

REPUTATIONAL SANCTIONS IN PRIVATE AND PUBLIC REGULATION

*Judith van Erp**

Abstract

This article analyses how reputation functions as a mechanism for social control in private and public regulation. It discusses three cases of private markets where reputation is a powerful and effective mechanism for social control. From the case studies, four characteristics of markets with effective reputational sanctions are identified. Reputational sanctioning is not limited to the private sphere. More and more, public regulators are disclosing names of sanctioned companies or experimenting with naming and shaming, in the expectation that this will enhance the impact of their enforcement strategies on compliance. However, this article argues that the conditions that contribute to the strength of reputation as a regulatory mechanism in private markets are often absent in public regulation.

1 Introduction

Many commercial markets are characterised by long-term cooperation, informal relationships and high levels of mutual trust. In these markets, upholding a reputation of trustworthiness is crucial for successful business performance. When an entrepreneur does not keep his promises or fails to

* Judith van Erp is senior researcher at the department of Criminology at the School of Law, Erasmus University Rotterdam. She is currently carrying out a research project on naming and shaming, which is funded by the Dutch Council for Scientific Research. The author wishes to thank Henk van de Bunt for his valuable comments on an earlier draft.

compensate for a broken agreement, he will not be granted deals in the future. A reputation of reliability thus enhances the chance of future deals. Therefore, reputation can be considered a form of capital, even more important than a company's financial capital. After all, financial capital can be regained, but it is much more difficult to rebuild a reputation that has been damaged. In these markets, the prospect that broken agreements will result in reputational damage is enough to ensure compliance to contractual agreements. Therefore, law is not the most important mechanism to influence and control corporate behavior.¹ On the contrary, compliance to the obligations of parties, whether or not they are written down in contracts, is enforced through out-of-court mechanisms of social control. In other words, entrepreneurs keep their promises not because they fear being sued, but because they fear developing a bad reputation.² As this article will show, there are even markets in which reputational regulation is so powerful and efficient that legal conflict resolution is virtually nonexistent.

The first aim of this article is to explore the way in which reputation functions as a mechanism of social control. What characterizes markets where reputation is an effective regulatory mechanism? How is information about reputations exchanged and what do reputational sanctions consist of? What mechanisms and conditions underlie the effectiveness of reputational sanctions in business relations? More insight into the functioning of reputation regulation is not only important for a better understanding of markets, it is also highly relevant for the public regulation of corporate behaviour in markets. More and more, public regulators are trying to incorporate reputational mechanisms in public regulation, using reputational sanctioning as an instrument of public policy.³ Public disclosure of corporate offenders, or naming and shaming, is gaining popularity as a regulatory tool. In many European countries, regulators are experimenting with the public disclosure of inspection results, offender indexes, or shaming offenders in the media. Of course, press releases or public notices following incidents have long been practice. What is new is the systematic and detailed character of the information published, as with the disclosure of all names and

¹ D. Black (ed.), *Toward a general theory of social control, vol. 1: Fundamentals* (Orlando: Academic Press 1984), R.C. Ellickson, *Order without law, How neighbors settle disputes* (Cambridge: Harvard University Press 1991).

² E. Posner, *Law and Social Norms* (Cambridge: Harvard University Press 2000) at 12.

³ D. Kahan and E. Posner, 'Shaming White Collar criminals: a proposal for reform of the federal sentencing guidelines' (1999) 42 *Journal of Law and Economics* at 365. J.G. van Erp, 'De dreiging van negatieve publiciteit: Is reputatieschade een alternatief voor handhaving?' in F. Leeuw, J. Kerseboom and R. Elte (eds.), *Turven, Tellen, Toetsen, Over toezicht, inspectie, handhaving en evaluatie en hun maatschappelijke betekenis in Nederland* (Den Haag: Boom Juridische Uitgevers 2007) 79.

offences of violating companies in a public register or on a blacklist. Here are some examples:

- The British Health and Safety Executive keeps a public register of convictions, where an overview of convicted companies can be found.
- The Dutch Authority for Financial Markets (AFM) issues warning lists with the names of companies that offer securities services without the required license. The AFM informs the public that these companies are infracting the law and ‘strongly advises’ investors not to do business with these companies.
- The European Directive on public access to environmental information obliges member states to publish names of polluting companies in the European Pollutant Emission Register.
- The European Commission has established a public list of airlines considered to be unsafe and therefore not allowed to carry passengers or cargo within European airspace.
- Both in Denmark and in the UK, ‘scores on the doors’ of restaurants show the extent to which the restaurant complies with hygiene standards. A positive smiley denotes compliance, a negative smiley indicates discrepancies.

