Trust, Institutionalization, & Corporate Reputations: Public Independent Fact-Finding from a Risk Management Perspective

Gregory Todd Jones

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* Director of Research, Consortium on Negotiation and Conflict Resolution, Faculty Research Fellow and Adjunct Professor of Law, Georgia State University College of Law. B.A., Philosophy, University of the South, Sewanee, TN; M.B.A., Decision Sciences & Information Systems, Auburn University; M.P.A., Policy Analysis & Evaluation, Georgia State University Andrew Young School of Policy Studies; J.D., Georgia State University College of Law; Ph.D., Decision Sciences, Georgia State University Robinson College of Business. Co-chair, Association for Conflict Resolution Research Section Committee on Next Generation Research. The author extends thanks to Doug Yarn, Professor of Law at the Georgia State University College of Law and Executive Director of the Consortium on Negotiation and Conflict Resolution, and Bill Ide, Partner in the law firm of McKenna, Long & Aldridge and Chair of the Panel Advisory Committee of the Independent Fact-Finding Service of the American Arbitration Association, whose formative work and personal guidance have informed this research a great deal.
"Trust and similar values, loyalty or truth telling . . . have real, practical, economic value; they increase the efficiency of the system . . ."^1

I. INTRODUCTION

It turns out that Adam Smith was right.\textsuperscript{2} As communism and associated command economies have come tumbling down, there is widespread agreement that market economies are the means by which wealth is produced.\textsuperscript{3} Given this point, what features are required in the building of a

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\textsuperscript{1} KENNETH ARROW, THE LIMITS OF ORGANIZATION 23 (1974). "More than two decades ago, Kenneth Arrow suggested that 'virtually every commercial transaction has within itself an element of trust' and further, that 'much of the economic backwardness in the world can be explained by the lack of mutual confidence.'" William A. Galston, Trust—But Quantify, PUB. INTEREST, Winter 1996, at 129, 129.

\textsuperscript{2} See generally ADAM SMITH, WEALTH OF NATIONS (1776).

By preferring the support of domestic to that of foreign industry, [the owner of capital] intends only his own security; and by directing that industry in such a manner as its produce may be of greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectively than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good. \textit{Id. at 400.}


By defining a rational process of risk-taking, [innovative risk management scholars have] provided the missing ingredient that has propelled science and enterprise into the world of speed, power, instant communication, and sophisticated finance that marks our own age. Their discoveries about the nature of risk, and the art and science of choice, lie at the core of our modern market economy that nations around the world are hastening to join. Given all its problems and pitfalls, the free economy, with choice at its center, has brought humanity unparalleled access to the good things of life.

\textit{Id. at 2.} Bernstein continues:
successful market economy? Standard answers to this query are predictable, including “the removal of dead-weight government intervention,”4 “the construction of key institutions—stock exchanges, banks, impartial legal systems—as reliable frameworks for individual transactions,”5 and “the circumscribed, but active, use of public power to correct ‘market failures.’”6

While all of these factors are important, this article joins other recent efforts7 in a widely multi-disciplinary literature that stresses the importance of a less traditional, or at least less frequently treated, building block of market economies: trust. Even amid a diversity of scholarly approaches, it is universally agreed that trust is vital to the development and efficient functioning of modern markets.8 Indeed, the vulnerability that trust at once

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4 Galston, supra note 1, at 129.
5 Id.
6 Id.
8 See, e.g., Ralph Chami & Connel Fullenkamp, Trust and Efficiency, 26 BANKING & FIN. 1785 (2002); Giancarlo Spagnolo, Social Relations and Cooperation in Organizations, 38 J. ECON. BEHAV. & ORG. 1 (1999); Roderick M. Kramer, Trust and Distrust in Organizations: Emerging Perspectives, Enduring Questions, 50 ANN. REV. OF PSYCHOL. 569 (1999); Ronald C. Nyhan & Herbert A. Marlowe, Jr., Development and
requires and attempts to mitigate is necessary in order for specialization in production, capital accumulation, and social exchange to take place. In recent times, however, we have witnessed an avalanche of corporate wrongdoing or incompetence that has led to widespread “cris[es] of social legitimacy and [a] loss of public trust.”

High profile cases of shareholder abuse, gutted pension funds, and massive job loss have hung a dark cloud over the markets as a whole, bringing about a startling downturn and exacerbating an economic recession. These scandals represent a failure of not only laws and regulations, but of corporate leadership and corporate counsel. “Public confidence in large corporations, their executives and financial officers has reached an all-time low.” In response, lawmakers, 

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9 See Galston, supra note 1, at 129.

[T]he modern market economy rests on associations of production and exchange that extend beyond the family or village. This requires, in turn, trust, widely distributed. Societies endowed with broad-based trust enjoy a form of “social capital” that contributes at least as much to their success in modern economic competition as do the factor endowments stressed by traditional economic analysis.

Id.

10 Ide & Yarn, supra note 7, at 1114. The Enron and WorldCom debacles, along with the fraudulent auditing practices of Arthur Andersen, represent particularly notable examples, although there are many more. Id. The recent acceleration of these incidents is attributed by some to the media’s appetite for the intrigue of corporate fraud and the technological ability to widely distribute such information at the blink of an eye. Id. at 1115-16.

11 Note, The Good, the Bad, and Their Corporate Codes of Ethics: Enron, Sarbanes-Oxley, and the Problems with Legislating Good Behavior, 116 HARV. L. REV. 2123, 2123 (2003) [hereinafter The Good, the Bad] (“Allegations of accounting fraud and corporate misdeeds at high-profile companies such as Enron, WorldCom, Tyco International, and Adelphia Communications, along with five of the ten largest bankruptcies in United States history, shook investor confidence in 2001 and 2002 and gave rise to widespread calls for the reform of corporate diligence, ethics, and controls.”). Some commentators seem to see the abuses as symptomatic of the market downturn, that is, it is because of the downturn that such abuses are being revealed. See generally Randall S. Thomas, Should Directors Reduce Executive Pay?, 54 HASTINGS L.J. 437, 437 (2003); Jerry W. Markham, Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, The United Kingdom, and Japan, 28 BROOK. J. INT’L L. 319, 400 n.421 (2003).

12 See The Good, the Bad, supra note 11, at 2123.

13 See Michael B. Bixby, The Enron/Arthur Andersen Debacle: A Case Study and
regulators, and private institutions have all scrambled to restore public trust in corporate governance and to mitigate the effects that the loss of trust has had on markets worldwide.

Crisis in corporate behavior is not novel. The list of major corporations that have suffered financial collapse is a lengthy one; Polaroid, Penn Central, Pan Am, TWA, Kidder Peabody and Drexel Burnham, just to name a few. The thrift industry and the commercial banking industry have both come apart at the seams at various times in our history. Most recently, huge chunks of market value evaporated as the ethereal dot-com industry was decimated. So what was it about the downfall of Enron, the high-tech energy

LEGAL IMPLICATIONS 2 (2003). "A poll conducted even before the WorldCom disclosures showed that 57% of Americans said they do not trust corporate executives or brokerage firms to give them honest information, and the number is probably higher now." Id. (citing Americans Distrust Institutions in Poll, WALL ST. J., Jun. 13, 2002, at A4.) (emphasis added).


In recent years, there has been the price-fixing crisis in the 1960s electrical equipment industry, the 1970s foreign payments crisis, the 1980s insider trading crisis, and the 1980s defense procurement fraud crisis. See The Good, the Bad, supra note 11, at 2124. For a look at responses to these crises in the form of corporate codes of conduct, see Harvey L. Pitt & Karl A. Groskaufmanis, Minimizing Corporate Civil and Criminal Liability: A Second Look at Corporate Codes of Conduct, 78 GEO. L.J. 1559, 1562, 1582-98 (1990).
conglomerate, as well as other corporate scandals in the same timeframe,\textsuperscript{18} that was different? What was it about Enron that caused a collective shiver down to our national, in fact international, bones?

This article will begin by proposing a manner in which the Enron debacle was very different and by fathoming the depths of concern over the future of our financial markets that were brought about by this difference. Next, in preparation for support of a trust generating mechanism that has been designed to address these dire circumstances, this article will offer a very brief taxonomy of trust with discussion as to how this taxonomy highlights specific aspects of trust important to the context of problems considered here. For any study of trust, context is very important,\textsuperscript{19} and to be clear, the focus of this article is trust as a component of the relationship that shareholders have with corporations and corporate management. However, much of the insight is directly applicable to relationships between corporate management and other stakeholders.

This article continues with a consideration of the theoretical relationship between trust and risk. Employing a game theoretic framework known as the “trust game” or the “reliance game,” the discussion illustrates that the critical focal point of the aftermath of crisis in corporate governance is the dearth of shareholder reliance. Various strategies for managing this form of relational risk are appraised.

One means of addressing relational risk, and specifically the lack of shareholder reliance, is the notion of public independent fact-finding (PIFF), which has recently been proposed in the literature and which has taken shape in the offerings of a few providers of dispute resolution services. This article provides an overview of PIFF as a trust-generating mechanism and looks more closely at the specific features of services offered by one private institution, the American Arbitration Association (AAA).

