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TRUST, TRUSTWORTHINESS, AND THE BEHAVIORAL FOUNDATIONS OF CORPORATE LAW

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Conventional legal and economic analysis assumes that opportunistic behavior is discouraged and that cooperation is encouraged within firms primarily through the use of legal and market incentives. This presumption is embedded in the modern view that the corporation is best described as a "nexus of contracts," a collection of explicit and implicit agreements voluntarily negotiated among the rationally selfish parties who join in the corporate enterprise. In this Article we take a different approach. We start from the observation that, in many circumstances, legal and market sanctions provide, at best, imperfect means of regulating behavior within the firm. We consider an alternate hypothesis: that corporate participants often cooperate with each other not because of external constraints but because of internal ones. In particular, we argue that the behavioral phenomena of internalized trust and trustworthiness play important roles in encouraging cooperation within firms.

In support of this claim, we survey the extensive experimental evidence that has been produced over the past four decades on human behavior in "social dilemmas." This evidence demonstrates that internalized trust is a common phenomenon, that it is at least in part learned rather than innate, and that different individuals vary in their inclinations toward trust. Most importantly, the experimental evidence indicates that decisions whether or not to trust others are in large part determined by social context rather than external payoffs. By altering social context—subjects' perceptions of others' beliefs, expectations, likely actions,

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and relationships to themselves—experimenters can reliably produce in subjects in social dilemmas everything from nearly universal trust to an almost complete absence of trust. In other words, most people behave as if they have two personalities or preference functions. One is competitive and self-regarding. The other is cooperative and other-regarding. Social framing is key in triggering when the cooperative personality emerges.

These behavioral findings carry important implications for corporate law. For example, in this Article we demonstrate first that the phenomenon of trust offers insight into the substantive structure of corporate law and particularly into the nature and purpose of that elusive legal concept, fiduciary duty. Second, the experimental evidence on trust sheds light on how corporate law works, by suggesting that judicial opinions in corporate cases influence corporate officers' and directors' behavior not only by altering their external incentives but also by changing their internalized preferences. This possibility helps explain the notoriously puzzling relationship between the duty of care and the business judgment rule. Third, trust highlights the limits of law by explaining how cooperative patterns of behavior can sometimes develop within firms even when external incentives, such as legal sanctions, are unavailable or ineffective. In the process, it underscores the dangers of the contractarian approach by suggesting that an excessive emphasis on external sanctions—including formal contract and even the rhetoric of contract—may be not only ineffective but counterproductive, serving to undermine trust and trustworthiness within the firm.

INTRODUCTION

A corporation is a collective enterprise. Shareholders and creditors provide financial capital, while managers and employees offer up expertise, loyalty, and long hours. In making these contributions, individuals who participate in corporations often expose themselves to great risk of loss from other participants' failures or misbehavior.[1] Yet investments are made, companies are built, and value is created from complex joint production.

How is this done? Contemporary legal scholarship generally assumes that shareholders, creditors, managers, and employees cooperate with each other because the market and the law give them incentives to do so. In accord with conventional economic analysis, these parties are presumed to be rational actors concerned only with maximizing their own gains. Thus the primary factors thought to discourage corporate participants from stealing, shirking their duties, or otherwise mistreating each other are market incentives and legal rules, including contract rules. These assumptions are embedded in the modern view that the corporation is best understood as a "nexus of contracts," a collection of express and implied agreements voluntarily negotiated among the rationally selfish actors who join in the corporate enterprise.[2]

In this Article we take a different approach. Although we do not abandon economic analysis, we revisit one of its basic assumptions—the assumption that people always behave in a rationally selfish fashion.[3] We posit that corporate participants cooperate with each

[1] Shareholders and creditors obviously can lose their money. However, managers and employees may also place themselves at risk if they invest in firm-specific skills and knowledge or if they rely on implicit promises of future compensation or job security. The risk of loss due to other participants' misbehavior is separate from and in addition to ordinary business risks and risk of "bad luck."

[2] *See* Melvin A. Eisenberg, *The Conception That the Corporation Is a Nexus of Contracts, and the Dual Nature of the Firm*, 24 J. CORP. L. 819, 819 (1998) ("[T]he conception that the corporation is a nexus of contracts . . . has dominated the law-and-economics literature in corporate law."). Contractarian thinking so preoccupies modern corporate scholarship that it is routinely discussed not only in introductory corporate law casebooks, *see, e.g.*, LEWIS D. SOLOMON ET AL., CORPORATIONS: LAW AND POLICY 517-33 (4th ed. 1998), but also in popular study aids, *see, e.g.*, ROBERT W. HAMILTON, THE LAW OF CORPORATIONS IN A NUTSHELL 52-62 (5th ed. 2000).

[3] *See* Robyn M. Dawes & Richard H. Thaler, *Anomalies: Cooperation*, J. ECON. PERSP., Summer 1988, at 187, 187 ("Much economic analysis—and virtually all game theory—starts with the assumption that people are both rational and selfish."). In questioning the wisdom of this assumption in the context of corporate law, we join the growing ranks of scholars who have argued that the conventional "law and economics" approach should be modified to incorporate behavioral phenomena. *See, e.g.*, Robert C.

other not just because of external constraints, but because of internal ones. In particular, we argue that the behavioral phenomena of internalized *trust* and *trustworthiness* play important roles in discouraging opportunistic behavior among corporate participants. (Because these two behaviors are so closely linked, we sometimes refer to the combination as "trust behavior," or simply "trust.")[4]

We contend that people often trust, and often behave trustworthily, to a far greater degree than can possibly be explained by legal or market incentives. Although this picture of internalized trust conflicts with the neoclassical portrait of *homo economicus* as a hyperrational, purely self-interested actor, it is supported not only by casual observation but by an overwhelming amount of empirical evidence. Decades of experimental work on human behavior in "social dilemmas" establishes that trust is a reality.[5] This work also demonstrates that people do not trust randomly. To the contrary, a variety of factors have been identified that predictably elicit greater or lesser degrees of trust. One of the most important is *social context*—individuals' perceptions of *others'* motivations, beliefs, likely behaviors, and relationships to themselves. By manipulating social context, experimenters can reliably produce everything from nearly universal trust to an almost complete

Ellickson, *Bringing Culture and Human Frailty to Rational Actors: A Critique of Classical Law and Economics*, 65 CHI.-KENT L. REV. 23, 23 (1989) (proposing that the law and economics movement "should increasingly look to psychology and sociology"); Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: The Problem of Market Manipulation*, 74 N.Y.U. L. REV. 630, 630 (1999) ("In recent years, legal scholars dissatisfied with the behavioral assumptions of the rational actor model have increasingly turned to the findings of cognitive psychologists and decision theorists to enhance the accuracy of efficiency analysis."); Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1471 (1998) (offering "a broad vision of how law and economics analysis may be improved by increased attention to insights about actual human behavior"). For a general discussion, including a bibliography on behavioral decisionmaking research, see Donald C. Langevoort, *Behavioral Theories of Judgment and Decision Making in Legal Scholarship: A Literature Review*, 51 VAND. L. REV. 1499 (1998). *But see* Jennifer Arlen et al., Endowment Effects, Other-Regarding Preferences, and Corporate Law 2 (Apr. 21, 2000) (unpublished manuscript, on file with authors) (noting that while some scholars have begun to apply a behavioral approach, "corporate law... has traditionally served as an intellectual bastion of economic conventionalism").

[4] Trust and trustworthiness are linked in a number of ways. *See infra* note 19 and accompanying text (defining trust as depending on the expectation of trustworthiness); *infra* notes 68-71 and accompanying text (discussing empirical findings that trustworthy people are more likely to trust others); *infra* text accompanying note 74 (discussing findings that when trusting behavior is not responded to with trustworthiness, it tends to disappear).

[5] *See infra* notes 53-61 and accompanying text (discussing empirical literature on trust).

absence of trust among subjects in social dilemmas.

These behavioral findings have enormous importance for a wide range of social and legal relationships and institutions in which cooperative, other-regarding behavior is of value. Examples include marriages, nonprofit firms, "relational" contracts, even the community as a whole.[6] In this Article, however, we focus on one particular institution in which we believe trust plays an especially critical role—the business corporation.

We believe that an understanding of the role of trust and of the variables that encourage or discourage it is essential for understanding both the business world and much of corporate law. Focusing on the role of trust sheds light on a number of debates and difficulties in corporate scholarship. Examples include the nature of corporate fiduciary duties, the ways in which corporate case law constrains and directs behavior, and the puzzling persistence of cooperative patterns of behavior in firms in circumstances in which legal and market sanctions are ineffective or unavailable. Accordingly, we suggest there is tremendous value to be added by incorporating the phenomenon of trust into legal scholarship. There is also danger in failing to do so—danger not only for academics but for lawmakers, practicing lawyers, and businessfolk. This is because one of the most important lessons of trust is that cooperation is not always best promoted by promising rewards and threatening punishments. To the contrary, attempts to employ external incentives can often reduce levels of trust and trustworthiness within the firm by eroding corporate participants' *internal* motivations.

We begin our analysis in Part I by defining what we mean by "trust" and "trustworthiness." We describe trust as a willingness to

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[6] *See* Eric A. Posner, *Altrusim, Status, and Trust in the Law of Gifts and Gratuitous Promises*, 1997 WIS. L. REV. 567, 578 ("It has been increasingly recognized by academics that some nonlegal mechanism such as trust must account for long-term or 'relational' contracts.... Examples include the relationships among family members, long-term supply contracts ... and, in one view, the nonprofit corporate form ...."); Carol M. Rose, *Trust in the Mirror of Betrayal*, 75 B.U. L. REV. 531, 534 (1995) ("First, pure rationality argues against trust. Second, people trust each other anyway. Third, it is very important that they do so, because without trust, we could not undertake any cooperative ventures, from the most trivial to the most cosmic."); *see also, e.g.*, MILTON C. REGAN, JR., ALONE TOGETHER: LAW AND THE MEANINGS OF MARRIAGE 22-29 (1999) (arguing that marriage often requires spouses to adopt an "internal stance" in which they internalize each others' welfare); Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 875-76 (1980) (discussing the importance of normative constraints and preferences for serving others in nonprofit organizations); *infra* note 38 (citing authorities on the importance of trust and "social capital" to communities).

make oneself vulnerable to another, based on the belief that the trusted person will choose not to exploit one's vulnerability (that is, will behave trustworthily). We then develop the idea of trustworthiness as an unwillingness to exploit a trusting person's vulnerability even when external rewards favor doing so. Our focus is on the importance of internal factors—tastes, preferences, intrinsic character—in producing trustworthiness that in turn encourages trust in others.

We then turn to the question of why trust and trustworthiness may have special importance in business institutions. It is widely recognized that one of the most pressing economic problems associated with doing business in the corporate form is the "agency cost" problem of encouraging managers, employees, and other corporate agents faithfully to serve the firm's interests rather than their own. We have also recently argued elsewhere that a second key economic problem in corporations is the "team production" problem of encouraging corporate participants to make mutual investments that expose them to each other's opportunism.[7] Market incentives and legal sanctions can reduce agency costs and foster team production to some extent. But markets and law work best when the situation is transparent and opportunistic behavior can be detected and punished. *Trust can work even when the situation is opaque.* As a result, business firms that cultivate and support trust can enjoy a competitive advantage over those that do not. This reality is well-recognized among management theorists and business consultants, who have produced an extensive literature on the importance of creating and maintaining trust within and between business organizations.[8] The centrality of trust to business firms has been overlooked, however, by contractarian corporate scholars who emphasize market incentives, enforceable contracts, and other external constraints on opportunism within firms.

Why is this so? Part of the answer may lie in the observation that

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[7] Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 U. VA. L. REV. 247 (1999) [hereinafter Blair & Stout, *A Team Production Theory*]; Margaret M. Blair & Lynn A. Stout, *Team Production in Business Organizations: An Introduction*, 24 J. CORP. L. 743, 745 (1999) [hereinafter Blair & Stout, *Team Production in Business Organizations*] (describing the "team production" problem). *See generally* Symposium, *Team Production in Business Organizations*, 24 J. CORP. L. 743 (1999).

[8] *See, e.g.*, JORDAN D. LEWIS, TRUSTED PARTNERS: HOW COMPANIES BUILD MUTUAL TRUST AND WIN TOGETHER (1999); TRUST WITHIN AND BETWEEN ORGANIZATIONS (Christel Lane & Reinhard Bachmann eds., 1998); Aneil K. Mishra, *Organizational Responses to Crisis: The Centrality of Trust*, *in* TRUST IN ORGANIZATIONS: FRONTIERS OF THEORY AND RESEARCH 261-87 (Roderick M. Kramer & Tom R. Tyler eds., 1996); *Special Topic Forum on Trust in and Between Organizations*, 23 ACAD. MGMT. REV. 384 (1998); sources cited *infra* note 49.

trust behavior in business firms often occurs in circumstances in which cooperation is consistent with, rather than contrary to, external legal and market incentives.[9] When a manager refrains from stealing, she may do this because she is intrinsically trustworthy, but she may also do it because she is afraid of being fired or ending up in jail. As a result, it can be tempting to assume that external incentives *cause* all the cooperative, coordinated behavior we observe. Legal scholars may be particularly prone to jump to this conclusion. Legal analysis focuses on case law, and case law usually involves situations in which trust and cooperation have broken down and the parties seek to invoke legal sanctions. Hence, it may be especially easy for legal scholars to assume that it is the threat of the law that reins in misbehavior in *all* situations.

We demonstrate in Part II that such an assumption is mistaken. We do this by reviewing the extensive empirical evidence that has been developed on trust, focusing particularly on experimental studies of behavior in "social dilemmas." Social scientists use the phrase "social dilemma" to refer to situations that present incentives resembling those in the more familiar "prisoner's dilemma" game, such that cooperating is the worst strategy for the individual but the best for the group as a whole. Experimental evidence of behavior in social dilemma games is highly relevant to trust for two reasons. First, the optimal outcome requires the players both to trust (to make themselves vulnerable by cooperating) and to be trustworthy (to refrain from "defecting" and exploiting the vulnerability of the other players). Second—and in marked contrast to the business world, where trust behavior often is consistent with external incentives—a social dilemma experiment can be structured to eliminate any possibility of external incentive for cooperation. Social dilemma experiments thus isolate and highlight the pervasive and powerful effects of internalized trust.

What do social dilemma experiments teach us? Over the past four decades, experimenters have conducted hundreds of these studies. Five interesting and consistent results have emerged from these efforts. First, social dilemma experiments irrefutably demonstrate that human beings do not behave in the strictly individualistic and self-interested way that economic theory often implies they do. Rather, they behave as if they sometimes have a preference or "taste" for cooperative, other-regarding behavior generally and for trusting and

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[9] *See infra* text accompanying note 98 (discussing how reducing the cost associated with trustworthy behavior increases the incidence of trust).

trustworthy behavior specifically.[10] Second, the evidence suggests that different individuals vary in their willingness to trust and to be trustworthy in new situations. Thirdly, these differences seem due at least in part to differences in experience, hinting that trust may be a learned behavior.

But even among those inclined toward trust, their inclination is not absolute. A fourth fundamental finding of the social dilemma studies is that trust is *socially contingent.* Individuals in social dilemmas decide to cooperate or defect not primarily by calculating their individual payoffs but instead by looking at and trying to decipher *others'* beliefs, likely behaviors, and social relationships with themselves. For example, experimenters have found that cooperation in social dilemmas is dramatically enhanced when the experimenter states (or even hints) that the players ought to cooperate, when the players share a sense of group identity, and when the players expect their fellows to behave cooperatively. These are striking findings because such social variables do not change the economic structure of the game. Defecting remains the optimal strategy for the self-interested player.

The observation that social context plays a critical role in determining whether individuals trust or distrust should not be taken to imply, however, that economic variables are irrelevant. A fifth significant finding of social dilemma experiments is that, even while people cooperate far more than the *homo economicus* model would predict, trust behavior does respond to economic incentives. In particular, as the personal cost of choosing cooperation over defection rises for individual players, the likelihood of cooperation decreases. Although most people are willing to behave in an other-regarding fashion when the social context is right and the personal sacrifice involved is relatively small, as the cost of trust rises, trust tends to disappear.

Taken as a whole, the experimental evidence consequently indicates that *most people behave as if they have two personalities or preference functions.*[11] In some social contexts they are competitive and behave

[10] Trust behavior is other-regarding, *see infra* note 11; *infra* text accompanying notes 29-30. However, it is not the only possible kind of other-regarding behavior. *See* Anthony M. Yezer et al., *Does Studying Economics Discourage Competition? Watch What We Do, Not What We Say or How We Play,* J. ECON. PERSP., Summer 1996, at 177, 180-86 (discussing "lost letter" experiments that test altruism not involving trustful reliance); *infra* note 30 (discussing vengefulness). We focus on trust here because of its special importance in business firms.

[11] In this Article we take a behavioral approach to trust. In other words, we do not offer a cognitive theory of the motives underlying trust, but rather rely on experimental evidence to identify the social and economic variables that increase the likelihood

selfishly. But when the social conditions are right, their cooperative, other-regarding personalities emerge. Social "framing," tempered by considerations of personal costs, plays a critical role in determining whether or not individuals choose to trust and be trustworthy.

In Part III, we consider how the insights developed in Parts I and II shed light on three enduring puzzles in corporate scholarship. The first is the nature and meaning of the concept of fiduciary duty. We argue that the phenomenon of trust aids our understanding of the elusive idea of fiduciary obligation because it suggests that the essence of a fiduciary relationship is the legal expectation that the fiduciary will adopt the other-regarding preference function that is the hallmark of trustworthy behavior. Moreover, the law encourages fiduciaries to do this not only or even primarily by threatening punishment but by framing the relationship between the fiduciary and her beneficiary as one that calls for a psychological commitment to trustworthy, other-regarding behavior. This approach offers important insights into the bitter and ongoing debate between "contractarian" and "anticontractarian" corporate scholars over whether officers' and directors' fiduciary duties ought to be thought of as just another set of negotiable provisions in the nexus of contracts that supposedly makes up the firm.[12] In particular, it supports the anticontractarian position that allowing corporate fiduciaries to "opt out" of their loyalty duties would undermine the principal function of the fiduciary concept—to trigger trust behavior by signaling that the social context calls for trust.

We then turn to a second mystery of corporate law—the puzzling relationship between the corporate director's duty of care and the business judgment rule.[13] Case law supposedly requires directors to

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of trust behavior. If one assumes, as economists generally do, that behavior reflects tastes and "revealed preferences," the evidence suggests that most people shift readily from a self-centered, *I*-oriented preference function that considers only their own payoffs, to an other-regarding, *we*-oriented preference function that incorporates concern for others' welfare.

[12] The literature addressing the "opt out" debate is too vast to cite in its entirety here. Classic contributions include: Lucian Arye Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820 (1989); Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985); Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1 (1990); John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618 (1989); Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989); Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549 (1989); *see also* sources cited *infra* notes 115, 117, 137, 143.

[13] The relationship between the duty of care and the business judgment rule is one of the thorniest problems in contemporary corporate law. *See* ROBERT C. CLARK,

exercise due care. This requirement, however, is rarely enforced. While judges frequently moralize about the importance of care, the business judgement rule and a variety of other doctrines and arrangements ensure that careless directors are largely immune from any realistic threat of monetary liability. If one views directors as purely self-interested actors, this inevitably raises the question of why directors of publicly held corporations (who are often significantly insulated from shareholders'—or anyone's—control) should be expected to exercise due care. The phenomenon of trust offers an answer. By articulating a social expectation that directors will exercise due care, judicial opinions on the duty of care may influence directors' behavior not so much by changing their external incentives as by changing their internal *preferences*.[14] This approach explains the schizophrenic quality of modern case law on the duty of care, which generally exhorts directors to meet a high standard of behavior while simultaneously declining to impose liability for failing to meet that standard.

Finally, we consider how trust highlights the potentially limited importance of law in promoting cooperation in firms. To illustrate, we consider the case of the closely held corporation. It is widely recognized that participants in closely held corporations face a high risk

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CORPORATE LAW 124 (1986) ("Is the duty of care simply gobbledygook?"); Stuart R. Cohn, *Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule*, 62 TEX. L. REV. 591 (1983) (criticizing the business judgment rule); Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437 (1993) [hereinafter Eisenberg, *Divergence*] (discussing the divergence between the standard of due care and the business judgment rule); Daniel R. Fischel, *The Business Judgment Rule and the* Trans Union *Case*, 40 BUS. LAW. 1437, 1438 (1985) (criticizing case law on the business judgment rule as lacking "a coherent theory"); Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*, 67 S. CAL. L. REV. 287, 288-89 (1994) (arguing that the business judgment rule is "either meaningless . . . or misguided"); Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1478 (1984) (arguing that judicial formulation of the duty of care "is both out of contact with reality and is analytically unsound"); Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1010-11 (1997) (discussing the divergence between the standard of due care and the business judgment rule).

[14] Outside the corporate context, a number of scholars have argued that law can perform such an "expressive" or "preference-shaping" function. *See, e.g.*, Robert Cooter, *Expressive Law and Economics*, 27 J. LEGAL STUD. 585 (1998); Kenneth G. Dau-Schmidt, *An Economic Analysis of the Criminal Law as a Preference-Shaping Policy*, 1990 DUKE L.J. 1; Dan M. Kahan, *What Do Alternative Sanctions Mean?*, 63 U. CHI. L. REV. 591 (1996); Lawrence Lessig, *The Regulation of Social Meaning*, 62 U. CHI. L. REV. 943 (1995); Cass R. Sunstein, *On the Expressive Function of Law*, 144 U. PA. L. REV. 2021 (1996). Our analysis contributes to this literature by providing insight into the underlying behavioral mechanism.

of loss from their fellow participants' opportunism and that legal and market incentives provide imperfect solutions to such mutual vulnerability.[15] We explore how other forces can supplement the market and legal rules as means of deterring misbehavior in closely held firms. In particular, we consider how processes of self selection and partner selection may favor the participation of high-trust individuals in closely held firms while working to exclude those who are less likely to trust and be trustworthy. This approach suggests how cooperative relationships can develop and thrive in the absence of law or markets. It also illustrates how using legal rules, including contract, to discourage opportunistic behavior can, in some situations, be not only unnecessary but counterproductive, increasing the likelihood of the very sort of misbehavior against which it was intended to protect.

We conclude in Part IV that the time has come to incorporate the reality of trust behavior into the analysis of corporations and corporate law. One of the most important lessons of the experimental evidence on trust behavior is that trust often depends on social context. Case law, statutes, lawyers' memoranda, and even scholars' writings are part of that context. When lawmakers, scholars, and practicing attorneys fail to take account of trust, they may not only fail to understand behavior within the firm—they may distort it.