The academic evaluation of the effectiveness of naming and shaming as a policy instrument has not kept up with its increasing use. Therefore, the second aim of this article is to draw lessons from successful reputational regulation in private markets, for public regulation. Understanding the strengths and weaknesses of reputational mechanisms in non-legal settings can help us understand whether, and when, reputational sanctions can be successfully used as part of governmental social control. In what circumstances can legal and reputational sanctions reinforce each other, and can reputational sanctions that are initiated by governments be just as powerful as reputational sanctions in markets?

To answer these questions, I will present three cases of successful reputational regulation in commercial markets (section 2): the market for Cotton in the American South,⁴ the diamond trade in New York,⁵ and the Dutch construction industry.⁶ These cases were chosen because of the detailed insight they provide into the working of reputational mechanisms.

⁴ L. Bernstein, ‘Private commercial law in the cotton industry: creating cooperation through rules, norms, and institutions’ (2001) 99 *Michigan Law Review* 1724.

⁵ B.D. Richman, ‘How community institutions create economic advantage: Jewish diamond merchants in New York’ (2006) 31 *Law & Social Inquiry* 383.

⁶ H. van de Bunt, ‘Rekeningen vereffenen in de bouw’ (2008) 50 *Tijdschrift voor Criminologie* 130.

Despite the fact that the authors originate from different theoretical backgrounds – law and economics, law and sociology, and criminology respectively – the case descriptions have several characteristics in common. All three cases are examples of situations that are very vulnerable to conflicts, but where legal regulation is either considered undesirable or is unavailable. In the case of the market for cotton, the volatile nature of the merchandise calls for a strong mechanism for conflict prevention, whereas legal dispute settlement provides an ex post solution. The same goes for the diamond market, where traders need to entrust their precious stones to potential buyers without receiving advance payment or formal security. The third case deals with the Dutch construction industry, which was involved in a market-wide cartel for many years. In this case, the illegal nature of the cartels makes it impossible to settle conflicts via a legal procedure. In all three cases, reputational sanctions function as mechanisms of social control that is so effective that markets flourish without any legal backup.

On the basis of these cases, I will identify characteristics of markets with successful reputational regulation (section 3). Finally, I will analyse the extent to which situations where public regulators disclose reputational information about offenders, or attempt to name and shame, correspond to these characteristics (section 4). In other words, I will ask the question whether the conditions that account for the effectiveness of reputational sanctions in commercial markets are present in public regulation. The article ends with a brief conclusion.

2 Effective reputational social control: three examples

2.1 The Cotton trade in the American South⁷

For many years, the city of Memphis in the American South has been the centre of the cotton trade. The cotton trade provides us with an example of a market where traditional forms of social control have been able to survive by adapting to modern times. Information about traders' reputations are exchanged through both formal and informal communication channels, providing knowledge about traders' past behaviour to third parties without their personally experiencing this behaviour.

⁷ For a further analysis of this case, see Bernstein, above n. 4 and J.G. van Erp, 'Naming en Shaming in het contractenrecht? Het reputatie-effect van schadevergoedingen tussen ondernemingen' in W. van Boom, I. Giesen and A. Verheij (eds.), *Gedrag en Privaatrecht, over gedragspresumpties en gedragseffecten bij privaatrechtelijke vraagstukken* (Den Haag: Boom Juridische Uitgevers 2008) 153.

Trust is a defining characteristic of the American cotton trade. The highly volatile prices and quality of cotton and the difficulty of judging that quality beforehand is the reason for this. Deals, even if worth millions of dollars, are made face to face or by telephone, and only later does the buyer actually assess the quality of the merchandise. Agreements are only documented for tax or customs reasons. Because of these characteristics of the cotton trade, it is crucial that cotton traders have a reputation of trustworthiness on the subject of timely delivery and payment; flexibility; and quality-price assessment. As a trader explains,

You want to do business where you know people and can depend on what they say on quality, since it is so subtle and so subjective. You are more likely to rely on quality when you know the guy.⁸

To cotton traders, commercial and tort law are not suitable mechanisms for enforcing compliance with agreements. For most traders, obtaining compensation for damages through a court procedure is not a very comforting scenario. Litigation is costly, insecure and complex and business people generally want to prevent problems from occurring instead of remedying them afterwards. Compensation of damages is not an effective sanction because it does not adequately prevent conflicts. Instead, it simply puts a price on non-compliance.⁹