Finally, this article concludes that the environment of corporate governance is indeed fundamentally different in the post-Enron world and that traditional legal and regulatory responses seen in the context of previous

\textsuperscript{18} Including Adelphia, Arthur Andersen, Dynegy, Global Crossing, Tyco, WorldCom, and Xerox. See Roger C. Cramton, Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues, 58 BUS. LAW. 143, 144 (2002) ("The Enron affair and the flood of other recent corporate scandals (e.g., Adelphia, Arthur Andersen . . ., Dynegy, Global Crossing, Tyco, WorldCom, Xerox) have led to a loss of investor and public confidence in the integrity of the securities and other markets that make American capitalism work.").

\textsuperscript{19} Lawrence Lessig, Preface to a Conference on Trust, 81 B.U. L. REV. 329, 332 (2001) ("The point is that the value of trust for a particular purpose is obviously, and plainly, contingent upon a pile of factors that cannot be known in the abstract. How one will substitute for the other is something we can only know in particular cases."); TRUST & RECIPROCITY: INTERDISCIPLINARY LESSONS FROM EXPERIMENTAL RESEARCH, supra note 7, at 14 ("Trust appears to be a complex concept strongly affected by context.").
corporate crises may not be effective at restoring order. PIFF, while possibly in need of fine-tuning and wanting for the benefits of further institutionalization, offers one hope of shoring up the shortfalls of these traditional approaches. It does so by relying upon a free market for trust and reputation and by avoiding the inefficiencies virtually always incumbent in governmental intervention.

II. THE LOSS OF TRUST

Crisis in corporate governance and the inevitable resulting loss of trust are not new phenomena to our economic system. However, the tone of the marketplace and the character of investor confidence have been quite different since the disintegration of Enron, the former stock market star with its sights set on becoming the world's leading energy firm. In myriad previous cases of corporate wrongdoing, there have been substantial losses suffered by shareholders as well as employees. What was it that prompted the public outcry, the unprecedented number of Congressional investigations, and the regulatory tightening that we witnessed post-Enron? No doubt, we have learned a lot from careful study of the circumstances that led to Enron's demise, but one of the most salient questions involves what made these circumstances different.

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20 See supra note 17 and accompanying text.
In early 2001 Enron Corporation was listed #5 on the list of "Fortune 500" corporations (just behind Ford Motor Company and ahead of General Electric) based on its revenue. In a little over 15 years Enron had grown from a modest Houston gas pipeline company into a $100 billion-a-year business. Its stock was selling in excess of $80 per share, giving the company a total equity of some $60 billion. Enron owned power companies and pipelines around the world, and had pioneered the energy trading business.

Id.
22 "At least ten Congressional committees and several government agencies, including a Justice Department criminal task force" have investigated Enron. Bixby, supra note 13, at 1.
A central premise of the arguments made in this article is that the Enron catastrophe was different because it demonstrated, in one fell swoop, the frailty of virtually all of the safeguards that investors have placed their faith in for decades. The relationship of shareholders with corporate management is one of virtually pure agency. Shareholders have very little influence over how capital is deployed by the company and have no opportunity for direct oversight. As a result, the trust that investors place in the companies in which they invest rests on the foundations of a small number of institutional mechanisms that act as "gatekeepers" for the protection of their interests. In the case of Enron, these mechanisms—including corporate governance and directors' oversight, public accounting and auditing firms, the standards of GAAP accounting, and assessments by brokerage firm analysts—all failed at the same instant, in a colossal "perfect storm," a breach of shareholder trust that brought the house of cards that was Enron tumbling down and taking the life savings of thousands with it.

A. Corporate Governance & the Board of Directors

Standards of corporate governance are designed "to provide a mechanism by which the express or implied promises of the company's management are monitored and enforced." Because shareholders do not enjoy the capacity of conducting this monitoring for themselves, they formally delegate this authority to the board of directors. Conflicts of interest can certainly arise where directors have close relationships with management and are suborned to neglect their responsibilities to shareholders in favor of management

24 Peter J. Wallison, The Significance of Enron, Le Centre Francais sur les Etats-Unis, May 15, 2002, http://www.aei.org/publications/pubID.14874/pub_detail.asp ("[T]he Enron collapse called into question the most fundamental beliefs of investors in the United States about how their interests were protected.").


26 Laura Goldberg, Did No Wrong, Skilling Says: Defends His Role in Enron Fall, HOUS. CHRON., Jan. 17, 2002, http://www.chron.com/cs/CDA/story.hts/special/enron/dec01/1183520 ("[Former Enron CEO Jeffrey] Skilling offered a hypothesis for what brought Enron down, calling it a 'perfect storm' of events."). See also Jennings, Perfect Storm I, supra note 23; Rapoport, Perfect Storm II, supra note 23.


28 Wallison, supra note 24.
interests. So, one might imagine that Enron's board was loaded with insiders. Not so. In fact, Enron's directors have been widely characterized as a "model," with vast experience and only two, out of 17, insiders. A "model" board, "as good as it gets," but nevertheless a failed institution of shareholder trust and confidence.

B. Public Accounting & Auditing Firms

In the rare circumstance that a board of directors, particularly a board as strong as the one that provided oversight and guidance for Enron management, failed in its obligations to shareholders, public accounting and auditing firms would surely take up the slack and intervene with vigilance to protect investor interests. In fact, the Securities Act of 1933 and the Securities Exchange Act of 1934, created requirements for auditor independence and placed auditors in the position of acting as gatekeepers for the markets. Indeed, the present litigation climate is one in which accounting and auditing firms have been found liable when erroneous financial reports have misled investors. Combined with the incentives to protect their

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29 Id. ("The possibility that directors may be suborned to neglect their duty is most likely of course in cases where the directors are the management: where the board is what is known as an "inside board" or where the directors are beholden to management through contractual or financial relationships.").

30 See Jennings, Perfect Storm I, supra note 23, at 197 ("Enron’s Board was a model judging by the standards of those who urge strong corporate governance."); Wallison, supra note 24 ("If any board would have been expected to apprehend, understand and stop illegal, unethical or manipulative actions by management, it would have been this board. . . . One might say this was as good a board as any company could assemble in the United States, and the audit committee was—relative to the experience of other audit committees—much better than most."). Only Kenneth Lay, Chairman, and Jeffrey Skilling, CEO prior to his August 2001 departure, were insiders on the board. The audit committee was made up of six independent members, including two who were former senior government officials in the United States and the United Kingdom, and a chairman, Robert K. Jaedicke, who was Professor Emeritus of Accounting and the former Dean of the Stanford Business School. Id.


32 Pub. L. No. 73-290, §§ 4, 12-13, 19, 14 Stat. 881, 885, 892-95, 898-99 (1934) (codified as amended at 15 U.S.C. §§ 78(a)-78(mm), 78(d), 78(l), 78(m), 78(s) (2000)).


34 Wallison, supra note 24.

In a litigious society such as the United States, accountants have been required to pay huge judgments for mistakes or inattentiveness in attesting to the financial statements of their clients. Auditors can be sued directly by shareholders who bought or sold shares in reliance
reputations within the marketplace, one would think that a prominent firm with the stature of Arthur Andersen would not allow the misleading financial results reported by Enron to be made public. Andersen, however, did not intervene, instead choosing complicity in an attempt to cover up the misreporting, and "call[ing] into question investors' faith in the accounting profession generally to protect them against the depredations of management."\(^3\)

C. GAAP Accounting

The Generally Accepted Accounting Principles (GAAP) are a set of standards for financial reporting in the United States.\(^3\) "GAAP is [sic] essential to the efficient functioning of the economy because decisions concerning resource allocations rely heavily on credible, concise, and understandable financial reporting."\(^3\) The experts that revise and update GAAP, the Financial Accounting Standards Board (FASB), and the SEC have for a very long time contended that GAAP, as practiced in the United States, represented the most highly developed system of accounting available.\(^3\) "For years, investors had no reason to doubt this."\(^4\) Unfortunately, GAAP also failed to protect the investors who had for so long placed their confidence in the complex set of rules. In fact, Enron's accounting practices "fell within

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on misleading or false financial reports that the auditor certified, even if they were not complicit in the company's manipulative action. Simple negligence is enough to result in liability.

Id.


\(^3\) Wallison, supra note 24.


Generally Accepted Accounting Principles (GAAP) guide corporate financial reporting in the United States. GAAP consists of conventions, rules, and procedures necessary to define accepted accounting practice at a particular time. These principles have gained substantial support either through the actions of authoritative rule-making bodies or through general acceptance of a practice over time because of its universal application by the accounting profession.

Id.

\(^3\) Id.

\(^3\) Id.
Yet another pillar of trust had let investors down. D. Brokerage Firm Analysts

Investors must have been suspicious all along about the independence of advice offered by analysts employed by brokerage houses. Right? How could they not have realized that most brokerage houses, and their analyst employees, are in the business of selling securities to investors? Nonetheless, in a dramatic playing out of the old advertising slogan “When E.F. Hutton talks, people listen,” many investors did listen to analyst recommendations and “rode [Enron] all the way down to almost zero.” Now, there is increasing evidence that these analysts, these sophisticated experts that investors have long relied upon, continued to recommend buying the stocks of Enron and other similar companies even when they knew that they were vastly overvalued or even worthless. One last vestige of investor trust had been violated.

The failure of Enron’s model board resulted in a loss of investor confidence in corporate governance generally. Andersen’s failure as the
gatekeeper for publicly reported financial results deepened distrust. GAAP accounting had been manipulated by clever management. Brokerage analysts, falsely perceived as objective overseers of financial performance, had whipped up hysteria over Enron stock that was designed for their own profit rather than grounded in accurate analysis, and which many investors found hard to resist. Combine these institutional failures with the culture at Enron that encouraged aggressive risk-taking and the pursuit of short-term profits, and the result was disastrous.

