A Firm's Reputation as a Regulatory Tool

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Berlin, im Juni 2011 David Matthias Bachmann

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Summary

The question of how to achieve behavior modification of firms and make them comply with certain rules or standards is a subject at the interface between law and economics. This thesis examines the behavior modifying capacity of threatening a firm's reputation and investigates the conditions that have to prevail in order for reputational sanctions to be effective regulatory tools. The thesis is organized in three chapters:

The **first chapter** gives an overview of the regulatory landscape and seeks to present the essential characteristics and functions of regulation. A broad definition of regulation that allows us to consider the behavior modifying effect of structures outside the direct effect of law is established and the premises on which this thesis is built are introduced. In particular, it is demonstrated that there has been a shift in practice and theory from state-centered and hierarchical forms of regulation to alternative forms: these contemporary forms of regulation are characterized by the interaction of a variety of actors and instruments, and an increasing reliance on dispersed mechanisms.

The **second chapter** turns to the actual research question and examines the conditions that have to exist in order for threatening a firm's reputation to be an effective regulatory tool. Not only can *reputational loss* that has effectively occurred have a behavior modifying effect but already the *deterrent effect* of threatening a firm's reputation. Theory and practice suggest that this deterrent effect is due to the negative financial impact (*reputational costs*) *reputational loss* can have on a firm's business, caused by the reactions of a firm's stakeholders. Based on this finding, the conditions under which a firm's *non-compliant behavior* is likely to cause *reputational loss* and when this loss of reputation is likely to lead to the occurrence of *reputational costs* are analyzed. Furthermore, it is demonstrated that the emergence of digital technologies, particularly the internet, and the increased availability and transmission of information on a global scale, has raised the probability significantly that both reputational loss *and* costs will occur.

The findings of the second chapter are summarized in the *formula of reputational costs*, stating that the behavior modifying potential of this regulatory tool depends on three factors: a firm's *stakeholders' expectations* regarding the firm's behavior, the *observability* of a firm's effective (possibly non-compliant) behavior and a firm's stakeholders' *potential to react to* the occurrence of reputational loss caused by a firm's non-compliant behavior.

In the **third chapter** the practical and legal constraints of threatening a firm's reputation are highlighted. A brief model, based on the findings of the second chapter, is introduced allowing potential regulators to assess whether firms in a certain setting are likely to respond to this regulatory tool. Furthermore, attention is drawn to the legal constraints state and private actors face when they provide information about firms' effective behavior that is likely to cause a reaction of firms' stakeholders, which might again lead to the occurrence of reputational costs.

Summary (German)

Die vorliegende Arbeit setzt sich mit der Frage auseinander, unter welchen Bedingungen Reputationssanktionen eine verhaltensändernde Wirkung auf Unternehmen haben und somit ein effektives Regulierungsinstrument darstellen können.

Die Arbeit ist in drei Kapitel gegliedert:

Im ersten Kapitel wird ein Überblick über zentrale Eigenschaften und Funktionen von Regulierungssystemen und -mechanismen gegeben und der Begriff der Regulierung für diese Arbeit definiert. Zudem werden die Prämissen dieser Arbeit getroffen und in diesem Rahmen aufgezeigt, dass es in Theorie und Praxis einen sich verändernden Fokus von staatlich-hierarchischen zu alternativen Regulierungsformen gegeben hat, deren wesentliches Charakteristikum die Interaktion verschiedener Regulierungsakteure und -instrumente ist.

Im zweiten Kapitel werden die Bedingungen erarbeitet, die für die Wirksamkeit von Reputationssanktionen erfüllt sein müssen. Nur wenn diese Bedingungen erfüllt sind, kann das Verhalten von Unternehmen in der erwünschten Weise beeinflusst werden. Zudem zeigt der Autor auf, dass ein durch den Siegeszug der digitalen Technologien veränderter Informationsprozess das Regulierungspotential von Reputationsmechanismen gestärkt hat. Die Ergebnisse des zweiten Kapitels werden in einer *formula of reputational costs* zusammengefasst.

Im dritten Kapitel werden schließlich die rechtlichen und praktischen Grenzen von Reputationssanktionen aufgezeigt.

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List of Abbreviations

BGE	Bundesgerichtsentscheid (Decision of the Swiss Federal Supreme Court)
BPEO	Best Practicable Environmental Option
CSR	Corporate Social Responsibility
DAX	Deutscher Aktien Index (German Stock Index)
DHS	Department of Health Services
DNV	Det Norske Veritas
DZI	Deutsches Zentralinstitut für soziale Fragen (German Institute for Social Questions)
EC	European Commission
EFRAG	European Financial Reporting Advisory Group
e.g.	exempli gratia (for example)
EIU	Economist Intelligence Unit
EU	European Union
FATF	Financial Task Force on Money Laundering
FSC	Forest Stewardship Council
i.e.	id est (that is)
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IFRSs	International Financial Reporting Standards
IGO	Intergovernmental Organisation
IOSCO	International Organization of Securities Commission
ISO	International Standards Organization
MNC	Multi-National Corporation
NCCT	Non-Cooperative Country or Territory
NGO	Non-Governmental Organization
NIE	New Institutional Economics
OECD	Organisation for Economic Co-operation and Development
OSPAR	Oslo/ Paris convention (for the Protection of the Marine Environment of the North-East Atlantic)
SARG	EC's Standards Advice Review Group
SEC	U.S. Securities and Exchange Commission
SMS	Short Message Service
SRO	Self-Regulatory Organizations
TNC	Trans-National Corporation
UK	United Kingdom
US-GAAP	United States Generally Accepted Accounting Principles

Introduction

Asking about how to make people follow rules and how to modify individuals' and collectives' behavior has occupied humankind for millennia and has led to a wide range of different answers: ranging from the reliance on the deterrent effect of gladiator fights, to social ostracism by pillorying people, to behavioral rewards such as the bestowal of decorations.

Influencing and governing the conduct of people in order to make their conduct conform to some form of rule or standard is the subject of regulation. Contemporary forms of regulation are characterized by the interaction of a variety of state and non-state actors and an increasing reliance on dispersed mechanisms. The behavior modifying effect of structures outside the direct effect of law is recognized and, furthermore, private actors have proved to be capable of *de facto constraining* the behavior of individuals, firms and even state governments. Examples include the influence of rating agencies and their impact on political processes in the context of the financial crisis 2007-2010 or the increasing importance of private certificates and standards such as international accounting rules.

The intent of this thesis is to examine the behavior-modifying capacity of firms' reputations. Several examples can be observed where damage to a firm's reputation has caused firms to change their behavior. Not only civil society actors have demonstrated their ability to impose pressure on companies by putting them and their misconduct in the public eye, but the success of the internet has now empowered individuals by providing the platforms necessary to share their observations about and experiences with firms' behavior with a worldwide audience.

The probability that a firm's (perceived) misconduct will be detected has increased significantly and so has a firm's chance of being convicted in the court of public opinion and of having its reputation tarnished. These developments have led to an enhanced perception of firms' reputations as a valuable but vulnerable asset in general. However, while some firms seem to fear the verdict of the court of public opinion and the negative financial consequences of a loss of reputation, others do not.

Why is this? This thesis is to give answers to the question of why reputational sanctions, and regulatory regimes relying on such sanctions, achieve behavior modification among certain firms and are likely to be absolutely toothless in the case of others. The objective of this thesis is to find out the conditions that have to exist for the threatening of firms' reputations to be a powerful regulatory tool in order to ensure compliance with rules, whatever their nature. This question is a subject just at the interface between law and economics.

Research Question, Hypotheses and Approach

Regulation is about how to ensure that actors behave in conformity to rules. This doctoral thesis is based on the idea that a firm's reputation has the potential to modify the firm's behavior and that this mechanism can be used as a regulatory instrument in order to make firms behave according to defined rules or standards. In particular, the enhanced availability and transmission of information on a global scale is assumed to have increased the potential of threatening a firm's reputation as a promising tool to cause behavior modifications.

This doctoral thesis aims to investigate the conditions that have to prevail in order for threatening a firm's reputation to be an effective regulatory tool.

The underlying premises and hypotheses provide the structure of this thesis, which is organized as follows:

Chapter One: Regulation – An Overview

Chapter one gives an overview of the regulatory landscape. The idea to use threatening firms' reputations as a regulatory tool implies a broad definition of regulation that does not limit regulation to approaches which are state-centered and of an imperative nature but rather includes the activities of a multitude of state and non-state actors and regulatory sources which *de facto* constrain and determine firms' behavior.

Part A of chapter one will establish such a broad definition by critically discussing different definitions and concepts of regulation.

In **Part B** the premises of this thesis – which lead to the idea of using threatening firms' reputations as a regulatory tool – are introduced. The following three premises serve to explain some of the essential developments in regulatory studies and to point out why there has been an increasing interest from different disciplines in alternatives to traditional state-centered and hierarchy-based regulation, and thus in conceptualizations of regulation that focus on the idea of understanding regulation as an activity based on the interactions and interdependencies of a variety of regulatory actors, sources and instruments.

Premise I Traditional forms of regulation, state-centered and hierarchical in nature, are challenged as not being capable of dealing with an increasingly complex, interdependent, and fragmented economic and political environment and its actors.

Premise II Alternative forms of regulation have emerged within the last decades on large scale on all levels (domestic, international, global). These regulatory regimes are characterized by a variety of actors (*who*), state and non-state, executing the functions of standard-setting, information gathering and behavior modification by using a variety of instruments and tools (*how*).

Premise III The full potential of using the variety of regulatory sources provided by the four modalities of regulation (hierarchical control, community-based control, competition-based control and design-based control) has not yet been tapped. There is a demand, particularly regarding the regulation of firms, for new ideas which take advantage of the variety of monitoring and enforcement instruments provided by the four modalities and which are able to cope with the needs of a changed environment.

Part C of the first chapter summarizes the findings. Understanding the interaction of varieties of actors and instruments to be essential to regulation allows us to turn to the idea of using firms' reputations as a regulatory resource, thus as a strategy to achieve behavior modification by means other than formalized legal sanctions.

Chapter Two: Firms' Reputations as a Regulatory Tool

In chapter two, based on the findings of the first chapter, we turn to the main idea of this thesis – the use of threatening firms' reputations as a mechanism to achieve behavior modification. The objective of the second chapter is to identify the conditions that have to prevail for this regulatory instrument to be applied.

In **Part A** the general capacity of firms' reputations to modify behavior is demonstrated.

Hypothesis I Losing its reputation can modify a firm's behavior.

Furthermore, it is illustrated that not only reputational loss that has effectively occurred can have a behavior modifying effect but also the deterrent effect of threatening firms' reputations due to the negative financial impact of reputational loss on firms' businesses (the latter is the preliminary definition of reputational costs).

Hypothesis II Threatening a firm's reputation can have a behavior modifying effect on a firm as the firm will act in a manner not leading to reputational loss.

This fact makes it possible to use the deterrent effect of reputational sanctions as an instrument to achieve compliance with rules, whatever their nature.

Hypothesis III This behavior modifying effect can be used as a regulatory instrument in order to achieve that business follows rules within and outside of formalized regulatory regimes.

The results of Part A suggest that the behavior modifying effect of threatening firms' reputations is only possible if non-compliance with rules leads to loss of a firm's reputations and if this loss results in the occurrence of reputational costs.

Based on this finding, **Part B** of the second chapter turns to the nature of *reputational loss*, seeking to understand under which circumstances a firm is faced with loss of its reputation.

Hypothesis IV Reputational loss occurs under two conditions: firstly, the effective behavior of a firm deviates from the expectations of its stakeholders, both towards each particular stakeholder itself and towards other stakeholders, and, secondly, if the divergence between stakeholders' expectations and effective behavior is observable.

According to the finding of Part A, and having gained an understanding why reputational loss occurs, we turn to the nature of *reputational costs* in **Part C** of the second chapter in order to understand under which conditions the occurrence of reputational loss leads to the occurrence of reputational costs.

Hypothesis V Reputational costs occur only if a firm's actual and potential stakeholders are willing to react to reputational loss and if the firm's stakeholders are capable of doing so.

Part D demonstrates that the emergence of digital technologies has a significant impact on the conditions that have to exist in order for reputational loss *and* reputational costs

to occur and that they increase the probability of occurrence of both. Therefore, digital technologies increase the potential of threatening firms' reputations as a regulatory tool and also enhance its deterrent effect.

Hypothesis VI The emergence of digital technologies, particularly the internet, has significantly increased the potential of using the behavior modifying effect of threatening firms' reputations as a regulatory tool. This is due to the emerged altered information process and its enhancing impact on the factors determining the occurrence of reputational loss and costs.

In **Part E** of chapter two we summarize the findings of Parts A–D and answer the research question of this thesis by explaining the conditions that have to prevail for threatening firms' reputations to be an effective regulatory tool. Furthermore, we introduce the formula of reputational costs.

Hypothesis VII The size of potentially occurring reputational costs is determined by three factors: (1) stakeholders' expectations regarding a firm's behavior (based on their preferences and available information about firms' likely future behavior), (2) the observability of firms' effective behavior, and (3) the potential of company's stakeholders to sanction behavior deviating from their expectations.

Chapter Three: Limits, Prospects and Legal Constraints of Regulation by Reputation

Based on the conclusion of chapter two, that threatening firms' reputations is indeed a powerful regulatory instrument under certain conditions, the objective of chapter three is to highlight the prospects, limits and legal constraints of regulatory strategies that seek to achieve behavior modification by threatening firms' reputations.

In **Part A** of the third chapter a model is introduced that provides a guideline for assessing whether threatening a firm's reputation is likely to have a behavior modifying effect if applied to a particular firm or in a particular market. Thereby, we highlight the prospects and limits of this regulatory instrument.

Referring to the crucial role played by the aggregation, provision and diffusion of information about firms' effective behavior regarding the effectiveness of threatening firms' reputations as a regulatory tool, **Part B** discusses the legal constraints for state

and non-state actors when aggregating, providing and diffusing information about firms' effective behavior that is likely to cause firms' stakeholders to react.

In **Part C**, the findings regarding the practical limits and legal constraints of using firms' reputations as a regulatory tool are summarized.

Conclusion of this Thesis

The conclusion of this thesis is drawn in a last step, evaluating the potential of the regulatory tool of threatening firms' reputations.

Chapter One: Regulation – An Overview

The objective of the first chapter is to give an overview of the regulatory landscape and to explain how the idea of threatening a firm's reputation as a regulatory tool fits into the bigger puzzle of regulation.

In **Part A** we ask what is meant by the term regulation. In order to gain an overview of the regulatory landscape we seek to understand the essential characteristics and functions of regulation. We furthermore seek to introduce and understand common definitions of regulation and labels given to distinct constellations of regulating actors and instruments. We will see that there is no commonly accepted definition of regulation but rather that an activity qualified as regulation by the one definition would be considered as something different by other definitions. Additionally we establish a broad definition of regulation that sets the focus on all actions that have a constraining effect on the behavior of individuals and collectives. The idea of using threats to a firm's reputation as a regulatory tool relies on such a broad understanding that does not limit regulation to approaches that are state-centered and solely rely on hierarchy.

In **Part B** we introduce the premises on which the idea of threatening a firm's reputation as a regulatory tool is built. The premises imply that there has been a shift from traditional state-centered and hierarchy-based forms of regulation to alternative conceptualizations that set the focus on the regulatory potential of the interaction of a variety of actors and instruments. The objective of Part B is to outline the way to this broadened understanding of regulation and to give reasons why these alternative forms of regulation have emerged on a large scale and why the focus of regulatory studies is set on these new constellations.

Part C summarizes the findings of this first chapter and illustrates how the idea of using threatening firms' reputations as a regulatory resource fits into the outlined regulatory landscape and a broadened understanding of regulation.

A What is Regulation?

What is meant by the term regulation? The term regulation is used in many different contexts and fields and has experienced an increasing popularity within the last years. Indeed, it is often used as a *buzzword* in legal, economic and political controversies: the need for "more", "less" or "new" regulation, "deregulation" and "re-regulation" is claimed and a somehow predetermined meaning of the term in these different settings seems to be taken for granted. In times of economic crises the term "regulation" seems to resound through the world louder than ever.[1] Another reason is the growth of regulation as an academic industry, resulting in competition among academics and professionals to colonize these newly important fields of interest.[2]

Taking into account this almost inflationary use of the term regulation, it is essential to have a clear understanding of the term, its different connotations, the concepts understood as regulation, as well as its use in this thesis. Without clarification, any debate about whether "traditional" forms of regulation seem to be losing importance, whether "alternative" forms of regulation have emerged on a large scale, and whether firms' reputations might play a role in these regulatory arrangements, will be confused.

In a first step, we will elaborate what kinds of activities are generally understood as regulation, referring to its etymological roots and the characteristics seen as inherent to any form of regulation (**I**). We will see that the term regulation generally refers to an activity of controlling and/ or influencing the behavior of somebody or something in order to make this conduct comply with some form of rule or standard – containing a minimum of the three functions of standard-setting, information gathering and behavior modification. In a second step we will introduce three approaches to define or classify activities of regulation (**II**): three widely accepted definitions of regulation, a scheme to classify forms of regulation based on the actors involved, and finally an approach to regulation that aims to capture all *de facto* regulating forces. In a third step we summarize the results and define the understanding of regulation that serves as the basis for this thesis (**III**).

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1 Some data underscoring this perception: references to the term "regulation" for the periods October 1997-October 1999 and October 2007-October 2009: *Wall Street Journal* 1312 vs. 1989 (+51.6%); *New York Times* 1905 vs. 2298 (+20.63%); *Frankfurter Allgemeine Zeitung* 369 vs. 1131 (+206.5%); according to FACTIVA.COM, November 11, 2009.

2 BLACK, 2002, 11; BALDWIN/ SCOTT/ HOOD, 1998, 2.

I The Basic Activity of Regulation

In order to answer the question of which activities the term regulation generally refers to we will first take a look at the etymological roots of the term and its general linguistic usage (**1**). In a second step we introduce three functions that are inherent to any form of regulation (**2**). In a third step we will summarize the findings and derive a preliminary understanding (**3**).

