Trust and Its Formal Substitutes in Economic Life

by

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I. ABSTRACT

In this paper, I explore the concept of trust and its ability to facilitate economic transactions. As such, I begin with an understanding of trust and the psychological and economic satisfaction that it provides. I further delve into characteristics of trust such as the costs and limitations of a trusting state both in regards to individuals and society as whole. Given that trust is both a useful yet fragile state, this paper I present the idea that the legal system functions as a substitute to trust by creating weak form trust and allowing for an increasing level of contractual relationships to be formed, even amongst strangers. By establishing a sense of weak form trust, trust that is formed due to reliance upon legal institutions or social practices, we see an overall emergence of economic efficiency and a potential expansion of overall wealth. I then conclude with an analysis of the evolution of business structures – contracts, relational contracts, joint ventures and corporations – as responses to contractual difficulties faced by non-trusting contracting parties by showing how the law instills a sense of trust through the use of doctrines such as the implied covenant of good faith and fair dealings evident in relational contracts and the enforcement of fiduciary duties between corporate officers and shareholders.

II. INTRODUCTION

> *"Trust is central to all transactions and yet economists rarely discuss the notion. For trust to be developed between individuals they must have repeated encounters, and they must have some memory of previous experiences. Moreover, for honesty to have potency as a concept there must be some cost involved in honest behavior. And finally, trust is linked with reputation, and reputation has to be acquired."*[1]

The relationship between trust and economics is one of great importance. Although trust is an elusive ideal whereas economics presents a concrete study of social science the former nonetheless, has the ability to facilitate the latter. Not only can it be said that a contractual relationship based on trust is economically efficient but trust in itself is efficient. It allows two contractual partners to partake in economic exchange whereby increasing overall benefits not only to the individual partnership but to that of the overall society. However, what happens when trust either never existed or no longer exists between contractual partners? Do we see an overall decrease in net gains to society or are there other constructs, whether societal or psychological, that help to substitute for the lack of trust? This very question is the fundamental basis of this paper which analyzes trust and its formal substitutes in economic life.

In searching for formal substitutes to trust, we turn to the legal system. For centuries now, the Anglo-American legal system has provided safeguards and constraints to guide the relationships between contractual partners. As the complexity of business corporations evolves, as individuals demand more legal rights, and as technological innovations surface, the law tries to shape itself to meet such evolving needs. Thus, the court systems set new precedents to align regulatory objectives with those of the changing society. As a result, the natural development of society is complemented by the continuous amending of the legal system. Naturally, individuals

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[1] Williamson, Oliver E. "Calculativeness, Trust and Economic Organization." *Chicago Journals* 2nd ser. 36.1 (1993): 453-86. *JSTOR*. Web. 1 Apr. 2010. <http://www.jstor.org/stable/725485>.

and various business structures have developed a sense of trust and reliance in regards to the legal system. However, to what does one owe such trust? More specifically, how does the legal system instill trust? The parallel between trust, a psychological condition, and the legal system, a body of laws and regulations, is important to understanding how the law encourages productive economic activity.

The motivation behind this study rests in the desire to understand trust and its formal substitutes in economic life. More specifically, to understand why it is that human beings trust the legal system and how such a psychological condition affects the business world. In doing so, I explore the relationship between trust, economic transactions and various legal entities that help to instill trust within society. I first begin the study with an understanding of trust and present a classification system for different categories of trust. I then use these definitions to analyze the uses, limitations and costs of trust from both a psychological and an economic standpoint. Trust has the ability to influence not only personal relations but those of contractual partners as well. Therefore, from an economic perspective, I attempt to assess the role that trust plays in stimulating economic transactions and facilitating exchange as a whole. A critical observation that I make is that a lack of personal trust between contractual partners has the ability to hinder economic transaction, particularly between strangers. As such, I propose the idea that the legal system has the ability to compensate for the lack of personal trust by creating weak form trust. In conclusion, I analyze various legal entities to demonstrate how it is that the law is able to instill trust between contractual partners. It is through the analysis of these entities that I demonstrate the relationship between law and trust and how contractual partners rely on the law to protect their interests.

Section I of this paper defines trust and its uses from a psychological standpoint. It hen offers a classification system which is useful for categorizing different types of trust. Section II presents the effects of trust on economic transactions and how the presence of trust facilitates such exchange by addressing trust and its economic benefits. Section III analyzes the limitations of a trusting state both for individuals and contractual partners. Section IV addresses the legal system and its role in economic affairs. It analyzes the evolution of business forms – contracts, relational contracts, joint ventures and corporations – and assesses how each of these legal entities helps to instill trust and facilitate economic transactions. Finally, Section IV presents a conclusion about the overall relationship between the legal system and its ability to instill trust.

II. TRUST AND ITS USES

A. WHAT DO WE MEAN BY TRUST

Trust is an abstract concept. Although predominantly viewed as a social construct which is limited to personal relationships, trust plays an essential role in economic exchange. As such, trust can be defined as a psychological state in which one is willing to expose personal interest to the risk of default, on the belief that there is an insignificant chance that the other will act opportunistically. Thus, one party decides to give power of himself or his property, to another, without resorting to costly and extreme measures of risk reduction. Although past scholarships argued that the concept of trust strictly belongs under the academia of sociology or psychology, more and more integration of trust into all disciplines of study has been evidenced. Scholars are now realizing that economic transactions and relations of all kinds – between individuals or corporate entities - are inevitably intertwined with trust.

B. CLASSIFICATION OF TRUST

Given that the concept of trust is an immeasurable and unobservable psychological state, it is often hard to quantify the amount of trust that exists in a relationship. Although we may be able to state that we have more trust for one person than another, it is often difficult to judge the extent to which we can deem a partner as trustworthy. However, for analytical purposes, it may be helpful to build a classification system that although not perfect in all cases, will be useful to categorize different kinds of trust.