As we all know from personal experience, once lost, trust is harder to regain. The simultaneous failure of various traditional oversight mechanisms has therefore created an urgent need for new trust-generating mechanisms. One possibility, PIFF, which attempts to address the complexity of roles in the shareholder-management relationship, will be considered in what follows. Before turning to proposed means for the restoration of trust, however, this article will provide a brief taxonomy of trust and will propose a working definition of trust that will ground the analysis moving forward.

III. DEFINING TRUST

What is trust? Researchers have proffered a wide variety of definitions and subtleties of meaning, making it challenging to compare any specific piece of research to others. As Voltaire admonished, "If you wish to converse with me, define your terms." This section takes heed of Voltaire's warning by providing one framework for the examination of trust. To begin, a number of ways in which one may operationalize trust, based on deterrence, a subjective calculus, relationships, or institutions, are explored. Next, possibly armed with a better understanding of what trust is, this section examines what trust is explicitly not, paying particular attention to a contrast between law and trust and a posited failure of regulatory rule-based responses.
to the loss of trust. Finally, this section underscores the critical importance of trust and describes the important role that reputation plays to generalize the expectations that allow trust to function in society as a lubricant for cooperative behavior.

A. Typologies of Trust

The study of trust is a highly multidisciplinary enterprise with exceedingly divergent meanings and understandings.\(^{50}\) Even so, confident expectations\(^{51}\) regarding the behavior of others and a willingness to make oneself vulnerable\(^{52}\) seem to be features of most definitions of trust.\(^{53}\) A definition based on these common elements, and the working definition employed by this article, is as follows: [t]rust is a psychological state comprising the intention to accept vulnerability based upon positive expectations of the intentions or behavior of another.\(^{54}\) Within the general boundaries of this definition, different forms of trust have been proposed.\(^{55}\) A closer examination of some of these forms will facilitate understanding of roles that trust may play generally and will help to operationalize trust in the context of the arguments presented in this article.

1. Deterrrence Based

When costly sanctions, such as contract-based damages or legal penalties, are employed to deter a breach of promised obligation, then such deterrence
may be said to be a source of trust, at least to the extent that the cost of the sanctions exceed the perceived benefit of opportunistic behavior. Ultimately, however, this begs the question of whether the deterrence actually produces trust or, if instead, the sanctions simply substitute for trust. Deterrence-based trust may not really be trust at all.

2. CALCULUS BASED

Calculus-based trust derives from a subjective accounting in which the rational trustor tallies the expected benefits to be gained by interacting with a trustee and weighs them against risk-adjusted losses that might ensue from a breach of trust on the part of the trustee or from foregoing the interaction entirely. This cost-benefit analysis proceeds in the spirit of standard expected utility theory that has found application in virtually all disciplines that deal with behavior. As such, the expectancies related to trustee

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56 "Deterrence-based trust emphasizes utilitarian considerations that enable one party to believe that another will be trustworthy, because the costly sanctions in place for breach of trust exceeds any potential benefits from opportunistic behavior." Id. See generally Peter Smith Ring & Andrew H. Van de Ven, Developmental Process of Cooperative Intergorganizational Relationships, 19 ACAD. OF MGMT. REV. 90 (1994); Peter Smith Ring & Andrew H. Van de Ven, Structuring Cooperative Relationships Between Organizations, 13 STRATEGIC MGMT. J. 483 (1992); Debra L. Shapiro et al., Business on a Handshake, 8 NEGOTIATION J. 365 (1992).

57 Rousseau, supra note 53, at 399 ("[T]rust is not a control mechanism but a substitute for control . . . . Control comes into play only when adequate trust is not present."); Sim B. Sitkin & Nancy L. Roth, Explaining the Limited Effectiveness of Legalistic Remedies for Trust/Distrust, 3 ORGANIZATIONAL SCI. 367, 369 (1993). This distinction will be important to the argument that trust can serve a function that legalistic remedies cannot. See infra notes 72, 83 and accompanying text.

58 Such an economically minded person "has three properties. (a) He is completely informed. (b) He is infinitely sensitive. (c) He is rational." Ward Edwards, The Theory of Decision Making, 51 PSYCHOL. BULL. 380, 381 (1954). "The crucial fact about economic man is that he is rational. This means two things: He can weakly order the states into which he can get, and he makes his choices so as to maximize something." Id.


60 See, e.g., PAUL ANAND, FOUNDATIONS OF RATIONAL CHOICE UNDER RISK 131 (1993) ("There can be few theories that would appear to be so important in so many disciplines."); JANET LANDMAN, REGRET: THE PERSISTENCE OF THE POSSIBLE 117 (1993) ("By now utilitarian decision theory has achieved canonical status."); R. J. Herrnstein, Rational Choice Theory: Necessary but Not Sufficient, 45 AM. PSYCHOL. 356, 356 (1990) ("Not just economics, but all the disciplines dealing with behavior, from political philosophy to behavioral biology, rely increasingly on the idea that human and other organisms tend to maximize utility, as formalized in modern economic theory . . . . The scattered dissenters to the theory are often viewed as just that—scattered and mere dissenters to an orthodoxy almost as entrenched as a religious dogma."), John C. Hershey & Jonathon Baron, Clinical Reasoning and Cognitive Processes, 7 MED. DECISION MAKING 203, 203 (1987) ([Expected utility theory] is generally accepted, having formed the basis in the last forty years for virtually all theoretical and applied research in economics, finance,
behavior can certainly arise from the existence of deterrence but, importantly to the main thesis of this article, such calculus-based trust can also be generated "because of credible information regarding the intentions or competence of another." One source of such credible information is independent third parties that must themselves have a reputation for trustworthiness. This is precisely the arrangement that is proposed by PIFF.

3. RELATIONAL BASED

Relational trust, also referred to as affective trust or identity-based trust, develops between trustors and trustees who engage in repeated interactions and come to rely upon the dependability of party intentions. Relational trust may offer more stable, long-term interaction even where some degree of breach has taken place. Where trustees make some effort, such as engaging in PIFF, to signal a restoration of good faith, relational trust can survive a breach, as long as the breach does not create expectancies that develop into a reputation for untrustworthiness.

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insurance, marketing, and gambling."); Mark J. Machina, Decision-Making in the Presence of Risk, 236 SCIENCE 537, 537 (1987) ("[Expected utility theory has] become the dominant, and indeed, almost exclusive model of decision-making under risk in economics, operations research, philosophy, and statistical decision theory."); Paul J. Schoemaker, The Expected Utility Model: Its Variants, Purpose, Evidence and Limitations, 20 J. ECON. LITERATURE 529, 529 (1982) ("It is no exaggeration to consider expected utility theory the major paradigm in decision making since the Second World War.").

See generally Rousseau, supra note 53, at 399 (citing BERNARD BARBER, THE LOGIC AND LIMITS OF TRUST (1983)).


See generally JAMES S. COLEMAN, FOUNDATIONS OF SOCIAL THEORY (1990).

See Rousseau, supra note 53, at 399.

"Exchanges based on calculus-based trust are likely to be terminated once violation occurs, but exchanges characterized by relational trust often are more resilient. Unmet expectations can be survived when relational trust exists, particularly if parties make an effort to restore a sense of good faith and fair dealing to their interactions." Id. at 400 (emphasis added).

These expectancies may derive from the calculus-based trust previously discussed. See supra Part III.A.2.
4. Institutional Based

Institutional support at both the organizational level, as in corporate culture, and the societal level, as in legal systems, can facilitate the development of both calculus-based and relational trust. "Institutional factors can act as broad supports for the critical mass of trust that sustains further risk taking and trust behavior." A critical consideration in the determination of the role that institutionalization will play is whether the institution functions as a control, and therefore becomes largely a deterrent, or as support for trust, and therefore an accelerant for calculus-based and relational trust. This article will later argue for the institutionalization of PIFF as a means of supporting the generation of trust.

B. What Trust is Not

Trust is a state of mind. Trust is not a behavior, but a means to control behavior. Thus, the concern of this article is not a means of controlling trust as a choice, per se, but a means of generating trust, in this case PIFF, as an alternative for guiding behavior; in this case the individual investment in corporate equities. Further, trust is not independent of other behavior controlling mechanisms. In fact, it has been demonstrated that legalistic

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68 See Brian Allen Warwick, Reinvoding the Wheel: Firestone and the Role of Ethics in the Corporation, 54 ALA. L. REV. 1455, 1468 (2003) (arguing that a conscientious corporate culture "will help prepare a corporation to act more quickly, and more responsibly. . ."). But see Robert Prentice, Enron: A Brief Behavioral Autopsy, 40 AM. BUS. L. J. 417, 436 (2003) (pointing out that inappropriate corporate culture can have disastrous effects). "Individuals will find it difficult to 'do the right thing when the right thing is not among the options presented by the institutional processes in which they are participating." Id. (citing Charles R.P. Pouncy, The Rational Rogue: Neoclassical Economic Ideology in the Regulation of the Financial Professional, 26 VT. L. REV. 263, 322 (2002)).