1 Etymological Roots and General Usage

Why should we care about the etymological origins of the term? One of the first findings from reviewing articles on the subject of legal, economic or social regulation is that authors either do not bother defining or specifying the meaning they ascribe to the term regulation – and therefore seem to know what they are referring to – or they state that there is no single agreed meaning or generally accepted definition of the term regulation at all.[3] Taking the etymological roots into consideration seems to be a good starting point on the way to a general understanding of the activity or the activities encompassed by the term of regulation.

Taking a look at the BARNHART CONCISE DICTIONARY OF ETYMOLOGY, the following can be found:[4]

> **regulation** *n.* 1672, act of regulating; later, rule, law (before 1715); formed from English *regulate* + *-ation*.
>
> **regulate** *v.* Before 1425, borrowed from Late Latin *rēgulātus*, past participle of *rēgulāre* to control by rule, direct, from Latin *rēgula* rule.
>
> **rule** *n.* Probably before 1200 *riwle* principle or regulation governing conduct; also *reule* (before 1225), and *rule* (about 1378); borrowed from Old French *riule*, *reule*, from Vulgar Latin *regula* alteration (by influence of *regere* to rule) of Latin *rēgula* straight stick, bar, ruler pattern; related to *regere* to rule, straighten, guide.
>
> **regular** *adj.* Before 1387 *reguler* belonging to a religious order bound by certain rules; borrowed from Old French *reguler*, and directly as a learned borrowing from Late Latin *rēgulāris* containing rules for guidance, from Latin *rēgula* rule.
> The meaning of following some rule or principle, symmetrical, is first recorded in 1571, and that of marked by steadiness or uniformity, habitual, constant, is implied

[3] OGUS, 1994, 1; BALDWIN/ CAVE, 1999, 2; BALDWIN/ SCOTT/ HOOD, 1998, 2.

[4] BARNHART, 1995.

in *regularly* order, systematically, 1392.[5]

A similar result can be found in the CONCISE OXFORD DICTIONARY OF ENGLISH ETYMOLOGY: [6]

> **regular** subject to a religious rule XIV; conforming to a rule, principle, or standard XVI; ME. *reguler* (later with ending assim. to L.) – OF. *reguler* (mod. régulier) – L. *rēgulāris*, f. *rēgula* Rule.
>
> **regulate** control, adjust, XVII. f. pp. stem of late L. *rēgulāre*. Hence **regulation**.

The general linguistic usage of "regulation" and "to regulate" is quite similar to these first findings, even if less specific. The OXFORD DICTIONARY defines "to regulate" and "regulation" in the following broader sense:[7]

> **regulate** *verb* 1. control or maintain the rate or speed of (a machine or process). 2. control or supervise by means of rules and regulations.
>
> **regulation** *noun* 1. a rule or directive made and maintained by an authority. 2. before another noun informal of a familiar or predictable type: regulation blonde hair. 3. the action or process of regulating or being regulated.

Considering the etymological roots and general linguistic usage, regulation describes an activity existing of the elements of (1.) controlling, governing or influencing (2.) the conduct of somebody or something (3.) in order to make this conduct conform to some form of rule or standard, and possibly – according to the OXFORD DICTIONARY – using some form of authority in order to achieve this goal.

The understanding of the activities encompassed by the term regulation, at least on a general level, gives us an initial idea why this term is used in such a variety of different contexts: it apparently describes an activity that can be found in almost every part of life.

2 Characteristics Inherent to Regulation

Understanding regulation as an activity consisting of the elements of controlling or influencing the behavior of somebody or something in order to make this conduct comply with some form of rule or standard emphasizes its character as a system of control. This is a view of regulation that can be described as increasingly dominant[8]. Referring to

[5] Interesting, as a side note, is the meaning of *regular* as belonging to a religious order bound by certain rules as the opposite of *secular*.

[6] HOAD, 1986.

[7] See OXFORD (2009).

[8] MURRAY/ SCOTT, 2002, 502; HOOD/ ROTHSTEIN/ BALDWIN, 2001, 23; LODGE, 2004, 125.

regulation as a system of control allows us to understand regulation as a system containing a minimum of the three functions, which are considered essential to any viable control system: the function of standard-setting, the function of information gathering, and the function of behavior modification.[9] It is apparent that these functions are similar to the elements identified by looking at the etymological roots of regulation.

Disassembling regulation into these three functions enables us to analyze different anatomies of regulatory settings in a more systematic way – both regarding their general design and regarding the questions of how and by whom these functions are executed in each case. Let us look at the three functions of regulation:

- **The function of standard-setting:** the setting of standards, goals or targets is central to any system of control – and therefore any system of regulation – in order to *allow a distinction between more and less preferred states* of the object which is to be controlled. The function of standard-setting can be performed in a variety of ways and is generally not limited to any specific actor or mechanism.[10]
- **The function of information gathering:** mechanisms for information gathering are necessary in order *to know the current states* of the concerned regulated object. These monitoring or feedback mechanisms are also central to all forms of regulation and come in different forms. Again, this function just highlights the fact that any system of regulation needs some mechanism for gathering information about the current state in order to know whether the latter is a more or less preferred state regarding the standards of the system. The way this function is performed has to be answered by each system of regulation and includes a broad range of mechanisms.[11]
- **The function of behavior modification:** the capacity to modify behavior in order *to correct states* which deviate from the standards set is the third necessary function to be performed by any system of regulation.[12] The question of how to change individual or organizational behavior is central and is closely linked to the other two functions – and, again, it can be answered by referring to a multitude of different mechanisms.

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[9] BLACK, Regulatory Conversations, 2002, 170; HOOD/ ROTHSTEIN/ BALDWIN, 2001, 20-27; WEGRICH, 2009, 22; LODGE, 2004, 125.

[10] HOOD/ ROTHSTEIN/ BALDWIN, 2001, 25; WEGRICH, 2009, 23ff..

[11] HOOD/ ROTHSTEIN/ BALDWIN, 2001, 24.

[12] HOOD/ ROTHSTEIN/ BALDWIN, 2001, 24.

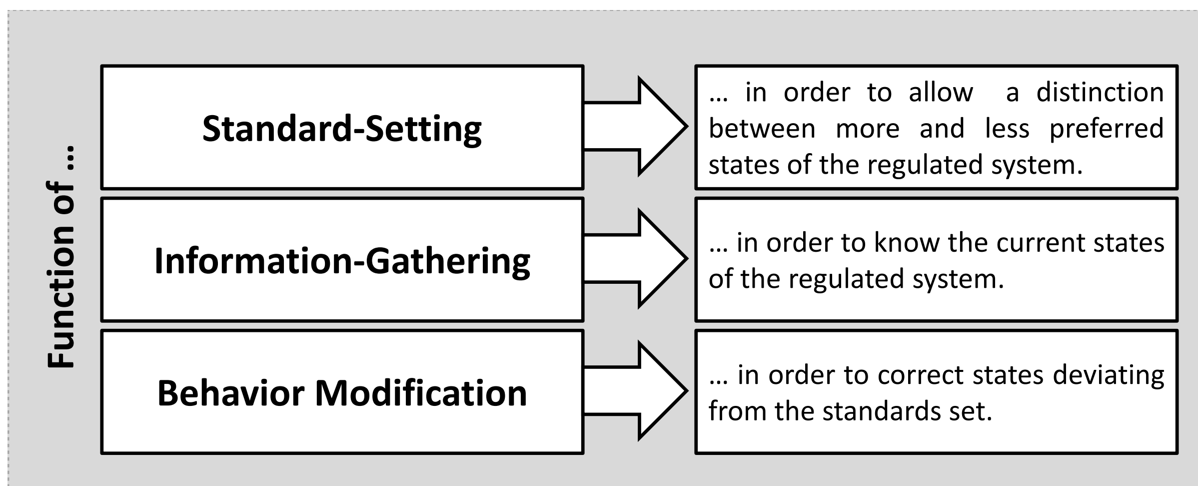

Figure 1: The Three Functions of Regulation

These three functions are essential to any system of control, thus regulation. The ways they can be performed, especially regarding the actors and their mechanisms and tools, are nearly countless. This is especially apparent when bearing in mind the general use of the term regulation, referring not only to economic or legal regulation but also to its use, for example, in medical contexts. Scott highlights this perspective by referring to the human body and the example of temperature control:[13] the standard set for temperature control is that a temperature of around 37° Celsius is the preferred status. Furthermore, there is a range of feedback and monitoring mechanisms which have the task of gathering information about the body's current temperature in order to detect deviations from the standard of 37° Celsius. In case these mechanisms should report a deviation from the 37° Celsius standard, there is, again, a series of mechanisms for correcting the deviations, for example, sweating if the norm is exceeded or shivering if the body temperature falls below this standard temperature.

For us, disassembling the general activity of regulation into the three functions of standard-setting, information gathering, and behavior modification is helpful not only to understand to which activities the term of regulation refers to but also as it provides a tool in order to describe and compare different definitions and forms of regulation in a systematic and analytical way – and to understand *by whom* and *how* these different levels of control are performed. This is particular helpful in order to comprehend how the different definitions of regulation differ.

[13] Scott, 2008, 7.

3 Summary

The opening question of this part, "What is meant by the term regulation?", has not yet been answered by this section. However, by considering its etymological roots we have achieved a *preliminary understanding* of the term regulation by referring to *an activity that consists of the elements of controlling or influencing the behavior of somebody or something in order to make this conduct comply with some form of rule or standard*.

Furthermore, this understanding of regulation is enhanced by referring to regulation as a system of control which has to contain a minimum of the three functions of *standard-setting*, in order to allow a distinction between more and less preferred states of a regulated system, *information gathering*, in order to know the current state of a regulated system and detect possible deviation from the preferred state, and *behavior modification*, in order to correct such deviations.

This preliminary understanding provides an initial frame of reference in order to analyze different definitions and forms of regulation and their anatomies in a systematic matter.

II Definitions and Actors of Regulation

We stated at the beginning of this part that regulation has turned into a buzzword in recent times and that scholars dealing with regulation either do not bother defining the meaning they ascribe to the term regulation or they agree on the fact that there is no generally accepted definition of the term. On the contrary, we have just developed a preliminary understanding of regulation that refers to an activity consisting of the elements of controlling or influencing the behavior of somebody or something in order to make this conduct comply with some form of rule or standard. Furthermore, we have been able to identify three functions that are inherent to any regulatory regime: the functions of standard-setting, information gathering and behavior modification. This raises the question of the extent to which the different concepts and definitions of regulation differ, and why they do so.

One of the main reasons to explain the alleged “definitional chaos”[14] is that regulation has turned into a popular subject of study in many disciplines across and beyond the social sciences: Thus, the phenomenon of regulation is studied by scholars with different theoretical perspectives, using different methodologies and focusing on different aspects of regulatory activities.[15] With each field using its own vocabulary and approaches and focusing on different research agendas, it may not surprise that the term regulation has been defined in a variety of ways[16] – legal sciences tending to use narrower definitions, sociology rather broad ones[17].

The preliminary understanding developed above provides an initial frame of reference and highlights which functions generally have to be performed in regulatory regimes, but it does not refer to any actors (*who* regulates *whom*), nor to the tools, institutional arrangements or techniques used or involved (*how*), nor to the justifications for regulatory attempts (*why*).

This section aims to give an *overview of the most common definitions* of regulation and answers to the question of who is regulating whom (and therewith what areas of life), by using what techniques and tools. This means we will introduce standard definitions and classifications of regulation that are necessary in order to understand the implied broadening of regulation.

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14 Black, 2002, 8.

15 Jordana/ Levi-Faur, 2004, 2.

16 Nottage, 2006, 137.

17 Black, Regulatory Conversations, 2002, 170.

Firstly, we introduce three standard definitions of regulation that reflect diverse approaches as to the question of what activities are embraced by the term regulation and therefore differ regarding the actors (who) and instruments (how) involved (**1**). These three textbook definitions illustrate that an activity understood as regulation by the one definition would be considered as *an alternative* to regulation by another definition. The three definitions expand from the narrowest meaning of regulation as a state activity to tackle market failures to the broadest which defines regulation as all forms of social control.

Secondly, we introduce a widely accepted scheme that classifies forms of regulation based on the actors involved (**2**). This classification distinguishes regulatory regimes by asking whether the three functions of regulation are performed only by state or private actors or whether these two parties *co-regulate*. By embracing regulatory regimes that include private actors, this classification builds on the broadest of the three definitions introduced (regulation as all forms of social control).

The three textbook definitions and the classification scheme are necessary in order to get an overview of the regulatory landscape and the existing concepts of regulation. However, neither the three definitions nor the classification reflect the broad range of interactions that can actually be found in regulatory regimes.

Therefore, in a *third* step, we introduce the four modalities of regulation, the New Chicago School approach to regulation that defines regulation as “the constraining effect of some actions, or policy, whether intended or not” (**3**). This framework, which is based on the four modalities, reflects the variety of *de facto regulating sources* that seek to influence someone’s behavior and focuses on capturing all these different sources.

Fourthly, we will summarize the results (**4**).

1 Three Definitions as a Starting Point

Let us start by introducing three definitions which are commonly accepted as reflecting most forms of activities referred to as regulation and which can be found in every textbook of regulation:[18] from the narrowest definition of regulation as sets of commands (**1.1**), to regulation as all state action designed to shape behavior (**1.2**) and to the broadest definition of regulation as all forms of social control (**1.3**). We will mainly focus on two aspects: which actors are defined as regulators and regulatees (*who* regulates *whom*) and which regulatory tools are encompassed by each definition as techniques for performing these three functions (*how*). We will see that the three definitions differ regarding the question of what activities should be qualified as regulation. Finally, we will summarize the results (**1.4**).

1.1 Regulation as Sets of Commands of the State

The first and the narrowest definition defines regulation as the promulgation of a binding, specific, authoritative set of rules combined with some sort of mechanism which monitors and promotes compliance with this specific set of commands.[19] It refers to regulatory activities by the state through the use of legal rules, backed by (often criminal) sanctions, designed to influence *economic behavior* and particularly to tackle market failures.[20] In this form, regulation is a state activity – all three functions are performed by state actors. Standards are set by enacting legally binding rules, while the enforcement of the rules (the functions of information gathering and behavior modification) might be delegated, for example, to a public agency especially devoted to this purpose.[21] While our preliminary understanding[22] was that all three functions of regulation can be performed by different actors and do not have to be located in a single institution or at the same level, *this definition asks for all actors to be some form of state actors*.[23] Such understanding

[18] Baldwin/ Cave, 1999, 2; Jordana/ Levi-Faur, 2004, 3; Baldwin/ Scott/ Hood, 1998, 3; Wegrich, 2009, 17; Black, 2002.

[19] Baldwin/ Scott/ Hood, 1998, 3; Baldwin, 1997, 65; Baldwin/ Cave, 1999, 2; the general role of criminal law in regulation, see Ogus, 1994, 79ff..

[20] Black, 2002, 2.

[21] Havinga, 2006, 516.

[22] See chapter one/ A/ I/ 2.

[23] Baldwin, Scott and Hood point out an important distinction between Europe and the United States concerning this matter: in the United States it is more common that independent powerful federal regulatory commissions are put in charge of exercising these functions together with the power to sanction; while in Europe rule-making powers have more usually been retained by central government and only the functions of monitoring and sanctioning are devolved to local authorities or central agencies (Baldwin/ Scott/ Hood, 1998, 3).

of regulation is a centralized one, with the state as the only party acting as a regulator. Therewith, the question of *who* regulates is clearly answered for this first definition: the state.

Understanding regulation as binding rules made and executed by state actors already gives an answer to the question of *how* regulation takes place: the state formulates mandatory behavioral demands by enacting binding rules, monitoring the enforcement and having the power to punish those whose behavior deviates from the norms set.

Regulation understood in this sense has come to be called *command and control* regulation.[24] It is a hierarchical, imperative and directive approach to constrain individual and organizational behavior by setting commands and the threat of punishment to achieve behavior modification.

Within this definition comes the traditional US-American understanding of regulation as a specific type of policy making "that has spawned a distinct theoretical and empirical literature"[25], referred to as American-style regulation[26]. This type of regulation refers to "sustained and focused control exercised by a public agency", on the basis of a legislative mandate, over activities that are generally regarded as desirable to society.[27]

1.2 Regulation as all State Action Designed to Shape Behavior

The second common definition of regulation has a much broader approach and "covers all state actions designed to influence industrial or social behavior"[28]. Steering the economy[29] and other societal processes through deliberate[30] state influence is the essence of this meaning of regulation. This definition encompasses the primarily described rule-making and enforcement mechanisms but it also includes a broader range of governmental tools and techniques[31] which – regarding the first definition – would have been considered as *alternatives to regulation* and not as regulatory activities themselves.

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24 Ogus, 1994, 79.

25 Majone, 1990, 1.

26 Majone, 1996, 10.

27 Selznick, 1985, 363; Majone, 1990, 2; Statutory regulation by specialized single-purpose agencies has a long tradition in the United States and goes back to the Interstate Commerce Act of 1887, regulating the railways and setting up the regulatory body, see Majone, 1996, 10.

28 Baldwin/ Cave, 1999, 2.

29 Baldwin/ Scott/ Hood, 1998, 3.

30 Baldwin/ Cave, 1999, 1.

31 Baldwin/ Scott/ Hood, 1998, 3.

In addition to commands, these alternative tools are, for example, the use of economic incentives, the deployment of resources[32], the disclosure of information or the establishment of procedural frameworks[33]. Regulation conceived in this sense "potentially takes in all instruments directed towards the achievement of economic and perhaps social policy ends"[34] which are available to the state. By including regulatory tools other than commands, this definition outstrips the idea of regulation as an activity which solely restricts behavior and prevents the occurrence of undesirable activities and rather stresses the idea that regulation can also be enabling or facilitative by creating the necessary environment.[35] While still focusing on the state as the only regulator, this definition includes a broader range of regulatory instruments, granting them the potential to modify individual or organizational behavior as well. Thereby this definition also widens the range of possible objects of regulation by not being focused on economic actors anymore, as well as widening the reasons for state regulation by including social ends as justification (or motivation) for state regulation.

