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REPUTATION THROUGH LITIGATION: HOW THE LEGAL SYSTEM SHAPES BEHAVIOR BY PRODUCING INFORMATION

Roy Shapira[*]

Abstract: The law affects our behavior not only directly by imposing legal sanctions, but also indirectly, by providing information that shapes the reputations of individuals and organizations. This Article is the first to fully flesh out the reputation-shaping aspects of the law.

The Article's first major contribution is in explaining how reputation works. Legal scholars are increasingly recognizing that reputation matters: reputational concerns are touted as an important factor that shapes our behavior across a wide range of phenomena, from product safety to corporate governance to international relations. Yet so far the literature has stayed remarkably silent on how exactly reputation matters. This Article draws from a fast-growing multidisciplinary body of reputation research to examine why similar behaviors lead to different reputational outcomes. A key takeaway is that reputational sanctions are much noisier than was previously acknowledged: the market systematically under-reacts to certain types of misbehaviors and over-reacts to others.

The Article's second major contribution comes from mapping out the different ways in which the law affects reputational sanctions. Specifically, the Article focuses on the previously overlooked "second-opinion role" of the law. When bad news breaks about an adverse action by a company, market players react immediately by downgrading their beliefs about the company and their willingness to interact with it. But the same bad news may also get the legal system involved. Then, in the process of finding out whether to impose legal sanctions, the legal system produces as a byproduct information on the behavior of the parties to the dispute: what top managers knew and when they knew it, whether the adverse action was an isolated mistake or whether it is indicative of the company's operational culture, and so forth. This information reaches third parties, and makes them reassess their beliefs about the company. Contrary to the common assumption among legal scholars, law

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and reputation are not independent of each other, but rather complement each other. A well-functioning legal system reduces noise and increases the accuracy of reputational sanctions.

Acknowledging the informational role of the law generates important policy implications. First, the Article calls for a more cautious approach to scaling back legal intervention. If the law indeed complements non-legal sanctions, then any proposal to scale back legal intervention should also take into account the expected negative impact on non-legal deterrence. Second, the Article reassesses practical and timely debates such as the desirability of heightened pleading standards. If litigation indeed generates quality information on the behavior of market participants (a positive externality), then we should reevaluate key legal institutions according to how they contribute to information production.

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INTRODUCTION

"Reputation matters" is becoming the new mantra in the legal literature. Legal scholars increasingly refer to reputational concerns as important forces that shape our behavior across a wide range of phenomena: from product safety to corporate governance and the recent financial crisis to state compliance with international obligations.[1] Mounting empirical evidence shows just how real reputational sanctions can be: news about corporate misbehavior often brings with it declines in stock prices, in consumer willingness to pay, and in employee motivation.[2] Yet so far the literature has stayed remarkably silent on *how* reputation matters, or how reputation interacts with the law.[3]

This Article narrows the gap in our understanding of reputation by exploring the basic question of why similar behaviors lead to different reputational outcomes. The conventional approach assumes that whenever misconduct is revealed, the misbehaving

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1. *See, e.g.*, Mitchell Polinsky & Steven Shavell, *The Uneasy Case for Product Liability*, 123 HARV. L. REV. 1437 (2010) (reputation and product safety); ANDREW T. GUZMAN, HOW INTERNATIONAL LAW WORKS: A RATIONAL CHOICE THEORY (2008) (reputation and international relations); JONATHAN R. MACEY, THE DEATH OF CORPORATE REPUTATION (2013) (reputation and the financial sector).

2. *See* Jonathan M. Karpoff, *Does Reputation Work to Discipline Corporate Misconduct?*, *in* THE OXFORD HANDBOOK OF CORPORATE REPUTATION 361, 362, 364 (Timothy G. Pollock & Michael L. Barnett eds., 2012).

3. *See* Thomas Noe, *A Survey of the Economic Theory of Reputation: Its Logic and Limits*, *in* THE OXFORD HANDBOOK OF CORPORATE REPUTATION 114 (Timothy G. Pollock & Michael L. Barnett eds., 2012).

company/businessman will suffer reputational damages. But everyday experience and systematic empirical evidence demonstrate that not all bad news is created equal.[4] Some companies and businessmen emerge from failures unscathed while others go bankrupt. What explains the variation? Why does the market react negatively to some bad news but not to others?

A large part of the answer, this Article argues, is dictated by the legal system. When news breaks about some adverse action by a company, the company's stakeholders update their beliefs about the company and assess whether they want to continue doing business with it. But the process of belief-updating—the process of reputational sanctioning—does not operate in a vacuum. The same bad news that ignites an initial market reaction may also get the legal system involved—through litigation or regulatory investigations. Then, in the process of determining whether to impose legal sanctions, the legal system produces as a byproduct information on the behavior of the parties to the dispute: what top managers knew about the problem, when they knew it, whether they could have stopped it, and so forth. This information is available to outside observers and affects the way that these third parties treat the parties to the dispute. In other words, the legal system provides better information to the public on which to base reputational judgments. Contrary to the common assumption,[5] law and reputation are not independent of each other, but rather complement each other. The legal system's reaction to misbehavior affects the market reaction.

Recognizing the reputation-shaping role of the law carries important policy implications. Most basically, this Article calls for a more cautious approach to advocating for nonintervention. According to the conventional approach, when we recognize an area with strong reputational forces, we can scale back on legal intervention.[6] For

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4. *See infra* Part I.

5. For an overview of the conventional approach, see Peter-Jan Engelen, *Legal Versus Reputational Penalties in Deterring Corporate Misconduct*, *in* DOES ECONOMIC GOVERNANCE MATTER? GOVERNANCE INSTITUTIONS AND OUTCOMES 71–95 (Mehmet Ugur & David Sunderland eds., 2011). For notable exceptions, see Eric Talley, *Disclosure Norms*, 149 U. PA. L. REV. 1955, 1982–83 (2001) (strong market norms facilitate better legal control); Scott Baker & Albert H. Choi, *Embedding Costly Litigation into Repeat Interactions* 18 (Va. L. & Econ. Research Paper No. 2013-02, 2013), http://ssrn.com/abstract=2195749 [https://perma.cc/7D6V-68SH] (firms can choose to subject themselves to formal sanctions, thus facilitating better informal sanctions); Edward M. Iacobucci, *On the Interaction Between Legal and Reputational Sanctions*, 43 J. LEGAL STUD. 189 (2014) (legal sanctions affect reputational sanctions).

6. *See* Engelen, *supra* note 5, at 71–72, 85; David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104 HARV. L. REV. 373, 390 n.57 (1990); Yoshinobu Zasu, *Sanctions by Social Norms and the Law: Substitutes or Complements?*, 36 J. LEGAL STUD. 379, 381–82 (2007).

example, Polinsky and Shavell propose abolishing product liability for widely sold products.[7] Their logic is that if non-legal forces are strong enough to carry most of the burden of deterrence, then it is not cost-effective to keep a costly adjudication system simply for the sake of an incremental contribution to deterrence.[8] At the heart of such an argument lies an implicit assumption that the legal system and the non-legal system are independent of each other. Polinsky and Shavell assume that we can remove the law—remove the background threat of litigation—and the market forces will continue to function just the same. But in reality the strength of market forces is a function of the existing legal system. If we remove the background threat of litigation, perhaps the costs of reputational sanctions will rise.

A few words on methodology and scope are in order from the outset. Scholars have largely neglected the question of how reputation matters not because they find reputational incentives to be unimportant, but rather because scholars find them to be messy.[9] Reputational forces follow fuzzy dynamics and are hard to capture in neat models. My strategy in fleshing out the important yet understudied reputational forces is therefore to *triangulate*.[10] That is, I examine reputation from multiple theoretical and empirical angles: synthesizing insights from various literatures (information economics, social psychology, and communication science); examining the fit of my theory with existing statistical data and case studies to delineate the theory's strengths and limitations; and gathering insights from interviewing key practitioners who work on the intersection between the court of law and the court of public opinion (crisis management consultants, litigators, and business journalists).[11] For considerations of brevity and scope I do not cover here all the vast topic of interactions between legal and non-legal systems. I focus here mostly on reputational sanctions rather than moral

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7. Polinsky & Shavell, *supra* note 1, at 1438. I am extrapolating freely from Polinsky and Shavell's paper for the sake of the argument. I do not treat all of their arguments against product liability, but rather focus only on their points about deterrence.

8. *Id.*

9. *Cf.* Arvind Parkhe, *"Messy" Research, Methodological Predispositions, and Theory Development in International Joint Ventures*, 18 ACAD. MGMT. REV. 227, 247 (1993) (noting that important yet fuzzy factors are being left out of analysis).

10. The idea behind triangulation is that combining multiple theoretical and empirical materials can minimize the biases of any single theory/method. Triangulation is especially fitting when dealing with messy factors with little existing hard data, as in this case. It bolsters the prima facie plausibility of the theory-building stage. *See* Paulette M. Rothbauer, *Triangulation*, *in* THE SAGE ENCYCLOPEDIA OF QUALITATIVE RESEARCH METHODS 893 (Lisa M. Given ed., 2008).

11. *See infra* Appendix: List of Interviews, detailing the methodology and listing the most consequential interviews.

sanctions;[12] and on corporate reputation rather than individual reputation.[13]

The Article proceeds in five parts. Part I explains how reputational sanctions work and why they are inherently noisy. Consider the different components involved in the process of reputational sanctioning. First, those who dispense reputational sanctions (the company stakeholders) do not have enough information to judge correctly what happened and how it happened. Even when stakeholders do have information, they often process it imperfectly due to well-documented behavioral biases such as focusing too much on available and salient issues. Second, the intermediaries who disseminate information on corporate behavior, such as mass media or corporate watchdogs, have incentives to cater to their audiences' biases. They tend to exaggerate certain criticisms and downplay others, as a function of what sells newspapers or attracts donors and volunteers.[14] Finally, those who are sanctioned—the companies themselves—invest heavily in distorting the information environment with tactics such as smokescreens and scapegoating. As a result of all these inherent flaws, the market tends to over-react to certain misbehaviors and under-react to others. Indeed, there exist plenty examples of stakeholders that stop doing business with perfectly fine companies or continuing doing business with rotten companies. The market, when left alone, has trouble calibrating reputational sanctions correctly.

But in reality the market is rarely left alone. This is where Part II comes in, fleshing out the different ways in which the law affects reputational sanctions. The Part focuses especially on the previously

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12. To clarify the terminology: adverse actions may trigger various non-legal sanctions. When the violator suffers from diminished business opportunities in the future, the sanction is reputational. When the violator suffers shaming—the opprobrium of others—the sanction is an external moral sanction. When the violator suffers from her own guilty feelings, the sanction is an internal moral sanction. For more on the typology of non-legal systems of control, see Robert C. Clark, Laws, Markets, and Morals (Jan. 2010) (unpublished manuscript).

13. The reason for such a focus is pragmatic: I believe that in the context of big businesses the supply and demand of credible reputation information is the most burning issue, due to severe asymmetric information problems. The focus on *corporate* behavior also distinguishes my work from some of the previous analyses of law and social norms. I do not focus on close-knit communities with repeated interactions, but rather on contexts where reputation information travels via intermediaries, relying on technology to reach larger, loose-knit communities. *Cf.* Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115, 116 (1992). Accordingly, I do not deal with the traditional problems of reputation information, such as local distribution and impermanence, but rather with understudied problems, such as how to make sense of an abundance of ambiguous information, or which intermediary to trust. *See infra* Part V.

14. *See infra* Part I.

overlooked "second-opinion effects." When company stakeholders read bad news about the company, they face a decision: whether to continue interacting with the company or not. Litigation and regulatory investigations generate another third-party assessment on the behavior of primary wrongdoers, which stakeholders can then use to rethink their initial decision. The legal system's second opinion can be valuable because it produces new facts and more nuanced interpretations of the misbehavior in question. Take the classic example of internal e-mail communications exposed during the discovery stage, showing what and when top managers knew about the misconduct. Litigation and investigations can also shape stakeholders' beliefs without producing new information, simply by increasing the saliency and reducing the uncertainty about existing information. For instance, legal disputes with large, visible companies often generate ready-made quotes and documents that increase the scope and change the tone of media coverage.

Although overall the existence of a well-functioning legal system facilitates better reputation systems, there exist specific contexts where the law generates zero or even negative impact on reputational evaluations. Part III, therefore, proceeds to provide a blueprint to apply the general second-opinion theory to specific legal fields, and delineates the conditions that determine whether legal disputes increase or decrease the reputational sanction attached to misbehavior. This Part emphasizes the forces that distort the information flow from the courtroom to the court of public opinion. It analyzes why judicial scorning can actually *help* the defendant company's reputation, when companies manage to hijack the information flow by producing smokescreens, and how information intermediaries selectively pick what pieces of information to highlight and what to ignore.

Part IV sketches policy implications. We have already mentioned one basic implication, namely, that strong non-legal forces do not necessarily eliminate the need for legal intervention. More specifically, to the extent that litigation produces an informational public good (that is, accurate information on the behavior of prominent companies) court practices should be tailored to assure the flow of credible information. Part IV therefore reevaluates key legal institutions based on their contribution to information production. In the process the Article refocuses timely and practical debates, such as the desirability of the heightened pleading standards recently adopted in *Twombly*[15] and *Iqbal*.[16]

15. Bell Atl. Corp. v. Twombly, 550 U.S. 544 (2007).

Part V synthesizes the Article's original contributions by juxtaposing them with the extant related literature. For example, this Part revisits and amends existing applications of reputation theory to international law and product liability. I then conclude with a few caveats and directions for further extending the Article's arguments.

I. REPUTATIONAL SANCTIONS: HOW THEY WORK; WHY THEY ARE NOISY

To understand how the law affects reputation, we first need to understand how reputation works. The legal literature has said surprisingly little about the process by which bad deeds translate into reputational sanctions. The conventional approach treats reputational sanctioning as a straightforward, binary process: as long as market players learn about misbehavior, they will punish the misbehaving entities by withholding future business opportunities.[17] Under this simplistic approach, legal scholars *assume* that reputational concerns shape behavior in a certain scenario, without fully explaining why this is so or examining the social costs of reputational sanctions. This Part shifts our approach from making assumptions on whether reputation matters to explaining *how* exactly reputation matters. By drawing on recent theoretical and empirical insights from the multidisciplinary reputation literature,[18] I show that in reality reputational sanctioning is *an inherently noisy process*, with the potential to exact heavy social costs. Even when market players learn about certain misbehavior, they often lack the incentives and/or information to properly update their beliefs about the misbehaving company. As a result, the market systematically under-reacts to certain types of misconduct and over-reacts to others.

A. How Reputational Sanctions Work

A company's reputation can be defined as the set of beliefs that stakeholders hold regarding the company's quality.[19] Without the ability

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16. Ashcroft v. Iqbal, 556 U.S. 662 (2009).

17. *See* Talley, *supra* note 5, at 1960 n.15 (collecting references for the common approach).

18. For an overview of the recent surge in reputation scholarship, see Charles J. Fombrun, *The Building Blocks of Corporate Reputation: Definitions, Antecedents, Consequences*, *in* THE OXFORD HANDBOOK OF CORPORATE REPUTATION 94–96 (Timothy G. Pollock & Michael L. Barnett eds., 2012).

19. *See* Cynthia E. Devers et al., *A General Theory of Organizational Stigma*, 20 ORG. SCI. 154, 156 (2009).

to directly observe the company's abilities and intentions, stakeholders rely on the company's past observable actions as cues to evaluate how the company is likely to behave in the future.[20] In that sense, a reputational sanction is the product of stakeholders updating beliefs and lowering expectations. Upon hearing bad news about the company, stakeholders infer that the company's "type" is worse than they have realized. The company is now perceived as more likely to defect in the future, and so stakeholders reduce their willingness to interact with the company going forward. Investors hearing about a corporate governance scandal will start demanding higher returns for their investment, customers hearing about a product recall will purchase fewer products, and so forth. The aggregate of diminished business opportunities constitutes the reputational sanction for violating market norms.

So far, the story seems straightforward: if a company misbehaves, it risks losing future business opportunities. But a much more interesting question remains understudied: how exactly do stakeholders update their beliefs? How many business opportunities will the company lose for a given misconduct? After all, we know from everyday experience that *not all bad news is created equal*. Similar adverse actions cause different reputational outcomes. One financial company weathers fraud allegations relatively unscathed while another goes bankrupt. One top executive takes the fall when her company misbehaves while another is unaffected. So what explains the variation in market reaction?