I. THE IDEA AND EFFICIENCY OF TRUST

Scholars sometimes use the term "trust" in different ways to mean different things.[16] In this Article, we use the word "trust" to describe behavior with the three following characteristics. First, trust involves

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[15] *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271 (1986) [hereinafter Easterbrook & Fischel, *Close Corporations*]; Paul G. Mahoney, *Trust and Opportunism in Close Corporations, in* CONCENTRATED CORPORATE OWNERSHIP (Randall K. Morck ed., 2000); Lawrence E. Mitchell, *The Death of Fiduciary Duty in Close Corporations*, 138 U. PA. L. REV. 1675 (1990); Douglas K. Moll, *Shareholder Oppression in Close Corporations: The Unanswered Question of Perspective*, 53 VAND. L. REV. 749 (2000); Charles R. O'Kelley, Jr., *Filling Gaps in the Close Corporation Contract: A Transaction Cost Analysis*, 87 NW. U. L. REV. 216 (1992); Edward B. Rock & Michael L. Wachter, *Waiting for the Omelet To Set: Match-Specific Assets and Minority Oppression in Close Corporations*, 24 J. CORP. L. 913 (1999); Eric Talley, *Taking the "I" Out of "Team": Intra-Firm Monitoring and the Content of Fiduciary Duties*, 24 J. CORP. L. 1001 (1999).

[16] *See* Craig D. Parks et al., *Trust and Reactions to Messages of Intent in Social Dilemmas*, 40 J. CONFLICT RESOL. 134, 135-36 (1996) ("[T]here is no universally accepted definition of trust."); Oliver E. Williamson, *Calculativeness, Trust, and Economic Organization*, 36 J.L. & ECON. 453, 453 (1993) ("'[T]rust' is a term with many meanings.").

at least two actors—the actor who trusts and the actor who is trusted.[17] Second, the trusting actor must deliberately make herself vulnerable to the trusted actor in circumstances in which the trusted actor could benefit from taking advantage of the trusting actor's vulnerability.[18] Third, the trusting actor must make herself vulnerable in the belief or expectation that the trusted actor will in fact behave "trustworthily"—that is, refrain from exploiting the trusting actor's vulnerability. Trust and trustworthiness accordingly are closely linked, with the former depending upon an expectation of the latter.[19]

Consider the following example. Ann wants to spend the summer overseas. Beth has a summer job in Ann's city and needs a place to live. Ann thinks that the valuable art collection in her apartment will be safer if the apartment is occupied, so she offers to let Beth live in the apartment for the summer if she waters the plants, refrains from throwing wild parties, and locks the door when she goes out. Ann has chosen to make herself vulnerable, because Beth could gain at Ann's expense by stealing or shirking (for example, stealing the art collection or neglecting the plants). Ann decides to do this because she expects Beth to behave "trustworthily" by caring faithfully for the apartment.

A. *Sources of Trust and Trustworthy Behavior*

Why would someone voluntarily expose herself to the risk of loss from another's acts? We explore several different answers below, each focusing on the trusting party's belief or expectation that the trusted

[17] The trusted actor could be a person or, possibly, an institution such as "the firm" itself. *See infra* text accompanying notes 108-10, 204 (discussing trust in nonhuman institutions).

[18] *See* Mishra, *supra* note 8, at 265 ("*Trust* is one party's willingness to be vulnerable to another party. . . . Without vulnerability, trust is unnecessary . . . ." (internal citations omitted)). Trust thus implies volition on both sides.

[19] In our formulation, the expectation of trustworthy behavior is a necessary counterpart and inducement to trust. We argue below that people may behave trustworthily for a variety of reasons, some self-interested and some not. But where intrinsic trustworthiness exists, trust itself can be rational. Hence the puzzle in our story is why *homo economicus* would be intrinsically trustworthy in the first place. Some theorists go further and argue that true trust is not based on rational calculations of others' likely behavior. *See, e.g.*, Gary Alan Fine & Lori Holyfield, *Secrecy, Trust, and Dangerous Leisure: Generating Group Cohesion in Voluntary Organizations*, 59 SOC. PSYCHOL. Q. 22, 25 (1996) ("One not only thinks trust, but feels trust."). Although our argument does not depend on this view, there is evidence to support it. *See infra* text accompanying note 71 (discussing how the psychological phenomenon of projection may lead trustworthy people to assume others are also).

party has reason to behave trustworthily. We see these reasons as being layered like an onion, with the outside layers representing the most obvious and calculating of reasons and the inside layers representing deeper sources of trust that spring from the trusting party's views about the personal preferences and basic character of the trusted party.

1. Legal Sanctions

The most obvious reason why Ann might trust Beth would be that Ann knows that untrustworthiness might subject Beth to *legal sanctions*. For example, Ann might "trust" Beth not to steal her art collection because to do so would be theft, and Ann knows that Beth knows that stealing is illegal.

The notion that legal rules are needed to curb opportunistic behavior dates back at least to Thomas Hobbes.[20] But consider the magnitude of the information and the resources needed for legal sanctions, alone, to work. Ann must be able to detect Beth's illegal act and Beth must know Ann can do so. (This could be a problem, for example, if Beth claims that the art collection was stolen by a burglar.) Both parties must believe that there is a high probability that a theft would be prosecuted or that a civil claim would be brought, that the court would find Beth guilty or liable, and that Beth would be punished or required to pay damages. And both parties must believe that the resulting sanction would be severe enough (after discounting for the possibility that Beth's treachery would never be discovered or successfully sanctioned) to make the theft unattractive.

These strong requirements suggest that, in many cases, the threat of legal sanctions will impose only a weak constraint on Beth's behavior. The obvious corollary is that legal rules may rarely be the sole, or even primary, reason Ann would trust Beth.

2. Market Sanctions

Going deeper, we find a second category of reasons for Ann to believe that Beth will behave trustworthily. This second category rests on the notion that Beth might have external incentives to refrain from abusing Ann's trust if stealing or shirking would signal to others in the marketplace—including Ann herself—that Beth cannot be trusted. Ann might calculate, for example, that she can trust Beth because if

[20] *See* THOMAS HOBBES, LEVIATHAN (C.B. Macpherson ed., 1968) (1651).

the plants die or any of the art disappears, Ann can retaliate by either declining to deal with Beth in the future or by requiring her to put up a substantial deposit if she wants to use Ann's apartment the next summer.[21]

Even if Ann and Beth are unlikely to deal with each other again, similar considerations apply in situations in which they are likely to deal with third parties who know each of them. If Beth is a research assistant for one of Ann's colleagues, for example, Beth might fear that if she does not care for Ann's apartment faithfully, her reputation for trustworthiness among Ann's colleagues might suffer. Thus, Beth might do a good job not because she fears that Ann will refuse to deal with her in the future but because she fears that other potential trading partners will shun her.[22] It is also possible that third parties might not only become more reluctant to do business with Beth but also subject her to cold stares, unpleasant remarks, and other "social sanctions." This latter possibility provides the foundation for much of the mushrooming contemporary literature on law and social norms.[23]

In this Article we combine fear of retaliation, reputational loss, and social sanctions together under the label of *market sanctions*, because all three constrain and direct behavior by changing individuals' perceptions of their future opportunities for beneficial exchanges with others.[24] Rational choice theorists have placed a great deal of emphasis on such external rewards and punishments as sources of trust. For example, in his preeminent article on "calculative" trust,

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[21] Like the related strategy in game theory, trust based on fear of retaliation might also be termed "tit-for-tat" trust. *See generally* ROBERT AXELROD, THE EVOLUTION OF COOPERATION (1984) (discussing the tit-for-tat strategy); S.S. Komorita et al., *Reciprocity and Cooperation in Social Dilemmas*, 35 J. CONFLICT RESOL. 494 (1991) (studying the effectiveness of tit-for-tat strategies in eliciting cooperation in social dilemmas); S.S. Komorita et al., *Reciprocity and the Induction of Cooperation in Social Dilemmas*, 62 J. PERSONALITY & SOC. PSYCHOL. 607 (1992) [hereinafter Komorita et al., *Reciprocity and Induction*] (outlining experiments concluding that tit-for-tat strategies are effective in inducing cooperation).

[22] *See, e.g.*, Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115, 116 (1992) (discussing the importance of reputational concerns in ensuring compliance with industry norms).

[23] *See generally* Richard H. McAdams, *The Origin, Development, and Regulation of Social Norms*, 96 MICH. L. REV. 338, 343-46 (1997) (reviewing the literature on law and norms).

[24] *Cf.* Roderick M. Kramer, *Trust and Distrust in Organizations: Emerging Perspectives, Enduring Questions*, 50 ANN. REV. PSYCHOL. 569, 573 (1999) ("'When trust is justified by expectations of positive reciprocal consequences, it is simply another version of economic exchange, as is clear from treatments of trust as reputation in repeated games ....'" (quoting JAMES G. MARCH & JOHAN P. OLSON, REDISCOVERING INSTITUTIONS: THE ORGANIZATIONAL BASIS OF POLITICS 27 (1989))).

Oliver Williamson argues that most of what we call trust in commercial exchange is actually strategic behavior driven by the fear of retaliation or loss of reputation.[25] (Although Williamson does not entirely dismiss the idea of noncalculative trust, he suggests that it is "irrelevant to commercial exchange."[26]) Similarly, much norms scholarship ultimately relies on market sanctions as an explanation for cooperative behavior, although the "market" in question includes social, as well as obviously economic, exchanges.[27]

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[25] *See* Williamson, *supra* note 16, at 463, 485-86 (using the phrase "calculative trust" to describe trust in business relationships, while noting that the phrase is "a contradiction in terms," and arguing that it is misleading and confusing to use the word "trust" in connection with commercial relationships).

[26] *See id.* at 483 (suggesting also that the idea of noncalculative trust be reserved for describing personal relationships).

[27] Norms scholars frequently describe norms as behavioral rules that are enforced not by courts but primarily by social sanctions imposed by third parties on normbreakers. *See, e.g.*, Robert D. Cooter, *Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant*, 144 U. PA. L. REV. 1643, 1665, 1668-69 (1996) (suggesting that third-party enforcement is important in explaining the emergence of norms); Eric A. Posner, *Law, Economics, and Inefficient Norms*, 144 U. PA. L. REV. 1697, 1699 (1996) ("[A] norm is like a law, except that a private person sanctions the violator of a norm, whereas a state actor sanctions the violator of a law."); Rock, *supra* note 13, at 1013, 1104 (focusing on the role of reputational concerns and social sanctions as reasons to obey norms); Cass R. Sunstein, *Social Norms and Social Roles*, 96 COLUM. L. REV. 903, 915 (1996) (discussing norms as enforced through social sanctions). Thus, much norms scholarship ultimately relies on the *homo economicus* model in explaining cooperative behavior.

There is an important puzzle associated with this approach. Note that Beth might care about her reputation for two reasons. First, Beth might hope to gain economically from cooperative business relationships with others around her. Even rationally selfish outsiders might avoid doing business with an untrustworthy Beth, and a rationally selfish Beth would fear such avoidance. But Beth may also worry about her reputation simply because she cares about others' opinions and does not want to be subject to dirty looks, rude remarks, and social ostracism. This second possibility seems inconsistent with rational selfishness. Why does Beth care about others' opinions? And given that Beth cares, why should others invite conflict with her by socially sanctioning her, when conflict can be costly and the benefits of doing so flow largely to others? *See* McAdams, *supra* note 23, at 352, 355 (noting that "if sanctioning is costly, as most analyses assume, the puzzle is to explain why individuals will ever begin to sanction violators" and suggesting that third parties enforce norms by costlessly withholding "esteem" from violators); *see also* Cooter, *supra*, at 1665, 1667-69 (suggesting that third-party enforcers must "internalize" norms); Geoffrey P. Miller & Lori S. Singer, Norm Enforcement in a Noncooperative Setting (Oct. 4, 1999) (unpublished manuscript, on file with authors) (discussing numerous accounts of instances when third parties employed social sanctions against strangers to enforce handicapped parking rules at significant personal cost, including threat of injury). *See generally* Lynn A. Stout, Other-Regarding Preferences and Social Norms (Mar. 2, 2001) (unpublished manuscript, on file with authors).

The experimental evidence on trust behavior offers insights into how social norms are created and enforced by helping to illuminate the circumstances under which

Fear of retaliation, loss of reputation, and social sanctions may indeed provide important motives for cooperative behavior in many social interactions. But such motivations continue to rely on a view of people as always strategic, calculating, and self-interested. Moreover, note again the demanding information and resource requirements that must be met for such external forces to constrain Beth and, therefore, to provide the basis for Ann's trust in Beth. Beth must know that if she behaves untrustworthily, Ann will realize that her resulting loss was due to Beth's unfaithfulness rather than to bad luck or other factors. Beth must also know that Ann will be willing to incur the future cost of not doing business with Beth in order to punish Beth, or the possibly higher cost of making it widely known to other potential trading partners that Beth abused Ann's trust.[28] In the latter case, Beth must know that others will be able to verify that Beth abused Ann's trust (or at least be willing to believe Ann) and will inflict costs on Beth by refusing to do business with her, charging her a higher price, or punishing her with social sanctions. Finally, Ann must know that Beth knows all of these things.

Because the costs involved in employing legal and market sanctions to enforce trustworthiness can be so high, there is reason to suspect that other influences may be at work as well. Calculative trust may not be all, or even the most important part of the story.

3. Internalized Trust

So we turn finally to the deepest layer of the onion—the constraints on Beth's behavior that may come from Beth's internalized belief that she ought not to abuse Ann's trust. We posit that in some circumstances Beth may have a taste or preference for behaving trustworthily toward Ann, even if untrustworthy behavior would not trigger any external sanction. If Ann believes that Beth's desire to behave trustworthily is strong enough to deter Beth from taking advantage of Ann, Ann may conclude it is safe to make herself vulnerable to Beth—that is, to trust Beth.

Henceforth we shall use the term "trust" to refer to this sort of in-

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people adopt other-regarding preferences. Other-regarding preferences, in turn, explain both why people are willing to incur costs to comply with social norms and why they are willing to incur costs to enforce them.

[28] One has to ask why Ann might be willing to spread the word that Beth had abused her trust. This could be quite costly to Ann if others took it as a signal that Ann was gullible or vindictive. *See supra* note 30 (discussing vengefulness); note 27 (discussing third-party enforcement of social norms).

ternalized trust and not to calculative behavior motivated by external rewards or sanctions. This idea of trust driven by expectations of intrinsic trustworthiness bears a much closer resemblance to the lay understanding of trust than the economists' notion of calculative trust does. Dictionary definitions of trust, for example, center on the trusted person's essential integrity and character, rather than on whether he or she has external incentives to refrain from exploiting another.[29]

But the idea of internalized trust also poses a fundamental challenge to the neoclassical model of human behavior driven by rational self-interest. Internalized trust implies either that Beth altruistically feels some degree of concern for Ann's welfare (inconsistent with pure selfishness)[30] or that she does not recognize that she could benefit from behaving untrustworthily (inconsistent with rationality). The resulting tension between trust and rational self-interest may explain why economists and legal scholars who rely on economic analysis tend to focus on the role external incentives play in explaining cooperative behavior in general and trust behavior in particular.[31] This tendency

[29] *See, e.g.*, RANDOM HOUSE DICTIONARY OF THE ENGLISH LANGUAGE 2031 (2d ed. 1987) (defining trust as "reliance on the integrity, strength, ability, surety, etc. of a person or thing"); WEBSTER'S NEW COLLEGIATE DICTIONARY 1246 (1979) (defining trust as "assured reliance on the character, ability, strength, or truth of someone or something").

[30] For a variety of reasons, the word "altruism" may be inadequate to describe the phenomenon we examine. First, altruism implies a general concern for others' welfare. The experimental evidence on trust suggests, however, that it involves altruism only to a limited degree and only toward a limited circle of individuals. *See, e.g., infra* Part II.D.2 (discussing the role of group identity in social dilemmas); Part II.E (discussing the role of personal cost in determining the incidence of cooperation in social dilemmas). Second, there is evidence that the phenomenon of trust may be related to another, less-attractive form of other-regarding behavior—vengefulness. The existence of vengefulness is supported not only by casual empiricism but also by experimental studies of "ultimatum games" in which one player is asked to divide a monetary stake (say, ten dollars), and the other player is asked either to accept or to reject the proposed division. If the division is rejected, both players get nothing. Rational selfishness predicts that the first player will offer the second only the minimum amount needed to make accepting the division more profitable than rejecting it (say, one penny). In real ultimatum games, however, the first player often chooses to offer the second a substantial portion (sometimes half) of the total. More importantly, when the first player fails to do this, the second will often reject the division, ensuring that both get nothing. *See generally* Colin Camerer & Richard H. Thaler, *Anomalies: Ultimatums, Dictators, and Manners*, J. ECON. PERSP., Summer 1995, at 209, 209-19. Although vengefulness may seem irrational at the individual level, it may be evolutionarily advantageous if it promotes group cohesiveness and cooperative behavior within the group. *See infra* text accompanying notes 192-95 (discussing the evolutionary problem of excluding noncooperators from a cooperative group).

[31] Although economists and legal scholars who write in the tradition of law and

is especially apparent in the corporate law literature, where the "law and economics" approach has had a tremendous (some might say defining) influence.[32]

Yet the neoclassical assumption that people are both rational and selfish is just that—an assumption. For at least two reasons, we believe that the *homo economicus* model may be potentially misleading when it is applied to explain the relationship between corporate law and cooperative behavior within firms.

First, trust behavior is a fact. Casual empiricism reveals that people often behave in an other-regarding fashion, including behaving both as if they trust and as if they are trustworthy.[33] As we discuss in greater detail in Part II, this evidence from everyday life is amply supported by experimental findings that people conduct themselves in ways that are difficult or impossible to explain unless they are capable

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economics often give lip service to the idea that people can behave altruistically or irrationally, as a rule, they also presume that the best way to analyze and regulate human behavior in commercial relationships is to start from the assumption of rational selfishness. *See, e.g.*, RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 3-4, 74-75, 143-44, 464-65 (4th ed. 1992) (noting that "the happiness . . . of other people may be a part of one's satisfactions," but going on to discuss altruism primarily in the contexts of family relationships and charities); Williamson, *supra* note 16, at 482-83 (suggesting that trust may be important in personal but not in business relationships).

[32] *See supra* text accompanying notes 2, 12 (discussing the dominance of the "nexus of contracts" approach). Corporate scholars who discuss the role of trust in business relationships tend to rely on notions of calculative trust driven by concerns about retaliation and reputation. *See, e.g.*, Easterbrook & Fischel, *Close Corporations*, *supra* note 15, at 274 (discussing the role of social and familial relationships in closely held corporations); Mahoney, *supra* note 15, at 9 (describing trust in closely held corporations as driven by "extralegal constraints" such as "the threat of social sanctions" and concern for reputation); Rock, *supra* note 13, at 1013, 1104 (discussing the roles of social sanctions and reputation in motivating trustworthy behavior). Three notable exceptions are Bruce Chapman, Tamar Frankel, and Lawrence Mitchell. All have written on the importance of trust in business relationships, although they do not explore the underlying behavioral mechanism. Bruce Chapman, *Trust, Economic Rationality, and the Corporate Fiduciary Obligation*, 43 U. TORONTO L.J. 547 (1993) (arguing that a contractual view of corporations is ineffectual without trust); Lawrence E. Mitchell, *Fairness and Trust in Corporate Law*, 43 DUKE L.J. 425 (1993) [hereinafter Mitchell, *Fairness and Trust*] (arguing that courts and legislatures unwittingly have destroyed the fiduciary fabric of corporate law by disregarding the role of trust); Lawrence E. Mitchell, *Trust and Team Production in Post-Capitalist Society*, 24 J. CORP. L. 869 (1999) (claiming that where trust is lost, suspicion, self-protection, and diminished dedication will follow); Tamar Frankel, Trusting and Non-Trusting: Comparing Benefits, Cost and Risk (1999) (unpublished manuscript, on file with authors), *available at* http://papers.ssrn.com/paper.taf?abstract_id=214588.

[33] For example, people leave tips in restaurants while traveling, ask for and rely on directions from strangers in unfamiliar cities, and respond to disabled persons' requests for assistance negotiating street hazards.

of internalized trust.[34]

Second, given that internalized trust exists, economic analysis itself predicts that it is likely to be an important and potent force in business organizations. This is because trust offers distinct efficiency advantages for both individuals and institutions, including but not limited to the institution known as the corporation.

B. *The Efficiency of Trust*

Social scientists have long argued that evolution can favor the development of a capacity for altruism in social organisms such as *homo sapiens*.[35] This is because "irrationally" cooperative behavior within a particular group (including but not limited to trust and trustworthiness) often enhances the group's overall welfare. If the group does well, members of the group on average also do well. Thus concern for others—including concern for those who trust you—can be highly adaptive in species that rely on social interaction and exchange.[36]

For similar reasons, cooperative behavior can be an important factor in the evolution not just of social organisms but also of social *institutions*. This is because groups whose members cooperate with each other can often thrive and grow at the expense of groups whose members do not cooperate.[37] Social institutions that can promote and

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[34] *See infra* text accompanying notes 54-61 (reviewing experimental evidence).

[35] *See, e.g.*, RICHARD DAWKINS, THE SELFISH GENE 4-5 (1976) (discussing whether altruism lowers or raises the survival prospects of an animal); ROBERT TRIVERS, SOCIAL EVOLUTION 44 (1985) (explaining that altruism is favored by kinship, reciprocity, and parasitism); EDWARD O. WILSON, SOCIOBIOLOGY: THE NEW SYNTHESIS 3-4 (1975) (citing kinship as the explanation for why altruism has evolved by natural selection); William D. Hamilton, *The Genetical Evolution of Social Behavior*, 7 J. THEORETICAL BIOLOGY 1, 1 (1964) (describing altruism in natural selection with a genetic-mathematical model); Robert L. Trivers, *The Evolution of Reciprocal Altruism*, 46 Q. REV. BIOLOGY 35, 35 (1971) (showing how natural selection can operate against nonreciprocal behavior); *see also infra* note 67 (discussing evidence that capacity for trust and trustworthiness is "attractive to the opposite sex").