1.3 Regulation as all Forms of Social Control

The third definition of regulation encompasses all forms of social control, whatever their origin. That means that all mechanisms affecting behavior are considered as being regulatory – regardless of the source of these mechanisms. There is no longer a focus on state-derived actions, which means that any action of individuals which affects others' behavior is considered as regulation, including for example market forces. Furthermore, there is "no requirement that the regulatory effects of a mechanism are deliberate or designed rather than merely incidental to other objectives"[36], which means that the notion of intentionality has been dropped[37].

Regulation in this sense is obviously no longer considered as an exclusive task of the state – this definition clearly breaks the connection to the state[38]. The underlying assumptions

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32 Baldwin/ Cave, 1999, 2.

33 Wegrich, 2009, 19.

34 Baldwin/ Scott/ Hood, 1998, 4.

35 Regarding the question whether regulation is limited to restricting behavior and preventing undesired action ("red light") or rather a facilitative activity ("green light") which set for example formalized arrangement in which individuals and groups can "clothe" their welfare-seeking activities, see Ogus, 1994, 2, and Harlow/ Rawlings, 1997, chapter 2 and chapter 3.

36 Baldwin/ Cave, 1999, 2.

37 Baldwin/ Scott/ Hood, 1998, 5.

38 Black, 2002, 8.

are that there are other forces *de facto* regulating and constraining human behavior apart from the state, and that non-state actors are capable of performing all of the three elements of regulation, whether intentionally or incidentally.

1.4 Summary

The three definitions introduced above can be understood as concentric bands, expanding from the narrowest meaning of regulation as sets of commands to a more general definition of regulation as state action to shape individual and organizational behavior, ending with the broadest definition of regulation comprising all forms of social control.[39]

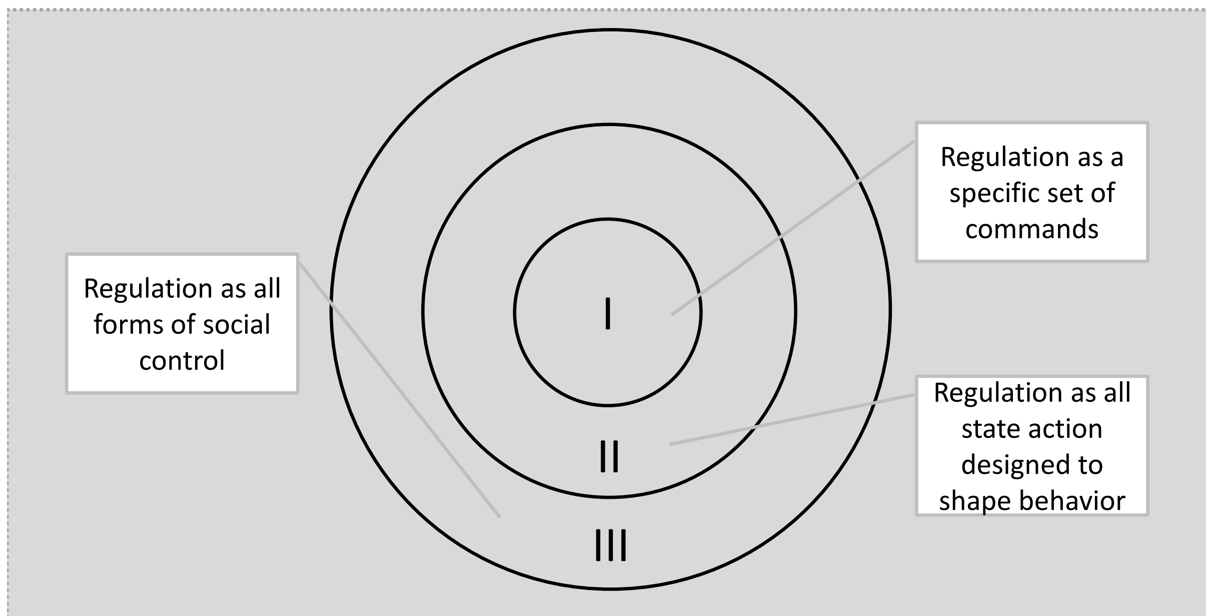

Figure 2: The Three Definitions of Regulation as Concentric Circles [Jordana/ Levi-Faur, 2004]

What do these definitions tell us about the question of what has to be understood as regulation? Although the activity being referred to in each definition is very similar, the question of *"who regulates whom and how?"* is answered differently. Regarding the regulator, the first two definitions have a centralized view and define state actors as exclusively executing the functions of regulation. The third definition breaks this connection to the state and pursuits a decentralized view, encompassing state as well as non-state actors, including for example the interactions of actors in markets. Regarding the question of who is regulated, the definitions provide different answers; the first refers to economic actors, the second to industrial or social behavior, the third to just about everything. More specific answers can be found regarding the question of *how* regulation

[39] Jordana/ Levi-Faur, 2004, 3.

takes place: the first definition limits regulation to command and control style regulation by relying on legal rules backed by sanctions; the second refers to a range of policy instruments such as taxation or the disclosure of information; lastly the third definition encompasses anything that has an effect on the behavior of somebody or something, whether intended or not.

These three definitions reflect different meanings given to the term regulation. Comprehensibly, these three definitions are seen as incapable of capturing and classifying the different forms of regulation that can be found *in reality*[40] and are accused of glossing "over the multiplicity of meanings given to regulation"[41]. Therefore, let us have a look at a widely accepted *classification*, distinguishing different forms of regulation by referring to the actors involved. This classification does not define the term regulation itself but classifies different *forms* of regulation.

2 The Classification of Regulatory Regimes

Besides the three standard definitions of regulation presented in the last segment, the distinction of different regulatory regimes depending on the actors involved (and performing the three functions of regulation) is a widely used way of classifying and explaining different *forms of regulation*. This classification builds on the broadest of the three definitions of regulation presented above, the definition that leaves the state-centered approach behind. Typically, three types of regulation are distinguished: command and control regulation (**2.1**), self-regulation (**2.2**), and co-regulation (**2.3**).

2.1 Command and Control Regulation

As already mentioned above, the narrowest definition of regulation has come to be called command and control regulation.[42] The essence of this kind of regulation is the exercise of influence by imposing standards backed by (often criminal) sanctions. While "command and control" rather explains and defines a hierarchical *style* of regulation, the term has become *the umbrella term for all kinds of imperative, state-centered forms of regulation in which private actors do not play any role*. Command and control regulation in this sense is characterized by the performance of all three levels of control (standard-

40 WEGRICH, 2009, 21.

41 BLACK, 2002, 11.

42 BALDWIN/ SCOTT/ HOOD, 1998, 24.

setting, information-gathering/ monitoring, behavior modification) *by the state*, using hierarchical structures. States are assumed "to have the capacity to command and control, to be the only commander and controller, and to be potentially effective in commanding and controlling"[43].

2.2 Self-Regulation

At the other end of the range of regulatory styles there is self-regulation which can basically be understood as "an institutional arrangement whereby an organization regulates the standards of behavior of its members"[44].[45]

There are two commonly distinguished forms of self-regulation. Firstly, it usually refers to a form of regulation in which a non-profit organization or, more generally, a collective group with a link to the business community, such as a trade organization, performs all three functions of control:[46] it develops and imposes standards, monitors the commercial behavior with respect to those standards and enforces these rules against its member, or even against a larger community[47]. A very common example is that of codes of conduct. While the form just described is sometimes referred to as *external*, a second commonly distinguished form of self-regulation is referred to as *internal*[48]. Here, the three tasks are not performed and overseen by an organization, but by a single enterprise itself which enforces those standards on its own employees and – possibly – on its suppliers.[49] Common to both forms is that they rely only on private actors.

Considering that self-regulatory systems come in all shapes and sizes, the following criteria are furthermore usually considered to distinguish different forms:[50] the first is the degree of *monopoly power*, i.e. whether the self-regulatory system applies to all actors in one market, or whether it is only adopted by a group of suppliers who compete with others. The second is the degree of *formality*, i.e. whether the self-regulatory system derives legitimacy from a legislative framework. The third is the *legal status*, i.e. whether

[43] Black, 2002, 2.

[44] Bagotta, 1989, 438.

[45] Baldwin and Cave refer to "self-administered command-and-control" (Baldwin/ Cave, 1999, 39); Baldwin/ Scott/ Hood, 1998, 27.

[46] These organizations are often labeled "self-regulatory organizations" (SRO).

[47] Baldwin/ Cave, 1999, 39.

[48] Schulz/ Held, 2002, A-3.

[49] Some, like Ogus summarize these two forms by a broader understanding of self-regulation as "rules private to a firm, association or organization" (Ogus, 1994,108).

[50] Harlow/ Rawlings, 1997, 339; Ogus, 1994, 109; Bagotta, 1989, 435; Ogus, 1998, 377.

or not it has binding force, and the fourth is the degree of *external involvement*, i.e. regarding the participation of third parties in the formulation, monitoring and enforcement of the rules.

There are two controversial points, already indicated by these four criteria. Firstly, the *role state actors may play* in these settings: Some, like BLACK[51], refer to the two forms of self-regulation described above as *voluntary* self-regulation and distinguish other forms. These other forms might include: self-regulation with *some* role of state actors as *mandated* self-regulation (in which an organization "is required by the government to formulate and enforce norms within a framework defined by the government"), *sanctioned or enforced*[52] self-regulation (in which a collective group itself formulates the regulation, which is then subject to governmental approval), and *coerced* self-regulation (in which the industry itself develops a regulatory framework but in response to threats from the government that, if it does not, the government will impose statutory regulation). For others, like MAJONE, self-regulation always involves the formal *delegation* of state responsibilities to private or semi-private bodies.[53] The second controversy is the role of intentionality and relates to the question whether or not *implicit* forces, such as market forces, which *de facto* regulate the behavior of individuals or collectives, should be included.[54]

2.3 Co-Regulation

Command and control regulation is state-driven and hierarchical while self-regulation is a private form of regulation. The term co-regulation serves as an umbrella for all arrangements in the broad spectrum within these two ends. The pivotal criterion is that there is some interaction between state and non-state actors regarding the execution of the three regulatory functions of standard-setting, information gathering and behavior modification. State and non-state actors cooperate by either performing one or more functions together or by allocating each of these functions to either state or non-state actors. As in self-regulation, these forms of interaction can take many different forms and names.

In co-regulatory regimes, state, second- and third-party actors combine their efforts to perform the three functions of control. An example of co-regulation was mentioned in

[51] BLACK, 1996, 25.

[52] This concept is also often referred to as "enforced self-regulation", see BRAITHWAITE, 1982; BALDWIN/ CAVE, 1999, 38-41; BALDWIN, 1997, 69.

[53] MAJONE, 1996, 23.

[54] See SCHULZ/ HELD, 2002, A-3, and their distinction of explicit and implicit self-regulation.

the previous paragraph by referring to *enforced self-regulation* in which a collective group itself establishes the regulatory design, which is then subject to governmental approval.[55]

Generally speaking, co-regulation is used as term encompassing all forms of regulation in which private actors and state actors "share" the regulatory stage and perform the three elements of regulation together. Private actors can be part of the standard-setting process, for example, by contributing their expertise, they can be part of the monitoring process by multiplying the eyes and ears available, or play a decisive role in modifying and sanctioning deviating behavior – and vice versa.

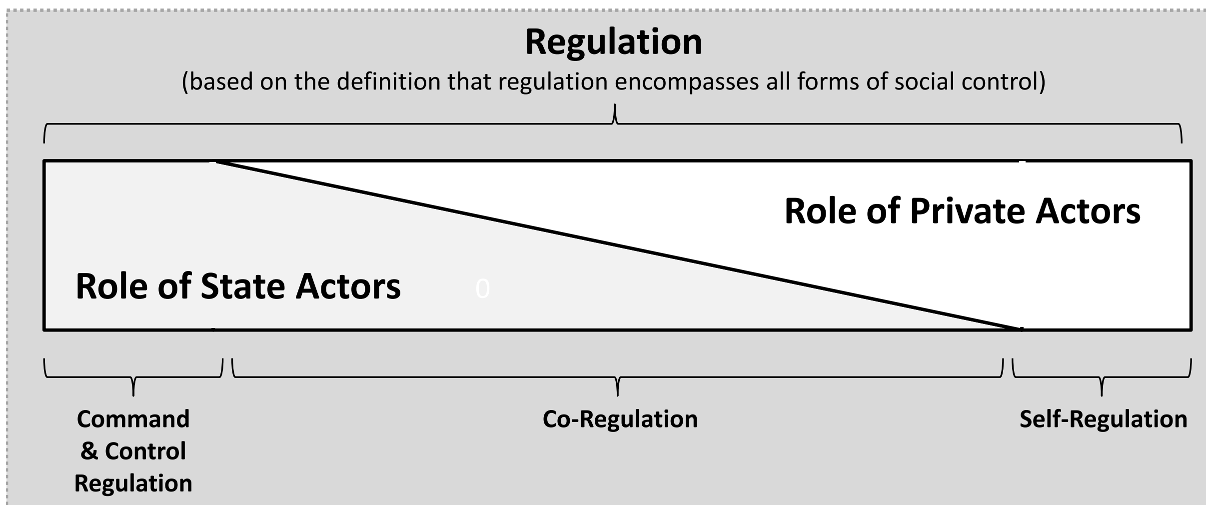

Figure 3: The Classification of Different Forms of Regulation

3 The Four Modalities of Regulation

Neither the three textbook definitions nor the three classifications of regulations that depend on the actors involved are capable of providing a framework that captures all different possible combinations of actors regulating (*who*), the techniques/mechanisms involved (*how*), and the actors or areas of life that different forms of regulation seek to regulate (*whom*) that can be found in reality. The latter classifications already imply a broader understanding of regulation as the regulatory attempts of state as well as non-state actors are encompassed, thereby clearly abandoning the criterion of the first two definitions that regulation is a centralized activity solely performed by state actors.

[55] The term *enforced co-regulation* is another example of the "definitional chaos", as (WEGRICH, 2008, 13) uses the terms *meta-regulation* and *enforced self-regulation* equivalently to describe regulatory designs in which the government only oversees a self-regulatory system by setting general targets or objectives. OGUS refers to the same mechanisms as a form of self-regulation (OGUS, 1998, 376), and BALLEISEN uses *enforced self-regulation* as a synonym for all concepts of co-regulation (BALLEISEN, 2010, 475).

The definitions and the classification of regulation introduced above fail to give a systematic answer to the questions of how the three functions of regulation *can* be performed in cases where regulation is an activity not limited to state actors. The term co-regulation, for example, does not reflect the existing broad range of regulatory interactions between state and non-state actors that is implied by the third definition of regulation as all forms of social control.

While the introduction of the definitions and classifications is necessary in order to get an overview of the regulatory landscape and to later understand the implied broadened understanding of regulation, we turn now to an approach that already builds on such *broad understanding* of regulation and has the power to describe the interactions of different regulatory actors and instruments more accurately. The four modalities of regulation sometimes referred to as the New Chicago School define regulation as all forms of social control which have an effect on somebody's behavior (**3.1**). We then introduce a framework combining the four modalities with the three functions of regulation, thus standard-setting, information gathering and behavior modification (**3.2**).

3.1 The New Chicago School: Four Modalities of Regulation

The four modalities of regulation, sometimes referred to as the New Chicago School[56], is an approach to regulation proposed by the American legal scholar LAWRENCE LESSIG. The approach is to acknowledge that *forces outside state law regulate* (and may even regulate better than the law), and it aims to understand the "structures of regulation outside law's direct effect"[57]. Its understanding of regulation is a broad one, defining regulation as "the constraining effect of some action, or policy, whether intended by anyone or not"[58], similar to the third definition of regulation introduced above.

[56] LESSIG presented the idea of the four modalities of regulation for the first time in an article titled "The New Chicago School", in which he explained the parallels of the "new" and the "old" Chicago School: "Both the old school and new share an approach to regulation that focuses on regulators other than the law. Both, that is, aim to understand structures of regulation outside law's direct effect. Where they differ is in the lessons that they draw from such alternative structures. From the fact that forces outside law regulate, and regulate better than law, the old school concludes that law should step aside. This is not the conclusion of the new school. The old school identifies alternative regulators as reasons for less activism. The new school identifies alternatives as additional tools for a more effective activism. The moral of the old school is that the state should do less. The hope of the new is that the state can do more." (LESSIG , 1998, 661).

[57] LESSIG, 1998, 661.

[58] LESSIG, 1998, 662.

The framework consists of four types of behavior-regulating constraints, or modalities of regulation, that, according to LESSIG, regulate everyone's life: law, social norms, markets, and architecture.[59]

- *Law* is defined as commands backed up by the threat of (*ex post*) sanctions, constraining the behavior of individuals and firms by telling them what to do and what not to do. Acknowledging that law is more than a "set of commands and threats", the focus is on the well-defined constraints that state law can impose on individuals: if somebody does not obey an order set by law, he or she is faced with the threat of punishment.[60]
- *Social norms* are defined as normative constraints which are not set through the organized and centralized actions of a state, but through the enforcement of a community and "the many slight and sometimes forceful sanctions that members of a community impose on each other"[61]. LESSIG refers to the fact that ordinary life is filled with "such commands about how we behave"[62] and argues that these forms of norms constitute a serious constraint on the behavior of an individual or a company.[63]
- Individual and collective behavior is also, according to LESSIG, constrained by *markets* and prices and price-related signals, indicating the point "at which a resource can be transferred from one person to another"[64]. LESSIG acknowledges that constraints of the market exist because of a sophisticated system of legal and other rules and norms which define what is generally buyable and sellable – but ascribes the market its own form of setting constraints[65]: given a set of norms, and scarcity, and law, the market constrains individuals' behavior through the instrument of price, a constraint functioning differently from a sanction.[66]
- The fourth constraint identified by LESSIG is (this world's) *architecture* – the umbrella term for physical constraints which are determined by "the way the

[59] LESSIG, 1999, 87ff. and 235ff.; LESSIG, 1998, 662-663: LESSIG's framework of constraints is widely regarded as one of the most complete analytical attempts to describe the broad variety of forces and forms of regulation. See MURRAY/ SCOTT, 2002, 502.