69 See generally FUKUYAMA, supra note 3.

70 See Rousseau, supra note 53, at 400.

71 Id. (citing Ranjay Gulati, Does Familiarity Breed Trust? The Implications of Repeated Ties for Contractual Choice in Alliances, 38 ACAD. OF MGMT. J. 85 (1995); Peter Smith Ring & Andrew H. Van de Ven, Structuring Cooperative Relationships Between Organizations, 13 STRATEGIC MGMT. J. 483 (1992)).

72 "Institutional controls can also undermine trust, particularly where legal mechanisms give rise to rigidity in responses to conflict and substitute high levels of formalization for more flexible conflict management." Id. (Citing SIM B. SITKIN & ROBERT J. BIES, THE LEGALISTIC ORGANIZATION (1994)).

73 Some commentators "see a minimum level of institutional trust as sine qua non for the emergence of interpersonal trust." Id. at 401.

74 See infra Part VI.

75 "Trust is not a behavior (e.g. cooperation), or a choice (e.g. taking a risk), but an underlying psychological condition that can cause or result from such actions." Rousseau, supra note 53, at 395.
controls inhibit the development of trust. Finally, trust is not subsumed by other control mechanisms such as the law. It takes more than law and regulation to constrain the way that people, and the corporations that they manage, behave. "Legal constraints may increase the probability that one will perform as promised, but cannot increase one's willingness either to perform in the absence of constraints or to make oneself vulnerable to the risk of non-performance." Rule-based behavior regulation quickly becomes prohibitively expensive as a product of self-perpetuation. Because rules give rise to efforts to narrowly comply with the letter of the rule and skillfully

76 Rousseau, supra note 53, at 399.

"[A] detailed legal contract is one mechanism for controlling behavior. However... detailed contracts can get in the way of creating an effective exchange relationship: in effect, people do not need to develop trust when their exchange is highly structured and easily monitored. Although detailed contracts promote limited cooperation based upon deterrence, most firms that form alliances do so because of a social network of prior alliances, which makes detailed contracts less necessary."

Id. at 399.

77 See Ide & Yarn, supra note 7, at 1120-21.

[Law] cannot eliminate the need for trust. The law's regulatory function is simply inadequate to ensure trustworthy behavior. First, the costs of enforcement are too great to be able to police every interaction. Second, too much regulation begets untrustworthiness. One of the more curious aspects of trust is that trust reinforces trustworthiness and that distrust undermines trustworthiness. In other words, people are more likely to be trustworthy when other people trust them, the more external sanctions and restraints on individual discretion signaling distrust, the less trustworthy the behavior.

Id. See also Sim B. Sitkin & Nancy L. Roth, Explaining the Limited Effectiveness of Legalistic Remedies for Trust/Distrust, 3 ORGANIZATIONAL SCI. 367, 369 (1993).

Attempts to "remedy" trust violations legalistically frequently fail because they paradoxically reduce the level of trust rather than reproducing trust. The adoption of legalistic "remedies" (i.e., institutionalized mechanisms that mimic legal forms and exceed legal/regulatory requirements) imposes a psychological and/or interactional barrier between the two parties that stimulates an escalating spiral of formality and distance and leads to a need for more rules.

And so the process is perpetuated.

Id. For a thorough treatment of this idea in the context of tax evasion, see Kahan, supra note 8, at 340-44. Kahan goes on to qualify this view, however, pointing out that laws also serve an expressive function. Id. at 345 ("Like other types of material incentives, laws have meanings; they are understood to express societal values and attitudes.").

78 Lessig, supra note 19, at 329 ("[M]ore than law regulates behavior. More than law constrains how people behave."). For considerations of how social norms contribute to this social regulation without law, see ERIC A. POSNER, LAW AND SOCIAL NORMS (2000) and ROBERT C. ELLICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES (1991). For the opposite, or contractarian view, that contractual relationships, existing within the framework of the law and the markets, are what governs corporations, see Henry N. Butler & Larry E. Ribstein, Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians, 65 WASH. L. REV. 1 (1990).

79 Larry E. Ribstein, supra note 7, at 562.
evade the spirit, rules beget more rules. Fortunately, trust also begets trust.

C. The Importance of Trust

As Alan Greenspan has testified, "our market system depends critically on trust—trust in the word of our colleagues and trust in the word of those with whom we do business." There is robust evidence that social capital, including indicators of trust and civic norms, has significant impact for economic performance. Indeed, there is widespread agreement that "trust is important in a number of ways: it enables cooperative behavior; promotes adaptive organizational forms . . . reduces harmful conflict; [and] decreases transaction costs." "Trust is a kind of social glue that allows people to interact at low transaction costs . . . [and] increases social wealth by permitting more investment in production." In fact, it has been compellingly argued that the corporate organizational form depends upon trust for its very existence. And yet, there is increasing evidence of a loss of trust in the

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80 See supra notes 72, 76, 77, and accompanying text.
81 See Frankel, supra note 59, at 322:
[I]f people receive "tokens of esteem" that is, signals that they are trusted, they are more likely to live up to the expectation and become more trustworthy. Conversely, if people receive signals that they are not trusted, they are likely to become less trustworthy. Thus, trust begets trust and mistrust begets mistrust.
82 Alan Greenspan has stated that:
[w]ell-functioning markets require accurate information to allocate capital and other resources, and market participants must have confidence that our predominantly voluntary system of exchange is transparent and fair. Although business transactions are governed by laws and contracts, if even a modest fraction of those transactions had to be adjudicated, our courts would be swamped into immobility. Thus, our market system depends critically on trust—trust in the word of our colleagues and trust in the word of those with whom we do business. Falsification and fraud are highly destructive to free-market capitalism and, more broadly, to the underpinnings of our society . . . . Lawyers, internal and external auditors, corporate boards, Wall Street security analysts, rating agencies, and large institutional holders of stock all failed for one reason or another to detect and blow the whistle on those who breached the level of trust essential to well-functioning markets.

84 Rousseau, supra note 53, at 394. See also Galston, supra note 1, at 130-31.
85 Ribstein, supra note 7, at 553-54.
86 "Societies in which trust is confined to families (even extended families and kinship systems) are unable to sustain either the large-scale corporate organizations or the far-flung networks among
marketplace, a loss of trust in traditional institutions such as the law, and a loss of trust among individuals. Generalization of these expectations regarding trust and cooperation is the fodder for reputation, an important recognition of character or trustworthiness, which this article will consider next.

D. Trust & Reputation

One way that trustees can provide assurance, or a "bond [of] future performance," is the development of a reputation, or a generalized recognition of trustworthiness. Repeated interactions in which trustworthiness is exhibited increases the value of reputation. Similarly, however, "misconduct diminishes the value of the trustee's reputation according to the [trustor's] perception of the seriousness of the misconduct." Clearly, then, a reputation for trustworthiness is extremely valuable and can be determinative in the holder's ability to engage in economic exchange within the smaller businesses that play such a central role in successful modern economies." Galston, supra note 1, at 130 (referring to Fukuyama, supra note 3).

87 Galston, supra note 1, at 132.

Until recently, Americans have combined an intense mistrust of concentrated power (including, but not limited to, government) with high levels of trust among their fellow citizens. The result: a dense network of voluntary associations and a highly successful economy. But today, Americans have less trust in institutions than they did 30 years ago, and they are far less trusting of one another. Evidence collected and recently published by [Robert Putnam] suggests that our associational life has declined commensurately. Id. See generally Robert D. Putnam, Bowling Alone: The Collapse and Revival of American Community (2001).

88 Ribstein, supra note 7, at 569.

89 Id.

90 Ide & Yarn, supra note 7, at 1119.

Trust is essential to efficient cooperation. Cooperation allows for the production of benefits exceeding those achievable by an individual acting alone; however, cooperative behavior by one individual usually confers benefits to another with the risk that the recipient will fail to reciprocate. If A cannot trust B to reciprocate, then either A will not cooperate and will forfeit the potential benefits or A will expend resources to monitor and control B to ensure B reciprocates. Alternatively, A can spend resources to punish B for B's failure to reciprocate. The more A can trust B to reciprocate, the less A must spend to ensure reciprocation or punish B. One way interpersonal or mutual trust develops between individuals is through repeated interactions that allow the actors to generalize the expectation of continued cooperative behavior in subsequent interactions.

Id. In this manner, trust generally, and reputation specifically, can offer tremendous efficiencies in reduced transaction costs.

91 Ribstein, supra note 7, at 569.
marketplace. Additionally, a positive reputation can make such exchanges more efficient, by helping to reduce the burden of transaction costs. Where a corporation faces a loss of reputation, "society may punish the corporation and require more trust-generating regulation, thereby constraining corporate discretion." 

Indeed, reputation is so important to corporations that increasing attention is being given to the formal management of reputational risk. In what follows, this article will consider alternative responses to social legitimacy crises where reputation loss is possible, beginning with a theoretical

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93 Faced with greater risks, people prefer to deal with individuals of known reputation even in the presence of other trust-generating institutions. This makes a reputation for trustworthiness extremely valuable for the holder. As uncertainty increases, reputation becomes an even more important determinate; therefore, it is in a person's interest to manage their reputation.