To ensure that agreements are complied with, cotton traders choose trading partners with a reputation of reliability. The cotton market is generally characterised by long-term, cooperative relations. However, the market is too complex for traders to be fully informed about all interactions of their business partners. This calls for a network in which reputation information can be exchanged. The various cotton trade associations provide this information by actively registering and disclosing information about the traders' reliability. The American Cotton Shippers Association, for example, keeps a register of breaches of contract and is authorised to inform a potential trade partner confidentially on the reliability of a trader on request. Membership of a trade association generally requires breaches of contracts of business partners to be reported, to ensure the association has complete and up-to-date information. Names of traders that have broken promises are published in a newsletter. Serious offenders are suspended or expelled from the trade association, making it impossible for them to participate in the trade. Finally, an active trade press and specialised commercial banks contribute to the distribution of information on the reliability of traders.

⁸ Bernstein, above n. 4 at 1746.

⁹ J.S. Johnston, 'Should the Law Ignore Commercial Norms? A Comment on the Bernstein Conjecture and Its Relevance for Contract Law Theory and Reform' (2001) 99 *Michigan Law Review* 1791.

In addition to these formal disclosure mechanisms, there are informal ones that facilitate the exchange of reputational information. These informal mechanisms aim to strengthen and maintain the connection between business relations and social relationships. Traditionally, the small trading towns in the South constitute a community in which commercial and social relationships are strongly intertwined and the reputation as a businessman goes hand in hand with his social status and position. Today, this interdependence of personal and professional reputation is actively kept in existence. Although telephone and the Internet have replaced face-to-face trade, Front Street in Memphis remains the regional trade centre and constitutes a physical meeting point for traders. Traders explain, 'Front Street is worse than a bunch of old women' and 'It is like a sewing circle'.¹⁰ Also, trade associations organise or support all kinds of social events, thus expanding social control from business life to the social circle. There is an annual debutante ball, Memphis Mardi Gras, a Cotton Wives Club with its own *Cotton Tales* magazine, and there are golf and other sports tournaments. These events make sure that family members are actively involved in the cotton trade community. Thus, when information about dishonest behaviour circulates, it not only damages the economic position of a trader but also negatively affects his social position and that of his family. The financial consequences of breach of contract could even be perceived as less damaging than the social consequences in terms of shame and expulsion from the community.

2.2 The diamond trade

The American cotton trade exemplifies a market where traditional forms of out-of-court social control have survived in modern times through an active role of trade associations. The next case study shows that the reputation mechanism even effectively operates as a social control mechanism in the market for the most expensive and exclusive product on earth: diamonds. In the New York diamond trade, social control is so powerful and efficient that it even replaces commercial law.

Trading diamonds is a risky business. Aside from the immeasurable value of the stones, the trade offers many other opportunities for cheaters. Firstly, diamonds are usually traded on installment. Secondly, countless intermediating parties and traders handle and transport the stones to inspect and value them before they reach their final owner. And thirdly, there is a flourishing black market for diamonds. These characteristics provide traders with an enormous need for information about the trustworthiness of business partners. The diamond trade is concentrated in closed communities, both in geographic terms – Antwerp and New York are the diamond capitals of the

¹⁰ Bernstein, above n. 4 at 1752.

world – and in socio-cultural terms: the diamond trade is traditionally the domain of Jewish traders. In both communities, diamond traders have established trade associations that function as platforms for the exchange of information and for conflict resolution. In Antwerp, the Hoge Raad voor Diamant (HRD) is the centre of the trade; in New York, it is the New York Diamond Dealers Club (DCC), located on 47th Street in Manhattan.

Siegel characterizes the Antwerp trade as a high-trust subculture that is closed to outsiders.¹¹ The task of regulation and conflict resolution is not performed by the government but by the Hoge Raad voor Diamant. This HRD aims to protect the reputation of the diamond traders by excluding newcomers from membership. For example, Jewish gold traders from Georgia or Russia are not admitted to the HRD because they are associated with organised crime in Eastern Europe. The HRD continuously stresses the difference between the diamond trade and the supposedly mala fide gold trade, and even has summoned the assistance of the criminal prosecutor in order to prevent the Mafia from infiltrating into the diamond market.