Strong Form Trust

For our purposes, I will define strong form trust as relatively unconditional or pure trust. Strong form trust is the degree of trust which is generated based on knowledge of another either through repeated experiences which have created a great degree of credibility or trust based on interactions with those to whom we have a strong shared emotional attachment (e.g. family members, close friends or lovers). As such, we use the values and norms which have sustained previous relations to guide those which we wish to create in the future. Not only does strong form trust help to solidify personal relations between two parties but is also helps to bring about contractual relations since in both cases partners have a tendency to gravitate towards those whom they trust.

The existence of strong form trust can be a source of great satisfaction and therefore provides many benefits. The utility which is derived from personal trust is two-fold: human and economic. Human satisfaction arises from the ability to confide in another and to rely on his/her good intentions – ultimately, the deepest source of human satisfaction. Thus, the close ties that we form with our core circle of friends and relatives are dependent upon the existence of trust. Without such trust, relations with those who are close to us start to lose personal value. In terms of economic utility, strong form trust allows two or more people to become contractual partners and enter into joint endeavors without the need to implement any legal constraints to guide the partnership. Strong form trust exists when the trustee has the ability to breach his agreement yet refrains from doing so based on values and standards that have been formed from past relations. Thus, not only does trust increase economic productivity but it allows for cost efficient exchange – a benefit both to the individual contracting partners and society as a whole since it permits investment in production.

Semi-Strong Trust and Weak Form Trust

Once legal parameters are employed to limit the risk between two partners, the categories of trust can be further bifurcated into two concepts: semi-strong form trust and weak-form trust. Semi-strong trust arises when legal structures are implemented that govern relations between two parties. Both parties, however, are cautious of the other in fear that the legal constraints will be inadequate and permit a breach whereby a level of uncertainty in one or the other party's future conduct still remains. [2]

On the other hand, we have weak form trust, or what can also be referred to as formal trust. Weak form trust can be defined as trust that is formed due to reliance upon legal institutions or social practices such as codes of ethics, to establish a framework in which contractual partners can rely on one another. Weak form trust is a constructed condition and "exposes the relying party to very little risk because of legal or other constraints on the [counterparty's] conduct."[3] Although we may not know our contracting partner, the support of a legal system and binding laws, creates a level of trust which allows us to interact <u>as if</u> we trust one another. As such, it can be said that weak form trust provides an objective utility. The end goal is not the formation of trust on an emotionally and personally gratifying level rather that of economic and financial security. It is the confidence in a set of laws or regulations that allows for the exchange of goods, whether financial or intellectual, to occur. Thus, we begin to see the legal system as a partially effective substitute to strong form trust. In the absence of trust between contractual partners and a need or desire for economic exchange to occur, there is an automatic reliance on the legal system as a source of protection.

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[2] Ribstein, Larry E., Law v. Trust (October 23, 2000). George Mason Law & Economics Research Paper No. 00-38. Available at SSRN: http://ssrn.com/abstract=247224 or doi:10.2139/ssrn.247224

[3] Ibid

C. PSYCHOLOGICAL BENEFITS OF THE TRUSTING STATE

Trust as a Concept of Self-Maximization

The trusting state provides rewards in two categories: human and economic. Although these two utilities, in and of themselves are different, it can be said that psychological utilities, similar to those of economic utilities, can help to achieve self maximization. The development of trust creates a natural "backbone" or system of support upon which one can rely. Therefore, personal trust has the ability to increase the overall psychological and emotional utility of human beings. Some theorists and economists argue that trust exists outside of economics because it does not conform to the principal of rational self maximization.[4] Contra to such a belief, maximization can be achieved not only economically but emotionally and psychologically. The economist Gary Becker describes such a relationship by assuming "that individuals maximize welfare as they conceive it, whether they be selfish, altruistic, loyal, spiteful or masochistic."[5] As such, it can very well be said that trust may increase our utility as well. Self-maximization need not be based on economic wealth or possession of goods. Rather, knowing that we have trustworthy relationships with people whom we can rely on increases one's utility on an emotional level. As such, strong form trust can be seen as a long run utility which may lend itself to economic opportunities between parties that have developed long term personal trust.

Trust and Societal Culture

Trust plays a critical role in stimulating interaction amongst members of society. Many

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[4] Ribstein, Larry E., Law v. Trust (October 23, 2000). George Mason Law & Economics Research Paper No. 00-38. Available at SSRN: http://ssrn.com/abstract=247224 or doi:10.2139/ssrn.247224

[5] Becker, Gary S. *Accounting for Tastes*. Cambridge, Mass.: Harvard UP, 1996. 138-40. Print.

trust theorists "assert that trust in the sense of willingness to be vulnerable to another improves social welfare by reducing friction in society."[6] However, more so than simply reducing friction in society, trust has the ability to form strong relations based on societal culture, more specifically, commonalities evident in respective communities. Thus, as a result of strong form trust, we see the emergence of "trust networks." Various social forces, such as ethnic groups, vouching systems, religious groups or even similar ideologies, help to provide a sense of trust amongst members that share similar views. Thus, we see that members are more prone to trusting others, whom they may not necessarily personally know, due to a certain degree of commonality. We are inclined to believe that people who belong to similar social groups share the same values and mentalities and we are therefore more likely to have an immediate sense of trust for them than for those with whom we cannot relate.

Not only do social commonalities provide human satisfaction, they have the ability to create economic efficiencies. Given that a strong sense of trust is built into these "trust networks," members are able to transact with one another without incurring costly transaction constraints. Oliver Williamson describes the effect of societal culture upon trust in the following manner: "the main import of culture, for purposes of economic organization, is that it serves as a check on opportunism."[7] It is only in a trusting relationship that human beings can rely on their partners to not act opportunistically.