94 See supra note 84 and accompanying text.

95 Id. at 1127-28.

96 See generally Judy Larkin, STRATEGIC REPUTATION RISK MANAGEMENT (2003); Grahame Dowling, CREATING CORPORATE REPUTATIONS (2002); Gary Davies et al., CORPORATE REPUTATION AND COMPETITIVENESS (2002); Charles J. Fombrun, REPUTATION: REALIZING VALUE FROM THE CORPORATE IMAGE (1996); David Bernstein, Strategic Reputation Risk Management, 7 J. OF COMM. MGMT. 275 (2003); Konrad S. Alt, Managing Reputational Risk, THE RMA J., Sep. 2002, at 40; Charles J. Fombrun, Naomi A. Gardberg, & Michael L. Barnett, Opportunity Platforms and Safety Nets: Corporate Citizenship and Reputational Risk, 105 BUS. & SOCY REV. 85 (2000); Jim Kartalia, Reputation at Risk?, RISK MGMT., Jul. 2000, at 51, 52 ("In response to evolving concerns, [such as growing anti-business virulence that poses new strategic risks for all corporations], a new business management concept has developed—reputation management. Because reputation is the most strategic of assets and thus, at the greatest risk, reputation management has generated a great deal of interest.").

97 For a consideration of corporate apologia as an alternative public response to a social legitimacy crisis, see Ide & Yarn, supra note 7.

Apologia is not the same as an apology. The latter contains an admission of wrongdoing and acceptance of responsibility, neither of which are appropriate if the corporation believes the
model of the relationship between trust and risk, followed by consideration of the role that trust may play in the management of reputational risk and the impact that institutionalization\textsuperscript{98} may have upon this role.

IV. TRUST AND RISK

Trust and risk are tightly intertwined.\textsuperscript{99} In fact, it is because of the existence of risk that trust finds necessity.\textsuperscript{100} Where a transaction is theoretically risk free, either due to absolute certainty with regard to the actions of others or perfect control of these actions, trust is not necessary.\textsuperscript{101} On the other hand, where uncertainty is the source of risk in a transaction,
trust may serve to mitigate the need to control entirely for such risk, thereby reducing the burden of transaction costs associated with this control as well as creating other efficiencies. Where trust does not exist, individuals and organizations may be exposed to sources of risk that cannot be cost-effectively mitigated by other risk management mechanisms.

One such risk emanates from the strategic importance of reputation and the organizational consequences that can ensue should a reputation for trustworthy behavior not be cultivated and nurtured. Where such a reputation and associated trust does not exist, an organization may find it difficult to secure interaction with the various stakeholders upon whom they rely for success. The uncertainty surrounding the ability to form these strategic relationships has been referred to as relational risk. The form of relational risk particular to the specific context considered in this article is one related to shareholder reliance—the consequences of unconstrained risk are attenuated shareholder reliance, difficulty in the formation of shareholder relationships, and a resulting inability to accumulate sufficient assets for long-term organizational success.

This dependence on shareholder reliance can best be illustrated by means of simplifying models of the trust relationship. This section will begin with a brief examination of a model of mutual trust, that is, a model in which trust is extended by both parties to the other simultaneously. Simultaneous trust models offer insight into the general dynamics of the dyadic relationship and provide a baseline of comparison for models that better illustrate the trust relationship between corporate management and shareholders treated here—sequential trust models. In sequential trust models, trust is extended in one direction only and both parties are dependent on the cooperative behavior of the trustor in order to benefit from an interaction or exchange.

A. Simultaneous Trust

The problem of cooperation, or simultaneous trust, can best be represented in a simplifying framework by the famous prisoner's dilemma. In the

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102 See supra notes 81, 82 and accompanying text.
103 See Kartalia, supra note 96, at 51, 52.
104 For an analysis of the effects of trust on relational risk and the formation of strategic alliances, see Bart Nooteboom et al., supra note 7.
105 See ROBERT AXELROD, THE EVOLUTION OF COOPERATION (1984). According to Axelrod,
prisoner's dilemma, there are two players, or prisoners, who are interrogated separately. Each can choose to cooperate with their colleague by not providing information to the authorities or to defect by incriminating the other. Each must reach a decision regarding cooperation or defection independently. As is illustrated in Figure One, if both prisoners cooperate and provide no information to the authorities, cases against them will be weak and they will each be sentenced to only one year. Should both prisoners defect on each other, the cases will be stronger, and they will each likely face three years of jail time. However, should one prisoner cooperate and the other defect, the defector will receive special treatment and no jail time, and the cooperator will go up the river for five years.

The central observation to be gleaned from this illustration is that should Player A independently decide to cooperate, he must trust that Player B will also cooperate. Player B is faced with an unpleasant decision, however. Should Player A cooperate, it is in Player B’s best interest to defect and get off scot-free. On the other hand, should Player A defect, it is in Player B’s best interest to also defect and avoid a five year sentence. In other words, it is in Player B’s best interest to defect regardless of what Player A may choose to do. This dilemma is symmetrical, or identical for Player A, and therefore, both players will defect and lose the benefit of mutual cooperation.

<table>
<thead>
<tr>
<th>Player A</th>
<th>Player B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cooperate</td>
<td></td>
</tr>
<tr>
<td>Cooperate</td>
<td>A = 1, B = 1</td>
</tr>
<tr>
<td>Defect</td>
<td>A = 3, B = 3</td>
</tr>
</tbody>
</table>

**FIGURE ONE**
The Prisoner's Dilemma

"[t]he Prisoner's Dilemma game was invented in about 1950 by Merrill Flood and Melvin Dresher, and formalized by A. W. Tucker shortly thereafter." *Id*. at 216 n.2.

106 In game theoretical terms, these rational choices are known as the Nash equilibrium. See HERBERT GINTIS, GAME THEORY EVOLVING 6 (2000) ("A Nash equilibrium in a two-player game is a pair of strategies, each of which is a best response to the other; i.e., each gives the player using it the highest possible payoff, given the other player's strategy.").

107 Configuration based upon AXELROD, supra note 105, at 8.
David Hume wrote that the keeping of a promise is obligated by one's own interest. This assertion is played out quite clearly when the prisoner's dilemma is iterated. Thus, when two players, prisoners or corporate management and shareholders, face each other multiple times, they may proceed in a fragile relationship of trust in order to share the benefits of mutual cooperation rather than the costs of mutual defection prescribed by rational choice in a one-time interaction. However, should one player defect, then trust will be broken and the victim of this defection will logically choose to defect at their next meeting, and future interactions will be stuck in an equilibrium of mutual defection that is sub-optimal for both players. For corporate management that defects on shareholders, the most significant loss is not that shareholders will no longer rely upon management, but rather that management will no longer be able to rely on shareholders.

B. Sequential Trust

This insight can be fine-tuned by structuring a sequential model of trust that more accurately depicts the relationship between corporate management and shareholders, which is the focus of this article. In what is known as the "trust game" or the "reliance game," Player A must decide whether to trust or rely upon Player B. Should Player A elect to trust, then Player B decides whether to fulfill or to exploit this trust. As Figure Two demonstrates, Player A's choice is between forgoing interaction with Player B and receiving a payoff of 1 with certainty, or trusting Player B to fulfill the

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109 As observed above, this is one reason why trust, once broken, is so hard to regain. See supra Part II.

110 See Russell Hardin, Gaming Trust, supra note 51, at 87.

The force that generally backs exchange promises is the loss of credibility that follows from breaking them. Without credibility, one loses the possibility of making promises. Why should anyone want the power to make promises? All I really want in my own interest is the power to receive promises. And there's the rub, because promises are generally part of a reciprocal exchange. The real penalty here is not that others will no longer rely on me but that they will not let me rely on them.

Id. (emphasis added).

111 See generally David M. Messick & Roderick M. Kramer, Trust as a Form of Shallow Morality, in TRUST IN SOCIETY, supra note 7, at 93; Toshio Yamagishi, Trust as a Form of Social Intelligence, in TRUST IN SOCIETY, supra note 7, at 143; Robert Gibbons, Trust in Social Structures: Hobbes and Coase Meet Repeated Games, in TRUST IN SOCIETY, supra note 7, at 335.

extended trust so that they may both receive payoffs of 3. However, after receiving the trust of Player A, it is in Player B’s best interest to exploit this trust and receive a payoff of 5. By backwards induction, Player A is well aware of these incentives and will therefore be satisfied with withholding trust and the resulting payoff of 1 as opposed to exploitation by Player B that will result in no payoff at all for Player A. Both players end up with suboptimal payoffs.

Similar to the iterated outcome proposed by the simultaneous model, repeated encounters between two players alter predicted behaviors. Player B is much more likely to forgo the payoff of 5 and be satisfied with fulfillment and a payoff of 3 if she faces the prospect of facing Player A again, at which time Player A can unilaterally decide to withhold trust and limit Player B to a payoff of 1. The lesson is similar to that taught by the simultaneous model. “The central problem in the reliance predicament is . . . not that there is too much exploitation; the problem is rather that there is too little

\[ \text{Figure Two} \]

\text{The Trust Game}^{113}

\footnote{Configuration based upon \textit{id.} at 199.}
reliance."  This is a crucial point and is therefore worth emphasizing by application to the current shareholder problem. Investors enjoy the power of deciding whether to trust a particular corporate management team and to deploy assets to their care. This is a decision made under significant risk. After the decision to trust is made, corporate management makes a risk-free\textsuperscript{115} choice between fulfilling this trust and accruing some benefit to themselves and their investors or exploiting this trust and maximizing their own benefit while leaving investors without.

