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TRUSTING AND NON-TRUSTING: COMPARING BENEFITS COST AND RISK

Tamar Frankel*

I. INTRODUCTION

Trusting can be viewed as a non-quantifiable "touchy-feely" aspect of human relations. Legal decisions dealing with fiduciary relationships may have strengthened this image. The judges' language evokes values of human behavior that are not necessarily enforced by law: honor, ethics, trust, and a sense of security provided by caring elders. The whole field has reverberated with the words of Judge Cardozo on trusting among co-partners:

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 honor the most sensitive, is then the standard of behavior. . . . Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.¹

Arguably, such sentiments have no place in the exact, rational analysis of the legal scientist. Judge Cardozo does not make assumptions about human nature but emphasizes the high moral standard of trustworthiness instead. A venerable group of scholars in the law has focused on *risk* from trusting, pressing to limit if not eliminate Judge Cardozo's approach. In that

*. Professor of Law, Boston University. I am indebted to Professor Hugh Baxter, Dean Ronald Cass, Professor Michael J. Meurer, of Boston University School of Law, and Wendy Seltzer, Esq. for their insightful comments on this Article, and to the participants in the Law School's Workshop for very helpful comments and suggestions. Many thanks to my assistants Dan Pierce, William Hecker, Diep Ngoc Shoemaker and Cathleen Gabriel, for meticulous research. Thanks to Benjamin Kantor for editing and typing the manuscript.

¹. Meinhard v. Salmon, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928).

scholarship people are defined as rationally self-interested, seeking to maximize their benefits, presumably even at the expense of others. Hence, people are not trustworthy by nature and pose a danger of "moral hazard" to each other. Risk brings a high premium on means of assuring certainty and predictability in human relationships. Therefore, energy is devoted to designing self-protections against the risks of trusting. Because presumably suspicious parties will not engage others for services that require dependence, scholars are searching also for ways of convincing others of their own trustworthiness.

The focus in this literature is on the individual:² the trusted and trusting. The world rarely includes associations, institutions and society. Risks from trusting³ are reduced by self-help and market support rather than law's protection.

Focus on risk reduces interest in, and valuation of, other aspects of trusting relationships, such as benefits. Focus on individuals - micro economic considerations - reduces attention to the macro aspects of trusting and its effects on systems, such as the financial system and its benefits to the economy. This is a new Hobbesian vision of society. However, Hobbes advocated a strong central government.⁴ The proponents of the new Hobbesian vision of society advocate minimal government involvement. It is the world of people who are alone mistrusting others, laboring on the verge of paranoia.

The approach outlined above is familiar to lawyers; for it serves as the foundation of contract law. In the past twenty years scholars of renown have advocated an ever-expanding application of contract to business institutions (and others as well), such as corporations, financial markets, and financial institutions.⁵ While our law offers two models, trust and contract, the balance between these two models is shifting as contract erodes trust's legal protections. Legal literature, concerned with risk from trusting, seeks to build the security systems and

² Timothy C. Earle and George T. Cvetkovich, *Social Trust Toward a Cosmopolitan Society* (1995), at 48 (Earle & Cvetkovich) *citing* Nikolas Luhmann, *Essays on Self Reference* (1990) at 177 ("fear of regret, fear of dealing with others, fear of being made a fool of--all the varied manifestations of distrust--are selected because of the support they provide for American individualism."). In "The Sicilian Mafia" *The Business of Private Protection* (1993) at 35 Diego Gambetta (Gambetta) describes the cultural conditioning of distrust: The father puts his four year old on a high stone fence and says: Jump, I will catch you. The child hesitates; the ground seems far away. After a few more strong suggestions and promises the child jumps. The father steps aside. The child falls and hurts. The father says: "You must learn to distrust even your parents." Long ago, a friend told me this story: In the Greek Islands, a large group of extended family and friends sits in the evening breeze when a small three year old enters. The mother beckons to him and offers a sweet. As the child extends his hand the mother withdraws hers. The group roars with laughter. The mother puts her hand forward, and the child tries to take the sweet, but she withdraws again. The laughter persists. The child finally give up. Without much explanation he has learned that trusting is stupid and exposes you to ridicule.

³ Self help cannot possibly mean self-sufficiency. We need others to survive, not only as infants but even as CEOs of large companies; not only in small farms but in developed, sophisticated large economies.

⁴ Thomas Hobbes, *Leviathan* (ed. Introd. by C.B. Harmondsworth 1968).

⁵ *E.g.*, *The Contractarian Basis of the Law of Trusts*, John H. Langbein, 105 *Yale L. Rev.* 625 (1995); Henry Hansmann & Ugo Mattei, *The Functions of Trust Law: A Comparative Legal and Economic Analysis* 73 *N.Y.U. L. Rev.* 434 (1998). *See also* Lucian Arye Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 *Colum. L. Rev.* 1395 (1989).

acquire fire arms that would lock the parties in fortified citadels. Judicial protection from the risks of trusting is minimized, encouraging individualism, and independence.⁶

I reject the vision of this school of thought, its approach, its rationales, and its solutions. I reject this risk-centered, individualistic approach and deal with *relationships of trust or distrust*, whether personal, impersonal, among people, institutions, and in society.⁷ I reject the unrealistic (irrational) fear of trusting others, most of the assumptions on which fear-theories are based, and their application to business relationships; and I reject the belief that markets forces and a restricted contract law are sufficient to support successful financial systems.

This Article will demonstrate that preaching the application of contract to business and financial relationships is irrational; it is grounded in ideology, anchored neither in theory nor in reality.⁸ More importantly, a stable financial system requires the support of fiduciary law principles, judicial enforcement, and monitoring by independent regulatory agencies. The contract model is suitable for simultaneous exchanges among few parties with respect to easily verifiable subject matters. Such transactions usually do not benefit, and do not pose the risks, from trusting. This type of contract model is not suitable to dependent relationships based on future promises and information that is difficult to verify. The model is also not suitable to institutional and social organizations, such as corporations, and institutions that form the financial system. In these contexts trusting is crucial and benefits all parties, while mistrust is corrosive, and disadvantages all.⁹

⁶ See Avner Ben-Ner & Louis Putterman Values and Institutions in Economic Analysis, *in* Economics, Values, and Organization 29-33 (Avner Ben-Ner & Louis Putterman eds. 1998); Chaim Fershtman & Yoram Weiss, Why Do We Care What Others Think About Us? *id* at 133; Nancy Folbre & Thomas E. Weskopf, Did Father Know Best? Families, Markets, and the Supply of Caring Labor, *id* at 171 (explaining why people who are caring have not become extinct even though they do not pursue and maximize their self-interest); Andrew Schotter, Worker Trust, System vulnerability, and the Performance of Work Groups *id* at 364 (suggesting that people with same attitude towards self interest or "other interest" usually seek to interact and thus create a group with common attitudes).

⁷ Arguably, institutions consist of people. The "industry," about which I speak, consists of institutions composed of people. Every relationship can be reduced to relationships among individuals. That, however, does not mean that associations of individuals behave as individuals would (even through their individual representatives). Associations, whether the states, international organizations, business corporations, professional associations, the families, even law school classes, have a unique personality, modes and rules of behavior, values and guiding principles. For example, law schools have personalities that are far from identical with that of their individualistic members. That personality, like that of other association, is determined by the leadership, reputation, history, location, unique events, behavior and constitutional rules, among others. It may be that the personality is determined by the same factors as that of a person. But outcomes are different.

I suspect that, in part, individuals are able to play different and sometimes conflicting roles because they think of themselves as members of a prototype of an association. The German and Polish sadistic killers of Jews at concentration camps could behave as loving and devoted parents and spouses. Joseph Mengele, the doctor who experimented with Jewish inmates in these camps commanded the deep love of his son to his very last days. Businessmen, such as the first Rockefeller who pursued the profit motive single-mindedly also contributed enormous sums and established the University of Chicago.

⁸ Earle & Cvetkovich at 48; Mary Ann Glendon, Rights Talk: The Impoverishment of Political Discourse, at 14 (1991).

⁹ See Carol M. Rose, Giving, Trading, Thieving, and Trusting: How and Why Gifts Become Exchanges, and (More Importantly) Vice Versa, 44 Fla. L. Rev. 295, 311, 316 (1992) (suggesting that exchanges representing executory contracts are based on hoped for and promised reciprocity, and that involves trusting).

There is danger in applying contract to the business and financial systems. There is a crying need for strengthening the weakened legal trusting model. Regardless of the causes, our reality is changing. Studies indicate that the Americans trusting culture is eroding, or, as one apologetic scholar put it, while they remain trusting, Americans are more skeptical and cautious.¹⁰ The trend is loss of trust in what other people say (they are all cheats!) and what they promise (they are all crooks!).¹¹

One can argue that there is nothing wrong with this trend. After all, Americans have been experiencing an unprecedented economic prosperity. Like greed, distrust is good! Not so. Long-term, such a trend may spell disaster. There is tentative evidence that poor societies are grounded in mistrust while prosperous economies are based on a culture of trust.¹² National and personal habits hardly develop by command. Neither are they established exclusively by pure rational choice. Mostly, they evolve by learning and acquired habits.¹³ The current trend in America may point to where we might end.¹⁴

Throughout the past fifty years, America has built a rich "trusting commons," that is being depleted.¹⁵ Social trust, like any system, is as strong as its weakest link. That weakest link - the law -- is becoming weaker. Therefore, we need to strengthen legally the "trusting

¹⁰ Toshio Tamagishi, *Have Americans Become Distrustful?* (1996) (unpublished paper available with the author). Earle & Cvetkovich at 47 ("We argued earlier that American individualism is bolstered by the traditional conception of social trust as based on competence and responsibility. Now we can also say that, above all, traditional American culture is supported by social distrust."); id. at 48 (discussing American individualism); Id., at 52 (noting, but not fully agreeing with suggestions that electronic media produce individual, self absorbed isolated entities)

¹¹ Lawrence S. Wrightsman, *Impersonal Trust and Attitude Toward Human Nature*, in *1 Measures of Personality and Social Psychological Attitudes* 373, 378 (John P. Robinson, Phillip R. Sjaver, Lawrence S. Wrightsman eds. 1991); Terrence E. Deal and Allan A Kennedy, *The New Corporate Cultures* 173 (1999) (describing the culture of distrust in many work places); id. at 187 (discussing the adverse effects of distrust).

¹² John O. Whitney, *The Economics of Trust Liberating Profits and Restoring Corporate Vitality*, (1996) (arguing that creating a trusting environment within the organization and outside is both profitable and good). See 23 *The Academy of management Review*, Special Forum on Trust in and Between Organizations 459 (Sim B. Sitkin, Denise M. Rousseau, Ronald S. Burt, and Colin Camerer, eds. 1998) (containing papers on trusting building and its benefits in business organizations); See also Bruce Chapman, *Trust, Economic Rationality, and the Corporate Fiduciary Obligation*, 43 *U. Toronto L. J.* 547 (1993) (arguing against the concept of a corporation as a contract and emphasizing the role of trust and loyalty in the corporate organization).

¹³ See Robert Axelrod, *The Complexity of Cooperation. Agent-Based Models of Competition and Collaboration* 4 (1997) (using models that represent adaptive rather than rational agents).

¹⁴ Proof of such a fate is found not only in present experiences of other countries but also in American history after the stock market crash in the 1930s. What seems to have revived America after the 1930s, among other things, was the return to trust in their financial institutions, and that took almost ten years. It took only about two years after the market crash of 1987. I believe that one of the likely causes for this quick rebound was trust in the financial institutions.

¹⁵ Francis Fuquyama in his book *The Great Disruption* 256-57 (1999) speaks of social capital, and claims that it is not public assets but a private property mired with externalities. Since there comes a point with private property mired with externalities is considered to be in the public domain, I prefer to view the trusting commons as commons.

commons," to encourage the culture of trust by reducing the risk of trusting and offering reputational support to trusted persons. That is what fiduciary law provides.

The law classifies certain relationships where trusting is necessary but too costly to establish, as fiduciary and imposes on fiduciaries duties and remedies that contract law does not provide, thereby protecting those who entrust to fiduciaries their money (or power). The law endows fiduciaries with reputation, legitimacy and credibility--a "brand name" as moral and honorable persons, as Judge Cardozo referred to them. Fiduciary law enhances trusting relationships and their model by protecting against a breach of trust, and providing a special place for trustworthy persons. Markets can help establish trusting, as the e-Bay site example will later demonstrate. But they cannot do the job alone, as the financial system example will later demonstrate.¹⁶

This Article offers a benefit, cost, and risk analysis to bring trusting benefits back into the calculus of legal policy making. Supporting evidence is derived in great part from literature in other disciplines about human nature and behavior.¹⁷ Most people are trusting and trustworthy. They may turn out to be the fittest, and survive very nicely.¹⁸ They protect themselves by interacting with other trustworthy people. Left to their own kind, mistrusting and untrustworthy people do not do as well,¹⁹ and fewer of their kind are likely to survive, because, between the two attitudes, trusting relationships are more efficient. Both attitudes are reflexive and self-perpetuating. Trust begets trust. Distrust begets distrust, often producing the very same behavior that distrustful persons fear.