A heavy reliance on strong social networks can be found predominantly in nations with corrupt governments and consequently, weak governance structures. The inability to place

[6] Ribstein, Larry E., Law v. Trust (October 23, 2000). George Mason Law & Economics Research Paper No. 00-38. Available at SSRN: http://ssrn.com/abstract=247224 or doi:10.2139/ssrn.247224

[7] Williamson, Oliver E. "Calculativeness, Trust and Economic Organization." *Chicago Journals* 2nd ser. 36.1 (1993): 453-86. *JSTOR*. Web. 1 Apr. 2010. <http://www.jstor.org/stable/725485>.

confidence in the formal legal system causes the formation of trust networks in which people of similar social groups form contractual relations on the basis of personal trust. In many societies, the reliance on commonalities has allowed for the prosperity of many businesses. For example, in countries such as Italy and those of Latin America, governments are constantly scrutinized for their tendencies to take part in corrupt practices. As such, we see that the competitive landscape in both regions is primarily dominated by small-, medium- and even large-sized family businesses which in many cases have existed for centuries.[8] In Italy, we see the survival of vineyards and wineries that were first formed hundreds of years ago. For example, the Frescobaldi family business has been in existence since the middle ages and can be attributed to social capital – "a set of beliefs and values that facilitate cooperation among the members of a community."[9] It is the internal trust built due to the relations between family members, which to this day remains a central key in the company's management, that has allowed the company to thrive throughout the past few centuries. Though many of these families function under a system of internal hierarchy, it is essentially the trust amongst family members and close friends that have allowed these companies to last for so long – a testimony to the strength of strong form trust. As such, lack of trust in the overall corporate system enhances trust amongst small networks of individuals.

Establishment of Credibility and Predictability in Partners

In any personal relationship, trust helps to establish the credibility and predictability of a counterparty. Having had previous relations and developed a sense of personal trust, parties are

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[8] Corbetta, G. "Patterns of Development of Family Businesses in Italy." *Family Business Review* (1995). *Fbr.sagepub.com*. Web. 30 Apr. 2010.

[9] Guiso, Luigi, Sapienza, Paola and Zingales, Luigi , Social Capital as Good Culture (December 1, 2007). Available at SSRN: http://ssrn.com/abstract=1077672

more likely to be confident in each other's intentions. Thus, the desire to transact with another is often based on credibility. We derive credibility from material fact, direct evidence of another's actions. Thus, credibility is established out of specific instances where individuals have proven capable of dealing with similar situations with which they are presented. Rather than reputation, which can at times be distorted by false perceptions of an entity or a human, credibility serves as a key factor in facilitating transaction. Furthermore, when two parties have confidence that their partner will act within certain confines and without opportunistic motives, his or her actions become increasingly predictable. Being able to more or less gauge future outcomes provides contractual partners with a sense of control and confidence and increases their desire to participate in future transactions.

III. TRUST AND ITS ECONOMIC USES

An economic transaction is often thought of as a mere act of exchange. One party contracts with another to allow for the transfer of goods, money, or intellectual property in the hopes of reaping financial gains. Thus, the end goal in any economic transaction is monetary reward, or at least a positive gain in some respect. However, although it is not always realized at first, intuitively, parties of an exchange seek more reassurance than a simple contract or binding agreement. Rather, a key condition must be met before any exchange occurs and that is trust – the fundamental building block of relationships. In well functioning legal systems like the United States, strangers can and do contract with one another due to the understanding that the legal system protects both parties from the opportunistic actions of their counterparties. In countries where contractual parties cannot rely on the legal system, there is a dependency on strong social forms to provide for trustworthy relations.

By default, any actions that are subject to human involvement, in one way or another, are shaped by one's ability to trust in his/her counterparty. Whether these relations are formed based on personal knowledge of the contracting partner or derivative trust, a reliance on legal constraints, is not of material importance at the moment. The critical point is that in one way or another, trust plays an immense role in shaping our relations. A simple example can be demonstrated by assessing the relationship between private wealth managers and their clients. The function of a private wealth manager is to invest and manage the assets of his clients. Naturally, an economic exchange occurs. The private wealth manager grows the client's money and is then paid a certain percentage based on the increase in the value of assets. Prior to the occurrence of such an exchange, the private wealth manager must not only prove himself as a skillful and valuable worker, but as a reliable human being. Especially when dealing with the financial well being of others, it is of the utmost importance for a sense of confidence in and reliance of the manager to exist. These needs are satisfied by the presence of trust. Only in circumstances where one believes the good intentions of another, will he/she take the risk of becoming somewhat vulnerable to the actions of another. Thus, it is only because the client trusts the private wealth manager that he "opens his wallet" so to speak, and has faith in the manager to safeguard his assets.

D. ECONOMIC BENEFITS OF TRUST

An economic transaction, governed by a sense of strong form trust, ensures the welfare of contractual partners. Thus, parties engage in economic transactions when the exchange can be defined as an "act of trust associated with an expectation that the act will pay off in terms of the investor's goal"[10] or at least will not place either party in a worse condition than before the transaction. In essence, when we trust in an economic transaction, we rely on the relationship to bring about gains – the probability of a positive outcome should outweigh that of any negative outcomes. Thus, trust has the remarkable ability to facilitate economic transactions.

Decreases in Transaction Costs

The existence of trust in a contractual relationship has the ability to decrease transaction costs – "the decision to rely relates to what is generally referred to as "trustworthiness," or the likelihood that the person relied on will honor his promise…Trustworthiness, like trust, has the welfare-increasing attribute of reducing transaction costs."[11] The economic efficiency of such transactions can be accredited to the fact that neither party seeks an outside source to protect himself from the opportunistic actions of his counterparty. As such, there is no need for legal constraints or any other structures that function as "surveillance systems." Such an idea can be illustrated by taking into consideration the sale of an asset. For example, let's assume that Party A wishes to sell his house to party B. In the case where both parties have developed a sense of strong form or simply personal trust, the use of legal constraints is unnecessary. Rather, the two

[10] Fehr, Ernst, On the Economics and Biology of Trust. IZA Discussion Paper No. 3895. Available at SSRN: http://ssrn.com/abstract=1318854

[11] Ribstein, Larry E., Law v. Trust (October 23, 2000). George Mason Law & Economics Research Paper No. 00-38. Available at SSRN: http://ssrn.com/abstract=247224 or doi:10.2139/ssrn.247224

parties are able to transact with one another based on the moral values that they uphold. In the case that party A and party B lack a mutual sense of trust for one another, the sale of the house becomes more costly and more complicated. The assistance of an intermediary is necessary to help facilitate the transaction and ensure that neither party breaches his/her obligations. Therefore, not only does the transaction create additional costs but it requires ample amount of time to bring the desired transaction to fruition. As such, not only are costs decreased in the monetary sense, in a trusting relationship, but fewer resources are needed when trust exists. Thus, trust decreases the risk in the economic transaction and allows for more investment to occur.