[36] The problem (from an evolutionary perspective) is how cooperative individuals can reap the benefits of their cooperation if others in the group choose to behave opportunistically. *See* Donald T. Campbell, *On the Conflicts Between Biological and Social Evolution and Between Psychology and Moral Tradition*, 30 AM. PSYCHOLOGIST 1103, 1111-12 (1975) (describing this problem). For cooperation to have survival value, cooperators must be able somehow to exclude noncooperators; otherwise, the noncooperators can flourish at cooperators' expense. We discuss this problem in greater detail later in the context of closely held corporations. *See infra* Part III.C (discussing nonlegal forces that encourage trust within firms).

[37] *See generally* ELLIOTT SOBER & DAVID SLOAN WILSON, UNTO OTHERS: THE EVOLUTION AND PSYCHOLOGY OF UNSELFISH BEHAVIOR (1998) (discussing the evolutionary advantages of altruism for groups, institutions, and cultures).

support trust among their participants can, as a result, have an evolutionary advantage over institutions that cannot.[38]

In this Article, we focus on one particular social institution in which we believe the role of trust behavior is both fundamental and largely neglected in the legal literature. That institution is the business corporation. Corporate production typically requires the combined efforts and contributions of a wide range of groups and individuals, including shareholders, employees, and managers. The nexus of contracts theory of the firm holds that these efforts and contributions are coordinated primarily through a web of express and implied contractual agreements. At the same time, however, it is widely recognized that complex joint production in a business firm raises at least two types of contracting problems. The first and perhaps more familiar problem is the *agency cost* problem. The second problem, which has attracted recent scholarly attention, is the *team production* problem.

Consider first the agency cost problem. In the typical agency relationship, one person (the principal) wants to pay another (the agent) to perform some task that the principal is unable or unwilling to perform for herself. But hiring an agent to do something for you immediately raises the question: How can you make sure your agent does a good job? Economic and legal scholars have devoted tremendous energy over the years to investigating how legal rules, formal contracts, compensation systems, and market incentives can be used to motivate agents to serve their principals' interests.[39] Two fundamental points

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[38] Taken to its logical conclusion, this analysis suggests that nation-states and societies that encourage trust are likely to flourish relative to those that do not. In this vein, there is an emerging literature in social and political science on the importance of "social capital" to economic development. *See, e.g.*, FRANCES FUKAYAMA, TRUST: THE SOCIAL VIRTUES AND THE CREATION OF PROSPERITY 27 (1995); LUIGI GUISO ET AL., THE ROLE OF SOCIAL CAPITAL IN FINANCIAL DEVELOPMENT (Nat'l Bureau of Econ. Research, Working Paper No. W7563, 2000); RAFAEL LA PORTA ET AL., TRUST IN LARGE ORGANIZATIONS (Nat'l Bureau of Econ. Research, Working Paper No. 5864, 1996); Paul S. Adler & Seok-Woo Kwon, Social Capital: The Good, The Bad, and the Ugly (Sept. 28, 1999) (unpublished manuscript, on file with authors).

[39] *See* Blair & Stout, *Team Production in Business Organizations, supra* note 7, at 743 n.1 (citing literature). Agency problems are often viewed, at least in the legal literature, as the *central* problem of corporate governance. This argument grows out of a model of the firm that views the corporation as a bundle of assets that belongs to its shareholders. Hence shareholders, as ultimate "owners" of the firm (or in more sophisticated versions, the firm's sole "residual claimants"), are principals who hire officers and directors to serve as their agents. *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 22-35 (1991); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 357 (1976); Roberta Romano, *Theory of the Firm*

emerge from that effort. First, agency costs are an endemic problem associated with doing business in the corporate form. (After all, corporations are fictional entities that must act, if at all, through human agents.) Second, no combination of legal rules and market forces can bring agency costs in firms down to zero. Negotiating contracts, monitoring agents, and enforcing legal rights in the courts are all costly activities, and, in any case, such efforts usually cannot eliminate all opportunities for an agent to shirk or steal. This is true to a greater or lesser extent for every agent employed by the firm, from the chairman of the board down to the janitor.

While agency cost analysis focuses on the problem of getting agents to act in their principals' interests, complex economic production can also give rise to a second type of economic problem—the team production problem.[40] Team production occurs when two or more individuals must each contribute valuable resources to produce a single, nonseparable output. If these inputs are complex or difficult to monitor, it may be impossible for team members to draft ex ante a contract that specifies exactly who is to contribute what, in return for what payment. But if the team members wait until the project is completed to divvy up the profits, how will they decide who is entitled to what share, when all parties had to contribute to earn the profits in the first place? Such contracting difficulties can discourage investment in team production, especially when invested resources become "team-specific," so that team members cannot walk away from the project without losing some of the value of their investment.[41]

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and Capital Markets, *in* FOUNDATIONS OF CORPORATE LAW 3, 3-62 (Roberta Romano ed., 1993); *see also* Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737 (1997) (stating that the central problem of corporate governance is the agency problem).

We disagree with the notion that shareholders are or should be thought of as the sole residual claimants of publicly held corporations. Instead, we believe that it is more accurate to think of "the firm" as composed of the interests of a number of groups with strong residual claims, including not only shareholders but also managers and rank-and-file employees. *See* Blair & Stout, *A Team Production Theory*, *supra* note 7. Nevertheless, because the firm as a fictional entity must act through its agents, we agree that agency costs are an important problem in corporations.

[40] *See generally* sources cited *supra* note 7.

[41] *See generally* Blair & Stout, *A Team Production Theory*, *supra* note 7, at 265-76 (discussing the team production contracting problem); *see also* CHARLES R. O'KELLEY, JR. & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS: CASES AND MATERIALS 7-9 (3d ed. 1999) (discussing team production in firms). As this description implies, market and legal sanctions provide only limited protection for investment in team production. The very nature of team-specific investment ensures that the market provides little protection, while complexity of inputs makes it difficult to rely on legal constraints or contractual incentives.

Corporate scholars generally recognize that team production, with its attendant contracting problems, plays a central role in closely held corporations in which a small number of individuals participate both as investors in and managers of the firm.[42] We have recently argued elsewhere that team production may also be important in publicly held firms.[43] In particular, we argued that an essential economic function of the publicly held corporation may be to provide a vehicle through which shareholders, executives, rank-and-file employees, and others who invest team-specific resources can, for their own benefit, protect and promote such investments by jointly relinquishing control over those resources and their joint enterprise to a third party—a board of directors—charged with representing the team's interests and with allocating rewards among team members. Although this approach does much to explain the actual structure of corporate law,[44] it

[42] *See, e.g.*, POSNER, *supra* note 31, at 423 (describing the problem of "bilateral monopoly" for closely held corporations); Easterbrook & Fischel, *Close Corporations*, *supra* note 15, at 273-75 (describing closely held corporations' problem of shareholder "conflicts of interest"); O'Kelley, *supra* note 15, at 218-30 (discussing the team production problem in closely held firms); Talley, *supra* note 15, at 1002-05 (same).

[43] *See* Blair & Stout, *A Team Production Theory*, *supra* note 7, at 276-89 (arguing that team production analysis helps explain the rationale for hierarchical decisionmaking structures within publicly held corporations as well as for directors' almost absolute freedom from the direct control of shareholders, senior executives, or other potential "stakeholders" in the firm); *see also* O'KELLEY & THOMPSON, *supra* note 41, at 7-9 (discussing team production as a basic economic problem found in firms).

[44] A variety of features of corporate law have proven difficult to reconcile with a principal-agent model of firms that treats shareholders as "owners" of publicly held corporations and corporate directors as shareholders' "agents." For example, a corporation's assets belong not to the shareholders but to the firm itself. Moreover, control over these assets rests in the hands of the board of directors. While the members of the board are nominally elected by the shareholders, once elected they are not subject to direct shareholder control. As a matter of law, it is difficult for dissatisfied shareholders to remove them, and as a matter of practice it is often impossible. Meanwhile, corporate officers (whom commentators often lump together with directors, somewhat misleadingly, under the term "managers") fall into another legal category altogether. They are employees, hired and fired by the board of directors and subject to the board's direct control. *See* Blair & Stout, *A Team Production Theory*, *supra* note 7, at 290-315 (discussing directors' legal roles and shareholders' voting rights).

Despite such evidence of director autonomy, modern corporate scholars generally seem to fall into two camps: those who believe that shareholders control directors through such devices as incentive contracting and the market for corporate control and those who believe that directors do what the firm's senior executives want them to do. The discussion above suggests that neither of these two conflicting views is quite accurate. Directors are neither shareholders' puppets nor pawns of the CEO. Rather, they are "mediating hierarchs" who enjoy a substantial range of legal discretion to use the firm's assets in ways that *neither* shareholders nor managers would necessarily choose were they in charge. A major innovation of the team production approach is that it provides a theoretical rationale for this independence.

also raises the obvious question of why a board largely insulated from the direct command and control of either shareholders *or* other corporate stakeholders should do a good job for either.[45]

The bottom line is that, whether one focuses on agency costs or team production problems, opportunistic behavior of one kind or another is an unavoidable problem associated with doing business in the corporate form. Indeed, it is the *paramount* problem and the focus of the vast bulk of the modern literature on corporate law and policy.[46]

Thus the stage is set for understanding the importance of trust. Where trust can be harnessed, it can substantially reduce the inefficiencies associated with both agency and team production relationships. Trust permits transactions to go forward on the basis of a handshake rather than a complex formal contract; it reduces the need to expend resources on constant monitoring of employees and business partners; and it avoids the uncertainty and expense associated with trying to enforce formal and informal agreements in the courts. Trust behavior also reduces losses from others' undetectable or unpunishable opportunistic behavior, losses that could discourage the formation of valuable agency and team production relationships in the first place.

Business organizations that promote trust in relationships among investors, managers, and employees accordingly can reduce and, in some cases, avoid many of the costs associated with policing against opportunism—costs that other firms must bear. The corollary is that firms that successfully encourage trust among their participants on relevant tasks can enjoy an evolutionary advantage over firms that do

45 Thus while the institution of a corporate hierarchy topped by the board may address one economic problem (team production), it may exacerbate another (agency costs). Under the team production approach, directors are conceived not as shareholders' agents, but as agents for the entire corporate team. This team consists of all who make firm-specific investments and expect a share of the resulting output, including not just shareholders but also managers, employees, and possibly other groups as well. *See id.* at 276-87 (explaining why team members would decide to incorporate, knowing that doing so would result in a loss of influence over the corporation's future and over the division of rents).

46 Much of the corporate law literature, not to mention the average corporate law casebook, focuses on how opportunistic behavior within the firm can be discouraged through derivative suits, incentive compensation contracts, shareholder proposals, shareholder and director voting rules, an active market for corporate takeovers, and so forth. It nevertheless remains widely understood that each of the standard legal and market mechanisms thought to constrain and direct behavior within the firm has its own costs and limitations. As a result, external incentives cannot completely eliminate the costs associated with opportunistic behavior within firms.

not.[47] Economic analysis itself suggests that a corporate capacity to promote trust behavior may often be not just important to business success but essential.[48]

This is something that management theorists, consultants, and businesspeople themselves have always known. There is an extensive literature both in the popular and business press and in management theory that stresses the importance of establishing, building, and supporting trust among corporate participants.[49] As the book jacket of one recently published book in the trade press puts it: "Trust is the glue that holds organizations together. More powerful than contracts or authority, trust enables partner companies—or groups within a company—to achieve results that exceed the sum of the parts."[50] Nevertheless, legal scholarship largely neglects the role of trust in firms, assuming instead that the best—indeed, only—way of controlling opportunistic behavior is through legal and market incentives that discourage the shirking and stealing that is to be expected of rationally selfish individuals.

Why is this so? As noted earlier, part of the reason may lie in the fact that trust behavior in business firms often appears, on first inspection, to be consistent with (if not fully explained by) observed external incentives, making it easy to jump to the conclusion that those incentives *cause* trusting and trustworthy behavior.[51] Law professors may be

[47] Trust behavior is valuable in situations in which the best outcome requires cooperative, coordinated efforts. In some situations, however, cooperation is unnecessary and the optimal outcome is more likely to be reached through individual efforts. In such circumstances, it is better to encourage competitive rather than cooperative behavior. Thus successful business firms likely encourage competition in some tasks and cooperation in others. In this Article, we focus our attention on the second situation.

[48] *See* Mitchell, *Fairness and Trust, supra* note 32, at 425 ("[T]rust is essential for corporate survival.").

[49] *See* Mishra, *supra* note 8, at 282 ("[R]ecent discussions by both scholars and the business press suggest that trust is a central factor in organizational behavior and organizational survival for both public and private organizations.... Several scholars have recently proposed that trust is a central factor enhancing organizations' long-term success and survival, especially because environments have become more uncertain and competitive."); *see also* Christel Lane, *Introduction: Theories and Issues in the Study of Trust, in* TRUST WITHIN AND BETWEEN ORGANIZATIONS, *supra* note 8, at 1 ("Trust... is increasingly being viewed as a precondition for superior performance and competitive success in the new business environment."); Sue Shellenbarger, *Workplace Upheavals Seem To Be Eroding Employees' Trust,* WALL ST. J., June 21, 2000, at B1 (citing a study that found a correlation between workplace trust and profits); sources cited *supra* note 8.

[50] LEWIS, *supra* note 8.

[51] *See supra* text accompanying note 9; *see also* Jane J. Mansbridge, *On the Relation of*

particularly prone to this leap because legal education traditionally emphasizes the case method, and case law inevitably focuses on situations in which trust has broken down and the parties are seeking to invoke the weight of the law to control behavior.

But it seems likely that the contemporary dominance of the law and economics approach to corporate law, with its implicit reliance on the *homo economicus* model of human behavior, has also worked to blind corporate theorists to the importance of trust. Economic analysis has made a number of important contributions to the legal culture's understanding of corporate law, not the least of which has been its emphasis on rigorous and exacting analysis. At the same time, the resulting tendency to focus only on behavior that can be easily captured in formal mathematical models may have contributed to many modern corporate theorists' reluctance to abandon the idea of rational selfishness in favor of such an apparently soft and "mushy" concept as trust.

We believe, however, that it is possible to develop a formal conception of trust that allows us (1) to understand when and how it comes into play, (2) to identify what factors and variables determine its incidence, and (3) to make and test predictions about behavior. To demonstrate, we review below an especially compelling and useful form of evidence of when and why trust occurs—experimental studies of human behavior in social dilemmas.

II. EXPERIMENTAL EVIDENCE ON TRUST IN SOCIAL DILEMMAS

Social scientists use the term "social dilemma" to describe situations in which groups of individuals find themselves facing incentives identical to those presented in the familiar prisoner's dilemma of game theory. In a classic prisoner's dilemma, two players are asked to choose between either "cooperating" with their partner or "defecting." Payoffs are structured so that, whatever her partner does, a player can always receive a higher payoff by defecting than by cooperating. Yet if both players defect, they each receive less than if both cooperated. In other words, although the best group outcome requires cooperation, the best strategy for each individual is always to defect. The net result is that the pursuit of self-interest inexorably

Altruism and Self-Interest, *in* BEYOND SELF-INTEREST 133, 141 (Jane J. Mansbridge ed., 1990) ("We seriously underestimate the frequency of altruism when, having designed our lives to make self-interest and altruism coincide, we interpret such coincidences as demonstrating the pervasiveness of self-interest rather than altruism.").

diminishes the players' mutual welfare.[52]

Consider a common example of a social dilemma, the "group contribution game." A group of *n* players is assembled and each player given a sum of money (say, $10) as an initial "stake." The players are told that they can either keep the cash or contribute it to a common investment pool. They are also told that any money contributed to the common pool will be multiplied by some factor greater than 1 but less than *n* and distributed equally among all the players in the group, including those who chose not to contribute. Thus the best individual strategy in the game is to keep the $10 (while taking a pro rata portion of anything that ends up in the common investment pool). The best group outcome, however, requires universal contribution.

Social dilemma experiments offer important insights into trust. This is because the structure of a social dilemma drives selfish players always to defect. Trust, however, can provide a motivation for players in a social dilemma to choose the optimal, cooperative outcome over the individually rational but suboptimal solution. In other words, trust can solve the dilemma.

Suppose four players trapped in a social dilemma each believe that their fellow players are intrinsically trustworthy. In such a situation, the players could achieve the optimal outcome by choosing to trust each other (to make themselves vulnerable by selecting a cooperative strategy, in the expectation that their fellows also will cooperate) and, in the same act, choosing to be trustworthy (to refrain from exploiting their fellows' vulnerability, even though defecting would produce a higher individual payoff). Although this may seem an obvious solution, it is important to emphasize that rational and purely selfish players would never actually cooperate in this manner. Although they might agree to cooperate, defection remains the dominant strategy, and all would renege on their agreement.

Rational selfishness therefore precludes trust. Yet, over the past forty years, social scientists have published the results of literally hundreds of experiments in which individuals were placed in situations in which they faced payoff structures resembling those in the group contribution game.[53] These experimental studies demonstrate beyond

[52] For example, suppose that each player is told that she will receive $6 if she defects and her partner cooperates, $4 if both cooperate, $2 if both defect, or $0 if she cooperates but her partner defects. In such a case, each player maximizes her individual returns by defecting. However, mutual defection produces a total payoff of only $4 ($2 each). Mutual cooperation would produce a total payoff of $8 ($4 each).

[53] *See* Robyn M. Dawes et al., *Cooperation for the Benefit of Us—Not Me, or My Con-*

question that trust exists. *Homo sapiens* in a social dilemma—unlike *homo economicus*—shows a marked and predictable tendency toward "irrationally" cooperative behavior in general and toward trust behavior in particular.

We explore below some of the factors and variables that have proven empirically important in determining the incidence of trust in social dilemma games. As will be seen, this evidence supports five findings. First, trust is an empirical reality; individuals in social dilemma experiments exhibit far more cooperative behavior than can possibly be explained by external incentives. Second, different individuals manifest different levels of willingness to cooperate in social dilemma experiments. Third, these individual variations to some degree reflect differences in individuals' past experiences, suggesting that trust may be a learned behavior. Fourth, trust is also a *socially contingent* behavior. In other words, trust appears to depend significantly on individuals' perceptions of *others'* expectations, likely behaviors, and social relationships to themselves; in some social situations people predictably display trust, while in others they predictably do not. Finally, however, economic payoffs are not irrelevant. Although people cooperate in social dilemmas even when they must incur a personal cost, the levels of cooperation observed begin to decline as the cost of cooperating increases.

Taken as a whole, the experimental evidence on human behavior in social dilemmas consequently provides a portrait of humanity that differs markedly from the picture painted by the *homo economicus* model. In particular, people appear to shift readily between at least two preference functions or modes of behavior, depending on the social context. Put differently, *the typical individual manifests at least two distinct personalities.* One might be described as a "competitive" or "self-regarding" personality. When the competitive personality is dominant, an individual will choose options that maximize her per-

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Science, *in* BEYOND SELF-INTEREST, *supra* note 51, at 97, 97-110 [hereinafter Dawes et al., *Cooperation*] (summarizing social dilemma studies); Dawes & Thaler, *supra* note 3 (same); David Sally, *Conversation and Cooperation in Social Dilemmas: A Meta-Analysis of Experiments from 1958 to 1992*, 7 RATIONALITY & SOC'Y 58 (1995) (summarizing the results of over 100 studies done between 1958 and 1992); *see also, e.g.*, John M. Orbell et al., *Explaining Discussion-Induced Cooperation*, 54 J. PERSONALITY & SOC. PSYCHOL. 811 (1988) (describing two social dilemma studies in which group discussion was shown to enhance cooperation); Parks et al., *supra* note 16 (describing a social dilemma study); Julian B. Rotter, *Interpersonal Trust, Trustworthiness, and Gullibility*, 35 AM. PSYCHOLOGIST 1 (1980) (same); Toshio Yamagishi, *The Structural Goal/Expectation Theory of Cooperation in Social Dilemmas*, *in* 3 ADVANCES IN GROUP PROCESSES 51 (Edward J. Lawler ed., 1986) (same).

sonal payoffs without regard for effects on others, implying a preference function indifferent to others' welfare. The second self is a "cooperative" or "other-regarding" personality. When the cooperative personality governs, an individual will choose options that maximize group welfare over options that maximize her own individual welfare, implying an other-regarding preference function. Social context, tempered by considerations of personal cost, determines when the cooperative personality emerges.

A. *The Reality of Trust*

As noted earlier, one reason why modern corporate scholarship tends to overlook the role of trust in encouraging cooperative behavior may be that the cooperation we observe in firms is often consistent both with internalized trust and with external incentives.[54] One of the most valuable attributes of social dilemma experiments is their ability to untangle such external and internal motivations for cooperative behavior. Similarly, one of the most important and intriguing findings of such experiments is that the incidence of cooperation in social dilemma games is far higher than can possibly be explained by external incentives alone. Consider the case of the social dilemma game played by strangers who never expect to see each other again and who are told that the game will be played only once. Defection is the only sensible strategy for the rationally selfish player in such a "one-shot" game. Yet cooperation rates in one-shot social dilemma games approximate fifty percent.[55]

Further evidence of the existence of trust emerges from comparing cooperation rates in one-shot games with cooperation rates in games in which players are told that they will play repeatedly. If behavior that looks like "trust" is actually driven by the fear of retaliation or loss of reputation—as most economists presume—then when cooperation occurs at all it should occur only in repeat-game situations in which one player's cooperation can be rewarded by her partner's future cooperation (and, conversely, defection punished by future defection).[56] The *homo economicus* model accordingly predicts that repeat

[54] *See supra* text accompanying notes 9, 51.

[55] That is, the average player typically contributes about 50% of her initial stake to the common investment pool. *See* Dawes & Thaler, *supra* note 3, at 189 (noting that, on average, subjects contribute between 40% and 60% of the socially optimal quantity in single-play contribution games); Sally, *supra* note 53, at 62 (finding that the mean cooperation rate for a sample of over 130 experiments averaged 47%).

[56] There is reason to question whether the prospect of "tit-for-tat" really provides a

games should have higher cooperation rates than one-shot games. Yet the experimental studies show the *opposite* result; cooperation rates are *lower* in reiterated play than in one-shot games.[57] Later we will consider an explanation for this finding. For the moment, we simply note that it is clearly inconsistent with the assumption that people behave only in a calculative, self-interested way.