Richman provides a case study of the New York diamond trade that permits a closer understanding of the functioning of reputational mechanisms within the diamond trade.¹² The New York Diamond Dealers Club serves several purposes. It serves as an exchange. 95 per cent of the diamond trade in the US takes place on its 25,000 square foot trading floor; the trade value is 30 billion dollar per year. In addition, the DCC is a traders association and provides its members with numerous advantages. It has a heavily secured trade room. But more relevant in the light of this article is the fact that the DCC has the sole right to collect and disclose reputation information. In case there is a conflict, members are obliged to resort to the DCC's arbitration committee. Members who bring their conflicts to court are fined or expelled. This ensures that DCC is well informed about all non-compliant members.

Next, DCC actively discloses this reputation information in a way that is surprisingly simple, if we take the value of the merchandise into consideration. One of the walls in the large trading room is used as a members' picture gallery and for posting all relevant information on their reputation. Candidate members see their picture attached to the wall for a period of ten days, during which other members can post remarks on their reputation. The decisions of the arbitration committee are published on this wall, which also displays the pictures of traders that have failed to pay their debts, in a format that somewhat resembles a *Wanted* message. It is clear that traders will prevent at all cost their picture from being displayed in this manner.

¹¹ D. Siegel, 'De joodse gemeenschap en de Antwerpse diamantsector in historisch perspectief' (2002) 44 *Tijdschrift voor Criminologie* at 338.

¹² Richman, above n. 5.

Besides this wall, the trading floor also provides the opportunity to physically exchange the latest news and gossip and to ask for references about potential business partners. Thus reputation information is quickly disseminated. And finally, we find a mixture of commercial and personal relations: 85 to 90% of the DCC members are orthodox Jews, many traders come from trading families, and family and community ties are strong.

2.3 The Dutch construction industry

Thus far, I have presented two examples of markets in which reputation provides a mechanism for out of court social control that overrules legal enforcement. Participants to these markets prefer informal enforcement through the reputational mechanism to legal conflict resolution. However, it cannot be denied that both markets still operate under the shadow of the law, in the sense that criminal activity can be prosecuted. For those cases in which out of court arbitration fails to solve appropriately, parties can always use the law as last resort. Complete non-existence of legal social control is in fact only the case in illegal markets. After all, criminals cannot go to court to settle their disputes. However, even in illegal markets, reputational sanctions are a pervasive and effective mechanism for social control, as the next case study shows.

An excellent example of the role of reputation in illegal markets can be found in the Dutch construction fraud.¹³ The Dutch construction industry is characterised by a history of private contracting, and informal price coordination and work distribution. This has contributed to a continuous work flow for construction companies and thus to a stable and long-lasting market. Nevertheless, this system of informal coordination was forbidden in 1992, when the Dutch Antitrust Act was adopted. The new legislation did not end the system of price agreements, however. Almost all construction companies were involved in secret pre-bidding consultation in practically every contracting procedure. This conspiracy only came to an end after the publication of a parliamentary investigative report, which was initiated by the revelations of a whistle-blower. This whistle-blower, a former director of one of the largest construction companies, published the handwritten shadow administration he had kept for ten years. The setoffs in this administration were related to market sharing, price fixing and mutual compensation.

The construction fraud gives rise to two questions, to both of which the reputation mechanism provides an answer. Firstly, the scale and operational detail of the fraud is exceptional. Almost every construction company in the Netherlands was involved, and the system was also open for participation to Belgian and German companies. For each construction agency, it would have been very easy to blow the whistle and reveal the

¹³ Van de Bunt, above n. 6.

secret cartel. This would no doubt have raised this company's position in governmental, and probably also in commercial biddings. What kept parties from breaking the conspiracy?

The answer is the companies' concern to uphold a reputation of being a fair player to their business partners. Apparently, a reputation of compliance to the law was not as important to contractors as a reputation of reliability with their colleagues. This is because construction companies are not only competitors but also constantly cooperate in subcontracting relations. A construction company cannot execute a large order alone: it needs the cooperation of reliable subcontractors. However, the incidental company that had stepped out of the cartel found itself in a pariah position. They were not assigned subcontracts and all kinds of obstacles were created by the others to participating in public biddings. Not participating in pre-tender consultation was considered to be extraordinarily non-collegial. The construction industry is characterized by strong social ties, and the forbidden pre-bidding gatherings were a much valued social event 'with very nice coffee and sandwiches', as one of the participants remarked. Cheaters could be sure that they would be the subject of extremely negative comments at social meetings.

