THE NOTION OF TRUST AS A COMPREHENSIVE THEORY OF CONTRACT AND CORPORATE LAW: A NEW APPROACH TO THE CONCEPTION THAT THE CORPORATION IS A NEXUS OF CONTRACT

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I. INTRODUCTION

Trust is the notion underlying the fulfillment of promises and expectations in contract law. Enforcing the promises implicit in a contract[1] and protecting the expectation interest of a promise[2] reflect this

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1. *See* RESTATEMENT (SECOND) OF CONTRACTS § 1 (1981) ("Contract Defined – A contract is a promise or a set of promises for the breach of which the law gives a remedy . . . ."); *see also* CHARLES FRIED, CONTRACT AS PROMISE: A THEORY OF CONTRACTUAL OBLIGATION (Harvard Univ. Press 1981).

2. *See* RESTATEMENT (SECOND) OF CONTRACTS § 344 (1981)

> Purposes of Remedies—Judicial remedies under the rules stated in this Restatement serve to protect one or more of the following interests of a promisee: (a) his "expectation interest," which is his interest in having the benefit of his bargain by being put in as good a position as he would have been in had the contract been performed, (b) his "reliance interest," which is his interest in being reimbursed for loss caused by reliance on the contract by being put in as good a position as he would have been in had the contract not been made, or (c) his

understanding.[3] The expectation created in the wake of a promise implicit in the contract, which is usually the highest expression of trust, is thus the quintessential feature protected by contract law. Moreover, the voluntary relationships established during the negotiations preceding the contract, and at the time of its signing and implementation, constitute the most prevalent form of social and economic engagement, raising expectations and inviting mutual trust. Every contract can thus be considered a microcosm that, in its broadest sense, both reinforces and draws on the "social contract." Protecting the value of trust in the context of contract law conveys the core attitude of the law to the idea of trust itself. Creating a bridge between contract as a legal concept and trust as a social concept, while both aim to reach the same universal goal of cooperation, risk-taking and fulfillment of reasonable expectations, is the theme of this article. This pragmatic insight, including its wider implications, can be applied to corporate organizations to view them as a nexus of contracts. Could this insight function as the long-sought missing link in the chain of descriptive and

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"restitution interest," which is his interest in having restored to him any benefit that he has conferred on the other party.

3. For one definition of "trust" *see* Diego Gambetta, *Can We Trust Trust?, in* TRUST: MAKING AND BREAKING COOPERATIVE RELATIONS 217 (D. Gambetta ed., 1988)

> (Trust (or, symmetrically, distrust) is a particular level of the subjective probability with which an agent assesses that another agent or group of agents will perform a particular action, both before he can monitor such action (or independently of his capacity ever to be able to monitor it) and in a context in which it affects his own action . . . . [W]hen we say we trust someone or that someone is trustworthy, we implicitly mean that the probability that he will perform an action that is beneficial or at least not detrimental to us is high enough for us to consider engaging in some form of cooperation with him.)

For another definition and for a recent comprehensive sociological theory of trust *see* PIOTR SZTOMPKA, TRUST: A SOCIOLOGICAL THEORY 25 (Cambridge Univ. Press 1999) ("Trust is a bet about the future contingent actions of others."); *see also* THE WESTMINSTER DICTIONARY OF CHRISTIAN ETHICS 632 (James F. Childress II ed., The Westminster Press 1986) ("In the broad sense, trust is the expectation that the other will act in accord with his or her public presentation of self; in its narrow sense, it is the expectation that the other will act morally.") For another definition which also relies on the notion of expectation, *see* Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1745-46 (2001)

> ([W]e use the word "trust' to describe behavior with the three following characteristics. First, trust involves at least two actors—the actor who trusts and the actor who is trusted. Second, the trusting actor must deliberately make herself vulnerable to the trusted actor in circumstances in which the trusted actor could benefit from taking advantage of the trusting actor's vulnerability. Third, the trusting actor must make herself vulnerable in the belief or expectation that the trusted actor will in fact behave "trustworthily"—that is, refrain from exploiting the trusting actor's vulnerability.).

prescriptive research in corporate law, especially in the post-Enron, WorldCom, Tyco, and Adelphia era?

In his recent and original paper, *The Conception That the Corporation Is a Nexus of Contracts, and the Dual Nature of the Firm*,[4] Eisenberg brings fresh insights and examples to demonstrate his contention that the usual conception of the corporation as a nexus of contracts is, *inter alia*, "[u]nsatisfactory as a positive—that is, descriptive—matter," "lacks intellectual coherence," and gives rise to unsatisfactory implications. One of Eisenberg's main arguments against the contractual view of the corporate organization rests on the claim that trust and loyalty between corporate actors is an ideal goal of corporate law, but a problem persists regarding the internalization of these norms in the context of *contractual* relationships:

> If all corporate actors fully internalized the social norm of loyalty and gave full effect to that norm, the costs of both legal sanctions and monitoring-and-bonding systems would be unnecessary, and the levels of loyalty would be much higher than those sanctions and systems can achieve. Accordingly, whatever the law does do to increase the force of the social norm of loyalty, and further its internalization, will lead to greater efficiency. Whatever the law does to diminish the force of the social norm of loyalty, and lessen its internalization, will lead to diminished efficiency. Authentic loyalty can run to an organization, or at least to the group of individuals that inhabit an organization, but it is not likely to run to a set of contracts.[5]

Blair and Stout suggest a somewhat similar argument, claiming that contract law encourages parties to be self-interested, whereas fiduciary law encourages them to be other-regarding; hence, a relationship cannot be both fiduciary and contractual at the same time.[6]

In this article, I support the view that considers "trust" as a crucial and efficient concept in the analysis of social, economic, human, and humane interactions, but contrary to Eisenberg and to Blair and Stout, I will argue that the concept of trust is inevitably latent in every contractual relationship

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4. Melvin A. Eisenberg, *The Conception That the Corporation Is a Nexus of Contracts, and the Dual Nature of the Firm*, 24 IOWA J. CORP. L. 819, 835 (1999).

5. Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1274 (1999) [hereinafter Eisenberg, *Corporate Law and Social Norms*] (challenging the contractual model of the corporation based on the concept of trust); *see also* Bruce Chapman, *Trust, Economic Rationality, and the Corporate Fiduciary Obligation*, 43 U. TORONTO L.J. 547 (1993).

6. Blair & Stout, *supra* note 3.

and is best understood as a comprehensive theory and justification of contract law.[7] If so, and rather surprisingly, the answer to Eisenberg's concern may be found in the "problem" itself: contract law as a whole, and particularly its "good faith" doctrine, might be the main and most direct *legal* tool (complementing other social methods) for internalizing the social norm of loyalty.[8] Accordingly, in a view of the corporation as a nexus of contracts and as a voluntary organization based on cooperation and consent, trust can thus function as a (universal) axis that best fits corporate law, and also serves to justify it.[9]

Intuitively, trust appears as a crucial, and possibly axiomatic, element in any human interaction, including the performance of large organizations based on the cooperation of many constituencies.[10] The integration I suggest between corporations, contracts and trust, however, still lacks this immediate intuitive resonance. Common wisdom tends to view legal contracts and even legal regimes in general, as an artificial substitute ensuring cooperative behavior between people when trust, as a cultural-sociological-psychological concept, seems to be missing.[11] Yet, this very

7. The claim that the corporation is a set of contracts, and even that "contracts and fiduciary duty lie on a continuum best understood as using a single, although singularly complex, algorithm," was established by Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J. L. & ECON. 425 (1993), and Frank H. Easterbrook & Daniel R. Fischel, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1416 (1989). Still, Easterbrook and Fischel did not adduce that the concepts of fiduciary law, contract law, and corporate law all share one theory. In that sense, my argument, claiming that the notion of trust provides a comprehensive theory of contract law, embodied in every contractual setting and helpful in its understanding, refines the explanation lacking in their model. For an explanation of other oversights of Easterbrook and Fischel, *see* Roberta Romano, *Comment on Easterbrook and Fischel, "Contract and Fiduciary Duty,"* 36 J. L. & Econ. 447 (1993). For a view that attacks the "elusive notion of trust" based on its non-calculativeness, *see* Oliver E. Williamson, *Calculativeness, Trust, and Economic Organization*, 36 J. L. & ECON. 453 (1993) and Richard Craswell, *On the Uses of "Trust": Comment on Williamson, "Calculativeness, Trust, and Economic Organization,"* 36 J. L. & ECON. 487 (1993).

8. In other words, if corporate law is mainly about norm management, using contract law to substantiate a culture of trust sounds promising.