The purposes of this article are to raise concern and sound the alarm for the complacent;

¹⁶ Markets themselves require a legal infrastructure, or else they will fall into abuse and non-use. *See* Tamar Frankel, Essay, The Legal Infrastructure of Markets (The Role of Contract and Property Law), 73 B.U. L.Rev. 389 (1993)

¹⁷ A number of legal scholars have begun to focus on this literature. In addition, some of these scholars are testing the reality of the assumptions underlying governing theories. *See e.g.*, Donald C. Langevoort, Behavioral Theories of Judgment and Decision Making in Legal Scholarship: A Literature Review, 51 Vanderbilt L. Rev. 1499 (1988). *See also* Ward Farnsworth, Do Parties to Nuisance Cases Bargain After Judgment? A Glimpse Inside the Cathedral, 66 Chi. L. Rev. 373 (1999) (testing 20 cases in which current theories are proven false. Posing the question of whether animosity and distastes for bargaining may play a role in the result, and whether "greater particularity might be needed before economic models can generate advice about remedies reliable enough to be useful to courts.").

¹⁸ *See* Avner Ben-Ner & Louis Putterman Values and Institutions in Economic Analysis, *in* Economics, Values, and Organization 29-33 (Avner Ben-Ner & Louis Putterman eds. 1998); Chaim Fershtman & Yoram Weiss, Why Do We Care What Others Think About Us? *id* at 133; Nancy Folbre & Thomas E. Weskopf, Did Father Know Best? Families, Markets, and the Supply of Caring Labor, *id* at 171 (explaining why people who are caring have not become extinct even though they do not pursue and maximize their self-interest); Andrew Schotter, Worker Trust, System vulnerability, and the Performance of Work Groups *id* at 364 (suggesting that people with same attitude towards self interest or "other interest" usually seek to interact and thus create a group with common attitudes); Theodore C. Bergstrom and Oded Stark, How Altruism Can Prevail in an Evolutionary Environment, AEA Papers and Proceedings, May 1993 at 149 (concluding that "[t]hose who inherit a genetic tendency to cooperate are more likely than others to enjoy the benefits of cooperative siblings. Similarly with cultural inheritance. Altruism can prevail when individuals are likely to interact with others who share the same role model").

¹⁹ For example, the Prisoner's Dilemma haunts such people; it disturbs trusting people less. *See infra* at

to explain the meaning, to point to the consequences of the trend to distrust, to call for a professional leadership to teach the value of trusting and its legal support. The business communities and their leaders have long known what the lawyers have yet to discover. Economists are catching up with sociologists, and now recognize the importance of trust and other elements of civil society that help make markets work, and support commerce, especially when governments are unreliable. A number of legal scholars have recognized the importance of trusting, although not all support legal intervention to strengthen this relationship.²⁰ Scholars that recommends “do it yourself” contract law for all transactions should catch up.

The Article uses an economics approach by adopting a benefits, cost and risk analysis of trusting and mistrust. To simplify the discussion, the Article speaks in terms of dollars, recognizing that other values that are not included. However, assertions are based on empirical studies in sociology, psychology and behavioral sciences. The Article absorbs knowledge and methodology of other disciplines, but not their contexts: absorbing them, rather than being absorbed by them. The context, language, and concepts are those of the law. Three types of relationships are used to contrast trust and non-trusting relationships and show the different results under contract and fiduciary laws regimes: a sale of a newspaper; investment of a life’s savings in mutual fund shares, and trading on e-Bay site in items valued at about \$15.

The Article starts by defining trusting, and distinguishing it from faith and hope. Part II compares the relative benefits, costs, and risks of trusting and non-trusting, under different circumstances, in personal and societal contexts. Part III examines the American system that maximizes the benefits of trusting and reduces its costs. Part IV discusses the role of law in encouraging trusting and reducing its risks, and especially, its lead role in shaping the culture of trust and distrust.

I conclude with a call for removing contract off the pedestal as the most efficient legal business relationship under all (or most) circumstances. It is time to recognize the great value and efficiency of trusting in commercial and financial relationships, the role of institutions in creating impersonal trusting, and the place of the social "trusting commons." This recognition should lead to weakening significantly the legal model of contract by adjusting contract law and strengthening the legal model of trusting relationships.

II. DEFINING TRUSTING

A. What is Trusting?²¹

1. Definition

a. General. I define trusting as a relationship²² among individuals or entities and

²⁰ Lisa Bernstein, Cooter

²¹ I chose the terms "trusting" rather than trust as the subject of the Article in order to emphasize the verb "to trust" as distinguished from the legal institution of "a trust," even though this institution is based on legally enforceable trusting.

²² See Rajeev Bhattacharya, Tomothy M. Devinney, Madan M. Pillutla, A Formal Model of Trust Based on Outcomes, *in* 23 The Academy of management Review, Special Forum on Trust in and Between Organizations 459

institutions, involving a (i) reasonable belief in (ii) an assertion of fact, or (iii) in a promise made by the parties. Facts relate to the present or the past; promises raise expectations relating to the future.²³ "Trust presupposes beliefs, and often those beliefs are based on evidence."²⁴ Reasonable belief is supported by an acceptable level of verification.²⁵

b. Trusting Distinguished From Faith, Gullibility, and Hope by the Risk Level of The Evidence. Faith,²⁶ gullibility, and hope are relatives of trusting, but reflect different degrees of verification and focus. Gullibility is unreasonable belief as the famous story of the sale of the Brooklyn Bridge demonstrates.

Hope involves a strong component of wishing for a future event. For example, "a second marriage is a triumph of hope over experience." While experience may indicate otherwise, the second marriage reflects the parties' hope that with different spouses and behavior the second marriage will work. Faith is belief based mainly on other than verification; whether or not proof exists is mostly irrelevant to the believer. Because the quantum of proof is not as important, faith is not usually one of degree. You have faith or you don't.

c. Trusting is a Belief That is Reasonable. A reasonable belief is based on a certain level of verification--on evidence. The source of verification may be individuals, organizations, and systems. For example, if Smith trusts his broker or the trading system he uses, Smith will not seek to verify the identity of the other party to the transaction or the authenticity

(Sim B. Sitkin, Denise M. Rousseau, Ronald S. Burt, and Colin Camerer, eds. 1998) (showing that the main view of trusting is a relationship among individuals and groups and rejecting the view that trust is merely an individual trait. The issue of trusting can be raised only in the context of interaction with others).

²³ Expectations are important to trusting promises. Trusting creates and is based on expectations. When these are disappointed, trusting is undermined. Thus, faith, hope, and expectations represent different degrees of reason-based evidence. There are numerous definitions of trust. For a survey and proposed definition by outcome see Rajeev Bhattacharya, Tomothy M. Devinney, Madan M. Pillutla, A Formal Model of Trust Based on Outcomes, *in* 23 The Academy of management Review, Special Forum on Trust in and Between Organizations 459 (Sim B. Sitkin, Denise M. Rousseau, Ronald S. Burt, and Colin Camerer, eds. 1998).

²⁴ *But see* Trudy Govier, Social Trust and Human Communities 5, 14 (1997) (criticizing the distinction between faith as "an undoubting, unconditional belief in which data for proof and refutation is ignored" and trust undoubting belief does not ignore pertinent proof). Webster dictionary defines trust as "the belief or confidence in the honesty, integrity, reliability and justice of another person or thing." I have limited that definition since I believe that the belief must be reasonable, based on some verification.

²⁵ I reject the definition of the problem as merely asymmetrical information, which a number of scholars have used. No two parties have symmetrical information. So that problem always exists. The issue is the cost of getting the relevant information and the degree of assurance that the information is true, regardless of whether the other party has the information. Govier at 24 ("Cognitive . . . trust is based on a chosen 'leap' from considered evidence to belief beyond what that evidence would warrant." That is because of the creation of an emotional bond among the actors).

²⁶ Trusting does not mean believing *all* unverified representations; rather it means believing unverified representations when it is not unreasonable to do so. On the other hand, "believing when most people of the same social group would consider belief naive and foolish" qualifies as gullibility. See Julian B. Rotter, *Interpersonal Trust, Trustworthiness, and Gullibility*, 35 Am. Psychologist 1, 4 (1980).

of its signature. If Jones does not trust his broker or the system, he would seek such verifications.

Perception of mutual trust depends on ideas about temptation and risk.²⁷ General experience may provide a signal. Commonality of self interest can render parties trustworthy as commonality of nature does. Parties to a relationship with similar interests and few alternatives, are likely to be trustworthy towards each other.²⁸ When the relationship can be terminated without serious adverse effects, interdependence and verification will be weak, and the parties are more likely to renege on their promises as more attractive opportunities come along. However, "good behavior in business evolves from an economic interest in keeping promises and acquiring reputation for honest dealing. . . Without such interest or with a low interest the likelihood of developing moral norms is low."²⁹

Generally, it is reasonable to believe in the continued existence of the *status quo*.³⁰ In commerce, it is reasonable to believe that another person's performance will be consistent with his past performance and representations, unless there are indications to the contrary. The assumption of continuity of the *status quo* depends on experience and efficiency. For example, change and the pace of change in some businesses, such as the electronics industry can be relatively quick. Likewise, the stock market is chaotic, with few windows of predictable patterns. Conversely, pace of change in peoples' behavior is slower. Those who are fickle, depending on how closely they are watched, are not likely to become steadfast.

Those who are reliable, regardless of whether they are watched, are not likely to become erratic. Therefore, as compared to the environment, peoples' past behavior is more indicative of future behavior. Too many drastic changes in behavior are costly to the actors and to those who deal with them. In light of these assumptions, people who trade on e-Bay trading site will rely on the experience of others to avoid trading with those who reneged on their promises to others. They will, however, continue to trade with others who have demonstrated trustworthiness.

Arguably a reasonable belief should be based on an objective standard rather than on the subjective state of mind of the believer. The standard for "reasonable belief" should depend on the context. The level of evidence necessary to make a belief reasonable may differ, just as different levels of evidence are necessary to form the basis of a jury finding in criminal, in

²⁷ Chris Snijders and Gideon Keren, Determinants of Trust *in Games and Human Behavior* 355 379 (David V. Budescu, Ido Erev, and Rami Zwick eds. 1999) (the volume is devoted to experiments in human behavior concerning cooperation, competition, bargaining and other economic activities).

²⁸ Thus, a manufacturer of unique products and the customer who needs them are likely to honor their contract obligations, at least so long as both are interested in the arrangement, and so long as the alternatives to their relationships are not available or more costly.

²⁹ Diego Gambetta *The Sicilian Mafia. The Business of Private Protection* 28 (1993) ("This may also explain why the opposite norm obtains and the ability to cheat is praised and encouraged").

³⁰ See Bernard Barber, *The Logic and Limits of Trust* 9 (1983) ("In its most general sense, trust means the expectations, which all humans in society internalize, that the natural order--both physical and biological--and the moral social order will persist and be more or less realized.").

contrast to civil, cases. As in legal rules of evidence, the level of evidence may be related to the importance and impact of the subject matter fact or promise.³¹

"Do it yourself" verification may be less costly and more reliable than delegating the function to others. But that is not always true. Cost depends on the "doer's" time value and lost opportunities, as compared to the compensation of experts and agency costs of delegation.³² One's own judgment may be more reliable than that of others, but one's level of wisdom may be lower. People ask for the opinions of others, but then make up their own minds.

2. Default Presumption. The starting point in trusting attitude is a *presumption that the other person or institution is trustworthy*, barring evidence that conflicts with trustworthiness. Observable facts and events are interpreted in this light. The starting point of mistrust is the reverse. Others are presumed untrustworthy until proven otherwise. Thus, Thomas Hobbes recommended a generalized suspicion of fellow men and women.³³ Jesus recommended a generalized trust in fellow men and women.³⁴

Presumptions affect the burden of proof. In terms of presumptions, lack of trust is not identical with mistrust. Mistrust is a positive assumption that another's is not trustworthy, and requires proof that mistrust is not justified; non-trusting requires evidence of trusting. Trusting persons require a less proof than non-trusting persons.

B. Trust and Mistrust Are Relationships: Reciprocal and Self-Feeding. Devices which form the basis for trust also require trust. The process is reflexive.³⁵ A system that signals mistrust will breed a culture of mistrust. In one case, the attempt of teachers in a Canadian law school attempted to control the students through minutely detailed rules of examinations. That led to a culture of mistrust.³⁶ In contrast, often trusting creates pressure on trusted persons to behave in a trustworthy manner. Like personal trust and institutional trust, social trust is not blind. It emerges with experience of persons, informal and formal groups.³⁷

³¹. Criminal law requires more evidence than civil. *See* McCormack on Evidence §341, at 577 (John William Strong ed. 4th ed. 1992) (noting higher degree of persuasion required in criminal cases; consequences of an erroneous conviction are usually more serious than those of an erroneous civil judgment).