The fast-emerging reputation literature has recognized several determinants of reputational sanctions.[21] For our purposes, it suffices to focus on the general criterion: *indicativeness of future behavior*.[22] Reputation sanctioning rests on the "how is it relevant to me" question. That is, stakeholders finding out about a corporate misconduct try to infer how this specific event is indicative of their own future interactions with the company. Some pieces of bad news are deemed more relevant

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20. A company's reputation can be thought of as the cash value of the trust that different stakeholders put in the company. *See* Karpoff, *supra* note 2, at 363. I refrain from using the notion of trust here, in order to avoid the common confusion between Bayesian belief-updating models and repeated-interaction models of reputation. *See* Luís M. B. Cabral, The Economics of Trust and Reputation: A Primer 3 (June 2005) (unpublished manuscript) http://pages.stern.nyu.edu/~lcabral/reputation/Reputation_June05.pdf [https://perma.cc/N32V-HGWY].

21. *See, e.g.*, Yuri Mishina et al., *The Path Dependence of Organizational Reputation: How Social Judgment Influences Assessments of Capability and Character*, 33 STRATEGIC MGMT. J. 459, 461 (2012).

22. *See* Noe, *supra* note 3, at 117.

than others.[23] For example, when stakeholders believe that the bad outcome resulted from an isolated temporary mistake (such as a rogue low-level employee who was subsequently fired), the reputational sanction will be relatively low. By contrast, when stakeholders believe that the bad outcome resulted from a deep-seated organizational flaw (such as a total breakdown of checks and balances throughout the company hierarchy), the reputational sanction will be relatively high. After all, no one wants to work for, buy from, or invest in companies with deep-rooted problems that will likely resurface.

This intuitive point is worth emphasizing, as it has largely escaped the legal literature. The revelation of bad news about a company does *not* automatically translate into reputational sanctions. Public revelation of misconduct is a necessary but not a sufficient condition. For one, certain types of bad news carry zero reputational repercussions. Indeed, Karpoff and co-authors showed that when companies get caught polluting the environment or bribing officials in developing countries (misbehavior against unspecified third parties), there is little to no reputational harm.[24] More importantly, even for misbehaviors that do carry reputational repercussions (misbehavior against trade partners, as in breaching contracts), the magnitude of the sanction varies greatly as a function of the public perception of what caused the debacle. Generally speaking, when stakeholders read bad news, they try to infer the degree of intentionality and controllability involved in the misconduct.[25] The more stakeholders perceive the reported misbehavior as intentional and controllable, the more they will update downward their evaluation of the company—a bigger reputational sanction.

To illustrate, consider an empirical study of stock market reactions to airplane crashes.[26] The study finds that not all news of crashes is created equal. Crashes have a negative effect on stock prices only when the air carrier is reported to be at fault.[27] When the *Wall Street Journal* attributes the crash to internal causes, such as maintenance problems, the

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23. After all, reputational sanctions rest on self-interest, unlike other types of non-legal sanctions. Those who engage in social shaming or guilty feelings make a conscious decision to incur costs for the sake of sanctioning.

24. *See* Karpoff, *supra* note 2, at 372.

25. *See* Rebecca Reuber & Eileen Fischer, *Organizations Behaving Badly: When Are Discreditable Actions Likely to Damage Organizational Reputation?*, 93 J. BUS. ETHICS 39, 42–43 (2010); Batia M. Wiesenfeld et al., *The Stigmatization and Devaluation of Elites Associated with Corporate Failures: A Process Model*, 33 ACAD. MGMT. REV. 231, 235 (2008).

26. *See* Mark L. Mitchell & Michael T. Maloney, *Crisis in the Cockpit? The Role of Market Forces in Promoting Air Travel Safety*, 32 J.L. & ECON. 329 (1989).

27. *Id.* at 354.

stock prices decline dramatically.[28] By contrast, when the *Journal* reports that the crash was caused by external conditions, such as unanticipated weather conditions or a mistake by the ground crew at the airport, the market does not react negatively.[29]

The upshot is that the process of translating bad news into reputational assessments requires *not just facts about what happened but also interpretations and judgments of how things happened*.[30] And the next crucial step is to acknowledge that the facts are often open to multiple interpretations and market players often get the interpretation wrong. Unlike in the airplane crashes scenario, where it is relatively easy to attribute the right cause to the problem, in other contexts stakeholders often interpret an isolated mistake as a deep-seated flaw and vice versa. There is often a gap between outsiders' perceptions and the reality of how things happened. To better understand reputational sanctions, we therefore need to delve into the sources that bridge gaps between perception and reality.

B. Why Reputational Sanctions Are Noisy[31]

Legal scholars tend to assume that reputational sanctioning is a frictionless, uncomplicated process in which individuals somehow get access to information about corporate misconduct, rationally process this information, and reevaluate companies' abilities and characters. The aggregate of atomistic individual re-evaluations supposedly forms the reputational sanction.[32] In reality, these assumptions rarely hold. For

28. *Id.* at 353–54.

29. *Id.*

30. *See* Daniel B. Klein, *Knowledge, Reputation, and Trust, by Voluntary Means*, *in* REPUTATION: STUDIES IN THE VOLUNTARY ELICITATION OF GOOD CONDUCT 1, 4 (Daniel B. Klein ed., 1997).

31. "Noise" is a well-developed concept in information economics. *See, e.g.*, URS BIRCHLER & MONICA BÜTLER, INFORMATION ECONOMICS 20–22 (2007). It has also been applied to reputation in various contexts. *See, e.g.*, Sarah C. Rice, *Reputation and Uncertainty in Online Markets: An Experimental Study*, 23 INFO. SYS. RES. 436, 442 (2012). For our purposes, saying that reputational sanctions are noisy basically means that they are inaccurate. A company can lose many business opportunities for a minor misbehavior, while losing very few business opportunities for a bigger misbehavior.

32. For references to and critique of the conventional approach see Christopher McKenna & Rowena Olegario, *Corporate Reputation and Regulation in Historical Perspective*, *in* THE OXFORD HANDBOOK OF CORPORATE REPUTATION 260, 272 (Timothy G. Pollock & Michael L. Barnett eds., 2012); Juan Jose Ganuza et al., Product Liability Versus Reputation (Feb. 3, 2013) (unpublished manuscript), http://www.webmeets.com/files/papers/earie/2013/371/EARIE%202013%20FGP%20JJG.pdf [https://perma.cc/WZ7B-EHC7]. For notable exceptions see David Charny, *Illusions of a Spontaneous Order: "Norms" in Contractual Relationships*, 144 U. PA. L. REV. 1841, 1857

one, information does not simply fall in our path. Individuals get information from intermediaries who selectively screen what information to convey and add their own (distorted) take. The process of reputational sanctioning is systematically distorted due to issues with *asymmetric information, judgment biases, and divergent incentives*. This section elaborates by breaking the process of reputational sanctioning into its different components.

1. Players Who Dispense Sanctions (Stakeholders)

Unlike legal sanctions, reputational sanctions are not dispensed by public officials, but rather by the company stakeholders themselves. The stakeholders who reduce their interactions with misbehaving companies have the right incentives: they stand to gain from accurately judging how things happened and from staying away from bad companies. However, stakeholders often lack the right information. It is especially hard for outsiders to know the inner workings of the company. And so even when outsiders know with some certainty *what* happened—that a company granted a big bonus for a failed CEO, or that a certain amount of people were harmed by an auto tire defect—they find it hard to understand *how* things happened. In other words, stakeholders are not well informed about questions such as what top managers knew, when they knew it, and could they have stopped it.[33]

Furthermore, even when stakeholders have information, they process it imperfectly.[34] Judgment biases sway our reputational assessments.[35] For example, we tend to overly focus on issues that can be easily summoned into our memory (availability bias), and attribute bad outcomes to internal rather than external causes (fundamental attribution error).[36]

(1996); V.S. Khanna, *Corporate Criminal Liability: What Purpose Does it Serve?*, 109 HARV. L. REV. 1477, 1505 (1996); Kyle D. Logue, *Coordinating Sanctions in Tort*, 31 CARDOZO L. REV. 2313, 2356–57 (2010) (informal sanctions may suffer from high information costs); David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811, 1825 (2001).

33. Stakeholders are thus asymmetrically informed about "second-level information": we observe the bad outcomes but are unaware of the circumstances that led to them. *See* MICHAEL REGESTER & JUDY LARKIN, RISK ISSUES AND CRISIS MANAGEMENT 187 (2005); OLIVER E. WILLIAMSON, ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING 396 (1985).

34. *See* DANIEL J. SOLOVE, THE FUTURE OF REPUTATION 70 (2007).

35. *See* Mishina et al., *supra* note 21, at 459.

36. *See, e.g.*, Donald Lange et al., *Organizational Reputation: A Review*, 37 J. MGMT. 153, 173 (2011); Andrea M. Sjovall & Andrew C. Talk, *From Actions to Impressions: Cognitive Attribution Theory and the Formation of Corporate Reputation*, 7 CORP. REPUTATION REV. 269, 274–75

2. *Players Who Facilitate Sanctions (Information Intermediaries)*

Another basic and overlooked problem with reputational sanctions stems from the narrow incentives of those who provide information and interpretations on corporate misbehavior.[37] We form impressions of companies based not just on direct experience, but also on what we gather from mass media, as well as other intermediaries such as stock analysts, institutional investors, and corporate watchdogs.[38] Reputational sanctions in mass markets are therefore largely determined by how intermediaries interpret and diffuse information. These intermediaries often possess more information and expertise than the average stakeholder. However, intermediaries have their own narrow incentives to push the market toward overreacting to some behaviors and underreacting to others.[39] As a corporate watchdog, it pays to publish exaggerated criticisms against the McDonald's-es of the world. After all, eliciting a strong market reaction against visible companies will help you win the competition for donors' money and volunteers' time. And as a profit-minded newspaper owner, it pays to avoid investing in the risky venture of investigating opaque corporate shenanigans, focusing instead on rebroadcasting publicly available information.[40]

(2004). *See generally* RICHARD H. THALER, MISBEHAVING: THE MAKING OF BEHAVIORAL ECONOMICS 22–23 (2015).

37. The broader point here is that there is no systematic relationship between the private and social benefits of reputational sanctions. *See* Steven Shavell, *The Fundamental Divergence Between the Private and the Social Motive to Use the Legal System*, 26 J. LEGAL STUD. 575 (1997) (same regarding legal system). Accurate reputational sanctions carry social benefits: warning market players of a specific wrongdoer, deterring future potential wrongdoers, and causing market players to switch to doing business with the worthier competitors of the wrongdoer. *See* Robert Cooter & Ariel Porat, *Should Courts Deduct Non-Legal Sanctions from Damages?*, 30 J. LEGAL STUD. 401, 405–06 (2001). Reputational sanctions also come with social costs, such as resources spent on certifying rumors or fighting back false allegations. Those who engage in reputational sanctioning—rumor propagators, media channels, stakeholders—do not fully internalize the social costs and benefits. And so even when market players enjoy access to information and process it correctly, they may still engage in too little or too much reputational sanctioning.

38. *See* PETER FIRESTEIN, CRISIS OF CHARACTER: BUILDING CORPORATE REPUTATION IN THE AGE OF SKEPTICISM 241 (2009); Stefano DellaVigna & Matthew Gentzkow, *Persuasion: Empirical Evidence*, ANN. REV. ECON. 643, 644 (2010).

39. *See* DellaVigna & Gentzkow, *supra* note 38, at 659–60; Alexander Dyck & Luigi Zingales, *The Bubble and the Media*, *in* CORPORATE GOVERNANCE AND CAPITAL FLOWS IN A GLOBAL ECONOMY 83, 90–95 (Peter K. Cornelius & Bruce Kogut eds., 2003).

40. *See* Alexander Dyck & Luigi Zingales, *The Corporate Governance Role of the Media*, *in* THE RIGHT TO TELL: THE ROLE OF MASS MEDIA IN ECONOMIC DEVELOPMENT 119–20 (World Bank Inst. ed., 2002); Damian Tambini, *What Are Financial Journalists For?*, 11 JOURNALISM STUD. 158, 162 (2010). A growing literature documents the flaws in media reporting, such as dependence on corporate insiders for information and advertising revenues. *See, e.g.*, Jonathan Reuter & Eric

Indeed, one study found that the financial media criticizes executive stock-option plans based on high value at the exercising date (which is a function of external conditions) rather than at the granting date (which is more related to the strength of corporate governance).[41] Another study found that the media criticizes shady accounting practices based on the visibility of companies rather than the size of the discrepancy: large, well-known companies get more negative coverage for more minor deviations.[42] Such studies corroborate our notion that the media targets companies based not on the social harm done, but rather on visibility of and resentment toward these companies. More generally, even if intermediaries *can* produce accurate information (that is, they manage to overcome their own limited attention span or expertise), they often do not *want* to (because they prefer catering to their constituents' biases).[43]

3. Players Who Are Sanctioned (Misbehaving Companies)

To debunk yet another simplifying assumption: reputational sanctions are not a one-sided event. Companies do not go down without a fight. Much like legal control, reputational control is a function of ongoing interactions between regulators and regulated players.[44] Corporate insiders invest billions in an attempt to hijack the information flow and influence how their adverse actions are being interpreted by the market.[45]

Companies often push the market to underreact to problems by hiding their misconduct (preventing/delaying reputational sanctions). Consider for example the documented pattern of camouflaging executive pay.[46]

Zitzewitz, *Do Ads Influence Editors? Advertising and Bias in the Financial Media*, 121 Q.J. ECON. 197, 225 (2006) (finding evidence for biased reporting in favor of advertisers).

41. *See* John E. Core et al., *The Power of the Pen and Executive Compensation*, 88 J. FIN. ECON. 1, 17 (2007).

42. *See* Gregory S. Miller, *The Press as a Watchdog for Accounting Fraud*, 44 J. ACCT. RES. 1001, 1004 (2006).

43. *See* Brian J. Bushee et al., *The Role of the Business Press as an Information Intermediary*, 48 J. ACCT. RES. 1, 11 (2010); Timur Kuran & Cass R. Sunstein, *Availability Cascades and Risk Regulation*, 51 STAN. L. REV. 683, 714, 750 (1999); Wiesenfeld et al., *supra* note 25, at 235.

44. The "New Governance" scholars emphasized this point for legal systems of control. *See* Yuval Feldman & Orly Lobel, *The Incentives Matrix: The Comparative Effectiveness of Rewards, Liabilities, Duties, and Protections for Reporting Illegality*, 88 TEX. L. REV. 1151, 1174 (2010). It is time we flesh it out for reputation systems of control as well.

45. *Cf.* Jon Hanson & David Yosifon, *The Situation: An Introduction to the Situational Character, Critical Realism, Power Economics, and Deep Capture*, 152 U. PA. L. REV. 129, 264–72 (2003).

46. *See* LUCIAN A. BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 64–70 (2004).

Corporate managers anticipate that if news breaks about their inflated pay, it will cause an outrage among stakeholders.[47] In anticipation of the outrage, corporate insiders often manipulate outsiders' perceptions by changing how the pay package looks.[48] By choosing to give the CEO an extra undeserved ten million dollars through complex and opaque stock option plans, insiders may prevent an outrage that would have occurred if the CEO had received a less costly but more visible five million dollars in cash.[49]

Another distortion comes from companies' attempts to affect the market interpretation of revealed misconduct. Consider for example companies' investment in corporate social responsibility (CSR) as an image buffer. Stakeholders are less likely to attribute bad intentions to a perceivably nice company, chalking up the bad news to a one-off mistake rather than a deep-seated flaw.[50] When the nice-guy buffer works effectively, the company mitigates the risk of reputational sanctions. Enron serves as a case in point: one of the least-covered aspects of the heavily covered debacle is that Enron was considered the poster child for CSR before its collapse.[51] Some scholars and activists believe that the accolades showered upon Enron for its CSR image contributed to the slow detection and punishment of Enron's misbehavior.[52]

C. The Implications of Noisy Reputation: Market Under- and Over-Deterrence

Taken together, the emerging pieces of evidence suggest that reputational sanctions are much noisier than was previously assumed. The next necessary step is to examine why it matters that reputation is noisy: what are the social costs stemming from noisy reputational assessments? At the most basic level, the evidence demonstrates that flaws in reputational sanctions are not limited to instances where the market does not detect corporate misbehavior. Market players can

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47. *Id.*

48. *Id.*

49. *Id.*

50. *See* Jay J. Janney & Steve Gove, *Reputation and Corporate Social Responsibility Aberrations, Trends, and Hypocrisy: Reactions to Firm Choices in the Stock Options Backdating Scandal*, 48 J. MGMT. STUD. 1562 (2011); Daryl Koehn & Joe Ueng, *Is Philanthropy Being Used by Corporate Wrongdoers to Buy Good Will?*, 14 J. MGMT. & GOVERNANCE 1 (2010).

51. *See* Roy Shapira, *Corporate Philanthropy as Signaling and Co-optation*, 80 FORDHAM L. REV. 1889, 1939 (2012).