9. This claim targets Ronald Dworkin's "super" judge Hercules, which deals with a "theory" that best fits and justifies most of the formal argument, and "must construct a scheme of abstract and concrete principles that provide a coherent justification for all common law precedents and . . . constitutional and statutory provisions as well." Ronald Dworkin, *Hard Cases*, 88 HARV. L. REV. 1057, 1094 (1975).

10. *See* Rafael La Porta et al., *Trust in Large Organizations*, 87 AM. ECON. REV. 333, 334; *see also* FRANCIS FUKUYAMA, TRUST: THE SOCIAL VIRTUE AND THE CREATION OF PROSPERITY (Free Press 1995).

11. *See, e.g.*, Eisenberg, *Corporate Law and Social Norms*, *supra* note 5 and accompanying text; FUKUYAMA, *supra* note 10; Larry E. Ribstein, *Law v. Trust*, 81 B.U. L.

substitution, which suggests both trust and contracts (more than any other legal action) aim toward the same universal goal of cooperation, risk-taking and fulfillment of reasonable expectations, makes it possible to infer a reciprocity between contract as a legal concept and trust as a social concept. Contract law, *per se* and through its "good faith" doctrine, could then function as an expressive, coercive, and thus corrective legal tool, serving to symbolize, build, and internalize a culture of trust wherever it has failed to develop.

Given that contracts are a basic, and probably universal, legal tool, the concept of trust as a comprehensive theory of contract law (discussed in Part II), and the view of the corporation as a nexus of contracts, could function as the missing link in the descriptive and prescriptive inquiry of corporate law and its dilemmas. Indeed, as a vast organization, and especially in a multinational and global economy, the corporation seriously challenges most traditional legal concepts and principles, including, among others, property law,[12] criminal law[13] and constitutional law.[14] Contract law, however, is different. As a significant socio-economic organization involving many constituencies, the corporation supplies clear and strong evidence for a trust theory of contract law, and can also substantiate an atmosphere of trust rather than merely benefiting from it. In this sense, the corporation might be described as the quintessential embodiment of contract.

This article is organized as follows. In Part II, I briefly consider the essential role of trust. Although trust is discussed in this article as a crucial concept in the corporate arena, some interdisciplinary insights about the "axiomatic" necessity of trust will be cited in order to substantiate its systematic and universal role. The major theoretical claim of the article will then be outlined: namely, that the concept of trust serves as a

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REV. 553, 556 (2001) ("law *substitutes for* rather than *complements* trust") (emphasis added).

12. MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW, 1870-1960: THE CRISIS OF LEGAL ORTHODOXY 166 (Oxford Univ. Press 1992).

13. This is the case with the attribution of criminal liability to an artificial entity such as the corporation. *See, e.g.*, PAUL L. DAVIES ET AL., GOWER'S PRINCIPLES OF MODERN COMPANY LAW 229-32 (6th ed. 1997).

14 *See* MEIR DAN-COHEN, RIGHTS, PERSONS AND ORGANIZATION: A LEGAL THEORY FOR BUREAUCRATIC SOCIETY (Berkeley, University of California Press, 1986); Michael J. Horan, *Contemporary Constitutionalism and the Legal Relationship Between Individuals*, 25 INT'L & COMP. L.Q. 848, 860 (1976); Carl J. Mayer, *Personalizing the Impersonal: Corporations and the Bill of Rights,* 41 Hastings L.J. 577 (1990).

comprehensive theory of contract law. Emphasis will also be placed on the "good faith" principle developed in contract law during the last few decades. Since the claim is that contract law is both justified by and also serves as the main legal bridge toward substantiating the social norm of trust, especially in the modern global economy, reference will also be made to the recent literature discussing the interaction between social norms and the law, as well as the internalization of social norms within the law. In Part III, I illustrate the integration of the concept of trust within contract law and corporate law in some recent decisions of the Israeli Supreme Court, which applied the "good faith" principle (mainly in the corporate context) and used other legal techniques to substantiate the social norm of trust in the corporate context. Israeli precedent resorts rather extensively to the "good faith" doctrine of contract law in corporate contractual settings, explicitly justifying this by reference to the trust principle, and stressing the implicit obligation of the corporation and its organs to fulfill the reasonable expectations of *all* corporate actors. This experience can provide an interesting point of departure for future research. In other words, this part will demonstrate the reciprocity between contract law, corporate law, and trust as a descriptive and prescriptive concept, and identify the potential uses of contract law as a legal tool for the internalization of trust, by conveying the goals of contract law and by using its remedies to entrench cooperation and trust. In Part IV, I point out some preliminary thoughts concerning specific issues in corporate and securities law that seem best suited for a research project based on the trust theory of contract and corporate law outlined here. Although the focus of this article is on a relatively abstract claim, which I hope may prompt a new research direction in corporate law, some initial discussion will be offered regarding the applicability of the thesis presented here to various corporate matters. These matters include issues of comparative corporate law, the search for an efficient corporate governance structure, the scope of mandatory rules in corporate law, and legal methods for the protection of mixed investors within a corporate law model of shareholder supremacy. In addition, the applicability of trust theory to the area of corporate law can help to crystallize the justification and content of the disclosure philosophy in securities regulation, and may also supply us with a consistent and predictable application of the doctrine of "piercing the corporate veil." Part V concludes with a discussion about the potential role of the corporation in generating an environment of universal trust, which is crucially important in the global economy in general, and within the context of the virtual internet world in particular.

II. THE UNIVERSAL CONCEPT OF TRUST AS A COMPREHENSIVE THEORY OF CONTRACT LAW AND ITS INTERNALIZATION AS A SOCIAL NORM

A. THE UNIVERSAL AND "AXIOMATIC" ROLE OF TRUST

Since countries differ greatly with regard to such aspects as their constitutional and legal regimes, their economic and social institutions, their culture and so forth, it is only natural to expect them to vary concerning the legal rules governing corporate issues, including the structure of corporate ownership.[15] Any inquiry into intellectual history, however, shows that some ideas do seem to bear larger universal significance,[16] and this is also the case concerning the notion of trust.[17] Cultural and legal differences notwithstanding, trust seems to be an all-pervading, universal concept, both socially—"The importance of trust derives directly from the nature of human beings as social animals who can only satisfy most of their needs by means of coordinated and cooperative activities;"[18] economically—"It can be plausibly argued that much of the economic backwardness in the world can be explained by the lack of mutual confidence;"[19] and psychologically—trust is a central ingredient of the "healthy personality."[20] More specifically, and closer to the thesis of this article, La Porta, Lopez-de-Silanes, Shleifer and Vishny emphasize the relevance of the concept of trust in the area of large corporations:

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15. Lucian A. Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127 (1999).

16. Such as, for instance, the ideals of the French Revolution, or the principles of the Bill of Rights.

17. As an anecdote to illustrate the broad and yet basic nature of the concept of trust, it may be interesting to note the following passage from a swimming-instruction manual: "Asked what the single most important factor is in learning to swim, most people would reply 'Confidence.' A sense of trust—what we have called being at home in the water—provides the foundation for us to do whatever else might come naturally in the water." S. SHAW & A. D'ANGOUR, THE ART OF SWIMMING: IN A NEW DIRECTION WITH THE ALEXANDER TECHNIQUE 89 (Ashgrove Pub. 1996).

18. STANLEY I. BENN & RICHARD S. PETERS, SOCIAL PRINCIPLES AND THE DEMOCRATIC STATE 279 (London, Allen & Unwin 1977) (1959). *See also* FUKUYAMA, *supra* note 10 ("High trust among citizens accounts for the superior performance of all institutions in a society, including firms.").

19. Kenneth J. Arrow, *Gifts and Exchanges*, 1 PHIL. & PUB. AFF. 343, 357 (1972).

20. ERIK H. ERICKSON, IDENTITY, YOUTH, AND CRISIS (W.W. Norton & Co. 1968). *See also* Julian P. Rotter, *Interpersonal Trust, Trustworthiness, and Gullibility*, 35 AM. PSYCHOL. 1 (1980) ("Common sense tells us that interpersonal trust is an important variable affecting human relationships at all levels.").