[60] LESSIG, 1999, 235; LESSIG, 1998, 662.

[61] LESSIG, 1999, 235.

[62] LESSIG, 1999, 235.

[63] LESSIG, 1998, 662.

[64] LESSIG, 1999, 236.

[65] LESSIG, 1998, 663.

[66] LESSIG, 1998, 663.

> world is, or the ways specific aspects of it are"[67]. LESSIG refers to features of the world, irrespective of whether found or made, which, according to him, "restrict and enable in a way that directs or affects behavior"[68]: walls, locked doors, or the panopticon (a design for prisons enabling guards to monitor all prisoners), all constraining individuals' behavior.[69] LESSIG focuses on the role of codes built into software by their designers and discusses their (self-enforcing) regulatory potential.

LESSIG's general assumption is that these four modalities of regulation operate together and that regulation is therefore a *mixture of direct and indirect control* and the sum of the combined regulatory effects of the four modalities. He suggests understanding these four modalities as a net which implies that a change to any of these four constraints will change the resulting "sum" of regulation.[70] LESSIG's approach is interested in elaborating on alterative modalities of regulation – and in the question of how these four constraints regulate an individual's behavior and the possible substitutions of these constraints.[71] Its objective is to call attention to the potential of this "range of regulatory means for any particular state regulation"[72]. LESSIG, or the New Chicago School, does not see these as displacing law; rather the school sees each of these constraints as subject to law. It is argued that regulation always has a direct and an indirect subject and that law regulates behavior not only directly, but also indirectly by regulating the other modalities of regulation[73]. LESSIG's focus is on "law's meta-role in affecting other structures of constraints"[74] and the question of how law uses or co-opts the regulatory powers of all modalities of regulation to the law's own ends.[75]

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67 LESSIG, 1999, 236.

68 LESSIG, 1998, 663.

69 MURRAY/ SCOTT, 2002, 500.

70 LESSIG, 1998, 664.

71 LESSIG, 1998, 664.

72 LESSIG, 1998, 666.

73 LESSIG, 1998, 666.

74 LESSIG, 1998, 667.

75 LESSIG, 1998, 666-668: LESSIG refers to the example of smoking: "Say the government's objective is to reduce the consumption of cigarettes. There are many number of means that the government could select to this single end. A law could ban smoking. (That would be law regulating the behavior it wants to change directly.) Or the law could tax cigarettes. (That would be the law regulating the market to reduce the supply of cigarettes, to decrease the consumption of cigarettes.) Or the law could fund a public ad campaign against smoking. (That would be the law regulating social norms, as a means to regulating smoking behavior.) Or the law could regulate nicotine in cigarettes, requiring manufacturers to reduce or eliminate nicotine. (That would be the law regulating the architecture of cigarettes, as a way to reduce their addictiveness, as a way to reduce the consumption of cigarettes.)".

The argument of the New Chicago School is that any modern regulatory regime should use the effects of direct and indirect regulation and that it is therefore necessary to understand how these different tools and modalities function together, how they interact, and how law affects their influence in order to be able to use the various techniques of regulation in a more comprehensive way.[76]

LESSIG's approach to regulation is a step towards a more general understanding of regulation, driven by the idea of overcoming the dichotomy of state and non-state regulation and to take advantage of *de facto* regulating forces in both state and non-state regulation. Furthermore, the four modalities of regulation are capable of describing different regulatory regimes in a more precise way than the previous approaches.

3.2 A Framework Based on the New Chicago School

LESSIG's approach is based on a broad understanding of regulation and takes into account all sources of regulation that, *de facto*, constrain the behavior of individuals (and organizations). He argues that state and non-state regulation should include these regulatory tools and mechanisms in their regulatory regimes, whether in their pure form or as hybrids of two or more combined modalities of regulation. An attempt to refine and generalize this idea is that of SCOTT and MURRAY, drawing on LESSIG's findings. Their objective is to enrich LESSIG's framework by combining the four modalities of regulation with the three functions of regulation (standard-setting, information gathering and behavior modification). Their aim is to develop a framework that is able to capture and therewith analyze the whole variety of forms of regulation in order to make it transparent that the different functions of regulation "can be widely dispersed among state and non-state actors, even within a single regime, and can be assembled in mixed or hybrid forms"[77].

a Adaption by Murray and Scott

MURRAY and SCOTT state that LESSIG's framework suffers from weaknesses as it excludes forces (or at least the labels imply that it does so) which they presume to be essential to a "complete" analysis of regulatory constraints.[78] Acknowledging the broad approach of LESSIG, they adapt the four modalities as follows:

76 LESSIG, 1998, 672.

77 MURRAY/ SCOTT, 2002, 502.

78 MURRAY/ SCOTT, 2002, 492.

Law becomes hierarchical control: from the perspective of MURRAY and SCOTT, the category of law suffers from the weakness that it fails to capture regulatory regimes that are based on command but not on commands set by state law. They argue that one should look at the source of control rather than at its form in order to capture the plurality of forms based on a hierarchical structure. Furthermore, the concept of "hierarchical control" abandons the focus on the standard-setting function of law and emphasizes the institutional dimension of law, including the functions of information gathering and behavior modification.[79]

Social norms become community-based control: the concept of norms is criticized for being imprecise, as the term norm is seen as a rather generic term for standards, guidelines, and legal and non-legal rules. In order to capture not only social norms, existing among a particular group, but also a broader use of the term – including, for example, socially generated self-regulatory standards – MURRAY and SCOTT propose to call this modality of regulation "community-based control".[80]

Markets become competition-based control: the concept of markets is criticized by MURRAY and SCOTT as being under-inclusive. They argue that rivalry and competition provide a form of control even in environments where there is no identifiable market[81]. As a more general label they choose "competition-based control".

Architecture becomes design: the fourth modality of regulation, architecture, is again seen as under-inclusive by MURRAY and SCOTT. From their perspective, "architecture" does not capture those mechanisms "which are premised upon design as a basis of control"[82] – thus, for example, social and administrative systems which have control creating design features which cannot be affected by the regulatees. Therefore, they re-label the fourth modality of regulation as "design".[83]

b Modalities and Functions of Regulation: A New Framework

Enriching LESSIG's framework is only the first step conducted by SCOTT and MURRAY. Much more important – in order to understand the variety of regulatory sources and constraints – is the second step: MURRAY and SCOTT combine LESSIG's four modalities of regulation with the three functions of regulation, which we have seen to be inherent in

[79] MURRAY/ SCOTT, 2002, 502.
[80] MURRAY/ SCOTT, 2002, 503.
[81] MURRAY/ SCOTT, 2002, 503.
[82] MURRAY/ SCOTT, 2002, 503.
[83] MURRAY/ SCOTT, 2002, 503.

any system of control. The resulting framework serves as a frame of reference in order to understand the multitude of varieties which can be combined by bringing elements of hierarchical, community-based, competition-based and/or design-based forms of regulation together on each of the three functional levels of control. The resulting framework is depicted graphically:[84]

Four Modalities of Regulation / Three Functions of Regulation	**Hierarchical Control**	**Community-Based Control**	**Competition-Based Control**	**Design Based-Control**
Standard Setting **… in order to allow a distinction between more and less preferred states of the system.**	Law or other formalised rules	Social norms	Price/ quality ratio (and equivalents in non-market decisions)	Inbuilt design features
Information Gathering **… in order to know the current states of the system.**	Monitoring powers (by agencies or third parties)	Social observation/ interaction	Monitoring by dispersed buyers/ outcomes of competition	Interaction of design features with environment/ lack of response
Behavior Modification **… in order to correct states deviating from the standards set.**	Formalized (legal) sanctions/ enforcement	Social sanctions (e.g. disapproval or ostracism)	Aggregate of decisions by buyers, clients etc/ striving to perform better	Interaction of design features with environment/ physical inhibition

Figure 4: Modalities and Functions of Regulation [Fn 84]

The four resulting "pure" modalities of regulation can be described as follows:

In forms of regulation that are based on *hierarchical control*, the function of standard-setting is performed by setting binding commands, information about the "status" and the behavior of the regulated is gathered by monitoring mechanisms (for example, by a public agency) and the behavior modification is supposed to be achieved by the threat of sanctions against deviating behavior.

An example of such a form of regulation is criminal law, where the state by enacting law defines which forms of behavior are prohibited, where other state actors (for example, the public prosecution department) gather the information about deviating behavior and where behavior modification is to be achieved by the threat of punishment (legal sanctions) and the assumed deterrent effect of these foreseeable punishments.

[84] This framework is based on MURRAY's and SCOTT's work (MURRAY/ SCOTT, 2002, 504) as well as on a later publication of SCOTT (SCOTT, 2008, 18). A somewhat similar distinction can be found in BLACK (2002), identifying five forces of regulation: 1. State institutions (regional, national, extra-national), 2. Non-state actors, 3. Economic forces, 4. Social forces and 5. Technology.

Within *community-based* forms of regulation, norms are set informally as societal or group standards, members of the relevant community observe and monitor the behavior with peer-based mechanisms and have informal sanctions available such as showing disapproval or ostracizing those who do not behave in the way required by the norms. A well-known example is family life, with its unwritten rules, as well as social etiquette[85].

Forms of *competition-based* regulation are primarily based on markets or generally speaking on any kind of competition mechanisms and forces. The standards are, for example, set by consumers' expectations that a certain quality of a product or service should be sold for a certain price. The aggregate decisions of dispersed consumers monitor – each individually – whether this expectation is met or not. In both cases, again, the dispersed (re)actions or decisions of consumers to continue or discontinue consuming a certain product or service can modify or confirm a company's actions regarding its price and quality decision.

In *design-based* regulation, standards are set by (intended or unintended) physical constraints, inhibiting undesirable behavior. The functions of monitoring (information gathering) and behavior modification are performed through the interaction of the design feature with its environment. Both functions are therefore self-executing. Examples of such forms of regulation are parking bollards[86] (the physical inhibition of cars parking in certain areas) or LESSIG's examples of software codes which – due to inbuilt design features – control and constrain the behavior of users.

Apart from these four "pure" modalities, each capable of being applied on its own, the framework provides us with the opportunity to link one or more modalities to hybrid forms of regulation. Let us have a look at how the classification of regulatory regimes depending on the actors involved can be described – or re-classified – by referring to MURRAY's and SCOTT's framework.[87]

How to classify *command and control* regimes is rather obvious: it is clearly a hierarchy-based control system where the (state) regulator performs the tasks of setting binding rules (laws), monitoring compliance is carried out by particular designated bodies and enforcing the rules is done through the threat of sanctions or directly by sanctioning

[85] Another example are criminal organizations like the Mafia: the Italian police report they have encountered a "Ten Commandments"-style code of behavior for Mafia members, see <http://news.bbc.co.uk/2/hi/7086716.stm>, accessed on January 17, 2011.

[86] SCOTT, 2008, 23.

[87] See MURRAY/ SCOTT, 2002, 505.

deviating behavior of individuals and firms. *Self-regulation* is already more complex to classify: in its pure form it may be classified as community-based control, such as when an industrial group or association generates its own standards within its group, monitors the behavior of its members and modifies behavior by social sanctions. Often, however, elements of hierarchy-based control or competition-based control may be involved, for example, if sanctions are more formalized, or monitoring and behavior modification are "outsourced" to markets by publishing rankings (on compliance, such as black lists, or product quality) and therefore rely on aggregated decisions. *Co-regulation* is by definition a hybrid form of control which combines elements of different control systems, for example, combining the strengths of community-based control elements with hierarchical elements such as the approval of standards set by state actors.

In summary, this framework is able to picture a much broader variety of different forms of regulation: from the four "pure" modalities, each capable of being applied on its own, the framework provides the opportunity to link one or more modalities to hybrid forms of regulation – and highlights the multitude of manners in which it is possible to *regulate*, e.g. constrain individual and collective actions.

4 Summary

The aim of this section (**II**) was to give an overview of the regulatory landscape. We introduced three standard definitions of regulation: regulation as sets of commands, regulation as all state action designed to shape behavior, and regulation as all forms of control. The three definitions give different meanings to the term regulation so that actions considered as regulation by one definition would be considered as an alternative to regulation by another definition. (**1**). Afterwards, we introduced a widely accepted scheme classifying regulatory regimes based on the actors involved: command and control regulation, self-regulation and co-regulation (**2**). In a third step we introduced a broad approach to regulation, aimed at capturing all sources *de facto* regulating the behavior of individuals and collectives by classifying four modalities of regulation: hierarchy-based, community-based, competition-based and design-based (**3**). As expected, due to its use in a variety of contexts, we could find a number of different answers regarding actors, institutional arrangements and fields of life involved (*who* regulates *whom*), tools and techniques seen as regulating (*how*) and regarding the reasons and justifications given, from market failures as the "traditional" justification to

the absence of any reason for regulation as it is seen as the result of even unintended interactions of individuals in markets or societal groups (*why*).

In the next section we define the use of the term regulation in this thesis and explain why we rely on this broad definition of the term.

III Conclusion of Part A and Use of the Term "Regulation" in this Thesis

The starting point of Part A was to ask what is meant by the term regulation, considering its wide use in different contexts. In a first step we elaborated on the *general activity* understood as regulation, referring to its etymological roots and characteristics seen as inherent to any form of regulation (**I**). The result was to understand regulation as an activity of controlling and/or influencing the behavior of somebody or something in order to make this conduct comply with some form of rule or standard, composed of the three functions of standard-setting, information gathering and behavior modification. In a second step, we introduced three standard definitions of regulation, a scheme allowing to classify different *forms* of regulation based on the question of how private and state actors share the regulatory stage and a framework based on the New Chicago School approach to regulation, focusing on the *de facto regulating forces* (**II**). Because regulation is not a term with a single agreed meaning, we have to answer the question of what understanding or definition we give to the term regulation in this thesis. It is the objective of this section to achieve such necessary clarification.

How does the objective of this thesis have implications for our understanding of the term regulation? As outlined in the research question, this thesis aims to investigate the conditions that have to exist in order for threatening firms' reputations to be used as an effective regulatory tool. In order to understand and embrace as many contributing factors as possible in our analysis, we have to understand which sources *de facto* constrain a firm's behavior (e.g. the results of formal rules such as laws, informal rules such as social norms, and/ or market outcomes), how these forces interact with each other and in what respect reputation mechanisms depend on these sources and their interactions (e.g. market mechanism or social sanctions). Due to this positive approach, we have to be able to picture the "real" constraints under which firms' decision-making processes take place.[88]

[88] Therefore, we take an approach that is based on the premise that institutions matter as they define, in their entirety, the incentive structure of societies and economies together (WILLIAMSON, 2000, 595); NORTH defines institutions as: "The rules of the game: the humanly devised constraints that structure human interaction. They are made up of formal constraints (such as rules, laws, constitutions), informal constraints (such as norms of behavior, conventions, self-imposed codes of conduct), and their enforcement characteristics." (NORTH, 1994, 360); NORTH points out the distinction of institutions from organizations: "Institutions are the rules of the game of a society or more formally are the humanly-devised constraints that structure human interaction. They are composed of formal rules […], informal constraints […], and the enforcement characteristics of both. Organizations are the players: groups of individuals bound by a common purpose to achieve objectives. They include political bodies […]; economic bodies […]; social bodies […]; and educational bodies […]." (NORTH, 1992, 5-6); see COASE (1998).

Therefore, we define *regulation* in this thesis as

> All actions having a constraining effect on the behavior of individuals and collectives, characterized by the four modalities of regulation: hierarchical control, community-based control, competition-based control and design-based control.

This broad definition is based on the assumption that the four modalities of regulation operate together and that regulation is therefore *a mixture of direct and indirect control* and the sum of the combined regulatory effects of the four modalities.[89] With this definition we are also accounting for LESSIG's proposal to understand the four modalities as a net, implying that a change to any of the four constraints will change the resulting "sum" of regulation. Furthermore, this understanding of regulation helps to highlight the variety of regulatory means available to any form of regulatory regime.

Even more importantly, it highlights which parameters might have to exist in order to use a firm's reputation as a behavioral incentive and how legislation can change these parameters (regulate the modalities of regulation) in order to take advantage of the constraints set by a firm's reputation. By doing this, another form of regulation becomes apparent: regulating indirectly via the incentives set by reputational effects.

Furthermore, we define *regulatory regime* in this thesis as

> A system of control that may comprise many actors, but within which it is possible to identify standards of some kind (function of standard-setting), ways of detecting deviation from the standards (function of information gathering) and mechanisms from correcting such deviations (function of behavior modification).

Lastly, we define *regulatory instruments and tools* in this thesis as

> Instruments and tools applied to perform the three functions of regulation.

We assume that this broad approach to regulation, reflecting forces that are *de facto* regulating behavior, is a necessary and helpful step in order to understand what constraints are set by indirect regulatory incentives – such as reputational effect – on individuals' and collectives' decision making and behavior.

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89 See chapter one/ A/ I/ 1.1.

B The Premises of this Thesis: The Way to a Broadened Understanding of Regulation

The objective of Part A was to illustrate that there is no commonly agreed definition of the term regulation but rather different coexisting meanings given to the term. Besides having given this overview, we have laid down the understanding of regulation on which this thesis is based by referring to a broad approach to regulation, viewing regulation as the interaction of all actions which set constraints on the behavior of individuals and collectives. The objective of this broad definition of regulation is to capture the *de facto* constraining, and thus regulating forces and to see how they interact and depend on each other. This is the precondition in order to know how to use these interactions.

In this part we will turn to the premises on which this thesis and therefore the idea of threatening firms' reputations as a regulatory tool are built. These premises serve to explain some of the essential developments in regulatory studies and to point out *why* the focus in theory and practice has shifted to concepts of regulation whose characteristic is the interaction and interdependency of a variety of instruments, actors and sources. The objective is to give reasons for the emergence of and the increasing reliance on alternative forms of regulation which are not solely state-centered and hierarchy-based.