52. *Id.*

become aware of a certain corporate behavior, yet interpret it inaccurately. Stakeholders may stop doing business with perfectly fine companies, or they may ignore early warning signs and continue doing business with rotten companies.

More importantly, as I will explain, the evidence suggests that the market *systematically* over-reacts to certain misbehaviors and under-reacts to others. The noise in reputational sanctions should not be discarded as irrational mistakes that cancel each other out. Companies that care about their reputation face incentives to excessively avoid some worthy behaviors (reputational over-deterrence), and excessively engage in some bad behaviors (reputational under-deterrence). As a result, reputational forces may distort primary behavior and hurt allocative efficiency. Companies may pick projects based on their reputational value and not on their "real" value.

Polinsky and Shavell's proposal to abolish product liability for widely sold products provides a good case for illustration.[53] In making the argument that the market already monitors and deters misbehavior (whereby we can eliminate litigation without losing much deterrence), Polinsky and Shavell use three motivating examples: Johnson & Johnson's cyanide-laced Tylenol, Audi's self-accelerating cars, and Odwalla's contaminated juice.[54] In all these famous crises, information indeed disseminated quickly when something bad happened to widely sold products.[55] When people died because they took a Tylenol, drove an Audi, or drank an Odwalla apple juice, the media were all over the story, consumers stopped purchasing products, and the stock prices plummeted.[56] But a closer look at these three examples reveals an important yet overlooked point: we cannot assume that reputational forces punished and deterred optimally. In fact, in all these cases the market badly misjudged what happened and how it happened.

The Tylenol poisonings and Audi's self-accelerating cars are good examples of market *over*-reaction. In the Tylenol case, Johnson & Johnson initially suffered huge reputational damages for something that it did not do—it was a case of external product-tampering that happened

53. Polinsky & Shavell, *supra* note 1.

54. *Id.* at 1443–44. The Tylenol crisis broke in 1982, when seven individuals died after taking a cyanide-laced drug. The Audi crisis broke in 1986, when Audi was accused of manufacturing a car that accelerated by itself. The Odwalla crisis broke in 1996, when several toddlers were harmed by drinking bacteria-infected juices.

55. *See id.* (citing media coverage).

56. *Id.*

on the retailer level.[57] The madman who tampered with Johnson & Johnson products could have tampered with other companies' products. Audi was also initially punished for something it did not do. As was later proven, the self-acceleration allegations were false.[58] Audi's cars did not accelerate by themselves; they accelerated because the accusers mistook the gas pedals for the brakes.[59] Odwalla's case is a perfect example of the flip-side: the market *under*-reacted to Odwalla's breakdowns in quality control. Odwalla had a preexisting image of a do-gooder, a socially responsible company, and that image served as a reputational buffer of sorts.[60] And so, when top management stated that they could not have anticipated the juice contamination, stakeholders were willing to buy the company's version and interpret the event favorably.[61]

At their core, then, these three famous examples do not tell the tale of optimal reputational sanctioning. They rather tell the tale of distorted reputational sanctioning. We cannot assume that the market reaction to those crises incentivized companies to invest optimally in product safety. If anything, those market reactions only distorted incentives: companies will now invest too much in the safety of certain visible products (following Tylenol); invest less in safety in general because arbitrary allegations against you may erase your reputational capital (following Audi); or invest too much in erecting reputational buffers—focusing on image instead of real quality (following Odwalla).

The lesson for legal scholars and policy makers is straightforward: recognizing an area of market behavior with strong reputational concerns only begins analysis. A full analysis requires identifying whether the reputational forces deter optimally or not. In particular, we should start paying attention to the previously overlooked problem of market *over*-deterrence. Existing analyses usually assume that the noise in reputational sanctions leads strictly to under-punishment: large companies enjoy mismatches of information and power versus market

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57. *See* ERIC DEZENHALL & JOHN WEBER, DAMAGE CONTROL 15, 13–22 (2007).

58. The details of the Audi case are based on PETER W. HUBER, GALILEO'S REVENGE: JUNK SCIENCE IN THE COURTROOM 57–74 (1991); Greg Farrell, *Lurching into Reverse*, 1 BRILL'S CONTENT 55 (1998).

59. HUBER, *supra* note 58, at 57–74; Farrell, *supra* note 58, at 55.

60. The details of the Odwalla case are based on Mallen Baker, *Odwalla and the E-Coli Outbreak*, MALLENBAKER.NET, http://www.mallenbaker.net/csr/crisis05.html [https://perma.cc/RCC2-E5NJ] (last visited June 27, 2015); Jon Entine, *The Odwalla Affair—Reassessing Corporate Social Responsibility*, AT WORK (1999), http://www.jonentine.com/articles/odwalla.htm [https://perma.cc/QK6V-EL2Z].

61. Entine, *supra* note 60.

players, and so are likely to exploit the holes in reputation systems in their favor.[62] But while it is indeed intuitive to think that companies can camouflage failures, one cannot ignore the dynamics that are in play once their failures are revealed. As scholars in other disciplines have recognized, once bad news breaks, market arbiters face incentives to pile on criticisms and stakeholders tend to overreact and unnecessarily sever ties with otherwise healthy companies.[63]

An interesting question then becomes how to identify the circumstances that give rise to systematic under- or over-deterrence. While future empirical research is very much needed in this area, we can already glean some initial patterns from the extant literature. One important determinant of under-/over-reaction is the saliency of the company and issue at question. The market tends to over-react to failures of well-known companies and vivid failures, and under-react to less visible companies and opaque, complex issues.[64] Another factor to consider is the type of harm done: the market is likely to under-react when the misbehavior causes multiple small harms or concealed harms, and over-react when the victims are easily identifiable.[65] Yet another determinant is the state of the overall economy. Evidence suggests that

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62. *See, e.g.*, Robert Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for Its Future*, 51 DUKE L.J. 1397, 1429–34 (2002).

63. *See* ERIC DEZENHALL, NAIL 'EM! CONFRONTING HIGH-PROFILE ATTACKS ON CELEBRITIES & BUSINESSES 107 (1999); DEZENHALL & WEBER, *supra* note 57, at 39; Dyck & Zingales, *supra* note 40; R. William Ide & Douglas H. Yarn, *Public Independent Fact-Finding: A Trust-Generating Institution for an Age of Corporate Illegitimacy and Public Mistrust*, 56 VAND. L. REV. 1113, 1115, 1139–40 (2003); Wiesenfeld et al., *supra* note 25, at 240–42.

Granted, sometimes giving the public villains is socially beneficial: there are plenty of corporate villains worthy of punishment out there. But, overall, catering to biases generates incentives to punish villains more than they deserve, to make villains out of honestly incompetent businessmen, or to under-punish villains who fly under the radar. To further clarify: I do not claim that the market necessarily under- or over-deters. There will be times when the market punishes in the right measure. My point is not that the invisible hand of the market for reputation never works, but rather that it cannot be assumed to generate optimal deterrence consistently.

64. *See* DEZENHALL, *supra* note 63 at 55, 86–88; DEZENHALL & WEBER, *supra* note 57, at 200–01 (detailed examples of how corporate watchdogs selectively bark at visible companies); Pauline M. Ippolito, *Bonding and Nonbonding Signals of Product Quality*, 63 J. BUS. 41, 55 (1990) (availability bias causes stakeholders to excessively update upward their beliefs about a product defect after they read front-page news about a case of one product defect); Reuber & Fischer, *supra* note 25, at 47. To recast the example of criticizing executive pay arrangements: media and activists focus their criticism on the issue of overall *level* of pay, while in reality the *structure* of pay (how managerial incentives are tied to long-term performance) is more relevant to the company's stakeholders. *See* BEBCHUK & FRIED, *supra* note 46, at 121.

65. *See* Polinsky & Shavell, *supra* note 1, at 1444–45.

reputational sanctions follow a supra-cyclical pattern.[66] When the economy is down, the public is actively searching for villains, so news about corporate misconduct may attract more attention. As a result, the market may over-react. By contrast, when the economy is booming, stakeholders might be more likely to ignore early warning signs.

Whether the market is under- or over-reacting, the basic point about markets for reputation stands: they are much more flawed than was previously acknowledged. Accurate reputation information is in a sense a public good.[67] And private players, when left alone, lack the information and incentives to produce accurate reputational sanctions. How can reputation markets function, then? Part of the answer lies in the fact that in reality the market is rarely left alone. Adverse actions are interpreted and assessed not just by market arbiters, but also by legal arbiters. In the Tylenol, Audi, Odwalla, and many other famous cases, the legal system produced information that propelled market players to revise their initial reaction to the bad news. In order to get a full picture of reputation we therefore need to explore the different channels through which the law generates information and affects reputations.

II. HOW THE LEGAL SYSTEM AFFECTS REPUTATIONAL SANCTIONS

It is intuitive that decisions and events in the court of law affect the court of public opinion, and vice versa. Yet up to this point legal scholars have tended to assume away complementarities between law and reputation, by treating the two systems as independent of each other.[68] This Part challenges the conventional assumption by mapping the various channels through which the law can influence reputational evaluations. I divide the different influences into two categories, which will be termed "first-opinion" and "second-opinion" effects. The first deals with cases where market players are slow to react to corporate misconduct and the legal system propels them to react. The second category deals with cases where market players react almost immediately to corporate misconduct and the legal system later propels them to reevaluate their initial reaction.

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66. *Cf.* Dyck & Zingales, *supra* note 40; Gregory Mark, *The Legal History of Corporate Scandal: Some Observations on the Ancestry and Significance of the Enron Era*, 35 CONN. L. REV. 1073, 1083 (2003); Wiesenfeld et al., *supra* note 25, at 239–40.

67. *Cf.* David S. Ardia, *Reputation in a Networked World: Revisiting the Social Foundations of Defamation Law*, 45 HARV. C.R.-C.L. L. REV. 261, 264, 293 (2010).

68. *See supra* note 6.

A. *First-Opinion Effects*

We saw that one basic problem of reputational control arises from the difficulties of detecting and reacting in real time to corporate misbehavior. Parties who are harmed by corporate misbehavior may find it too costly to communicate the violation to third parties. The legal system helps reputation systems in such instances by revealing and drawing attention to adverse actions that would have otherwise gone unnoticed.[69] Take for example mandatory disclosure requirements, which incentivize corporate decision-makers to publicly reveal information about their own misconduct.[70] Similarly, whistleblower laws incentivize employees to reveal information about their employers' misconduct. Litigation serves a similar function, albeit more indirectly. Litigation generates monetary incentives for harmed parties (such as damages and lawyers' fees) to expose the misbehavior in court. As a side benefit, once the story is discussed in the court of law the gossip can spread more readily and credibly to the court of public opinion, increasing the chances that information about the company's breaches will reach its stakeholders.[71]

In other words, the law can serve to reduce the *detection costs* of reputation control systems: the costs of revealing misconduct and communicating it to a critical mass of market players. In such instances the law sets a reputational sanction in motion, pushing market players to react to corporate misconduct.

In many other situations, however, market players hardly need pushing. Research suggests that market players learn about misconduct by large public companies—and act upon it—long before a lawsuit is filed. One recent comprehensive study estimates that the filing of a lawsuit is responsible for breaking bad news in less than seven percent of financial misconduct cases.[72] In the other ninety-three percent of the

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69. *See* Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393, 443 (2005); Polinsky & Shavell, *supra* note 1, at 1454–55.

70. Troy A. Paredes, Sec. & Exch. Comm'r, Statement at Open Meeting to Propose Amendments Regarding Facilitating Shareholder Director Nominations (May 20, 2009), https://www.sec.gov/news/speech/2009/spch052009tap.htm [https://perma.cc/Q7UR-FREN].

71. Indeed, it is a common practice to search for past and pending legal disputes of potential business counterparties. G. Richard Shell, *Opportunism and Trust in the Negotiation of Commercial Contracts: Toward a New Cause of Action*, 44 VAND. L. REV. 221, 271 n.223 (1991).

72. *See* Jonathan M. Karpoff et al., Database Challenges in Financial Misconduct Research 43 tbl.4 (May 30, 2014) (unpublished manuscript), http://ssrn.com/abstract=2112569 [https://perma.cc/3KJU-WQE3] (indicating that the filing of a class action lawsuit contributed to the announcement of wrongdoing in only 73 out of 1099 cases). The filing of a lawsuit lags the date on

cases market players learn about misbehavior from whistleblowers, investigative reporters, financial reports, and the like, rather than from courtroom records.[73] Still, even when the legal system's reaction is lagged it may nevertheless affect the market, albeit in a different way, to which we turn next.

B. Second-Opinion Effects

1. The Basic Story

Bad news about a company often ignites two reactions. First, the market system's reaction: stakeholders reducing their willingness to do business with the company. Then, the legal system's reaction: a plaintiffs' lawyer files a lawsuit or a regulator initiates an investigation to examine whether the company broke some rules and needs to pay for it. Importantly for our purposes, the process of determining whether to impose legal sanctions produces information on how the company behaved. In particular, litigation and investigations tend to produce information on questions such as what top managers knew and when they knew it. In that sense, litigation or regulatory investigations often create another "third-party assessment" of the company's behavior. And to the extent that such information is made publicly available, it allows market players to reevaluate their assessment of the company's quality.

In other words, the company's stakeholders can use the legal system's lagged version of what and how things happened as a second opinion on their reputation judgments. In the second-opinion analogy, stakeholders are the decision-makers, pondering how to update beliefs about a misbehaving company; market arbiters (media, watchdogs, analysts) are the first-opinion givers; and legal arbiters are the second-opinion givers.

To be sure, the fact that another assessment is available does not mean that it will be used. Not all second opinions are effective. In our context, however, the legal system's version often makes a valuable second opinion, because it complements the market's initial reaction nicely. Based on what we have learned so far about reputational judgments, we can generalize that the market will have a reasonable sense of *what* happened, but will have problems understanding *how* it happened. When news of corporate misbehavior breaks, stakeholders quickly learn exactly what the product defect was or how hefty a

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which the market first learned about misconduct by a median of 23 days and an average of 150 days. *Id.* at 16.

73. *Id.* at 43 tbl.4.

severance package was awarded to the soon-to-be-leaving CEO. But stakeholders have poor information and resort to biased heuristics when trying to interpret whether the event is indicative of future behavior. Perhaps the product defect was an unforeseeable isolated mistake; perhaps the hefty severance package was the only reasonable card that the board could play given the circumstances. Legal arbiters, by contrast, enjoy more fact-finding powers, expertise, and credibility than market arbiters did when they initially judged the event.[74]

First and foremost, the legal system vests powers in judges, investigators, and private litigants to probe and demand relevant information from corporate insiders. These insiders, in turn, know that the information they are disclosing during legal proceedings has to be full and accurate. These facts-generating powers were primarily designed to increase the accuracy of legal adjudication.[75] But they also generate as a byproduct information to which market arbiters were not privy when they made their initial assessment. Think for example about intra-company emails being revealed only during discovery, exposing exactly what top managers knew and when they knew it. The factual picture painted during the process of litigation is therefore often more accurate and nuanced than the one painted by mass media during the initial market reaction.[76]

Aside from being provided with better facts through the discovery process, the public is also provided with better *interpretations* of the facts through the adjudication process. For example, in order to evaluate whether misconduct is indicative of future behavior or not, one needs to assess the intentionality of the act. Judges are arguably seasoned experts in evaluating intentions: in many scenarios the legal doctrine requires a judge to determine the animus associated with a behavior. The legal system's opinion may thus replace not just half-truths with verified facts, but also bias-laden judgments with expert judgments.

To illustrate, let us now delve into four concrete examples where the legal system's second opinion corrected different types of initial market misjudgments.

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74. *Cf.* David S. Law, *A Theory of Judicial Power and Judicial Review*, 97 Geo. L.J. 723, 752–53 (2009) (comparing the courts' and the media's strengths in policing misbehavior).

75. *See, e.g.*, Robert D. Cooter & Daniel L. Rubinfeld, *An Economic Model of Legal Discovery*, 23 J. LEGAL STUD. 435, 436 (1994).

76. *See* Cooter & Porat, *supra* note 37, at 420; Tamar Frankel, *Court of Law and Court of Public Opinion: Symbiotic Regulation of the Corporate Management Duty of Care*, 3 N.Y.U. J.L. & BUS. 353, 356 (2007); Wendy Wagner, *When All Else Fails: Regulating Risky Products Through Tort Litigation*, 95 GEO. L.J. 693, 700 (2007).