Trust as a Solution to the Hold-Up Problem

More important than simply reducing the cost of transactions, trust provides a solution to the hold-up problem in contracting. The hold-up problem is a leading paradigm in the field of economics[12] and can be described as a condition in which contracts contemplate sequenced performance in which the first performer, after his performance, is at risk of the second party demanding a renegotiation. Thus, the first party, having already performed his obligations, is at a disadvantage. The absence of trust, which is often the normal state in economic interaction, may be said to trigger the fear of a contracting partner due to the possibility of being held up in the future. Because of this potential of a hold up occurring – which we discuss in greater depth in connection with our discussion of the evolution of the corporate form – this contract may not be entered into at all. As a result, society suffers a net loss opportunity. We see that in spot market transactions, where exchange often occurs quickly and immediately, the need for a trusting

[12] Hoppe, Eva I. and Schmitz, Patrick W., Can Contracts Solve the Hold-Up Problem? Experimental Evidence (February 1, 2009). Available at SSRN: http://ssrn.com/abstract=1351777

relationship is not needed. However, when we discuss issues regarding future performance, trust or legal restraints are critical to the interests of both parties. Thus, strong form trust has the ability to decrease the fear of future hold up. When contractual partners have personal knowledge of one another and can rely on each other's intentions, they expect certain values and norms to guide their relationships. Thus, where trust exists certain kinds of useful contracts are more likely to occur.

Mitigation of Agency Problems

The concept of trust provides owners with the ability to be confident in the fact that their workers will not act opportunistically. From an organizational perspective, it can be said that trust has the power to mitigate agency problems. Agency theory deals with "how the actions of one actor "the agent" affects the interest of another "the principal" with whom he/she is tied to by contract or otherwise.[13] The agent is someone who is employed by the principal and acts on the behalf of the principal and the property which he/she owns. Given that there is often a misalignment between the goals of the principal and that of the agent, such a relationship may give rise to specific transaction costs which call for constraints on behalf of the agent. However, the presence of personal trust alleviates transaction costs needed to mitigate agency problems. Studies show that "economic activities that require some agents to rely on the future actions of others are accomplished at lower cost in higher-trust environments." [14] Mutual trust between agent and principal cause the principal to be confident in the intentions of the agent's actions and

[13] Allen, Kraakman, and Subramanian, *Commentaries and Cases on the Law of Business Organization*, pg. 306

[14] Goergen, Marc, Corporate Stakeholders and Trust (July 2008). ECGI - Finance Working Paper No. 213/2008. Available at SSRN: http://ssrn.com/abstract=1156102

thus the principal spends minimal time in protecting him/herself. The need for legal constraints is diminished as are costs.

III. THE LIMITATIONS OF A TRUSTING STATE

Default Risk

A significant cost of a trusting relationship occurs when a partner, engaging in a bilateral alliance, breaks his/her trust due to obligations to a third party or self interest. Without formal structures to govern the boundaries of obligations owed to each partnership, trust alone cannot provide economic efficiencies. Thus, we see that trust is a fragile psychological condition. Although it is easy to break, it is hard to build. Once a breach of trust has occurred, it is not likely that contractual partners will be able to trust in the same way again.

In the case of personal trust, partners are limited to past experiences and personal feelings when assessing the trustworthiness of their counterparties. Although initial alliances may be formed based upon prior knowledge of those with whom one interacts with, the future prosperity of such an alliance is not guaranteed. Trust on its own does not provide any boundaries or ascertain concrete outcomes in the future. As such, trust in a partner based on inner feelings has the power to overshadow the need for mechanisms that govern business transactions. Therefore, a partner who engages in transactions with another, purely based on personal trust, exposes him/herself to a significant level of risk. Diego Gambetta presents an interesting relationship between trust and risk. He states that “social scientists have begun to describe situations of trust as a ‘subclass of those involving risk.’ They are situations in which the risk one takes depends on the performance of another actor…Indeed, the decision to accept such a risk is taken to imply trust."[15] As such, the nature of trust being fragile is directly correlated with the notion that trust is risky. Although trust can be a solid foundation for a contractual relationship, our tendency to rely on trust presents a risk in and of itself.

Non-Scalability of Trust

Although one could categorize trust into different types such as strong form trust or weak form trust, there is no concrete system for measuring trust. Given the deeply embedded nature of trust, such a condition is not scalable. For example, two partners who through long years of association come to trust each other deeply and derive benefit from that trust cannot admit new partners and double both their circle of trust. More correctly, they cannot do so without encountering potential risk from the new partners. Thus, even in a world of high trust, we cannot expand relationships or businesses indefinitely, based on trust. Trust too has its limitations. As our relationships or businesses grow and more people become involved, social trust becomes thinner. A strong degree of strong form trust is often reserved for a core circle of people whom we have known for a long time and have had repeated experiences with. However, once more and more people begin to join our "circle" of trust, our trust starts to thin as we trust those with whom we have greater degrees of separation, less.

Thus, it can be said that the circle of trust for any individual is limited at some point. As those bestowed with trust move out from a core of family and close relations, to members of a small community or other basis for solidarity (e.g. religion or ethnicity) the degree of trust that a rational person will bestow will be reduced. We call trust in these reduced circumstances weak form trust.