Perhaps the most thorough investigation of the ineffectiveness of calculative selfishness in predicting cooperative behavior may be found in an analysis of the accumulated results of thirty-five years of social dilemma experiments prepared by David Sally.[58] Sally developed a data set of 130 social dilemma experiments and categorized each according to a variety of experimental variables (one-shot versus repeated games, two-person versus multiperson games, and so forth). He then performed a regression analysis that compared the cooperation rates observed in the different experiments with identified experimental variables. He found that the variables one would expect to matter most for calculative trust (for example, reiterated games ought to have higher cooperation rates than one-shot games, and reiterated games with relatively small numbers of players ought to have higher rates still) either had little effect on cooperation rates or effects *opposite* to those predicted by neoclassical theory.[59]

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meaningful incentive for cooperation in repeat games, especially when the games are played by more than two people. In such situations it can be difficult for players to identify the individuals who have defected. And even when this can be done, it is impossible to "punish" the defector without also punishing others in the group who have cooperated. Dawes & Thaler, *supra* note 3, at 191; *see also* Yamagishi, *supra* note 53, at 75 (noting that cooperation often continues in reiterated games even when penalized).

Cooperation is also hard to explain under the neoclassical model when the players know that play will end after a certain number of rounds, giving rise to the "end-game" scenario. Game theory predicts that in the known last round of play, both players should defect because there is no prospect of cooperation being rewarded in the future. Knowing that defection is certain in the last trial, both players will also defect in the penultimate trial, and so on by backward induction, until defection becomes the dominant strategy for both players in all trials. *See* Dawes & Thaler, *supra* note 3, at 191; Sally, *supra* note 53, at 65.

57 *See* Dawes & Thaler, *supra* note 3, at 188-89 (finding that single-trial games, which accounted for about one-third of the sample, actually had higher cooperation rates than repeated games).

58 *See* Sally, *supra* note 53, at 58.

59 For example, the size of the experimental group appeared to have little influence on the incidence of cooperation, while (as noted above) cooperation rates actually were lower in reiterated games than one-shot plays. *See id.* at 77. The notable exception was the size of the benefits from defection. In accord with neoclassical theory, subjects were more likely to defect when the monetary benefits from defection were greater. *See also infra* note 100 and accompanying text (discussing how trust with large

In contrast, cooperation rates seemed highly sensitive to variables that should be irrelevant to the rationally selfish player. For example, cooperation was far more likely when the experimenter instructed the players to cooperate. This is inconsistent with rational selfishness, as mere instructions do not change either the players' payoffs or the dominance of defection as the optimal individual strategy.[60] Similarly, players were much more likely to cooperate in experiments in which they were allowed to exchange promises to contribute. Again, this is a striking result. Absent legal sanction or some threat of retaliation, there is no reason in economic theory why such promises should be either believed or kept.[61]

Social dilemma studies accordingly provide overwhelming evidence that a behavioral model of trust that relies solely on calculative self-interest is likely to miss much if not most of the phenomenon it attempts to describe. There is more—much more—going on here.

B. *Variations in Individual Tendencies to Trust*

To develop a better understanding of the cooperative behavior observed in social dilemmas, it is worthwhile to explore a second consistent finding of such experiments: Different individuals playing a social dilemma game appear to bring to the table differing predispositions to trust and to behave trustworthily.[62]

One notorious example of this phenomenon can be seen in experiments that have found that economics students are significantly less likely than others to cooperate in social dilemma experiments. One frequently cited study by Gerald Marwell and Ruth Ames, for example, found that cooperation rates in a social dilemma game generally averaged between forty percent and sixty percent. The notable exception was the series of games played by economics graduate students.[63] In those games, the cooperation rate was only twenty per-

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stakes can develop in repeated games in which parties start with small stakes).

[60] *See* Sally, *supra* note 53, at 78.

[61] *See id.* As Thomas Hobbes famously put it, "Covenants, without the Sword, are but Words, and of no strength to secure a man at all." HOBBES, *supra* note 20, at 223.

[62] *See* James E. Alcock & Diana Mansell, *Predisposition and Behavior in a Collective Dilemma*, 21 J. CONFLICT RESOL. 443 (1977) (discussing people's predisposition to cooperate or defect).

[63] *See* Gerald Marwell & Ruth E. Ames, *Economists Free Ride, Does Anyone Else?*, 15 J. PUB. ECON. 295, 306 (1981) (finding that economics graduate students are far less likely to cooperate in social dilemma experiments than others are); *see also* Sally, *supra* note 53, at 78 (reporting the results of meta-analysis of over 100 studies and concluding that psychology students are significantly more likely to cooperate than others are, while economics students are less likely to cooperate, although not to a statistically sig-

cent.[64]

This result illustrates a more widespread phenomenon—that individuals appear to differ significantly in their willingness to trust others. Some people are "high trusters" who behave as if they generally expect others to behave trustworthily (for example, to tell the truth, refrain from stealing, keep their promises, and contribute to public goods). Others are "low trusters" who expect people to behave opportunistically (for example, to lie, steal, break promises, and free-ride). These differing expectations show up reliably in responses to questionnaires designed to measure trust, such as the Rotter Interpersonal Trust Scale.[65]

Being a high truster is associated with a variety of personality characteristics. One such characteristic is likability. Although as a general rule people prefer others who are like themselves,[66] trust is an exception: Studies have found that both high *and* low trusters perceive high trusters as "happier, more ethical, and more attractive to the opposite sex."[67] In other words, everyone likes a high truster.

Perhaps more importantly, trust in others is also closely correlated with trustworthiness. High trusters not only expect others to cooperate; they are also far more likely to cooperate themselves.[68] Conversely, individuals who score low on trusting others are themselves more likely to lie, cheat, and steal.[69] They also are less likely to coop-

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nificant degree); Yezer et al., *supra* note 10, at 177 (reporting evidence that economics students are less likely to cooperate in experimental games).

64 *See* Marwell & Ames, *supra* note 63, at 306.

65 *See, e.g.*, Peter Brann & Margaret Foddy, *Trust and the Consumption of a Deteriorating Common Resource*, 31 J. CONFLICT RESOL. 615, 617 (1987) (using the Rotter Interpersonal Trust scale); *see also, e.g.*, Parks et al., *supra* note 16, at 137 (using the Yamagishi scale to separate high from low trusters). Social scientists have developed a number of measures of individuals' willingness to trust others. *See, e.g.*, Julian B. Rotter, *A New Scale for the Measurement of Interpersonal Trust*, 35 J. PERSONALITY 651, 653 (1967); Toshio Yamagishi, *The Provision of a Sanctioning System as A Public Good*, 51 J. PERSONALITY & SOC. PSYCH. 110 (1986).

66 *See* Rotter, *supra* note 53, at 2.

67 *Id.* at 3. This observation is not only cause for woe among economics graduate students; it also provides empirical support for the claim that a capacity for trust offers evolutionary advantages. *See supra* text accompanying notes 35-38 (discussing the evolutionary advantages of trust). Interestingly, low trusters, but not high trusters, also perceived high trusters as having less common sense. *See* Rotter, *supra* note 53, at 3.

68 *See* Rotter, *supra* note 53, at 2; *see also, e.g.*, Robyn M. Dawes et al., *Behavior, Communication, and Assumptions About Other People's Behavior in a Commons Dilemma Situation*, 35 J. PERSONALITY & SOC. PSYCH. 1, 7 (1977) [hereinafter Dawes et al., *Behavior, Communication*] (finding that individuals who chose to defect in social dilemmas were four times more likely to predict that their fellow players also would defect).

69 *See* Rotter, *supra* note 53, at 2.

erate in social dilemmas.[70] This pattern is often explained as one of projection. People who are untrustworthy expect others to be like themselves (that is, untrustworthy) and behave accordingly. Similarly, people who are trustworthy assume others also are trustworthy and, therefore, safe to trust.[71]

C. *Trust as a Learned Behavior*

The notion that some people are more likely than others to display trust and trustworthiness naturally raises the question: What causes these differences? It is possible that differences in trust behavior may be to some extent inherited. This would suggest, for example, that economics students tend to defect in social dilemmas because low trusters for some reason are attracted to the study of economics. A second possibility, however, is that economics students score low on trust in social dilemmas because studying economics *teaches* them to be distrustful.[72] There is substantial evidence to suggest that individ-

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[70] *See, e.g.*, Brann & Foddy, *supra* note 65, at 622-23 (finding that individuals who score highly on trust on the Rotter scale were more likely to exercise restraint in consuming a rapidly deteriorating common resource); John M. Orbell et al., *Do Cooperators Exit More Readily than Defectors?*, 78 AM. POL. SCI. REV. 147, 159 (1984) [hereinafter Orbell et al., *Do Cooperators Exit?*] (finding that individuals who expected others to cooperate were themselves more likely to participate and cooperate in a social dilemma); Parks et al., *supra* note 16, at 142 (finding that sixty-one percent of high trusters opted for cooperation in social dilemma, while only sixteen percent of low trusters did so).

[71] Michael W. Macy & John Skvoretz, *The Evolution of Trust and Cooperation Between Strangers: A Computational Model*, 63 AM. SOC. REV. 638, 640 (1998); John Orbell & Robyn M. Dawes, *A "Cognitive Miser" Theory of Cooperators' Advantage*, 85 AM. POL. SCI. REV. 515, 517 (1991); *see also* Dawes et al., *Behavior, Communication*, *supra* note 68, at 7; Orbell et al., *Do Cooperators Exit?*, *supra* note 70, at 147.

The causal connection between trustworthiness and trust is unclear. Someone who is initially untrustworthy may simply assume that others are like herself. Alternatively, someone who initially concludes that others are untrustworthy may thereafter feel that there is less reason to be trustworthy herself. *See* Brann & Foddy, *supra* note 65, at 617; Rotter, *supra* note 53, at 3; *see also infra* text accompanying notes 92-97 (discussing how expectations regarding others' likely behavior are important determinants of willingness to trust in a particular situation).

[72] *See* Robert H. Frank et al., *Does Studying Economics Inhibit Cooperation?*, J. ECON. PERSP., Summer 1993, at 159 (arguing that "exposure to the self-interest model commonly used in economics alters the extent to which people behave in self-interested ways"). This possibility is consistent with the extensive evidence available on the importance of social framing to trust. *See infra* Part II.D.

The authors would like to note that we find both possibilities distressing. One of us holds a Ph.D. in economics and the other has co-authored a casebook in law and economics. DAVID W. BARNES & LYNN A. STOUT, LAW AND ECONOMICS: CASES AND MATERIALS (1992). We take heart, however, from an experiment suggesting that while economics students may be less inclined to cooperate in a formal social dilemma ual differences in willingness to trust in new situations are significantly determined by differences in past experience, both recent and distant. In other words, trust seems in large part a learned behavior.

Let us return to the empirical finding that players in repeat social dilemmas tend to cooperate less than players in one-shot games. This result (which is, as noted earlier, inconsistent with the assumption of rational self-interest[73]) appears driven by the following peculiar pattern: Players' willingness to trust and be trustworthy in repeated social dilemma games deteriorates over time.[74] This pattern can be explained as a result of players' initial trust in the other players' likely cooperation being steadily eroded by experience. As cooperators learn that other players are defecting, they become increasingly willing to defect themselves.

If individuals' willingness to trust others and to behave trustworthily toward them can be influenced by such relatively recent experiences,[75] it seems plausible that it can also be influenced by the weight of accumulated past experiences. In accord with this view, psychologists and sociologists posit that trust is a generalized expectancy or belief about others' behavior formed on the basis of accumulated experience.[76] When faced with a new situation, an individual choosing

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game, they may be more inclined to cooperate in "real world" situations. *See* Yezer et al., *supra* note 10, at 181 (reporting that students in economics classes were significantly more likely to seal and mail a "lost" letter enclosing currency apparently intended to repay a loan); *see also infra* note 77 (discussing why even economics students inclined toward trust in everyday life might be less likely to cooperate in the context of a formal experiment).

[73] *See supra* text accompanying notes 56-57.

[74] *See* Dawes & Thaler, *supra* note 3, at 189; Sally, *supra* note 53, at 65; *see also id.* at 77-78 (finding that increasing the number of trials from 1 to 100 diminishes the average cooperation rate by 13 to 15 percentage points).

[75] Studies have also found that cooperation rates in a social dilemma can be significantly influenced by asking the players, immediately before playing the game, to participate in some other cognitive task. Players who engage in a task that requires cooperation are then more likely to cooperate in the dilemma. Conversely, players assigned a competitive task are more likely to defect subsequently. *See* Samuel Bowles, *Endogenous Preferences: The Cultural Consequences of Markets and Other Economic Institutions*, 36 J. ECON. LIT. 75, 99 (1998) (citing public goods experiments that show that trust depends in part on whether the most recent cognitive task required competitive or cooperative behavior).

[76] *See, e.g.*, Rotter, *supra* note 53, at 1 (describing this view and citing research that "suggests that modeling and direct teaching are the most potent forces in developing high- or low-trusting beliefs in children"); *see also* TOM R. TYLER, WHY PEOPLE OBEY THE LAW 170-78 (1990) (arguing that most people obey the law because they feel that they ought to and that this belief is in part a product of socialization); *supra* note 72 and accompanying text (describing the argument that studying economics makes people more distrusting).

whether or not to trust will be influenced not only by the likely economic payoffs in the immediate circumstances but also by her past experiences. If trust has proven adaptive for her in the past, she is likely to opt for trust again in the present—even if a cold calculation of payoffs would favor defection.

D. *The Influence of Social Context*

It is important to note that the claim that trust is a learned behavior does not imply that high trusters always favor cooperation over competition in new situations. To the contrary, a fourth key empirical finding from the social dilemma studies is that even high trusters, in the right circumstances, predictably choose to defect rather than cooperate. The key appears to be whether, when faced with a new situation that presents social dilemma payoffs, an individual categorizes it as a *competitive* task or a *cooperative* task. If the task is viewed as competitive, both high and low trusters pursue self-interest and defect. If the task is categorized as cooperative, high trusters in particular will choose a cooperative strategy that appears to reflect concern for others' welfare.[77]

What determines whether a social dilemma situation is perceived as cooperative or competitive? One critical variable appears to be social context—players' perceptions of what *others* expect and need, how *others* are likely to behave, and what *others'* relationships are to themselves. The importance of social context can perhaps be seen most clearly from David Sally's comprehensive survey of the results of more than one hundred social dilemma experiments. Sally found that cooperation rates in these studies ranged from as low as five to more than ninety-five percent.[78] (This is an astounding degree of range, given that all the experiments presented situations in which defection

[77] This observation raises questions about labeling individuals as high or low trusters. True, there may be some individuals who have only one preference function (that of *homo economicus*) and always choose defection over cooperation in a social dilemma. For most, however, the decision to cooperate or defect—that is, to opt for a purely self-interested preference function or an other-regarding preference function—seems determined at least in part by whether past experience leads us to categorize the present situation as cooperative or competitive. Thus, economics graduate students may cooperate less in social dilemmas, not because they are less cooperative, but because the process of studying economics and game theory under assumptions of selfish rationality leads them to recognize the payoff structure of a social dilemma and categorize it mentally as a competition game rather than a cooperation game. *See supra* text accompanying note 72.

[78] Sally, *supra* note 53, at 62, 71.

was the *only* dominant strategy for the rationally selfish player.) Further, Sally concluded that a variety of purely social factors appeared highly influential in determining the degree of cooperation observed in social dilemma games. For example, players were more likely to cooperate when they believed that their contribution was important to the group's welfare: As the size of the loss to the group from an individual's defection increased, the likelihood of defection decreased.[79] (An interesting implication is that the more vulnerable one becomes, the greater the likelihood that a trusted person will in fact prove trustworthy.[80]) Visual contact was another variable that significantly increased cooperation rates, even though allowing players to view each other does not change the payoffs in a social dilemma.[81]

These types of social variables—perceptions of others' dependence and personal contacts—are the sorts of variables that business institutions can and do take account of and even deliberately manipulate. It is not unusual to find employers telling employees how valuable their contributions are or organizing meetings and social events to give them opportunities to interact. In this Article, however, we wish to draw attention to how the behavioral phenomenon of trust can change our understanding not only of the nature and functioning of corporations, but also of the nature and functioning of corporate law. In this vein, we explore in greater detail below three particular social variables that the empirical studies suggest strongly influence trust behavior. These are: (1) instructions from authority, (2) perceptions of group membership, and (3) expectations regarding others' trust behavior.

1. Instructions from Authority

One of the most consistent findings in the social dilemma literature is that players are far more likely to cooperate with each other if the experimenter simply asks them to do so. Sally's survey, for exam-

[79] *Id.* at 79; *see* David Good, *Individuals, Interpersonal Relations, and Trust*, *in* TRUST: MAKING AND BREAKING COOPERATIVE RELATIONS 31, 44 (Diego Gambetta ed., 1988) (noting that incidence of trust is influenced by the perceived importance of one's contribution to others, even though it is hard to see how this affects economic payoffs); *see also* Bowles, *supra* note 75, at 94-95 (suggesting that contractual incompleteness, which implies vulnerability, leads to trusting behavior).

[80] Defection becomes more likely, however, when the personal economic payoff from defection increases. Sally, *supra* note 53, at 75. Thus, increasing vulnerability can only reliably promote trustworthy behavior when it does not also increase the potential gain from defecting.

[81] *Id.* at 67, 83.

ple, found that explicit instructions to cooperate in a social dilemma raised base cooperation rates by as much as forty percentage points. Correspondingly, formal instructions to compete decreased cooperation rates by as much as thirty-three percentage points.[82]

This result is unlikely to surprise either a psychologist or the average person on the street. It might, however, bewilder an economist; whether the experimenter tells the players to cooperate or defect has no effect on the *economic* payoffs in the game. Nevertheless, formal instructions exert a strong influence on the likelihood of cooperation. People seem inclined to do what they are told to do, especially when instructions come from someone who is perceived as something of an authority.

This effect is so strong that significant changes in behavior occur when the experimenter even hints at her desires. For example, in one social dilemma study by Lee Ross and Andrew Ward, players were divided into two groups. The first group was told that they were going to play "The Community Game." The second group was told that they were going to play "The Wall Street Game." Although both groups were presented with identical payoff structures, the different labels produced dramatic differences in behavior. Only about one-third of the players chose to cooperate in playing "The Wall Street Game." In contrast, more than two-thirds cooperated when playing "The Community Game."[83]

2. Perceptions of Group Identity

A second social variable that consistently has been found to exert a strong influence on cooperation rates in social dilemmas is group identity. Social scientists have long argued that group identity is an important component of most individuals' psychological makeup and that in situations in which group identity is brought into play, individuals appear to adopt preference functions that consider the

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[82] *Id.* at 78.

[83] Lee Ross & Andrew Ward, *Naive Realism in Everyday Life: Implications for Social Conflict and Misunderstanding*, *in* VALUES AND KNOWLEDGE 103, 106-07 (Edward S. Reed et al. eds., 1996). Similarly, in some social dilemma trials, the experimenters used the relatively value-laden words "give" or "cooperate" to describe the cooperative strategy. In others, experimenters used neutral phrases (such as "project *X*" and "project *Y*") to describe cooperating and defecting strategies. Cooperation is significantly more likely in the former sorts of games than in the latter. *See* Sally, *supra* note 53, at 65; *see also* Bowles, *supra* note 75, at 88-89 (reviewing experimental studies that show cooperation is more likely when the experimenter bids the subjects to "divide $10" than when the decision is called an "exchange").

group's welfare as well as their own.[84] This argument is amply supported by the social dilemma evidence. Players who perceive their fellow players as members of their own "ingroup" are more likely to cooperate than individuals who see themselves as playing against members of an "outgroup."[85]

Evidence of the importance of group identity can be seen in the consistent finding that allowing the players to communicate with each other in a social dilemma significantly increases the incidence of cooperation.[86] Sally's meta-analysis, for example, found that allowing communication raised base cooperation rates in repeated games by forty percentage points.[87] Social scientists have offered a variety of reasons for why communication encourages cooperation. One possibility is that communicating promotes feelings of group identity.[88]

A test of this hypothesis can be found in a series of social dilemma experiments designed by Robyn Dawes, Alphons van de Kragt, and John Orbell.[89] Groups of fourteen subjects, each of whom had been given an initial monetary stake, were then randomly divided into two subgroups of seven. Half of the subgroups were then told that if they gave away their money, twice that amount would be distributed to the other members of their subgroup (their ingroup). The other half were told that if they gave away their money, twice that amount would be distributed among the members of the *other* subgroup (their outgroup). Players who did not communicate with each other seemed almost equally willing to contribute to their outgroup as to their in-

[84] *See, e.g.*, Henri Tajfel, *Social Identity and Intergroup Behavior*, 13 SOC. SCI. INFO. 65, 68-70 (1974). *See generally* SOCIAL GROUPS AND IDENTITIES: DEVELOPING THE LEGACY OF HENRI TAJFEL (W. Peter Robinson ed., 1996).

[85] Sally, *supra* note 53, at 68; *see also* Dawes et al, *Cooperation, supra* note 53, at 99 ("[E]xperiments have led us to conclude that cooperation rates can be radically affected by . . . group identity."); Kramer, *supra* note 24, at 588 (describing experiments in which arbitrarily categorizing individuals into groups "often resulted in individuals' evaluating outgroup members as less . . . trustworthy").

[86] *See* Robyn M. Dawes, *Social Dilemmas*, 31 ANN. REV. PSYCHOL. 169, 185 (1980) (citing studies and noting that "the salutary effects of communication on cooperation are ubiquitous"); Komorita et al., *Reciprocity and Induction, supra* note 21, at 608 (citing studies and noting that "communication between group members seems to produce high contribution rates").

[87] Sally, *supra* note 53, at 78.

[88] *See, e.g.*, Kelly S. Bouas & S.S. Komorita, *Group Discussion and Cooperation in Social Dilemmas*, 22 PERS. & SOC. PSYCHOL. BULL. 1144, 1144 (1996) (discussing this hypothesis); Dawes et al., *Behavior, Communication, supra* note 68, at 3 (same).

[89] Orbell et al., *supra* note 53, at 811-18. For more discussion of the nexus between group discussion and cooperation, see Dawes et al., *Cooperation, supra* note 53, at 103-06.

group (an average thirty-four percent versus thirty-three percent cooperation rate). Only ten minutes of communication, however, increased the cooperation rate (up to nearly seventy percent) among players who had been told that their contribution would benefit their ingroup. In contrast, communication slightly *decreased* cooperation (down to thirty-one percent) among players who had been told that their contribution would benefit their outgroup, although this effect was not statistically significant.[90]

Such results demonstrate both that a sense of group identity can easily be fostered and that it can be extremely important to the decision to categorize a particular social relationship as either cooperative or competitive. Although significant cooperation can occur without overt efforts to create a group identity, enhancing feelings of group identity predictably leads to increases in the levels of observed cooperation.[91] People are more willing to sacrifice self-interest for "us" than for "them."