2. *Motivating Examples*

The above-mentioned crisis of Audi's self-accelerating cars illustrates several flaws in reputational sanctioning, such as misinformed stakeholders and allegation-driven media.[77] The major reputational damage to Audi occurred after CBS's *60 Minutes* picked up the self-acceleration allegations and aired a story with dramatic interviews and a (fabricated) visual illustration of a driverless car accelerating.[78] At that point, Audi's reputation among U.S. customers was close to zero.[79] Then, after the immediate market overreaction, the story was picked up by plaintiffs' lawyers who filed lawsuits and government regulators who initiated investigations.[80] During cross-examination a new crucial piece of information came to light: the featured interviewee from the *60 Minutes* piece admitted to telling the police officer on the scene that she mistook the gas pedal for the brakes.[81] And a thorough investigation by the regulatory agency—the National Highway Traffic Safety Administration—concluded that the cars did not accelerate by themselves.[82] Audi then used the information produced by the legal system to try and correct the noisy information produced by rumor propagators and the media.[83] The company bought full-page ads in major newspapers and simply filled them with quotes from the regulatory report, claiming vindication.[84]

Another earlier example—the Odwalla case—illustrates the flip side: how asymmetric information and judgment biases may lead stakeholders to *under*-react. After Odwalla initially succeeded in convincing the public that the failure was unforeseeable,[85] some of the lawsuits against it reached the discovery stage. The plaintiffs' lawyers then exposed internal company documents showing that Odwalla's managers actually knew about the potential health hazards in advance and chose to ignore

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77. The details of the Audi case are based on PETER W. HUBER, GALILEO'S REVENGE: JUNK SCIENCE IN THE COURTROOM 57–74 (1991); Greg Farrell, *Lurching into Reverse*, 1 BRILL'S CONTENT 55 (1998).

78. HUBER, *supra* note 58, at 57; Farrell, *supra* note 58, at 53–55.

79. *See* Farrell, *supra* note 58, at 53.

80. HUBER, *supra* note 58, at 61–62.

81. *Id.* at 66; Farrell, *supra* note 58, at 54.

82. HUBER, *supra* note 58, at 66–69; Farrell, *supra* note 58, at 53–54.

83. Farrell, *supra* note 58, at 54–55.

84. *Id.* at 54.

85. *See* Entine, *supra* note 60.

the warnings.[86] Consequently, the market rethought the trustworthiness of Odwalla, and the company's reputation took a big dip.[87]

In both the Audi and Odwalla examples, the legal system generated new pieces of information that helped stakeholders de-bias their judgments. Another famous corporate debacle—the Disney-Ovitz divorce—illustrates how judicial opinions affect stakeholders' beliefs even without producing new information.[88] In the mid-1990s Disney hired Hollywood's super-agent Michael Ovitz to serve as president.[89] "Ovitz failed to perform satisfactorily and was fired after a year, but not before collecting a $140-million termination package from Disney."[90] The Ovitz affair drew media coverage that was voluminous in scope and unfavorable in tone. Market and social arbiters piled on criticisms, framing the events as a classic case of managerial greed and total disregard for market norms.[91] Some even insinuated that all the hiring and firing was a scam meant simply to transfer money from shareholders' pockets to Ovitz's.[92]

Following the initial market reaction, Disney's shareholders sued the directors for breaching their fiduciary duties in supervising the hiring and firing of Ovitz.[93] After a prolonged legal battle, the Delaware judge presiding over the case delivered a lengthy decision that exonerated the defendants.[94] For our purposes, more important than the legal outcomes are the reputational outcomes of the opinion. In a separate paper I looked at the content of media coverage of the Disney-Ovitz debacle, and showed that the valence of media coverage had become more favorable toward Disney following the verdict.[95] For example, after the judge released his version, the media started to emphasize contextual (and not just causal) explanations of the debacle.[96] The media started talking

86. Bill Marler, *Another Lesson Learned the Hard Way: Odwalla E. Coli Outbreak 1996*, MARLER BLOG (Jan. 23, 2013), http://www.marlerblog.com/legal-cases/another-lesson-learned-the-hard-way-odwalla-e-coli-outbreak-1996/#.VeHwwnvItnw [https://perma.cc/6D4V-EDDB].

87. *See* Entine, *supra* note 60.

88. For a detailed account of the history of the debacle, see *In re* The Walt Disney Co. Derivative Litig., 907 A.2d 693 (Del. Ch. 2005).

89. *Id.* at 703–10.

90. Roy Shapira, *A Reputational Theory of Corporate Law*, 26 Stan. L. & Pol'y Rev. 1, 26 (2015); *see also* Brehm v. Eisner, 746 A.2d 244, 253 (Del. 2000).

91. *See* Shapira, *supra* note 90, at 27.

92. *Cf.* A. M. Rosenthal, Opinion, *Hardtack for the Journey*, N.Y. TIMES, Dec. 17, 1996, at A25.

93. *Brehm*, 746 A.2d at 258–59.

94. *See In re* The Walt Disney Co. Derivative Litig., 907 A.2d 693, 772, 776 (Del. Ch. 2005).

95. *See* Shapira, *supra* note 90, at 30.

96. *Id.* at 30–31.

about the debacle in terms that suggested a perfect storm, reminding the readers that Disney was rushed into luring Ovitz with a hefty severance package because its previous president died in a helicopter crash and its CEO suffered a heart condition.[97] To emphasize: the facts of a helicopter crash and a heart condition were never disputed or hidden; they were just not emphasized by the media prior to the judicial opinion. Another key fact that was readily available yet seldom mentioned prior to the verdict was how the market reacted to Ovitz's hiring in real time.[98] As the judge spotlighted (and the media followed suit) the stock market actually reacted extremely well to the hiring decision.[99] Overall, even though the judge strongly criticized Disney's directors on several occasions,[100] there is reason to believe that his opinion helped convince stakeholders that Disney's problems were less deep-rooted and more easily fixable than they had previously thought.

We find the same pattern in many other cases.[101] Stakeholders' initial reactions when reading about corporate misbehavior are plagued by attribution errors and hindsight bias. Once bad news breaks, stakeholders often over-react because they tend to downplay the context and attribute negative outcomes to deep-seated flaws. Judges can balance this tendency, because their version usually spotlights the external conditions surrounding the event in question.

The fourth and final example illustrates how the legal system's second opinion helps stakeholders de-bias the information coming from the misbehaving companies. As the debacles of Salomon Brothers and Arthur Andersen illustrate, the legal system can either lend credibility to or discard a company's version of the events. In 1991, news about Salomon Brothers' trading shenanigans ignited a media firestorm, which in turn resulted in mass sell-offs of the company's shares.[102] The company acted promptly to recover the reputational harm: Warren Buffet took charge and the company offered transparency and full cooperation with the investigation.[103] Salomon's recovery is widely

97. *See Disney*, 907 A.2d at 699, 702.

98. *Id.* at 708.

99. *Id.*

100. *Id.* at 760.

101. *See* Shapira, *supra* note 90, at 38–40.

102. The details are based on CHARLES J. FOMBRUN, REPUTATION: REALIZING VALUE FROM THE CORPORATE IMAGE 362–85 (1996); Lynn Sharp Paine & Michael A. Santoro, Forging the New Salomon (Harv. Bus. Sch., Case Study No. 9-395-046, 2004) (on file with author).

103. FOMBRUN, *supra* note 102, at 375–81; Paine & Santoro, *supra* note 102, at 4, 10–11.

considered a success story.[104] But *why* exactly did the Salomon recovery succeed? After all, many companies follow the same recipe of changing the management and promising to be nice from now on, yet do not recover reputational damages.

In this specific case, the recovery efforts received a boost of credibility from financial regulators. Following the initial outcry, the Justice Department, Securities and Exchange Commission (SEC), and other government agencies started investigating Salomon.[105] Several months later, the SEC announced that Salomon had agreed to pay a $290 million fine to settle the case.[106] More importantly, the SEC chairman included in his announcement an assessment of the company's behavior that pretty much certified what the company was claiming.[107] The SEC lent credibility to the company's attempts to distance itself from the wrongdoing, believing that the "infractions were rooted in individual excess rather than in systemic abuse," and that current management did right in responding to the misconduct and "purging the company of its rogue elements."[108] The stock market reacted very positively to the announcement.[109]

By contrast, when Arthur Andersen followed the same recipe in an attempt to distance itself from the Enron debacle, the market was not convinced.[110] I argue that this is partly because the legal system produced information that discredited the company's version. Arthur Andersen claimed that the misbehavior was the work of a single partner, who was subsequently fired.[111] But the prosecutors chose to cut a deal with the singled-out partner, and the trial produced information about how pervasive the problems were, and how the higher-ups in Andersen were aware of them in real time.[112]

Taken together, all these examples illustrate how the "legal system thus can serve as *a safety valve* for reputation systems. In instances where market players greatly under- or over-reacted, the legal system later provides a more balanced perspective of how things happened, thereby allowing market players to go back and correct their initial

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104. *See* FOMBRUN, *supra* note 102, at 375, 384–85; Paine & Santoro, *supra* note 102, at 19–20.

105. FOMBRUN, *supra* note 102, at 371–72; Paine & Santoro, *supra* note 102, at 10.

106. FOMBRUN, *supra* note 102, at 384; Paine & Santoro, *supra* note 102, at 19.

107. *See* FOMBRUN, *supra* note 102, at 381; Paine & Santoro, *supra* note 102, at 20.

108. FOMBRUN, *supra* note 102, at 381.

109. *See id.*; Paine & Santoro, *supra* note 102, at 20.

110. *See* Reuber & Fischer, *supra* note 25, at 42.

111. *Id.*

112. *See id.*; MACEY, *supra* note 1, at 141–42.

assessment."[113] Perhaps more importantly and beyond the impact of the legal system on specific under- or over-reactions after the fact, "the mere background threat of litigation affects all future reputational assessments" to begin with.[114] The next section elaborates.

3. Ex Ante Effects

Studies across various contexts show that when first-opinion givers anticipate the possibility of an accurate second opinion, they invest more in the accuracy of their initial assessments.[115] We have ample reason to believe that the analogy applies to our context of providing information on corporate failures. Both the accusers and the accused are disciplined by a credible threat of second opinions.[116]

The mere background threat of litigation pushes the accused companies to refrain from lying when denying accusations. Indeed, crisis management experts explicitly advise their clients to be disciplined in how they fight accusations, bearing in mind the possibility that their denials will be exposed in discovery as lies.[117]

The background threat of litigation also pushes information intermediaries to make their accusations more accurate. A journalist or a corporate watchdog probably anticipates the possibility that future litigation will surface nuanced information about the behavior it is currently criticizing. Assuming they care about their reputation as a journalist/activist, the possibility of being later exposed as wrong will

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113. Shapira, *supra* note 90, at 13 (emphasis original).

114. *Id.*

115. In the literature on second opinions, such a reaction is termed the "*sentinel effect*." Adrian Vermeule, *Second Opinions and Institutional Design*, 97 Va. L. Rev. 1435, 1464 (2011) (emphasis in original). For overviews of second-opinion effects in the legal literature, see Michael Klausner et al., *Second Opinions in Litigation*, 84 Va. L. Rev. 1411 (1998); Vermeule, *supra*.

116. To be sure, the background threat of litigation will not *completely* align the incentives of intermediaries with the social interest in accurate reputational sanctioning. For example, even if the media anticipate that the legal system will shed light on what actually happened, they will still over-report on salient issues while under-reporting on opaque issues.

117. *See* REGESTER & LARKIN, *supra* note 33, at 194. The background threat of litigation thus facilitates the ex ante investment in reputation research. Searching for corporate misbehavior brings more predictable returns when searchers (watchdogs) know that companies cannot simply brush aside worthy attacks. However, in certain scenarios the threat of litigation is unlikely to discipline corporate denial/justification communications. Corporate insiders with a very high discount rate (a CEO nearing retirement, a company on the brink of insolvency) need all the recovery that they can get. So they may choose to lie and take the risk that their lie will be exposed down the road. Or, the information may be unverifiable: adjudicators will not be able to determine ex post whether the company lied. My point here is not an absolute but a relative one: the more credible the threat of future litigation/investigation is, the more disciplined companies will be in their recovery talk.

make them invest more in their initial assessments. It is as if the legal system helps us better assess not only the behavior of business corporations, but also the behavior of corporate watchdogs. Watchdogs that make unfounded accusations can later be exposed as unprofessional. By contrast, high-quality watchdogs can use legal success stories to boast of their effectiveness as compared to their competitors, namely, other watchdogs advancing the same cause.[118] In that sense, the legal system facilitates a market for corporate watchdogs' reputation.[119]

Indeed, when I sampled websites of prominent corporate watchdogs, I found that almost every website contains a list of "legal victories" describing how watchdog-initiated fights led to hefty damages awards or changes in regulation.[120] For example, the Natural Resources Defense Council (NRDC), an environmental non-governmental organization, declares itself "the most effective lobbying and litigating group on environmental issues."[121] What makes them so effective, you may ask? Well, for one thing, they tell you, they have an army of 500 savvy lawyers, scientists, and policy advocates.[122] The website then refers the visitor to a long list of legal battles that the NRDC has won.[123] To be sure, these anecdotal observations are not enough to prove that the legal

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118. In that sense, courts serve as a clearinghouse for watchdogs. Over time litigation allows the public to form rough proxies about the quality of certain watchdogs. We observe that watchdog X is behind many legal fights that were found to be credible, while watchdog Y is behind too many frivolous fights. So we trust future assessments of watchdog X more than those of watchdog Y. For example, when Wendy's was accused of selling a woman chili containing a severed human finger, the vivid accusation threatened to kill the Wendy's brand. But Wendy's reputation quickly recovered because journalists found out that the accuser had a record of frivolous lawsuits. The public's attention then shifted from the alleged misbehavior of the company to the bad intentions of the accuser. *See* DEZENHALL & WEBER, *supra* note 57, at 127–30.

119. *See generally* Ling Liu, Systematic Measurement of Centralized Online Reputation Systems 14 (Apr. 2011) (published Ph.D. thesis, Durham University), http://etheses.dur.ac.uk/881/ [https://perma.cc/2DTL-XJAT]. Reputation information is a credence good: it is hard for consumers to ascertain whether the information that they are buying is accurate. When we purchase credence goods, we base our decisions on whether we trust the seller or not. So, aside from the market for for-profit reputation, there is a market for non-profit reputation: some watchdogs are considered more credible than others. The question then becomes: where can we get information on the abilities and intentions of watchdogs? I argue that the legal system helps to distinguish between high- and low-quality reputation arbiters.

120. My sampling criterion was straightforward: all the watchdogs that Dezenhall's crisis management book mentions as prominent.

121. *About Us*, NAT. RES. DEF. COUNCIL, http://www.nrdc.org/about/ (last visited Aug. 1, 2015) (quoting *The Wall Street Journal*). *See also Litigation Project - Current Docket*, CTR. FOR SCI. PUB. INTEREST, http://www.cspinet.org/litigation/current.html [https://perma.cc/S7U9-EG95] (providing an even more straightforward example).

122. NAT. RES. DEF. COUNCIL, *supra* note 121.

123. *Id.*

system facilitates a better market for watchdog reputation, and more systematic evidence is needed.[124] Nevertheless, the observations indicate how watchdogs think that success in the legal arena is a good indicator of their competence.

Overall, the second-opinion effects reduce the "enforcement costs" of reputational systems: the costs of calibrating and carrying out responses to detected violations of market norms. In doing so, the second-opinion role of the law coexists and complements nicely the first-opinion role, in which the law helps market players detect violations. We cannot determine with certainty which of these two informational effects is more important, as both depend on the company and issue at hand.[125] But we can observe, more generally, a gradual shift in the informational role of the law: in the past, when markets and information technologies were not as developed, the role of the law in reputation markets was mostly to detect violations.[126] Nowadays, the problem is not so much lack of information, but rather sorting out what pieces of information are more relevant and credible. In such an environment, adjudication does not break news, but rather serves as a second opinion, a safety valve that corrects market under- or over-reaction.

C. Multiple Layers of Reputation Information

So far we have examined how the legal system can help market players overcome problems with asymmetric information (through fact-finding powers in discovery), judgment biases (through expert and experienced arbiters), and divergent incentives (through independent adjudication). But the legal system is not categorically better or more accurate than reputation systems. The legal system's assessments sometimes suffer from distortions similar to the ones that plague reputation systems: asymmetric information, lack of expertise, strategic

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124. From my anecdotal observation I found little to no reports of legal losses or frivolous suits. Watchdogs report only successes. And it seems like watchdogs take credit even for success stories to which they contributed marginally. The legal success-story signal is thus very noisy. It is better than no signal, though. Fly-by-night watchdogs are not able to boast a long list of legal success stories.

125. To generalize: first-opinion effects are only relevant when negative events are likely to fly under the radar to begin with. And so the first-opinion role is less relevant when the misbehaving company is large or the defective product is widely sold. *See* Polinsky & Shavell, *supra* note 1, at 1455; David W. Prince & Paul H. Rubin, *The Effects of Product Liability Litigation on the Value of Firms*, 4 Am. L. & Econ. Rev. 44, 64–65 (2002).