[15] Williamson, Oliver E. "Calculativeness, Trust and Economic Organization." *Chicago Journals* 2nd ser. 36.1 (1993): 453-86. *JSTOR*. Web. 1 Apr. 2010. <http://www.jstor.org/stable/725485>.

Monetary Limitations in Maintaining Weak Form Trust

In relations governed by strong form trust, the cost and benefits of such relations are the same. Given that the relationship involves a reciprocation of trust, the benefit and cost to each partner is trust. Weak form trust, on the other hand, since it entails a greater, though not perceived as too great a risk of default, begins to require a rationalistic analysis. Even though the existence of weak form trust has the ability to limit search costs, information costs, and expected risk of default, maintaining long lasting relations under the constraints of the law can at often times be financially demanding. In such instances, monetary constraints limit the amount of relationships that can be extended and consequently, the number of contractual partnerships that are formed in any circle of trust.

Predisposition to Trusting

The level to which one is predisposed to trusting others is often a critical limitation of trust. Past experiences whether from one's childhood or simply past experiences with certain individuals or entities has the ability to affect the ease with which one is able to trust. Although some humans are more likely to trust others and allow trust to serve as an eliminator of risk, other people require outside constraints to ensure a certain degree of security. Having experienced many incidents in which breaches of agreements have occurred often causes people to inherently seek to protect themselves by limiting those whom they trust.

Furthermore, a substantial limitation of trust is the deference that it creates in respect to economic institutions. Particularly in moments of economic prosperity, individuals as well as legal entities tend to trust in the market. Due to repeated success, individuals often forget the possibility of failure and tend to expect the players who control much of what occurs in the market to perform accordingly. As such, it is almost as if our trust is to blame for overshadowing our ability to fairly judge certain situations. Thus, deference is created as a derivative of trust. We tend to become preoccupied with positive results and our trust in the market to the point at which we are unable to fairly assess situations. Therefore, as trust becomes natural and we forget to question whether or not the outcomes of a particular trusting relationship are feasible, we tend to lose base with reality. Such a phenomenon can in many ways be related to the financial crisis of 2007 and 2008. Years of economic growth and financial prosperity had instilled a level of trust that individuals held with respect to financial institutions, powerful individuals and the overall market itself. As incredible wealth poured into the system, many people forgot to question the factors which caused such growth and whether or not it was even sustainable. Therefore, our trust in the overall system made us blind to reality and impaired our judgment in assessing the problems that were being created.

IV. THE ROLE OF THE LEGAL SYSTEM IN ECONOMIC AFFAIRS

While there is an explicit relationship between the legal system and the economy, the most fundamental features of the legal system in economic life are the following:

1.) Creating and protecting property rights

2.) Defining what constitutes enforceable promises (contracts) and

3.) Providing enforcement mechanisms to enforce contracts.

Thus, we will further focus on the evolution of corporate entities starting with a focus on contracts and its evolutionary progeny, joint ventures and the corporate form. Through such an analysis, it will be made evident that the law allows for the formation of partnerships not only amongst acquaintances but strangers who act as if they trust one another, due to the existence of weak form trust. Furthermore, the analysis will focus on doctrines that are not clearly written commands mandated by statutory law, but are vague and almost "moral in character." These doctrines, known as the implied covenant of good faith and fair dealing and fiduciary duties demonstrate how the law reverts to them in an attempt to instill standards that a trusting person would expect his trusted other to follow.

ANALYSIS OF THE EVOLUTION OF CORPORATE STRUCTURES AND THEIR RELATION TO WEAK FORM TRUST

A. CONTRACTS

A contract is a legal device which works to enforce agreements between two parties. An agreement can also be defined as a promise. Thus, when a person makes a promise, he invites another party to trust him or her and when that promise is broken, or an agreement is breached, mistrust occurs. Autonomy theories "thus justify contractual obligation on the grounds that enforcement enhances the freedom of the promisor and respects the trust of the promise."[16] Thus, the role of a law contract is to "protect the ability of individuals to trust agreements in circumstances in which that trust is socially beneficial."[17] As such, contract law serves the purpose of facilitating trust amongst partners as it builds grounds for confidence in that another

[16] Bellia Jr., Anthony J., Promises, Trust, and Contract Law. American Journal of Jurisprudence, Vol. 47, 2002. Available at SSRN: http://ssrn.com/abstract=910204

[17] Ibid

will not breach his/her commitment. If by law, the actions of an engaging party are enforceable, then the counterparty may trust that it will be performed.

Contracts bring about a sense of confidence in the promise of others. It is this confidence that allows individuals to seek out the resources of others and engage in alliances that allow for further collaboration. However, if confidence in a counterparty is insufficient, risk may hinder coordination. As such, legal enforcement of contracts helps to create confidence which then helps to encourage economic transactions. Consequently, contracts help to facilitate cooperation and to encourage reliance. They help to establish a sense of reassurance that is built outside the confines of personal relations. As such, when contracting parties have not had any preexisting trust or experience with one another, contracts function as legal substitutes and bring forth reassurance to the relationship. Dori Kimel sets forth an interesting argument. He argues that the intrinsic value of a contract "lies in its propensity to promote the value of 'personal detachment': the value of being able to do certain things without having to commit to a personal relationship with others in order to do them."[18] Thus, we directly see the acknowledgement of a legal entity acting as a substitute to trust. By reverting to contracts as mechanisms to safeguard contractual relations, both parties need not form personal relations. Thus, it is clear that the ability of the legal system to substitute for personal trust, allows for an increasing level of contractual relations between strangers.

The Limitations of Classical Contracts

Counterarguments exist in which the enforceability of contracts is said to "crowd out" the development of personal trust amongst contracting parties. In analyzing ex post relationships

[18] Bellia Jr., Anthony J., Promises, Trust, and Contract Law. American Journal of Jurisprudence, Vol. 47, 2002. Available at SSRN: http://ssrn.com/abstract=910204

between governance and trust, “the use of complex governance mechanisms can crowd out trust in the sense that the level of trust in the relationship can be eroded when the partners rely on complex governance.”[19] Although certain theories postulate that partners who have developed a strong sense of conditional trust, may seem offended by the use of legal constraints, such a condition is not common. Instead, one can often find trusting relationships that employ legal constraints as a matter of habit. The use of contracts is a common day practice that even the closest of friends and relatives resort to.