3. Expectations About Others' Behavior

Finally, a third social variable that appears to influence individuals' willingness to exhibit trust behavior is their perceptions of whether others are likely to exhibit trust. Studies have found that players are much more likely to cooperate in a social dilemma when they expect their fellow players to cooperate.[92] Similar evidence may be observed in the consistent finding that players are more likely to cooperate with each other when they are allowed a short time period in which to communicate with each other. But they are particularly likely to cooperate when their communication takes the form of exchanged statements of intent to cooperate.[93]

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[90] *See* Dawes et al., *Cooperation, supra* note 53, at 106.

[91] *See* Sally, *supra* note 53, at 79.

[92] *See* Scott T. Allison & Norbert L. Kerr, *Group Correspondence Biases and the Provision of Public Goods*, 66 J. PERSONALITY & SOC. PSYCHOL. 688, 688 (1994) ("Numerous studies have reported that individuals are more likely to cooperate when they expect other group members to cooperate than when they expect others to defect."); Dawes, *supra* note 86, at 187-88 (describing studies finding that cooperation rates are positively correlated with expectations that other players will cooperate); Yamagishi, *supra* note 53, at 64 (discussing experimental findings that "[e]xpectations about other members' behavior is one of the most important individual factors affecting members' decisions in social dilemmas"); *see also* Komorita et al., *Reciprocity and Induction, supra* note 21, at 608 ("[I]ndividuals are more cooperative when they expect others to be cooperative.").

It should be noted that a high probability that others will cooperate makes defecting even more attractive to the rationally selfish player.

[93] *See, e.g.*, Dawes et al., *Behavior, Communication, supra* note 68, at 1, 5-7 (finding

Why does the expectation that others will cooperate increase the incidence of cooperative behavior in social dilemmas? One possibility is that the belief that others will cooperate increases perceptions of ingroup membership.[94] A second theory is that players in a social dilemma are motivated much less by the hope that they might extract gains at their fellow players' expense than by the fear that their fellows might successfully exploit them. In other words, people want to avoid "being a sucker."[95] Yet a third possibility is that players look to others' behavior as a signal in a novel and otherwise ambiguous social situation of what the appropriate norm of conduct is, and whether the context calls for primarily cooperative or competitive behavior.[96]

Whatever the cause of herd behavior in social dilemmas, players in these games show a marked tendency to conform to the expected behavior of other players.[97] When in Rome, most do as they expect the Romans to do.

E. *The Influence of Economic Context*

In emphasizing the starring role social factors play in determining the incidence of trust, we do not mean to imply that economic factors are unimportant. *Homo sapiens* is a far more other-regarding species than *homo economicus.* But there is reason to believe that most people keep at least one eye on personal payoffs when deciding whether to

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that allowing subjects to exchange statements of intent to cooperate raised cooperation rates significantly compared to allowing subjects to communicate on irrelevant subjects).

[94] *See, e.g.*, Dawes & Thaler, *supra* note 3, at 195 (discussing this possibility).

[95] Dawes, *supra* note 86, at 187. A belief that others will cooperate increases the expected return from defecting but also decreases the expected losses from cooperating. If the second matters more to people than the first, expecting others to cooperate will increase one's own willingness to cooperate.

[96] *See* Bouas & Komorita, *supra* note 88, at 1144 (discussing a "perceived consensus" theory of cooperation). *See generally* Cristina Bicchieri, *Norms of Cooperation*, 100 ETHICS 838, 839 (1990) (discussing social norms as the tendency to replicate others' behavior); Robert B. Cialdini et al., *A Focus Theory of Normative Conduct: Recycling the Concept of Norms To Reduce Littering in Public Places*, 58 J. PERSONALITY & SOC. PSYCHOL. 1015 (1990) (same).

[97] Interestingly, in experiments in which players in multiple groups communicate, different groups often develop and then follow different norms (for example, "contribute a portion of your stake" versus "contribute everything"). *See* CRISTINA BICCHIERI, THE GRAMMAR OF SOCIETY (forthcoming 2001) (manuscript ch.5 at 18, 26, on file with authors). A related phenomenon may be the "carryover" effect observed in some social dilemma studies. When players in one group are allowed to exchange commitments to cooperate but are then told that their contributions will go to players in a second group, average cooperation rates remain higher than when players are not allowed to communicate their intent and benefits remain within the group. *Id.* at 6.

trust or be trustworthy.

Studies have found that, while people do cooperate in social dilemma games, as the personal cost associated with cooperating rises (that is, as players' expected gains from defection increase), cooperation rates begin to decline. For example, Sally's regression analysis found that doubling the reward from defecting decreased average cooperation rates by as much as sixteen percentage points.[98] In other words, people's willingness to trust appears to be mildly "downward-sloping." As the personal cost of trust in a social dilemma rises, cooperation rates decline. This observation raises the question: If trust behavior is only likely to occur when it is not too costly to behave trustworthily, how can trust be a source of significant social gains?

The answer to this question is twofold. First, the costs and benefits of trust behavior do not march in lockstep. Acts of trust that require only a modest sacrifice on the part of the trusted actor can produce much larger gains for the trusting actor. For example, a marginal increase in the degree of care exercised by a corporate director or employee may greatly benefit a firm if it prevents the loss or destruction of valuable corporate assets. Similarly, it is easy to imagine situations in which an agent who steals from a firm (say, by selling a trade secret) inflicts harm far greater than any benefit she receives. The experimental evidence indicates that it is in exactly these sorts of circumstances—when the individual cost of cooperation is relatively small and the benefits for others relatively large—that people are most likely to cooperate in a social dilemma.[99] Thus, trust behavior seems particularly likely to occur (and to lead to clear social gains) in situations in which a corporate participant's trustworthy behavior would create disproportionate gain or in which that participant's malfeasance would inflict disproportionate harm.

Second, studies have shown that while players in one-shot social dilemmas are less likely to cooperate when playing for large stakes (that is, when personal gains from defecting are large), players in repeated games can be induced to trust each other in such situations. This is done by starting with small stakes and increasing the stakes in later rounds.[100] In experiments of this sort, groups of players who cooperate with each other in initial rounds tend to continue cooperat-

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[98] Sally, *supra* note 53, at 75.

[99] *See id.* (finding that increasing players' costs of cooperation decreased cooperation rates in social dilemmas); *id.* at 79 (finding that as the gains to others in the group from cooperation increase, cooperation rates increase).

[100] *See* Good, *supra* note 79, at 44 (discussing the small increment effect).

ing in later rounds, suggesting that people view others' past cooperation as evidence of intrinsically trustworthy characters, increasing their own willingness to trust.[101] This sort of pattern of repeated interaction and increasing mutual vulnerability is often observed in the business world.[102]

The net result is that, even if the "supply function" for trust is downward-sloping, there is probably a wide variety of business circumstances in which trust behavior produces significant benefits. And even small acts of trust, when aggregated over many players and many transactions, can add up to very big gains. But the experimental evidence cautions against asking trust to bear too much weight in any individual case. When the price of honor gets too high, people refuse to pay for it.

F. *Caveats and Conclusions*

Economists and legal scholars who favor economic analysis traditionally view human behavior in terms of a simple model of rational selfishness constrained only by legal and market forces. Although this model has great explanatory power in many situations, it overlooks a third, less well understood but equally potent force for modifying human behavior: socially contingent other-regarding preferences, including, but not limited to, trust.[103] Extensive experimental evidence demonstrates that most people behave as if they have two personalities or preference functions. In some contexts, individuals behave as if they were purely selfish. But when the social and economic conditions are right, their cooperative, other-regarding personalities

[101] *See* Thomas Gautschi, *History Effects in Social Dilemma Situations*, 12 RATIONALITY & SOC'Y 131 (2000) (finding that subjects' past experience with other subjects in social dilemmas affects their present decisions whether to cooperate or not).

[102] For example, labor theorists frequently model the relationship between a firm and its employees as one in which the employee displays trust by making incremental investments in firm-specific human capital. *See* Edward B. Rock & Michael L. Wachter, *The Enforceability of Norms and the Employment Relationship*, 144 U. PA. L. REV. 1913, 1921-24 (1996) (discussing this model); *see also* LEWIS, *supra* note 8, at 57-59 (observing from case studies that companies in joint ventures can promote trust by collaborating on smaller projects before moving to larger ones).

[103] Although our analysis focuses on trust, other-regarding preferences can produce other forms of behavior as well. Altruism can lead one person to look out for another's interests even in situations in which the beneficiary has not made any conscious decision to make herself vulnerable. *See* Yezer et al., *supra* note 10 (describing "lost letter" experiments). Other-regarding preferences may also have a dark side in the form of vengefulness, where one individual incurs a personal cost in order to punish another. *See supra* note 30 (discussing vengefulness).

emerge.

This last point bears emphasizing, for it hints at the potential fragility of trust. As noted earlier, one of the critical determinants of cooperative behavior in social dilemma games is what the players expect the other players in the game to do. As a result, repeated social dilemma games tend to converge quickly on one of two possible equilibrium outcomes: Either most players cooperate, or most defect. The natural implication is that even a small change in initial conditions—perhaps a change in the proportion of low- to high-trusters in a social dilemma situation, in feelings of group identity, or even in the language used to describe a particular social or legal relationship—can shift the situation past a "tipping point," moving the end result from one behavioral extreme to the other.

The potential fragility of trust is heightened by the possibility that the social conditions that favor trust are easier to destroy than to create. Express and implied signals of trust and trustworthiness are subject to being disproved by contrary evidence—say, when a player in a social dilemma game tricks her fellow players into cooperating by announcing her own intent to cooperate and then exploits their trust by defecting. In contrast, signs of lack of trust and trustworthiness tend to be self-fulfilling. Once players in a social dilemma game come to believe that their fellows intend to defect, they themselves defect, and distrust prevails even if it was initially unjustified. In other words, the impact of social signals, including choice of rhetoric, may be asymmetric. Rhetoric alone cannot support trust, but rhetoric alone can undermine it.[104]

In sum, there is reason to believe that trust can only blossom in favorable social conditions. Moreover, even when people initially trust, if their cooperation is not reciprocated—if other players choose instead to defect—they will quickly switch to a competitive strategy. Trust, it turns out, is neither gullibility nor pure selflessness. When abused, trust tends to disappear. But when it is not abused, trust permits patterns of reciprocal, other-regarding behavior to spring up that are impossible to explain under neoclassical assumptions of selfish rationality. Moreover, as social dilemma experiments illustrate, this be-

[104] *See* Diego Gambetta, *Can We Trust Trust?*, *in* TRUST: MAKING AND BREAKING COOPERATIVE RELATIONS, *supra* note 79, at 213, 233-34 ("[T]rust itself affects the evidence we are looking for. While it is never difficult to find evidence of untrustworthy behaviour, it is virtually impossible to prove its positive mirror image .... [Distrust] has the capacity to be self-fulfilling." (emphasis omitted)); Kramer, *supra* note 24, at 594 (noting that in asymmetric-experience situations "distrust is very difficult to invalidate through experience").

havior allows individuals in groups to achieve outcomes that are far superior—on both a group *and* an individual basis—to the outcomes that can be achieved through rational selfishness. Although trust may not be strictly "rational," it can be efficient. That observation in turn suggests that, in many situations, the most effective way to constrain welfare-reducing, opportunistic behavior may not be by changing individuals' external rewards and punishments, but instead by changing their internal *preferences* and encouraging the emergence of their cooperative, other-regarding "personality."

The notion of endogenous preferences that can be changed by manipulating social context provides a dramatic departure from standard economic analysis.[105] But it can also provide significant insight into actual human institutions. To illustrate, we consider in Part III how several important and otherwise puzzling features of corporate law can be explained through an analysis that takes account of trust and the way actual people behave in actual situations. Before applying the lessons of social dilemma experiments to our understanding of corporate law, however, we note the potential pitfalls of relying on such experiments to predict human behavior in the far more complex environment of the corporation.

Social dilemma games are, by their very nature, poor imitations of the complexities of life in the everyday business world.[106] Yet, the information provided by such experiments is only useful if we are willing to take the next step and assume that the sorts of variables that determine cooperation rates in experiments also influence cooperation between and among corporate officers, employees, directors, and shareholders. In doing this we inevitably run the risks associated with extrapolation.

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[105] On first inspection, the notion of endogeneous preferences appears to pose a challenge to economic analysis by raising the following question: If efficiency lies in satisfying as many human desires as possible but if human desires change in response to social circumstances, how are we to know what is "efficient?" A complete answer to this question lies beyond the scope of this Article. For an excellent discussion, see Louis Kaplow & Steven Shavell, *Principles of Fairness Versus Human Welfare: On the Evaluation of Legal Policy*, 114 HARV. L. REV. (forthcoming 2001). We note, however, that while in many cases there are no obvious efficiency advantages to be derived from changing people's preferences (for example, from vanilla to strawberry ice cream), in other cases there are. For example, we improve social welfare if we induce individuals with sadistic preferences to adopt instead altruistic preferences. (Because sadists are satisfied by inflicting pain on others while altruists are satisfied by increasing others' happiness, shifting from sadism to altruism increases overall human happiness, other things being equal).

[106] *See* Dawes, *supra* note 86, at 188 (observing that social dilemma games "are lousy *simulations* of the social dilemmas with which most of us are concerned").

Some of these risks likely are not too serious. For example, because the participants in social dilemma experiments are often undergraduate and graduate students, it might be argued that their behavior is not representative of other segments of the population. However, we suspect that it is representative enough of behavior in most corporations.[107] After all, it is undergraduate and graduate students who often go on to inhabit the offices and cubicles of corporate America.

Similarly, we do not think that it is critical that players in social dilemma games usually believe that they are playing with other individuals. (This belief is not always accurate; in some social dilemma experiments, human players who were told that they were playing with other humans were in fact playing against an algorithm or computer program.[108]) Many acts of trust in firms involve individuals dealing directly with other individuals, as when employees are asked to trust their co-workers and immediate supervisors.[109] Moreover, there is reason to believe that people indulge in trust behavior not only with other persons, but also with nonhuman entities, including institutions like "the company." Individuals who are asked to play a social dilemma game with a computer and to interact with a workstation, for example, display behavior similar to individuals who play with human partners.[110]

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[107] *See also* Alvin E. Roth et al., *Bargaining and Market Behavior in Jerusalem, Ljubljana, Pittsburgh, and Tokyo: An Experimental Study*, 81 AM. ECON. REV. 1068, 1068-69 (1991) (finding no significant differences in experimental behavior in ultimatum games among subjects drawn from four different nations); *supra* note 30 (describing ultimatum games).

[108] Sara Kiesler et al., *A Prisoner's Dilemma Experiment on Cooperation with People and Human-Like Computers*, 70 J. PERSONALITY & SOC. PSYCHOL. 47, 48 (1996) (discussing the practice in social dilemma games of the experimenter or a computer acting as a fictional other player).

[109] These personal interactions often extend throughout the firm in a "linking pin" system in which members of workgroups know and trust each other and their immediate supervisors; supervisors know and trust their workers, their fellow supervisors, and their department head; and so forth up to the CEO and board of directors. Thomas H. Jerdee & Benson Rosen, *Effects of Opportunity To Communicate and Visibility of Individual Decisions on Behavior in the Common Interest*, 59 J. APPLIED PSYCHOL. 712, 716 (1974) (describing the "linking pin" concept in which small groups in firms make commitments of cooperation to leaders who convey this to the next level of the organization).

[110] Kiesler et al., *supra* note 108, at 55-60 (reporting the results of prisoner's dilemma games played with another human subject, with a computer workstation, and with a computer that responded with synthesized speech and presented a picture of a human face on the monitor and finding that people cooperate, albeit to a lesser degree, with computers). Casual empiricism also suggests that people often respond to institutional entities as if they were human.

Other limitations of social dilemma games may be more serious, however. In particular, social dilemma experiments only test what might be called "two-way" trust: players must choose to be either simultaneously trusting and trustworthy or simultaneously distrusting and untrustworthy. Yet in many business situations one participant is asked simply to trust, and the other simply to be trustworthy. There may be some risk in assuming that the same variables that influence two-way trust necessarily apply to "one-way" trust as well.[111]

More broadly, our approach to the social dilemma evidence is for the most part a crude, behaviorist one. We treat individuals as black boxes whose interior workings are unobservable. To draw inferences about trust, we simply compare the variables that go into the box with the behavior that comes out. This approach permits us to make a number of important predictions about trust behavior. We could make far more, however, if we had a *cognitive* theory of trust—if we could look inside the box to see what motivates trust behavior. Unfortunately, the question of what motivates trust remains a subject of hot debate among social scientists, though some things seem more likely than others. For example, it seems unlikely that trust behavior is the result of mental mistake or cognitive error. Researchers in most experiments have gone to some length to ensure that the players fully understand the payoff functions with which they are presented.[112] The obvious alternative is that trust behavior represents a form of socially contingent altruism in which people take account of others' welfare in making their own choices.

But why do people take account of others' welfare? Is trust true altruism, in which one person is made happy by another's increased happiness? Or is trust instead motivated by guilt? Perhaps *A* behaves

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[111] We are unaware of any significant body of empirical literature testing one-way trust.

[112] *See* Sally, *supra* note 53, at 70 ("[I]n almost all of the assays, subjects were tested on their knowledge of the instructions and any mistakes were addressed."). Although subjects in social dilemmas appear to understand that cooperation reduces their personal payoffs in the game itself, it is harder to rule out the possibility that they mistakenly believe that they will interact with their fellow players again sometime in the future, when a decision to defect might be punished. Put differently, other-regarding behavior may reflect not altruistic preferences but cognitive error in the form of biased overestimates of the likelihood of reciprocity. (This sort of cognitive error provides the basis for the joke about the aged professor who always attended his colleagues' funerals for fear that if he did not, they would refuse to attend his.) While this possibility is an interesting one that hints at the evolutionary origins of trust, it does not change our analysis. Whether trust is driven by altruism or error, it remains important to an understanding of how corporations and corporate law reduce agency costs and promote team production in business firms.

trustworthily toward *B* not because she wants *B* to be happy, but because she herself will be guilt-ridden and unhappy if she does not.[113]

Further work on these and related questions would be immensely valuable. In the meantime, we must content ourselves with a behaviorist approach. The result is undoubtedly a cartoonish, two-dimensional sketch of the complex reality of human behavior. Even this two-dimensional model, however, gives us a better understanding of corporations and corporate law than the one-dimensional model of *homo economicus.*

III. TRUST BEHAVIOR AND CORPORATE LAW

The conventional nexus of contracts approach to corporate law attempts to explain how firms work, and the role of law in making them work, solely in terms of market incentives and legal obligations. For the reasons we outlined in Part I, however, these explanations have not been fully satisfactory. Legal sanctions and market forces often cannot bind corporate participants tightly enough to restrain all opportunistic behavior (at least if one assumes that participants are rational and self-interested players). The information requirements are just too high and the business environment is too complex, opaque, and uncertain.

As a result, there is reason to believe that trust may play an important role in the success of many business firms. That possibility is of obvious interest to businesspeople as well as to management theorists and business consultants who study what makes successful firms tick. But an understanding of the role of trust in business relationships and the variables that influence trust is also important for lawmakers, legal scholars, and practicing lawyers.

We consider below how the behavioral phenomenon of trust can offer vital insights into a variety of debates and puzzles in contemporary corporate law. We begin by revisiting one of the longest-running engagements in contemporary corporate scholarship—the battle between the "contractarians" and the "anticontractarians" over the nature of corporate fiduciary duties.

A. *Trust Behavior, the Duty of Loyalty, and the Contractarian-Anticontractarian Debate*

Corporate case law frequently centers on the fiduciary duties of

[113] *See, e.g.*, Dawes & Thaler, *supra* note 3, at 190-96 (discussing this question).

loyalty and care that corporate directors and officers are said to owe the firm and its shareholders, or on the fiduciary duties shareholders are said to owe to each other.[114] Indeed, fiduciary relationships lie at the heart of modern corporate law. Yet what does it mean "to owe a fiduciary duty?"

According to the contractarian school of corporate scholars, the answer to this question is "not much." Contractarian commentators (including such noted theorists as Henry Butler, Frank Easterbrook, Daniel Fischel, Jonathan Macey, Geoffrey Miller, and Larry Ribstein) argue that corporate law is best understood as a kind of standard form contract for governing relationships among officers, directors, and shareholders.[115] A corollary of this view is that the contracting parties should be free to depart from the terms of the standard form whenever they so desire. In particular, the contractarians argue that the rules of fiduciary duty are and should be viewed as nothing more than default rules that corporate participants can "opt out" of upon mutual agreement.[116]

This claim is hotly disputed by an opposing group of equally prominent scholars that includes Victor Brudney, Robert Clark, Deborah DeMott, Melvin Eisenberg, and Tamar Frankel.[117] According to

[114] *See* Robert C. Clark, *Agency Costs Versus Fiduciary Duties, in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55, 61 (John W. Pratt & Richard J. Zeckhauser eds., 1985) ("Most corporate case law deals with alleged breaches of fiduciary duties . . . .").

[115] *See, e.g.*, Butler & Ribstein, *supra* note 12, at 71-72; Easterbrook & Fischel, *supra* note 12; Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395 (1983); Jonathan R. Macey & Geoffrey P. Miller, *Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory*, 42 STAN. L. REV. 1059, 1068-69 (1990) ("[C]ourts should treat an allegation of a breach of a fiduciary duty as they would treat any other alleged breach of contract."); *see also* Stephen M. Bainbridge, *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 CORNELL L. REV. 856, 858-73 (1997) (discussing the contractual approach); Lucian Arye Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1395-96, 1426-34 (1989) [hereinafter Bebchuk, *Debate*] (describing the debate); William A. Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE. L.J. 1521, 1526 (1982) (adopting the contractual approach).

[116] *See, e.g.*, Butler & Ribstein, *supra* note 12, at 28-32. This could be done, for example, through a charter provision that eliminates officers' and directors' fiduciary duties. Delaware permits corporations to adopt charter provisions that significantly restrict directors' *monetary liability* for breach of the duty of care. DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 2000). However, this is not necessarily the same thing as excusing directors from their duty of care. *See infra* note 150.