The consequences of this exploitation are more profound than mere losses incurred by investors. In future interactions, these investors, and others whose expectations of trustworthiness have been effected by the news of the exploitation, will be less likely to make the decision to trust. By choosing to withhold trust as well as their assets, the investors' payoffs are negatively affected. In addition, corporate management is burdened with the consequences of relational risk; unable to attract the assets necessary for the successful operation of their enterprises, their payoffs suffer. Society as a whole is significantly harmed.

Responses to the current manifestation of this crisis\textsuperscript{116} have to date largely addressed the prevention of further exploitation.\textsuperscript{117} However, models and arguments presented in this section counsel that the central problem is not exploitation, but instead a lack of reliance. How might reliance be promoted? In the context of game theoretic models like those considered here, a convention of correlated interaction\textsuperscript{118} in which those who cooperate are more likely to interact with those that cooperate and those that trust are more likely to interact with those that fulfill has been proposed as a means of overcoming the trap set by sub-optimal Nash equilibria.\textsuperscript{119} How might something like this correlated interaction be manifested in a manner that encourages reliance and provides a means for the management of relational risk? This article now turns to a brief consideration of relational risk

\textsuperscript{114} \textit{Id. at} 200. (emphasis added).

\textsuperscript{115} Risk-free as compared to the simultaneous model and when limited to a single interaction.

\textsuperscript{116} \textit{See supra} Part II.

\textsuperscript{117} \textit{See supra} notes 14-16 and accompanying text.

\textsuperscript{118} \textit{See} BRIAN SKYRMS, EVOLUTION OF THE SOCIAL CONTRACT 63-79 (1996). Skyrms has conducted numerous game theoretic simulations in which correlated interaction of players (and it does not take a great deal of correlation) are easily able to achieve superior results in repeated play. With regards to learning and reinforcement of correlated behavior, he writes, "We want to endow our agents with some simple way of learning correlations and of using that knowledge. So we could assume that the players carry a set of beliefs about what other players will do, and that they modify those beliefs incrementally in the direction of the observed frequencies." \textit{Id. at} 71. This is precisely the function that this article proposes for PIFF.

\textsuperscript{119} \textit{See supra} note 106 and accompanying text.
management in final preparation for the introduction of PIFF as a trust generating mechanism that would, in fact, encourage reliance.

V. MANAGING RELATIONAL RISK

Relatively recent recognition of the importance of stakeholder reliance has led to significant efforts to advance knowledge related to corporate reputations, their management, measurement, and valuation. Investment in reputation building efforts, however, is not the only means for controlling relational risk. There are other trust generating mechanisms that can be considered, as well as more direct measures that transfer stakeholder risk to the corporation or to third parties.

In short, corporate management can manage their own relational risk by doing everything feasible to mitigate the risk borne by various stakeholders. Stakeholder risk may be managed directly by means of warranties and guarantees, other contracts, and the often costly compliance with regulation, including audits and other monitoring devices. In addition, however, a key insight that follows from the previous discussion of the relationship between trust and risk is that management can also deal with relational risk by investing in reputation building and other trust generating mechanisms.

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121 Feasibility here is intended to be economic feasibility. Of course, there will come a point at which marginal gains resulting from the ability to attract stakeholder interactions will be exceeded by marginal costs associated with the mitigation of stakeholder risk. Clearly, engaging in every possible means of mitigation is not what this article proposes.

122 See supra Part IV.

123 Ide & Yarn, supra note 7, at 1125-26. Transactional stakeholders are composed of internal and external cooperating constituents. Internal constituents include directors, managers, employees, and shareholders. External constituents include lenders, vendors, suppliers, and customers. Lenders and suppliers expose themselves to uncollectible loans. Customers risk either never receiving or receiving substandard products and services. Trust among their internal constituents and external cooperators is necessary for corporate efficiency.
Such tactics do not shift stakeholder risk to other bearers, such as insurers, but rather provide a means to offset stakeholder risk by counterbalancing effects on subjective decision-making. These ideas may be formalized in the following simple way:

Let

- $R_e$ be the relational risk of a given corporate concern,
- $R_s$ be the aggregate risk borne by shareholders, and
- $T$ be trust generated by various trust generating mechanisms.

Then

$$R_e = R_s \cdot \frac{1}{T}$$

Thus, of course, corporate relational risk, $R_e$, can be managed by direct mitigation of the risk for the shareholders associated with the interaction, $R_s$, but the effect of remaining shareholder risk can also be attenuated by the promotion of trust, $T$.

Up to this point, this article has argued that the loss of trust associated with the collapse of Enron and other recent corporate debacles is different from previous corporate crises, both in its breadth and magnitude. As such, traditional legal responses and regulatory tightening may not be sufficient to return to long-term market stability. In fact, using well-known models in game theory, this article has demonstrated that focus should be placed on the encouragement of reliance rather than further attempts at monitoring and the prevention of exploitation. The consequences of these insights for the management of relational risk have been explored and a

Id. Ide and Yarn cast a wide net that hints at the generalizability of application that the insights offered by this article may offer, but particular focus is directed here at a particular group of stakeholders—the shareholders.

To be precise, shareholder risk will emanate from various sources, and many means to control such risk will be fraught with various levels of subjective uncertainty. Shareholder risk could therefore be written as an expectancy, $R_s = R_u - \sum C_i P_i$, where $R_u$ is a theoretical baseline risk, $C_i$ are risk reductions associated with particular mechanisms, (warranties, guarantees, audits, etc.), and $P_i$ are levels of confidence or subjective certainty with regard to effectiveness.

Similarly, trust may emanate from various sources and the targets for these trust generating mechanisms will hold varying degrees of confidence in each source. Trust could therefore be written as an expectancy, $T = \sum_{i=1}^{n} P_i$, where $i$ are the theoretical objective trust levels emanating from particular sources, (reputation, interpersonal relationships, PIFF), and $P_i$ are levels of confidence placed in each source.

See supra Part II.

See supra notes 44, 77-78 and accompanying text.

See supra Part IV A-B.
simplifying model that describes two means of accomplishing these tasks has been offered.\textsuperscript{129} This article will now decidedly narrow its focus, leaving behind the methods for direct mitigation of stakeholder risk that constitute typical responses to corporate crisis,\textsuperscript{130} the $R_S$ term in the model just described, and turn its attention to a novel trust generating institution that finds its home in the denominator of the second segment of the model, the $T$ term.

\section*{VI. PUBLIC INDEPENDENT FACT-FINDING AS A TRUST GENERATING INSTITUTION}

Trust and reputation may interact in a manner that allows trust to be placed in an individual, corporate entity, or institution because one "trust[s] the source of the reputation which could either be [another] trusted individual, [another who has engaged the target of the trust], or a trusted institution, [such as] a bar referral service."\textsuperscript{131} That is to say that the source for trust that this article advocates as a component of relational risk management may be trust in the reputation of another individual or institution. This section explores PIFF, one mechanism built around such external sources. Beginning with an overview of fact finding generally, this section then examines the importance of independence and of procedures for the public dissemination of findings. Next, some brief case histories of PIFF in action are presented. This section concludes with a discussion of the importance of institutionalization for the future of PIFF.

A. Fact Finding Generally

Fact finding as an element of dispute resolution is certainly not a new idea.\textsuperscript{132} Indeed, one stock in trade of any legal practice is competent, objective fact finding, even when representation will ultimately be conducted as an advocate. This article, however, focuses on an extrajudicial use of fact finding in which a form of public, self-critical analysis,\textsuperscript{133} conducted by

\begin{footnotesize}
\begin{itemize}
  \item \textsuperscript{129} See supra Part V.
  \item \textsuperscript{130} See supra Part II. and supra note 124 with accompanying text.
  \item \textsuperscript{131} Ide & Yarn, supra note 7, at 1125 ("[W]e trust because . . . our previous experience confirms the object's trustworthiness[] and trust-generating institutions, including those that mediate reputation, reduce the risk of trusting. In the latter case, the object of our trust includes the trust-generating institutions themselves.").
  \item \textsuperscript{132} Fact-finding is a "process of determining the facts relevant to the controversy and, as such, [is] a crucial aspect of most dispute resolution Processes." DICTIONARY OF CONFLICT RESOLUTION 178 (Douglas Yarn ed., 1999).
  \item \textsuperscript{133} Ide & Yarn, supra note 7, at 1141. "Major organizations in severe legitimacy crises sometimes
independent investigators, serves to bolster public trust, mitigate stakeholder risk, and thereby make important contributions to corporate management of reputational and relational risk. The process generally involves retaining a high-profile public figure, often a retired governmental official or a prominent lawyer, who carries out an independent investigation of a controversy, allegation, or other organizational problem and prepares a report that is made publicly available to various stakeholders. The importance of fact finder independence and public dissemination of investigation results cannot be overemphasized.