> Higher trust between people in a population should be associated with greater cooperation. These views of trust share an important implication, namely, that trust should be more essential for ensuring cooperation between strangers, or people who encounter each other infrequently, than for supporting cooperation of people who interact frequently and repeatedly. In the latter situations, such as families or partnerships, reputations and ample opportunities for future punishment would support cooperation even with low levels of trust. This implies that trust is most needed to support cooperation in *large organizations*, where members interact with each other only infrequently because they are only rarely involved in joint production . . . . In sum, trust enhances economic performance across countries . . . . Trust promotes cooperation, which is most important for large organizations.[21]

B. THE CONCEPT OF TRUST AS A COMPREHENSIVE THEORY OF CONTRACT LAW

The purpose of this part of the paper is to substantiate the claim that the concept of trust can serve as a comprehensive theory of contract law.[22] Moreover, since most of our daily actions are based on consent, reciprocity and cooperation, contract law can be viewed as the most social as well as the most basic legal foundation.[23] I suggest a harmonic perspective, whereby the principle of good faith will also be viewed as drawing its vitality and contents from a basic justification or overarching theory of contract law in general—the notion of trust.[24] From this perspective, the principle of good faith and contract law (and possibly, even law in general) are both construed as relying on the pivotal concept of trust. This strategy might be helpful in identifying the principle of good faith as part of a whole, and as a means for attaining trust whenever it is eroded in pre-contractual or contractual settings. It may also contribute to the consistent implementation of contract law by lawyers and courts, through their whole

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21. La Porta et al., *supra* note 10, at 333.

22. For a different view see DORI KIMEL, FROM PROMISE TO CONTRACT: TOWARDS A LIBERAL THEORY OF CONTRACT (Oxford: Hart Publishing 2003); Dori Kimel, *Neutrality, Autonomy, and Freedom of Contract*, 21 OXFORD J. LEGAL STUD. 473, 489-93 (2001); Dori Kimel, *Remedial Rights and Substantive Rights in Contract Law*, 8 LEGAL THEORY 313, 325-28 (2002). For a critique of this view *see* Anthony Bellia Jr., *Promises, Trust, and Contract Law*, 47 AM. J. JURIS. 25 (2002).

23. Section 61 of the Israeli Contract Law expresses this notion by applying the concepts of contract law to *every* legal action, even if not contractual in its nature. The Contracts (General Part) Law 5733-1973 (Isr.). *See also* Benn & Peters, *supra* note 18, at 279 (describing "the nature of human beings as social animals who can only satisfy most of their needs by means of coordinated and cooperative activities").

24. For concrete examples of this claim, *see infra* Part II.

range of rules and instruments, thus ensuring certainty and stability. Trust also plays a crucial role in strengthening confidence and reliable expectations, and is a vital element when individuals consider, before acting, whether to commit themselves to a move whose results depend on the future performance and cooperation of the other party. In these circumstances, the availability of the good faith principle as a complementary corrective standard to which the legal system can resort for maintaining trust in unforeseen situations is highly desirable.[25] The legal system will thereby promote a culture of trust in the context of contract law that will encourage efficiency, increase safety and confidence levels, and improve planning ability at all levels of interaction and commitment.[26]

Accordingly, while striving to create and strengthen trust both expressively and coercively, whether through conventional contract law or through the principle of good faith,[27] we will also see the institutionalization of a stable socio-economic culture that encourages cooperation. An additional and no less important aim is also achieved: namely, the flourishing of personal autonomy and mutual respect.

This article highlights the close bond between the notions of trust and reasonable expectations. The notion of "trust" is thus upheld as representing the most adequate comprehensive theory, both descriptive and prescriptive, for the justification of contract law. *First*, the notion of trust is already implicit in other justifications of contract law and, at the very least, supports their existence.

Second, the voluntary relationships established during the negotiations that precede the contract and at the time of its signing and implementation constitute the most prevalent form of social and economic engagement, raising expectations and inviting mutual trust. Every contract can thus be considered a microcosm that, in its broadest sense, reinforces and draws from the social contract. Accordingly, protecting the value of trust in the context of contract law conveys the core attitude of the law to the idea of trust itself.

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25. This claim can be used to extract more coherent standards for filling gaps occasionally found in contracts, based on the trust theory of contract law.

26. Since trust is crucial for shaping and maintaining our social and economic quality of life, striving for its attainment will, in itself, lead to the stability and certitude so sought after in the legal realm in general, and in contract law in particular.

27. RESTATEMENT (SECOND) OF CONTRACTS §§ 1, 205, *supra* notes 1 and 92.

Third, trust is the notion that stands behind the fulfillment of promises and expectations in contract law.[28] Enforcing the promises implicit in a contract, and protecting the expectation interest (particularly through the remedy of "specific performance," which is a central remedy in breach of contract) reflect this understanding.[29] So does the extension of contract law to promises that are essentially noncommercial.[30] The expectation created on the basis of a promise implicit in the contract, which is usually the highest expression of trust, is thus the quintessential feature protected by contract law.[31]

Fourth, the close association between contracts and the notion of trust can also be inferred from the "interchangeable" nature of the relationships between them. If we could expect, formulate, and implement detailed contracts that contend with all situations and developments without transaction costs, trust would be redundant. Conversely, in a world where total trust prevails between people, contracts would be unnecessary. We might therefore conclude that detailed contracts, the recourse to courts in general, and the frequent use of the good faith principle in particular, do not necessarily follow from stability, certitude and trust, but possibly from the absence of these values, and can thus act directly and potentially to strengthen them.

Fifth, a contract is, by definition, a meeting of the minds to integrate the intentions of two or more parties. This understanding is relevant to laws regulating the formation of contracts through the mechanics of "offer" and "acceptance," as well as to laws concerning the interpretation of contracts, which are meant to effectuate the parties' intentions and their shared aims. Essentially, the contract is a mutual desire for exchange and cooperation and, as such, creates mutual relationships of power and subordination that, in turn, the law recognizes as reflecting fiduciary relations.[32]

Finally, the view of trust as the comprehensive theory of contract law may serve as a consistent explanation for the existence of consumer legislation in contract law, which is generally perceived as compulsory. The increasing might of economic bodies and their alienation from clients who lack access to information and economic resources explain the need

28. *Id.*

29. RESTATEMENT (SECOND) OF CONTRACTS § 344(a), *supra* note 2.

30. As is the case in Israel, for instance, concerning promises involving surrogate mothers and political coalition agreements.

31. FRIED, *supra* note 1.

32. Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795 (1983).

for intervention, given that contracting in these areas could also lead to abuses. The principle of "let the buyer beware" is thus exchanged for one where the risk is assumed by the seller, for the sake of preserving trust and fulfilling expectations in contractual situations characterized by high incentives to breach them.

C. THE "EXPRESSIVE" AND "COERCIVE" FUNCTIONS OF CONTRACT LAW AS A BRIDGE TOWARD TRUST AS A SOCIAL CONVENTION

Using Gambetta's definition, "[t]rust (or, symmetrically, distrust) is a particular level of the *subjective probability* with which an agent assesses that another agent or group of agents will perform a particular action, both before he can monitor such action (or independently of his capacity ever to be able to monitor it) and in a context in which it affects his own action."[33] Hence, the origin (and destination) of trust belong in the psychological perception of expectation and confidence.[34] Such a perception, however, is inevitably affected by, and contingent on, external circumstances and cooperative behavior. The perspective of trust is twofold, and includes subjective and objective dimensions. Subjectively, trust is a psychological concern that is crucial for the "healthy personality,"[35] but objectively, trust is socially and economically valuable in promoting cooperation and risk-taking.[36] This twofold perspective of the notion of trust raises a question concerning methods for internalizing trust within the law. In sum, since "trust" is unquestionably a social norm[37] as well as a psychological perception, the main dilemma is whether the law can authentically substantiate (in its "complement function") this duality.[38] My response is that contract law is the legal domain most deeply anchored in trust and can thus serve, expressively and coercively,[39] as a bridge toward an atmosphere

33. Gambetta, *supra* note 3 (emphasis added).

34. As noted, Erickson considered trust "[a] central ingredient of the 'healthy personality.'" ERICKSON, *supra* note 20.

35. *Id.*

36. In a sense, trust is a unique social norm that, unlike other social norms that we *expect* to find in a given society, trust concerns the psychological perception of *expectation* itself.

37. Eisenberg, *Corporate Law and Social Norms*, *supra* note 5. Eisenberg uses the term "social norm of loyalty."

38. A different view appears to prevail now, namely, that the law affects trust artificially (the "substitute" function of law). RIBSTEIN, *supra* note 11 and the text accompanying notes 4-6.

39. For an attitude that views contract law as a coercive device *see* ERIC A. POSNER, LAW AND SOCIAL NORMS 160 (Harvard Univ. Press 2000)

of trust, at least as a social convention.[40] On these grounds, and given that social norms penetrate everyday life and are revealed as meaningful to legal analysis for a variety of reasons,[41] a discussion about definitions and explanations is appropriate at this point. The discussion will focus on the potential influence of law on social norms and will also be a preface to Part III, which illustrates how Israeli contract law has incorporated the social norm of trust both expressively and coercively.