126. Indeed, this is the main theme of historical case studies of *lex mercatoria*, where judges did not sanction but provided information to other merchants on the misconduct of disputants. Law, *supra* note 74, at 745.

behavior, and divergent incentives. There exist ample situations where we cannot trust the legal system to produce the positive externality of accurate reputation information. And so I do not portray here a horserace over who produces better information, with the legal system winning. I rather portray the legal and market systems as *providing multiple layers of reputation information*.

The value of the legal system to reputation systems stems largely from the fact that the systems' distortions are imperfectly correlated. The market's first opinion enjoys advantages in some areas and disadvantages in other areas compared to the legal system's second opinion.[127] The two systems in effect create one *diversified portfolio* of reputational assessments. Having different types of assessments mitigate the risk of extreme mistakes (that is, the risk that stakeholders will boycott perfectly good companies or interact with rotten companies). The idea of multiple layers of evaluations has been applied to similar contexts such as second opinions in medical treatment and user reviews in online commerce websites,[128] and it lends itself nicely to our context. Consider for example the four traits that were identified as necessary for well-functioning reputation systems: the system has to produce information in a timely, accessible, accurate, and thorough manner.[129] It is easy to envision how the market and legal system complement each other along these dimensions. The market system provides more timely and accessible information, striking fast whenever bad news breaks. The legal system then produces information that is often more accurate and complete than the market's initial version.

Granted, there are several specific factors that, when in play, severely limit the legal system's ability to affect reputations. For one, information produced during litigation may be *too lagged*. Often the judge's opinion comes a few years after the initial market reaction, when no one is interested in the matter anymore.[130] But while the time lag indeed represents a strong limitation, we should not overstate it. Remember that the relevant event for the purpose of measuring the lag is not the day on which the legal case is decided, but rather any day on which the legal system injects information into the market. Many times valuable facts become available in the earlier stages of the litigation process. Judges also provide interpretations of how things happened long before the final

127. *See id.* at 752–53.

128. *See, e.g.*, Vermeule, *supra* note 115, at 1435 n.1.

129. *See* Liu, *supra* note 119, at 29–31 (Liu breaks down the dimension I refer to here as "thoroughness" into "interpretability" and "completeness").

130. *See* Ardia, *supra* note 67, at 314; Ide & Yarn, *supra* note 63, at 1139.

judicial opinion: adjudication often happens in multiple stages, and judges speak their mind during early stages such as motions to dismiss or class/derivative action approvals.[131]

Another strong limitation of the second-opinion theory is that information produced in the courtroom may be *too obscure*, getting lost in translation on its way to market players. After all, individuals do not read judicial opinions and the media cover opinions only sparsely and distortedly. Indeed, we should acknowledge that litigation affects reputation only in a small subset of legal disputes (such as with big-firm defendants), which are interesting and important enough for third parties to follow.[132] At the same time, though, not all the information that is produced in the courtroom gets lost on its way to the court of public opinion.[133]

As I summed it elsewhere: "[o]verall, the existence of a well-functioning legal system facilitates better reputation systems."[134] Still, in order to move from claims about the average and improve our ability to predict the reputational impact of specific disputes, we need to introduce more context-specific details and focus on one area of market activity and law at a time.[135] The next Part shows how to apply the theory to specific contexts and identify the factors that determine the likely direction of reputational impact.

III. WHAT DETERMINES THE MAGNITUDE AND DIRECTION OF REPUTATIONAL IMPACT

So far we have kept a neat story for the sake of exposition: law enforcement actions produce as a byproduct a positive externality of reputation-shaping information. But in reality the story is much more

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131. *See* Érica Gorga & Michael Halberstam, *Litigation Discovery and Corporate Governance: The Missing Story About the "Genius of American Corporate Law,"* 63 EMORY L.J. 1383, 1431–40 (2014); Klausner et al., *supra* note 115, at 1425. For example, during the process of approving class and derivative settlements, judges engage in an evaluation of the merits of the case, and some judges choose to publish relatively detailed records of their evaluations. *See* FED. R. CIV. P. 23(e).

132. *See infra* Appendix: List of Interviews, Interview with Richard Clary, Former Head of Litig., Cravath, Swaine & Moore (Nov. 16, 2012). Still, it makes sense to focus on the above-mentioned small subset because it represents the most meaningful and practically important instances of behavior control.

133. *See infra* Part III. For example, the media disseminates information more accurately when they report about assessments of legal arbiters than when they are generating their own reputational assessments. This is because there is no inherent asymmetric information or ambiguity about information that is readily available, namely, what the judge wrote in the opinion.

134. Shapira, *supra* note 90, at 25.

135. Shapira, *supra* note 90, at 14.

complicated and context-specific. This Part fleshes out important factors to consider before applying the general theory to specific contexts. The Part especially emphasizes the forces that drive a wedge between information that is being produced in the legal system and stakeholders' actual reputational decisions. A lot of information gets lost in translation from the courtroom to the court of public opinion: sometimes judicial scorning actually helps the company's reputation, other times the company manages to hijack the information flow by producing smokescreens, and so forth.

A. *The Reputational Impact Depends on the Market Activity and Legal Field in Question*

The magnitude of reputational impact varies greatly across different types of legal disputes. One way to identify the conditions that determine whether a given dispute will affect reputations is to adopt a supply-and-demand framework. "Demand" here denotes the extent to which third parties will be interested in reading what the legal system has to say about the litigants' behaviors. Many types of legal disputes interest only the disputants themselves. Classic examples come from family law or torts committed by individuals. Demand for reputation-relevant information in such cases will be low. "Supply" denotes the extent to which the legal system can actually produce quality information for third-parties who are interested. We can envision a scenario such as medical malpractice litigation, where the demand is high yet supply is low. On one hand, the reputation of caregivers is very important to third parties and hard for them to assess. So the interest in hearing what the legal system has to say will be high. On the other hand, medical malpractice disputes—when they do not settle—are being decided by inexpert jurors who do not produce detailed opinions.[136] The legal system thus supplies little meaningful reputation information.

The legal system meaningfully impacts reputational sanctions only in areas with both high demand and good supply, namely, areas where market players are constantly looking to reevaluate their beliefs, and the legal institutions are perceived as a capable and credible source of information.[137] One example of an area where both supply-and-demand

136. *See infra* Appendix: List of Interviews, Telephone Interview with Jeff Segal, Founder, MedicalJustice (Nov. 27, 2012).

137. *See infra* Appendix: List of Interviews, Telephone Interview with Jeff Segal, Founder, MedicalJustice (Nov. 27, 2012); Telephone Interview with Peter Grossi, Drug Liability Litigator (Dec. 12, 2012). In fact, one can claim that medical malpractice litigation only increases the costs of detection for reputation markets ex ante: doctors who anticipate the biased judgments of jurors

conditions are met is corporate and securities laws.[138] Stakeholders who deal with large publicly traded companies have ample reason to continuously look for new information and interpretation on companies' abilities and intentions, given the high stakes and various asymmetric information problems involved. And the players in the market—private intermediaries such as securities analysts or institutional investors—enjoy enough sophistication and resources to mine legal proceedings for second opinions. Generally speaking, demand for reputation-relevant information on publicly-traded companies is high simply because players in the market are "more interested in the empirical truth and the de-biasing of information than consumers of news in other contexts."[139]

On the supply side, I articulated two reasons for why "the main adjudicators of corporate behavior—Delaware courts—are well positioned to provide timely, comprehensible, and thorough reputation information."[140] First, they are respected in legal and business communities.[141] "The nonpolitical appointment process (Delaware judges frequently come from the bar) and the specialized docket allow judges to develop expertise and a broad perspective on market norms."[142] Second, they manage to avoid the time lag that usually accompanies litigation: "the specialized and small docket also enables Delaware judges to adjudicate disputes relatively quickly, producing

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avoid fully reporting on their own errors (even when those errors were unavoidable) for fear of legal liability. Medical malpractice litigation, the argument goes, creates a "deny and defend" culture, which makes it even more difficult to get accurate reputational judgments to begin with. *See generally* Joanna C. Schwartz, *A Dose of Reality for Medical Malpractice Reform*, 88 N.Y.U. L. Rev. 1224, 1227, 1239–43 (2013).

138. *See* Shapira, *supra* note 90, at 14–15.

139. *Id.* For evidence suggesting that sophisticated investors continuously monitor and react to information disseminated during litigation, see Vladimir Atanasov et al., *Does Reputation Limit Opportunistic Behavior in the VC Industry? Evidence from Litigation Against VCs*, 67 J. Fin. 2215 (2012) (on venture capitalists' reputation); Jeremiah Green et al., The Bad News Dissemination Bias in the Business Press 9 n.13 and accompanying text (Aug. 2012) (unpublished manuscript), http://ssrn.com/abstract=1780162 [https://perma.cc/QBB5-SEZY]; Lars H. Haβ & Maximilian A. Müller, Capital Market Consequences of Corporate Fraud (2011) (unpublished manuscript), http://www.eea-esem.com/files/papers/eea-esem/2012/988/paper.pdf [https://perma.cc/XK4N-V9HS] (same argument applies also outside the VC context).

140. Shapira, *supra* note 90, at 15.

141. *See* Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. Rev. 1009, 1102 (1997).

142. Shapira, *supra* note 90, at 15. *See* David M. Wilson, *Climate Change: The Real Threat to Delaware Corporate Law, Why Delaware Must Keep a Watchful Eye on the Content of Political Change in the Air*, 5 ENTREPRENEURIAL BUS. L.J. 481, 486 (2010).

information in a timely manner."[143] To that we can add here a third point, namely, that the legal system is more likely to tell market players something they do not already know when the issue at hand concerns questions like what insiders knew and when they knew it (that is, issues that are usually the crux of streamlined discovery processes). This is why corporate law litigation usually provides valuable second opinions: it revolves around questions of management integrity.

Finally, and more generally, another factor that enables relevant information production in corporate litigation is the legal doctrine. With open-ended legal standards, such as the good-faith doctrine employed by Delaware courts,[144] judges enjoy more flexibility to tailor their own narrative of the events. Generally speaking, a *negligence regime is more likely to supply information on how things happened than strict liability*.

In other areas the reputational impact comes not from litigation but rather from regulatory investigations. Product liability is a case in point: stakeholders could get most of the relevant information on a company's reputation for product quality not from lagged litigation but rather from timely regulatory investigations. To illustrate, let us revisit the study on stock market reactions to airline crashes.[145] The findings indicate that reputational sanctions in the airline industry are accurate, in the sense that stock prices of airlines plummeted only when crashes were at-fault.[146] But the biggest puzzle for our purposes is: how did the market know the causes of the crash with accuracy? In forty-one out of forty-two crashes sampled, the *Wall Street Journal* journalist covering the crash knew to attribute the failure to the right cause.[147] How so? Part of the reason is the specific issue at hand. It is hard to conceal information on the causes of airline crashes.[148] Another part of the reason is the regulatory environment. The Federal Aviation Administration releases reports on crashes in a timely manner and determines with authority whether the crash was at-fault or not.[149] Market players are likely to rely

143. Shapira, *supra* note 90, at 15. *See* Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1086 (2000).

144. *See* Ehud Kamar, *Shareholder Litigation Under Indeterminate Corporate Law*, 66 U. CHI. L. REV. 887, 888 (1999) (noting the heavy reliance on open-ended legal standards).

145. *See* Mitchell & Maloney, *supra* note 26.

146. *See id.* at 354.

147. *See id.* at 340.

148. Anat R. Admati, *It Takes a Village to Maintain a Dangerous Financial System*, *in* JUST FINANCIAL MARKET: FINANCE IN A JUST SOCIETY (Lisa Herzog, ed. forthcoming 2016) (manuscript at 2), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2787177 [https://perma.cc/J78C-R28A].

149. *See Aviation Accident Reports*, NAT'L TRANSP. SAFETY BD., http://www.ntsb.gov/investigations/reports_aviation.html [https://perma.cc/SQX3-CUNZ] (last visited Aug. 27, 2015).

on these reports ex post, and the mere anticipation of such reports likely disciplines the market ex ante.[150]

While the supply-and-demand framework helps us predict the magnitude of reputational impact, it does not tell us what the *direction* will be. Does litigation necessarily increase the reputational sanction attached to misconduct? Does it affect the reputations of individuals differently than it affects organizations? The next sections answer these questions.

B. Litigation Affects the Reputation of Individuals Differently than It Affects Companies

When analyzing reputational impact we have to distinguish between individual- and organizational-level reputations. Legal scholars tend to assume that any judicial scorning of individuals reflects badly on their companies.[151] And granted, in many cases this intuitive assumption holds. Yet, as reputation and crisis management scholars have long recognized, scolding an individual does not *necessarily* impact the company's reputation negatively.[152] In general, factors such as the scolded individual's place in the hierarchy, whether the individual still holds office, or what other top managers knew about that individual's actions, play an important role in dictating the link between individual scolding and corporate reputation.[153] Specifically in the context of litigation, we can envision common scenarios where dressing down specific managers may actually boost the company's reputation (or at least not hurt it).[154]

First, singling out an individual for scorning may facilitate *scapegoating* dynamics. In typical corporate litigation scenarios—class/derivative actions —the claim is often jumpstarted by a sharp decline in stock prices (which constitutes the harm to the investor and draws the attention of plaintiff lawyers). And because the stock price decline is likely to push the manager out, by the time judges get to write

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150. In a similar vein, consider the case of Audi's self-accelerating cars. There, a large part of the correction to the initial market overreaction came after a regulatory report clarified that the fault did not lie with Audi.

151. *But see* Skeel, *supra* note 32, at 1855.

152. *See* DEZENHALL & WEBER, *supra* note 57, at 140; E. Deanne Brocato et al., *When Things Go Wrong: Account Strategy Following a Corporate Crisis Event*, 15 CORP. REPUTATION REV. 35, 36 (2012) ("Both theoretical and empirical research on corporate crises suggest that individuals and corporations may be viewed differently when evaluated, following a corporate crisis event . . . . ").

153. *See* Shapira, *supra* note 90, at 19–20.

154. *Id.* at 19–21.

their opinions they probably dress down a manager who is already gone or on the way out of the company. While such judicial scorning probably hurts the ousted manager's chances of getting rehired (that is, hurts the manager's labor-market reputation), it could help repair the *company's* reputation. To understand why, note that the crisis management literature considers "decoupling" as one of the most effective recovery strategies for companies.[155] In decoupling mode, the company is acknowledging the problem while isolating and localizing it, conveying a message along the lines of "this is not who we are as a company going forward."[156] Assigning blame to a single individual who was since purged from the company can be an especially effective form of decoupling, as long as the public believes it.[157] Thus, when judges single out the ousted manager for opprobrium, they lend credibility to the scapegoating attempts, thereby helping the company distance itself from the wrongdoing.

Another common occurrence in judicial scolding involves criticizing a manager for making mistakes out of incompetence. Here again, the individual's chances of being rehired would probably go down as a result of litigation. But the impact on the company's reputation is not necessarily negative, and could even be positive. Crisis management experts maintain that companies in crises stand a better chance of repairing their reputation when individual managers are portrayed as less than perfect.[158] I explained it elsewhere:[159]

> If stakeholders perceive the leader as perfect and in total control, they assume that she could have prevented the adverse outcome. As a result, stakeholders will interpret the company's misconduct as intentional and indicative of future behavior (that is, arising from deep-rooted disregard for shareholder interests and market norms in general). By contrast, if stakeholders perceive the leader as less than perfect, they are more likely to

155. *See, e.g.*, Anna Lamin & Srilata Zaheer, *Wall Street vs. Main Street: Firm Strategies for Defending Legitimacy and Their Impact on Different Stakeholders*, 23 ORG. SCI. 47, 61 (2012).

156. *Id.*

157. *Cf.* Celia Moore et al., Avoiding the Consequences of Misconduct: Becoming Licensed by and Insulated from Stigma 10–11 (Working Paper, 2011) (on file with Washington Law Review) (finding evidence that firing a CEO before announcing failures reduces the reputational harm for the company).

158. *See* DEZENHALL & WEBER, *supra* note 57.

159. *See* Shapira, *supra* note 90, at 20.

> interpret the adverse outcomes as a result of more easily fixable mistakes.[160]

The *Disney* opinion illustrates scapegoating dynamics in play.[161] Dozens of law review articles referred to the Chancellor's unusual style of scolding, with caustic and catchable criticisms.[162] But while the reputation-damaging effects of the opinion were widely recognized, one aspect of it has been grossly overlooked: *whose* reputation got damaged exactly? Who were the targets of the scolding? The Chancellor's strongest criticisms were reserved for six individuals: the CEO, three other directors who should have done more to prevent the debacle, and two non-directors—the general counsel and an outside compensation expert—who did not provide full information.[163] As I summed it elsewhere:[164]

> All six of these scolded businesspeople have one thing in common: none of them were any longer an integral part of Disney when the verdict was issued. The Disney 2005 board contained many directors who were part of the company in the Ovitz debacle days. Yet none of the retained individuals were scolded. The scolding was reserved for individuals who were already ousted or on their way out.[165]

This previously unnoticed fact suggests that scapegoating dynamics were in place: the company's reputation for management integrity stood to *gain* from the scolding of ousted individuals.