[117] *See, e.g.*, Brudney, *supra* note 12, at 1403-10; Clark, *supra* note 114, at 61; Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879; Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461 (1989); Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209 (1995)

these anticontractarians, it is misleading and fundamentally mistaken to apply the rhetoric of contract to fiduciary duties; describing a fiduciary relationship as a "contract" misses the heart of that special bond.[118] Anticontractarians also generally disagree with the notion that corporate officers and directors should be permitted to opt out of their fiduciary duties. In particular, they argue that the duty of loyalty is not a default rule but a mandatory rule that should be enforced by courts without regard to any apparent agreement otherwise.[119]

The war between the contractarians and the anticontractarians has raged for two decades and produced a voluminous literature.[120] We cannot hope to resolve that debate here or even fully address it. Instead, we demonstrate how the phenomenon of trust behavior helps to explain both the nature and the intensity of the anticontractarians' objections to the contractarian position. In particular, we explore how the empirical evidence surveyed in Part II supports the claim that there are fundamental differences between fiduciary relationships and the types of relationships normally thought of as contractual. It also suggests that significant dangers arise in treating fiduciary duty rules as default rules that can be freely contracted around.

To understand why, consider the basic elements of fiduciary duty. The hallmark of a fiduciary relationship is the legal requirement that the fiduciary act for the exclusive benefit of her beneficiary.[121] To discourage self-interest from rearing its head, the law prohibits her from using her position to reap any personal benefit without her benefici-

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[hereinafter Frankel, *Fiduciary Duties*]; Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795 (1983) [hereinafter Frankel, *Fiduciary Law*].

118 *See, e.g.*, Brudney, *supra* note 12, at 1404 (arguing that, when applied to corporate fiduciary duties, "the rhetoric of contract proceeds on doubtful assumptions about the circumstances of the parties, imports inappropriate normative consequences to govern the relationships thus assumed, and serves the ideological function of legitimating . . . managerial discretion . . . to serve itself at the expense of investors"); Clark, *supra* note 114, at 60 (noting that the "extreme contractualist viewpoint . . . is likely to blind us to most of the features of the modern public corporation that are distinctive, puzzling, and worth exploring"); DeMott, *supra* note 117, at 879-80 ("Resorting unreflectively to contract rhetoric is insidiously misleading and provides no rationale for further development of the law of fiduciary obligation.").

119 *See, e.g.*, Clark, *supra* note 114, at 64 ("[S]ome important corporate law rules cannot be bargained around . . . . Basic fiduciary duties fall in this category . . . ."); Melvin Aron Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1275 (1999) [hereinafter Eisenberg, *Corporate Law*] ("[I]f the duty of loyalty was contractual, it would follow that the duty could be . . . waived by agreement. Generally speaking, however, it cannot be.").

120 *See, e.g.*, sources cited *supra* notes 12, 115-19.

121 *See* Clark, *supra* note 114, at 73 (noting that a fiduciary must act only for the beneficiary's interest); DeMott, *supra* note 117, at 882 (same).

ary's authorization, even when she could do so without harming her beneficiary.[122] And a fiduciary is expected to act in her beneficiary's interest even when—*especially* when—the beneficiary cannot monitor or control the fiduciary's behavior.[123]

As these basic principles of fiduciary law make clear, the keystone of the fiduciary relationship lies in the fiduciary's commitment to abandon self-interest and promote her beneficiary's welfare instead of her own.[124] As Justice Cardozo put it in the famous case of *Meinhard v. Salmon*:

> Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.
>
> . . . .
>
> . . . *Salmon had put himself in a position in which thought of self was to be renounced, however hard the abnegation.*[125]

Cardozo's message is unmistakable: A fiduciary must "renounce" self-interest in favor of pursuing the interests of another. Expressed in terms of the evidence reviewed in Part II, what makes a fiduciary a fiduciary is that she has an obligation to behave as if she has adopted an *other-regarding preference function.* If she fails to do this, the courts condemn her in terms that are didactic and full of moral fervor.[126]

Recognizing that fiduciary duties demand other-regarding behavior reveals the heart of the distinction between fiduciary relationships

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[122] *See* Clark, *supra* note 114, at 73-74 (discussing the prohibition against "secret profits"); DeMott, *supra* note 117, at 908 (same). This rule against using one's fiduciary position to extract gains beyond one's express compensation provides the foundation for the state law prohibition against insider trading discussed in cases such as *Diamond v. Oreamuno*, 248 N.E.2d 910 (N.Y. 1969). This state law prohibition should not be confused with federal rules, such as the prohibition implied under Rule 10b-5 of the Securities Exchange Act of 1934. *See generally* SOLOMON ET AL., *supra* note 2, at 927-84 (discussing federal law on insider trading).

[123] *See* Brudney, *supra* note 12, at 1415 (noting that corporate law gives managers "a wide, and in many respects unpoliceable, range of discretion").

[124] It should be noted that the fiduciary relationship is not purely altruistic; a fiduciary is entitled to receive the compensation explicitly agreed upon when she entered the relationship.

[125] 164 N.E. 545, 546-48 (N.Y. 1928) (emphasis added).

[126] *See* Clark, *supra* note 114, at 75-76 (discussing moral rhetoric employed in fiduciary duty cases); Frankel, *Fiduciary Law*, *supra* note 117, at 830 ("[M]oral theme is an important part of fiduciary law. Loyalty, fidelity, faith and honor form its basic vocabulary.").

and the sorts of relationships commonly thought of as contractual.[127] Unlike fiduciary relationships, conventional contracts start from the assumption that the contracting parties are purely self-interested actors whose behavior must be channeled by external constraints. Thus the archetypal contract emerges from arm's-length bargaining between two parties who each seek to serve only their own ends and promote only their own welfare. Moreover, each party is free to decline to perform and pay damages instead if breach serves her self-interest. Describing a relationship as a contract both assumes *and legitimates* the adoption of a purely self-interested preference function by both parties.[128]

It seems peculiar indeed—given the importance of self-regarding behavior to conventional contract and the centrality of other-regarding behavior to the fiduciary "contract"—to describe both with the same label. Contractarian corporate scholars nevertheless persist in describing the fiduciary relationship between corporate officers and directors on the one side, and the firm and its shareholders on the other, as a subspecies of contract, an "agency" arrangement in which one party is paid to do another's bidding.[129] Because this ap-

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[127] Many fiduciary relationships might still be described as "contractual" in the broad sense that both the fiduciary and the beneficiary enter the relationship voluntarily. It should be noted, however, that fiduciary obligations also can arise by operation of law, a fact that again hints at a fundamental distinction from contract. *See* DeMott, *supra* note 117, at 910-11.

[128] *See* Clark, *supra* note 114, at 75 ("[J]udges have sometimes seemed to believe that a contracting party should feel perfectly free, in a psychological and moral sense, to break a contract, so long as he or she is prepared to pay the damages.... But in the case of fiduciary duties, courts ... try to create feelings of guilt for violation of duty and rectitude for fulfillment of duty."); Frankel, *Fiduciary Duties*, *supra* note 117, at 1268 (contrasting the "model of contract relationship representing mutual suspicion, 'realistic' mistrust, and independence" with the "model of fiduciary relationship representing trust and dependency").

[129] *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J. L. & ECON. 425, 427 (1993) ("[A] 'fiduciary' relation is a contractual one characterized by unusually high costs of specification and monitoring.... Fiduciary duties are not special duties; they have no moral footing."); *see also* John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 YALE L.J. 625, 650 (1995) (discussing the "functional correspondence of trust and contract"). One of the oddities of this view, as anticontractarians have noted, is that it glosses over the fact that in agency relationships the principal can control and direct the agent's acts. *See* Clark, *supra* note 114, at 56; Brudney, *supra* note 12, at 1428. Hence there is no need for the agent to adopt the principal's preferences: The principal can protect her interests through her control of the agent. In contrast, a key characteristic of a fiduciary relationship is that the beneficiary cedes a wide range of discretion to the fiduciary. *See* Frankel, *Fiduciary Law*, *supra* note 117, at 809 (stating that the central feature of fiduciary relation is the delegation of control). This is true as well of shareholders in a publicly held corporation, who

proach obscures the essence of the fiduciary obligation, it is not surprising that, as Dean Clark has pointed out, contractarian theorists "have done little to explain the concept of the fiduciary [or] to develop positive theories as to why fiduciary law has developed its particular doctrines and characteristics."[130] After all, if one assumes that the contracting parties are purely selfish, trying to control opportunistic behavior by asking individuals to adopt an other-regarding preference function makes about as much sense as trying to change the dietary habits of wolves by telling them to like vegetables instead of meat. Contractarian analysis, like neoclassical economics, treats preferences as fixed and exogenous. How can someone choose to alter her own preferences?

Yet the empirical evidence on trust reviewed in Part II demonstrates that people behave as if they do change preferences—and they do so on a regular and predictable basis. This evidence may offer valuable guidance to scholars and lawmakers seeking to understand better the nature of the fiduciary duties courts impose on corporate officers, directors, and shareholders.[131]

The phenomenon of trust behavior suggests that fiduciary relationships are created by the law in situations in which it is efficient or otherwise desirable to promote other-regarding, trusting and trustworthy behavior. Moreover, the key to a successful fiduciary relationship lies in framing both economic *and* social conditions so as to encourage the fiduciary to make a psychological commitment to further her beneficiary's welfare rather than her own.[132] For example, by making directors and officers who violate their duty of loyalty to the firm liable for damages, the law encourages trustworthy behavior in corporate fiduciaries by reducing the expected gains from malfeasance

have extremely limited power over officers and directors. *See* CLARK, *supra* note 13, at 56-57; Brudney, *supra* note 12, at 1428 ("Stockholders do not direct management's activities.").

[130] Clark, *supra* note 114, at 62.

[131] More broadly, a behavioral approach can guide judges and scholars seeking to determine whether and when a given legal relationship should be deemed to have a fiduciary character and what the substantive requirements for fiduciaries ought to be. As a number of commentators have noted, legal scholars have yet to produce a coherent positive theory of fiduciary duties. *See, e.g., id.* at 71 ("[P]erhaps because the subject matter is so elusive, there has been little legal analysis of the fiduciary concept that is simultaneously general, sustained, and astute."); DeMott, *supra* note 117, at 908-15 (describing the fiduciary obligation as "one of the most elusive concepts in Anglo-American law," one that "eludes theoretical capture").

[132] It may be important for the law, where possible, to minimize external incentives inconsistent with that psychological commitment. *See, e.g., supra* text accompanying note 122 (describing the rule against private profits).

(thus reducing the fiduciary's cost of behaving trustworthily).[133] At the same time, case law on the duty of loyalty unambiguously signals that the fiduciary relationship is a social situation that calls for other-regarding behavior, to the point where the fiduciary is discouraged from even thinking about her own interest through a prophylactic rule that bans unauthorized personal gains even in circumstances in which the fiduciary could arrange this without harm to her beneficiary.[134] Similarly, the sermonizing tone typically adopted by courts in fiduciary cases reinforces the social message that other-regarding behavior is demanded.

A behavioral analysis of the fiduciary relationship accordingly supports the anticontractarian view that it is fundamentally misleading—even dangerous—to apply the rhetoric of contract to fiduciary duties. Such an analysis also lends credence to the anticontractarian claim that corporate officers and directors ought not to be allowed to opt out of their fiduciary duties through bylaws, charter provisions, or employment agreements.

The contractarian argument for opting out is simple; if participants in a corporation perceive it as in their mutual interest to opt out of the rules of fiduciary duty, why not let them? While this argument is straightforward, anticontractarians point out that it overlooks an important possibility—that allowing participants in one firm to opt out of fiduciary duties may harm participants in *other* firms by introducing what might be called an "informational externality."[135] In par-

[133] This approach may seem on first inspection consistent with the *homo economicus* model of purely selfish behavior. However, closer inspection suggests at least two puzzles. First, the typical remedy for a loyalty violation is to compel the fiduciary to return whatever she stole from her beneficiary (for example, voiding a self-dealing transaction) or to disgorge any profits she has wrongfully earned. *See generally* CLARK, *supra* note 13, at 160 (discussing voiding transactions); *id.* at 224 (discussing disgorgement). In effect, the fiduciary is simply put back in the position she was in before she violated her duties. This creates insufficient incentives for purely selfish fiduciaries to remain loyal, given the chance that wrongful conduct would not be detected or punished. Second, discouraging fiduciaries from looking out for their *own* interests does not necessarily give them an incentive to do a good job looking out for someone else's. However, once we allow for the possibility of trust behavior, the duty of loyalty makes sense as a means of encouraging trustworthy behavior by reducing the costs associated with it. *See supra* text accompanying notes 98-102 (discussing the inverse relationship between cost and incidence of trustworthiness).

[134] *See supra* text accompanying note 122 (discussing the prohibition against unauthorized personal benefit).

[135] *See generally* Bebchuk, *Debate, supra* note 115, at 1406-07 (describing the anticontractarian argument); Butler & Ribstein, *supra* note 12, at 33-38 (same); Gordon, *supra* note 12, at 1567-69, 1593 (same).

ticular, allowing corporate officers and directors to opt out of fiduciary duties introduces ambiguity about whether someone who is called "officer" or "director" can be safely assumed to have made a commitment to put the firm's interests ahead of her own. This uncertainty requires individuals who want to participate in a business relationship to expend time, effort, and resources to determine whether their fiduciaries are *really* fiduciaries. For example, a potential investor interested in a particular company might have to obtain and read that firm's charter, bylaws, and employment contracts in order to research whether or not the company's officers and directors bore fiduciary duties.[156] Because increasing investors' research costs reduces their willingness to pay for shares, allowing officers and directors to opt out of the duty of loyalty in one firm imposes external costs on *other* firms by diluting the informational content of the "officer" and "director" labels.[157]

Strict contractarians might answer that such external costs may be negligible if the cost of investors' informing themselves about opt-out provisions is small. Alternatively, even if external costs are large, they might be worth bearing if opting out adds value in a significant number of cases. But behavioral analysis suggests that the costs of allowing opting out are likely to be large indeed, and the benefits quite small.

On the cost side, trust-based analysis suggests that the central purpose of fiduciary law is to induce trust behavior by socially framing fiduciary relationships as relationships in which the law expects the fiduciary to internalize a commitment to pursue her beneficiary's interests rather than her own. Allowing individuals in similar roles to opt out of such a commitment undermines both the very foundation

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[156] In a publicly held firm with thousands or even hundreds of thousands of shareholders, the total additional cost may be substantial indeed.

[157] From an ex ante perspective, the cost is borne by the promoters of the firm because shareholders discount the price that they will pay for shares to reflect the increased research cost of determining whether the firm's directors and officers are in fact fiduciaries. *See* Bebchuk, *Debate*, *supra* note 115, at 1406-07 (discussing "imperfect information" arguments); Gordon, *supra* note 12, at 1567-69, 1593 (discussing the "public good hypothesis" that mandatory rules reduce the external costs of uncertainty about the corporate contract, and noting that "a stable conception of fiduciary duty develops only through applying a single standard across a great range of cases").

A second, "quasi-anticontractarian" argument against opting out focuses on the problems associated with "midstream" changes to corporate articles and bylaws and the possibility that obstacles to collective action might prevent shareholders from successfully opposing amendments that reduce their group welfare. *See* Bebchuk, *supra* note 12 (discussing reasons for limiting the ability to opt out midstream); Bebchuk, *Debate*, *supra* note 115 (same); *see also* Gordon, *supra* note 12, at 1573-85 (discussing the "opportunistic amendment hypothesis").

and the source of the economic value of the concept of a fiduciary relationship.[138]

What about the possible benefits of opting out? Trust behavior seems most likely to be important in situations in which the trusting person cannot easily monitor or control the trusted person's behavior through external incentives.[139] Legal scholars note that it is in exactly such situations that fiduciary relationships are most likely to be created.[140] And it is in exactly such situations that an informed beneficiary would be most reluctant to free her fiduciary from the psychological constraints on self-interest imposed by the notion of a duty of loyalty. Perhaps we might want to permit fiduciaries to be able to deal at arm's length with their beneficiaries in discrete transactions (for example, in setting the fiduciary's compensation or in a sale of a specific property between the parties). In fact, the law permits this when certain substantive and procedural safeguards are met.[141] But why would any beneficiary ever want to make herself categorically vulnerable to someone who had no external *or* internal incentive to protect her interests? It seems implausible that allowing officers, directors, and shareholders to opt out of the fiduciary duties normally imposed

[138] As Melvin Eisenberg has put it in the corporate context, "the critical role of trust in the success of the corporate system would be significantly undermined if the law sent a message that the duty of loyalty was essentially a contractual duty." Eisenberg, *Corporate Law, supra* note 119, at 1275.

[139] Implicit in this notion is the idea that violations of the duty of loyalty are difficult to detect or prove in court. This cuts against the standard assumption that the principal purpose of fiduciary duty rules is to channel behavior by allowing courts to intervene and sanction or reward fiduciaries on beneficiaries' behalf. *See, e.g.*, DeMott, *supra* note 117, at 915 ("[F]iduciary obligation is a device that enables the law to respond to a range of situations in which . . . one person's discretion ought to be controlled . . . ."); Frankel, *Fiduciary Law, supra* note 117, at 816 ("Because the entrustor cannot satisfactorily protect himself . . . the law must intervene to protect him . . . ."). In contrast, our behavioral analysis suggests that the legal rules of fiduciary loyalty promote trustworthy behavior not so much by threatening to sanction fiduciaries as by changing their preferences. Later we pursue a parallel argument with regard to the corporate law duty of care. *See infra* text accompanying notes 155-77.

[140] *See* DeMott, *supra* note 117, at 901, 908, 914; Frankel, *Fiduciary Law, supra* note 117, at 808-09.

[141] *See, e.g.*, DEL. CODE. ANN. tit. 8, § 144 (1991) (allowing interested directors of a firm to contract with the firm as long as the material facts are known and the noninterested directors or the shareholders approve or as long as the contract is fair to the firm). Victor Brudney has recently argued that corporate law has gone too far in permitting this, with the net result of undermining the duty of loyalty. Victor Brudney, *Revisiting the Import of Shareholder Consent for Corporate Fiduciary Loyalty Obligations*, 25 J. CORP. L. 209 (1999); *see also* Mitchell, *Fairness and Trust, supra* note 32, at 426 (arguing that allowing transactions between a fiduciary and a beneficiary that meet a "fairness test" undermines fiduciary relationships).

by corporate law would be mutually desired in more than a handful of cases.[112]

This is not to suggest that it is never advantageous to structure business relationships as arm's length relationships or that business participants should never be allowed to opt out of fiduciary duties when they can do this without muddying the informational waters. For example, opting out is clearly unobjectionable when it is done by selecting another business form, such as a partnership or a joint venture.[113] However, an analysis of corporate law that takes account of the phenomenon of trust supports the anticontractarians' distaste for viewing corporate fiduciary duties as just another default term in a corporate form contract. As Tamar Frankel has observed, "[I]n terms of both psychological fact and organization of the law, a name is important and reclassification can be treacherous. When we blur the distinctions between fiduciary and contract relationships, calling them by the same name, we tend to disregard the reasons for the different rules that govern them."[114] We also run the risk of destroying the common understanding of social context that triggers the emergence of trusting and trustworthy behavior in fiduciary relationships in the first place.

B. *Trust Behavior, the Duty of Care, and the Business Judgment Rule*

The discussion above suggests that corporate law may alter the behavior of corporate participants not just by changing their external payoffs but also by changing their internalized preferences. But how, exactly, does the law accomplish this? We consider this question in connection with one of the most persistent and puzzling problems in corporate law: the relationship between the duty of care and the business judgment rule.

In theory, the directors of a corporation owe the firm and its shareholders a duty to manage the business with the skill, diligence, and care of a reasonably prudent person.[115] In practice, it is notoriously difficult for a plaintiff to win a claim of breach of the duty of

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[112] *See* Gordon, *supra* note 12, at 1597 ("[Where] fiduciary duties govern, why would shareholders want to opt out . . . ? It would be irrational for shareholders to waive or modify substantially the directors' duty of loyalty . . . .").

[113] *See* Charles Rogers O'Kelley, Jr., *Opting In and Out of Fiduciary Duties in Cooperative Ventures: Refining the So-Called Coasean Contract Theory*, 70 WASH. U. L.Q. 353, 358 (1992) (discussing the "signaling effect" of choosing a particular business form).

[114] Frankel, *Fiduciary Duties*, *supra* note 117, at 1211 (footnote omitted).

[115] CLARK, *supra* note 13, at 123.

care. As Judge Winter observed in the oft-cited *Joy v. North*:

> While it is often stated that corporate directors and officers will be liable for negligence in carrying out their corporate duties, all seem agreed that such a statement is misleading.... [L]iability is rarely imposed upon corporate directors or officers simply for bad judgment and this reluctance to impose liability... has been doctrinally labeled the business judgment rule.[146]

Case law describes the business judgment rule as "'a presumption that... the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.'"[147] The elements of "good faith" and an "honest belief" that one is serving the company's best interests are usually undisputed in cases that do not raise the sort of conflicts of interest typically analyzed under the duty of loyalty.[148] Thus, whether or not the business judgment rule applies will usually turn on whether a board's act was "informed."

In the watershed case of *Smith v. Van Gorkom*, the Delaware Supreme Court declared that directors will be deemed uninformed—and so outside the protection of the business judgment rule—only when the plaintiff can demonstrate that they were *grossly negligent* in failing to inform themselves, before acting, "'of all material information reasonably available to them.'"[149] The net effect of this rule is to insulate directors from liability whenever they make even a modest attempt to follow the appropriate formalities for reaching a decision. Provided proper procedures are followed, the business judgement rule precludes any further judicial inquiry into the substantive wisdom of the decision.

Even in the rare case in which directors might be found to have employed grossly defective procedures, other barriers stand between them and personal exposure to liability. For example, since the enactment of section 102(b)(7) of Delaware's General Corporation Law,

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[146] 692 F.2d 880, 885 (2d Cir. 1982) (citations omitted).

[147] Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).

[148] *See, e.g., id.* at 873 (noting, in a duty of care case that focused on whether directors were informed, that "there were no allegations of fraud, bad faith, or self-dealing" and that therefore "considerations of motive are irrelevant to the issue before us").