The term "social norm" can be understood in several ways. For the purpose of this article, the simplest definition is the most appropriate: a social norm is a social attitude of approval and disapproval, specifying what ought and what ought not to be done.[42] Yet, a critical question remains open: what are the interrelations between law and social norms in general, and between contract law and trust in particular?

Robert Cooter argues that effective laws must align with the morality already internalized by citizens.[43] While Cooter holds that costs are typically more responsive than internalized values to law and public policy, he also holds that the state affects the values internalized by its citizens. Once citizens respect the law, they habitually obey it in their daily lives without reflecting on it. Thus, a just state achieves stability by generating its own support among reflective citizens. In other words, according to Cooter's theory, citizens are more willing to do their civic duty because the state changes this duty in a way that increases its moral appeal. If that is so, and if we accept Erickson's psychological theory about the significance of trust as a basic component of human personality,[44] we must conclude that the law plays an important role in encouraging the promotion of trust.

Another question that concerns Cooter touches on the means available to the law in order to bring citizens to internalize values. According to Cooter, if a state wishes to reward citizens in order to promote the

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(The purpose of contract law is to enable parties to have the government penalize both if they have a dispute; and contract doctrines merely give parties a reliable way to indicate ex ante their desire for such government involvement, and to limit the size and the variance of the penalty to something close to what should be sufficient: a finger rather than a head.).

40. *Compare* Stephen Marks & Robert Mnookin, *Bargaining in the Shadow of the Law: A Testable Model of Strategic Behavior*, 11 J. LEGAL STUD. 225 (1982).

41. For detailed arguments see Richard H. McAdams, *The Origin, Development, and Regulation of Norms*, 96 MICH. L. REV. 338 (1997).

42. Cass R. Sunstein, *Social Norms and Social Roles*, 96 COLUM. L. REV. 903 (1996).

43. Robert Cooter, *Do Good Laws Make Good Citizens? An Economic Analysis of Internalized Norms*, 86 VA. L. REV. 1577 (2000).

44. Erickson, *supra* note 20.

internalization of civic virtue, the state must infer character from behavior. The problem is that, due to its size, the modern state is restricted in its ability to identify virtuous citizens. Inferring character from behavior requires intimate knowledge of the person, but officials in large states are far removed from most citizens, and the character of each citizen is thus relatively opaque to state officials. Consequently, officials lack the information needed to reward people for acquiring civic virtue, and instead of rewarding or punishing character, state law mostly rewards or punishes acts. According to Cooter, the state can rely on families, friends and colleagues in order to reward civic acts. Compared to the state, people involved in intimate relationships are relatively good at inferring character from behavior. Consequently, the primary influences on character are intimate relationships, and states should therefore refrain from attempting to instill civic virtue directly, and should instead encourage family, friends and colleagues to do so. Insofar as one's family, friends and colleagues prefer relationships with civic-minded people, individuals have an incentive to cultivate civic virtue. Civic acts can thus become signs of the possession of the moral traits that people tend to seek in partners in cooperative ventures. To achieve this goal, the State must first align law with the social norms that facilitate private cooperation. This point is important for our discussion: if we consider contracts as "intimate" relationships, and if we view the corporation as a microcosm of a social community and as a system of intimate relationships depending on private cooperation, then Cooter might support the view that contracts and corporations can be efficient and intimate tools for promoting the internalization of a culture of trust.

Elsewhere, Cooter attempts to lay the foundation for an economic theory of "expressive" law.[45] According to the expressive theory of law, the expression of social values is an important—possibly the most important—function of the courts.[46] For Cooter, the law can create a focal point by expressing values. These values could tilt the system toward a new equilibrium. Creating focal points is the first expressive use of law. In addition, the law can change the individual values of rational people. Internalizing a social norm is a moral commitment that attaches a psychological penalty to a forbidden act. A rational person internalizes a norm when commitment conveys an advantage relative to the original

45. Robert Cooter, *Expressive Law and Economics*, 27 J. LEGAL STUD. 585 (1998).

46. *See* Cass R. Sunstein, *Symposium: Law, Economics, & Norms: On the Expressive Function of Law*, 144 U. PA. L. REV. 2021 (1996) and *infra* text accompanying notes 50-51.

preferences and the changed preferences. By creating opportunities for pareto self-improvement, the law induces rational people to change their preferences. Cooter analyzes how the law can tilt aggregate behavior and change individual preferences by expressing values. Changing individual values is the second expressive use of law.

Cooter points to several ways in which the law can change preferences: for instance, by using coercive sanctions attached to acts. Concerning the present argument, Cooter shows how contract law creates opportunities for pareto self-improvement. Cooter's example is highly relevant to the claim of this article since both assume an interaction between contract law as a legal device and cooperation as a social concept. Cooter's argument proceeds as follows: assume that the State chooses whether or not to enforce contracts, and the actor chooses whether to be honest or dishonest. According to economic analysis, social sanctions for dishonesty are not very effective regarding the promises under consideration; consequently, given that there are only social sanctions and no legal sanctions, the immediate benefit from dishonesty outweighs the future cost. The gain from dishonesty largely offsets the modest social sanction so that, in the absence of contract law, dishonesty is more profitable. People have difficulty cooperating with each other without enforceable contracts, resulting in relatively low productivity. In contrast, when bound by enforceable contracts, people are more cooperative, resulting in relatively high productivity. Both honest and dishonest people, then, enjoy a larger payoff with contract law than without it. With contract law, the sanction for dishonesty is social as well as legal, and legal sanctions for dishonesty are effective concerning the promises under consideration so that, overall, honesty yields a higher payoff than dishonesty.

The dishonest person prefers the high present payoff (and the low future payoff) resulting from dishonest behavior, rather than the low present payoff (and the high future payoff) from honest behavior. The honest person prefers the opposite. In the absence of contract law, pareto self-improvement is impossible, so that a dishonest person and an honest person prefer to remain as they are rather than change their preferences. The main point, however, is that contract law produces a different result. State sanctions make dishonesty less attractive. Contract law creates a situation in which a person who shifts from being dishonest to being honest is better off relative to his initial and final preferences. Thus, contract law creates the opportunity for pareto self-improvement, where none had existed without contract law. In general, the law prompts improvement in character wherever a legal sanction creates an opportunity for pareto self-improvement. Adding to Cooter's model the possibility of legal liability,

monetary sanctions and stigma through the "good faith" principle in cases of trust breaching, can make his claim even more convincing, especially when accepting the internalization theory of Richard McAdams' "esteem model."[47]

Lisa Bernstein cites the diamond industry as a unique example of the preference for contractual relations.[48] As she shows, the diamond industry has systematically rejected state-created law. In its place, the sophisticated traders who dominate the industry have developed an internal, elaborate set of rules, complete with distinctive institutions and sanctions, to handle disputes between members of the industry. Bernstein's research is largely devoted to explaining why the diamond industry has for so long relied on extra-legal enforcement for its business norms. By a variety of reputational bonds, customary business practices and arbitration proceedings, the diamond industry has developed a set of rules and institutions that its participants find clearly superior to the legal system. This industry, as traditionally organized, has been able to make its own rules and, more importantly, enforce them. The market is organized to promote low cost and rapid dissemination of information about reputation. This enables it to use reputation bonds to create intra-industry norms that function as a deterrent to breach of contract, and a private sanctioning system whose judgments can be fully enforced, almost invariably outside the legal system. As Bernstein suggests, mores and institutions in the diamond industry developed for reasons wholly unrelated to shortcomings in the legal system; yet, even as the force of the old enforcement mechanisms of religion and secondary social bonds began to disintegrate, a network of trading clubs designed to promote the dissemination of information about reputation and socialization among members emerged to fill the gap. The fact that generations of diamond dealers have clung to nearly identical intra-industry norms in countries with a wide variety of legal rules and institutions suggests that the traditional rules and institutions are likely to be efficient from the perspective of market insiders.

Though unique to a specific community, Bernstein's model can inform the argument of this article. A general perception of corporations as small

47. McAdams identifies the desire of individuals for respect or prestige, that is, for the relative esteem of others, as an initial force behind norm creation. *See* McAdams, *supra* note 41. For the sanction of shaming in the corporate context see David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811 (2001).

48. Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992).

and sophisticated microcosms, possessing their own institutions and their own mechanisms for character-forging and enforcement, could emphasize the potential of such intimate communities to affect human behavior and culture.[49] Just as the concept of trust prevails, through voluntary and contractual arrangements, in an environment as materialistic and business-oriented as the diamond industry, we could infer its applicability, through contractual mechanisms, to other organizations and communities.

Finally, and as noted, the literature most concerned with social norms concentrates on the expressive function of law, "the function of law in 'making statements,'" as opposed to controlling behavior directly.[50] Given that the expressive (aside from the "coercive") function of contract and corporate law in promoting trust is well identified in Israeli Supreme Court opinions (which follow in Part II), some remarks in this regard are in place here.