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160. *Cf.* KIMBERLY D. ELSBACH, ORGANIZATIONAL PERCEPTION MANAGEMENT 60 (2006). *See generally* John Hendry, *The Principal's Other Problems: Honest Incompetence and the Specification of Objectives*, 27 Acad. Mgmt. Rev. 98 (2002) (identifying contexts where shareholders can more easily replace an incompetent element than root out moral hazard). To be sure, in the business world it is sometimes better to be (perceived as) immoral than incompetent. Still, there are areas where incompetence is considered less deep-seated and easier to root out than lack of integrity.

161. The details in this paragraph are based on Shapira, *supra* note 90, at 33–36.

162. *In re* The Walt Disney Co. Derivative Litig., 907 A.2d 693, 763 (Del. Ch. 2005) (describing Eisner as a man who "enthroned himself as the omnipotent and infallible monarch of his personal Magic Kingdom"); s*ee, e.g.*, Omari S. Simmons, *Branding the Small Wonder: Delaware's Dominance and the Market for Corporate Law*, 42 U. RICH. L. REV. 1129, 1178 (2008) ("The *Disney* litigation illustrates that, even where a decision does not result in liability for board members, embarrassing details of corporate dysfunction may tarnish a company's reputation.").

163. *See* Shapira, *supra* note 90, at 34.

164. *Id.* (emphasis omitted).

165. *See* Shapira, *supra* note 90, at 34 (footnote omitted) (citing THE WALT DISNEY CO., 2005 ANNUAL REPORT 100 (2005), http://cdn.media.ir.thewaltdisneycompany.com/2005/annual/ar-2005.pdf [https://perma.cc/EMW2-KJE4]).

And indeed, the media coverage of Disney following the Chancellor's opinion was much more favorable than before the opinion.[166] The verdict itself was presented as a victory for Disney and its incumbent board, albeit a blow to Eisner's individual reputation on his way out of the company.[167] And a few weeks later the media was already publishing stories about how Disney had learned from its past and quickly changed its ways, explicitly referring to Disney as the poster child of a corporate governance turnaround: "The bad company of the 1990s turned into the role model of the 2000s."[168]

C. The Process of Litigation Matters More than Its Outcomes

When we think about the reputational impact of litigation we usually focus on judicial opinions: how the outcomes (legal sanctions) or content (judicial remarks) of opinions shape the reputation of defendants.[169] But in reality judicial opinions are rare. Most legal disputes settle.[170] Yet even cases that settle sometimes affect the market reaction: the process itself prior to settlements (pleading, discovery, and trial) sheds light on reputation-relevant information.

To illustrate, recall that the Odwalla lawsuit settled, but not before the discovery process corrected the initial market reaction by flushing out important information.[171] Another example comes from Selmi's study of stock market reaction to settlements of racial discrimination class actions.[172] The study indicates that similar cases with similar legal outcomes yielded different market reactions, depending on what information was produced prior to settlement.[173] For example, Texaco's reputation took a hit when the media reported about a tape with explicit racial slurs that was exposed in discovery.[174] And we now have systematic indications that sophisticated market players indeed

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166. *Id.*

167. *Id.*

168. *Id.*

169. *See, e.g.*, Rock, *supra* note 141, at 1016 (reputational sanctions are affected by the content of opinions); Wiesenfeld et al., *supra* note 25, at 244 (reputational sanctions are affected by legal sanctions).

170. *See* J.J. Prescott & Kathryn E. Spier, *A Comprehensive Theory of Civil Settlement*, 91 N.Y.U. L. REV. 59, 61 n.2 (2016).

171. *See* Marler, *supra* note 86.

172. *See* Michael Selmi, *The Price of Discrimination: The Nature of Class Action Employment Discrimination Litigation and Its Effects*, 81 Tex. L. Rev. 1249 (2003).

173. *Id.*

174. *Id.* at 1270–72.

constantly monitor disputes and react to events during the early stages of the process.[175]

Note that the litigation process's impact on reputation differs markedly from the impact of judicial opinions. The process mainly affects *what* information is diffused, while judicial opinions mainly affect *how* information is diffused.[176] In disputes with large, publicly traded firms, market players will likely have access to the basic facts about the misbehavior before a lawsuit is even filed. Still, information produced during pleading, discovery, and trial can give market players more raw facts and inside information to work with, such as internal e-mail communications or board minutes that provide details about what top managers did (or did not do) to prevent the failure. By the time judicial opinions are released in such disputes, they probably contain mostly stale information; stakeholders with enough stake and expertise to mine verdicts for information could have already accessed prior sources for the same information. To be sure, verdicts still matter in the court of public opinion. But they matter in different and hitherto understudied ways. The main impact of verdicts is not in introducing new information but rather in affecting how existing information is diffused.[177]

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175. *See* Atanasov et al., *supra* note 139 (noting that events in the early stages of venture capital litigation affect the venture capitalists' reputation). In an interview conducted with a representative of Courtroom Connect—a company that streams online webcasts of Delaware trials—I learned that an important clientele of streaming services is institutional investors who monitor legal disputes in real time and alter investment decisions accordingly.

176. *See generally* TIMOTHY D. LYTTON, HOLDING BISHOPS ACCOUNTABLE (2008) (describing how litigation affects not just the facts we have, but also framing and media attention for these facts); Wagner, *supra* note 76, at 713–27. This subpart corresponds with an abbreviated subpart in Shapira, *supra* note 95, at 21–23.

177. Law and economics scholars have traditionally ignored issues of how information is diffused. *See* Dyck & Zingales, *supra* note 40, at 108–09. It is time we incorporate the burgeoning evidence on the effects of framing and scope of diffusion. For instance, financial economists have been consistently showing that the scope and tone of media coverage moves stock market prices even when the media reports contain no new information. One classic study found that a front-page *New York Times* article about a biotech company caused the stock prices to skyrocket, even though the article contained no new information and was actually repeating information that the *Times* had previously published in a back-page story. *See* Gur Huberman & Tomer Regev, *Contagious Speculation and a Cure for Cancer: A Nonevent that Made Stock Prices Soar*, 56 J. FIN. 387, 387–90 (2001). More generally, see Bushee et al., *supra* note 43, at 12–13 (coverage by mass media affects stock returns even when not breaking new information); Lily Fang & Joel Peress, *Media Coverage and the Cross-Section of Stock Returns*, 64 J. FIN. 2023 (2009) (same); Paul C. Tetlock, *Does Public Financial News Resolve Asymmetric Information?*, 24 Rev. Fin. Stud. 3520 (2010); Paul Ma, Information or Spin? Evidence from Language Differences Between 8-Ks and Press Releases (Nov. 29, 2012) (unpublished manuscript), https://server1.tepper.cmu.edu/seminars/docs/Ma%20Job%20Market%20Paper.pdf [https://perma.cc/5THU-64WM]. The scope of media

Consider how litigation can shape the scope and content of media coverage through three channels that do not involve producing new information: saliency, credibility, and framing. First, litigation or regulatory investigations may raise the saliency of an issue. A certain issue may be long past its days in the sun when a lagged judicial opinion enlivens the media attention to it, providing the media reporters with readymade quotes sheltered from defamation liability.[178]

Second, judicial opinions change reputations through certifying existing information. This is the source-credibility effect. Psychologists and communication scholars have long recognized that not all sources of information are created equal. The same piece of information may be discounted when coming from a non-credible source, yet move the needle when coming from a credible one.[179] When well-respected judges put their name on a certain version of the events, stakeholders are more likely to update their beliefs based on it.

Finally, both the earlier stages in the process and the judicial opinion affect reputations through *framing*: producing readily available packaging of the facts. Plaintiffs, defendants, and third-party intermediaries may use tidbits from earlier stages (complaint, motion to dismiss, expert testimonies) to help their specific interpretations gain traction in the court of public opinion. And the judge's version also affects how market players package an existing set of facts in their minds. Here, however, other noteworthy dynamics come into play: the framing effects of verdicts work in counterintuitive ways, as the next section explains.

D. Legal Outcomes Are Imperfectly Correlated with Reputational Outcomes

After the previous section acknowledged that legal outcomes are not the *only* factor correlated with reputational outcomes, the present section spotlights a closely related phenomenon: sometimes legal outcomes are even *negatively* correlated with reputational outcomes. Two enforcement actions with identical legal outcomes may generate completely different reputational outcomes. This is because the legal outcome of a case is

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coverage affects the market by drawing the attention of more investors to information that was previously known only to a small group of sophisticated investors.

178. *See* LYTTON, *supra* note 176, at 94–95; Frankel, *supra* note 76, at 357.

179. *See* DellaVigna & Gentzkow, *supra* note 39, at 657; Cass R. Sunstein, Opinion, *Breaking up the Echo*, N.Y. TIMES, Sept. 18, 2012, at A25 (people revisit their priors only when information comes from "surprising validators").

based on specific legal doctrines that may not be relevant to the stakeholders' reputation evaluation. For example, a judge may rule in favor of the defendant company, yet the judicial opinion will contain harsh remarks indicating that the company disregarded market norms, though it fell short of violating legal rules. In such cases, the legal consequences will be positive but the reputational consequences negative. Conversely, a judge may assign liability to the company, but the opinion will make clear that the misbehavior was carried out by a rogue employee and is unlikely to reoccur. In that case the legal consequences will be negative but the reputational consequences are likely to be positive.

Indeed, various empirical studies of stock market reactions to enforcement actions show that there is no systematic correlation between the size of the legal sanction and that of the reputational sanction.[180] To further illustrate we need simply revisit the Salomon Brothers case. As mentioned, the market reacted very positively to Salomon's settlement with the regulators.[181] But the positive reaction cannot be attributed to the legal outcome: Salomon agreed to pay what was then the second-highest fine ever paid in SEC settlements, and had to double its initial charge-out (indicating a higher-than-expected legal sanction).[182] The positive market reaction is therefore more likely attributable to the *information* contained in the settlement announcement, which suggested that Salomon's past mistakes are not indicative of how the company is managed now.[183] Another example—the Bankers Trust litigation—illustrates the flip side.[184] There, a financial giant won a series of legal battles, but the legal victory proved pyrrhic. The process of litigation exposed the pervasiveness of a sucker-punching culture in Bankers Trust, thus greatly damaging the firm's reputation.

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180. *See* Atanasov et al., *supra* note 139 (on venture capital litigation); Wallace N. Davidson III et al., *The Effectiveness of OSHA Penalties: A Stock-Market-Based Test*, 33 INDUS. REL. 283, 292–93 (1994) (on enforcement by the Occupational Safety and Health Administration); Bruce Haslem, *Managerial Opportunism During Corporate Litigation*, 60 J. FIN. 2013 (2005) (on private litigation in the U.S.); John Armour et al., Regulatory Sanctions and Reputational Damage in Financial Markets (Mar. 9, 2015) (unpublished manuscript), http://ssrn.com/abstract=1678028 [https://perma.cc/S4Q9-BJA7] (on enforcement by the United Kingdom's FSA).

181. *See* Paine & Santoro, *supra* note 102, at 19–20.

182. *Id.*

183. *See supra* section II.B.2.

184. *See* MACEY, *supra* note 1, at 71–74.

E. The Information Flow from the Courtroom Gets Distorted

So far we have assumed that stakeholders use information from the legal system to revisit their reputational assessments. But in reality information from the courtroom does not simply find its way to stakeholders intact. Individuals rarely read unfiltered court opinions or regulatory reports. They depend on information intermediaries to process and disseminate the main sound bites for them. Yet intermediaries have their own narrow interests to select what parts to highlight and then add their own take. And the misbehaving companies themselves also distort the information flow. As a result, a lot of information gets lost in translation. Consider two especially notable patterns.

First, different types of intermediaries—such as law firms, business media, or regular newspapers—select different pieces of information to convey to their respective audiences. Take for example the lessons learned from my analysis of the coverage of the *Disney* litigation.[185] Big Law firms tend to send "a memorandum to our clients" following significant cases, and did so with *Disney* as well.[186] When I sampled these memos, I discovered an "all-rules" approach: the law firms focused on what the verdict means for directors facing similar situations in the future in general terms.[187] They largely refrained from relaying the detailed narrative of what and how things happened in Disney. By contrast, the newspaper coverage of the *Disney* decision focused more on the judge's comments and vivid descriptions rather than on the legal doctrines.[188] Even there, different types of media outlets produced markedly different types of coverage. The business media's coverage was more favorable to Disney than the regular media's coverage.[189] Business newspapers were forward-looking: they focused on how the bottom line of the verdict is good for Disney and its current directors going forward, while associating the caustic criticism in the verdict with the retiring CEO.[190] Regular newspapers, by contrast, were more

185. *See* Shapira, *supra* note 90, at 36–37.

186. Rock, *supra* note 141, at 1070; Memorandum from Debevoise & Plimpton LLP, The *Disney* Case, The Bus. Judgment Rule and the Importance of Process (Aug. 12, 2005) (on file with Washington Law Review).

187. *See* Shapira, *supra* note 90, at 36–37.

188. *Id.*

189. *Id.*

190. *Id.*; *see, e.g.*, Christopher Parkes, Eisner's Disney Reign Cut down in Court, FIN. TIMES (Aug. 15, 2005, 5:14 PM), http://www.ft.com/intl/cms/s/1/38d063d2-0cdd-11da-ba02-00000e2511c8.html#axzz3mOoHmg75 [https://perma.cc/G5XR-QBJN].

backward-looking: they focused on the crushing criticism delivered in the verdict, and painted it as bad for everyone involved.[191]

The variation in the coverage of verdicts carries important implications for reputational outcomes. Reputational outcomes vary across the company's different audiences, as each stakeholder group typically taps different intermediaries for information. To illustrate: directors who read just the law firms' memos will have different perceptions of the company than investors who read the *Wall Street Journal* or customers who read the *Huffington Post* online. In the *Disney* case, the reputational outcomes were likely "zero for audiences relying on law firms' coverage; negative for audiences relying on regular newspapers; and mixed (or even positive) for audiences relying on business newspapers."[192] The upshot is that future analyses of the reputational impact of litigation should distinguish between different types of audiences and sources of diffusion of reputation-relevant information.[193]

A second important factor to consider is defendant companies' attempts to produce smokescreens that divert the public's attention away from bad information coming out of the courtroom. To go back to the *Disney* example: the verdict was not the only newsworthy event affecting Disney's reputation at the time. At the exact day that the verdict was released, Disney issued a quarterly report announcing strong earnings growth.[194] The media attention quickly turned away from the verdict and to these positive announcements. Disney's stakeholders ended up reading a commingled story of earning announcement and a verdict, framed by the media as a good day overall for Disney.[195]

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191. *See* Shapira, *supra* note 90, at 36–37; An Seon-Kyoung & Karla K. Gower, *How Do the News Media Frame Crises? A Content Analysis of Crisis News Coverage*, 35 PUB. REL. REV. 107 (2009) (finding that in general business newspapers tend to adopt an "economic" frame when reporting about crises while regular newspapers adopt a "morality" frame).

192. *See* Shapira, *supra* note 90, at 37.

193. In other words, any analysis of reputational impact should ask "reputation to whom"? "For what"? FOMBRUN, *supra* note 102, at 395–96. Companies and businessmen may exit litigation with a stellar reputation among one group of stakeholders but a tarnished reputation among another.

194. *See* Shapira, *supra* note 90, at 37–38.

195. *See* Kate Kelly, *Disney Earnings Jump on Gains from TV Division*, WALL ST. J., Aug. 10, 2005, at A3 ("Disney's upbeat earnings announcement came on the heels of another victory for the company: a Delaware judge's ruling that Disney's directors didn't breach their fiduciary duty . . . ."); Rupert Steiner, *Record Profits Put the Smile Back at Disney*, SUNDAY BUS. (Aug. 18, 2005), http://billingsgazette.com/business/record-profits-put-the-smile-back-at-disney/article_c0ec283c-a07e-5b52-9162-322fa61fc960.html [https://perma.cc/K2JM-JKM2] ("[H]ours after [the] ruling, all eyes from Wall Street were on the media group's stellar third-quarter results.").