³². For example, the decision would be made depending on which of the following costs exceed the others: the cost of "do it yourself" [X (acquiring expertise) + Y (lost opportunities)] or the cost of delegating verification to others [A (compensation to the delegate) + B (agency costs)].

³³ Leviathan (ed. Introd. by C.B. Harmondsworth 1968).

³⁴ *See* Govier at 18, 19.

³⁵ Govier at 27.

³⁶ Govier at 87-88.

³⁷ Govier at 153. *See also* Ann Marie Zak, Joel A. Gold, Richard M. Ryckman, Ellen Lenney, Assessments of Trust in Intimate Relationships and Self-Perception Process, 138 (2) J. Social Psychology 217 (1998) (finding that the trusting behavior of the participants in the experiments are often self fulfilling).

C. Trust and Mistrust are Evolving Relationships. Both Attitudes Are Limited in Depth and Scope, Depending on the Evaluation of the Trusted Person. In both attitudes uncertainty and risk are reduced with experience³⁸ However, even with most casual relationships a measure of trust exists. Even with deep trust (e.g., trust in a doctor, lawyer, or priest) the scope of the trust is usually limited to particular areas of knowledge or experience of honesty. There is a measure of trusting in a non-trusting or arm's length relationship, and some measure of self-reliance and external verification in a trusting relationship. There is a spectrum of different mixes of the two types. For the purpose of analysis, however, it is helpful to sharpen the distinctions and view each type of relationship as an ideal, "pure" type.

III. TRUSTING AND NON-TRUSTING; RELATIVE BENEFITS, COSTS AND RISKS

A. Benefits

1. Benefits From Personal Trusting. Personal trusting has two related types of benefits: the reduction of the cost of information (after a certain investment is made), and simplification of complex information. In addition, social trusting is important to economic prosperity.³⁹

a. There is a Fundamental Difference Between the Costs of Trusting and the Cost of Non-Trusting, Which is Often Ignored. In trusting the necessary verification relates to who the trusted party is, and not to the statements of facts or promises that it made.⁴⁰ During the cold war President Regan said: "trust the Russians but verify." That, of course, drew chuckles because the trusting contradicts verification by sources other than by the trusted person.

During the trust relationship, statement of facts may amount to thousands and promises to hundreds. Trust eliminates the cost of their continuing verification. For example, if the cost of verifying a fact is \$X, and the relationship (with one or more persons) involves y facts, a non-trusting party would have to expend \$XY to verify the facts. A trusting person would have to expend \$0. The cost of establishing the relationship, as discussed below, should be taken into

³⁸ Govier at 6.

³⁹ See Richard A. Posner, *Economic Analysis of Law* 284 (5th ed. 1998) ("Honesty, trustworthiness, and love reduce the costs of transactions.")

⁴⁰ In some cultures people focus mostly on the people with whom they do business. They will not do business with foreigners or with members outside the family group, or with strangers, or with people who are not known by reputation, or who do not belong to the same race, or with those who are not introduced by friends and acquaintances. Generally, evidence can be direct or circumstantial; it can be based on different sources, some more reliable than others, and on a combination of sources. The quantum and the sources of evidence form the measures of reasonableness of belief on which trusting is based. One can reasonably believe statements made by a trusted person, similar to indirect evidence, such as circumstantial evidence, or hearsay. One can reasonably believe in the reliability of promises by trusting the promisor on the basis of the promisor's character, reputation, and past performance. However, independent verification may support the trustworthiness of the trusted party. For example, verifications of a fact, for example, by documents or independent parties (e.g., accountants, lawyers, independent witnesses, or experts) can show indirectly that the other person's statements of fact are true. These include third party guarantees, promises spelled out in great detail, covenants and warranties.

consideration, but it is usually fixed. Thus, increased number of transactions among persons renders trusting increasingly less costly than non-trusting. For the non-trusting person, the cost of Y grows by the magnitude of X with each transaction. The trusting person's costs remains zero. Assume that trusting involves also some monitoring of the trusted person. We must then increase the cost of trusting by that amount. So long as the cost of verifying the facts and promises are lower than the cost of monitoring, trusting is more efficient in terms of these costs.⁴¹

b. Economy in Information-Retention. The second and parallel benefit from trusting is in terms of information retention. "By trusting we reduce the complexity of the world because we do not have to take every possibility into account; trusting we assume that an indefinitely large range of harmful and dangerous things will not happen." That includes other peoples' behavior.⁴² When we trust we need not retain all information regarding the facts and the promises of other persons, but retain mostly the information about the statements and promises they made. This benefit may not be easily quantifiable, but it is highly valuable, because our retention capacity is limited.

c. Trust May Substitute For Formal Contracts. There is some evidence that in trusting relationships people will forego formal contracts, and that reduces their costs.⁴³ "The development of trust is perhaps best described as a process of uncertainty reduction. The ultimate goal is to reach confident conclusions about the strength and quality of the partner's attachment to the relationship."⁴⁴

d. Reduced Cost of the Prisoner's Dilemma. Trusting people rarely bear the costs of the Prisoner's Dilemma. This classic prisoners' dilemma shows that reasoning from self-interest, we can work against our own self-interest. "Two people who work for their joint or collective interest instead of their separate interests would be better off. The Prisoner's Dilemma "serves to indicate the self-defeating character of the single-minded and solitary pursuit of one's

⁴¹ This analysis is similar to Coase's Theory of the Firm. A firm can be viewed as an organizational form that enhances enhance trusting thereby reducing costs of interaction. If contract were adequate, the firm would not be necessary. (This argument was suggested by Professor Michael Meurer).

⁴² Govier at 25.

⁴³ Juliet P. Kostritsky, *Bargaining With Uncertainty, Moral Hazard, and Sunk Costs: A Default Rule For Preconditional Negotiations*, 44 *Hastings L. J.* 621, 643 (1993); Michael Meyer, *Here's a "Virtual" Model for America's Industrial Giants* *Newsweek* Aug. 23, 1993 at 40 (describing a corporation that does business "on a handshake." "Trust cements the network. 'It is the essence of our relationships.' says Tu. . . The deals were closed on a handshake. Kingston style.").

⁴⁴ *Id.* at 191. See also John O. Whitney, *The Economics of Trust Liberating Profits and Restoring Corporate Vitality*, (1996) (arguing that creating a trusting environment within the organization and outside is both profitable and good); *id.* at 16-17 ("Trust is easier to achieve when the enterprise's sense of purpose is both understood and shared by the organization and its people. . . . "Aim, vision, mission, values, objectives, and goals. . ." Leaving room for diversity. Information-acceptance. Not serious divergence. *id.* at 17. The roots of mistrust in an organization are buried in: Misalignment of measurements and rewards (asking people to do one thing and measuring by another), incompetence or presumption thereof, lack of appreciation for a system (a system is as strong as its weakest chain), untrustworthy information and failure of integrity).

own self-interest."⁴⁵ A trusting person puts herself at risk that the other party will behave in an untrustworthy manner and in most cases finds that the risk was low and the benefits were high.

2. Benefits From Trusting Employees and Cooperating in the Work Place. In the past few years American businesses have worked hard to create trusting and cooperating relationships among their employees and between employees and management. Far more discretion has been vested in employees. Far more respect has been offered, even to the extent of allowing or asking the employees to choose their foremen and middle management. These efforts have resulted in enormous increases in productivity and profits. They worked. A similar development is occurring among competing business organizations.⁴⁶ Dirty tricks led to more dirty tricks and ended in hurting the perpetrators.⁴⁷

3. Benefits to the Economy. The previous discussions were based on benefits, costs and risks of individual trusting in terms of verification. However, even if we view the world as composed only of individuals, society plays a role in their lives because survival depends on others. So some trusting relationships must be forged, or we die. Thus, trust is also a social phenomenon. Even though general social trusting plays a significant role in our well being, in line with the other limits of this Article I limit the discussion to economic prosperity.

There are indications that social trusting is crucial to economic prosperity. Arguably, this type of trusting is required for the very existence of society.⁴⁸ Among other reasons, a prosperous

⁴⁵ Govier at 11.

⁴⁶ For an extreme example of trusting attitude in business see Michael Meyer, Here's a "Virtual' Model for America's Industrial Giants Newsweek Aug. 23, 1993 at 40 (describing a corporation that does business "on a handshake." "Trust cements the network. 'It is the essence of our relationships.' says Tu. . . The deals were closed on a handshake. Kingston style."). See also John O. Whitney, *The Economics of Trust Liberating Profits and Restoring Corporate Vitality*, (1996) (arguing that creating a trusting environment within the organization and outside is both profitable and good). See 23 *The Academy of management Review*, Special Forum on Trust in and Between Organizations 459 (Sim B. Sitkin, Denise M. Rousseau, Ronald S. Burt, and Colin Camerer, eds. 1998) (containing papers on trusting building and its benefits in business organizations); See also Bruce Chapman, Trust, Economic Rationality, and the Corporate Fiduciary Obligation, 43 U. Toronto L. J. 547 (1993) (arguing against the concept of a corporation as a contract and emphasizing the role of trust and loyalty in the corporate organization).

⁴⁷ John O. Whitney, *The Economics of Trust Liberating Profits and Restoring Corporate Vitality* McGraw-Hill 1996 (creating trusting within the organization and with outside parties is profitable as well as good); Trust in Organizations, *Frontiers of Theory and Research* (Roderick M. Kramer and Tom R. Tyler (1996) (showing the many ways in which trust is important to organizational life including business organizations).

⁴⁸ Govier 153 ("For politics, economics, and personal well-being, social trust is a valuable resource."). Lack of trust is costly in psychological terms. The unknown is risky; it breeds fear and anxiety, which can be debilitating. See Niklas Luhmann, *Trust and Power* 4 (1980), *quoted in* Bernard Barber, *The Logic and Limits of Trust* 10 (1983): "But a complete absence of trust would prevent him even from getting up in the morning. He would be prey to a vague sense of dread, to paralyzing fears. He would not even be capable of formulating distrust and making that a basis for precautionary measures, since this would presuppose trust in other directions. Anything and everything would be possible. Such abrupt confrontation with the complexity of the world at its most extreme is beyond human endurance." See also Lawrence E. Mitchell, *Fairness and Trust in Corporate Law*, 43 *Duke L.J.* 425, 432-33 (1993) (noting that the destruction of trust . . . would be the destruction of the possibility of social relations").

economy develops specialization. Specialization requires interdependence.⁴⁹ And interdependence cannot exist without a measure of trusting. In an entirely non-trusting relationship interaction would be too expensive and too risky to maintain.⁵⁰

Studies have shown a correlation between the level of trusting relationships on which members of a society operate and the level of that society's trade and economic prosperity.⁵¹ Arguably, in nations with a high level of trusting relationships, such as Germany and Japan, organizations are more flexible, and therefore more efficient.⁵² In stark contrast, at least one of the reasons for poor societies is a low level of trust.⁵³ The forms of trusting in prosperous economies need not be identical, but can reflect the culture and history of the society. Yet, trusting seems to have contributed to their prosperity.⁵⁴ Although these studies are not

⁴⁹ Govier at 26 (in complex societies we need to trust many people, including experts on information that we do not understand, even if it was disclosed to us). Tamar Frankel, *Fiduciary Law* 71 Cal. L. Rev. 795, (1983).

⁵⁰ Nature's world is no different; sharks are one of the few exceptions. See *Behavior* (visited May 24, 1999) <<http://www.seaworld.org/sharks/behavior.html>> (noting that sharks are basically asocial).

⁵¹ See Francis Fukuyama, *Trust* 7 (1995) (noting that a nation's ability to compete is conditioned by its level of trust); Francis Fukuyama, *The Great Disruption* 256 (1999); John O. Whitney, *The Economics of Trust: Liberating Profits and Restoring Corporate Vitality* (1996) (trusting is profitable as well as good); Bruce Chapman, *Trust, Economic Rationality, and the Corporate Fiduciary Obligation*, 43 U. Toronto L.J. 547 (1993).

⁵² See Edward H. Lorenz, *Trust and the Flexible Firm; International Comparisons*, 31 *Indus. Rel.* 455, 455-63 (1992). Lorenz's discussion of trust and organizational flexibility points to the fact that Germany and Japan experienced systems of labor-management consultation during the post-World War II decades. This experience established high levels of trust in German and Japanese firms making higher levels of organizational flexibility possible. See *id.* at 457; see also Robert D. Cooter & Wolfgang Fikentscher, *Indian Common Law: The Role of Custom in American Indian Tribal Courts* (pt. 1), 46 *Am. J. Comp. L.* 287, 316 ("Theory and empirical research suggest that people in enduring relationships tend to create efficient rules of interacting that allow them to accomplish their ends.").