The premises of this thesis are:

Premise I Traditional forms of regulation, state-centered and hierarchical in nature, are challenged as not being capable of dealing with an increasingly complex, interdependent, and fragmented economic and political environment and its actors.

Premise II Alternative forms of regulation have emerged within the last decades on large scale on all levels (domestic, international, global). These regulatory regimes are characterized by a variety of actors (*who*), state and non-state, executing the functions of standard-setting, information gathering and behavior modification by using a variety of instruments and tools (*how*).

Premise III The full potential of using the variety of regulatory sources provided by the four modalities of regulation (hierarchical control, community-based control, competition-based control and design-based control) has not yet been tapped. There is a demand, particularly regarding the

regulation of firms, for new ideas which take advantage of the variety of monitoring and enforcement instruments provided by the four modalities and which are able to cope with the needs of a changed environment.

Referring to these premises, we argue that the focus in regulatory studies and the understanding of regulation has shifted from traditional forms of regulation to an approach that calls attention to the potential of a variety of regulatory mechanisms, actors, and structures provided by the four different modalities of regulation. This view on regulation understands regulation as the outcome of interactions between different actors and modalities or as an interdependent network of different behavioral constraints, rather than as the result of a single actor's activity with a clear principle of cause and effect.

In a first step (**I**) we start to discuss the development expressed in our premises by looking at the cases of the International Accounting Standards and the Dodd-Frank Wall Street Act that has incorporated whistleblowing as a strategy to detect frauds in the financial industry. Both cases illustrate the importance of the interaction of private and state actors and the reliance on more than one modality of regulation for contemporary regulatory regimes.

In a second step (**II**) we look at the reasons that have led to a broader understanding of regulation. Corresponding to the wide range of academic disciplines dealing with the subject of regulation and their approaches to, as well as conceptualizations of, regulation, the reasons why these disciplines and their exponents have turned to exploring alternatives to traditional state-centered and hierarchy-based regulation have been various. However, we can find similarities in the way they describe changes regarding the manner in which regulation occurs, and why they express the need to understand regulation as an activity based on the interactions and interdependencies of a variety of actors, sources and instruments. There are two strands of arguments that are to be presented:

Firstly, a number of disciplines have analyzed the general shortcomings of traditional state-centered, hierarchical regulation and highlighted that this form of regulation does not always achieve the intended ends of policies for a variety of reasons. As a result of these criticisms, practice as well as theory have turned to both alternative regulatory instruments (e.g. the setting of behavioral incentives through taxes) and the idea that

states should not interfere with markets and that state regulation in general should therefore be minimized, as government failures (and resulting insufficient regulatory strategies) could do more harm than market failures.

Secondly, a different, more decentralized understanding of regulation is the result of changes of the economic and political environment in which regulation takes place: the processes of globalization have challenged the nation state's capacity to regulate domestically and have led to the development that new actors, such as non-governmental organizations (NGOs) and multinational corporations (MNCs), have stepped on to the regulatory stage and became active on all three levels of regulation. Non-state actors as well as state-actors – faced with the question of how to pursue their interests while challenged with an increasingly interdependent economy – became the initiators of a multitude of regulatory arrangements which were not solely based on state actors and hierarchy. Most of these regulatory arrangement are characterized by the hallmarks of "decentered" strategies:[90] *hybrid* (combining state and non-state actors) and *multi-faceted* (using a number of strategies simultaneously or sequentially), thereby constraining indirectly rather than directly by relying on a wide range of community- and competition-based instruments.

In a third and last step of Part B (**III**) we will summarize the arguments, and discuss how this thesis and its subject fit into these developments.

[90] As defined by Black, 2002, 6.

I Examples: International Accounting Standards and Whistleblowing

Let us look at two examples which illustrate the role of “alternative forms of regulation”, characterized by the interaction of a variety of actors and modalities on the three levels of standard-setting, information gathering and behavior modification. The first example, the International Financial Reporting Standards, illustrates the role of new private actors as standard-setters and the mechanisms used to promote and enforce these standards – relying on hierarchical, community-based and competition-based mechanisms (**1**). The second example, the Dodd-Frank Wall Street Reform and Consumer Protection Act recently signed into law, illustrates the role of whistleblowers as an instrument to detect fraud in the financial industry (**2**). The reliance on private actors, such as employees or analysts, in order to monitor and enforce public laws is an interesting example of how law can regulate indirectly by taking advantage of *other* modalities of regulation.

1 IFRSs: International Accounting Standards

The International Financial Reporting Standards (IFRSs) highlight the degree to which private actors or rather associations of private actors have become standard-setters (thus, how the process of standard-setting in “global regulation” has been privatized) and how mechanisms interact regarding the promotion and enforcement of these standards. The IFRSs are accounting rules issued by the International Accounting Standards Board (IASB), the standard-setting body of the IFRS Foundation, which is an independent, not-for-profit, private sector organization mostly financed by voluntary contributions.[91] Between 1973 and 2000, international accounting standards were issued by the IASB’s predecessor organization, the International Accounting Standards Committee (IASC). The IASC was established in 1973 by representatives of the professional accountancy bodies in Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the United Kingdom/ Ireland and the United States.[92] From 1973 to 2000, the IASC’s rules were named the International Accounting Standards (IAS). Since 2001, the standard-setting (or rule-making) function has been taken over by the IASB.[93]

At the time of its founding, the IASC’s main purpose was to make steps towards a *harmonization* of accounting rules, being faced with an increased cross-border

[91] See the IASB’s website <http://www.ifrs.org/the+organisation/iascf+and+IASB.htm>, accessed on January 17, 2011.

[92] Deloitte, 2010, 15.

[93] Deloitte, 2010, 16; Ball, 2006, 6; for historical notes on the foundation of IASC, see Benson (1976).

integration of markets and politics.[94] The increasing internationalization of capital markets highlighted the need for convergence in financial reporting. This demand was driven mainly by the participants of the world's capital markets (thus, users of financial statements) and their informational requirements, particularly by investors, as providers of risk capital interested in information on the inherent risks and potential returns of their investments[95], lenders interested in information that enables them to find out whether their loans (and interest) will be paid when due[96] and the corporations themselves, as issuers of financial reports, dependent on the tool of financial reports as a source of credible financial information in order to satisfy the informational needs of investors or lenders.

Rules securing "credible information" and enabling participants of capital markets to compare the performance of corporations was already subject to the establishment of national accounting standards.[97] Due to increasingly integrated and interdependent capital markets, the need for comparability of financial reports, hitherto regulated by national laws and different regarding their principles and rules, became evident.[98] This is where the IFRS Foundation and its standard-setting body, the IASB, as well as their predecessor organizations, came into play: their objective was "to develop […] a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the various capital markets of the world and other users of the information to make economic decisions"[99].

In the first instance, the objective was to develop a set of "global" but voluntary accounting standards to make it easier to compare financial reports issued under different national laws and principles. Such a tool becomes more effective when applied by many. The second objective of the IFRS Foundation and the ISAB – besides harmonization – was to "promote the use and rigorous application of those standards"[100]. The IFRS foundation took different approaches to achieve the objective of promoting its

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94 Ball, 2006, 8; in more detail: Ball (1995).

95 IFRS, 2001, B1714.

96 IFRS, 2001, B1715.

97 Ball defines the fundamental economic function of accounting as providing "agreement about how important commercial transactions are to be implemented" (Ball, 1995, 19).

98 Ball, 2006, 5-8.

99 IFRS, Preface, 2001, A16.

100 See the IASB's website <http://www.ifrs.org/the+organisation/iascf+and+IASB.htm>, accessed on January 17, 2011.

rules. Initially it focused on involving the International Organization of Securities Commissions (IOSCO) in order to achieve a higher acceptance of the IFRSs/ IASs by important stock exchanges. As a result, the IOSCO recommended in 2000 that its members "permit incoming multinational issuers to use the 30 IASC 2000 standards to prepare their financial statements"[101] – an important step towards a global acceptance. Besides an increasing acceptance of these accounting standards as "best practice" by the financial community (and thereby relying on market- and community-based regulatory mechanisms *de facto* regulating and/or constraining behavior), the IFRS foundation promoted the acceptance and enforcement of the standards on a political level with great success:[102] today 85 countries in the world require all domestic listed companies to use IFRSs, in an additional 23 countries the use of IFRSs is permitted, while only 35 countries do not permit the use of IFRSs.[103] This reliance of state regulators on standards developed by an association of private actors has come about in different ways.

Let us look at the example of Germany, as it features two different approaches over time: in 1998 a new section (§ 292a HGB old version) was introduced into the German Commercial Code (*HGB/ Handelsgesetzbuch*), allowing companies listed on a German stock exchange to prepare their consolidated financial statements using "international recognized accounting standards" instead of the German standards (as required by § 290 HGB old version), thereby referring indirectly to IAS and US-GAAP[104]. This exemption rule was used by almost all large companies listed in the DAX[105]. The reasons for introducing this rule was that several large German companies had already started to use international accounting standards such as the IFRSs/IAS (or US-GAAP) as result of their increasing involvement in the international financial community – and they did not wish to be required to report according to another standard. Daimler-Benz AG, for example, was the first German company to be listed on the New York Stock Exchange in 1993 and was forced to publish its financial reports using US-GAAP as the accounting standard.[106] The exemption clause in § 292a HGB (old version) – referring to vaguely

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[101] See IOSCO President's Committee approval, available at <http://www.iasplus.com/restruct/restiosc.htm>, accessed on January 17, 2011.

[102] Ball, 2006, 9; for the role of lobbying, see Zeff (2006).

[103] Deloitte, 2010, 19-26.

[104] US-GAAP is the US Generally Accepted Accounting Principles.

[105] Accounting Standards by Jurisdiction see <http://www.iasplus.com/country/germany.htm>, accessed on January 17, 2011.

[106] Norris (1993); for further information on Daimler-Benz's listing on the NYSE, see: Radebaugh/ Gebhardt/ Gray (1995).

defined *private* standards without establishing any endorsement mechanisms or incorporating them into national law – was heavily criticized, particularly for accountability and legitimacy reasons. But also the IASs themselves were considered with skepticism due to their focus on investors' interests (principle of fair and true view and decision usefulness) and as thus violating the rule of law.[107] Additionally, in 2002 the European Union (EU) approved an Accounting Regulation requiring all EU companies listed on a regulated market to follow the IFRSs in their consolidated financial statements, starting in 2005.[108] The reasons given were that there was "the need to accelerate completion of the internal market for financial services" – and that the requirement for publicly traded companies "to apply a single set of high quality international accounting standards for the preparation of their consolidated financial statements" will contribute "to a better functioning of the internal market" and to "the efficient and cost-effective functioning of the capital market".[109] The requirement for all EU listed companies to follow IFRSs in their consolidated financial statements became directly applicable in all member states as there was no need to incorporate this rule into national law before it would become effective.[110] A second important mechanism is the endorsement mechanism:[111] Every ISAB/IFRSs rule can only be individually applied if the EU has endorsed and published it officially. This mechanism (in contrast to the former German opening clause) ensures that the EU keeps its legislative power instead of private actors making rules which would otherwise turn directly into EU law.[112]

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[107] For many others, see HELLERMANN (2000) and KIRCHHOF (2000).

[108] Articles 2 and 4, Regulation (EC) No. 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards; the § 292a HGB old version was in force until the end of 2004.

[109] Premises - Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards.

[110] Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards.

[111] DELOITTE, 2010, 27. The endorsement process involves the following steps: EU translates the IFRS into all European languages; the private-sector European Financial Reporting Advisory Group (EFRAG) gives its views to the EC, the EC's Standards Advice Review Group (SARG) gives its views to the EC on EFRAG's recommendations; the EC's Accounting Regulatory Commission makes an endorsement recommendation; finally the EC submits the endorsement proposal to the European Parliament's Regulatory Procedure with Scrutiny Committee and to the 27-member Council of the EU. Both must approve endorsement or the proposal is sent back to the EC for further consideration.

[112] HALLSTRÖM (2004) has compared the strategies of the International Standards Organization (ISO) and the International Accountancy Standards Committee (IASC) to promote their standards with interesting findings regarding the role of input and output legitimacy: standard-setters in a technical environment need to show what they do, while in a more institutionalized environment they also have to show how they do it.

Why do we introduce the case of accounting rules, particularly that of the internationally successful implementation of IFRSs? The IFRSs and their development from purely voluntary standards based on the initiative of private actors without any formal enforcement mechanisms to binding law for all listed companies in the EU highlights some of the different mechanisms which have been outlined in our premises. *It highlights the extent to which private actors have become part of the regulatory landscape* – in this case particularly as agenda- and standard-setters. It also highlights that – besides a variety of actors – there is an *increasingly interdependent interaction of different regulatory sources and instruments*: the promotion and enforcement of the IFRSs were in the first instance driven by market- and community-based mechanisms before they became legal requirements in more than 80 countries and finally could fall back on hierarchy-based regulation and the instrument of law to enforce compliance.

2 Fraud Detection by Whistleblowing: The Dodd-Frank Wall Street Reform and Consumer Protection Act

While the first example illustrated particularly the role of private actors in standard-setting and their interactions with traditional forms of regulation, we will now turn to another level and focus on the use of alternative instruments within regulatory regimes (in this case state law), by looking at the role of whistleblowing as a monitoring and enforcement mechanism relying on dispersed private actors in the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (H.R.4173.ENR) is a federal statute in the United States that was signed into law on July 21, 2010, and is named after two of its initiators, Representative Barney Frank and Senator Chris Dodd.[113] This Act is part of the financial regulatory reform undertaken as a response to the financial crisis of 2007–2009. The Act aims, according to its preamble, to "promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail', to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes".

An interesting aspect of this Act of more than 800 pages is the reliance on private actors and their dispersed monitoring activities regarding the detection (and enforcement) of

[113] Available at <http://thomas.loc.gov/cgi-bin/bdquery/z?d111:H.R.4173:>, accessed on January 17, 2011.

violations of the law. These are the so-called whistleblowers[114] who provide original information that may lead to a successful enforcement action enforced by the SEC. In cases that involve penalties of more than US$ 1 million, the whistleblower will be entitled to between 10% and 30% of any monetary sanction by the SEC – thereby setting not only an incentive for employees to whistleblow, but also for law firms to represent those employees.[115] Furthermore, the Act provides protection for whistleblowers by the prohibition of retaliation. It allows those who think they have been discriminated against or fired in retaliation to bring the case to a federal judge within six years.[116] In case of such retaliation, the Act furthermore provides that relief may include measures from "reinstatement with the same seniority status that the individual would have had, but for the discrimination" to "compensation for any special damages sustained as a result of the discharge or discrimination, including litigation costs, expert witness fees, and reasonable attorney's fees"[117].

The instrument of whistleblowing is not completely new and there has been much discussion about how to implement internal organizational structures in corporations offering their members the opportunity to notify special committees of any wrongdoing anonymously, as well as external systems to ensure compliance with accounting systems, namely regarding the Sarbanes-Oxley Act[118]. However, the practice of whistleblowing laid down in the Dodd-Frank Act has been called "a far cry from previous practice"[119] due to its "tremendous"[120] monetary incentives and the protection of whistleblowers – this particularly as the SEC so far has only rewarded whistleblowers involved in insider-trading cases[121]. This fact is also stressed by the SEC, thereby highlighting the intention

[114] Whistleblower is defined as "any individual, or 2 or more individuals acting jointly, who provides information relating to a violation of this Act to the Commission, in a manner established by rule or regulation by the Commission", see Sec. 748 Dodd-Frank Wall Street Reform and Consumer Protection Act and resulting amendments of the Commodity Exchange Act.

[115] See Sec. 748 and Sec. 922–923 Dodd-Frank Wall Street Reform and Consumer Protection Act and resulting amendments of the Commodity Exchange Act.

[116] See Sec. 748 Dodd-Frank Wall Street Reform and Consumer Protection Act and resulting amendments of the Commodity Exchange Act.

[117] See Sec. 748 Dodd-Frank Wall Street Reform and Consumer Protection Act and resulting amendments of the Commodity Exchange Act.

[118] Schmidt, 2005, 146-148; see also for a more detailed discussion Benston/ Bromwich/ Litan/ Wagenhofer (2003); Barnett (1992); Bowen/ Call/ Rajgopal (2010).

[119] Johnson (2010).

[120] See also Columbia University Professor of Law, John Coffee, quoted in the Financial Times: "We've seen recent settlements of SEC actions of up to $800m […] this is a tremendous incentive for people to blow the whistle and for entrepreneurial law firms to present them" in Eaglesham/ Masters (2010).

[121] The SEC has only paid about $160,000 out of its whistleblower program in its 20-year history, see Johnson (2010).

of this law: “The scale and awards reflects the high quality of whistleblowers we hope to get”[122].

What is the rationale of relying on private actors to perform the function of information gathering, thereby privately enforcing public law? The recourse to private actors is first of all based on the finding that the existing institutions designed to uncover fraud in the financial world have failed, that reliance on other instruments and actors is more promising, and that there is a need to make more use of these alternative monitoring and enforcement mechanisms by enhancing the incentives of private actors to perform these roles.[123] This has been driven mostly by the accounting scandals such as Enron and Worldcom. Again, the 2008–2009 financial crisis – as explicitly expressed in the preamble of the Dodd-Frank Act – highlighted the need for other, more effective instruments to detect corporate fraud and malpractice. Reality challenged not only the legal perspective that fraud detection would be accomplished by securities authorities and auditors but also the economic perspective that monitoring would be accomplished by “those with residual claims (equity and debt holders) and their agents (analysts and auditors)”[124]. An extensive study researching the role of different actors and mechanisms in detecting fraud in 216 cases from 1994 to 2004, conducted by Dyck, Morse and Zingales, produced interesting results, confirming the important role of private actors and dispersed monitoring mechanisms. Regarding the sources of information in the 216 fraud cases the results of Dyck, Morse and Zingales show that only 7% of the frauds were detected by the SEC, 10% by auditors, 27% by equity/debt holders and their agents, 17% by employees, 13% by the media (based on information from employees), and 13% by non-financial-market regulators.[125] These numbers already challenge the role of public enforcers, and the results changed significantly as soon as whistleblowing mechanisms with strong monetary incentives were introduced. Under the Federal False Claims Act[126], individuals who bring forward relevant information in a case in which the fraud involves a false claim against the government are entitled to between 15% and 30% of the money recovered

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[122] See Eaglesham/ Masters (2010) quoting SEC official Stephen Cohen.

