances the real impact on regulators' reputation comes from a less intuitive channel: private litigation to which the regulator is not even privy. Think about a scenario of mass tort litigation between a polluting plant and victims who live in proximity to the plant. Such litigation may reveal information on how the defendant company skirted environmental regulation and got away with it. The litigation may thus affect not just the defendant company's reputation, but also the regulator's reputation, raising questions about how the regulator let the pollution happen under her not-so-watchful eye.

Chapters 7 and 8 sketch big-picture policy implications that cut across legal fields. Chapter 7 cautions us from taking the law-as-facilitating-reputational-deterrence function as given. For law to affect reputation meaningfully, government agencies need to grant Freedom of Information requests, judges need to resist the temptation to approve the sealing of court documents too easily, and regulators need to resist the temptation to quickly settle enforcement actions without releasing a detailed investigatory report. If they do not, the law's role as a source of media scrutiny diminishes, and, in turn, the effectiveness of reputational deterrence diminishes as well. A social planner should therefore take into consideration the information–production function of the law when evaluating the desirability of legal institutions.

Specifically, we revisit the long-standing debate in the legal literature over how publicly available law enforcement records should be. The debate spans multiple applications: settlement versus trial, openness of proceedings, and so on. The reputational framework contributes to the debate along three key dimensions. First, it injects a real-life implications perspective into a too often abstracted debate. Second, it allows us to disentangle the normally comingled facets of the openness versus secrecy debate.[4] Law-as-source dynamics play out differently in questions such as whether to keep the amount of a settlement secret or whether to seal documents already submitted to the court. Finally, the reputational perspective provides a roadmap for concrete steps that can facilitate more law-as-source benefits. One way to mitigate the existing failure-to-warn problem without overburdening courts is to install an information safety valve: pre-specify criteria under which the filing of additional disputes would trigger a mechanism that makes information about previous disputes publicly available.

The timeliest and most critical issue that the reputational framework sheds light on is the proliferation of one-sided arbitration clauses that effectively waive class actions. The heated debate over this recent mandatory arbitration wave concentrates on justice and efficiency toward parties to the dispute: proponents argue that it will streamline dispute resolution and reduce lawyer fees, while opponents argue that it will hurt the already disadvantaged workers, consumers and suppliers, depriving them of their day in court. Yet, as Chapter 8 shows, the existing debate too often misses the forest for the trees. Instead of analyzing fairness and efficiency toward parties to a given dispute, we should focus on effects on the market overall.

The chapter specifically cautions from current proposals to adopt mandatory arbitration in corporate and securities law. Even if shifting from litigation to arbitration may be good for a specific company *and* its investors, it may prove detrimental to the market overall. We will lose the positive externality (in the form of quality information on corporate behavior) that comes with

4 Laurie K. Doré, *Secrecy by Consent: The Use and Limits of Confidentiality in the Pursuit of Settlement*, 74 Notre Dame L. Rev. 283, 317 (1999) (showing that different facets of the debate are unjustifiably intertwined).

litigation. A shift to mandatory arbitration may reduce the administrative costs of litigation, but hurt the ability of the market to discipline itself. In other words, mandatory arbitration provisions may reduce the effectiveness of reputational deterrence, and therefore be bad for investors as a group.

A short Conclusion offers a recap of the overarching themes and sketches directions for potential extensions of the law-and-reputation framework.

METHODOLOGY

A few words on methodology are in order from the outset. The reason legal scholars have understudied reputation is not because they find reputational incentives to be unimportant, but because scholars find them to be messy. The extant corporate governance literature, for example, deals extensively with "hard" market incentives such as executive compensation or the market for corporate control, which are easier to quantify, but it understudies "soft" market incentives such as maintaining a reputation for integrity. Reputational forces follow fuzzy dynamics and are hard to capture in neat models or direct statistical proofs.[5] My strategy in addressing the gap and fleshing out the important yet understudied reputational forces was therefore to triangulate, examining them from multiple theoretical and empirical angles. The idea behind triangulation is that combining multiple theoretical and empirical materials can minimize the biases of any single theory/method. Triangulation is especially fitting when dealing with messy factors with little existing hard data, as in our case. It bolsters the prima facie plausibility of the argument.[6]

I start every inquiry by synthesizing theoretical insights from multiple disciplines (as any theory about reputation should).[7] The process of reputational judgment involves issues of belief revision, diffusion of information, economic incentives, and feedback. I therefore combine insights from information economics with insights from social psychology, communication science, and management. For example, I delve into attribution and

5 Heski Bar-Isaac & Steven Tadelis, *Seller Reputation*, 4 Foundations and Trends in Macroeconomics 273 (2008) (a survey of the reputation literature, noting how challenging it is to empirically test reputation theories).

6 The Sage Encyclopedia of Qualitative Research 893 (Given, ed., 2008).

7 Luis Cabral, *Reputation on the Internet*, *in* The Oxford Handbook of the Digital Economy 351 (Peitz & Waldfogel, eds., 2012) (a survey of the reputation literature, calling for an economics and psychology multidisciplinary approach); Thomas Noe, *A Survey of the Economic Theory of Reputation: Its Logic and Limits*, *in* The Oxford Handbook of Corporate Reputation 134 (Barnett & Pollock, eds., 2012) (another survey, advocating borrowing insights from the management literature and practitioners).

impression formation theories, to understand how stakeholders make sense of good/bad news and change their attitudes accordingly.[8]

Existing statistical data can serve as a check, highlighting my theoretical insights' strengths and limitations. In Chapter 5, for example, I show why a signaling explanation is better than a goodwill explanation in accounting for the fact that most corporate philanthropy expenditures are in cash, or that the high-tech and pharmaceutical industries are the biggest donors. In Chapter 2, I use large-N studies of stock market reactions to litigation to identify the set of cases in which my reputational theory applies. Most notably, the fact that the size of the legal sanction is not correlated with reputational sanctions, and that legal disputes that culminate in verdicts are better for shareholder value than disputes that culminate in settlements, illustrate the need to rethink common assumptions and adopt a more nuanced reputational theory.

The core arguments in this book rest on my independent empirical work, which follows a mixed-methods approach. I emphasize three methodologies in particular: interviews, case studies, and content analysis.

Each line of inquiry in this book contains insights from conducting in-depth open conversational interviews with practitioners.[9] The iterative process of picking practitioners' brains about holes in existing theories and then going back to the drawing board generated some interesting insights. For example, I revised the book's core thesis when practically all the interviewees (litigators, crisis management consultants, and journalists) kept raising the same theme: the information flow from the courtroom to the court of public opinion is badly distorted. In other words, they made me rethink my initial theory: even if the legal system does manage to produce accurate reputation information internally, such information does not necessarily reach stakeholders and affect their beliefs. This insight redirected my attention and I began searching for patterns of distortions in information flows using other methodologies, such as conducting content analysis of media coverage.

Another qualitative method that this book frequently invokes is case studies. My mode of case-studies research is "constructivist": I use specific cases to illustrate, shed light, and serve as a check on competing theoretical frameworks.[10] To these ends, I employ several "purposive" selection criteria.

8 Yuri Mishina et al., *The Path Dependence of Organizational Reputation: How Social Judgment Influences Assessments of Capability and Character*, 33 STRATEGIC MGMT. J. 459 (2012).

9 In this type of interview the researcher introduces a topic in broad strokes, the interviewee talks freely about his experience and insights into the topic, and the researcher further probes specific experiences with follow-up questions.

10 Harry Eckstein, *Case Study and Theory in Political Science*, *in* CASE STUDY METHOD 80 (2009).