Cass Sunstein emphasizes that, in general, actions are expressive because they carry meanings.[51] As is true for nearly all our activities, from the most mundane to the most significant, this is also true of the law. Sunstein suggests that the expressive function of the law is closely related to the effects of the law on prevailing social norms, given the rough analogy between the social and legal mechanisms. He claims that a society might identify the norms to which it is committed and insist on those norms via the law. Accordingly, one of the clearest expressive functions of the "statement" made by the law may be to affect social norms and, thereby, ultimately affect both judgments and behavior. A law that is appropriately framed may influence social norms and thrust them in the right direction.

In sum, the literature identifies a largely reciprocal relationship between law and social norms. Arguably, the most important aspect of the relationship between norms and the law is the law's ability to shape social mores. Strong and convincing arguments are advanced about the expressive and coercive ways through which the law can shape social norms, and about the voluntary establishment of commercial communities characterized by a high level of trust implemented through the contractual

49. In a somewhat broader context, in 2001 the U.S. Sentencing Commission revisited the federal Corporate Sentencing Guidelines and noted that the "guidelines have had a tremendous impact on the implementation of compliance and business ethics programs over the past ten years. [They] prompted a serious reconsideration within the American business community of methods and rationale for improved corporate governance." Jeffrey M. Kaplan, *The Sentencing Guidelines: The First Ten Years*, ETHIKOS, Nov./Dec. 2001, at 1.

50. Sunstein, *supra* note 46, at 2021.

51. *Id.*

mechanism.[52] As far as contract law, corporate law and trust are concerned, I claim that trust serves as a comprehensive theory of contract law and as a highly influential factor in the area of corporate law. The "expressive" and "coercive" opinions of the Israeli Supreme Court provide a good illustration of this claim, and this is the topic of Part III.

III. THE INTEGRATION OF TRUST, CONTRACT LAW, AND CORPORATE LAW: SOME EXAMPLES FROM ISRAEL

This article focuses on a claim that is relatively theoretical. Nevertheless, this part is devoted to preliminary thoughts about practical ways by which contract law may be used to internalize a trust concept into corporate law and culture. Part III addresses selected issues in corporate and securities law that seem most appropriate for a research endeavor based on the trust theory of contract and corporate law suggested here.

In an era of governance-related scandals in the American corporate environment, few, if any, will dismiss the claim that there is an urgent need for "restoring trust in American Business."[53] As this article contends, contract law can be used to promote the cultural and social norm of trust. For that purpose, this part will illustrate developments in Israeli corporate and securities law, as they are affected by the trust principle in general and by contract law in particular.[54] A review of some decisions of the Israeli Supreme Court pointing to the reciprocity between corporations, contract law and trust could prompt research into concepts of contract law which are potentially useful for internalizing (expressively and coercively) a culture of trust in the corporate arena. These methods can be easily adopted by the American legal system, as both the American and the Israeli systems are rooted in the same Anglo-American legal thinking, and most corporate and contract legal principles and doctrines are similar.

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52. In a recent article, Bernstein illustrates the complementarity between trust and contract and how it has led to cooperation also in the cotton industry. *See* Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions*, 99 MICH. L. REV. 1724 (2001).

53. *See, e.g.*, the various articles in RESTORING TRUST IN AMERICAN BUSINESS (Jay W. Lorsch, Leslie Berlowitz & Andy Zelleke eds., MIT Press 2005).

54. Since this article concentrates on contract law, the illustrations discussed in this part deliberately overlook classic corporate cases, insofar as they are grounded on traditional corporate fiduciary duties.

A. THE APPLICATION OF THE "GOOD FAITH" PRINCIPLE OF CONTRACT LAW IN THE CONTEXT OF CORPORATIONS

One of the most useful doctrines of contract law, which emphasizes the trust relations created by contractors, is the concept of "good faith" during the negotiation process and during the contract's performance.[55] This concept is also well established in the American legal system,[56] in contact law as well as in corporate law, and has received renewed attention after the scandal and crisis in American corporate governance.[57] The Israeli Supreme Court has used this principle to induce people to fulfill the reasonable expectations of their counterparts by instituting, for example, requirements of disclosure and other forms of cooperative behavior. Sanctions for breaching this obligation usually include monetary compensation and involve a stigma, which induces people to obey this duty ex ante and, hopefully, helps them to internalize this norm of trust. These opinions are usually accompanied by explicit normative statements about

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55. Notably, good faith principles apply to everyone involved in negotiations, even if they are not intended to be a party to the contract and even if a contract is not ultimately achieved at the end. Sections 12 and 39 of the Israeli Contract Law deal with negotiation and performance in good faith. The Contracts (General Part) Law 5733-1973 (Isr.) (Section 12:

> (a) In negotiating a contract, a person shall act in customary manner and in good faith. (b) A party who does not act in customary manner and in good faith shall be liable to pay compensation to the other party for the damage caused to him in consequence of the negotiations or of the conclusion of the contract, and the [remedies] provisions . . . of the Contracts Law . . . shall apply, mutatis mutandis." Section 39: "An obligation or right arising out of a contract shall be fulfilled or exercised in customary manner and in good faith.)

On the rationale of these two sections, the Israeli Supreme Court said:

> This instruction (in section 12 of the Israeli Contract Law), imposes special 'relationships of trust' on the participants in the contractual negotiations, thus expanding contractual trust, originating in Section 39 of the Israeli Contract Law, toward the pre-contractual stage. The obligation to conduct negotiations in the accepted way and in good faith means that the participants in the negotiation must behave honestly and fairly toward each other. They are no longer 'strangers' to one another; rather, the law creates a 'closeness' between them leading to expectations, and imposes a duty of consideration.

CA 207/79 Raviv Moshe Ltd. v. Beit Yules Ltd. IsrSC 37(1) 533, 543-44.

56. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981); U.C.C. § 1-203 (2001).

57. Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J.(2005), *available at* http://ssrn.com/abstract=728431 ("After a period of scandal and crisis in American corporate governance, corporate law has rediscovered good faith"). Unlike the attitude in this article, which views the contractual "good faith" doctrine as a legal device to entrench a culture of trust and fulfillment of reasonable expectations, Griffith claims that the emerging duty of good faith is best understood as a rhetorical device rather than a substantive standard.

the inherent trust relations created by contractual and pre-contractual relations, and the significance and benefit inherent in the concept of trust.

1. Eximin S.A. (a Belgian Corp.) v. Textile ve-Hanhala Itel Stile Ferrari Ltd[58]

In this trailblazing decision involving a contractual conflict between two corporations, former Chief Justice Shamgar applied the good faith principle and formulated the doctrine of "contributory fault" as part of contract law so as to encourage a culture of cooperation between contractors. In order to induce this practice, Chief Justice Shamgar held that the respondent was legally obligated to disclose and cooperate *ex ante*, and found liability for damages that occurred as a result of its failure to do so. The facts were quite simple: the appellant, a Belgian corporation, bought jeans and boots from the respondent, an Israeli corporation, in order to market them in the United States. The respondent manufactured and sent the goods to the United States, where they could not be marketed because the boots' name involved a breach of a trademark. The appellant suffered monetary damages and sued the respondent. The legal question was how to allocate the contractual risk for the breach of the trademark, and whether the contractual responsibility needs to be absolute. Chief Justice Shamgar's expressive rhetoric about the economic benefit of cooperative behavior and its harmony with contractual interaction is worth citing:

> Is achieving the aims of the law dependent on the existence of absolute responsibility? The opposite is true. As in any contract or negotiation, the basis of the sales deal is the parties' wish to cooperate, obviously assuming that cooperation will benefit both of them, separately and together. There is no reason to assume that this cooperation will end with the signing of the contract . . . but it is plausible that, along their shared path, the parties will face problems that might require a certain level of flexibility and even a departure from what was determined *a priori*. Cooperation will unquestionably also be required in the future. One aspect of this cooperation is the understanding that damages might be caused to one of the parties due to a lack of good faith displayed by both parties. In such a case, "cooperation" will be manifest in a division of responsibility for the damages between the two parties, a division that, *a posteriori*, will actually encourage cooperation a priori.[59]

58. CA 3912/90, IsrSC 47(4) 64.
59. *Id.* at 82.

Elsewhere in the decision, Chief Justice Shamgar emphasized the direct link between the good faith principle in contract law and the principle of trust:

> The concept of trust and the concept of legal good faith appear to be closely related. Both concepts share an identical foundation: at the basis of the sociological concept of trust is the possibility of every individual to assume that his plausible expectations from the other or from an institution will be fulfilled, and that the latter will behave according to what is required by their situation or their role. At the basis of the concept of good faith is the ability of every individual to assume that his plausible expectations from the legal relationship in which he is involved with the other will be fulfilled . . . .[60]

Since this dispute involved Israeli and foreign corporations, we may easily infer that, in an era of global trade and economy, the application of such a contractual principle can also give impetus to a universal culture of trust.