Furthermore, it must be noted that contracts are not a guarantee that an engaging party will perform his/her duties. Although contracts serve as a source of confidence, if they are breached, the law does not automatically mandate the breaching party to perform his duties – a limitation of the power of contracts. Rather, it is at the expense of the breached party to use other forms of law, such as suits and litigation, to have the state coerce a remedy. [20] Moreover, what is critical to note is the inevitable imperfection of contracts as substitutes to trust due to the imperfection of the legal system. Although the law provides a framework in which decisions are to be made and actions are to be restrained, the law does not always provide finite answers. Thus, not every contract will govern the same rights, produce the same results or even be similarly upheld in a court of law.

Given the nature of classical contracts, the trust which such legal entities create is at an arm’s length away. Whether an executed contract, in which people turn to the market place to sell fungible goods or executory contracts, written documents contracted for future performance, neither entity seeks to create personal trust. Although the creation of weak form trust occurs, in

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[19] Vanneste, Bart S., and Phanish Puranam. "Trust and Governance: Untangling A Tangled Web." *Academy of Management Review* 34.1 (2009): 11-31. *Business Source Premier*. EBSCO. Web. December 15, 2009.

[20] Bellia Jr., Anthony J., Promises, Trust, and Contract Law. American Journal of Jurisprudence, Vol. 47, 2002.

comparison to other legal entities that will be discussed in this paper, classical contracts create the least amount of strong form trust.

B. RELATIONAL CONTRACTS

Relational contracts are governance structures that are formed based on strong form trust. Contracting partners thereby rely on the knowledge and experience that they have of one another to supplant their need for other legal constraints to govern the relationship. The explicit terms of such a relationship lay out a mere foundation for the alliance whereas the implicit terms, established based on knowledge of the counterparty, serve as the fundamental basis.

By definition, contracts that outline ongoing relations or "discrete transactions in ongoing relations" mandate the need for personal trust. A contracting partner, whose business relies on long term alliances, is vulnerable to the defamation of his/her reputation. Thus, reputation and the concern for one's reputation drive the basis of the relationship and to a large extent limit breaches. In the end, obligations are self-enforced. Given that parties are at the mercy of their counterparties, for a long period of time, each needs to act with merit. It can therefore be said that relational contracts depend on repeated interactions between members and a set of values and norms that govern the relationship.

Implied Covenant of Good Faith and Fair Dealing in Relational Contracts

An underlying principle of relational contracts is the implied covenant of good faith and fair dealing. Similar to the notion of fiduciary duties, such a covenant also functions as an informal sort of law. The covenant guides the manner by which partners are to act with respect to each other. Therefore, it assumes that "people will act in good faith and deal fairly without breaking their word, using shifty means to avoid obligations or denying that the other party obviously understood."[21] The definition of good faith and fair dealings is a vast topic open to interpretation. Even so, these concepts bring about a sense of reliance which is bestowed upon a contractual partner. Although relational contracts are formed on the basis of strong form trust, the implied covenant helps to further guide the relationship. Not only do contractual partners have faith in one another based on preexisting trust, but they are able to rely on an "informal" law which further ascertains fair dealings.

Limitations of Relational Contracts

In comparison to the previously discussed section on contracts, it is evident that relational contracts provide a greater sense of ex ante trust than do traditional spot market contracts. Relational contracts are not only enacted based on preexisting strong form trust, they are further supported by implied covenants that help to guide the relationship. These contracts act as an extension of spot market contracts and as such allow for a stronger sense of reliance and trust in contractual partners. Even so, a key distinction must be made. Unlike classical spot market contracts, relational contracts are executory contracts that have the intention of establishing long term relations. Due to the proposed longevity of the relationship, the future stream of expected profits and the present value of this relationship present a lucrative opportunity. As such, it can be stated that the "value of the future relationship must be sufficiently large that neither party wishes to renege."[22] However, if the contract contemplates sequenced performance in which case one partner performs his/her obligations first, there is an incentive, on the part of the

[21] "Implied Covenant of Good Faith and Fair Dealing." *Law.com Law Dictionary*. Web. 20 Apr. 2010. <http://dictionary.law.com/Default.aspx?selected=906>.

[22] Baker, George P., Gibbons, Robert S. and Murphy, Kevin J., Relational Contracts and the Theory of the Firm (December 29, 1997).

counterparty to exploit his/her partner. In this case, the issue becomes relationship value versus extra payoff. Although it is assumed by both partners, especially at the initiation of the contract, that their knowledge of one another will prevent any mal conduct, certain incentives in such long term relationships may act in opposition to such a belief. Unlike relational contracts, classical contracts do not embody a long term outlook. As such, the chances of a breach or the value of a breach is minimal.

C. JOINT VENTURES

Joint ventures play a significant role in both the national and international business landscape. The evolution of corporate structures from classical contracts to relational contracts to joint ventures increases the amount of security to which each contracting partner is subject. As we evolve from relational contracts to joint ventures we see that joint ventures are different in that they have highly negotiated governance provisions which safeguard the interests of both parties. The emergence of joint ventures often has to deal with the desire of contractual parties to take advantage of a specific opportunity quickly. As such, each party has a special property or resource that is needed to produce or market a product. Let us first analyze the joint venture and then proceed to analyze the institution as it plays out in terms of our conceptual trust map.