⁵³ See Govier at 72 (describing the findings of Collin Turnhill's description of the IK in Africa, a treacherous society on a near starvation existence). *Id.* at 74 (deception in the IK society was not something to be ashamed of); Ruth Benedict, *Patterns of Culture* 130-166 (1959) (describing a community in the South Seas dominated by fear of magic spells that each member can cast on the others. Distrust is so great that husband and wife cook their own meals lest each will poison the other. When one spouse dies, the assumption is that the surviving spouse did indeed cause the death. The survivor is therefore required to atone for the wrong by serving for one year as a slave to the tribe of the deceased spouse. At the end of the year the survivor is redeemed by the spouse's own tribe. There seems to be a direct relation between such over-arching mistrust and the dire poverty of the tribe. The community has little or no specialization of skills, and little interaction among members. Above all, its members are known to be treacherous and deceitful. That imposes a high cost of constant vigilance by members of the group against harmful behavior of the others); Fukuyama, note 4; Edward C. Banfield, *The Moral Basis of a Backward Society* (1958).

⁵⁴ See Fukuyama, *Trust* *supra* note ---, at 269-281 (arguing that the United States is based on trusting). However, legal scholarship puts this argument in question. Francis Fukuyama has argued that because Americans and Japanese are trusting people, their economies are very successful. It seems however, that Americans and Japanese trust in a different way. The Japanese seem to value personal relationships and deeply trust the people in their work places. Arguably American business people are far more ambivalent in respect to personal trusting, especially people in the work places. Many Japanese put a higher premium on the trustworthiness of persons with whom they are to do business than on the terms of the agreement. Many Americans focus on the terms of the contracts that they sign rather than on the trustworthiness of the other parties to the contracts.

determinative, the possibility of positive impact on prosperity should be added to the benefits of trusting, and possibility of negative benefits should be added to distrusting.

B. The Cost of Establishing Personal Trusting Relationships

1. Verification of Truthfulness and Trustworthiness is Usually Slow, Through Long-Term, Repeat, Relationships. Establishing trusting requires investment of time and attention, and risking disappointment. It costs to persuade others of one's trustworthiness; it is risky to trust. The parties start a non-trusting relationship that over time may bloom into a trusting relationship. Verification depends on past experience, and that, in turn, depends on the frequency of the experience. Notwithstanding the tendency to repeat patterns of behavior, a trusted party may change, for example, with age and illness, marriage, or great temptations. The trustworthiness of an institution may change if it was acquired by others or its key personnel left. Experience helps predict how a person will behave in the future, under the same and different circumstances. People are creatures of habit, personality traits are life-long, and other behavior habits are long-term. In personal relationships it is also easier to discover whether a person can perform her promises, has the necessary money or product, or possesses the requisite skill.⁵⁵

This development involves detection of signals first, and then attributing the signals to general character traits, such as responsiveness dependability, and honesty.⁵⁶ The process involves a reciprocal reassurance, accommodation and control. Whenever possible, equal involvement is an insurance against risk.⁵⁷

2. Building Personal Trusting Relationships Involves Lost Opportunities. Personal trusting is costly in terms of lost opportunities. There is a limited number of people with whom a person can interact. There are fewer persons with whom the interaction can be long-term. It has been shown that in poor societies people limit their business interaction to family, and that limits their ability to recruit talent for their business.⁵⁸ Family businesses may thrive for a generation if they produce many children some of whom continue to develop the family business. But limiting the leadership of a business to family members puts the business at a competitive disadvantage that at some point may lead to its demise.⁵⁹

⁵⁵ *But see* Rolf Ziegler, Trust and the Reliability of expectations, *Rationality and Society* 427 (Sage Publications 1998) (focusing on trusting in "one-short" situations. "In the short run, an actor may decide to raise his forecasting ability by increased but costly attention, but in the medium run it can only be improved by learning processes").

⁵⁶ John G. Holmes & John K. Rempel, *Close Relationships* 187, 192 (Clyde Hendrick, ed. 1989) (citing Kelly & Stahelsk, 1970; Miller & Holmes, 1975).

⁵⁷ *Id.*

⁵⁸. *See* Fukuyama, Trust *supra* note---- at 78-79.

⁵⁹ *See* Fukuyama, Trust *supra* note ---, at 78-79 (noting that distrust of non-family members usually prevents institutionalization of Chinese businesses and drawing on outside talent). When trusting relationships have evolved not within the family but within the work place, and most important work places are few and large, even though worker mobility among these work places is rare, they are sufficiently large to maintain and nurture talent.

C. Risks From Trusting and Risk Reduction

1. Risk. Risk from trusting is generally based on the evaluation of human nature: arguably, by nature, people are not trustworthy. Further trusting offers temptations that render people even less trustworthy. The magnitude of the risk, however, is debatable.

a. One View: People Are Not Trusting Nor Trustworthy. People are competitive, self-regarding and greedy. Given benefits and opportunity, they will be tempted to lie rather than tell the truth and renege on their promises rather than keep their word. People seek to survive in an environment of limited resources. Those who do not end on top of the food-chain will not produce strong offspring and their (weaker) genes will be bred out.

Trusting tempts exploitation. Without deterrence, people may succumb to temptation, even if they were taught otherwise, even if they internalized trusting behavior and norms, even if long-term they may suffer the consequences of their betrayal. People who are not monitored, who do not feel constraints, are likely to become untrustworthy over time. Trust is power. It causes one party to depend on another. The cliché about power and corruption applies to it. Trusting involves risk. Temptation undermines trustworthiness. Mistrust is based on evaluation of these two components.⁶⁰

b. Another view: People Tend Generally to Be Trusting and Trustworthy. If we believe in the Darwinian law of survival (and we do) people should never indulge in trusting. They will be robbed blind by those who would discover their "weak" spot. Recent researchers on trusting, however, contradict the assumption about the innate nature of lack of trustworthiness.

Yet, there is evidence that most people are trusting and want to be trusting, not only to be trusted. Further, trusting people survive and thrive. The explanation is twofold: society needs trusting and trusted people, as it needs altruistic people, such as parents. Mother Theresa and nuns' orders constitute another example. Further, trusting people protect themselves by avoiding untrustworthy people; they interact with their own kind. It seems that people who have internalized trusting tendencies seek and interact with other people who have internalized similar trusting tendencies.⁶¹ In the process, trusting persons may lose (but usually only once); they gain much by finding a reciprocating match. In that scenario, trusting people do much better because their relationships are far more efficient. Like other human relationships trust and its opposite are reciprocal. Trust begets trust. Mistrusts begets mistrust.⁶²

⁶⁰ Chris Snijders and Gideon Keren, Determinants of Trust *in Games and Human Behavior* 355, 378 (David V. Budescu, Ido Erev, and Rami Zwick eds. 1999) (stating that the extent "to which mutual trust will be established depends on the notions of temptations and risk." The decision to trust is based both on temptation and risk but risk is stronger. Loss of not being trusted is not considered a factor).

⁶¹ See Andrew Schotter, Worker Trust, System vulnerability, and the Performance of Work Groups *in Economics, Values, and Organization* at 364 (Avner Ben-Ner & Louis Putterman eds. 1998) (suggesting that people with same attitude towards self interest or "other interest" usually seek to interact and thus create a group with common attitudes).

⁶² John G. Holmes & John K. Rempel, Close Relationships 187, 190 (Clyde Hendrick, ed. 1989) ("People who distrust the motives of others tend to have more rigid and narrow expectations and to provoke the very reactions they fear." *citing* Kelly & Stahelsk, 1970; Miller & Holmes, 1975). Govier at 38 (trust and mistrust perpetuate and feed

I trust (reasonably believe) that trusting has a chain effect. This effect continues to reduce verification costs while non-trusting tends to increase the verification costs or reduce the benefits of relationships over time.⁶³ In general, both in the United States and in other cultures, people tend to reciprocate; trusting often breeds trusting and non-trusting breeds non-trusting. The signal of trusting or non-trusting need not be explicit, but is reciprocated.⁶⁴ Thus, trusting people take the risk of trusting and find that, long-term, it pays. Even if people are entirely self interested,

2. Building Trusting: Reducing the Risk

a. Risk Can be Reduced Through Self-Interest. In commercial transactions, self-interest in maintaining long term relationship can render parties trustworthy. Such self interest can be based on shared interests, mutual dependence, and few or more costly alternatives. Thus, a manufacturer of unique products and the customer who needs them are likely to honor their contract obligations, at least so long as both are interested in the arrangement, and so long as the alternatives to their relationships are not available or more costly. However, assuming self interest as the main driving force, dependence may be also serve as a tool for pressure, especially if one of the parties has better alternatives than the other. Further, when attractive alternative opportunities can be expected, parties may prefer weak trusting relationships in which they can terminate the relationships. In such situations, when the relationship can be easily terminated without many adverse effects, and when interdependence is weak, verification will not be very comforting. If self interest is dominant, and no other sentiments are binding, the parties are more likely to renege on their promises as more attractive opportunities come along, or use the first opportunity to terminate.

b. Risk Can Be Reduced by Self Help and Trustworthy Behavior. On-going interdependent relationships tend to create a pattern of reciprocity among the parties, for both good and bad behavior. Disabused of trusting, people build protections. On the assumption that the other party will not keep his promise, people justify breaking their promises to the other party in advance. Under conditions of distrust, the assumption and expectation that others will be treacherous and deceitful gives rise to treachery and deceit. Studies suggest, for example, that a supervisor may build trustworthiness by deciding matters in a way that is perceived by subordinates as fair, and, among other things, altruistic.⁶⁵

on themselves).

⁶³ See Avner Ben-Ner & Louis Putterman Values and Institutions in Economic Analysis, *in* Economics, Values, and Organization 29-33 (Avner Ben-Ner & Louis Putterman eds. 1998); Chaim Fershtman & Yoram Weiss, Why Do We Care What Others Think About Us? *id* at 133; Nancy Folbre & Thomas E. Weskopf, Did Father Know Best? Families, Markets, and the Supply of Caring Labor, *id* at 171 (explaining why people who are caring have not become extinct even though they do not pursue and maximize their self-interest); Andrew Schotter, Worker Trust, System vulnerability, and the Performance of Work Groups *id* at 364 (suggesting that people with same attitude towards self interest or "other interest" usually seek to interact and thus create a group with common attitudes).

⁶⁴ See Lawrence C. Becker, Reciprocity 73-144 (1986).

⁶⁵ Ronald J. Deluga, Supervisor trust-building, leader, member exchange and organizational citizenship behavior, *J. Occupational and Organizational Psychology* 67, 315 (1994); *id.* at 324 ("Perhaps perceived supervisor fairness is

3. Risk and Costs Can be Reduced through Markets. Information regarding trustworthiness can be acquired in the markets.

a. Reputation. It has been shown that reputation reduces the costs of verification. While information about the character of a person is more reliable when gathered first hand, information can also be gathered through others. Thus, people rely on reputation (good or bad) as a form of verification if the direct sources of information are more costly. Reputation, however, may be less reliable than personal observation or institutional intermediary trusting, and is not supported by law. It results from the aggregate opinion of others. Like price, it can be a "black box" unless others have similar concerns.⁶⁶

b. Signals of Trustworthiness. Membership in professional and other groups provides reputational value. It signifies a high probability that the members have passed the requirements of membership into that group, be they educational (e.g., medical) or character requirements (e.g., clergy), or acceptance by peers and conformity to the rules of the group (e.g., trade organizations). These groups subscribe to certain norms that build trustworthiness. As part of the norms, the groups impose on members a duty to enforce the norms, and that renders the norms powerful and the membership--credible.⁶⁷

An example of such membership reputation-building is the April 1998 announcement of the association of investment advisers (AIA) that its members will take "an oath of a fiduciary." They vowed to disclose their fees, their method of doing business, and the parties with whom they are affiliated. Advisers found this self-enforcement to be good business. The American Association of Retired Persons has supported the advisers' movement. Presumably, the AIA and the AARP will monitor the implementations of the "oath."⁶⁸ The Investment Company Institute is similarly concerned with public trust of its members, and the Securities and Exchange

the social exchange conduit (i.e. subordinates modify their behaviour as a function of perceived equity)").

⁶⁶ Reputation is a marketing device distinguishing competitors in the markets. Trustworthy people offer reduced information costs to the other parties and can therefore charge more for their services and products. When transactions are trust-dependent to the extent that most people would not engage without trusting, the assurance of trusting becomes crucial to the transaction. In such a case, the interference of the law as guarantor of trustworthiness may be necessary.

⁶⁷ Robert Axelrod, *The Complexity of Cooperation. Agent-Based Models of Competition and Cooperation* 65-66 (1997) (describing metanorms).