The second question is how agreements of such detail and financial importance were enforced without legal means. It is striking that conflicts occur relatively seldom. One mechanism of conflict prevention is the meticulous documentation of agreements in a so-called shadow account. Companies that passed an order on to someone else built up a claim that they could trust to be compensated in future tender negotiations. At various times during the year, companies came together to clear their credits and debts with each other. Under the leadership of a retired, authoritative businessman, they tried to settle their claims. Since the exchange of money was highly undesirable (for risk of financial streams being discovered by the tax authorities), claims that could not be settled were paid out in work, in goods, or in last resort by postponing a claim to the next year.

Another factor promoting informal conflict resolution is that it pays to have a reputation of cooperativeness. A reputation for unfairness in the resolution of disputes that may arise in the course of transactions is held at high cost of being passed over in future contracts. The informal pre-tender consultations and the settlement meetings provide the occasion for the rapid dissemination about businesses failing to comply with market-share agreements. Because many companies have existed for several generations and the sector is relatively small, a strong common culture and code of honour has developed. In this shared culture, breaking a promise is considered to be dishonourable and not-done.

3 Characteristics of successful reputational regulation in commercial markets

In the previous section, I have shown that reputation is a most powerful and effective mechanism for social control. We find it successfully regulates markets that operate under unique pressure, either because of the financial value of the merchandise or because of their illegal nature. In these markets, reputational sanctions replace legal sanctions, the last being either inappropriate or unavailable.

In this section, I will analyse the characteristics of markets where effective reputational regulation is exerted. I have identified four characteristics of markets with successful reputational sanctions. Firstly, the nature of the activity in these markets calls for high levels of trust. Secondly, a broken agreement directly damages the market position of traders in these markets. Thirdly, the markets are characterized by a small amount of relational distance. And finally, compliance to agreements is not only valued for reasons of self-interest, but also for moral reasons.

3.1 Absence of formal mechanisms of social control

All three cases I have presented are markets that are characterized by information asymmetry and high transaction costs, where compensation for breaches of trust or violations of agreements is problematic. In the market for cotton and diamonds, legal conflict resolution is perceived as inefficient and inadequate. In the Dutch construction industry, legal enforcement is not available because of the illegal nature of the trade. In these asymmetric markets, entrepreneurs preferably only interact with business partners that have proven themselves reliable. This is of course not possible. As the sociologist Simmel observes in his classic work on trust and social control,

Very few relationships are based entirely upon what is known with certainty about another person, and very few relationships would endure if trust were not as strong as, or stronger than, rational proof or personal observation.¹⁴

To avoid contractual problems arising from the difficulty of assessing the quality of products or services or uncertainty about other people's motives, people rely on information about their reputations. Thus, reputation can be seen as a simplifying device, providing efficient contractual relations.¹⁵ It is the absence of the possibility of effective ex post enforcement through legal conflict resolution that stimulates business partners to actively gather and

¹⁴ G. Simmel, *The philosophy of money* (London: Routledge 1978) at 178-179.

¹⁵ B.A. Misztal, *Trust in modern societies: the search for the bases of social order* (Cambridge: Polity Press 1996) at 121-122.

exchange reputation information. In other words, the exchange of reputational information thrives when a need for this type of information arises from the inefficiency or impossibility of external regulation.

3.2 Market position

A second common characteristic of markets with effective reputational regulation is the fact that a broken agreement seriously damages the market position of the noncompliant party, because of the reactions of third parties. A broken agreement not only damages the relation with the business partner involved, but with many other potential business partners as well. If information about past transactional behavior is available to a significant number of participants, breach of contract with one transactor will be transformed into breach of contract with numerous market transactors as far as a transactor's commercial reputation is concerned. The costs of losing one contract is multiplied by the costs of losing business opportunities with all market parties. This multiplying effect is what makes fear for reputational damage a strong motive for compliance in commercial relationships.¹⁶ In the cases that I have presented, being known as an unreliable business partner makes it impossible to acquire contracts. Reputational damage can consist of withdrawal of support and cooperation of business partners, customers no longer buying goods or services, or investors refraining from investment. Reputational damage thus not only works as an ex post sanction but also prevents non-compliance by serving as a deterrent.

It follows from this argumentation that reputational damage only represents an effective regulatory mechanism for parties for whom a good reputation is necessary to obtain future contracts. Companies with many alternating business partners, end-game actors facing bankruptcy, and monopoly actors do not depend on a good reputation.¹⁷

3.3 Relational distance

A third factor causing the reputational mechanisms in the cases described to be so powerful is the effective dissemination of reputational information. Information on past performance is spread both through formal publication and through informal chat and gossip. This implies that markets in which reputation is an effective regulatory mechanism consist of a relatively limited number of parties that frequently exchange information on the

¹⁶ D. Charny, 'Nonlegal sanctions in commercial relationships' (1990) 104 *Harvard Law Review* 373. Bernstein, above n. 4. Posner, above n. 2. S. Macaulay, 'Non-contractual relations in business: a preliminary study' (1963) 28 *American Sociological Review* 55.