... engag[e] eminent persons as independent fact finders. We believe this development is a promising trust generating process in the current environment of distrust." Id. Ide and Yarn detail two types of fact-finding: (1) as a form of alternative dispute resolution (ADR), and (2) as a self-critical analysis or internal investigation. They describe fact-finding as a form of ADR as an "ad hoc and voluntary process" where the results of the investigation are "typically for the parties' use only" and are therefore rarely made public. Id. at 1142-1143. Fact-finding as self-critical analysis is employed "unilaterally simply to determine the facts of a situation and to respond to or correct it accordingly. In the private sector, a corporation might unilaterally engage a fact finder to investigate a complaint or problem internal to the organization." Id. at 1144. As Ide and Yarn warn, these self-critical analyses are often conducted internally "by selected board members or committees, internal staff, ombudsmen, general counsel, outside counsel, or accountancies and which is implicitly encouraged by emerging legal trends." Id. at 1144-45, n. 141, 142 (citing Michael P. Kenny & William R. Mitchelson, Corporate Benefits of Properly Conducted Internal Investigations, 11 GA. ST. U. L. REV. 657, 658 (1995))

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B. The Importance of Independence

Clearly, independent fact finding will not assuage concerns that various stakeholders may have about a given crisis, and the objective of mitigating relational risk will not be achieved, unless the investigation is perceived as independent from internal control and other conflicts of interest. There are a number of important implications related to this requirement. The fact finder should be given complete control over the process and broad access to both information and resources. Additionally, obvious conflicts of interest arise when management is afforded the opportunity of selecting the fact finder without some sort of institutional oversight. Even more importantly, "a fact finder cannot be independent if the corporation or any of its constituents are capable of terminating the engagement at any time."\(^{135}\)

C. Public Dissemination

While it is evident that independent findings must be made public in order to instill the trust that is the objective of the PIFF process, this requirement for publicness extends to more than just substantive results. "For PIFF to function successfully as a trust-generating mechanism, both the process and the person conducting it must obtain the public trust."\(^{136}\) For this reason, the independence of the process and the fact finder, in addition to the results of the investigation, must be made publicly clear.\(^{137}\)

D. PIFF in Action

While the use of PIFF as a means of restoring public trust is a growing trend, it is not entirely new and there are a few examples of cases in which corporate management has relied upon PIFF as a means of addressing a crisis.\(^{138}\) Two such cases are briefly considered below.

\(^{134}\) Ide & Yarn, supra note 7, at 1146.
\(^{135}\) Id.
\(^{136}\) Id. at 1153 n.182. "Fair procedures promote trust in the decisionmaker and acceptance of the outcome, not because they achieve a more advantageous outcome, but instead because people evaluate the outcome through a 'fairness heuristic' that judges the outcome based on perceived aspects of procedural fairness in how the decision was reached." Id. (citing E. ALLAN LIND & TOM R. TYLER, THE SOCIAL PSYCHOLOGY OF PROCEDURAL JUSTICE (1988)).
\(^{137}\) Id. at 1153 ("If the public is relying upon the report, all indices of independence must be public and must withstand public scrutiny.").
\(^{138}\) In fact, in the aftermath of the Enron crisis, Arthur Andersen, Enron's auditing firm hired former Senator John Danforth, with the Saint Louis law firm of Bryan Cave, and former Federal Reserve
1. E. F. Hutton

In what may have been the naissance of the use of PIFF during the management of corporate crisis, the Wall Street giant E. F. Hutton hired Atlanta lawyer and former Attorney General Griffin Bell to investigate an internal check-kiting scheme that came to light in the mid 1980s. In an effort to stem the ominous tide of public opinion that threatened the firm’s continued existence, Hutton hoped that Bell would “determine the cause, . . . identify who in the company should be held accountable for the scheme, and . . . recommend [improved] control measures.” The product of the investigation was the so-called “Hutton Report,” which recommended discipline for numerous Hutton employees. Hutton ultimately merged with Shearson and Lehman Brothers.

2. Nike

Another household name, Nike, faced crisis when accusations were lodged against the company related to allegedly exploitative labor practices. In fact, Nike had led its industry in the development of guidelines for labor relations, both internally and among its suppliers, with the creation of the Nike Code of Conduct. Nonetheless, “reports of sweatshop conditions


and substandard wages precipitated a corporate social legitimacy crisis." Nike hired former U.N. ambassador Andrew Young to conduct an independent investigation of the allegations. Young's very public report made recommendations for enhancement and more effective application of the Code of Conduct—recommendations that contributed, according to some, to the dissipation of the crisis.

E. Institutionalization

As the high profile cases and the associated high profile investigators considered above illustrate, it is critical to the success of PIFF that corporations that employ the tactic are perceived as genuinely concerned about getting to the truth rather than as merely trying to bask in the glow of the halos associated with famous public figures. As this article has previously argued, a high level of transparency, with regards to both fact finders and process is required in order to achieve the public perceptions of independence and publicness required in order for PIFF to generate trust. One approach that has been proposed to accomplish this transparency is an

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146 Ide & Yarn, supra note 7, at 1149.
148 See Andrew Young, Andrew Young's Report, at http://www.calbaptist.edu/dskubik/young.htm (last visited Nov. 12, 2004).
149 Ide & Yarn, supra note 7, at 1151. ("Young's PIFF cannot be credited directly for Nike's continued success—however, in spite of some criticism of Young's efforts, accusations of exploitive labor practices have largely dissipated."). But see Tina Cassidy, Can't Just Do It Anymore; Nike's Recent Success Turns Spotlight on Firm—For Better or Worse, BOSTON GLOBE, Jun. 28, 1997, at F1 (quoting human rights group Global Exchange's president as saying that Nike "bought off Andrew Young.").
150 Ide & Yarn, supra note 7, at 1154-55. Ide and Yarn also warn that "corporations that abuse the process and public figures who merely sell their reputation to 'whitewash' socially irresponsible corporations" may undermine the promise of the PIFF process. Id. at 1154 (citing Dana Canedy, Checking What's Under Nike's Heel, N.Y. TIMES, Mar. 25, 1997, at D1; Liza Kaufman, Credibility for Hire? Griffin Bell, Tapped for Implant Probe, Draws Fire, LEGAL TIMES, Feb. 24, 1992, at 1; Blessed by Paul: Paul Volcker and Other Corporate Cleanup Men, SLATE, Feb. 4, 2002 (noting that Arthur Andersen hired former Federal Reserve Board Chairman, Paul Volcker, Jr., to monitor the company's accounting practices, and quoting Volcker as saying, "The reason I got involved is that Andersen is in big trouble and they were looking for someone to sprinkle holy water on them."); at http://slate.msn.com/?id=2061633 (last visited Dec. 19, 2003); David Plotz, Former Sen. John Danforth: Why is "St. Jack" Helping Arthur Andersen?, SLATE, Jan. 18, 2002 (describing the engagement as one in which "Andersen basks in the reflected glory of St. Jack" and asserting that "Andersen approached Danforth because they know he will give the company a nice scrubbing. Andersen wants Danforth to make dozens of recommendations for document handling, and then to walk away, leaving the world with the impression that St. Jack has given Andersen a gold stamp.").
151 See supra Part VI.B.-C.
institutionalization of standard procedures and best practices that would make PIFF less vulnerable to the variation that individual fact finders bring to the process. Institutions may advance trust relationships. Consideration of how such an approach may be pursued is well informed by a study of the PIFF institutionalization efforts of one well-known provider of alternative dispute resolution services—the American Arbitration Association (AAA).

VII. AAA INDEPENDENT FACT FINDING

The AAA is a very large, diversified provider of dispute resolution services with over 800 employees, 35 offices, and more than 8,000 arbitrators and mediators worldwide. With more than 75 years of history in the field, the AAA has administered more than 2 million cases. In response to the epidemic of corporate crises witnessed in the early part of the new century, the AAA announced in 2002 "an entirely new service—AAA Independent Fact-Finding Services (IFFS)—that [would] provide [ ] an impartial, objective investigation in emerging crisis situations." The AAA sought to leverage its reputation for integrity and impartiality to address the very need for new trust generating mechanisms that has been described in this article. The

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152 Institutionalization refers to "the extent to which there are well-known, regularized, readily available mechanisms, techniques or procedures for dealing with a problem." Richard E. Miller & Austin Sarat, Grievances, Claims, and Disputes: Assessing the Adversary Culture, 15 L. & SOCY REV. 525, 563 (1980-81); Ide & Yam, supra note 7, at 1156.

It includes, but is not limited to, the following: policies, laws, procedures, and practices embedded in social and organizational systems and culture of society to integrate conflict prevention and resolution in an organization, the process by which conflict prevention and resolution become part of the organizational identity, and absorption, adoption, or melding of conflict prevention or resolution activities into an organization or policy.

Id. at 1156 n.189.


156 See supra note 18 and accompanying text.


158 Promotional Brochure from American Arbitration Association, AAA Draft Promotional Brochure (on file with author) [hereinafter AAA Promotional Brochure].

159 Id.
AAA hoped that this reputation, together with uniform standards and a panel of high profile public figures, would help to counter the "growing public perception that traditional responses to a developing crisis—investigation by internal resources or existing outside counsel—[lacked] the objectivity essential to credibility."  

Overall, the AAA did an excellent job of designing IFFS policies and procedures to address the fundamental requirements of independence and publicness that are so critical for PIFF to be successful in generating public trust. To ensure independence, a prospective client is required to make the initial contact with the AAA rather than any candidate fact finder. The AAA independently vets a list of potential fact finders, ensuring that conflicts of interest will not threaten the independence of the process. Only then does the client have the opportunity to select an acceptable fact finder from a list of three candidates. The fact finder maintains complete control over the investigation, but must limit their activities to those congruent with independence. The role of advocate is explicitly forbidden. Should a client attempt to discontinue an IFFS engagement prematurely or in some other way obstruct the fact finder's efforts, the fact finder is contractually permitted to terminate the engagement and make publicly available a report describing why such termination was necessary. Finally, the IFFS policies and procedures meet each of the requirements for publicness. Policies, procedural guidelines, and rosters of fact finders are, or will be, all publicly available in their entirety on the AAA website and in promotional materials. Results and conclusions of investigations "must be disclosed to an

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Operating under the Association's [AAA] imprimatur of integrity and impartiality, AAA Independent Fact-Finding Services offer a unique degree of credibility. Fact-finders are drawn from a prominent panel of nationally recognized and experienced lawyers. Their mission is not one of advocacy, but of independent investigation conducted according to the highest ethical standards. Their report or conclusion—because of their arms-length independence—can be a major factor in preserving public trust and confidence during a potential crisis.