2. Penidar, a Corporation for Investment, Development, and Building Ltd. v. Castro[61]

This well-known Israeli Supreme Court decision held that a corporate manager was *personally* liable for an inactive misrepresentation it made during a contractual negotiation with a corporate customer. This decision, considered so important that it was followed by a rare legal proceeding involving a further hearing before an enlarged panel of judges, also relied on the "good faith" principle in contract law. Former Chief Justice Shamgar, joined by present Chief Justice Barak, upheld this decision, which deviates from the classic limited liability principle of shareholders and managers of corporate law, and expanded the responsibilities of a corporate manager toward corporate constituencies (the corporate customer) other than shareholders. The main explicit reason for the court's decision was the personal responsibility of every human being as a social character—even as a corporate organ and even if he/she is not intended to be a formal side of the contract—to obey and substantiate an atmosphere of trust that was developed and expected in the course of the contractual negotiation process:

> The basis of section 12 in the [Israeli] Contract Law is the relationship of trust that must prevail between parties involved in negotiations conducted

60. *Id.* at 83.

61. (Additional Hearing) CA 7/81, IsrSC 37(4) 673.

> with the aim of signing a contract. Contractual trust is thereby expanded, based on section 39 of the [Israeli] Contract Law, to cover the pre-contractual stage.[62]

And elsewhere:

> This step creates a proper doctrinal infrastructure for responsibility according to Section 12 of the law. It expresses a legal policy determining a level of behavior that is based on trust and fairness, incumbent on everyone engaged in actual negotiations toward the making of a contract, whatever his function.[63]

3. Tefahot, Mortgage Bank Ltd. v. Sabach[64] and Eliahu Insurance Co. Ltd. v. Yashar[65]

Some of the most important and frequently cited Israeli legal decisions that applied the "good faith" principle have involved major corporations, such as banks and insurance companies.[66] These decisions imposed on the corporations heavy disclosure burdens toward their customers and, again, were explicitly justified through the concept of trust.

In the case of *Tefahot, Mortgage Bank Ltd. v. Sabach*, the court dealt with the question of whether a bank had a duty to disclose to its clients, who were borrowing from the bank to buy houses built by a company that was also one of the bank's big debtors, that the bank knew about the building company's financial problems. When the building company could not perform its obligations, one of the bank's clients sued the bank claiming that the bank had breached its duty to disclose the problems affecting the building company. Accordingly, the client asked to waive his duty to repay the loan to the bank. The court was aware that the disclosure duty owed to one customer involved facts about the financial circumstances of another customer, but emphasized the socio-economic significance of banks, and the trust and expectations the public places in them. In respect of this, the court attributed a "role of trust" to the bank and read the bank's disclosure duty into its good faith obligation, in the name of trust:

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62. CA 230/80 Penidar, a Corporation for Investment, Development, and Building Ltd. v. Castro IsrSC 35(2) 713, 724.

63. Penidar (Additional Hearing), IsrSC 37(4) at 703.

64. CA 5893/91, IsrSC 48(2) 573.

65. CA 4819/92, IsrSC 49(2) 749.

66. Most of these decisions were issued by former Chief Justice Shamgar.

> The prevalent approach is that the duty of disclosure exists as a matter of routine between parties about to enter a contract, even without a special relationship of trust between them but by virtue of the trust created between the parties to a negotiation. . . . The bank has a duty of disclosure to its clients about essential details by virtue of the duties of trust imposed on it, even beyond the obligations incumbent on parties to a regular contract. Yet, as the scope and level of the duties of trust differ from case to case and from service to service, so does the scope and level of the duty of disclosure.[67]

Another case, *Eliahu Insurance Co. Ltd. v. Yashar*, concerned an insurance company that had promised a client, before sending him the written contract, that the terms of insurance for his trucks would be identical to those stipulated in a former insurance policy issued by another company. After the client's trucks were stolen, the insurance company claimed that the specific security device required in the written insurance policy was not the one that the client had installed in his trucks and, therefore, he was not insured. Chief Justice Shamgar described the client as a "simple, unsophisticated man, a laborer who trusts his fellows," and stated that the insurance company has a duty to issue explicitly warnings and disclose facts that might affect the reasonable expectations of its contractual partners:

> The relationships created between the insuring company and the client should not be seen as the usual contractual relationships created through sales deals. A basic difference prevails between these two situations: in the latter, very broad discretion is ascribed to the parties' will and, when estimating their wishes at the time of their meeting, we consider them equals . . . . This is not the case when at stake is the contract between an insurance company and a client . . . . Not only are the parties required to be more open than in other types of contract, but we are also strict with them concerning preciseness and meticulousness in the formulation and, obviously, in the implementation of agreements . . . . Our system has adopted and developed a principle of mutual openness even prior to the anchoring of the doctrine of good faith in civil legislation . . . . The legislative innovation in sections 12 and 39 of the [Israeli] Contracts Law paved the way, concerning our issue, for shifting from the realm of passive sincerity and openness to the imposition of operative liabilities . . . . In sum, an insurance company trying to limit the scope of its liability must ensure that the client is indeed aware of these limitations.[68]

67. Tefahot, IsrSC 48(2) at 596-97.
68. Eliahu, IsrSC 49(2) at 762-64.

B. THE "PUBLIC-PRIVATE" DISTINCTION IN CONTRACT LAW IN THE CONTEXT OF CORPORATIONS

The tendency to use contract law to internalize general social norms—at least expressively—became evident in Israeli law in recent contract law cases, which imported social values and "public" norms into "private" interactions.[69] It is interesting that this public viewpoint was also incorporated into the realm of the classically private law of contracts, mainly when corporate contractors were involved. In essence, the court recognized the semi-public orientation of giant corporations and their significance as social agents that affect the business culture and social culture of the society.[70] Although this legal tendency is not unique to the social norm of trust, it shows how the Israeli Supreme Court uses contract law and corporate actors as instruments to internalize social values and concepts.

C. CORPORATE CHARTER AS A FORM CONTRACT

Another interesting case recently decided by the Israeli Supreme Court (by an expanded seven-judge panel) held that the charter of a specific cooperative corporation should be classified as a "form contract" and should be exposed to wide legal scrutiny.[71] The "form contract" category indicates that the corporation's relationship with consumers failed to involve negotiation (similar to a so-called "adhesion contract" in the United States). Obviously, once a charter is placed in this category, it is easier for the court to intervene and revoke sections of the organization's bylaws considered one-sided. As noted, although consumer law is sometimes mandatory, it can be justified and interpreted as part of contract law through the concept of trust.[72] Thus, the possible consumer classification of asymmetrical contractual relations between the corporation and its constituencies seems to substantiate the claim that contract law is used to encourage an atmosphere of trust in the area of corporate law.

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69. These include the Basic Law: Freedom of Occupation, 5754-1994 and Basic Law: Human Dignity and Liberty, 5754-1994 (Isr.). *See, e.g.*, CA 294/91 Kadisha Co. v. Kestenbaum IsrSC 46(2) 464; CA 239/92 Egged v. Mashiach IsrSC 48(2) 66.

70. This is also the rationale for Section 239(d) of the new 1999 Israeli Corporate Law, which binds publicly-held corporations to nominate, among its outside directors, at least one man (if all other directors are women) or at least one woman (if all other directors are men). Companies Law, 5759-1999 (Isr.).

71. CA 1795/93, 1831/93 The Egged Pension Fund v. Yaakov IsrSC 51(5) 433.

72. *See* Frankel, *supra* note 32; *see also infra* notes 74-75 and accompanying text.

D. TRUST AS A MAIN JUSTIFICATION FOR THE SECURITIES LAW

Finally—and even if not directly part of conventional contract law—we may consider a recent trend in the Israeli Securities Law, which deals with very large and publicly-traded corporations. The goal of this body of law is to maintain the confidence of local and international investors in the Israeli capital market,[73] and is evident in almost every section of the Securities Law. This is manifested in the liberal approach of the Israeli Supreme Court when applying the disclosure requirements of the Securities Law,[74] the court's liberal approach toward the scope of legal authority invested in the SEC and the Stock Exchanges, its liberal attitude when approving securities class actions, and its broad interpretation of criminal offenses in the securities code. This trend illustrates that the compulsory legal regime affecting corporate securities, through an impersonal and diversified capital market, aims to reinforce a culture of trust, especially when other market mechanisms fail to foster such an atmosphere.[75]

IV. RESEARCH POSSIBILITIES IN CORPORATE AND SECURITIES LAW BASED ON THE TRUST THEORY OF CONTRACT LAW

As indicated earlier, despite the theoretical orientation of this article, some selected issues in corporate and securities law seem appropriate for further research based on the trust theory of contract and corporate law suggested above.