⁶⁸ Groups with similar interests undertake to enforce the members' obligations to be trustworthy trust and thereby maintain the trustworthiness of the group. *See* Tamar Frankel, *Should Funds and Investment Advisers Establish a Self-regulatory Organization?* in *The Financial Services Revolution, Understanding the Changing Roles of Banks, Mutual Funds and Insurance Companies* at 447 (Clifford E. Kirsch ed. 1997). *See also* TRUSTe Privacy Principles, *Multimedia & Web Strategist* vol. 4 at 3 (Apr. 1998) (Web sites that bear the TRUSTe trustmark have agreed to adhere to privacy principles. "TRUSTe enforces its policies and license terms by penalties, further audits, revoking the site's license, referring the case to the FTC, and bringing a breach of contract or trademark infringement suit"); *Is Your System Safe?* *Intellectual Property Magazine*, (Aug. 1998) (describing the developments of the emergences of TRUSTe).

Commission is concerned with the public perception's image of the securities industry.⁶⁹

c. Market Verifiers. Rating Agencies. The Moody's trust package supports the view of trusting as verification. Moody is providing information about trustworthiness of parties in different countries who wish to establish business relationships but do not wish to take the risks of non-trusting or make the investments in personal trusting. This information focuses on the other parties' truthfulness and trustworthiness. Trusting has been commodified; it can be bought.⁷⁰

Similarly, because consumers cannot see peeling plaster and surly shopkeepers on line,⁷¹ retailers offering their wares on the Internet are reducing consumer costs by providing effective verification. A commercial outfit has developed criteria for retailers' trustworthiness and those that meet the criteria can bear the Truste sign, which has a great deal of power. Even with the Truste sign, consumers take time to develop trusting, but the time lag is shorter than the time of building trust without the sign.⁷²

Other sources, such as accountants, and business acquaintances are sometimes checked for trustworthiness in terms of expertise and proof.⁷³ In this case, Moody's might be checked to ensure that its "trusting package" is accurate and has a history of producing good results. I believe that the Internet will develop intermediaries suitable to monitor and verify facts and promises of the other parties to relationships, and benefit from the service.⁷⁴

⁶⁹ See e.g., the Rule G-37 prohibiting broker dealers from serving as underwriters of municipal securities for two years after they and their associates make or solicit contributions for elected officials that have influence in allocating underwriting contracts for municipal and state securities. A proposed similar rule imposing restrictions on advisers that "pay-to-play" and obtain advisory services contracts for public pension funds has been published in August 4, 1999.

⁷⁰ See Bernard S. Black & Ronald J. Gilson, *Venture Capital and The Structure of Capital Markets: Banks versus Stock Markets*, 47 *J. Fin. Econ.* 243 (1998); Symposium, *the Internet and Small Business Capital Formation*, 2 *Journal of Small and Emerging Business Law* (1998). Venture capital companies also provide a similar, though more intrusive service.

⁷¹ Maryann Jones Thompson, *E-Commerce Spotlight: Building Trust Online*, *Industry Standard Media*, Jan. 25, 1999.

⁷² The Cheskin Research. *eCommerce Trust Study*. March 21, 1999 (noting that consumers for whom the Internet is new move from a feeling of a chaotic environment to seeking control and finding it in the symbol of trust. It is recognized that trust is a dynamic process which can rise and fall and depends on experience. With trust comes reduced demand for information); Michael Hintze, *Data Privacy: Self Regulation Works*, *New York Times T3* (Nov. 9, 1998) (noting the Truste and OPA trusting brand names as self-regulatory devices. Truste guidelines are stricter than EU directives on privacy issue. TRUSTe conducts initial and periodic reviews of members. Similarly Online Privacy Alliances has membership that has agreed to abide by a published a set of principles. The FCC is bringing actions against violators, but market pressures prove adequate).

⁷³ It is suggested that the value of board directorship for busy corporate leaders is in "networking" and current information, including information about other actors in their field.

⁷⁴ The Internet offers far more information than before, and far cheaper, but it does not always provide verifiable information. That was true in the past in other forms of communications, but is magnified a thousand fold. In addition, the balance of costs has changed. The cost of transferring information by the Internet is far smaller than by any other means of communications, while the cost of verifying the information has increased substantially. The

d. Market Trusting Services. Accountants, lawyers, doctors and others command trusting in their competence and honesty. They offer verification of these qualities through diplomas and membership in professional organizations. Some, like accountants, offer verification of the trustworthiness of others or verification of facts and promises by those who are not trustworthy.

4. Risk Can Be Reduced By Mistrust. Focus on the Facts and Promises Rather Than the Other Parties. Arguably, mistrust protects against harm from others. Not necessarily. "Distrust and control are "backward-facing self-defense strategies. They derive their seductive appeal from their encouragement of individual vanity, hubris, and belief we all want to have that each of us is self-made, unique, and specially blessed."⁷⁵ Scholars focused on the means by which self-protection against abuse of trust is achieved.⁷⁶ These mechanisms can be very costly. They can also signal lack of trust, especially if they are used as a matter of course in long-term relationships. Mistrust can breed dishonesty, and bring added risk. An assumption that the others will be untrustworthy provides a justification for treating the others in a dishonest manner first, as a defense. By such actions the protectors prove their own dishonesty, and are driven to deal with their own kind. They are the ones who face the Prisoner's Dilemma relatively often. Distrust may backfire. "People who distrust the motives of others tend to have more rigid and narrow expectations and to provoke the very reactions they fear."⁷⁷

B. The Balance Sheet

1. Under What Circumstances would Rational Cost and Risk Sensitive Individuals Enter Into Trusting Business-Relationships? The elements discussed in the previous sections help calculate the benefit, cost, and risks of trusting: we can evaluate the benefits from trusting and deduct the costs of establishing the trusting relationship, the cost of monitoring. These could be compared with verifying and monitoring in non-trusting relationships. This calculation is made on an on-going basis. Thus, if the cost of establishing the relationship is \$a, the cost of monitoring is \$b, and the cost of verifying facts and promises \$c, and the number of times in which the relationship is repeated is d, the cost of trusting and non-trusting can be compared.

In transactions with no cost or low cost verification of facts and promises, trusting is likely to be more costly. For example, buying a newspaper involves very low verification costs. The identity, quality, and price of the newspaper are easily established and are not subject to

identity and location and therefore the trustworthiness of the transmitters are hard to verify.

⁷⁵ Earle & Cvitkovich at 56 ("... control and distrust generate tragic disappointment because the future, as the product of uncontrollable social processes, cannot ever match the past. And to devote oneself solely to the past is, in any event, simply to give up on life.").

⁷⁶ See Anthony T. Kronman, *Contract Law and the State of Nature*, 1 J.L.Econ.& Org. 5, 11-12, 23 (1985) (listing techniques used to reduce risks in a nonsimultaneous exchange where there is no coercive "common power;" the use of hostages, the use of collateral, the use of "hands-tying," and the method of union).

⁷⁷ John G. Holmes & John K. Rempel, *Close Relationships* 187, 190 (Clyde Hendrick, ed. 1989) *citing* Kelly & Stahelsk, 1970; Miller & Holmes, 1975). Govier at 38 (trust and mistrust perpetuate and feed on themselves).

bargain. Exchange of the paper for money is simultaneous. It is more costly to establish the trustworthiness of the seller than to verify the facts and promises of each party. No trusting should be established even in the case of repeat transactions. I can buy a newspaper from the same vendor every day for years without necessarily establishing trusting relationship with him.

However, if the nature and quality of the product or service are less clear, and if the exchange is not simultaneous, the costs of verification rise and trusting can reduce these costs. In a purchase of an expensive diamond, the net benefits of trusting, after deducting costs and risks, could be quite higher. In the case of repeat transactions among diamond dealers, trusting is a must.⁷⁸

Between the extremes are situations of "creeping trusting." For example, while in the first year of interaction Smith and Jones may spend \$100 on verifying their statements of facts and their promises, at the end of the fifth year they may spend \$20, while in a non-trusting relationship they would continue to spend \$100. The mechanisms for reducing the costs and risks of trusting especially when the benefits are high involve self help, market forces and the law. These are discussed below.

IV. THE UNITED STATES IMPERSONAL TRUSTING

A. The Puzzle of the United States

1. The Myths. The United States presents a complex puzzle. Historically, America seems to be a society of faithful, trusting souls.⁷⁹ In America people engage to an extraordinary degree with total strangers. Yet culturally, Americans demonstrate beliefs that would lead to anything but trusting: they cherish the image of the rugged, individualistic, self-sufficient⁸⁰ entrepreneur. They believe in independence and disdain dependence (which trusting produces). And many Americans seem to believe that self-interest reigns supreme. Such an image would point to non-trusting, or at least strong doubts about personal trusting, resulting in limited interaction with strangers.

2. Contra. These speculations, however, do not reflect reality. In real life, Americans, as any other people living in an advanced economy, depend on others and deal with them. Many Americans are most generous and charitable. They contribute to social causes in their own country and around the world. As individualistic as they are, most Americans are also community sensitive. The right to associate is written in their constitution and protected with passion. They participate in many groups, from nature lovers to investment clubs and PTAs. In sum, Americans seem to demonstrate nearly schizophrenic tendencies, combining trusting that

⁷⁸ See Lisa Bernstein *Opting Out of the Legal System: Extralegal Contractual Relationships in the Diamond Industry*, 21 J. Legal Stud. 115 (1992).

⁷⁹ See e.g., *id.* at 276 (arguing that "[t]he United States was . . . a relatively high-trust society throughout the period of its initial industrialization").

⁸⁰ I do not think there is any country in the world in which middle class and upper middle class people build, repair and paint their homes, and maintain their cars.

borders on faith and gullibility with cynical mistrusting.

B. The Explanation

1. Back to Benefit, Cost and Risk. The explanation of the American attitudes is related to the benefits, costs and risks of trusting. Americans have created a system which reduces the costs of trusting and maximizes its benefits. I believe that what makes America so successful is the method it has developed for resolving the conflict between necessary trusting on the one hand, and its culture and disadvantages of personal trusting on the other hand.

Americans have developed an extraordinary degree of trusting in their *institutions*. In fact, this trust embraces both business and political norms and institutions. Cynical as they are on the interpersonal level, Americans revere their constitution and trust their banks, mutual funds, and insurance companies. This trusting relationship is the foundation of American capitalism.

2. Trusting the Institutions. Benefits. Trusting the institutions enables Americans to trade with strangers, allocate their financial resources among producers, and "make the money work for everyone." Americans might not trust each other, but, at least in their impersonal trusting facilitates business relationships among total strangers through the intermediation and guardianship of trusted institutions. The American system fits the American culture: it allows people to establish trusting and dependent relationships largely with institutions, and frees them to the extent they choose from a need to trust and depend on individuals. This combination underlies the efficiency and strength of the American economy.⁸¹ In the United States, commercial relationships are based neither on faith nor on mistrusting but on impersonal trusting.

The system mediates between the beneficial efficiencies of trusting, reduces the costs and risks of trusting, and accommodates the cultural patterns of America. The relative costs of trusting described above relate to face-to-face and personal relationships. These involve: sunken costs (long-term repeat relationships that may also prove to be disappointing), lost opportunities (limiting the range of human interaction both in number and geographically) and monitoring.

As compared to personal relationships, trusting relationships with institutions and intermediaries are less costly to establish. In the United States, as well as many Western countries, impersonal trusting relationships reduce the costs of establishing personal trusting relationship among individuals, and the costs of direct legal enforcement.

The number of institutions is smaller; American institutions have relative longevity, and have built an impressive reputation.⁸² Most importantly, American financial institutions and

⁸¹ American impersonal trusting can be compared now with the Japanese personal trusting to highlight the weakness of the Japanese system. The focal point of this weakness is the financial institutions, which Japan is now remodeling. In an international economy, impersonal trusting has become crucial to national economic prosperity.

⁸² Govier at 153 (social trust is based on the experience of individuals and groups. People involved in associations are not likely to let others down. "for politics, economics, and personal well-being, social trust is a valuable resource."

intermediaries' trustworthiness is established and maintained by strict legal regulation; they are surrounded by substantial guarantees against hard fall. The institutions serve well, through competition. Thus, there are little sunken costs in establishing trusting relationships with financial institutions.

American financial institutions are subject to fiduciary duties of the common law. Banks and insurance companies are subject to such duties even towards depositors and policy holders with whom they have a creditor-debtor relationships.⁸³ Independent agencies monitor their activities and examiners visit their offices and their books and records. Mutual funds are subject to an extensive array of regulation. All institutions and intermediaries who deal with other peoples' money must safeguard the integrity of the funds they manage. Market competition and some monitoring exist induce good service and lower costs. All these are beyond the ability of individuals to ensure through self help. If the contract regime were the only available protection, I am willing to bet that Americans will put their money under the mattress or invest it in gold.