*Id.*

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161 See *supra* Part VI.B.
162 See *supra* VI.C.
163 AMERICAN ARBITRATION ASSOCIATION, AAA IFFS POLICIES AND PROCEDURES 2.1, 2.3 (May 30, 2002) [hereinafter IFFS POLICIES & PROCEDURES] (draft on file with author).
164 *Id.* at 2.1, 5.2.
165 *Id.* at 5.
166 *Id.* at 7.3 ("The Fact-Finder shall not act as an advocate for the Client but shall instead conduct an independent investigation and shall control all aspects of the investigation.").
167 *Id.*
168 *Id.* at 8.1-8.4.
169 See *supra* note 136 and accompanying text.
independent committee of the board of directors or trustees, the public, a court, or some other appropriate independent body approved by the AAA.  

The AAA's IFFS is still taking shape and has yet to become what would be considered a going concern. Institutionalization can be a slow process. Whether the AAA's offerings will be accepted by the public and by corporations seeking to restore public trust remains to be seen.

VIII. CONCLUSIONS

Trust, or the decision to make oneself vulnerable based on positive expectations of the intentions of others in order to achieve long-term joint benefit, has been a factor in human interaction for many thousands of years. In fact, this is supported by the existence of a brain that, as a product of evolution, has developed a finely tuned capacity to recognize human faces and employ a framework of mental accounting that allows humans to trust some individuals and distrust others in highly context sensitive circumstances.

This article has proposed a way that corporate concerns may capitalize on this feature of human nature to make their organizations more viable and their social exchanges more efficient. By making themselves more vulnerable, corporations can reduce the risk for investors and other stakeholders to interact with the corporation, thereby mitigating the corporation's reputational or relational risk. The need for new trust generating mechanisms has arisen from a profound loss of trust characterized by a rash of corporate crises, exemplified by the Enron debacle, that have brought into question the viability of the safeguards that have long been thought of as adequate protection for shareholder interests. As Alan Greenspan testified,
“[l]awyers, internal and external auditors, corporate boards, Wall Street security analysts, rating agencies, and large institutional holders of stock all failed for one reason or another to detect and blow the whistle on those who breached the level of trust essential to well-functioning markets.” These stunning failures “[have] caused a profound loss of trust by investors, financial institutions and the general public . . .”

Furthermore, traditional legal responses to corporate crises may be incapable of addressing the problem. New laws and regulations may have the unexpected effect of “diluting the practical importance of corporate codes by increasing the costs and risks of self-policing.” It can, in fact, be perilous to believe that any amount of new regulation will have the effect of preventing corruption. This article has proposed a typology with some alternatives to purely deterrence-based forms of trust. Trust of these different types can help to optimize market organization, reduce transaction costs, and promote social welfare.

This article has demonstrated that trust and risk are inextricably intertwined; that, in fact, trust is only necessary in the presence of risk. Employing game theoretic models of trust relationships, this article has shown that response to the loss in trust should focus not on the prevention of further exploitation, as traditional responses do, but rather on the promotion of stakeholder reliance. Drawing attention to trust generating mechanisms, such as relational risk management alternatives to direct mitigation, this article has presented a simplified model that formalizes some of the ideas that have motivated this research.

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175 See supra note 82.
176 BIXBY, supra note 13, at 2 (emphasis added).
177 See supra Part III.B.
179 Id. Laws can become counterproductive because “when [companies are] over-regulated, [they] begin to gear the system to comply with the regulations in such a way that [they are] adhering to the letter of the law but the actual spirit of it has totally evaporated.” Id. (citing Jeffrey L. Seglin, Will More Rules Yield Better Corporate Behavior?, N.Y. TIMES, Nov. 17, 2002, § 3, at 4 (quoting comments of Jeffrey E. Garten, Dean of the Yale School of Management)).
180 See supra Part III. The alternatives include calculus-based, relational-based, and institutional-based trust.
181 See supra note 84 and accompanying text.
182 See supra Part IV.
183 See supra note 100 and accompanying text.
184 See supra notes 110, 114, and accompanying text.
185 See supra Part V.
Finally, this article has examined PIFF as a means for generating public trust, promoting stakeholder reliance, and managing relational risk. PIFF avoids the sanction-like characteristics of deterrent-based measures while offering information from reputable third parties that informs the subjective probabilities of the calculus-based typology and signaling the restoration of good faith that can maintain relational trust, even in the face of a breach. Early attempts at institutionalization, such as the AAA's IFFS, are designed to be supportive of calculus-based and relational trust rather than as another control that would function merely as a deterrent.

Critics may object that information technology has fundamentally changed the dynamics of economic exchange in such a manner as to reduce the importance of trust. These arguments have been rejected on empirical grounds. In fact, in a world characterized by increasing ease of interaction, but interaction among strangers, trust may be even more important. Even with the rise of contractual relationships, legal and regulatory responses have been overwhelmed by the sheer magnitude of

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186 See supra Part VI.
187 See supra notes 56, 57, and accompanying text.
188 See supra notes 59-62 and accompanying text.
189 See supra notes 66-67, and accompanying text.
190 See supra Part VII.
191 See Galston, supra note 1, at 131.
192 Id.
193 For an attribution of changing trust dynamics to modernity, see Seligman, supra note 47, at 621-22:

Traditional societies organized around kinship bonds were societies with very high levels of prediction, hence high levels of confidence based on a combination of familiarity and sanctions. The system of obligations, responsibilities and mutuality is clear and visible and hence confidence in behavior is remarkably high. Modernity, if not urbanity is of course precisely the opposite of this. It is life among strangers, among those one does not know and those who do not know you. Unable to assume familiarity and rooted in a "system" of much greater cognitive liability than one based on kinship we nevertheless enter into myriad of interactions with others on the basis of something akin to trust.

Id.
economic exchange, and trust has remained largely a product of voluntary association.

We would do well to be reminded that "every economic activity is also a social activity." In the end, it all comes down to people. As Representative Jackson-Lee reminded her colleagues in 2002, "the insistence on corporate ethics does not diminish the importance of the ethics of individuals and institutions." It could be that markets of self-interested individuals may be more effective than increased regulation at turning the tide of corporate governance and managerial ethics. Trust begets the

194 See also Elias L. Khalil, Trust, in THE ELGAR COMPANION TO INSTITUTIONAL AND EVOLUTIONARY ECONOMICS 340 (Geoffrey M. Hodgson et al. eds., 1994).

First, as economic exchange becomes less intermingled with kinship and more based on formal contractual relationships, the monitoring conducted by the kin members and the threat of ostracism almost vanish. Second, the modern judicial system, which replaces the threat system of ostracism and shunning, cannot practically monitor the extensive growth of contractual agreements—even the explicit ones.

195 See Galston, supra note 1, at 130.

Trust . . . rests on a set of ethical habits and reciprocal moral obligations internalized by members of a community. It is the expectation that arises within that community of regular and honest behavior based on shared norms, such as truth-telling, good intentions, reciprocity, and competence. The seedbeds of these virtues are neither economic nor political institutions but, rather, the voluntary associations of civil society, starting with (but extending beyond) the family.

196 Quddus, supra note 3, at 95.

197 See The Good, the Bad, supra note 11, at 2123 ("[A] corporate code of behavior is only as good as the directors and officers responsible for implementing it.").

198 148 Cong. Rec. H5472-73 (daily ed. July 25, 2002). Rep. Jackson-Lee continued, "It has become common practice for corporations to prepare an ethics code for the guidance of their officers and employees. However, one corporate C.E.O. has argued that this is simply an empty gesture . . . 'those corporations with a sound moral base do not need it and for the others it is just a fig leaf.'" Id.

199 Wallison, supra note 24 ("The decentralized, somewhat chaotic US financial markets have a self-correcting element that is powerful, pervasive and generally underestimated.").


Mr. Lay had always described himself as "passionate about markets". That fervent belief in the invisible hand led him to spot one of the most powerful trends of the past decade: the deregulation of commodity markets. He would often forge ahead fearlessly into newly deregulating markets, bully recalcitrant regulators into speeding reforms and develop clever financial vehicles that pressed to the very edge of the law. In the end, though, Enron appears to have overstepped the mark. The resultant backlash comes as a bitter reminder that the market forces that Mr. Lay once worshipped can prove a double-edged sword.

Id., http://www.economist.com/business/PrinterFriendly.cfm?Story_ID=896844
willingness to take risks that drives the markets forward. PIFF provides a way of generating this trust, relying upon a market for reputation rather than more of the legal and regulatory interventions that have once again been proven ineffective. Adam Smith would be proud.

See BERNSTEIN, supra note 3, at 8. The word "risk" derives from the early Italian riscare, which means "to dare." In this sense, risk is a choice rather than a fate. The actions we dare to take, which depend on how free we are to make choices, are what the story of risk is all about. And that story helps define what it means to be a human being.

Id.