[149] *Id.* at 872 (quoting *Aronson*, 473 A.2d at 812). For example, in *Smith v. Van Gorkom*, the directors of Trans Union were denied the protection of the business judgement rule when they approved the sale of the company in a two-hour meeting on the basis of a short oral report by the CEO. *See id.* at 868-70 (outlining the board's decisionmaking process).

many corporations have taken advantage of that provision by adopting charter provisions that expressly eliminate director liability for monetary damages for breach of the duty of care.[150] When section 102(b)(7) does not apply, the rules of derivative suit procedure may require a would-be shareholder plaintiff to allege (before any discovery) "particularized facts" supporting his claim.[151] Should the plaintiff meet this burden and be allowed to proceed, Delaware law permits the directors to create an "independent committee" that may be able to terminate his suit.[152] Finally, even if the directors are ultimately found liable for breach of the duty of care, any damages they must pay often will be reimbursed under a directors' and officers' liability insurance policy.[153]

The net result is that, as a practical matter, a negligent director is more likely to be hit by lightning after leaving her board meeting than she is to pay damages. Why then would any rational director expend significant time or effort to manage a company with care?[154]

To answer this question, we begin by highlighting another mysterious aspect of the case law on the duty of care that has long provoked law professors and students alike—the fact that, even while courts have steadfastly refused actually to sanction directors for failing to use due care, they have continued to insist that a duty to use reasonable

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150 DEL. CODE. ANN. tit. 8, § 102(b)(7) (Supp. 2000). Some might describe section 102(b)(7) as allowing firms to "opt out" of the duty of care. We reject this characterization because the provision does not excuse directors from using care—it merely relieves them of personal liability for damages for failing to do so. *See, e.g.*, Rock, *supra* note 13, at 1012 ("[S]ection 102(b)(7) . . . allows Delaware corporations to opt out of director *liability* for breach of duty of care . . . ." (emphasis added)). A contractarian scholar might respond that these are the same thing. Such an analysis overlooks the distinction between a standard of conduct and a standard of judicial review. *See infra* text accompanying notes 158-59 (discussing the distinction). Nor does it account for section 102(b)(7)'s failure to bar injunctive relief based on a duty of care violation.

151 *Aronson*, 473 A.2d at 814.

152 Zapata Corp. v. Maldonado, 430 A.2d 779, 785 (Del. 1981).

153 For example, in *Smith v. Van Gorkom* itself, the defendant directors settled the claims against them for $23.5 million. Of that amount, $10 million was paid by their insurance carrier, and nearly the entire balance by the company with which they had negotiated the merger. SOLOMON ET AL., *supra* note 2, at 704.

154 Although our discussion focuses on the fact that the duty of care does not appear to provide a persuasive stick with which to threaten directors, note the shortage of carrots as well. Even in firms in which some component of director compensation is based on stock performance rather than a flat fee, any single director's efforts at care are likely to have only an infinitesimal effect on her paycheck when compared with other factors such as industry changes, stock market movements, and executives' effort and savvy (not to mention the efforts and savvy of the other members of the board).

care exists.[155] *Van Gorkom* itself offers an example. In interpreting the "informed" element of the business judgment rule, the Delaware Supreme Court held, "[t]he determination of whether a business judgment is an informed one turns on whether the directors have informed themselves . . . 'of all material information *reasonably available* to them.'"[156] The court then went on to state, "[w]e think the concept of *gross negligence* is . . . the proper standard for determining whether a business judgment reached by a board of directors was an informed one."[157]

Consider the schizophrenic quality of this statement. In exhorting directors to inform themselves of all material information reasonably available, the court uses the language of negligence, impliedly testing directors' conduct by the standard of the "reasonable person." Yet in the next breath, the court makes clear that no liability will be imposed unless the directors are grossly negligent—a far more lax standard of behavior.[158] This bipolar aspect of corporate case law has been noted by a number of scholars, among them Melvin Eisenberg, who has prominently argued that in corporate law generally—and in duty of care cases in particular—"the standards of conduct and review pervasively diverge."[159] The standard of *conduct* for directors (courts say) is that of the reasonably prudent person. But the standard of *review* (that is, the circumstances under which courts will intervene and impose sanctions) is the business judgement test of gross negligence.

Why is the standard of review in duty of care cases so much less demanding than the standard of conduct? The most frequent explanation offered is that the business world is complex, opaque, and uncertain. As a result, it is almost impossible for a judge, after the fact, to determine reliably whether a particular board's decision was or was not reasonable at the time it was made. Making it easy for plaintiffs to prevail in duty of care cases accordingly could result in frequent legal error, as courts both dismiss meritorious cases and award damages in

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155 *See* sources cited *supra* note 13.

156 Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (quoting *Aronson*, 473 A.2d at 812 (emphasis added)).

157 *Id.* at 873 (emphasis added).

158 Such case law tempts one to muse along with Dean Clark about "whether the courts are serious when they say directors may be held liable for negligence." CLARK, *supra* note 13, at 126.

159 Eisenberg, *Corporate Law*, *supra* note 119, at 1269; *see also* Eisenberg, *Divergence*, *supra* note 13, at 437 (discussing the divergence of the standards of conduct from the standards of review within corporate law).

cases without merit.[160] The first type of error undermines, perhaps fatally, the value of lawsuits as vehicles for deterring careless conduct. The second raises the specter of other harms, such as groundless "strike" suits filed by plaintiffs' lawyers who hope to extract a settlement, or overanxious directors who avoid any risky course of business, however profitable.[161]

These are good reasons for courts to make it difficult to sue corporate directors for negligence. But there remains the essential question of why directors shielded from liability for negligence should bother to exercise due care. Also, if the business judgment rule is the proper standard of *review*, what purpose is served by suggesting that the standard of *conduct* be higher?

Under the nexus of contracts approach and its assumption of rational selfishness, the mysteries of the business judgement rule and the duty of care remain just that—mysteries. If directors respond only to carrots and sticks, and if both are noticeably missing from the boardroom, why should we expect directors to do (as they mostly seem to do) tolerably decent jobs of representing the interests of firms and their shareholders? And why do courts continue to preach the gospel of due care while refusing to punish the "sinners" who fail to meet that standard?[162] Why should a court waste its breath?

Both Melvin Eisenberg and Edward Rock have recently offered provocative and related answers to these questions. Writing separately in articles published in 1997 and 1999, Eisenberg and Rock each note that over the past two decades, the relevant standard of conduct for corporate directors under Delaware law has shifted and become more demanding, even as the standard of judicial review has become, if anything, more lax.[163] They further argue that conventional corporate law scholarship cannot explain such developments because it fails to incorporate the important phenomenon of social norms.[164] In par-

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[160] *See generally* Lynn A. Stout, *Type I Error, Type II Error, and the Private Securities Litigation Reform Act*, 38 ARIZ. L. REV. 711 (1996) (discussing both types of legal error).

[161] *See* Joy v. North, 692 F.2d 880, 886-87 (1982).

[162] Rock, *supra* note 13, at 1009.

[163] *See* Eisenberg, *Corporate Law, supra* note 119, at 1266-69 ("The common experience of informed observers is that the level of directorial care has risen significantly in the last ten years or so . . . . What has caused this shift to a greater level of care? Pretty clearly, not an increased threat of liability."); Rock, *supra* note 13, at 1021-39 (describing the evolution of the heightened standard of conduct in a series of five management buyout cases, out of which the court only enjoined one transaction).

[164] Rock and Eisenberg use the term "norm" to refer to rules of conduct that influence behavior through some mechanism other than the imposition of legal sanctions. *See* Eisenberg, *Corporate Law, supra* note 119, at 1255 ("I use the term *social norm* to

ticular, they argue that corporate case law, and especially fiduciary duty case law, influences corporate managers' behavior not primarily by threatening liability but by expressing and reinforcing social norms of careful and loyal behavior.[165] As Rock puts it, "[F]iduciary duty law evolves primarily at the level of norms rather than the level of rules."[166]

The claim that corporate law works primarily by clarifying and expressing social norms is appealing to anyone who has struggled to reconcile the duty of care standard and the business judgment rule. However, this argument begs a fundamental question. Corporate law may work by shaping social norms, but how do social norms work?[167] Why should officers, directors, or shareholders comply with the norms the courts express? Rock and Eisenberg each address this question to a limited extent. Yet in the end their analyses are not complete and, for this reason, not entirely convincing. What is missing—and what can make a norms-based theory of corporate law both powerful and persuasive—is the empirical phenomenon of trust behavior.

In making their arguments, Eisenberg and Rock each note that individuals may "internalize" norms to the point where they obey them automatically, even when a failure to obey the norm would go unnoted by others.[168] However, they fail to explain under what circumstances a norm becomes internalized.[169] Moreover, Rock in particular appears reluctant to rely on internalized norms as strong constraints on behavior. He views social norms as being enforced first and foremost through social "shaming"—"disdain in the eyes of one's acquaintances, the loss of [future] directorships, the harm to one's

mean all rules and regularities concerning human conduct, other than legal rules and organizational rules [which] have the effect of legal rules."); Rock, *supra* note 13, at 1011 (excluding behavior driven by fear of legal sanction or the pressures of formal markets such as the market for corporate control). In their recent work, Rock and Michael Wachter abandon the norms label and instead propose the acronym NLERS, for "nonlegally enforceable rules and standards." Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1641 (2001).

[165] *See* Eisenberg, *Corporate Law*, *supra* note 119, at 1265 ("[D]irectorial care is largely driven by social norms, rather than by the threat of liability . . . ."); Rock, *supra* note 13, at 1016 ("My claim . . . is that the Delaware courts generate in the first instance the legal standards . . . which influence the development of the social norms of directors [and] officers . . . .").

[166] Rock, *supra* note 13, at 1097.

[167] *See supra* note 27 (discussing norms and how they might work).

[168] *See* Eisenberg, *Corporate Law*, *supra* note 119, at 1258-61 (discussing internalization); Rock, *supra* note 13, at 1013 (same).

[169] Eisenberg suggests that guilt might motivate people to comply with "obligational norms." However, he does not offer a theory of when or why guilt is likely to come into play. Eisenberg, *Corporate Law*, *supra* note 119, at 1259.

reputation."[170]

In Part I, we described the fear of such slings and arrows as falling within the broad category of "market sanctions" in order to emphasize its essentially external character. In relying primarily on social sanctions and reputational concerns to explain why norms are followed, Rock follows the lead of some of the most prominent and pioneering legal scholars writing today on law and norms.[171] But while the idea that people might follow a social norm to avoid reputational harm and social shaming seems plausible, we believe that, at least in the corporate context, this approach may miss the mark.[172]

As discussed in Part I, one of the fundamental problems associated with controlling opportunism within firms through legal sanctions is that it is often difficult or impossible to detect and prove opportunistic behavior in court. Opportunism that cannot be proven in a court of law may also be difficult to prove in the court of public opinion. Even when other members of the business community can observe accusations and disagreements between and among shareholders, officers, and directors, they may find it hard to determine which side is at fault. Moreover, in many cases they are unlikely to observe even the accusations and disagreements. The boardroom is a notoriously opaque environment.[173] Even in large firms, only the most public and bitter battles are reported in the press. Smaller firms may

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[170] Rock, *supra* note 13, at 1104; *see id.* at 1013-14 ("The story I tell in this Article is very much the story of how a small community imposes formal and informal, legal and nonlegal, sanctions on its members."); *see also* David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811 (2001) (discussing "shaming" sanctions).

[171] *See supra* notes 23, 27 (discussing norms literature); *see also* Robert C. Ellickson, The Evolution of Social Norms: A Perspective from the Legal Academy 3-5 (2000) (unpublished manuscript, on file with authors) (reviewing norms literature and discussing norms scholars' focus on third-party enforcement), *available at* http://papers.ssrn.com/paper.taf?_abstract_id=191392

[172] Perhaps norms scholars focus on third-party sanctioning in order to keep their arguments consistent with the rational selfishness model. However, this simply moves the problem one step back. *See supra* note 27.

[173] Rock argues that the managers and directors of large publicly held corporations "form a surprisingly small and close-knit community." Rock, *supra* note 13, at 1013. In support of this claim, Rock estimates that this "small" community consists of at least *four or five thousand* individuals. Moreover, Rock's estimate includes only directors of Fortune 500 companies. *Id.* at 1013 & n.7. *But see* Stephen P. Ferris et al., Monitoring by Directors with Multiple Board Appointments: Corporate Performance and the Incidence of Securities Fraud 7 (1999) (unpublished manuscript, on file with authors) (reporting the results of an empirical study of a sample of 45,000 directors that found that only four percent sat on three or more boards, and that even among the Fortune 500 companies, fewer than twenty percent sat on three or more boards), *available at* http://papers.ssrn.com/paper.taf?abstract_id=167288.

go years without seeing their names—much less their individual directors' or officers' names—mentioned in the *Wall Street Journal.*

The fear of social sanctions as a result seems likely to provide only a weak constraint on opportunism within firms.[174] But the idea that norms may be a potent force for altering behavior becomes far more persuasive if we add trust to the equation. This is because the empirical evidence on trust sheds light on both why and when social norms become "internalized."

As we saw in Part II, individuals' decisions to adopt either a competitive or a cooperative mode of behavior are often determined by their perceptions of others' expectations, likely behaviors, and relationships with themselves.[175] These social cues both define and determine the appropriate norm of behavior. When social context says "cooperate," cooperative behavior is the norm; when context calls for self-interested behavior, competition prevails.

Corporate case law accordingly can encourage corporate participants to internalize norms of cooperation through social framing—providing information about the social context of relationships within the firm. Judicial opinions unambiguously communicate that directors are fiduciaries and that fiduciary relationships call for trustworthy (loyal and careful) behavior. Corporate directors internalize this norm when they respond to the social signal by adopting the other-regarding preference function that is the hallmark of trust-based relationships. In other words, *fiduciary duty law works through framing, not shaming.*

The behavioral phenomenon of trust thus offers a critical addition to the arguments of Eisenberg, Rock, and other scholars who argue for norms-based theories of corporate law. In particular, it provides support for the idea that discussions of fiduciary duty in corporate case law act as judicial "sermons" on proper motives and conduct that filter down to directors, officers, and shareholders through corporate lawyers and the business press.[176] Courts preach these sermons not to enlist the aid of third-party "norms enforcers," but primarily to influence corporate participants' behavior more directly by fleshing out

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[174] *See* Eisenberg, *Corporate Law, supra* note 119, at 1261 (suggesting that, "[w]ithout a significant degree of internalization, . . . reputational effects will usually be insufficient" to enforce social norms of corporate behavior).

[175] *See supra* Part II.D (discussing the role of social context).

[176] *See* Rock, *supra* note 13, at 1067-72 (describing how judicial opinions are communicated to corporate participants through judges' speeches, the business press, and lawyers' "memoranda to our clients").

the social context of their relationships, and particularly by framing relationships between managers and their firms as fiduciary relationships based on trust.

The empirical evidence reviewed in Part II suggests why judicial opinions may be especially powerful and effective vehicles for performing this framing function.[177] Social dilemma experiments indicate that individuals trying to decide whether a particular social context calls for cooperation or competition are remarkably sensitive to the signals they receive from the experimenter who defines and has authority over the game. In the context of corporate law, the court, as the authority charged with both creating and enforcing many corporate law rules, may play the role of the experimenter and enjoy similar influence. When the Delaware chancery court trumpets the importance of careful attention to fiduciary duties, directors and officers are likely to heed that call—even though they may have little or no external incentive for doing so.

Corporate case law may also have a second and previously unrecognized effect on director, officer, and shareholder behavior through the information that it provides about the behavior of *other* directors, officers, and shareholders. Recall that one of the important influences on decisions to cooperate or defect in social dilemma games appears to be expectations about what other players are likely to do.[178] That finding raises the possibility that judicial doctrines, such as the business judgment rule, that make it difficult to sue corporate participants for alleged breaches of fiduciary duty may in fact reduce the incidence of such breaches. Conversely, trying to shore up trust behavior by making it easier for corporate participants to "litigate trust" may produce the counterintuitive result of an increase in the incidence of the untrustworthy behavior.

The argument goes as follows. Lawsuits can indeed help deter opportunism by creating a threat that opportunistic behavior will be punished, if detected and proven. But at the same time, lawsuits—if members of the business community are aware of them—unavoidably send the signal that others in the business world are choosing to violate their fiduciary duties. The more suits brought, the stronger the signal.[179]

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177 *See supra* Part II.D.1 (discussing the role of authorities' instructions).

178 *See supra* Part II.D.3 (discussing the role of expectations about others' behavior).

179 A proliferation of shareholder lawsuits brought against corporate directors might also discourage trust behavior by signaling that shareholders view the relation-

The net result is that the deterrent effect of making it easier for plaintiffs to sue for breach of fiduciary duty may be outweighed by a second and countervailing effect—the increase in opportunistic behavior that results from suggesting that breach of duty is common, even normal, in business relationships.[180] Such a suggestion might lead corporate participants to conclude that they are suckers to obey the rules when others do not. The business judgment rule, which affirms a standard of conduct much higher than the courts are willing to enforce, may consequently be understood as a "second best" solution to the problem of opportunism in corporate relationships—a solution that recognizes that corporate law influences behavior not just by imposing sanctions but also by shaping perceptions of what sort of behavior is expected, appropriate, and common.[181]

As this argument illustrates, an analysis of corporate law that accounts for trust behavior and the signaling role of case law offers theoretical support to the scholars who argue that law can serve an "expressive function" and promote desirable behavior by changing preferences as well as by changing payoffs.[182] At the same time, how-

ship as competitive and untrusting, rather than cooperative and trusting. This signal could reduce directors' willingness to look after shareholders' interests by suggesting that shareholders and directors are not members of a common "ingroup." *See supra* Part II.D.2 (discussing the importance of group identity to trust behavior).

[180] *See* Dan M. Kahan, *Social Influence, Social Meaning, and Deterrence*, 83 VA. L. REV. 349, 352-54, 356-57 (1997) (discussing herd behavior and suggesting that when people observe others committing crimes, they are more likely to commit crimes themselves). Our analysis offers an interesting twist on Kahan's approach, which recommends that policymakers reduce the incidence of observable crime through more active policing. *Id.* at 395. In contrast, we note that, in the corporate context, director misconduct usually cannot be directly observed by outsiders. As a result, active "policing" through derivative suits makes such conduct observable and can *increase* the incidence of misbehavior. A similar phenomenon may explain management studies that have found that when work environments are altered by adding visible monitoring (for example, by adding video surveillance cameras), employees actually become *more* likely to engage in noncooperative behaviors such as stealing or shirking. Although this finding cannot be reconciled with the neoclassical view that misbehavior should become less common as the likelihood of detection increases, the negative effects of visible monitoring make more sense if employees interpret visible monitoring as evidence that their *fellow employees* are untrustworthy, and thus as a signal that their relationship with their employer is a competitive rather than a cooperative game. *See* Bowles, *supra* note 75, at 80; *see also* Kramer, *supra* note 24, at 591 ("[I]nnocent employees who are subject to . . . mass screening designed to deter misbehavior may become less committed to internal standards of honesty and integrity in the workplace.").

[181] *See* Allison & Kerr, *supra* note 92, at 697 (noting that social dilemma studies suggest that one "promising strategy for promoting cooperative behavior in social dilemmas might consist of intentionally exploiting people's [beliefs about others' behavior] to facilitate positive outcomes for [the] group[]").

[182] *See, e.g.*, authorities cited *supra* note 14.

ever, it cautions against a simplistic approach. Judicial pronouncements can influence behavior by sending a variety of signals. Some of these signals may be intended; others may not. But all may have an effect.

C. *Trust Behavior, the Limits of Law, and the Case of the Closely Held Corporation*

We argue above that corporate law channels behavior not just by imposing external sanctions, but also through social framing that encourages officers, directors, and shareholders to view their relationships as cooperative ones calling for other-regarding behavior. It seems plausible, however, that in many circumstances corporate participants may perceive both the threat of legal sanctions and the framing effects of corporate case law as distant and relatively weak influences. Are there other, nonlegal forces that encourage and shore up trust within firms? If so, how important is corporate law in influencing behavior?

We consider these questions below in the context of "closely held" corporations—firms with relatively few shareholders who also serve as the firm's managers.[183] As this description implies, closely held corporations generally do not suffer the "separation of ownership and control" thought to plague publicly held firms.[184] Closely held firms are famous for presenting their own problems, however, in the form of opportunistic behavior *between* shareholders.[185] Moreover, the conventional tools used by shareholders in publicly held firms to patrol against the agency costs imposed by professional managers—the shareholders' rights to vote, to sell their shares, and to sue for breach

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[183] Although publicly held firms control the lion's share of corporate assets in the United States today, the vast majority of incorporated entities are "closely held" corporations that are distinguished from publicly held firms by three characteristics: First, they have relatively few shareholders; second, there is no active market for their stock; and third, shareholders usually are not passive investors but also the firm's managers. *See* CLARK, *supra* note 13, at 24-27; JOEL SELIGMAN, CORPORATIONS: CASES AND MATERIALS 533 (1995).

[184] *See generally supra* text accompanying note 39 (discussing the agency cost problem in publicly held firms).

[185] Shareholders in publicly held firms often share a relatively homogeneous interest in maximizing the economic return from their investment. They therefore have a common interest in patrolling against managerial malfeasance. In contrast, shareholders in closely held corporations often also serve as managers and, as a result, are more likely to find themselves at odds with each other, giving rise to a second potential layer of problems. Moreover, because their shares are not readily marketable, they are "locked into" their investment more than shareholders in publicly held firms are.

of fiduciary duty—are far less useful to shareholders in closely held firms who want to protect themselves from each other.[186]

Legal scholars have long recognized that closely held corporations present special governance problems above and beyond the agency cost problem associated with publicly held firms.[187] In accord with the contractarian tradition, scholars have also long argued that contract provides the best solution. Thus, participants in closely held firms have been thought to curb intershareholder opportunism primarily by designing special agreements and charter provisions that alter the shareholders' rights to vote, buy and sell their shares, receive dividends, or participate in the firm's management.[188] Yet these arrangements are widely recognized as providing, at best, a limited restraint on intershareholder opportunism in closely held firms. No matter how carefully they draft the corporate charter, participants in closely held corporations remain mutually vulnerable. As Frank Easterbrook and Daniel Fischel describe the problem:

> [The] Drafters of the organizing documents of a closely held corporation cannot avoid a tradeoff. On the one hand, they must provide some protection to minority investors to ensure that they receive an adequate return on the minority shareholder's investment if the venture succeeds. On the other hand, they cannot give the minority too many rights, for the minority might exercise their rights in an opportunistic fashion to claim returns at the majority's expense.[189]

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[186] Consider the example of a closely held corporation formed by three individuals, *A*, *B*, and *C*. *A* is the CEO, *B* is the CFO, and *C* is the Senior Vice President. Each holds one-third of the firm's shares. Now suppose *C* is unhappy with the way the firm is being run. (Perhaps she thinks her salary too small.) Unlike a shareholder in a large publicly held firm who can "vote with her feet," *C* cannot exit by simply selling her shares in a liquid market. Nor does her right to vote her shares give much comfort, given that she will consistently be outvoted by *A* and *B*. Finally, fiduciary duties provide a notoriously dangerous form of protection for minority shareholders in closely held corporations. Making it easy for the minority to sue the majority discourages the majority from opportunistically exploiting the minority's vulnerability. However, it also makes it easier for the *minority* opportunistically to exploit the *majority*. For example, if *C* could sue *A* and *B* easily, she might regularly threaten to do so unless they voted to raise her salary.