Encountering the overlooked smokescreen angle of the Disney story illustrates that reputational sanctions are not a one-sided event. Companies have the incentives and ability (think public relations departments) to hijack unfavorable information flows. When discussing the informational role of the law we should therefore consider what conditions make information flows more (or less) likely to get hijacked by companies. My initial conjecture, following my research of the Disney case, was that "companies control the information flows from verdicts better than they control information flows from continuous discovery or trial processes. Verdicts are one-time, isolated events, so companies can more easily produce a timely smokescreen, issuing an unrelated press release to steer media attention away from the verdict."[196]

At first glance, the observed distortions in information flows cast a doubt on the legal system's ability to impact reputational sanctions. It can be argued that the media will not widely diffuse corrections of market overreactions (because nuanced, contextual explanations do not sell newspapers like vivid, template-like allegations), and that companies' smokescreens will prevent corrections of market under-reaction. However, a deeper look reveals a "multiple layers" dynamic: the distortions in information flows are imperfectly correlated and somewhat balance each other. When the media fails to fully diffuse information that is favorable to companies, the companies themselves have incentives and resources to make sure that stakeholders get the message. To illustrate, recall how Audi purchased full-page ads in major newspapers to increase the public exposure to the exonerating regulatory report.[197] The Exxon Valdez spill serves as another good illustration. Exxon's spokespersons continue to refer to parts of the judicial opinion in the spill-damages litigation that commended Exxon. For example, when an Alaskan politician brought up the Exxon failure in 2004, the company issued a press release quoting the judicial opinion, suggesting that no one can claim that they are the bad guys anymore.[198] And in

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196. Shapira, *supra* note 90, at 38. Several empirical studies have recently fleshed out the different ways in which firms try to control the information flow of bad news to the market: bundling bad news with good news, releasing bad news at times when investor attention is distracted, and so forth. *See generally* Lauren Cohen et al., *Playing Favorites: How Firms Prevent the Revelation of Bad News* 1 (Harv. Bus. Sch., Working Paper No. 14-021, 2014), http://nrs.harvard.edu/urn-3:HUL.InstRepos:11508220. [https://perma.cc/DUB9-Y7WE].

197. HUBER, supra note 58, at 57–74; Farrell, supra note 58, at 55.

198. *See* Press Release, ExxonMobil, ExxonMobil Sets Valdez Record Straight (Oct. 6, 2004), http://ir.exxonmobil.com/phoenix.zhtml?c=115024&p=irol-newsArticle_print&ID=624293&highlight [https://perma.cc/8ZGJ-3NNA].

instances where companies try to prevent unfavorable information flows, sophisticated intermediaries have incentives to expose the company for the "villain" that it is (recall the Odwalla example).

F. Managers Often Fail to Maximize the Reputational Outcomes for Their Companies

So far our discussion has implicitly assumed that corporate insiders try to maximize the firm's reputation. In reality, though, managers may protect their own reputation at the expense of the company's reputation. Agency problems that plague large corporations loom even larger at times of crisis and legal disputes. Decision-makers facing an end-game situation think even more than usual about their own interests instead of the company's interests.[199] For instance, corporate managers may push for early settlements even when litigation can recover damage to the company's reputation.[200] This is because litigation may harm the managers' individual reputation or because litigation may increase the chances that managers will have to pay out of pocket.[201] Future work on the relationship between law and reputation should therefore find a way to incorporate agency considerations.

IV. POLICY IMPLICATIONS

If indeed the legal system produces a positive externality of valuable reputation information, the implications for policy-making can be significant. Granted, reputational sanctions follow fuzzy dynamics and do not lend themselves easily to generalizations. It is therefore hard to provide clear-cut normative solutions or specific design details. Nevertheless, there are at least two general policy implications that we can sketch here—two areas where the reputational perspective offers new ways to look at problems. First, I call for a more cautious approach when advocating for nonintervention. Scaling back legal intervention may have an indirect negative effect on deterrence by raising the costs of

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199. *See generally* Scott D. Graffin et al., *Untangling Executive Reputation and Corporate Reputation: Who Made Who?*, *in* THE OXFORD HANDBOOK OF CORPORATE REPUTATION 221 (Timothy G. Pollock & Michael L. Barnett eds., 2012) (theory); Brocato et al., *supra* note 152, at 36 (evidence).

200. *Cf.* Haslem, *supra* note 180 (finding that legal disputes that culminate in verdicts are better for shareholder value than disputes that culminate in settlements, and that the effect is more pronounced in companies with weaker corporate governance).

201. Under the common insurance policy, managers have incentives to settle without paying out of pocket. STEVE ALBRECHT, CRISIS MANAGEMENT FOR CORPORATE SELF-DEFENSE 180–81 (1996) (insurance considerations sometimes trump corporate reputation considerations).

non-legal sanctions. Second, legal institutions—such as pleading standards—need to be rethought according to how they affect the quantity and quality of information production.

A. *Cautioning Against Reducing Legal Intervention*

The most basic policy implication stems from my motivation in writing this Article: to correct the flawed assumption current in the economic analysis of law that legal and non-legal systems of control are independent of each other. Previous analyses have rested on the assumption that whenever we recognize an area with strong reputational concerns, we can afford to scale back liability law (since the reputational forces will carry the burden of deterrence).[202] But, as this Article shows, scaling back legal intervention may have an indirect negative effect on deterrence by raising the costs of non-legal (reputational) sanctions.[203] Reputational sanctions are costly, and their costs are a function of the shadow of the existing legal regime. Without the background threat of litigation, the market reactions to failures may become more cacophonic and distorted.[204]

A related stream of economic analysis of law and social norms calls not for eliminating litigation altogether, but rather calibrating and deducting legal sanctions so as to internalize the benefits of non-legal sanctions.[205] But even with this more modest proposal, the reality of reputational sanctions calls for a more cautious approach. For example, Cooter and Porat's model nicely incorporates the benefits of non-legal sanctions, but overlooks certain types of costs, such as the costs of market *over*-deterrence. To the extent that we want to calibrate legal sanctions, we need to account for the full array of social costs exacted by reputational sanctions.

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202. *See supra* note 6 (listing examples); Polinsky & Shavell, *supra* note 1.

203. *See generally* Ganuza et al., *supra* note 32 (product liability reduces the costs of reputational sanctions).

204. To be sure, the options for scaling back legal intervention are on a continuum. The choice is not between totally eliminating liability law and doing nothing. A costly litigation regime may be better than a no-liability regime because it facilitates market forces. But perhaps we can think of a less costly legal regime that would correct market forces just as adequately.

205. *See* Cooter & Porat, *supra* note 37, at 413–14.

B. Rethinking Key Civil Procedure Doctrines

The reputational impact of litigation depends not just on the legal outcomes, but also—indeed, more so—on the process itself.[206] If we want to increase the quantity and quality of information production, we need to focus not on liability rules but rather on procedural doctrines such as pleading standards or plaintiffs' rights to demand inside information in discovery. This Part reconsiders the desirability of key civil procedure doctrines from the reputational perspective, evaluating how they affect information production.[207]

1. Settlement vs. Trial

By emphasizing the informational role of litigation, this Article flushes out one previously overlooked advantage of full trials: facilitating better reputational deterrence. Full trials produce more high-quality, publicly available information than disputes that settle early or are resolved in less public ways. The efficacy of dispute resolution channels depends not just on the costs and benefits to the parties to a specific dispute, but also on the costs and benefits to society at large. Indeed, previous accounts of the settlement versus trial debate have mentioned several public goods of trials, such as setting clear legal precedents and notifying other potential victims of their legal rights.[208] But trials also supply a different type of public good—not a "legal" but a "reputational" one: trials make it easier for outside observers to evaluate the quality of companies and businesspeople. Settlements are bound to under-produce reputation-relevant information. When parties to legal

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206. *See supra* Part III.

207. There are several broader points here. When we think of the design of legal institutions, we usually have in mind goals such as compensation and (direct) deterrence. It is possible, however, that for a subset of cases, the previously overlooked benefits from facilitating non-legal deterrence outweigh the traditional benefits. This will necessitate rethinking basic institutions. For example, in big cases where the pre-trial information is extremely noisy and the stakes are high, we would want the legal system to produce an assessment with a shorter time lag. Furthermore, while this section focuses on changes to court procedures, there is also the intuitive possibility of changing *substantive* law to enhance the accuracy of reputational sanctions. Most of our discussion has revolved around the possibility that liability law corrects reputation as a byproduct, but there are more direct ways to produce reputation information. For example, a social planner who worries about reputational over-deterrence can reform defamation law to make it a more effective tool for companies to recover reputational harm. Alternatively, the planner could come up with a more tailored procedure that would allow attacked companies to initiate a fact-finding investigation into the merits of the attack on them. Delving into the endless moving parts of such suggestions is beyond the scope of this Article, however.

208. *See* Shavell, *supra* note 37, at 606–07.

disputes decide whether to settle, they do not internalize all the benefits from the informational value of full trials and verdicts. The benefits of better information on corporate behavior accrue to all market participants, while the costs of full trials fall mostly on the litigants. Even worse, litigants may sometimes even try to limit the information production. We can envision a scenario in which the defendant company pushes for a settlement precisely because it wants to prevent unfavorable information from getting out. At the same time, plaintiffs may not care whether the relevant information gets out to third parties, as long as they are getting money.[209]

To clarify, I do not present here a categorical argument against (or for) settlements. There are many other considerations in play, and my point is only to spotlight a previously overlooked factor. More concretely, recognizing the informational role of trials could help us think about what type of settlement *procedures* we want. For example, certain types of settlements must be approved by judges—most notably for our purposes, class and derivative actions.[210] When judges assess whether to approve these settlements, they supposedly already incur the costs of gathering information about the dispute.[211] This puts judges in a position to provide valuable information to the market. One concrete policy implication, then, concerns the *duty of reasoning*: we should encourage more detailed reasoning in judicial approvals of settlements, so that more relevant information will be accessible to market players.[212]

2. Openness of Proceedings

Directly related to our last point on accessibility of information is the debate on secrecy versus openness of proceedings. Legal scholars arguing in favor of open court proceedings usually emphasize how openness makes legal sanctions more accurate, such as by facilitating better checks on legal arbiters and inducing more victims to come

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209. *Id.* at 605.

210. *See* FED. R. CIV. P. 23(e).

211. *See* Law, *supra* note 126, at 745–46.

212. Of course, there is a trade-off here, with many other considerations. For example, gathering information in a preliminary stage with no adversarial conflict may be costly. The judge's assessment of how the company behaved may thus be worthless. *Compare* Jonathan R. Macey & Geoffrey P. Miller, *Judicial Review of Class Action Settlements*, J. LEGAL ANALYSIS 167, 182 (2009), *with* BARBARA J. ROTHSTEIN & THOMAS E. WILLGING, MANAGING CLASS ACTION LITIGATION 10–15 (2d ed. 2009).

forward and claim their rights.[213] But openness could also make *non*-legal sanctions more accurate, such as by drawing attention to unnoticed misconduct or helping market players get better information on noticed misconduct. All else being equal, the informational value of the law represents another previously overlooked argument against confidential litigation.

3. *Pleading Standards*

The recent Supreme Court decisions in *Twombly* and *Iqbal* sparked one of the most practical and heated debates in the legal world today: heightened versus liberal pleading standards.[214] The debate revolves around arguments such as conserving judicial resources, protecting defendants from frivolous lawsuits, and allowing access to justice.[215] This Article suggests one more important factor to consider: heightened pleading standards affect information production negatively, thus indirectly hurting reputational deterrence. To understand why, recall our discussion about how the earlier stages in the process often produce most of the reputation-relevant information.[216] In large-scale disputes—where the misconduct is already revealed prior to litigation—the legal system's comparative advantage (that is, the chance that litigation will teach market players something they do not already know) comes from discovery. Heightened pleading standards reduce the chances that these cases will reach discovery, thus reducing the chances that new light will be shed on the misconduct.[217]

Here, again, a modification and clarification are in order. In most cases the reputational considerations are irrelevant (outside observers do not monitor them), and so my argument for liberal pleading standards does not apply. Nor do I suggest that screening frivolous lawsuits is unimportant. All I am suggesting is to include an overlooked factor in the cost-benefit analysis, namely, the benefit of producing information

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213. *See* Laurie Kratky Doré, *Public Courts Versus Private Justice: It's Time to Let Some Sun Shine in on Alternative Dispute Resolution*, 81 CHI.-KENT. L. REV. 463, 469 (2006).

214. *See* Bell Atl. Corp. v. Twombly, 550 U.S. 544 (2007); Ashcroft v. Iqbal, 556 U.S. 662 (2009); Jonah B. Gelbach, *Locking the Doors to Discovery? Assessing the Effects of* Twombly *and* Iqbal *on Access to Discovery*, 121 YALE L.J. 2270, 2274 (2011).

215. *See, e.g.*, Daphna Kapeliuk & Alon Klement, *Contracting Around* Twombly, 60 DEPAUL L. REV. 1, 1 (2010).

216. *See supra* section III.C.

217. The argument here applies to broader issues with multistage adjudication. *See generally* Louis Kaplow, *Multistage Adjudication*, 126 HARV. L. REV. 1179 (2012). The decision *when* to invest resources in formal (legal) adjudication generates indirect consequences on informal (reputational) adjudication.

that helps market players assess companies (a positive externality of sorts). Concretely, a potential solution is to tailor different pleading standards based on the dispute's impact on third parties. On paper, we can identify a subset of cases—say well-publicized cases with large companies—where it is best to screen suits at a later stage (not at the motion to dismiss but rather at the summary judgment stage).

4. *Language for Condemning Wrongdoing*

The legal system's ability to produce valuable information to third parties depends also on the language that judges use. In order for the information to affect third-parties' beliefs, it has to be not just available and accurate, but also accessible and comprehensible.[218] Adherence to rigid doctrines and technical language will hurt the potential to correct reputation. In areas where the demand for reputation-correcting is great, we should therefore consider calibrating the legal language in a manner that is more relevant to market players. Think for example of moving from "liable"/"not liable" dichotomy to a "liability disproved"/ "liability unproved"/ "liability proved" system.[219]

5. *A Caveat on Selection Effects*

Any proposal to tweak legal institutions so as to induce more information production should come with a caveat: generating more information in given cases (ex post) may change future defendants' incentives to select into litigation to begin with (ex ante). A social planner who will increase the openness of proceedings, liberalize pleading standards, and demand more detailed judicial reasoning in settlement approvals may raise the costs of litigation to companies (due to an increased risk of reputational fallout). Defendant companies may then change their behavior accordingly, opting out of public dispute resolutions. In other words, straight policy implications are problematic in this area. We need to find the elusive balance between more accuracy in given disputes and selection effects in future disputes.[220]

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218. *See* Law, *supra* note 74, at 749.

219. *See* Cooter & Porat, *supra* note 37, at 420 n.22.

220. *Cf.* Scott A. Baker & Anup Malani, *Does Accuracy Improve the Information Value of Trials?* 1–4 (Nat'l Bureau of Econ. Res., Working Paper No. 17036, 2011), http://www.nber.org/papers/w17036 [https://perma.cc/5443-PBB3].

V. SYNTHESIS: APPLICATIONS AND THEIR RELATION TO THE EXTANT LITERATURE

The best way to synthesize and clarify this Article's original contributions is to juxtapose it with the extant related literature. While most legal scholars still ignore the interactions between legal and non-legal systems, several notable scholars have started recognizing the role of reputational forces across various legal fields. In this Part, I revisit specific applications of reputation theory to defamation law, international law, and product liability.[221] I then explain how my second-opinion theory adds to the extant law and social norms literature more generally.

A. Applications of Reputation Theory to Specific Legal Fields

More and more legal scholars recognize the importance of reputational concerns, yet stop short of developing a nuanced account of how exactly reputation works.[222] The second-opinion theory developed here can offer a fresh perspective on notable existing accounts.

1. Defamation Law

When talking about interactions between law and reputation, most legal scholars think about the role of defamation law. On paper, the scenario is straightforward: an interested source spreads false allegations against a company in an attempt to harm its reputation. The company then files a lawsuit against the rumor propagator for defamation. By winning a defamation lawsuit the company supposedly vindicates its reputation.[223] And the threat to punish attackers supposedly deters future attackers ex ante. In theory, then, defamation law fulfills a similar and more direct role than the second-opinion channel emphasized here, by reducing the noise in reputational sanctions.

For pragmatic and doctrinal reasons, however, the channel of defamation law has become very ineffective in affecting reputation.[224]

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221. The area where reputation theory is relied upon most heavily is corporate and securities law. I devote a separate article to this subject. Shapira, *supra* note 90.

222. *See, e.g.*, Rachel Brewster, *Unpacking the State's Reputation*, 50 HARV. INT'L L.J. 231, 267 (2009).

223. *See* Robert N. Bellah, *The Meaning of Reputation in American Society*, 74 CAL. L. REV. 743, 744 (1986).