A joint venture is an association between two or more contractual partners in which resources and expertise are combined to form a single business enterprise. The separate entity provides both partners with ownership rights and an ability to benefit from each other's competitive advantages. Joint ventures are undertaken for many reasons: risk sharing, particularly in capital intensive industries, funding constraints, market access, economies of scale and etc.[23] In return, joint venture partners are able to decrease costs per investor and diversify risk in terms of the cost of failure. In the end, such an alliance creates the following: joint proprietary interests, joint right to control and sharing of P&L.[24]

Joint ventures, as a legal institution, are structures that support weak form trust. Although personal knowledge of the contracting party would be beneficial to the alliance, it is not a necessity. Rather, the formation of such an entity is primarily based on the need for resources. Thus, the overall structure is governed by contractual agreements that contemplate long term relations.

The trust in a joint venture, more precisely the weak form trust, stems from joint proprietary interests and highly specified governance structures. Unlike contracts which promise future performance or pay, joint ventures not only mandate monetary payments for breaches but also call for enforceable governance rights that can be specifically enforced. By requiring both parties to provide resources at the onset of the relationship, both parties are bound by their individual investments. These resources need not be strictly financial. For example, certain ventures are formed due to the need for market accessibility. If firm A wishes to enter a particular market in which firm B has established brand equity, then firm A may want to leverage firm B's brand name by forming a joint venture. As such, firm A may agree to exchange technological "know hows" or other tangible resources in order to be associated with B's brand name. Given the interdependency of the two and the great amount of initial investment, the risk of both parties although not eradicated is mitigated. Neither party wishes to lose his/her investment thus there exists a greater incentive for both parties to act in good faith.

[23] Vaughan, Janel. "What Is a Joint Venture?" *The University of Iowa Center for International Finance and Development*. Web. 21 Apr. 2010. <http://www.uiowa.edu/ifdebook/faq/faq_docs/Venture.shtml>.

[24] Ibid

Unlike a classical or relational contract, both parties of a joint venture are less vulnerable to the actions of their counterparties. In a relational contract, one party can easily breach his/her agreement especially if he/she have not invested any resources into the future relationship. Furthermore, the potential for a hold up problem to occur is quite possible. Joint ventures, on the other hand, in a sense, are relationships that are a bit more real. They create a lock in effect by which more is at stake for each party and due to high means of governance, are less likely to act opportunistically.

Joint Ventures as a Solution to the Hold-Up Problem

The notion of hold up problems in contractual relationships was researched in depth by Oliver Williamson. In his Economic Institutions of Capitalism, Williamson discusses the problem of asset specificity which arises when transactions are to be made based on specific or very unique assets which are subject to lock in effects. The more tailored the asset, the more specific is its use and the higher the chances are that one of the parties will end up bearing the load. Since few buyers or sellers exist to provide or purchase such products, a hold up problem exists. A "hold up problem arises when one party makes a sunk relationship – specific investment and then engages in bargaining with an economic trading partner."[25] In such a case, two parties contract with one another. However, due to minimal governance restraints, one party may easily demand renegotiation whereby the other is left at an unfair disadvantage and inability to contract with many others. Fortunately, the joint ownership aspect of a joint venture and the assurance of specific governance structures help to alleviate such a problem. Williamson himself

[25] Hermalin, Benjamin E., and Michael L. Katz. "Information and the Hold-Up Problem." *RAND Journal of Economics* 40.3 (2009): 405-23. *Business Source Premier*. Web. <http://search.ebscohost.com/login.aspx?direct=true&db=buh&AN=43304062&site=ehost-live>.

states that “transactions are supported by investments in durable, transaction-specific assets experience ‘lock in’ effects, on which account autonomous trading will commonly be supplanted by unified ownership.” [26]

As such, the basis of the relationship stems from the existence of strong weak form trust. Particularly in organizational structures in which interdependence is vitally important, trust becomes all the more essential. We initially defined trust as the confidence in another that he or she will not act opportunistically in regards to a counterparty’s vulnerabilities. In the case of joint ventures, both parties are equally vulnerable to one another because both have invested resources and are further dependent upon the resources of his/her contractual partner. Whether one partner stands to lose more than another is a subjective issue. Therefore, for our purposes, we will assume a 50/50 venture in which both partners are equal owners. As such, both partners trust in their venture because they are governed by specific agreed upon regulations. In the example in which a buyer provides a product to a seller who at the last minute decides to renege on the agreement, it is mostly the seller who is disadvantaged. A joint venture, however, mediates the risk so that each partner is equally affected. Furthermore, the duties that are laid out in a venture’s creation “might reduce the costs involved in a venturer’s decision to trust the other as compared with relying solely on specific contract terms because such duties prevent venturers from opportunistically taking advantage of their contractual rights.”[27] Thus, not only are partners safeguarded during the life of the venture, they are protected even in the case that a counterparty acts opportunistically. All of these specific governance measures help to instill confidence and

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[26] Williamson, Oliver E. "Chapter 2." *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting*. New York: Free, 1985. 53. Print.

[27] Ribstein, Larry E., Law v. Trust (October 23, 2000). George Mason Law & Economics Research Paper No. 00-38. Available at SSRN: http://ssrn.com/abstract=247224 or doi:10.2139/ssrn.247224. Law v. Trust

most of all, trust in the venture, which only helps to facilitate further economic transactions. The law and its specific governance system substitute the need for personal trust and instead create weak form trust upon which contracting partners can rely.

D. CORPORATIONS

The corporate form is a staple trademark of today's business world. It creates a platform not only for global expansion but it paves the way for capital-intensive enterprises which have been in existence since the 19th century.[28] Essentially, the corporation is a superior structure for capitalizing large firms. It allows investors from all corners of the world to partake in similar investments and thus helps to facilitate contractual partnerships. As millions of dollars constantly flow in and out of corporations, a significant portion of which can be attributed to investors, especially shareholders, it is important to understand what key factors provide investors with the confidence to do so. To what does the corporate form owe its ability to capitalize and obtain the trust of thousands of individuals? In order to answer such a question we must firm analyze the corporate form as a legal structure and then assess how such a structure builds trust.