[187] *See* sources cited *supra* note 42 (discussing these special problems).

[188] *See, e.g.*, CLARK, *supra* note 13, at 763-80 (discussing share transfer restrictions and voting requirements as a solution to intershareholder conflicts in closely held corporations); Easterbrook & Fischel, *Close Corporations*, *supra* note 15, at 279 (discussing high voting and quorum requirements and employment and compensation agreements as contractual responses to shareholder conflicts).

[189] Easterbrook & Fischel, *Close Corporations*, *supra* note 15, at 285; *see id.* at 279 (recognizing that although contractual mechanisms have evolved to protect minority shareholders, "[t]he more power minority shareholders have, the more likely is dead-

Closely held corporations accordingly present an especially clear example of circumstances in which legal and market forces impose only weak restraints on opportunistic behavior within the firm. Yet despite the high degree of mutual vulnerability their participants must endure, closely held corporations continue to exist and, indeed, to outnumber publicly held corporations vastly. This puzzling fact has provoked legal scholars to suggest that some coordinating force *other* than the threat of a lawsuit or the discipline of the stock market restrains opportunism in closely held firms. For example, in a recent article, Professor Paul Mahoney proposed a norms-based model of closely held corporations in which shareholder opportunism is constrained "by the possibility of non-legal sanctions, including family or social disapproval and loss of reputation."[190]

For a number of reasons, however, such concerns seem unlikely to curb misbehavior in most closely held corporations reliably. First, closely held firms are often formed between individuals who have no familial relation. Second, when factions within a closely held corporation begin to point fingers at each other, it can be difficult for outsiders to determine who is at fault and ought to be socially "punished." Third, it is unclear why outsiders would want to punish the transgressors at all.[191] Finally, although it is hard (but not impossible) to replace one's family, there is a ready supply of substitutes for most other

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lock. . . . No way is costless."). In economic terms, the closely held corporation presents a classic problem of team production. *See supra* text accompanying notes 40-45 (discussing team production). This is because participants in closely held corporations usually invest large amounts of firm-specific financial and human capital. As a result, they can only recover funds spent on business expenses and customized equipment, as well as time and effort spent managing the firm, by waiting to share in the profits (if any) that the firm generates. If they try to decide who gets what share of those profits ex ante, they will run into contracting problems. Yet if they wait to divide up the profits after they have been earned, there is no obvious way to decide ex post how to divide the gains. Thus the majority may try to exploit the minority, or (if the firm's charter provides for strong minority rights) the minority may try to exploit the majority.

[190] Mahoney, *supra* note 15, at 1. Easterbrook and Fischel have similarly suggested that "[p]articipants in closely held corporations frequently have familial or other personal relations [that constrain] conflicts of interest." Easterbrook & Fischel, *Close Corporations*, *supra* note 15, at 274.

A related argument has been offered by Professors Edward Rock and Michael Wachter and by Professor Gordon Smith. These scholars have argued in recent articles that in privately held "Silicon Valley" firms for which entrepreneurs often raise capital by selling large blocks of stock to venture capital firms, the entrepreneurs often rely on the venture capitalists' reputation for "fair play" as protection against opportunism. *See* Rock & Wachter, *supra* note 15, at 927-29; D. Gordon Smith, *Team Production in Venture Capital Investing*, 24 J. CORP. L. 949, 969-70 (1999).

[191] *See supra* note 27 (discussing the puzzle of why third parties should enforce norms with social sanctions).

social relationships.

The empirical phenomenon of trust may provide the missing piece to the closely held corporation puzzle. To understand why, consider what happens in a firm in which the participants correctly perceive themselves and each other as both trusting and trustworthy. In such a firm, each participant has to some extent incorporated the others' welfare into her own preference function; the focus is on *we* rather than *I*. Knowing this, all will be less likely to feel either the need for elaborate and expensive contractual protections ex ante or the temptation to engage in wasteful squabbling over who gets what ex post. Thus trust can reduce the costs of intershareholder opportunism in closely held corporations when legal rules (including the rules of contract) and market pressures (including reputational concerns and the fear of social sanctions) fail to do so.

Trust only works, however, when one knows that one's fellow shareholders in the firm are indeed trustworthy. This may be a dangerous thing to assume, given the empirical evidence reviewed in Part II that not all individuals engage in trust behavior.[192] For trust to support cooperation in the absence of external enforcement mechanisms, it is essential for individuals inclined toward trust to be able somehow to "filter out" those who are not. How can a would-be participant in a closely held corporation ensure that her fellow shareholders are worthy of her trust?

The problem parallels social scientists' concern over how cooperative behavior can evolve in social organisms when "cooperators" are vulnerable to exploitation by "defectors."[193] At least two selection mechanisms have been suggested in the literature, both of which may apply to the formation of closely held firms. The first is the possibility that trustworthy people are somehow able to detect, and so avoid doing business with, untrustworthy individuals. Robert Frank, for example, has argued that trustworthiness is associated with observable characteristics, like involuntarily blushing when one lies.[194] Reputation might perform a similar signaling function if a good reputation is disproportionately expensive for untrustworthy individuals to acquire because it requires them to pass up many tempting opportunities to

[192] *See supra* Part II.B. Moreover, even among those inclined to trust, the behavior is context-dependent and thus potentially unreliable. *See supra* Part II.D.

[193] *See supra* note 36.

[194] *See* ROBERT H. FRANK, PASSIONS WITHIN REASON 9, 127-28 (1988); Robert H. Frank, *If* Homo Economicus *Could Choose His Own Utility Function, Would He Want One with a Conscience?*, 77 AM. ECON. REV. 593, 594-95 (1987).

better themselves at others' expense. (Note that reputation matters here, not because the threat of ruining a good reputation gives one leverage to punish one's partner, but because a good reputation is prima facie evidence of an intrinsically trustworthy character.[195])

It seems plausible that trustworthy individuals can indeed sometimes identify the untrustworthy by observation or reputation and so avoid dealing with them. Certainly shifty eyes and a bad reputation are usually disadvantages in the business world. But there is a second process that may also work to exclude low-trust individuals from closely held corporations. That process is self-selection.

This idea can be developed from an argument that has been offered by John Orbell and Robyn Dawes.[196] Orbell and Dawes's analysis relies on the psychological phenomenon of *projection*—the human tendency to assume others are like oneself.[197] As noted earlier, there is extensive empirical evidence that trustworthy people presume others are trustworthy while untrustworthy individuals distrust others.[198] This phenomenon implies that people who are trustworthy are disproportionately likely to enter potentially rewarding relationships that require a high degree of vulnerability (for example, to participate in a closely held corporation). Conversely, untrustworthy individuals are more likely to pass up the opportunity to exploit their fellow shareholders in a closely held firm because they assume their fellow shareholders will try to exploit *them*.[199] The net result is that self-selection works as a filter to ensure that individuals who opt into closely held firms are disproportionately trustworthy.[200]

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[195] Eric Posner has argued that people may also signal their trustworthiness by giving gifts, dressing conservatively, and so forth. However, he suggests they do this primarily because they expect external rewards from future exchanges, rather than because of other-regarding preferences. *See* ERIC A. POSNER, LAW AND SOCIAL NORMS (2000); Eric A. Posner, *Symbols, Signals, and Social Norms in Politics and the Law*, 27 J. LEGAL STUD. 765, 768-95 (1998).

[196] *See* Orbell & Dawes, *supra* note 71, at 526 (discussing the survival advantages of trust and positing models in which cooperators flourish because they project their own attitudes onto others, and so are more willing to undertake trust-based production, while defectors are too suspicious of others to do the same); *see also* Macy & Skvoretz, *supra* note 71, at 640 (positing a similar evolutionary model in which cooperators avoid interacting with defectors).

[197] *See* Orbell & Dawes, *supra* note 71, at 517.

[198] *See supra* text accompanying notes 68-71.

[199] *See* Orbell & Dawes, *supra* note 71, at 526 ("[O]ur model shows how entrepreneurs who intend honest cooperation can, in fact, end up ahead of those who intend exploitation of potential partners.").

[200] Evidence to support this hypothesis includes experimental studies finding that low-trust individuals who are given the option of participating in a social dilemma gen-

The possibility that trust plays a foundational role in the economic success of many closely held corporations and that both self-selection and partner-selection tend to discourage untrustworthy individuals from participating in closely held corporations can explain an interesting pattern commonly observed in closely held corporations.[201] Closely held firms are usually formed when a small number of individuals agree to band together to pursue a joint enterprise. In effect, the closely held corporation begins as an "incorporated partnership" in which each partner contributes a valuable resource or skill. Although the firm's original founders could negotiate elaborate contracts to control their future interactions, they often do not, choosing instead to assume that they can "work things out" if conflicts appear. And often they do work things out. Problems tend to arise, however, when the original founders of the firm die or retire and their interests pass into the hands of their heirs and successors. At this point, squabbling becomes more common, and the new shareholders often find themselves embroiled in litigation with each other.[202]

This pattern can be explained as a consequence of the fact that while the original founders of a closely held firm are subject to selective pressures that favor trust—including both self-selection and partner-selection—their heirs and successors are not. The children of the original founders acquire their shares even if they are shifty-eyed and disreputable or even if they would never willingly choose to participate in an arrangement that required such a high degree of mutual

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erally choose not to, while high-trust individuals tend to choose to play. This result is informative because defectors benefit from playing a social dilemma with cooperators and so should be more eager to play. *See* Orbell et al., *Do Cooperators Exit?*, *supra* note 70, at 147 (finding that cooperators are more likely to stay in the game).

[201] *See* SELIGMAN, *supra* note 183, at 536 (noting that in a closely held corporation, "the relationship among the shareholders must be one of trust, confidence, and absolute loyalty if the enterprise is to succeed"); Richard A. Epstein, *Contract and Trust in Corporate Law: The Case of Corporate Opportunity*, 21 DEL. J. CORP. L. 5, 11 (1996) ("[Corporate participants'] best protection against the inconsistencies of taste and temperament lies in their ability to *select* co-owners . . . . Most people know this. They pick the partners first and worry about the contract later, not the other way around.").

[202] *See, e.g.*, Lehrman v. Cohen, 222 A.2d 800 (Del. 1966) (regarding a dispute over the issuance of new stock arising after a son inherited his father's shares); Ringling Bros.-Barnum & Bailey Combined Shows, Inc. v. Ringling, 53 A.2d 441 (Del. 1947) (addressing a dispute over the election of directors after wives inherited their husbands' shares); Galler v. Galler, 203 N.E.2d 577 (Ill. 1964) (concerning a dispute over the interpretation of a shareholders' agreement after a wife inherited her husband's interest). This pattern strongly suggests that family and social ties alone are insufficient to constrain opportunism in closely held firms. *See supra* text accompanying notes 190-92 (discussing the social-sanctions hypothesis).

vulnerability.[203] And without trust to play its essential gravitational role, the unrestrained centrifugal forces of opportunism eventually cause the firm to disintegrate.

By focusing on the role of selection pressures in furthering trust in closely held corporations, we do not to mean to suggest that selection is irrelevant to trust in publicly held firms.[204] Rather, we seek to demonstrate how a behavioral approach counsels humility in our assumptions about the relative importance of law in encouraging cooperation and discouraging opportunism in social institutions. The case of the closely held corporation illustrates how business relationships characterized by a high degree of mutual vulnerability can survive and thrive even when legal and market forces are largely absent or impotent. As importantly, it suggests how attempts to discourage opportunism by appealing to the law can sometimes backfire and lead to an *increase* in misbehavior.

To understand why, let us return to the observation that participants in closely held corporations often decline to draft complex contracts to control their future dealings, instead preferring to deal with conflicts informally as they arise. To some extent, this reflects the inevitable difficulties of contracting under conditions of risk and uncertainty. In some cases it may also reflect ignorance, lack of imagination, or poor legal advice. The phenomenon of trust behavior suggests, however, that sometimes participants in closely held corporations may deliberately choose not to draft formal contracts, even when they could do so.[205]

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[203] The absence of selection among second-generation participants in a closely held corporation can lead to patterns of distrust even when the founders' successors are, in fact, relatively trustworthy. This is because it may be difficult for them to *prove* this to each other when participating in the firm did not require an affirmative decision to make themselves vulnerable, and so to signal their trustworthiness by themselves displaying trust.

[204] Indeed, the institution of the publicly held firm may perform a hitherto-unrecognized function by allowing trust behavior to persist beyond the life of the firm's founders, as employees, managers, and other human participants in the firm place their trust in the infinitely-lived institutional entity itself. *See supra* note 110 and accompanying text (arguing that individuals can display trust behavior with nonhuman entities such as "the company"); *see also* Roderick M. Kramer, *Cooperation and Organizational Identification*, *in* SOCIAL PSYCHOLOGY IN ORGANIZATIONS: ADVANCES IN THEORY AND RESEARCH 244 (J. Keith Murnighan ed., 1993) (arguing that people are more likely to behave cooperatively in firms when they share a sense of group identity with the organization itself).

[205] *See* LEWIS, *supra* note 8, at 263-64 (describing how large corporations in joint ventures based on trust often deliberately choose to draft only simple and incomplete contracts).

They do this because they recognize, at an intuitive level, the importance of selecting intrinsically trustworthy partners. In screening for trustworthiness, it is useful to pay attention not only to reputation and general demeanor, but also to present behavior. Suppose a potential business partner shows up armed with a lawyer and a ten-page contract loaded with fine print. What does that behavior suggest? Most obviously, a reluctance to trust. And given the empirical association between a willingness to trust and a willingness to behave trustworthily, revealing a fear to trust unavoidably signals one's own untrustworthiness.[206] Participants in closely held corporations accordingly may often decline to negotiate complex formal contracts because doing this would destroy the filtering value of mutual vulnerability as a means of excluding the intrinsically untrustworthy.[207]

This is not to say that contract is never useful in forming closely held firms. For example, negotiating and drafting a contract encourages would-be joint venturers to communicate more clearly what each wants to get out of their relationship. This makes it easier to take account of each other's preferences because those preferences are better known. It can also help avoid the sort of nasty surprises that undermine trust in a long-running relationship. (If your partner does something that you do not like, it can be difficult to tell if this happened because she was mistaken about what you wanted or because she knew what you wanted but was indifferent to your welfare.) In many closely held firms, this information-providing aspect of formal contracting may be at least as important as the threat of legal sanctions contract appears to bring into play.

But the reality of trust behavior cautions against the conventional assumption that opportunism in firms (including but not limited to

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[206] This analysis focuses on the possibility that formal contracting encourages intrinsically untrustworthy persons to participate in closely held corporations or, at least, leads trustworthy persons to perceive this as a risk. It also seems likely that explicit contracting can undermine trust between two individuals who each view the other as potentially trustworthy because it frames their developing relationship as an arm's-length one that calls for competitive rather than cooperative behavior. See Bowles, *supra* note 75, at 95, for a suggestion that cooperation is more likely when people see contracts as being incomplete, and describing experiments in which

> trust in and commitment to trading partners as well as a concern for one's own and others' reputations emerges when product quality is variable and non-contractible but not when it is contractible. . . . These experimental results suggest that trust or reciprocity may depend on the form of the contract, contractual incompleteness leading to trusting and reciprocal behaviors . . . .

[207] Similar considerations may explain why so few married couples negotiate prenuptial agreements.

opportunism in closely held firms) always is best addressed by bringing the force of the law and of formal contract into play.[208] Negotiating and enforcing contracts is always expensive. Such expense may be unnecessary in relationships based on trust, at least when selection pressures work to exclude the intrinsically untrustworthy. Worse, attempts to use contracts in relationships in which trust plays a central role can prove counterproductive and promote exactly the sort of opportunistic behavior they were intended to discourage.[209]

CONCLUSION

Economic theory has yielded great insights into the nature of the business firm and the role the law plays in shaping it. At the same time, conventional economic analysis has proven inadequate to resolve a number of important debates and questions in corporate law. These include the nature of corporate fiduciary duties, the mechanism by which judicial opinions influence corporate participants' behavior, and the puzzling persistence of cooperative patterns of behavior in business situations (most obviously closely held firms) in which legal and market forces seem too feeble to rein in opportunism.

In this Article we offer an explanation for these and other riddles of corporate law. Our approach does not reject economic reasoning. It does, however, reexamine one of its standard assumptions: the assumption that people always behave like *homo economicus*. We argue to

[208] Although our analysis focuses on the possibility that formal contract can undermine trust in closely held corporations, similar arguments can be made about attempts to control opportunism in closely held firms by making it easier for shareholders to sue each other for breach of fiduciary duty. For example, Eric Talley has recently argued that making it easier for shareholders in closely held corporations to bring claims of breach of duty might be inefficient because it creates incentives for them to spend resources on monitoring each other rather than on corporate production. *See* Talley, *supra* note 15, at 1005. Our analysis supplements Talley's by suggesting a second reason why such monitoring is undesirable, namely, that it signals that one does not trust one's partner and, correspondingly, that one may not be trustworthy oneself. *Cf.* David M. Kreps, *Intrinsic Motivation and Extrinsic Incentives,* 87 AM. ECON. REV., May 1997, at 359, 359 (noting that high levels of monitoring and high-powered incentives may reduce trust and destroy loyalty).

[209] In this vein, a newly emerging literature examines whether attempts to use formal contract to encourage cooperation can in some circumstances actually reduce cooperation by "crowding out" trust. *See, e.g.*, Iris Bohnet et al., More Order with Less Law: On Contract Enforcement, Trust, and Crowding (July 27, 2000) (unpublished manuscript, on file with authors). *See generally* Laura Poppo & Todd Zenger, Substitutes or Complements? Exploring the Relationship Between Formal Contracts and Relational Governance 3 (Apr. 27, 2000) (unpublished manuscript, on file with authors), *available at* http://papers.ssrn.com/paper.taf?abstract_id=223518.

the contrary that people often behave as if they care about costs and benefits to others. In support of this claim, we review the extensive empirical evidence that has been developed on human behavior in social dilemma experiments. This evidence demonstrates that most people shift readily from purely self-interested to other-regarding modes of behavior depending on past experience and present social context. Under the right circumstances, people can be counted upon with some degree of predictability to trust and to behave trustworthily, even when presented with economic incentives to do otherwise.

Relaxing the assumption that people are always self-interested in favor of the more realistic claim that people have a capacity for socially contingent, other-regarding behavior opens new channels for analyzing a wide variety of relationships in which the law seeks to encourage cooperation and discourage opportunism. These include not only relationships within families and among citizens in the broader community but also business relationships like partnerships, relational contracts, and (our focus here) incorporated firms.

We emphasize that we are not suggesting that legal rules, explicit contracts, and market sanctions are unimportant in governing business relationships. Social science confirms what most of us already know—not everyone can be counted upon to engage in cooperative, other-regarding behavior, no matter what social cues they are given. Moreover, even among people inclined to behave cooperatively, trust-based relationships sometimes break down, and competitive behavior sometimes yields better individual and group outcomes. In many situations, external incentives are still important and perform exactly the function contractarian theory assumes they perform—to promote cooperation and rein in uncooperative, untrustworthy behavior.

But the experimental evidence on trust teaches that human behavior can be influenced in a number of ways that are *not* captured by the standard nexus of contracts analysis. This observation carries important implications for corporate scholars, for it suggests that an understanding of trust behavior may be an essential foundation for a solid understanding of corporate law. Without taking account of trust, we cannot fully comprehend or explain the substantive structure of corporate law, how it channels behavior, or where its limits lie.

This is a matter of concern not only for academics but also for judges, legislators, practicing lawyers, and businesspeople. Mistaken assumptions about the role and importance of external incentives in furthering cooperative behavior can lead not only to mistaken descriptions but also to mistaken prescriptions. In particular, the experimental evidence warns that attempts to provide external motivations for cooperative behavior can instead reduce cooperation by undermining corporate participants' *internal* motivations. In this Article, for example, we have explored why making it easier to sue corporate directors for breach of the duty of care might actually reduce levels of care, if a proliferation of such lawsuits carries the unintended message that carelessness is common behavior. Similarly, we have suggested that using formal contracts to constrain shareholder opportunism in closely held firms can increase the likelihood of exploitative behavior by interfering with the natural filtering effect of self-selection under conditions of mutual vulnerability.

Indeed, trust can be undermined not only by using external incentives but even by using the *language* of external incentives. The experimental evidence demonstrates that individuals trying to decide whether to trust and behave trustworthily are exquisitely sensitive to the social signals they receive about what sort of behavior is expected and appropriate in a given context.[210] Language is such a signal. As a result, language can promote trust. We have argued here, for example, that judicial opinions encourage trustworthy behavior among corporate participants not only by promising external rewards and punishments but also by describing certain relationships within the firm as fiduciary relationships that call for other-regarding conduct. But language can also erode trust.[211] In particular, employing the rhetoric of contract can undermine trust among corporate participants by implying that trustworthy behavior is not important, not common, and not expected.[212]

This last observation raises troubling questions about the dominance of contractarian talk in corporate law scholarship. What is needed is a more tempered and nuanced approach to analyzing corporate law, an approach that recognizes the multidimensional quality of human nature. Human beings are individualistic *and* social crea-

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[210] *See supra* text accompanying notes 77-81 (discussing how cooperation rates in social dilemma games range from 5% to over 95%, depending on players' perceptions of social context).

[211] Indeed, there is reason to suspect that language may be more effective at destroying trust than creating it. *See supra* text accompanying note 104 (discussing the fragility of trust).

[212] Our arguments are not inconsistent with the contractarian view, writ broadly. Shareholders, managers, and employees who participate in and make themselves vulnerable in firms likely expect some personal benefit in the short or the long term. We suggest, however, that if corporate participants actually did sit down to negotiate their relationships in their mutual self-interest, one of the contractual terms they might choose would be a reluctance to rely upon and use the language of contract.

tures. They are capable of acute rationality *and* cognitive error. They are driven by self-interest *and* (in the right circumstances) by concern for others. They can be suspicious, greedy, and untrustworthy, as conventional economic analysis assumes. But they are also capable of trusting and being trustworthy, and reliably so. A solid understanding of the social and economic circumstances that elicit trust behavior is accordingly vital to our understanding of a wide range of social and legal institutions, including corporations and corporate law.