In addition, institutions expose Americans to far lower costs of lost opportunities.⁸⁴ The institutions allow Americans to interact with strangers and to benefit from services of capable strangers who function under the umbrella of the institutions.

c. Arguably, Groups and Institutions Have No Identity! They Are Composed of Individuals. This view is faulty. Groups and institutions are composed of members, managers, employees. Yet, institutions are distinguished from the individual members. Institutions have a personality composed of their internal structures and the rules, relationships among their staff and with the outside world, and their leadership. They have a history and a reputation for competence and honesty, which they can build and lose.⁸⁵ Truth-telling institutions, which honor their promises, will be distinguished and trusted, as will the persons who act on their behalf.⁸⁶

3. Intermediaries Cost-Reducing Mechanisms Creating Impersonal Trust. For

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⁸⁴ Govier at 24 (a sociologist "ties modern trust more to people's sense of how institutions operate than to their attitudes towards unknown individual"); 29 ("to live in a complex society without going mad, we must have trust in systems too.").

⁸⁵ Here are two examples. In the 1950s an aggressive and successful young underwriting firm , Otis & Co, reneged on its underwriting obligations on the ground that the issuer did not provide accurate information in its prospectus. The huge potential liability caused Otis to petition for bankruptcy protection. See Bankruptcy Referee Asks Court Dismiss Reorganization Plan, N.Y. Times December 9, 1992, at 53. The company was put up for sale even before the final decision. See Otis To Consider Officers For Its Retail Business, N.Y Times, July 28, 1951. Otis won the case, . Kaiser-Frazer Corp. v. Otis & Co., 195 F. 2d 838 (2d Cir. 1952). The management of Salomon Brothers turned its attention away from employees that violate the law but brought substantial profits. See John H. Gutfreund, Exchange Act Release No 31,554 (Dec. 3, 1992). Even though it settled the charges against it, it lost its independence five years thereafter to Travelers. See Thomas S. Mulligan, Travelers to Buy Salomon Bros. For \$9 Billion. L.A. Times, Sept. 25, 1997 at A1, A12 (noting that after 1991 scandal Salomon was "financially crippled" and sold to Warren Buffet; when company was sold again in 1997, a commentator noted that it "never really regained [its] position" after the scandal).

⁸⁶ Govier at 206. Citing Cecelia Bok A strategy for Peace (1989).

centuries, intermediaries have served to reduce the cost of trusting relationships among strangers. They earned their keep by creating close, trusting relationships between themselves and their customers and enforcing promises among strangers. For example, the Rothschilds have facilitated trusting relationships among unknown parties, inter-positioning themselves between them, and offering a competent family network backed by substantial capital. Likewise, banks have offered letters of credit to establish a trusting relationship among traders in different lands. Purchases by catalogs are made possible by the inter-positioning of banks and credit card banking associations. The securities markets would not have existed without the inter-positioning of brokers and dealers who ensure execution of transactions among strangers in volatile markets. While it is likely that one party will renege on the trade, the intermediary has an interest in executing the transaction because that is when the intermediary receives his compensation. Very few trades are litigated for breach. One of the reasons for the problems in Japan was loss of trust in Japanese intermediaries. These intermediaries compensated larger customers for market losses while the smaller traders did not. As a result, Japanese investors are now seeking United States brokerage firms and markets.⁸⁷

Trust intermediaries have re-appeared in the new environment of the Internet. Impersonal trusting has been "commodified" to some extent. Moody's rating agency is currently offering a service that provides information about the trustworthiness of individuals and firms abroad. This is to say that Moody's sells trusting. It ascertains that the unknown party abroad is trustworthy by performing a verification, the kind of fact-finding that people do to develop a trusting relationship. Moody's has developed a list of factors that demonstrate trustworthiness, and charges for the information about the unknown parties. It collects information about the unknown party's consistency in performing its promises, paying its debts, making true statements, and conducting long-term relationships.⁸⁸ In anonymous retail markets similar arrangements have appeared.

Most interesting is the development of group policing on trading web sites. On these sites: (i) risk of loss from one transaction is relatively low (e.g., \$15); (ii) the number of repeat players is fairly high; (iii) players value their reputation; (iv) the sponsor of the site guarantees a modest amount in the case of losses from fraud and monitors some of the players; (v) the cost of wide-spread information is extremely low. Under these conditions, traders report breaches of agreements, thus preventing repeat breaches of contracts. Moreover, such reporting supported by the site sponsor, creates a trusting relationship among strangers. In such situations the role of the law should diminish. Where the conditions differ, for example, where breach is hard to discover

⁸⁷. See Fidelity to Launch Internet Trading in Japan, Fin. Net News (Apr. 13, 1998) (noting that Japanese investors may want to trade with an American brokerage firm as recent Japanese brokerage firms' bankruptcies and economic problems have shaken confidence in Japanese brokers), *available in* LEXIS, News Library, Curnws File. See also Bernard S. Black, Information Asymmetry, The Internet, And Securities Offerings, 2 Journal of Small and Emerging Business Law (1998) (arguing that venture capital corporations serve to reduce the information costs of investors in public or semi public securities offerings, and that the Internet could act in the same way but undercutting the effectiveness of institutions).

⁸⁸. A service with a similar effect has been offered by banks since the 17th century in the form of letters of credit. The letters of credit, however, provide a guarantee to parties abroad, who do not know and therefore do not trust the domestic parties' promises. The bank undertakes unconditionally to pay upon presentation of the bills of lading providing evidence that the goods have arrived.

quickly and the amounts at risk are larger the system may not be sufficiently credible and the role of the law should increase, probably through regulated intermediaries.

3. Where Does the System of Impersonal Trusting Lead? Right now we wrap around tools of impersonal trusting the metaphor of personal trusting relationship. However, impersonal trusting may end up wrapped in the image of a commodity. Trusting may have a price; so many ounces of trusting will cost so many dollars; more trusting may cost more, but save more. The contrast between contract and fiduciary relationship parallels the contrast between trusting as a commodity and impersonal trusting. In fact, nothing is wrong with this picture except that it is incomplete. "The markets" do not do the whole job, and there is no evidence that they could do so in the future. The 1930s demonstrate that even state laws could not support trusting when financial markets became national.

I argue that preaching a reduced role of the law and self risk-reduction based on mistrust, poses enormous danger to our economy and our prosperity. To support this claim this Article discusses the risk to public trusting in financial institutions and the financial system, the inadequacy of contract law in support of such trusting, and the important role of far stronger intervening law (e.g., fiduciary law and statutory law) in shoring such trust.

VII. THE ROLE OF LAW IN SUPPORT OF TRUSTING

A. Legal Models and Norms. Legal models express and represent national culture and help establish cultural habits. As Francis Fuquyama stated: "The reconstitution of social order for the United States and other societies in a similar position, then, is not a matter of rebuilding hierarchal authority. It is a matter of reestablishing habits of honesty, reciprocity, and an enlarged radius of trust under changed technological circumstances."⁸⁹ While norms "often precede laws but are then supported, maintained, and extended by laws,"⁹⁰ in the case of the financial system the reverse may be true. Law may precede, and provide the basis for, norms.

1. Contract-Fiduciary Similarities and Differences. American law provides two legal models in business interaction: contract and fiduciary (common law and statutory law administrated by regulatory agencies).

Similarities. These models are similar in some respects. Both models require the parties to tell the truth and keep their promises. Both laws regulate consensual relationships among parties (except for trusts in which beneficiaries and trustees are bound by trust documents to which only the trustee has agreed. Therefore, arguably fiduciary and contract law are the same, and have no different effect. I strongly disagree.

First, even though the objective of both models is to reflect the parties intentions, however speculative the ascertainment of these intentions might be, fiduciary law is far more "manipulative." Fiduciary law provides incentives for people to enter relationships in which they

⁸⁹ Francis Fuquyama *The Great Disruption* 244 (1999); *id.* at 221 (formal law serves as a supplement for establishing cooperative norms).

⁹⁰ Robert Axelrod, *The Complexity of Cooperation. Agent-Based Models of Competition and Cooperation* 60 (1997) (describing metanorms).

are exposed to risks from the other parties. Contract law offers far weaker incentives. To be sure, the models are not mutually exclusive; fiduciary duties can often be trumped by contract.

Second, fiduciary law is more concerned than contract with macro economic effects of human interaction (or its absence), such as the preservation of commercial markets and the financial system as a whole, even though some parties may wish to reach different agreements. Thus, FDIC guarantees cover each bank deposit regardless of the parties' wishes. The markets did not provide close alternatives to bank deposits until the emergence of money market funds about twenty years ago, and that was due to regulation of the banks in times of inflation. FDIC insurance is based on the assumption that, as inefficient as it may be, preventing "runs" on banks is justified, and no one is willing to take the risk and find out whether that is not so. Thus, these are rules which the parties may not agree to contract out.

Third, contract is based on independence and individualism, self-protection and self-sufficiency. It is grounded in a staunch adherence to the principle that parties should have the utmost freedom in designing their relationship, and that government interference in business relationships should be kept to the minimum (or eliminated altogether).⁹¹ Emphasis on self-protection from others implies not only lack of trust in other parties but also lack of government support.

Fiduciary law encourages dependence and reliance on services by others. While recognizing the risks from trusting, the law interferes to reduce risk from trusting and cost of self-protection, encouraging trusting relationships.

Fourth, both contract and fiduciary law involve default rules, around which the parties can usually contract. Fiduciary law however, involves far more default rules. For example, suppose Mother creates a trust for Children, to be paid to them upon reaching the age of 25, and hands over \$100,000 to Trustee to manage the investment of the money according to the trust instrument. Although the instrument looks like a contract between the Mother and the Trustee. It is not. Rather, it is an agreement, subject to different default rules. They impose on Trustee numerous prohibitions against conflict of interest transactions, and requirements to act prudently and competently, and to segregate and earmark the money from Trustee's own assets. Further, the process under which the parties can opt out of these default rules can be demanding, requiring detailed disclosure by the fiduciary before the consent of the beneficiary is deemed binding. Even though most of Trustees' fiduciary duties under default rules can be waived by explicit agreement, the relieve the beneficiary of a heavy burden of substantial costs incurred to specify these rules in a trust instrument (or even to incorporate them by reference), if the relationship were contract. Moreover, in contrast to fiduciary law, courts will interpret contract terms narrowly, self-imposing limitations on creating the terms of the contracts for the parties.

Fifth, in contrast to contract law, fiduciary law is based on property, vesting in the trusting party property law remedies. For example, if Mother establishes a Trust for her children, or an Employee puts his savings in his Pension Fund, Children and Employee have property

⁹¹. See e.g., Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & Econ. 425, 427 (1993).

remedies, as beneficial owners of the entrusted money rather than contract remedies as creditors of the Trustees and money manager, or weaker remedies as third party beneficiaries. As creditors, Children cannot demand accounting from Trustee or limits on Trustee's use of the money until the payment date at their 25th birthday. Under property law they are entitled to accounting from Trustee and prevention of Trustee's conflict of interest transaction in trust property from the date of the Trust creation. Under contract law they would be entitled to damages. Under fiduciary-property law they will be entitled to accounting for profits earned by Trustee through unauthorized use of their property. Arguably contract is unlikely to sustain public trusting in Trusts.

One contractarian resorted to Sir Henry Maine's famous credo "from status to property to support a contract-based trust law. He suggested that modern trust law should follow Sir Henry Maine's "from status to contract," since the "two main uses of the declaration of trust are remote from the functions of the modern trust."⁹² Modern contract law, however, is also different from Sir Henry Maine's famous contract, and modern trust law is not his status idea either. Sir Henry Maine dealt with status--a person's station in life established by birth and circumstances over which he has no control, and contrasted that with contract, over which a person has presumably more control. Today's trust is far from status, as both trustee and usually beneficiary have contract over the entry and exit from the relationship.

More importantly, the main controversy in our context is not about status v. contract but about property v. contract. Should we reject Lord Mansfield's two hundred years' old innovation of splitting the property atom by creating beneficial ownership and legal title to property, and converting the beneficiaries' rights from contract--creditor's rights--to stronger property rights (beneficial rights)?⁹³

2. The Trend: Contract as the Universal Law of Business and Finance. The literature which I criticize views most, if not all, business (and perhaps other) relationships as contracts. This school of thought advocates changing the balance between contract on the one hand, and fiduciary, and regulation of the financial system on the other hand. The argument is for contract to be **the** foundation of commercial relationship. Some scholars in law seek to restrict or eliminate fiduciary law by classifying these relationships as contracts, including relationships between investors and their managers.⁹⁴ Partnerships, too, have been given the "contract treatment."⁹⁵

⁹² John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 *Yale L. J.* 625, 675 (1995) (following the arguments for the contractarian view of corporate law).