¹⁷ Posner, above n. 2.

quality of products and services, and that they have close ties. In business communities where reputational mechanisms appear to be strong, whether they are a legal market or a market with illegal practices, we see a strong social embeddedness of business transactions. An underperforming cotton trader experiences the consequences of his unreliability not only in business, but also in his private life. This is the result of the strong social ties within the community. This type of market can be characterized as market with a relatively short 'relational distance'.¹⁸ In close relationships, there is little legal social control and alternative non-legal social control is very intense. As communities grow larger and become more connected with the outside world, the relational distance between members tends to increase and informal sanctions are employed with decreasing frequency. Instead, the various activities comprising social control are delegated to specialists who perform this role full-time and exclusively.¹⁹ Although markets with strong reputational mechanisms have institutionalised reputational sanctioning in a trade association, these associations have the task of keeping membership exclusive and to diminish the distance between the members by exchanging information and organising meetings.

3.4 Morality

There are two types of reasons for parties to value their reputation. One arises out of self-interest: the expectation that a good reputation will pay off in terms of utilities. The other comes from moral obligation.²⁰ In the cases that I have presented, these two reasons are present at the same time. Complying to agreements is a matter of long-term self-interest, but also a matter of honour and decency. Those trying to cheat are not only excluded from business contracts but are also morally disqualified.²¹ The business relationships in the cases I have reviewed are more than just self-interested exchange relationships. Instead, they can be characterized as *fictive friendships*: obligating, public, strongly instrumental relationships, in which scarce resources are distributed.²²

Moral disapproval of norm infractions, in addition to the financial consequences, is a powerful regulatory mechanism. Case studies show that

¹⁸ Black, above n. 1 at 45-46.

¹⁹ J. Griffiths, 'The division of labor in social control' in D. Black (ed.), above n. 1.

²⁰ Misztal, above n. 15 at 127-128.

²¹ M. Hertogh, 'Van naleving naar beleving van regels. Bouwwereld en Bouwfraude vanuit een rechtssociologisch perspectief' in T. Barkhuysen, W. den Oudsten and J. Polak (eds.), *Recht realiseren, Bijdragen rond het thema adequate naleving van rechtsregels* (Deventer: Kluwer 2005) 62.

²² S. Falk Moore, 'Law and Social Change: The Semi-Autonomous Social Field as an Appropriate Subject of Study' (1973) 7 *Law & Society Review* 719.

norms that have a moral element are self enforcing; external enforcement is hardly necessary. External enforcement is not able to bring about the emotion that is so predominant in social relations: shame. Criminologist John Braithwaite claims that it is not the severity of the sanction in financial terms, but the amount of public shame that it invokes which is the most important motivator of compliance. In other words, 'The nub of deterrence is not the severity of the sanction but its social embeddedness'.²³ Fictive friendships are filled with mutual respect. The disappearance of this respect is an important part of the working mechanism of a reputational sanction.

4 Reputational sanctions in public regulation: strengths and weaknesses

Public regulation of corporate behaviour in markets was long characterised by external social control by public enforcement authorities. Increasingly, however, regulators have come to realise that external supervision alone cannot prevent organisational misbehaviour. Currently, regulators are attempting to shift from classic command and control regulation to forms of non-hierarchical regulation or governance that are more congruent with existing mechanisms of internal social control and self regulation within markets.²⁴ Regulatory theories such as 'responsive regulation'²⁵ and 'smart regulation'²⁶ have inspired this new approach. These theories advocate a mix of regulatory instruments that make more use of the influence of consumers, significant peers or market forces.

A manifestation of this approach is the increasing use of regulatory disclosure, or naming and shaming, techniques, which aim to increase the transparency of markets and to invoke reputational mechanisms. Disclosure of inspection results is meant to better inform consumers, in the expectation that they will weigh the compliance status of companies in their decision to do business with a certain company. Thus, it is attempted to invoke a market follow-up of public sanctions and to increase the impact of public sanctions on corporate reputations.

An important reason for the increasing use of naming and shaming is that reputational sanctions are considered more effective than traditional

²³ J. Braithwaite, *Crime, shame and reintegration* (Cambridge: Cambridge University Press 1989) at 55.