224. *See* Ardia, *supra* note 67, at 304, 315; *see, e.g.*, JENNY RAYNER, MANAGING REPUTATIONAL RISK 137 (2003); Shannon M. Heim, *The Role of Extra-Judicial Bodies in Vindicating Reputational Harm*, 15 COMMLAW CONSPECTUS 401, 410–12 (2006).

Sometimes the company cannot win a defamation lawsuit even when the accusation against it is inaccurate. Inaccurate reputational sanctions are not always the result of some attacker deliberately selling the public fabrications and blatantly false rumors. In many cases, inaccuracies stem from well-meaning journalists and watchdogs painting an incomplete picture—a category that is rarely punished by defamation law.[225] At other times, even if the company stands a good chance of winning a lawsuit, it chooses not to litigate because such a proactive litigious strategy will only backfire in the court of public opinion.[226] To recast the Audi illustration: Audi managers chose not to sue *60 Minutes* for airing fabricated visualizations because they feared the bad publicity that would be generated from mounting such a lawsuit.[227] The inadequacy of current defamation law to correct reputational sanctions therefore makes the second-opinion channel increasingly relevant.

2. *International Law*[228]

International law scholars invoke the notion of states' reputation to explain the puzzle of compliance. For example, according to Andrew Guzman, states obey international legal obligations in order to establish reputation as worthy partners to agreements.[229] Armed with the insights from this Article we can retool the existing reputational theory of international law. The existing theory is often read as suggesting that in the international relations context, reputation facilitates law: strong reputational concerns encourage compliance with legal obligations.[230] But this Article suggests an alternative, upside-down reading: in the international arena law facilitates reputation. The law allows better signaling of states' reputation through two channels: clarifying standards and providing second opinions.

First, legal requirements serve in the international arena as well-known, standardized benchmarks for states' proper behavior. In other words, international law gives third parties a rough proxy against which

225. *See* DEZENHALL, *supra* note 63, at 192.

226. *See infra* Appendix A: List of Interviews, Interview with Charles Bakaly, Head of the Litig. Comm. Dep't, Edelman (Aug. 21, 2012); Interview with Bill Ide, Partner, McKenna Long & Aldridge (Apr. 2, 2014).

227. *See* DEZENHALL & WEBER, *supra* note 57, at 30.

228. I thank Professors Gabi Blum, Oren Gross, and Billy Magnuson for insightful discussions about international law.

229. GUZMAN, *supra* note 1, at 33. Even among those criticizing Guzman's theory, there is a consensus that reputation does matter to some extent. Brewster, *supra* note 222, at 236, 244–49.

230. GUZMAN, *supra* note 1, at 33.

they can assess which countries are good types that can be trusted. Second, international tribunals that adjudicate disputes among states produce lagged third-party assessments on how the states behaved,that is, whether a treaty was really breached and what the circumstances were leading to the alleged breach. Other states that are not part of the dispute could then use the information coming from the international tribunal to update their beliefs about the disputants' discount rates more accurately. Acknowledging this second-opinion effect of international law explains an unsolved puzzle in the existing theory, namely, how outside observers know whether a breach of legal obligation is indicative of the breaching state's future behavior.

Note, however, that international law facilitates better reputational sanctioning only for a small subset of disputes. In many areas of international law, such as compliance with human rights treaties, there are no well-functioning tribunals that adjudicate disputes,[231] so the second-opinion effect is nonexistent. In other areas, such as use of force, the legal standard is very fuzzy and open to interpretation to begin with, and so the clarifying-standards effect is irrelevant.[232] In areas like international trade, by contrast, law enforcement is carried out by relatively respectable tribunals such as the World Trade Organization. In such areas, reputational sanctions are more effective, all else being equal.

3. Product Liability

We already discussed one prominent theory that ties reputation to product liability law: Polinsky and Shavell's proposal to reconsider product liability.[233] The key question in Polinsky and Shavell's theory is how to identify the conditions that make reputational sanctions effective for a given product market. Their solution was to focus on one criterion: how widely sold the product is.[234] Manufacturers of widely sold products, the theory goes, know that the market monitors their behavior and are therefore disciplined even without the threat of legal liability.[235] But the commonness of a product is a good proxy only if you want to

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231. *See generally* Oona A. Hathaway, *Do Human Rights Treaties Make a Difference?*, 111 YALE L.J. 1935 (2001) (decrying the lack of effective international human rights adjudication).

232. See Tarcisio Gazzini, *The Changing Rules on the Use of Force in International Law*, 106 n.226, 119, 217 (2005).

233. Polinsky & Shavell, *supra* note 1.

234. *Id.* at 1472–73.

235. *Id.*

measure the quantity of information disseminated, not the *quality* of information. As the examples of Tylenol, Audi, and Odwalla illustrate, with widely sold products the widely diffused information may actually be distorted. The amount of information disseminated is a necessary but not a sufficient condition for effective reputational sanctions. Other conditions that must also be taken into account are the complexity of the matter (how observable is the link between effort and quality), and the surrounding institutional environment (such as the information generated by the legal system).

More specifically, the analysis so far points to the need to take a harder look at the role of regulatory investigations. When Polinsky and Shavell examine the role of product liability law in promoting product safety, they focus on deterrence by ex post product liability litigation or deterrence by ex ante regulatory minimum thresholds.[236] But in regulated product markets, the legal system also contributes to deterrence by facilitating good reputation-information flows. Regulators frequently investigate product failures ex post and release a public report. It is no coincidence, then, that Polinsky and Shavell listed pharmaceuticals and general aviation crafts as two specific product markets where reputational control works effectively and can shoulder most of the deterrence without resorting to liability litigation.[237] Aside from widely sold products, these two markets have one thing in common: quick and thorough regulatory investigations into product failures.[238] To illustrate, recall the airplane crashes example: the market almost always attributes the failure to the right cause, partly because the Federal Aviation Administration releases credible and thorough reports quickly. The lesson for policy implications is that before we consider scaling back liability litigation, we need to make sure that there is an alternative information-producing institution that provides valuable second opinions to the market (such as regulatory investigations).

B. Relation to the Extant Law and Social Norms Literature

This Article adds to our understanding of the interactions between legal and non-legal systems along four basic dimensions. First, the Article shows that *non-legal systems are costly too (just less transparently costly)*. Legal scholars are usually aware of, and can

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236. *Id.* at 1450–54.

237. *Id.* at 1474–76.

238. *See infra* Appendix A: List of Interviews, Telephone Interview with Peter Grossi, Drug-Liability Litigator (Dec. 12, 2012).

relatively easily quantify, the costs of legal systems. But the costs of non-legal systems are less transparent to us, and we tend to underplay them.[239] This is especially true with respect to reputational systems, where the legal literature suffers from an "indefensible optimism about the actual operation of information markets."[240] To be sure, plenty of legal scholars have written about problems with reputational sanctions (usually in the context of making the case for legal intervention).[241] But the existing analyses do not elaborate on the full set of social costs that accompany reputational sanctions. Specifically, scholars focus almost solely on detection costs, suggesting that market players rarely learn about corporate failures in real time. But in reality another set of costs—enforcement costs—also looms large. Even when market players become aware of a certain failure, they may under- or over-react.[242]

Second, the Article fleshes out how *the costs of non-legal systems are affected by the legal system*. The Article's most basic contribution is to challenge the conventional economic analyses of law and social norms, which treat behavior as either law-complying or norm-following.[243] The Article spotlights the existing interdependencies between legal and non-legal systems of control, thus illustrating the need to rethink the conventional approach and its policy implications. If we scale back the background threat of litigation or regulatory investigations, we risk increasing the costs of reputational sanctions. The issue of complementarities between legal and non-legal systems should therefore move from the periphery to the center of the law and social norms literature.

Third, the Article emphasizes a *belief-shaping role of the law, instead of a preference-shaping role*.[244] Among the scholars who acknowledge that legal and non-legal systems interact, there is a tendency to focus more on interactions between law and morals, rather than between law and reputation. Under the prevalent approach—sometimes dubbed the

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239. *See* John C.P. Goldberg & Benjamin C. Zipursky, *The Easy Case for Products Liability Law: A Response to Professors Polinsky and Shavell*, 123 HARV. L. REV. 1919, 1929–30 (2010).

240. *See* Cass R. Sunstein, *"She Said What?" "He Did That?" Believing False Rumors* 22 (Harv. Law Sch., Working Paper No. 08–56, 2008), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1304268 [https://perma.cc/ZR5G-U6CP].

241. *See supra* note 63.

242. The terminology here—and elsewhere in the Article—follows Clark's typology. Clark, *supra* note 12.

243. *See* Talley, *supra* note 5.

244. The line between belief- and preference-shaping is murky, however, as is evident from our discussion on how non-informative components in verdicts affect stakeholders' beliefs through framing and salience. *See* DellaVigna & Gentzkow, *supra* note 38, at 656.

"expressive function" of the law—the law affects morals by pronouncing the right way to behave, thus facilitating social shaming or guilty feelings for those who misbehave.[245] I agree with the premise that the law affects behavior not just by what it does (sanctions) but also by what it says. But I argue that the law does not tell us just what the norms are or ought to be, but also whether given norms were violated in specific instances. To be sure, my emphasis on an informational role for the law does not exclude the possibility of a finger-wagging role for the law. The relative strength of each role depends on the context. I conjecture that my theory is more relevant in environments with diffused and atomistic participants and super-strong economic incentives (think publicly traded companies), where it makes sense to highlight reputational rather than moral sanctions.[246]

Finally, this Article is closely related to recent papers that stress the informational role of the law and its effects on reputation.[247] My approach can be distinguished from these accounts by the answers to two key questions: what gap in market knowledge is the legal system filling, and how is it filling it? First, other recent accounts usually assume that market players are not aware of corporate misconduct, and therefore conclude that the role of the legal system is to draw attention to previously unnoticed corporate shenanigans.[248] My account, by contrast, assumes (based on recent empirical evidence)[249] that in failures of publicly traded companies, market players often learn about and react to misconduct before the legal system gets involved. The role of the legal system in such cases is to provide second opinions on how things happened—reducing the *enforcement costs* rather than the detection costs of reputation systems. Second, other recent accounts tend to focus on the informational role of legal *outcomes*; that is, the signal that legal sanctions send to outside observers.[250] I, by contrast, focus on information disseminated in the *process* of determining legal outcomes

245. *See, e.g.*, Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1269–71 (1999).

246. *See also* Iacobucci, *supra* note 5 (noting same).

247. *See, e.g.*, *id.*; Baker & Choi, *supra* note 5.

248. *See also* MACEY, *supra* note 1, at 12; *cf.* Fairfax, *supra* note 69, at 443.

249. *See* Karpoff et al., *supra* note 73.

250. *See* Baker & Choi, *supra* note 5 (firms can opt to submit themselves to formal sanctions and thus facilitate better informal control); Iacobucci, *supra* note 5 (the size of legal sanctions affects the reputational signaling equilibrium by affecting firms' initial decisions whether to commit wrongs or not).

(again, following recent empirical evidence showing very little correlation between legal and reputational sanctions).[251]

CONCLUSION

The Article's main original contribution is not to tell us that reputation matters or that the law matters for reputation.[252] The main contribution comes rather from exploring *how* the law matters for reputation. Specifically, the Article narrows two key gaps in the conventional approach: showing that reputational sanctions are costly, too (just less transparently costly), and explaining how the legal system affects the costs of reputational sanctions.[253] Recognizing the informational role that the law plays in facilitating reputational sanctions carries important policy implications—both on a general level (cautioning against nonintervention) and on a more specific level (rethinking key civil procedure doctrines).

The broader recurring theme throughout this Article is the focus on *diffusion of information*. Commercial law scholars tend to rely on classical economics and agency theory, and this focus has steered them away from grappling with informational issues: market players are assumed either to have information or not to have it. This Article shifts our focus to questions such as how information is diffused (contrary to popular belief, information does not fall on individuals like manna from the sky), what is the role of information intermediaries, and what types of messages are perceived as being more credible than others.

Specifically, the Article spotlights the important and under-theorized role of the media: the magnitude of reputational sanctions is largely dictated by the frequency and tenor in which mass media cover the failure in question. Evidence suggests that similar acts of corporate misconduct (or corporate niceness) receive different amounts of attention from the media.[254] Importantly, the media's role is not limited

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251. In other words, I use the notion of "shadow of the law" differently: instead of denoting how market players consider the backstop of expected legal outcomes they can obtain in the courtroom, I use it to denote the backstop of what information will be revealed should the parties' behavior be evaluated in the courtroom.

252. We already know that. *See* Karpoff, *supra* note 2 (providing an overview of the extant empirical literature on the reputational outcomes of enforcement events).

253. Note that the Article's contributions stand alone. For example, even if you are not convinced by my arguments about how the law affects reputation (*see supra* Part II), you may still find my analysis of how reputational sanctions work useful (*see supra* Part I) because such an account is currently missing in the extant literature.

254. *See supra* notes 41–42.

to monitoring and shining light on issues that would otherwise be less salient to outsiders. The media also serve a more direct role in influencing reputation, by providing interpretations and judgments on known behaviors (think about the typical editorial following a highly publicized scandal).[255]

It is important to acknowledge that the contributions here represent only the first steps toward understanding the vast topic of interactions between law and reputation. Considerations of brevity and scope have left important angles for future work, such as engaging in more quantitative empirical work to test the hypotheses developed here, elaborating on the hypotheses' normative implications, and broadening the scope of analysis to incorporate other legal fields and systems. Still, the larger conceptual purpose of this Article remains to draw attention to the interactions between legal and reputation systems, and to highlight the need to design legal institutions with an eye to their reputation-affecting role. Hopefully the Article represents the beginning of a more robust inquiry into the under-studied field of law and reputation.

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255. *See* Michael K. Bednar, *Watchdog or Lapdog? A Behavioral View of the Media as a Corporate Governance Mechanism*, 55 ACAD. MGMT. J. 131, 131–33 (2012).

APPENDIX: LIST OF INTERVIEWS

In order to capture the fuzzy dynamics of law and reputation, I conducted in-depth open conversational interviews with practitioners who work on the intersection between the courtroom and the court of public opinion. In this type of interview the researcher introduces a topic in broad strokes, the interviewee talks freely about the interviewee's experience and insights into the topic, and the researcher further probes specific experiences with follow-up questions.[256] The iterative process of picking practitioners' brains about holes in existing theories and then going back to the drawing board generated some interesting insights. For example, almost every interviewee kept bringing up the same theme: the information flow from the courtroom to the court of public opinion is badly distorted. In other words, they made me rethink my initial theory: even if the legal system does manage to produce accurate reputation information internally, as I claimed, such information does not necessarily reach stakeholders and affect their beliefs. This insight redirected my attention, and I began searching for patterns of distortions in information flows using other methodologies, such as comparing the content of different media outlets.

This appendix lists only the most helpful and influential interviews in each group of practitioners: communication and reputation experts, legal experts, and journalists.

Interviews with communication/reputation experts:

E-mail Interview with Eric Dezenhall, President, Dezenhall Res. (July 2012);

Telephone Interview with Charles Bakaly, Head of the Litig. Commc'n Dep't, Edelman (Aug. 21, 2012);

Telephone Interview with Jeff Segal, Founder, MedicalJustice (Nov. 27, 2012);

Interview with Michael Fertik, Founder, Reputation.com (Feb. 11, 2013); and

Telephone Interview with Rupert Younger, Founder, Oxford Univ. Ctr. for Corp. Reputation (May 7, 2014).

256. *See* THE SAGE ENCYCLOPEDIA OF QUALITATIVE RESEARCH METHODS, *supra* note 10, at 127.

Interviews with legal experts:

Interview with Richard Clary, Former Head of Litig., Cravath, Swaine & Moore, in Cambridge, Mass. (Nov. 16, 2012);

Telephone Interview with Peter Grossi, Drug-Liability Litigator (Dec. 12, 2012);

Telephone Interview with Bruce Carton, Former Senior Counsel, SEC Enforcement Dep't (May 21, 2013);

Telephone Interview with a Representative of Courtroom Connect (June 13, 2013);

Telephone Interview with Bill Ide, Partner, McKenna Long & Aldridge (Apr. 2, 2014); and

Telephone Interview with Harvey Pitt, Former Chairman, SEC (May 28, 2014).

Interviews with media experts:

Interview with Guy Rolnik, Founding Editor, TheMarker, in Cambridge, Mass. (Nov. 15, 2013);

Telephone Interview with Kim Masters, Entm't Journalist (June 14, 2013);

Telephone Interview with Kim Christensen, Journalist, L.A. TIMES (Jan. 17, 2014);

Telephone Interview with Corie Brown, Journalist, NEWSWEEK (Jan. 20, 2014); and

Telephone Interview with Richard Verrier, Journalist, L.A. TIMES (Jan. 23, 2014).