⁹³ The outmoded law of private trusts and wills can be emancipated from constrictive traditional forms without unjustifiably watering down the protective rights of the beneficiaries.

⁹⁴ Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 *J.L. & Econ.* 425 (1993). For a contrary view see Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 *Ore. L. Rev.* 1209 (1995).

⁹⁵ Revised Unif. Partnership Act (1994), *reprinted in* Alan R. Bromberg & Karry E. Ribstein, *Bromberg & Ribstein on Limited Liability Partnerships and The Revised Uniform Partnership Act 205* (1995). For a critical evaluation of the Act see Allan W. Vestal, *Fundamental Contractarian Error in the Revised Uniform Partnership Act of 1992*, 73 *B.U. L.Rev.* 523 (1993).

Following historic economic theories, the law of corporations has been described and treated as criss-crossing contracts by different actors. Fiduciary relationships have been relegated to the back seat or eliminated altogether.⁹⁶ The parties were the decision makers regarding fiduciary duties, and if they waive those duties, they know best and lose legal protection. Corporate statutes have been amended recently to allow waiver of breaches of the duty of care by management (directors and officers) under fiduciary law (such as incompetence and imprudence) but not the duty of loyalty (such as conflict of interests transactions). We already noted that law lags behind best practices of corporate management, which has tightened rather than relaxed directors and officers duties, and some courts followed by heightening the boards' legal responsibility.

Recent developments raise the greatest concern. Following the contract approach, legal scholars have advocated chipping away at the law regulating business trusts--institutions in which some of American's life savings and investments are kept and managed.

These scholars equate business trusts, such as mutual funds, pension funds, and money managing institutions that serve the financial system, with the laws regulating operating corporations.⁹⁷ The distance of trusting principles to contract is shortened as business trusts become a conglomeration of **contracts** among actors. In the process, these scholars have suggested a new, presumably **real** value of these trusts: insulating investors' assets in the trustees' hands from claims of the trustees' creditors!⁹⁸ The purpose of creating and maintaining trusting relationships between investors and managers got lost in the search for something else. The name trust has not yet been banished from the lexicon, but its meaning has been changed.

Another aspect of the literature is the focus on the organizational form. Business trusts are equated with operating corporations (rather than the other way around). However, laws regulating the fiduciary duties of money managers are not and should not depend on the organization form but on the function of these managers, on the cost of monitoring them and preventing their abuse of trust and injury to individual investors and the financial system. Investors in mutual funds organized as corporations and business trusts should be similarly protected.

⁹⁶ See e.g., Frank E. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 *Colum. L. Rev.* 1416 (1989). For a critical evaluation of this approach see Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 *B.C. L. Rev.* 595 (1997).

⁹⁷ See Hansmann & Mattei, *supra*, note---- (arguing that trust law orders relationships between parties to trust-like relationship and third parties; the latter relationships cannot be rearranged easily by contract); Langbein, *supra*, note---- at 660 (viewing trust default law as a type of standardized contract).

⁹⁸ The law focuses not only on the form of organization (corporations or trusts) but on their functions. There is a fundamental difference between operating corporations and entities in the trustee business (whether they are unincorporated, or organized as corporations, partnerships or trusts), although both are crucial to our system. Commercial trusts, however, are the backbone of our financial system, in the business of ensuring trusting. Therefore, the law supports their credibility and legitimacy to a greater extent than it does operating corporations. See *contra* Henry Hansmann & Ugo Mattei, *The Functions of Trust Law: A Comparative Legal and Economic Analysis*, 73 *N.Y.U. L. Rev.* 434, 466 (1998).

As a guide, it is helpful to compare private trusts with business trust. Business trusts enable investors to “exit” by selling or redeeming their shares, and entitle investors to elect (and remove) trustees. Therefore, business trusts (and corporations) engaged in managing other people’s money should not be subject to as strict a supervision as private trustees. However, as compared to private trusts, business trusts (and corporations performing similar functions) are far more important to the financial system in terms of the number of investors and amounts they manage and intermediate. Therefore business trusts should be subject to a far greater judicial and regulatory supervision than private trusts or manufacturing and other operating companies.

In sum, the degree of supervision and fiduciary duties depends not on the form of organization in which the fiduciaries serve, but on the benefits, costs and risks of public trusting in these fiduciaries and the danger to the financial system from abuse of public trust. Ignoring these considerations poses a threat to the health of our system and integrity of our savings.

3. Need For Law’s Support.

a. Financial Institutions Pose Trusting Risks to the Public. The financial system and its institutions: the banks, mutual funds, insurance companies, and pension funds facilitates the movement of money from savers and borrowers through a complex maze of intermediaries. The system cannot exist without them, and they cannot function without public trust.

Yet, handing money to these institutions is fraught with risk. Money is easily embezzled and converted to other uses or higher risks; it is difficult to trace. Investments require substantial information and expertise, which many savers lack. The exchange of promises between the parties is not simultaneous. Savers hand their money for safe keeping or investment while the recipients' promises are fulfilled only later on. Temptations for fiduciaries rise with the high amounts of deposits. Self-protection in the form of insurance or guarantees is costly and likely to undermine the very utility of the arrangement. Proof of trustworthiness is just as costly for the institutions. Therefore, in many countries where government protection is weak, savers do not trust the intermediaries.

The liquidity of the money and investments in which financial institutions deal poses dangers to the institutions as well, and especially to institutions that the savers must trust. Depositors expect immediate right of withdrawal of their deposits. The greater the expectations of immediate availability, the more reliable and trustworthy the institutions must be. As to all financial institutions, however, American history and experience in other countries have shown that doubt or even a hint of doubt in the integrity of financial institutions can trigger "runs" and massive withdrawals of cash. Such runs can cause the demise of a financial institution, and in the worse case, the whole market, in days, even with the support of the regulators and public money.⁹⁹ To reverse the trend can take much longer.

⁹⁹ See Tamar Frankel, *Securitization* §3.3 (discussing the benefits of liquidity and its effect on volatility); *id* at §3.3.4 (dealing with runs on the financial markets and on the banks); Tamar Frankel, *What Can Be Done With Market Volatility*, 69 B.U.L.Rev.891 (1989)(dealing "public manias," runs and "bubbles in the markets).

b. Trusting Financial Institutions Does Not Depend on Their Legal Form. As discussed above, public trusting does not depend on the legal form in which financial institutions are organized. It is the **services** that these institutions offer to individuals and to the economy that determines the need for shoring trusting and protections from risks. Thus, it is not important that banks are organized as corporations, or mutual funds are organized as business trusts or limited partnerships, and whether pension funds are organized as separate accounts of insurance companies. It is their business and not their legal form that should command the public's trust, if the financial system is to function or exist.

c. Trusting Financial Institutions Require Legal Support. I argue that the law of publicly held "commercial trusts," such as mutual funds, justifies a continuous investors' trust in the competence and honesty of their managers.¹⁰⁰

An area of fiduciary law is carved for operational management relationship and the strongest legal support is bestowed (or legal burden is imposed) on financial institutions. The institutions and their leaders bear the burden of strict duties and tight monitoring through examinations and enforcement.¹⁰¹ Few countries, if any, have established such a regime.

Notwithstanding the de-regulation that has been taking place in the United States, these institutions are the less affected. Recognizing their unique position and its monopolistic benefits, they tend as industries (regardless of the tendencies of some of their members) to "self-regulate," and "do it themselves."¹⁰² They work at establishing and maintaining a "commons of credibility and trustworthiness" by self-limitation and regulation. To reduce short-term temptations self-regulation is often strengthened by a strong nudge of possible legal intervention. They understand the danger of public mistrust.

d. Markets Are Not Adequate to Support Public Trusting in the Financial Institutions. Markets require a legal infrastructure without which they cannot exist.¹⁰³ To be sure, not all market rules are laws and not all enforcers are government officials. The private sector participates in both.¹⁰⁴

¹⁰⁰ The role of financial intermediaries has become increasingly important with the globalization of the financial system and movement of capital. Arguably, the role of domestic law, especially in regulating business transactions through the Internet, has declined, as no one government controls. However, domestic governments retain substantial control over, and provide substantial legitimacy and credibility to, such transactions. They do so through cooperation with governments elsewhere and through financial intermediaries under their jurisdiction. The number of these intermediaries is far smaller than the number of transacting parties. Financial intermediaries are at the "hub" of the global financial system. Even as they complain about government interference, these intermediaries seek the credibility and legitimacy that domestic laws provide.

¹⁰¹ See *e.g.*, The Investment Company Act of 1940, 15 U.S.C. §80a-1-65.

¹⁰² See *infra*.

¹⁰³ Tamar Frankel, Essay, The Legal Infrastructure of Markets (The Role of Contract and Property Law), 3 BU. L.Rev. 389 (1993). In the language of the economists, markets experience good and bad externalities for which law is the usual solution.

¹⁰⁴ In fact, as business enterprises become larger, the first line of responsibility for enforcing the law moves to the business organizations and their leadership. Size makes external enforcement too costly and forces government to be

Over the centuries market actors have built a "trusting commons." But their work was performed with the backing of the law. If law withdraws its support (critics would call it intervention) of the "trusting commons," individuals can erode its value. The reaction of market actors is quite telling.

When investors suffer losses, and the investment management industry is near extinction, the industry and each of its members seek government regulation. Paradoxically, when the industry is awash in profits, as it is today, the industry as a whole strives to maintain government regulation, while the members strive to free themselves from regulation. One would assume the reverse.

The explanation seems to be grounded in timing. The industry as a whole has long-term time horizons, while the members have short-term time horizons. When financial conditions are bad, both the industry and its members seek regulation to bolster their credibility and the public's trust in the industry and its members. In good times, however, the industry has an interest in preserving its trusting and credibility commons, while the members nibble at it to benefit themselves short-term. Yet, lower public trusting levels may help bring down the industry, as has happened time and again.¹⁰⁵

B. The Implications of Contract Law Instead of Fiduciary and Statutory Laws? The implications of such a change are not merely in name.¹⁰⁶ Arguably, commercial law encourages trusting. It adds to self-regulating tools, assuring truthful statements and performance of promises, in business relationships similar to third parties' guarantees.

Contract, tort, fiduciary law, and many statutes regulating particular financial and commercial activities prohibit misrepresentation of fact.¹⁰⁷ Contract and statutory laws impose a legal duty to perform one's contract promises. Thus, laws, including contract law, deem truthful statements of fact and fulfilled promises to be socially valuable.

Nonetheless, contract in law reflects a mistrusting relationship. The law of contracts

involved in the internal affairs of private sector business, which is not a desirable result under capitalistic philosophy. The last tier of responsibility, however, is with Congress, government agencies and the courts.

¹⁰⁵ Govier at 25. As one sociologist suggested people today trust institutions rather than individuals and the trust in the institutions is based on legal support. Thus, consumer protection laws are the building blocks of trust today.

¹⁰⁶. To be sure, fiduciary relationships can be accompanied by contracts, but they need not be. Most such relationships are *consensual*, not contractual, for example elections are consensual (by entering the shareholder status), trusts can be established in wills, and agency relationships can rise by a non-binding agreements. Consequently, not contract law but fiduciary law should apply.

¹⁰⁷. See e.g., John D. Calamari and Joseph M Perillo, *The Law of Contracts* §9.13, at 325-26 (4th ed. 1998) (stating general rule that deceived party may avoid transaction, claim restitution); Prosser and Keeton on the Law of Torts §105, at 728 (W. Page Keeton ed. 1984) (describing modern tort of deceit); 2A Austin Wakeman Scott & William Franklin Fratcher, *The Law of Trusts*, §173, at 462-64 (4th ed. 1987) (noting trustee's duty to beneficiaries to give complete and accurate information as to administration of trust).

prohibits telling lies and breaking promises. However, silence is rarely a lie (although silence may be lying). A party must ask for information. Further, "efficient breach of contract" is good on the assumption that one party benefits while the other is not hurt.

Further, the remedies for violating contract law are limited, as compared to remedies for violating fiduciary duties. Contract would eliminate fiduciary law remedies, such as accounting for profits, and erase preventive rules, such as the requirement for segregation of fiduciary's assets from those of the beneficiaries. In contrast to fiduciary law, remedies for abuse of trust contract law imposes little punishment on breach of obligations. United States contract law does not factor in on-going relationships. Hence it recognizes an "efficient breach of contract."¹⁰⁸

Moreover, contract law vests in judges relatively narrow discretion to fashion business relationships, and is moving towards an ever restricted interpretation of this discretion, hopefully to allow the parties to guide the courts on the rules that courts should dutifully apply.¹⁰⁹ The broad discretion fiduciary law vests in judges will shrink to the narrow judicial domain of contract law.¹¹⁰

Finally, and most importantly, duties are due mostly on the basis of the contract terms. The written contracts govern.¹¹¹ Each party must decide and be responsible to protect itself from each other. There is no expectation of trusting. The reverse is true. Others are expected not to be

¹⁰⁸ See A. Mitchell Polinsky, *An Introduction to Law and Economics* 31-34 (2d ed. 1989) (noting that expectation remedy in contract law induces efficient breaches).