²⁴ H.G. van de Bunt and R. van Swaaningen, 'Privatisering van de veiligheidszorg' in L.W. Winkel and J.J.M. Jansen (eds.) *Privatisering van veiligheid* (Den Haag: Boom Juridische uitgevers 2005) 5.

²⁵ I. Ayres and J. Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford: Oxford University Press 1992).

²⁶ N. Gunningham and P. Grabosky (eds.) *Smart regulation, designing environmental policy* (Oxford: Oxford University Press 1998).

sanctions in deterring regulatory offences or stimulating regulatory compliance. A clear example of this argument is found in the *Macrory Review* on effective sanctions, the report of Better Regulation Executive professor Richard Macrory to the British Government. ‘A company’s reputation and prestige is an important and valuable asset,’ professor Macrory argues.

The consequences of damaging a firm’s reputation can potentially exceed the effect of a maximum fine that a court could impose. A company that loses its reputation even for a short time can suffer significant damages to consumer confidence, market share and equity value. (...) The threat of this type of sanction may encourage firms contemplating not complying with regulatory objectives to re-consider, even if the noncompliance would generate significant financial benefit.²⁷

The argument of consumer empowerment and regulatory effectiveness is also found in the Dutch policy programme ‘Towards a practical legal order’, which argues that the external pressure of stakeholders will leave public regulation with less costs and regulatory burden, and a larger effectiveness and public acceptance of enforcement and sanctioning.²⁸

Academic evaluation has yet to answer the question whether naming and shaming used by public authorities as a policy instrument can indeed meet the expectations. There are several questions that empirical research should address.²⁹ Are regulators able to effectively influence reputations and predict and control the effects? Does shaming effectively deter corporate crime or does it have little effect or even encourage criminal behaviour? And is there evidence that shaming changes people’s views about the harmfulness of criminal behaviour? This article is an attempt to analyse the potential strengths and weaknesses of naming and shaming by learning from situations where reputational regulation is successful. In the previous section, I have identified four conditions for reputational regulation that account for the effectiveness of reputational regulation in commercial markets. The next step is to analyse to what extent these conditions are present in public regulation.

Firstly, we have seen that reputational sanctions flourish in markets where legal enforcement is problematic. However, regulatory disclosure of

²⁷ R.B. Macrory, *Regulatory Justice: Making Sanctions Effective Final Report* (London: Macrory Review, Cabinet Office 2006) at 83.

²⁸ Tweede Kamer der Staten Generaal, Nota Bruikbare Rechtsorde, nr. 29279, nr. 9, vergaderjaar 2003-2004 20-21.

²⁹ Kahan and Posner, above nr. 3. R. Pawson, ‘Does Megan's law work? A theory-driven systematic review’, *ESRC UK Centre for Evidence Based Policy and Practice Working Paper 8* (ESRC: UK Centre for Evidence Based Policy and Practice 2002).

the names of offending companies is diametrically opposed to this situation. We must ask whether the fact that external regulation is already taking place does not make non-legal sanctions and informal social control redundant. For example, it is unclear what incentive European airline passengers have to consult the European list of banned airlines, since these airlines have already been forbidden to execute flights in the European skies. Since it is impossible to book a flight with these airlines, disclosure of this information seems unnecessary, at least in the form of a blacklist designed for the general public.

Secondly, I have argued that successful reputational regulation requires that an offence or broken agreement negatively affect a company's market position. However, the publication of legal offences does not always lead to a negative evaluation by relevant parties. Legal offences often do not damage the interests of stakeholders directly. On the contrary: public regulation is often designed to protect those interests that do not have a clear stakeholder. Offences of this nature do not result in a bad reputation, and in many cases they hardly affect a company's reputation at all. Research by the economist Karpoff illustrates this.³⁰ He has calculated the size of reputational sanctions for large American companies in terms of loss of stock value, both for financial misrepresentation and for environmental offences. Financial misrepresentation, or 'cooking the books', leads to a huge decline of stock value. The impact of legal sanctions is multiplied by the reputational sanctions in the shape of loss of stock value of a company. However, the case for environmental offences shows quite a different picture. The publication of environmental offences also leads to a drop in stock value, but this loss can be entirely accounted for by the costs of fines and restoration of the damage. There is no extra reputational sanction: stockholders do not value the company less for its unreliability to comply to environmental regulations or for unethical behaviour. As long as the environmental offence is not harmful to the quality of the products that are delivered, business partners have no incentive to limit the demand for the product and to impose a reputational sanction.