First, since contracts and trust are basic, universal concepts, a trust theory of contract and corporate law could supply comparative and descriptive explanations consistent with the path dependence theory of corporate law[76] and based on the levels of trust prevalent in different countries. These explanations would address the issue of why countries differ in their corporate governance structures, in their corporate law and in

73. *See, e.g.*, CA 218/96 Iskar Ltd. v. Discount Investment Co. Ltd. (Aug. 8, 1997, unpublished). The same rationale might also explain the 1991 amendment to Section 46(b) of the Israeli Securities Law, which restricted dual-voting structure in publicly held corporations. Securities Law, 5752-1991 (Isr.).

74. As noted in *supra* section A.3 of this part, there is an obvious link between disclosure and trust.

75. Chief Justice Barak has implied this notion: "Our economy differs from the American one, and our law differs from American law. Whatever the law in the United States, I . . . hold that in order to attain the aims of a class action suit, in Israel we should also allow the sophisticated investor to file a class action suit." RCA 4556/94 Tetset v. Zilbershatz IsrSC 49(5) 774, 789.

76. *See* Bebchuk & Roe, *supra* note 15; La Porta et al., *supra* note 10.

the level of protection granted to corporate constituencies.[77] Trust theory would hypothesize that, in low trust countries, corporate ownership structure was initially developed in a way that exposed corporate constituencies to exploitation. Trust theory would also hypothesize that these countries will have, or ought to have as a complementary tool, more compulsory contract and corporate law, as well as stronger legal protection for corporate constituencies.[78]

Second, the concept of trust supplies normative criteria for determining, even in one country, when corporate rules should or should not be mandatory,[79] analogous to what is known as "consumer legislation." The hypothesis and the analogy assume that trust also serves to explain the presence of compulsory consumer legislation in contract law, which is generally perceived as "enabling" legislation. The growing might of economic bodies and their alienation from their constituencies (which lack information and economic resources) explains the need for intervention when a trust culture is lacking, since mere contract might lead to abuses in these areas. The principle of "let the buyer beware" is thus exchanged for one where the risk is assumed by the seller for the sake of preserving trust and fulfilling expectations in contractual situations characterized by high incentives for breach.[80] This argument supports, for instance, the much more pronounced tendency to rely on mandatory rules for the regulation of

77. Given that trust is also a behavioral attribute, we can draw a cross-cultural analogy between low- and high-trust countries, on the one hand, and Kohlberg's psychological model of individual moral development on the other. *See* H. ANDREW MICHENER & JOHN D. DELAMATER, SOCIAL PSYCHOLOGY 73 (Harcourt Brace Jovanovich, 3d ed. 1994). Kohlberg's model begins with moral judgments based on external, physical consequences of acts, and proceeds to moral judgment based on social consequences of acts and moral judgments based on universal moral and ethical principles. Since this *individual* progression through three levels of moral reasoning is universal, and depends, inter alia, on *culture,* this model can also be applied collectively to a society.

78. It might be interesting to observe the correlation between the thesis presented here and the comparative findings presented in Raphael La Porta, et al., *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999); Raphael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3 (2000); Simon Johnson et al., *Tunneling*, 20 AM. ECON. REV. PAPERS & PROC. 22 (2000).

79. The issue of contractual freedom in corporate law is a fundamental issue in the theory and practice of corporate law. The literature on this subject is thus very extensive and was the theme of a symposium issue of the Columbia Law Review. *See* Lucian A. Bebchuck, *Foreward; The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989).

80. For a perspective on modern corporate and securities law as part of consumer law, see Eli Bukspan, *About the Linkage of the Foundation Constituting Corporate Law, Consumer Law and Standard Form Contracts*, 44 HAPRAKLIT 314 (1999) (in Hebrew).

public corporations characterized by dispersed and passive investors than for their private counterparts. This is also true of other issues involving the temptation to effect significant transfers between shareholders and managers, or between minority shareholders and the controlling shareholder, or issues that externalize risks in other constituencies.[81] These actions encourage breaches of trust and, therefore, should usually be subject to mandatory regulation. The notion of trust can also help justify the mandatory nature of the exception to the limited liability principle in corporate law (the doctrine of "piercing the corporate veil") and anticipate when the court will implement it even in voluntary settings. Specifically, personal liability will be imposed whenever corporate organs or shareholders, which were involved in corporate contract or negotiation, have breached the reasonable expectations *they* raised in the other party.[82]

Third, trust theory, as a comprehensive theory of contract and corporate law, can shed more consistent light on the justification of full mandatory disclosure in the securities law. Because disclosure is a crucial way of attaining trust, reducing risks and providing incentives to cooperate, the need for disclosure requirements in publicly-traded corporations—characterized by investors' diversification, inferiority, and rational passivity—is easily explained.[83]

Fourth, the application of trust theory as a comprehensive theory of contract law in the context of the multiple consent relationships prevalent among corporate actors may provide corporate managers with a coherent instrument for balancing the reasonable expectations of all contractual constituencies associated with the corporation. Moreover, the concept of

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81. It is worth noting that my thesis supports an argument similar to that of Bebchuk, although on different grounds. *See* Lucian A. Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820 (1989).

82. As the Israeli experience demonstrates, one way of cementing an atmosphere of trust in the corporate context is to ascribe personal contractual liability to corporate players vis-à-vis their corporate constituencies. There are rare precedents for this liability in corporate law, such as in the doctrine of "piercing of corporate veil." As noted, trust theory may supply a coherent justification for such rulings in the future.

83. *Compare* LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 92 (1914) ("Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman"); Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197 (1999). Similarly, and as shown in *supra* Part II, section D, the rhetoric of trust (protecting investors' confidence in the capital market) has been the prevalent legal justification in recent decisions of the Israeli Supreme Court concerning issues settled in the Israeli Securities Law.

trust can provide a consistent and holistic frame for the contents of the well-known "Business Judgment Rule" without sacrificing the shareholder supremacy goal of corporate law, because all other constituencies in a typical corporation implicitly *expect* this rule and take it into account ex ante when they enter the corporate scene. Since the fiduciary supremacy of shareholders (i.e., maximizing corporate value) is an "existentialist" attribute required for the corporation's survival, it affects the reasonable expectations of the typical corporate voluntary constituencies.[84] Thus, balancing the needs of all corporate constituencies does not mean that enforcing one contract will necessarily sacrifice the reasonable *expectations* of other constituencies, even though it may at times hurt their *interests*. Respectively, a legal regime that directs corporate managers to maximize corporate value without neglecting their obligation to meet the reasonable expectations of all corporate constituencies, might settle the purported conflict surrounding the role of the corporation in the modern society (the "property conception" of the firm verses its "social-entity conception").[85] It may also be more effective in improving efficiency and strengthening the drive toward cooperation among various constituencies than the traditional conception guiding managers to concentrate only on the myopic interests of shareholders, since the corporation itself can reap enormous benefits by relying on trust.[86] In other words, the traditional agency literature of corporate law, which views the shareholders as the main corporate constituency, is unrefined and less than optimal, as it is not broad enough in addressing the expectations of other corporate

84. *Compare* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 Geo. L.J. 439 (2001). The equation of the shareholders' residual interest with the corporate value of profit maximization led classic corporate literature to conclude that the most efficient allocation of voting rights is to shareholders (in the one-share-one-vote scheme) and to analyze in this light the efficiency of other corporate governance issues. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 72-74 (Harvard Univ. Press 1991).

85. Trust, then, will serve as a balancing tool between corporate constituencies, in a way that will circumvent the so-called "schizophrenic conception" of corporate law. *See* William T. Allen, *Our Schizophrenic Conception of the Business Corporation,* 14 CARDOZO L. REV. 261 (1992).

86. Paradoxically, a culture of trust that takes into consideration the reasonable expectations of corporate constituencies might act as a bonding signal and prove most efficient for shareholders as well. For an efficiency argument for trust relations between employees of a firm, *see* Ralph Chami & Connel Fullenkamp, *Trust and Efficiency,* SSRN Working Paper (July 2001), *available at* http://ssrn.com/abstract=206368. This paper is part of a larger project on the role of trust in market organizations and the interaction of both market and non-market organizations.

constituencies in particular, and the basic idea of trust relations and commitment implicit in any contractual obligation in general. In that sense, when we endorse the approach of the "nexus of contracts" to corporate law, and the notion of trust toward *all* corporate players, we proceed along a more holistic and integrative path regarding issues of corporate law, including the goal of protecting investors in a global economy.