[123] For the role of private enforcement in securities laws, see La Porta, Lopez-de-Silanes and Shleifer, stating that there is “almost no evidence that public enforcement benefits stock markets, and strong evidence that laws facilitating private enforcement through disclosure and liability rules benefit stock markets” that “for the case of securities markets, our evidence suggests that the efficient institutional choice takes the form of private enforcement of public rules, which encourages private recovery of damages by investors harmed by promoters” La Porta/ Lopez-de-Silanes/ Shleifer, 2006, 23; Dyck/ Morse/ Zingales, 2008, 2.

[124] Dyck/ Morse/ Zingales, 2008, 2.

[125] Dyck/ Morse/ Zingales, 2008, 12.

[126] Federal False Claim Act (31 U.S.C. 3729-3733).

by the government (particularly relevant in the healthcare and defense industries).[127] Fraud cases under the Federal False Claim Act highlight the effect of monetary incentives: 41% of the frauds in these cases were brought to light by employees, more than twice than in industries regulated by laws without whistleblowing mechanisms.

One of the reasons given by DYCK, MORSE and ZINGALES for why employees as well as analysts can play such an important role in the enforcement of public law is that they incur low costs of identifying fraud-relevant information, as they gather relevant information as a by-product of their daily work[128]. At the same time, employees face significant costs as soon as they become whistleblowers – 82% of those whistleblowers involved in the cases researched were fired later, which makes the case for the need for statutory protection from retaliation. Strong monetary incentives and protection from retaliation: both of these aspects were evidently considered in the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Why do we present this case? It is an interesting example of how information-gathering mechanisms that rely on private actors have been incorporated by state authorities into federal law in order to achieve a more effective detection of fraud. It is a good example to highlight how important it is to consider and use a variety of different regulatory strategies, involving a multiplicity of actors (in this case a "web of monitors"[129]) and taking advantage of their regulatory capacity by setting the "right" incentives. This Act recognizes the capacity of "alternative" forms of regulation in order to achieve its policy end: behavior of corporations which is compliant with existing law.

3 Conclusion

The two examples illustrate the variety of actors (state and non-state actors), instruments and modalities (simultaneously or sequentially) that can be observed in contemporary forms of regulation. The IFRSs example illustrates the degree to which private actors have become standard-setters and how other competition-based mechanisms are used, at least in the first instance, to promote and enforce these rules and how these different mechanisms interact (**1**). The second example highlights how alternative regulatory instruments can be built into traditional state-centered regulatory strategies and how

[127] DYCK/ MORSE/ ZINGALES, 2008, 15.
[128] DYCK/ MORSE/ ZINGALES, 2008, 14.
[129] DYCK/ MORSE/ ZINGALES, 2008, 5.

they can stimulate the potential of dispersed actors (**2**). It furthermore stresses how important it is, particularly for state regulators, to consider a variety of regulatory strategies, or as DYCK, MORSE and ZINGALES put it: “The involvement of these [private] actors, their comparative advantage in terms of access to information, and their incentives need to be considered when considering reforms of governance in the US and abroad”[130]. Furthermore, the two examples provide us with initial reasons for a broadened approach to regulation such as the unsatisfactory results of traditional regulation or the need for harmonized standards due to the increased interdependence and convergence of financial markets.

[130] DYCK/ MORSE/ ZINGALES, 2008, 6.

II Explanations for a Broader Understanding of Regulation

Our premises imply a development of new forms of regulation, a broadened understanding of regulation and a historical dimension to this development. The premises further suggest that “traditional” forms of regulation are no longer in favor as they are seen as incapable of dealing with an increasingly complex, fragmented and interdependent environment, and that ”alternative” forms of regulation have emerged, characterized by a variety of actors and instruments. Thereby, we imply that economic, political and social changes have led from a narrow, state-centered and hierarchy-based understanding to a broadened understanding of regulation.

In this part we will introduce some of the factors that have contributed to the recognition of the regulatory capacity of non-state actors and an increasing focus on the interactions and interdependencies of alternative regulatory arrangements, characterized by hybridization and the reliance on *de facto* behavior-constraining factors.

As roughly outlined above, we will first turn to criticisms of command and control-style regulation which was increasingly put forwards by socio-legal scholars in the 1970s and 1980s: the criticisms aimed both at the state as the exclusive regulator and law as its dominant instrument and have led to the recourse to other actors as well as to other instruments. As we will see, the result was the beginning of an increased interest in regulatory improvement strategies continuing until today (**1**). In a second step we turn to processes often summarized under the umbrella term of globalization, referring to an expansion of international trade and more inter-state connections, and their effects on states’ capacity to regulate. New actors, particularly civil society groups and transnational firms, have stepped on to the global regulatory stage, non-state regulatory regimes have emerged on large scale, and the regulatory capability of non-state actors as well as the need to rely on dispersed monitoring and enforcement mechanisms have been recognized (**2**).

1 Criticisms of the Idea of State-Centered and Hierarchy-Based Regulation

State-centered and hierarchy-based command and control-style regulation, thus regulation by the state through the use of legal rules backed by sanctions, has been the traditional core definition and understanding of regulation.[131] It is a concept of regulation

[131] Black, 2002, 2. See chapter one/ A/ II/ 1/ 1.1.

that strictly relies on the state as the regulator and its instrument of law: rules are made by the legislature, monitored by the executive arm of government (whether inspectorate, ministry or agency), and enforced by the judicial system, whether under criminal or administrative jurisdiction. However, it has "become shorthand to denote all that can be bad about regulation"[132] and is increasingly replaced in theory and practice by alternative, flexible, less state-centered forms of regulation[133]. Let us look at the criticisms against command and control-style regulation (**1.1**) and the consequences of these critical views on regulation as an exclusive state activity, relying on hierarchy and the authority of law (**1.2**). The results are summarized (**1.3**).

1.1 Criticisms of Command and Control-Based Regulation

Command and control-style regulation is mainly criticized for two reasons. Firstly, it is questioned whether states or governments should interfere with markets at all (**a**), and secondly the instrument of law itself was criticized for having several general shortcomings (**b**).

a Public vs. Private Interest, Market vs. Government Failure

Traditional command and control regulation has its roots in the notion of market failure. The underlying assumption is that markets by themselves are efficient and that unfettered markets will lead to general well-being.[134] It is the basic idea, as argued by Adam Smith, that individuals maximize the welfare of all simply by pursuing their self-interest, guided by an invisible hand.[135] However, the invisible hand of the market sometimes fails to optimize social welfare, as market failures occur. These market failures have often been (and still are) regarded as sufficient justification for government

[132] Black, 2002, 2.
[133] Havinga, 2006, 515.
[134] Stiglitz, 2010, 16.
[135] "[…] and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it." (Smith, 1904, 421).

intervention in order to produce outcomes which are in the public interest.[136] The idea of state regulation as the way to achieve certain publicly desired goals where markets would fail to yield these has been the standard explanation and widely accepted justification for state regulation.

By the late 1970s, that idea had been challenged, particularly in the United States, where there was an increasing disappointment with the performance of state-run regulatory agencies.[137] Skepticism about the ability of the state to tackle market failures became a dominant premise of policy debate.[138] Based on the perception that state regulation was ineffective in terms of meeting the public interest goals it was supposed to meet, the focus shifted from market failure to the notion of *government failure* and the possibility that "even in the presence of market failure policymakers could potentially do more harm than good"[139]. Government failure serves within this discussion as an umbrella term encompassing all the cases in which government intervention in markets causes a less efficient allocation of goods and resources than would occur without that intervention – for whatever reasons, e.g., the occurrence of unintended collateral consequences of a regulatory strategy.

A broad range of government failures were broad up, however particularly the notion of "capture" had been criticized: the idea is that state regulators, created to achieve public interest goals, do not act in the public interest but in the interest of particular interests, whatever they may be (e.g. their own interest or that of the regulated industries). Capture theory, based on STIGLER's article "The Economic Theory of Regulation", says that private interest groups as well as all other participants will try to use the power of governments

[136] BALLEISEN/ MOSS, 2010, 2; Based on the assumptions that there are some market places that are not able to deal with particular structural problems (BREYER, 1982, 15) and that state should intervene in order to "prevent purely private decision-making that would take inadequate account of the 'public interest'" (BREYER, 1990, 7-8) the three most important justifications for regulation are market failures of monopoly power, negative externalities and inadequate information (BREYER, 1990, 15-28). The existence of a "natural monopoly" is the most traditional and persistent rationale for governmental regulation of firms' prices and profits (BREYER, 1982, 15). In these cases a firm can increase its profits by restricting output and charging higher than competitive prices, and regulation tries to hold prices down closer to costs (BREYER, 1990, 10). The existence of negative externalities, describing situations in which a product's price does not reflect certain costs that its production imposes on society, is another important justification for regulation. See BREYER (1982) for a detailed review for "typical" justifications of regulation and the objections to these rationales.

[137] Regarding the different attitudes in the US and Europe, see MAJONE, 1990, 2: "Hence in industry after industry the response of most European governments to perceived market failure was not regulation [*in the narrow sense of the US understanding of regulation*], but nationalization, industrial reorganization and planning, and other forms of corporate intervention. […] Moreover, even when regulatory instruments like price control, standard setting or licensing have been used, there has been a general reluctance to rely on specialized, single-purpose agencies. Instead, regulatory functions have been assigned to traditional ministries or inter-ministerial committees." Emphasis added.

[138] STIGLER, 1971, 3; BALLEISEN, 2010, 443.

[139] BALLEISEN/ MOSS, 2010, 2.

to achieve forms of state regulation which is beneficial to them[140]. Those in charge of regulating are assumed vulnerable to be "subverted by pressure, influence and bribery to protect the interests of those who were the subjects of regulation"[141].

Capture theory became an important trigger to the question of *why* regulation arises and which objectives it serves. Public choice theory became by far the most influential way to explain why state regulation might not be in the public interest, but rather be driven by private interests. The basic assumption is that the behavior of politicians, government officials and other actors in the public arena is not different from behavior in the market: "the individual acting in both contexts rationally to maximize his or her own utility"[142]. On this analysis, public choice and capture theory argue that special interests will be unable to achieve efficient regulation due to focusing their resources on attempting to achieve forms of regulation that favor their own interests, while the public interest will not be represented by the state regulators.[143]

Government failure became the dominant subject of study at that time in the late 1970s and 1980s. The focus in the academic debate on regulation shifted to the question of whether state governments should interfere with markets at all, and if they do, whether command and control style is appropriate.

b General Shortcomings

Command and control-style regulation has been criticized for a number of more general shortcomings, questioning whether the hierarchical instrument of law in combination with state regulation is an effective way to regulate economic activities.

The first strand of arguments criticizes command and control-style regulation for lacking *adaptability and precision*. Command and control regulation relies on legal rules made by states' legislative bodies.[144] One of the major criticisms is that these rules do not meet the demands of a diverse business environment and its actors, but rather ignore this diversity[145].

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[140] See Stigler (1971) and Peltzman (1976); furthermore see Ogus (2004).

[141] Ogus, 1994, 57.

[142] Ogus, 1994, 59.

[143] Stiglitz, 2010, 50: "A second major set of issues concern capture – not only capture by special interests but also by particular ideologies".

[144] Baldwin/ Cave, 1999, 34.

[145] Balleisen, 2010, 455.

This criticism focuses on several aspects:

- The first aspect is about the difficulty of designing precisely targeted rules, and accuses command and control-style regulation either of generating rules of a too high degree of complexity or producing rules for "the lowest common denominator of proscribed behavior"[146].[147] According to the critics, the resulting universalistic rules impose unnecessary restrictions on some companies and overly lax conditions on others.[148] The argument is that rules that strive for universal applicability will be rather poorly targeted rules.
- The second aspect of the criticism contrasts the characteristics of legal institutions with the needs of a rapidly changing business environment.[149] It is argued that legal institutions are "designed to be stable and predictable" and made to last, while economic circumstances, due to technological innovation, tend to change rapidly.[150] As a result, it is argued, either the rules that are made fail to respond to the needs of a reshaped business context in an adequate period of time due to the general incapacity of state legislation to adapt rapidly, or new rules are "rushed through" and as a result may "create more problems than they solve"[151].

In summary, it is argued that command and control-style regulation produces rigid regulatory regimes and inflexible rules, which fail to respond to the diversity of different economic sectors.

The *second* strand of arguments criticizes the state as regulator for lacking *knowledge and capacity regarding all functions of regulation*:

- It is argued that states have insufficient knowledge to be able to identify the causes of problems in an industry or to design solutions that are appropriate to tackle these problems, and furthermore that they are not able to identify non-compliance with rules.[152] This argument is based on the assumption that the

[146] Braithwaite, 1982, 1474;

[147] See Neustadt (1980).

[148] Braithwaite, 1982, 1474.

[149] See Stewart (1981).

[150] Braithwaite, 1982, 1475.

[151] Braithwaite, 1982, 1475: "The likeliness of broad-brush rather than precisely targeted rules is seen as especially high when new rules are imposed due to former scandals or tragedies. In these cases government rule-makers may respond to a mischief before public concern dies down and while memories of a disaster are still fresh which puts them under time pressure which does not allow them to produce precise rules".

[152] Black, 2002, 2-6.

informational demands in order to make precise rules are onerous[153] and that state actors lack the time and research capacities to overcome the information asymmetries between regulator and regulated.[154] As a consequence, the argument goes that state regulators might fail to cover industrial conduct that should be controlled and might instead constrain activities that should stay unregulated.

- As already mentioned, states are not only criticized for their inability to be sufficiently informed rule-makers, but the alleged lack of information and knowledge is extended to the functions of information gathering and enforcement. The monitoring of complex rules being a costly and extensive activity[155], it is argued that due to informational problems, capacity and budget constraints, state actors are incapable of coping with the demands of monitoring the corporations that fall under their jurisdiction.[156]
- Another criticism related to the problems states face regarding the monitoring of industries is that command and control regulation and its imperative approach provokes opposition within the regulated industries instead of cooperation. State regulators are perceived as ignoring industries' interests and government interference is perceived as iniquitous; an argument often referred to as motivation failure.[157] Furthermore, the criticism is put forward that inflexible universalistic rules lead to the occurrence of creative compliance, thus firms try to avoid the intention of the law without breaking the terms of the law.[158] Resulting from this, relations become increasingly adversarial between state regulators and the regulated industry, leading to a lack of commitment of firms to the unilateral approach of command and control regulation.

In summary, hierarchical state regulation is said to have failed in many aspects. It is questioned whether public regulators do act in the public interest and whether states should interfere with markets at all (capture theory). Focusing on law and the threat of sanctions is judged an inappropriate and unsophisticated instrument. State regulators are said to have insufficient knowledge to perform the three functions of regulation and

[153] Baldwin/ Cave, 1999, 38.
[154] Baldwin/ Cave, 1999, 38.
[155] See Weidenbaum (1979).
[156] Balleisen, 2010, 455.
[157] Hans-Bredow-Institut (2006); Balleisen, 2010, 455-458.
[158] Baldwin/ Cave, 1999, 38.

to provoke opposition to regulation instead of compliance. BLACK summarizes the shortcoming as instrument failure, information and knowledge failure and motivation failure.[159]

1.2 Consequences of the Criticisms of Command and Control-Based Regulation

Our premises imply that there is a historical dimension to the broadening of the understanding of regulation from a state-focused to a more decentralized approach. Therefore, we will now turn to the developments which can be seen as consequences of the criticisms of state-focused command and control regulation. We will focus on the different regulatory approaches that have been developed in order to find an answer to the question of how states might achieve their regulatory objective in a more effective way than with command and control-style regulation, both aspects calling for a broader mix of instruments and actors.

As a result of the notion of government failure, "capture" and other criticisms, command and control- style regulation fell out of favor.[160] Instead, there was a call to diminish the role of the state in markets, and the idea that an unfettered market will generally lead to societal well-being moved increasingly into the spotlight. As a consequence, especially but not exclusively in the United States, traditional structures of regulation and control have been broken down or radically transformed.[161] Mechanisms such as price-setting were dismantled in order to leave to the markets functions which had formerly been regulated by the state. Furthermore, the call for the "privatization" of governmental functions, either by contracting out or by changing ownership structures, was becoming louder.[162] In the context of these developments in the late 1970s and 1980s, the search for answers to the question of how to achieve the relevant regulatory objectives by less burdensome methods of governmental intervention shifted into the focus of the

[159] BLACK, 2002, 2.

[160] BALLEISEN, 2010, 443-446; see KLEINSTEUBER (2006).

[161] MAJONE, 1990, 3; see LANDIS (1966).

[162] KAMARCK, 2000, 230; These processes are often summarized under the term deregulation but, as MAJONE highlights, "[…] that is a misleading term. […] Neither in the United States nor in Europe has deregulation meant an end to all regulation" (MAJONE, 1990, 3). On the contrary, the fields in which regulation takes place have shifted: for example, while the regulation of airlines in the United States regarding the activity itself [price-setting] has been dismantled, this industry has not been deregulated with respect to safety – or for example privatization of natural monopolies has often been followed by price regulation.

regulatory debate with contributions from a multitude of disciplines.[163] Common to these approaches is their intention to look beyond the traditional forms of regulation by exploring the regulatory potential of a wider set of techniques and a wider range of actors.