Many other examples illustrate that legal norms are not always shared by stakeholders and that the publication of an offence is not a signal for unreliability of a company or institution. A remarkable example was the recent rush of pupils to the Islamic primary school As Siddieq in Amsterdam. This school had just been rated as functioning poorly by the Dutch Board of Education and was placed under a strict regime. The new

³⁰ J.M. Karpoff, J. Lott and E. Wehrly, 'Reputational Penalties for Environmental Violations, Empirical Evidence' (2005) 68 *Journal of Law and Economics* 653. J.M. Karpoff, D. Scott Lee and G.S. Martin, 'The Cost to Firms of Cooking the Books' *Journal of Financial and Quantitative analysis* (forthcoming) available at <http://ssrn.com/abstract=652121>.

pupils' parents were aware of this status, but attached more importance to the Islamic character of the educational programme than to legal rules concerning the independence of the school board. 'The parents came to our information evening with the inspection report in their hands', one of the directors remarked.³¹

Thirdly, successful reputational regulation can be found in markets that are characterised by a small relational distance. The three cases I have provided are all examples of such markets. However, it will be clear that markets of this kind are relatively rare and that in most markets the dissemination and exchange of information is imperfect.³² Therefore, in most markets, reputational sanctions do not have the strong effect that they have in the three cases that I have described. Also, reputational sanctions are imposed by governments, which are rarely strongly socially embedded. Most of the time, governmental agencies do not form part of a close community; on the contrary, the size and disintegration of the community was the very reason for outsourcing social control to specialised governmental agents.³³

Finally, we have seen that reputational sanctions are the most effective when commercial effect and moral evaluations go hand in hand. However, most public regulation is not inflicted with morality in the same way as social norms among fictive friends are. Public regulation is not as widely accepted as collective rules in a business market. Offending cartel regulations, committing tax fraud or employing illegal staff does not meet with the same amount of social disapproval as the breaking of an agreement with a business partner. What's more, governmental sanctions usually do not invoke a sense of shame. 'The only shaming that induces shame is disapproval of the act by those who we respect very highly,' Braithwaite and Drahos argue.³⁴ It is doubtful if the public offenders indexes or registers that are published on the Internet by many public authorities are the best way of invoking shame. The information provided in these registers is impersonal and the registers do not invite the circle around the offender to express their disapproval, as the Wall of Shame in the diamond bourse does. The publication format makes it easy to neutralise the offence and to brush aside feelings of shame.

³¹ *NRC Handelsblad*, June 21, 2007.

³² Charny, above n. 16.

³³ Griffiths, above n. 19.

³⁴ J. Braithwaite and P. Drahos, 'Zero Tolerance, Naming and Shaming: Is there a case for it with crimes of the powerful?' (2002) 35 *Australian and New Zealand Journal of Criminology* 269 at 273.

5 Concluding remarks

This article has analysed the functioning of reputation as a mechanism for social control in private and public regulation. I have discussed three cases of markets where reputation is a powerful and effective mechanism for social control. We find that it successfully regulates markets that operate under unequalled pressure, either because of the financial value of the merchandise or because of their illegal nature. Reputational sanctions can be so powerful and efficient that they make legal sanctions redundant. We have seen several cases of reputational regulation taking the place of commercial law, which sometimes is considered unsatisfying as a conflict resolution mechanism, and in other situations is unavailable.

From the case studies, I have identified four characteristics of markets with effective reputational sanctions. Firstly, the nature of the activity in these markets calls for high levels of trust. Secondly, a broken agreement directly damages the market position of traders in these markets. Thirdly, the markets are characterised by a short relational distance. And finally, compliance with agreements is not only valued for reasons of self-interest but for moral reasons as well.

Reputational sanctioning is not limited to the private sphere. As a reaction to the growing criticism of command and control regulation, and the call for alternative types of regulation that are in better accordance with existing mechanisms for social control, public regulators are experimenting with reputational sanctions. Regulators expect the publication of inspection results to affect the reputation of a company and the threat of negative publicity to prevent companies from offending the law. However, I have argued that the conditions that contribute to the strength of reputation as a regulatory mechanism in private markets are often absent in the context of public regulation. Company offences of public regulation are not always considered a sign of unreliability. These offences are usually not heavily damaging to the market position, social position or moral evaluation of a company. Therefore, we should put the effectiveness of naming and shaming by public authorities into perspective. It is highly doubtful that they will be as effective as reputational sanctioning in commercial markets.