¹⁰⁹ See Eric Posner, *Gratuitous Promises*, *Wisconsin L. Rev.* (suggesting that the enforceability of contracts should depend on the parties' decision on whether their agreements are enforceable); Richard Posner, *Economic Analysis of Law* (attacking the rule that gratuitous promises are unenforceable, suggesting that the enforceability of such promises should depend on the parties' intent. However, the other party may not rely on the promise, yet the promisor may put value to have the other person rely on its promise. Altruistic promises, the "status generating" promises, and the promises attempting to create trusting relationships should also be enforced according to the parties' intent. The right to sue should reflect the desire of people to make the promises they receive and make enforceable by the courts. See also Lisa Berstein, *Law, Economics, & Norms: Merchant Law in a Merchant Court; Rethinking the Code's Search For Immanent Business Norms*, 144 *U. Pa. L. Rev.* 1765 (1996) (suggesting that the more relaxed terms during parties' working relationships should not govern the judicial resolution of their conflicts. Presumably the rules underlying trusting relationships, which the parties have laid out for themselves, should be enforced by the parties or other non legal mechanisms, but not in the courts).

¹¹⁰ See John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 *Yale L.J.* 625 (1995); see also Tamar Frankel, *Fiduciary Duties in 2 The New Palgrave Dictionary of Economics and the Law* 127, 131 (Peter Newman ed. 1998) (noting that some scholars view fiduciary relationships as contracts).

¹¹¹ For example, when Smith provides Jones with raw materials, the written agreement between them should be enforced verbatim. Even if the parties or the industry have developed a pattern of behavior that deviates from the written language (sometimes drawn by lawyers and not the parties' focus) the writing should govern.

This approach requires the parties to prepare specific and detailed contracts. Yet, details are not necessarily clearer than general ones, and even the most detailed contract will not address all future situations, especially in long-term relationships. The rules bind the courts' hands, and let the chips fall where they do. Such rules foster suspicious and strategic behavior: creating a self protective fait-a-complis attitude, grabbing more than would otherwise be necessary, just in case the contracts do not address unanticipated situations.

trustworthy.¹¹²

The mistrust of some legal scholars covers the courts and rules of law. Therefore, they recommend that the parties' own rules rein supreme; the less courts interfere in the relationships the better. And if courts do interfere, they should follow the parties' rules. We may wish to rethink the guiding principle of minimizing legal interference in the parties' own rules, and its tremendous cost to the economic and financial systems.

Detailed contracts and extensive use of lawyers demonstrate personal non-trusting. Like non-trusting relationships, contract focuses on, and enforces, the terms of the transaction, regardless of the parties' intent, while fiduciary law focuses and regulates the behavior of the fiduciary--the trusted party--and its intent. Contract dispute resolution involves application of rules, regardless of the parties' identity, and in many cases regardless of the nature of the trusting relationship among the parties, while fiduciary law and other trusting relationships -- dispute resolution -- often focuses on mending the relationship.¹¹³

To be sure, detailed contracts clarify some future possible misunderstandings, but uncertainty remains; we can never anticipate all misunderstandings. Further, parties use the detailed contract as shields; therefore the contracts signal mutual mistrust. Similarly, efficient breach of contract theory may be efficient in one sense but tends to destroy trusting, and encourage a pattern of considering a breach presumably even if the other party does not agree to the termination of the contract.¹¹⁴

Trusting can reduce the cost of contracting. Often it is more efficient if the other party is the kind that tends to reach working solutions and shares a similar sense of fairness. Trusting parties know approximately what they can expect each will do in the case of misunderstanding and are willing to take the risk that the result will not be satisfactory. That risk taking is not only reasonable but is likely to be cost-saving.¹¹⁵

Presumably, once the parties enter a court room no future relationship can be contemplated. That is not necessarily so. Even if it were so, law that views contract as a "spot" relationship is fashioned differently than a law that views contract as an on-going relationship, in

¹¹². Scholars have raised questions regarding the strict non-paternalistic view of contract. For a list of this literature see Donald C. Langevoort, Behavioral Theories of Judgment and Decision Making in Legal Scholarship: A Literature Review, 51 Vanderbilt L. Rev. 1499, 1511-1512 (1988).

¹¹³. See e.g., Robert D. Cooter & Wolfgang Fikentscher, Indian Common Law: The Rule of Custom in American Indian Tribal Courts (pt. 1), Am. J. Comp. L. 287, 314 (1998) (hypothesizing that Indian tribal courts will "attend to relationships more than rules" in tribal societies where disputes indicate "a rupture in the tribal relationships").

¹¹⁴. Perhaps the other party wishes to enjoy at least some of the benefits of the alternative that leads to the breach. That also spells mistrust if the tacit understanding is that it is entitled (or not) to such sharing.

¹¹⁵. Often, the parties do not pay attention to their contracts and begin to develop their own trust-based terms. When conflicts arise among them, the question is whether the contract or the later behavior should govern. Legal scholars have criticized the courts that have chosen to be guided by the later behavior. It is not clear, however, that enforcing the trusting relationship terms gives greater support to such a relationship.

which trust may not only arise but must be legally encouraged. Encouraging on-going trusting relationships may turn out to be more efficient than encouraging efficient "spot transactions," even if they are viewed in isolation pareto optimal. In light of the efficiency of trusting, "efficient breach" can be highly inefficient.

Similarly, a contract regime is justified when the parties are willing to bear the cost of policing the trusting relationship. Self-policing is possible, and is exercised even in a trusting relationship, to reduce temptation. The "do it yourself" protection mechanisms have received interesting and fruitful treatment in the literature.¹¹⁶ However, these are augmented by a more intrusive law. Fiduciary law, prohibitions on undue influence, and prohibition of abuse of confidential relationships support greater trusting because they provide default rules that are common when parties trust each other. Fiduciary law may be deemed to impose a duty of honesty--performing promises and telling the truth even if no police are around.¹¹⁷

C. The Pervasive Contract Approach is Wrong and Harmful to the Parties and the Economy. In my opinion the pervasive contract approach is wrong, descriptively and normatively, both with respect to personal relationships and especially with regard to the relationships with institutions in the financial system.

Further, as a matter of policy, the contract approach fails to account for, or underestimates, the efficiencies of trusting in some types of commercial contract and especially in money management business relationships. While the literatures of other disciplines are abandoning the view of contract as an efficient business relationship, some legal scholars are still following obsolete theories. While other disciplines, including economics and business management, factor in trusting as a substantial cost-reducing mechanism, trusting is not only ignored but positively rejected in legal literature.¹¹⁸ While scholars in other disciplines seek rules of behavior that provide incentives for trusting, legal scholarship seems to seek watering down or eliminating trusting altogether. Self-help and self-protection is the motto. To the extent that trustworthiness is valuable, self-creation is advocated and the role of market forces is explored. The role of the law is minimized.

Scholarship advocating contract models for the relationship of investors and their financial institutions is pernicious because it threatens our financial system. It may induce investors and savers to put their money in gold and other unproductive goods, and hide it under the mattress. As improbable as it seems in the age of millions of American investors in the securities markets, this possibility should not be ignored. It happened before, not only in other countries, but in the United States. It can happen again.

¹¹⁶ See Anthony T. Kronman, Contract Law and the State of Nature, 1 J.L.Econ.& Org. 5, 11-12, 23 (1985) (listing techniques used to reduce risks in a nonsimultaneous exchange where there is no coercive "common power;" the use of hostages, the use of collateral, the use of "hands-tying," and the method of union).

¹¹⁷ See Tamar Frankel, Fiduciary Law, 71 Cal. L. Rev. 795 (1983).

¹¹⁸ For recent literature, see generally Economics, Values, and Organization (Avner Ben-Ner & Louis Putterman eds. 1998); Trust Within and Between Organizations Conceptual Issues and Empirical Applications (Christel Lane & Reinhard Bachmann eds. 1998); Janet Tai Landa, Trust, Ethnicity, and Identity, Beyond the New Institutional Economics of Ethnic Trading Networks, Contract Law, and Gift-Exchange (1994).

The contract approach, coupled with reduced legal protection and enhanced self protection and the "market haven," renders a higher risk. Markets are chaotic and unpredictable. The law provides meager solutions and rules. The contract regime is inefficient requiring repetitious protections (at huge cost). In conflicts, parties face an unknowable and unpredictable future.

The emphasis on risk coupled with reduced legal protection makes little sense, except for one somewhat unrelated reason that seems to underlie the contract approach and its development: the underlying agenda of individual freedom; the libertarian ideology. It is hard to find another explanation to satisfy the enormous costs of this approach. For those like myself, who are less committed to this ideology and more committed to a coherent and predictable law, and to the encouragement of trusting among the parties, an attempt to wrap all business relationships in this approach must be strongly rejected.

IX. CONCLUSION

The United States has nurtured a number of social and legal institutions to induce each other. One institution is created by the parties themselves through long-term relationships and experience, as well as through self-interest and unique contribution to each others' welfare. These relationships can exist among individuals and in groups of self-regulatory institutions where people combine to further their own interests, and in doing so regulate each other. The organizations can encompass large numbers of people, who do not necessarily know each other. Belonging to the organization creates the type of trusting that facilitates interaction among themselves and with others.

Americans have expanded institutions to introduce trusting among total strangers located far apart. One institution uses intermediaries to ensure the performance of promises and sometimes the resolution of conflicts among the trading partners. The beauty of this arrangement is that the intermediaries' interests to execute the transactions no matter who wins or loses strengthens impersonal trusting. Further, when one party is continuously stronger and more favored than another, statutes interfere to ensure fair treatment.¹¹⁹

In order for this mechanism to work, however, intermediaries must be strictly regulated as fiduciaries. In fact, they are not only fiduciaries of the parties, but also the guardians of the financial and commercial system. If the parties trust their intermediaries, they can trade and interact as if they fully trusted each other, even if they do not know each other at all and have no relationship among them.

American culture of individualism is not homogeneous. Not all corporate leaders adopt the contract attitudes; some refuse to base their relationships on contract; a hand shake is what

¹¹⁹ See e.g., Tamar Frankel *Securitization: The conflict Between Personal and Market Law (Contract and Property)*, 18 *Annual Review of Banking Law* 197 (1999) (demonstrating that statutes protect small borrowers against powerful lenders (the banks) and small investors-lenders against powerful borrowers-issuers).

they offer and accept.¹²⁰ In addition, the culture of many countries, including Japan and to some extent Germany and England, is based on personal trusting. In an expanding world economy, Americans not only have a chance of spreading their culture but also learning the best of the cultures of others. Moreover, future commerce may well be mostly electronic. In a recent report *Six Forces Shaping Future Business*, Price Waterhouse Coopers, one of the largest accounting firms in the world, stated its belief that in the future E-Business will be the only way in which business will be conducted. It states: “In the final stages, business of all kinds will converge electronically to combine their expertise and provide packaged services. They will push the edge of their current E-Business capabilities to transform their strategies, organizations, processes, and systems so that they can better meet the needs of their customers. The focus here is on building trust.” (Emphasis added).¹²¹ Finally, and most importantly, American common law should offer and recognize a model of a trusting relationship. Judges faithful to the exclusive “pure contract” model cannot interpret the common law adequately to provide a robust trusting model. Absent such an interpretation, trusting relationships will continue to flourish, but the utility, legitimacy, and influence of the law and the courts will diminish. Alternatives will be devised.¹²²

The time has come to bring back a balance. Contract law has its place, but it is not a dominant place. Courts and regulators, as meddling as they are, have a strong role to play. Trusting must be recognized as a major objective of law. Otherwise, we render our commercial and financial systems costly and inefficient.

How does one resuscitate a failing trust culture? One way is by strengthening the legal trust model. Another way is through leadership that looks to the future and offers a vision of society. Right now the leadership offers a vision of a society beset by suspicion and hidden treachery.

Recent legal literature suggesting that relationships with trusted financial institutions be regulated as contracts or corporations, if taken seriously, is hazardous to the health of our commercial and financial system. These suggestions should be viewed as intellectual gaming: perhaps interesting, somewhat challenging, and, if they aim at being taken seriously--highly irresponsible.

¹²⁰. See *infra*.

¹²¹ Six Forces [Shape the Future of Business]
[Http://www.pwcglobal.com/sixforces/PWC_Force2/content_main2.html](http://www.pwcglobal.com/sixforces/PWC_Force2/content_main2.html) (on file with the author).

¹²² Perhaps we need not maintain the leading role of our legal system and its courts in commerce and finance. But if we believe that they should continue to lead, they ought to strengthen the legal mode of trusting. Otherwise other institutions will take their place.