Let us first look at the example of self-regulation (**a**) before we turn to two examples of co-regulation (**b**), responsive regulation and smart regulation, highlighting the development from a state-centered hierarchical approach to a broader approach to regulation.

a Self-Regulation

Due to the skepticism towards state intervention, self-regulation was seen as an "attractive alternative to direct governmental regulation because the state simply cannot afford to do an adequate job on its own"[164]. It was said that self-regulation might expand coverage, achieve greater inspectorial depth due to corporate institutions for internal compliance being better trained and equipped with more resources than their public sector counterparts[165] or that it might be easier for corporate inspectors to trap suspected wrongdoers[166]. The strengths of industry self-regulation were seen to be speed, flexibility, sensitivity to market circumstances, and lower costs.[167] Furthermore it was brought forward that self-regulation has a long tradition among the crafts and the professions, and has been proved to work successfully there.[168] Self-regulation was expected to mobilize private expertise and to increase the likelihood that participants would follow their (own) rules[169]. However, an increasing number argued that it was naïve to trust companies to regulate themselves without any other mechanisms being involved[170] and

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[163] von Weizsäcker (1990), Gunningham/ Rees, 1997, 364: "[…] governments of very different political complexions are experimenting with various forms of self-regulation in search of a middle way between laissez-faire capitalism and state-centered regulation".

[164] Braithwaite, 1982, 1467.

[165] Braithwaite gives the example of the pharmaceutical industry, where a number "of more reputable companies have corporate compliance groups, which send teams of scientists to audit subsidiaries' compliance with production quality codes. In one Australian subsidiary of an American firm […], inspections by the headquarters compliance group were conducted twice yearly and were normally undertaken by three inspectors who spent over a week in the plant. The government health department inspection, on the other hand, consisted of an annual one-day visit by a single inspector." (Braithwaite, 1982, 1468).

[166] Braithwaite, 1982, 1469.

[167] Gunningham/ Rees, 1997, 366.

[168] Majone, 1996, 23.

[169] Pieth, 2007, 94.

[170] See Balleisen, 2010; Gunningham/ Rees, 1997, 363.

that self-regulation was a symbolic sham rather than an effective way of regulating[171]. Firms "may be more capable than the government of regulating their business activities" but at the same time it was argued that being more capable does not mean that "they are […] necessarily more willing to regulate effectively"[172]. Self-regulation was said to be rather a cynical attempt of interested parties to give the appearance of regulation.[173]

b Responsive and Smart Regulation

These alleged fundamental weaknesses of voluntary self-regulation led to a preoccupation with other forms of regulation: new instruments and forms of regulation in which both state and non-state actors play a role, labeled as co-regulation, and the focus was increasingly set on the continuum between pure forms of self-regulation and state-centered regulation.[174] It was increasingly argued that a mixture of private and public regulation is the better path and that the interaction between public and private regulation "is crucially important, raising broader questions about the state's proper role in all this and how we can determine the most harmonious fit between particular industry structures and different public/private regulators' strategies"[175]. We will present two approaches which can be seen as having a major influence in driving the discussion toward a broader understanding of regulation: responsive regulation and smart regulation.

One of the most influential approaches within this field, regarding different instruments, modalities and actors involved, is the idea of *responsive regulation* proposed by IAN AYRES and JOHN BRAITHWAITE. The subtitle of their book, 'Transcending the Deregulation Debate', highlights its approach: the development of ideas which help to transcend "the intellectual stalemate between those who favor string state regulation of business and those who advocate deregulation"[176]. It is an approach based on the assumption that "in reality regulation occurs in many rooms"[177] and that private actors play an important part in these rooms. The essence of responsive regulation is that regulation should be

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[171] JENKINS, 2001, 26; GUNNINGHAM/ REES, 1997, 363.

[172] BRAITHWAITE, 1982, 1469.

[173] GUNNINGHAM/ REES, 1997, 370.

[174] GUNNINGHAM and REES distinguish between voluntary self-regulation, mandated self-regulation and mandated partial self-regulation (GUNNINGHAM/ REES, 1997, 366).

[175] GUNNINGHAM/ REES, 1997, 406.

[176] AYRES/ BRAITHWAITE, 1992, 3.

[177] AYRES/ BRAITHWAITE, 1992, 3.

responsive to industry structure, as different industry structures will be "conducive to different degree and forms of regulation"[178]. Furthermore, AYRES and BRAITHWAITE argue that the different motivations of regulated actors should be taken into account and that regulation should respond to industry conduct and its ability to make private regulation work effectively: "[T]he very behavior of an industry or the firm therein should channel the regulatory strategy to greater or lesser degrees of government intervention"[179]. Their

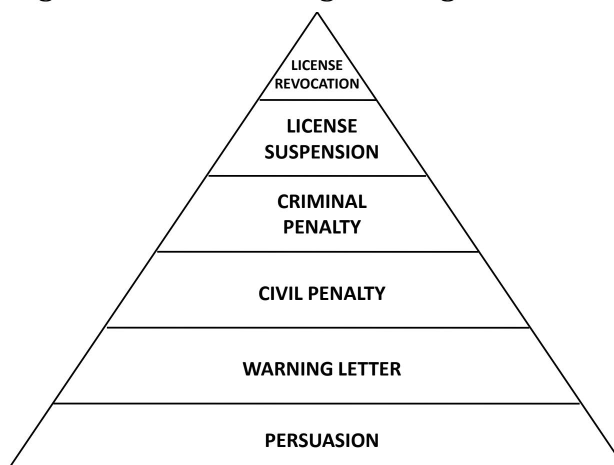

Figure 5: Responsive Regulation on Company Level [AYRES/ BRAITHWAITE, 1992]

idea of responsive regulation is best captured by their concept of the enforcement pyramid. This pyramid of sanctions applies at the level of the *individual* regulated company. It is a tit-for-tat strategy relying on the idea that as long as a firm is cooperating with the regulatory body, the regulator relies on rather soft instruments, but the moment a firm starts to behave less cooperatively, the regulator can move up (and down) on the pyramid to tougher enforcement strategies, from a cooperative to a deterrent response. The assumption is that the greater the severity of enforcement sanctions to which a regulator can escalate, the less likely it is that the regulator will have to resort to such sanctions.

On an *industry* level, regulation can generally range from self-regulation to command and control regulation. Again, AYRES and BRAITHWAITE argue for a responsive middle path between these two extremes by introducing their model of *enforced self-regulation*. They argue that such a regulatory strategy combines the strengths of both concepts. The idea is that firms are "required to write their own set of corporate rules, which are then publicly ratified"[180]; if private enforcement fails, the rules will be publicly enforced.

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178 AYRES/ BRAITHWAITE, 1992, 4.
179 AYRES/ BRAITHWAITE, 1992, 4.
180 AYRES/ BRAITHWAITE, 1992, 101.

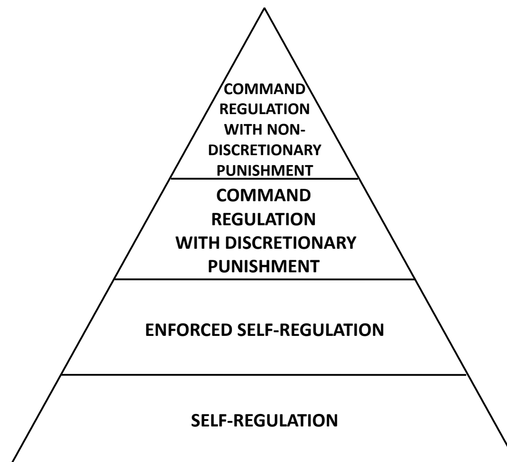

Figure 6: Responsive Regulation on Industry Level [AYRES/ BRAITHWAITE, 1992]

Furthermore, AYRES and BRAITHWAITE suggest involving and empowering citizens' associations in regulatory strategies, arguing that regulatory strategies that foster cooperation between the regulator and regulated companies might encourage capture and corruption. Therefore, they suggest involving relevant public interest groups as fully-fledged third players in the regulatory process[181]. AYRES and BRAITHWAITE conclude that a responsive attitude enables "the blossoming of a wide range of regulatory approaches"[182]:

> If we accept that sound policy analysis is about understanding private regulation – by industry associations, by firms, by peers, and by individual consciences – and how it is interdependent with state regulation, then interesting possibilities open up to steer the mix of private and public regulation. […] It is the mix, this interplay, that works to assist or impede solution of the economic problem. […] We argue that by working more creatively with the interplay between private and public regulation, government and citizens can design better policy solutions.[183]

Another important approach moving beyond the market-government dichotomy is *smart regulation*. GUNNINGHAM and GRABOVSKY's central argument is that in the majority of circumstances "the use of multiple rather than single policy instruments, and a broader range of regulatory actors, will produce better regulation"[184].

The underlying assumption of smart regulation is, that "neither the traditional command and control regulation nor the free market provide satisfactory answers to the increasingly complex and serious environmental problems"[185]. Even focused on

[181] AYRES/ BRAITHWAITE, 1992, 54.
[182] AYRES/ BRAITHWAITE, 1992, 5; for criticisms of responsive regulation, see BALDWIN/ BLACK, 2008, 62-65.
[183] AYRES/ BRAITHWAITE, 1992, 3.
[184] GUNNINGHAM, 1998, 4.
[185] GUNNINGHAM/ SINCLAIR, 1998, 37.

environmental policies, they argue that the general essence of smart regulation is "to take a far more imaginative, flexible and pluralistic approach than has so far been adopted in most jurisdictions"[186].

Smart regulation seeks an optimal mix of different regulatory instruments ranging from command and control regulation, self-regulation, education and information instruments (such as education and training, corporate environmental reports, pollution inventories, product certification, award schemes) to economic instruments (such as liability instruments, performance bonds, or fiscal instruments). Furthermore, GUNNINGHAM and GRABOVSKY suggest involving third parties such as NGOs or commercial parties (such as banks, insurance companies, wholesalers or retailers) in regulatory strategies as they can play an important and constructive role as *de facto* regulators by setting behavioral incentives (e.g. demanding for certain levels of transparency or the disclosure of data).[187]

The involvement of private actors and the use of a vast array of different regulatory instruments is still a subject of high importance to state regulators – a subject often labeled as "better regulation"[188]. The EU, for example, runs a "better regulation program" and so do almost all OECD countries[189]. A quick look at program run by the EU mentions the shortcomings of command and control regulation discussed above (e.g. the inability to adapt to technological change) and highlights the continuous search for alternative regulatory strategies. As to the reasons for a better regulation strategy, the program states that, in order "to face up to the challenges we face inside and outside Europe, policies, laws and regulations need to adapt to the fast pace of technological change, to foster innovation, to protect the welfare and safety of Europeans. Public administrations need to be effective, flexible and focused. This is the standard which the European Commission has set itself, and this is why we have made Better Regulation one of our core priorities"[190]. The European "better regulation program" includes a mix of different actions, including: the introduction of a system for assessing the impact and improving the design of major Commission proposals; the implementation of a program of simplification of existing legislation; and "looking at alternatives to laws and regulations (such as self-regulation, or co-regulation by the legislator and interested parties)"[191].

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[186] GUNNINGHAM, 1998, 4; see WEATHERHILL (2007) for an introduction to better regulation.

[187] GUNNINGHAM/ SINCLAIR, 1998, 371.

[188] See BALDWIN (2005) for the connection between better regulation and smart regulation.

[189] OECD (2005).

[190] EUROPEAN COMMISSION, 2006, 6-8.

[191] EUROPEAN COMMISSION, 2006, 8-9.

1.3 Summary and Conclusion

In a first step, we have presented the criticisms of command and control-style regulation. We have seen that hierarchical state regulation is argued to have failed in many regards (**1.1**): it is questioned whether public regulators do act in the public interest and whether states should interfere with markets at all. Furthermore, command and control-style regulation has been criticized for a number of other reasons, such as instrument failure, information and knowledge failure or motivation failure.

The shortcomings of command and control regulation have led to a search that is still continuing for regulatory improvement strategies, all of which have in common their interest in alternative regulatory regimes that do not rely solely on hierarchy and commands (**1.2**). Responsive regulation and its tit-for-tat approach focus on alternative instruments and their responsive application, depending on the conduct of the regulated. Smart regulation argues for a mix of instruments and a mix of state and non-state actors in regulatory strategies in order to use their *de facto* potential for the modification of firms' behavior. A mix of different actors and modalities of regulation is seen as essential in order to regulate effectively.

In summary, we can conclude that the focus has shifted from traditional, state-centered and hierarchy-based, regulation to an increasing interest in the nature of government–society, and intra-society interactions, and the question of how this potential for *de facto* regulatory constraint can be used or built into regulatory strategies in order to achieve regulatory objectives.

2 The World has Changed – The Impact of Globalization

The general criticisms of traditional, state-centered and hierarchy-based, regulation that were caused by the notion of government failure have led, as we have already seen, to an increased interest in the question of the role state actors should take in regulation or regulatory strategies on a *domestic* level and the search for alternative regulatory strategies and instruments. The discussion has led to the common finding that there is a need to take advantage of the potential of regulatory modalities other than hierarchy (e.g. competition mechanisms) and of regulators other than state actors (e.g. the involvement of third parties, the reliance on the regulated companies themselves as well as reliance on dispersed actors in markets or social communities) as they have the capacity to impose *de facto* behavioral constraints on firms. Agreeing on the fact that it is necessary to use

the potential of a wider range of different modalities of regulation, the approaches are still state-centered in the sense that their objective is to argue for a broader set of instruments and techniques *available to the state* as alternatives to law-based command and control regulation, and to outline conditions for how states could achieve their regulatory goals.[192] As outlined, the general criticisms of command and control regulation are one strand on the way to a broadening of the understanding of regulation.

The second strand circles around all the processes often implied under the umbrella term of globalization. While the term globalization describes a growing integration of economies and societies around the world and an increasing interaction across national boundaries, the discussion focuses on the impact of these developments on regulation and governance, particularly the regulatory capacity of nation states in a "globalized" world and the emergence of powerful actors, such as MNCs NGOs. This discussion is rooted in a variety of disciplines and has produced a rich body of literature discussing similar observations under a number of labels such as "Global Governance", "New Global Governance", "Global Regulation", "Private Global Regulation" and "Transnational New Governance". In the next section, we will highlight some of the overlaps of these different discussions regarding the need for a broader understanding of regulation (or depending on the definition, governance).[193] We will focus primarily on the regulation of transnational business, which itself has become a rather dynamic academic field.[194]

Common to these discussions, whether rooted in international relations, international public law, socio-legal regulation theory, or organizational theory, is not only their interest in policy issues, actors and forms of interaction[195] but also the analysis that a "globalized" world has become more complex, fragmented and interdependent[196]. It is acknowledged that the way in which control is exercised in general has changed and this has led to a call for, and the emergence in fact of alternative forms of regulation (and governance).

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192 Lehmkuhl, 2008, 345.

193 Governance is, again, a term with many definitions. In a broad sense it is defined as the processes and institutions (both formal and informal), that guide and restrain collective activities of a group (Keohane/ Nye, 2000, 12); mostly it refers to the economic, political, and social traditions and institutions by which authority is exercised in a country; see Mayntz (1993).

194 Abbott/ Snidal, 2009, 503.

195 Lehmkuhl, 2008, 355.

196 See Lehmkuhl and his study of overlaps of "largely unrelated research programs concerned with the legalization in international relations, on the one hand, and transnational regulation and governance, on the other hand" (Lehmkuhl, 2008, 336).

In a first step we will consider the term globalization, as it is the common starting point to refer to an increasingly complex, fragmented and interdependent environment posing collective problems that have to be addressed on a global scale to which state law does not provide satisfactory regulatory answers (**2.1**). In a second step we will turn to the common finding that regulation is no longer a privilege of states and governments and that regulatory regimes which do not rely on public authority have emerged on large scale (**2.2**). In a third step, we turn to the fact that there is an increasing interest in regulatory instruments that rely on modalities other than hierarchy and state sanctions (**2.3**). In a fourth step we will summarize the results (**2.4**).

2.1 Processes of Globalization

The common starting point for an analysis of different alternative forms of regulation in transnational settings is the processes often implied by the umbrella term of globalization.[197] Globalization has turned into the buzzword in order to describe or refer to economic, social and cultural changes which have occurred within the last few decades.[198] A single agreed definition does not exist, so it is helpful to look at the main characteristics ascribed to the term. The hallmarks are the expansion of international trade and foreign direct investments, the increase in the flow of commodities and cultural products, the rapid spread of information and communications technologies (ICT), the development of an increasingly integrated global economy resulting in an increasing degree of interconnectedness, the integration and interdependence of economies and societies around the world, and an increasing interaction across national boundaries.[199]

From an economic perspective the term particularly refers to the globalization of *firms* and *markets*: the former describing the extension of firms' operations from one specific territory of their origin to other territories through corporate groups and structures and the emergence of transnational enterprises, the latter describing the emergence of markets where buyers or sellers from any territory can meet with buyers and sellers from

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[197] See DJELIC and SAHLIN-ANDERSSON, proposing not to use the label "globalization" to refer to the rapid expansion of operations and interactions across and beyond national boundaries, but rather "transnational" (DJELIC/ SAHLIN-ANDERSSON, 2006, 3-4). See O'ROURKE/ WILLIAMSON (2002) for the question of "when did globalization begin?".

[198] PERRATON, 2003, 37: "Globalization has become arguably the buzzword of our times, but for all its resonance in academic and popular discourse it often remains a vague and elusive concept".

[199] GILLIES-GRAZIA, 2003, 140ff.; BEYNON/ DUNKERLEY, 2000, 5ff.; for the role of ICT see MAYER-SCHÖNBERGER/ HURLEY (2000).

any other territory to conduct transactions.[200] Both *globalized markets* and *globalized firms* are characterized by their significantly increased interdependence and complexity.[201] The financial market is *the* example of a genuinely globalized market as well as the host of truly globalized firms and actors – and shows a high degree of interdependence, as a shock in one country leads to co-movements, thus shocks in all other countries[202].

The emergence of these new phenomena and their interdependence and complexity is the first common observation[203].