In sum, the core of the typical corporation, as a business microcosm, is concerned with the goal of maximizing profits. This declared goal is the basic and most common expectation of a typical corporation upon its formation, and is implicitly accepted by all corporate players. Unlike the state or other public organizations, corporations are not usually subsidized by public resources. Pure social and altruistic goals, therefore, failing to ensure priority to the goal of profit maximization, will be ultimately self-destructive to the corporation and all its constituencies, not only to the shareholders. The concept of *shareholder* primacy reinforces this basic expectation from the corporation and its organs, because shareholders are the residual claimants, and their most homogenous interest is the only one that always correlates with the profit maximization goal of the corporation.[87] In this respect, the conclusion in Hansmann and Kraakman's recent work, *The End of History for Corporate Law,*[88] appears plausible, namely, that the shareholder primacy model of corporate law is today so indisputable that it represents the "end of history" for corporate law.[89]

Yet, the shareholder primacy model, even if it marks the "end of history" for corporate law, is also the beginning of a new research path in corporate law. In one sense, the shareholder primacy model is too narrow, even from the shareholders' perspective, if it ignores the expectations of

87. The survival and prosperity of the corporation are obviously in the best interest of all corporate constituencies. In any event, most corporate constituencies at present are also residual claimants in other corporations in their other capacities, such as investors in pension funds.

88. Hansmann & Kraakman, *supra* note 84.

89.

> [T]he basic law of corporate governance—indeed, most of corporate law—has achieved a high degree of uniformity across these jurisdictions, and continuing convergence toward a single standard model is likely . . . . Chief among these pressures is the recent dominance of a shareholder-centered ideology of corporate law among the business, government and legal elites in key commercial jurisdictions. There is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value.

Id. at 439. "The triumph of the shareholder-oriented model of the corporation over its principal competitors is now assured, even if it was problematic as recently as twenty-five years ago." *Id.* at 468.

other corporate constituencies and their willingness to optimize cooperation. For a long time, scholars of law and economics focused on the shareholder primacy model and ignored the corporation's interest in preserving loyalty toward other constituencies, as if these interests were mutually exclusive. In contrast, a realm of trust, which is implemented in every contract, implicitly binds the corporation and its organs not to thwart the reasonable expectations of all other corporate constituencies. In the long run, implementing trust in the interactions with shareholders and all other constituencies will serve everyone's best interests and, as a by-product, will be in the interest of residual claimants, saving agency costs and inducing risk-taking and cooperation by all the constituencies involved in the corporate community.[90]

Finally, the concept of trust, as a comprehensive theory of contract law and its application to corporate contracts, is the best prescriptive theory of corporate law because of its promising potential in helping to attain the long sought goals of corporate law: internalizing an atmosphere of trust. This is the best atmosphere for protecting investors and assisting them to maximize value by inducing corporate constituencies to incur risks and cooperate. Because each contract constitutes the most prevalent form of social and economic engagement, raising expectations, and inviting mutual trust, it can be used to reinforce a culture of trust both locally and globally when dealing with multinational corporations, with global contracts and global constituencies. Further research, which will be based on this view and will use corporate contracts as a universal lever for attaining trust, might supply promising outcomes. An interesting point of departure could be the Israeli experience,[91] which makes, as shown, rather extensive use of the "good faith" doctrine of contract law in corporate contractual constituencies, stressing their implicit obligation to fulfill the reasonable expectations of *all* corporate players.[92] Any breach of "good faith"

90. *Compare* Manuel Beccerra & Anil K. Gupta, *Trust within the Organization: Integrating the Trust Literature with Agency Theory and Transaction Costs Economics*, 23 PUB. ADMIN. Q. 177 (1999).

91. *See supra* Part II.

92. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981) ("*Every contract* imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.") (emphasis added). The comments to Section 205 state:

> (a) Meanings of "good faith" . . . . The phrase "good faith" is used in a variety of contexts, and its meaning varies somewhat with the context. Good faith performance or enforcement of a contract emphasizes *faithfulness to an agreed common purpose and consistency with the justified expectations of the other party*; it excludes a variety of types of conduct characterized as involving 'bad faith'

obligations by corporate organs, namely, any breach of the trust that was placed in them, exposes them to financial damages that—especially when involving a stigma and expressive rhetoric—help to internalize loyal behavior and improve the broader "business culture" of trust.

V. CONCLUDING NOTE—THE INTERRELATIONSHIP BETWEEN CONTRACT LAW, BUSINESS CORPORATIONS, AND SOCIETY

The fundamental characteristics of a business corporation, just like the most common and trivial contract, are based on reciprocity and exchange of future promises. Contractual attributes of this type, that are oriented toward future contingent actions and cooperative behavior, inherently generate expectations and involve risk.[93] The business corporation, as a nexus of ongoing contracts which must be coordinated, thus parallels the nature of human being as "social animals who can only satisfy most of their needs by means of coordinated and cooperative activities"—this is the essence of trust in this context.[94]

Contract law—which is justified by the concept of trust—is the legal device that regulates this voluntary social and economical interaction. The linkage between the attributes of the concept of trust as a social convention on the one hand, and contract as a legal concept on the other hand, is that *both are aiming to reach similar universal goals of cooperation, risk-taking, and fulfillment of reasonable expectations.* Accordingly, and as "cultures grow up out of the countless small choices of millions of people,"[95] we can view specific contract in a given society not merely as "private" and "micro" interaction, but rather as a subset of a broader social, macro, and cultural aspects of common trust.

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because they violate community standards of decency, fairness or reasonableness. The appropriate remedy for a breach of the duty of good faith also varies with the circumstances . . . . (d) Good faith performance. Subterfuges and evasions violate the obligation of good faith in performance even though the actor believes his conduct to be justified. But the obligation goes further: bad faith may be overt or may consist of inaction, and fair dealing may require more than honesty. A complete catalogue of all types of bad faith is impossible, but the following types are among those which have been recognized in judicial decisions: evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance. (Emphasis added.).

93. Recall that the "expectation" interest is the basic interest protected by contract law. *See supra* text accompanying notes 28-31.

94. Benn & Peters, *supra* note 18.

95. James Q. Wilson, *Human Remedies for Social Disorders*, 131 THE PUB. INT. 25, 35 (1998).

More significantly, if one can see the potential role of contract law, including its "good faith" doctrine, as a compliance device serving to symbolize,[96] build and internalize a culture of trust in any routine interaction, this is also the case in the especially complex contractual interactions entailed by corporations.

Since our daily lives are largely determined by the existence, activities, and ideology of large corporations,[97] the corporate phenomenon—as a community reflecting a web of ongoing contracts—can serve a significant role in guiding society toward a culture of trust. As the mere existence of corporations and their ability to obtain capital and other resources are heavily dependent on the expectations they generate in those who are asked to interact with them (e.g., shareholders, creditors, employees, vendors, and customers), corporations have substantial incentives to create expectations (and a direct and utilitarian incentive to actually fulfill them), thereby remaining attractive to the parties they transact with, and as a consequence, ensuring their survival, growth and profitability. The business corporation, then, and mainly as was evident by the trauma arising from the recent scandals in American corporate governance, is a substantial social driver in our society, which should create and foster an atmosphere of trust and not only benefiting from it.

In a generation that is characterized by expansion and globalization of corporations and investors, it is readily evident how these notions can be extended across countries and cultures wherein the corporate entity would assume an active role as a trust creator at the international level.[98]

In conclusion, it is evident that a culture of trust—as reinforced by any contract, and even more so by a nexus of contracts—will not only contribute to the prosperity of a specific transaction or an entity but also to the society as a whole.

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96. Griffith, *supra* note 57.

97. *See, e.g.*, the discussion in J.E. PARKINSON, CORPORATE POWER AND RESPONSIBILITIES – ISSUES IN THE THEORY OF COMPANY LAW ch.1 (Oxford Univ. Press 1993).

98. The ambition to promote a culture of trust in the international trade can be found also in section 7(1) of the United Nations Convention on Contracts for the International Sale of Goods, which was signed in Vienna on April 11, 1980: "In the interpretation of this Convention, regard is to be had to its international character and to the need to promote uniformity in its application *and the observance of good faith in international trade*" (emphasis added). Moreover, in the virtual age of e-commerce, the crucial and universal significance of trust is more pronounced than ever before. *Compare*: T. Frankel, *Trusting and Non-Trusting on the Internet,* 81 B.U. L. Rev. 457 (2001).

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