Economic Efficiencies of the Corporation

The legal entity of a corporation provides an economically efficient medium through which firms may interact. Given that legal boundaries, such as mandatory rules are in place to protect the rights of shareholders and directors, the risk of contracting with a corporation is significantly limited. Additionally, the firm overall gives off the impression of being investor friendly in that the principles of the firm "need not execute [transactions] or even agree to [them], the

[28] Allen, Kraakman, and Subramanian, *Commentaries and Cases on the Law of Business Organization*, pg. 306

information and coordination costs of closing the transaction are minimal."[29] Given the efficiencies that exist when transacting with corporations, these entities exist as capital gathering institutions.

Rights of Individual Participants in a Corporation

A corporation functions on the basis of contracts between its participants. There are three critical participant groups in a corporation: management, investors/shareholders and the board of directors. Each category contributes its own area of expertise to the overall organization. The board of directors serves as an advisory board which selects management and handles important issues such as consolidations, mergers, sales of most assets, and etc.[30] Management is then responsible for the skills which are used to run the daily operations of the organization. Managers can also be referred to as officers – agents of the corporation that have the ability to act on its behalf.[31] Investors or shareholders are parties that contribute financial resources in exchange for voting rights, the right to dividends as if and when declared, the ability to sue in the case of a breach of trust and the right to sell shares at any time. Although shareholders hope to economically benefit on increases in stock prices and can easily transfer shares, investors themselves have no legal right to returns nor do they have the right to dividends. Why then, might we ask, do shareholders invest money in these large corporations if they obtain no legal rights to returns? Such an answer, as in previous cases, reverts to the concept of weak form trust.

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[29] Allen, Kraakman, and Subramanian, *Commentaries and Cases on the Law of Business Organization*, pg. 85.

[30] Bagley, Constance E., and Diane W. Savage. *Managers and the Legal Environment: Strategies for the 21st Century*. Mason, Ohio: Thomson/West, 2006. Print.

[31] Ibid.

Weak form trust is what makes the modern corporation work. Members of a corporation cannot rely on personal or strong form trust because it is a constantly evolving entity in which many people change places too frequently. Thus, corporations are based on binding yet vague laws which help to alleviate opportunistic actions by either contractual party. These laws are known as fiduciary duties which govern the rights of all members (inside and outside members) of a corporation.

Fiduciary Duties

Fiduciary duties which govern most actions undertaken in a corporation are of extreme importance in creating weak form trust. A fiduciary duty is a legal or ethical relationship between a principal and a fiduciary. The fiduciary has what is called a "fiduciary duty" – an obligation to act fairly and with best interest in regards to his/her partner. To ascertain what exactly is meant by "fair" is quite difficult and thus fiduciary duties are not concrete laws which are straight forward. Rather, they must be interpreted by a court of law based on the context of the relationship. Although such governance can be described as an informal sort of law, it is key to note that fiduciary duties are owed in addition to legal duties that the law imposes.

Bifurcation of Fiduciary Duties

Fiduciary duties are bifurcated primarily into two key concepts: the duty of care and the duty of loyalty. Consequently, managers and board of directors have the responsibility of upholding the duty of care and loyalty when concerning the corporation as a whole as well as its shareholders. The duty of loyalty, in reference to a corporation, mandates that both agents and principals of the firm act in good faith and in the firm's best interest and no other purpose. In terms of the responsibilities that corporate officers have in terms of the duty of loyalty, they have a duty to disclose truthful and relevant information to its shareholders. The duty of care is "the duty of an officer to exercise the care of an ordinarily prudent person in the same or similar circumstances."[32] Essentially, officers must not act negligently and should adhere to a standard of care which prevents any foreseeable harm.

Given that any potential relationship between contractual partners presents a certain level of risk, which is an impediment to success, fiduciary duties help to alleviate opportunistic actions by either contractual party. As a result, "to the extent, that in circumstances that the parties cannot foresee presently, and thus cannot provide for, contracting individuals can trust the legal system to 'do the right thing' (or require the counterparty to do so) those parties will be more willing to enter into useful contracts that require trust."[33] The ability to be able to rely on the law to do the right thing and to mandate that our contractual partners do the same helps to instill a sense of trust. Although by no means personal, given that most relationships between members of a corporation are informal, weak form trust is key in securing one's confidence in investing in a corporation. Fiduciary duties limit the vulnerabilities that partners' would otherwise have to deal with had the courts and judges not devised a concept by which contractual partners are to act in a caring and prudent fashion. Essentially, such laws help to compensate for the large and impersonal aspects of the U.S. capital markets and act as a trust substitute in allowing millions of people to invest money in these large legal entities.

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[32] Allen. The Corporate Directors Fiduciary Duty of Care and the Business Judgment Rule in U.S. Corporation Law. Page 13

[33] Allen. The Corporate Directors Fiduciary Duty of Care and the Business Judgment Rule in U.S. Corporation Law. Page 2

V. CONCLUSION

Personal trust is not constant. Rather, it has a time component. Although it may exist today, tomorrow it may not. Thus, although trust presents a useful social construct it is both fragile and powerless. From the perspective of a modern economy, the ability of trust to provide a deep human satisfaction on a personal level, cannot supplant for the psychological and economic limitations that it presents. As such, a modern economy can only be effectively organized based on weak form trust.

Thus, the legal system, as a substitute to strong form trust, protects contractual partners from the fluctuations or absence of personal trust. In doing so, the ability of the legal system to allow even complete strangers to act as if they trust one another, is essential to the growth of a modern economy. It is the relationship between trust and the legal system that encourages productive economic activity.

Interestingly enough, the evolution of law of organization forms shows that the legal system resorts to enforcing vague legal doctrines - the implied covenant of good faith and fair dealing in relational contracts and fiduciary duties in corporations – as a mechanism to instilling weak form trust and achieving economic efficiency. Thus, these informal laws which form under the umbrella of weak form trust, have the ability to safeguard the interests of contractual partners. As such, it can be stated that the creation of weak form trust is the key factor that will drive economic efficiency.

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