What to do with global markets and global firms? Who is supposed to regulate these markets and firms? And who has the capacity to do so? These questions outline most of the problem which have been and are still asked by academia, politics, business communities and civil society actors.[204]

The reasons why these questions have been asked and are continuously discussed lie in the fact that the emergence of global markets and global firms has led to the second observation that the traditional forms of regulation do not provide satisfactory tools in order to regulate these markets and firms. The economic (as well as the social and cultural) interdependence between the world's nations has affected the capacity of law as the nation state's primary regulatory instrument[205]. This is argued for three reasons:

- **National law tends to stay within national borders:** the traditional concept of the Westphalian state relies on sovereign nation states, thus a nation controlled by a centralized system of government. Within their borders, state governments have been traditionally, particularly in international relations theory, seen as the appropriate

200 Braithwaite/ Drahos, 2000, 8.

201 Braithwaite/ Drahos, 2000, 8; or as Cohen explains an increasingly complex web of interdependencies and interactions: "The world-wide financial, economic, technological and ecological interdependence implies that goods, capital, knowledge, images, communications, crime, culture, pollutants, drugs, fashions and beliefs all readily flow across territorial boundaries" (Cohen, 2000, 52).

202 See Forbes/ Rigobon (2002).

203 Kooiman, 1993, 2-4; Omae (1995) explains the increasing interconnectedness and interdependence by the "four Is": Investments (which are no longer geographically constrained: the money goes where the good opportunities are); Industry (all industrial activities have become much more global and the strategies of MNCs are no longer conditioned by reasons of state, but rather by the need to serve attractive markets, wherever they can be found); Information technology (the role of information and communications technology as *the* essential base in order to operate on a global scale in different territories without having to build up entire business systems); Individual customers (more global in orientation due to better access to information about lifestyles around the world).

204 See Picciotto (2002), see Cafaggi (2006), see Scherer/ Palazzo/ Baumann (2006), see Knill/ Lehmkuhl (2002).

205 Kooiman, 1993, 6: "[…] growing complexity, dynamics and diversity of our societies, as caused by social, technological and scientific developments, puts government systems under such new challenges that new conceptions of governance are needed".

overseer of domestic activities, e.g. domestic business activities.[206] Both the scale and structure of contemporary global production and distribution (the results of global firms and markets) challenge states' capacities to regulate activities that extend beyond their borders.[207] Nation states, it is argued, are challenged as their major regulatory instrument of law tends to stay within national borders and they do not have the capacity to make, monitor and enforce rules which are able to address issues and regulate activities characterized by a global (or transnational) dimension.[208]

- **Traditional forms of handling international issues are inadequate:** it is commonly said that the transformation of traditional forms of regulation, relying solely on states and the instrument of law, to a transnational or global level does not provide satisfactory answers to global collective problems, or at least to do so only partly.[209] The international institutions created in the late 1940s, such as the IMF, are seen as "outdated and inadequate to meet contemporary challenges"[210] and, it is argued, they need to be reformed or even reinvented and, additionally, new institutions have to be voluntary agreements by sovereign states and international organizations under international law, as well as the resulting IGOs, are increasingly seen as being too limited in their reach and too restricted in their monitoring and enforcement mechanisms in order to respond to the demands of regulating global business activities or other issues which are in need of a response on a global scale.[211] Thus, the traditional instruments and techniques available to nation states in order to address problems on an international scale are argued to be failing.[212]
- **No new world government:** a consequent transformation of nation states' regulatory capacities and instruments to a global scale would be the creation of a new centralized world government. This would require one single common political authority for all of humanity which would have the power sovereign states have on a domestic level. However, this idea is seen as both infeasible and undesirable.[213]

[206] This refers to the fact that issues of governance and regulation have been traditionally approached in political science and international relations literature from a state-centered perspective, see Djelic/ Sahlin-Andersson, 2006, 8.

[207] Abbott/ Snidal, Governance, 2009, 44; see Teubner (1997).

[208] Abbott/ Snidal, Governance, 2009, 46.

[209] Scott, 2010, 7-9.

[210] Slaughter, 2004, 8.

[211] Scott, 2010, 7.

[212] Abbott/ Snidal, Governance, 2009, 57; see Abbott/ Snidal (2009).

[213] Slaughter, 2004, 8.

These two observations that the processes of globalization have led to an increasing economic and social interdependence and complexity between the world's nations and that traditional forms of regulation face limits within this context have led to the conclusion that people and their governments face collective problems[214] which have to be addressed on a global scale by alternative regulatory approaches.[215]

2.2 Private Actors Have Stepped on to the Regulatory Stage

A further common finding is that non-state actors have stepped on to the regulatory stage and have become powerful actors in the vacuum left by the state actors.[216] There is a new variety of actors which have become important players in the regulatory landscape besides state actors, particularly firms and their industry associations and NGOs as the most important representatives of civil society actors. ABBOTT and SNIDAL refer to this new constellation as the *Governance Triangle*, "which depicts the transnational regulatory space […] in terms of the participation of the three key actors groups"[217]. All three actors are generally playing a role regarding the three functions of regulation, thus standard-setting (rule-making), information gathering (monitoring) and behavior modification (enforcement). The cooperation and interactions of these three groups in collaborative regulatory arrangements is seen as one of the innovative features of a new distribution of power between state and non-state actors.[218]

While generally accepting that individuals, groups, movements or business enterprises have a major influence on the shape of regulatory regimes[219], the focus in the context of globalization is set on the role of transnational companies (TNCs) and NGOs, their role in the regulatory landscape and their way of becoming not only powerful actors but also creators of their own (private) regulatory arrangements, operating without the state.

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[214] For example globalized markets and globalized firms or the regulation of environmental issues such as measures to counteract climate change.

[215] See ZÜRN (1998); SLAUGHTER's concept of the *disaggregated state* refers to the "rising need for and capacity of different domestic government institutions to engage in activities beyond their borders, often with foreign counterparts" (SLAUGHTER, 2004, 8). SLAUGHTER stresses that the public and academic discussion of globalization has routinely focused on two major shifts, from national to global and government to governance – and argued that more attention should be paid to a third shift, "from the unitary state to the disaggregated state" (SLAUGHTER, 2004, 12).

[216] WOODWARD, 2003, 318.

[217] ABBOTT/ SNIDAL, Governance, 2009, 47.

[218] KEOHANE/ NYE, 2000: "Rules are no longer a matter simply for states or intergovernmental institutions".

[219] See HANNERZ (1996); BROWN/ KHAGRAM/ MOORE/ FRUMKIN (2000).

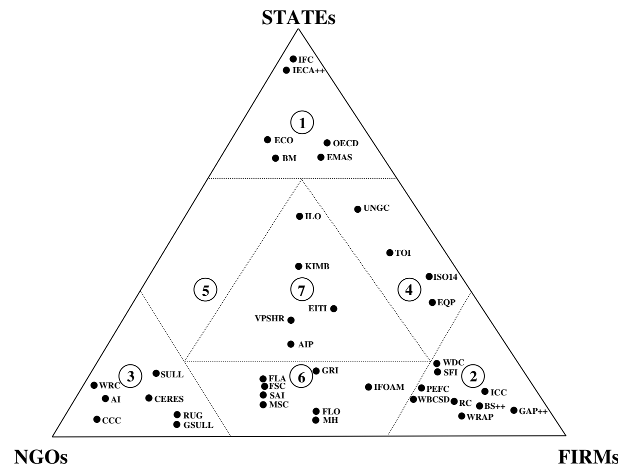

Figure 7: The Governance Triangle [ABBOTT/ SNIDAL, Governance, 2009]

It has become common knowledge that the role of TNCs increased considerably during the second half of the twentieth century as their activities grew at a considerably greater speed than the rate of increase of world output.[220] They are seen as the first actors truly operating on a global scale, in multiple national legal systems, and their emergence is seen as one of *the* results of an increasingly integrated economy. Furthermore, the emergence of TNCs is perceived as one of the main reasons why national regulators have been challenged due to TNCs' assumed ability to choose in which jurisdiction to locate their activities and due to the fact that no state regulator has the power, as already mentioned, to be a counterpart on the same global level.[221]

NGOs – the second group of non-state actors in the focus of interest – are seen to some extent as a reaction to counteract the increasing economic and political power and significance of TNCs on the same level.[222] During the 1990s TNCs gained much attention as they were accused of evading public control, exploiting the lack of regulatory capacity in less developed countries, and generally "getting away with behavior that harms employees, consumers, vulnerable communities or the environment"[223] as they were not faced with any effective regulatory counterpart on the same level. NGOs started to address these perceived negative consequences of the processes of globalization, particularly of global production, and nonexistent regulation on a global scale. They have been very successful on the level of agenda-setting by demonstrating failures, detecting misconduct and mobilizing support to create new regulatory mechanisms.[224] The role of

220 KOENIG-ARCHIBUGI, 2004, 234; see EPSTEIN (2003) for the role of TNCs in the world economy; see CRAGG (2005).

221 KOENIG-ARCHIBUGI, 2004, 242.

222 WOODWARD, 2003, 314; KOENIG-ARCHIBUGI, 2004, 245.

223 KOENIG-ARCHIBUGI, 2004, 235.

224 See VOGEL (2009).

such demonstration effects, particularly exposing scandals, as a trigger for the emergence of new regulatory processes is undoubted.[225]

It is widely acknowledged that the role and influence of NGOs "has exploded" in the 1990s[226], not least because the ICT revolution assisted them in low-cost networking and coalition-forming in order to mobilize against a common concern.[227] NGOs, whether advocacy groups, labor unions, consumer groups or social movements, epitomize the observation that there is an increasing arena of associations and actions which is neither part of the state nor part of the market sphere: *civil society as the third sector*.[228]

What was the effect of the emergence of NGOs to counteract the increasing power of TNCs, and how did the two parties started to play a role in the regulatory landscape? It is argued that the new regulatory arrangements have evolved in different time periods[229]:

First of all, transnational companies and their industry associations started to create new forms of regulation in areas where they depend on some forms of regulation[230]. This refers to the role of firms as private standard-setters. BRUNSSON and JACOBSSON argue that most standard-setters are private sector organizations, which are particularly common and important on the global stage due to the lack of state standards on this level[231]. The role of TNCs as private standard-setters has been intensively studied and examples like the IFRSs or the International Standards Organization (ISO) are striking examples.[232]

Secondly, having been accused of demonstrating behavior that was harmful to employees and the environment and of exploiting the weak enforcement capacities of less-developed countries, TNCs started to adopt different forms of self-regulation such as codes of conduct[233]. Many of these examples are efforts often referred to as Corporate Social

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225 MATTLI/ WOODS, 2009, 29.

226 MATHEWS, 1997, 53.

227 MATHEWS, 1997, 54.

228 ABBOTT/ SNIDAL, Governance, 2009, 59; HUTTER, 2006, 69; SALAMON defines civil society actors by five characteristics; organizations that are private, non-profit, self-governing and voluntary (SALAMON/ LIST/ TOEPLER/ ANHEIER, 1999, 3); for a general introduction see EHRENBERG (1999); furthermore GLENDON/ EBERLY (2000).

229 ABBOTT and SNIDAL divide the process into three periods: before 1985, 1985–1994 and after 1994 (ABBOTT/ SNIDAL, Governance, 2009, 58).

230 See HAUFLER (2001).

231 BRUNSSON/ JACOBSSON, 2000, 2; for the example of anti-money laundering see HÜLSSE/ KERWER (2007); furthermore see KERWER (2005).

232 BRUNSSON/ JACOBSSON (2000); see BÜTHE/ MATTLI (2009) for the role of non-state actors in setting standards for international product and financial markets; see NOBEL (2005) as well as NOBEL (2008).

233 ABBOTT/ SNIDAL, Governance, 2009, 58.

Responsibility (CSR) and Social Reporting.[234] Within this category falls the promotion of standards set by NGOs for voluntary adoption by firms.[235]

Thirdly, from the middle of the 1990s, a third form of regulatory arrangements emerged, characterized by the collaboration of two or more of the three key group actors; multi-actor schemes, whether bilateral or tripartite schemes, which involve different combinations of firms (and industry associations), NGOs and state actors.[236]

In summary, it is acknowledged that a new variety of actors have become important players in the regulatory landscape. Traditional forms of state-centered and hierarchy-based regulation have been challenged. Instead, state actors have become one of three key actor groups in the regulatory landscape. An increasing number of non-state or public-private regulatory arrangements have emerged within the last few decades[237]. However, there is a shift observable from these forms of non-state regulation to multi-stakeholder arrangements in which firms, NGOs and state actors in different constellations and combinations develop regulatory regimes for a wider acceptance.[238] The role of nation states has changed as the different functions of regulation have been pluralized or, as KEOHANE and NYE put it: “any emerging pattern of governance will have to be networked rather than hierarchical”[239].

2.3 New Mechanisms for Standard-Setting, Monitoring and Enforcement

A further common finding relates to the mechanisms and instruments that are used in order to fulfill the different functions of regulation. Regulatory regimes of non-state actors – as well as those with limited state participation – are mostly not rooted in public but in private authority[240]. Therefore, these regulatory arrangements have to rely on other mechanisms and instruments than hierarchy, particularly regarding the processes of

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[234] An example is the adoption of schemes for individuals’ labor rights in the clothing industry, after a number of accusations of violating labor rights (“Sweatshop”).

[235] Regarding the time periods proposed by ABBOTT and SNIDAL, these two developments fall in the second period, from 1985 to 1994.

[236] ABBOTT/ SNIDAL, Governance, 2009, 44; for an interesting case study on a private multi-stakeholder initiative (the Forest Stewardship Council), see PATTBERG (2005).

[237] DJELIC/ SAHLIN-ANDERSSON, 2006 , 1: “The proliferation of regulatory activities, actors, networks or constellations leads to an explosion of rules and to the profound re-ordering of our world”.

[238] KOOIMAN refers to the first development as a “tendency […] to shift the balance between government and society away from the public sector and more towards the private sector”, the second as an “effort to shift the balance towards a sharing of tasks and responsibilities” (KOOIMAN, 1993, 1).

[239] KEOHANE/ NYE, 2000, 37; see KOOIMAN, 1993, Governance and Governability.

[240] VOGEL, 2009, 3.

information-gathering and behavior modification. They cannot fall back on the most important instrument of state-centered forms of regulation: law.

As effective monitoring and enforcement are central to effective regulation, non-traditional regimes have to rely on different mechanisms in order to ensure that their rules are followed. Therefore the common finding is that the focus should be on instruments relying on modalities *other* than hierachy. Examples of such mechanisms are third-party auditing, information disclosure, auditor accreditation, social and environmental reporting, rankings, and social and environmental labels.[241] These new monitoring and compliance instruments are not limited to non-state actors. New regulatory techniques and instruments are increasingly used by states too[242] as all three groups – state actors, firms and NGOs – have each developed new understandings of "workable regulatory techniques"[243].

NGOs, as an already mentioned example, have played an important role in identifying problems, raising public awareness and thereby setting the agenda for regulatory gaps[244]. This awareness is often the first step in the regulatory process. By reporting facts about misconduct or scandals (e. g. by holding press conferences or publishing rankings) they use the pressure of public opinion in order to achieve direct behavior modification. The rationale is that other actors will set constraints on the conduct of actors by boycotting their products, by publicly criticizing them or by starting a joint effort for a private-public regulatory scheme. Thereby, NGOs rely on competition- and community-based mechanisms.

It is a common interest of the literature on governance and regulation to explore different organizing and monitoring activities, all based on the assumption that other mechanisms have to replace or complement traditional monitoring and enforcement instruments.[245] Non-state actors are widely accepted as playing a crucial role for the functions of monitoring and enforcement in transnational regimes.[246]

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[241] Abbott/ Snidal, Governance, 2009, 55.
[242] Djelic/ Sahlin-Andersson, 2006 , 8.
[243] Djelic/ Sahlin-Andersson, 2006 , 6.
[244] Hutter, 2006, 63.
[245] Djelic/ Sahlin-Andersson, 2006 , 1.
[246] Vogel, 2009, 3.

2.4 Summary

In this segment we presented the common findings of a rich body of literature on globalization as the starting point for an altered view of regulation, its actors and its instruments. The processes of globalization are argued to have produced complex collective issues, characterized by a high degree of interdependence, e.g. global markets and firms, which have to be handled on a global scale. The capacity of traditional forms of regulation is seen as inadequate to provide satisfactory results (**2.1**). A further finding is that states are not only faced with new powerful actors, but that states have to share the regulatory stage with those non-state actors whose regulatory attempts have increased in terms of quality and quantity and are now governing significant portions of global affairs (**2.2**). Furthermore, it is argued that a new variety of actors has led to a new variety of regulatory instruments for all three functions of regulation, particularly for the functions of information gathering and behavior modification. These instruments often rely on dispersed mechanisms, such as community- or competition-based mechanisms (**2.3**).

III Summary and Conclusion of Part B

The objective of Part B was to lay down the premises on which this thesis is built as they provide the necessary overview of the regulatory landscape in order to understand where the idea of using firms' reputations as a regulatory tool comes into play. The premises imply that traditional forms of regulation, state-centered and hierarchy-based, have lost importance as they are seen as not capable of dealing with an environment which is increasingly characterized by complexity, interdependence and fragmentation. Furthermore, they imply that new forms of regulation, characterized by a variety of actors and a variety of instruments, have emerged on large scale. Additionally, the premises imply that there is a demand for regulatory instruments relying on other modalities of regulation than solely hierarchy, i.e. competition- and community-based instruments.

In this part, we started with two examples illustrating the role of the variety of actors, instruments and modalities which can be observed in contemporary (alternative) forms of regulation (**I**). The IFRSs and their development from voluntary standards designed by private actors to binding law for listed companies in a multitude of countries illustrates not only the role of private actors as agenda- and standard-setters but also the interaction of different regulatory instruments: from the pressure of markets to apply these rules as best practice to the later reliance on state law. The Dodd-Frank Wall Street Reform and Consumer Protection Act, the second example, illustrates the variety of instruments available in order to monitor and enforce rules and how these instruments can be incorporated into state law. The example and its empirical evidence highlight how important it is to consider a variety of different regulatory instruments and to rely on the capacity of private dispersed actors by setting the right incentives in order to achieve the objective of regulation.

In the second section we introduced some of the factors that have contributed to the developments outlined in our premises: the recognition of the regulatory capacity of a variety of non-state actors and non-hierarchical instruments and an increasing focus on the interactions and interdependencies of alternative regulatory arrangements, characterized by hybridization, reliance on competition and community-based mechanisms and other *de facto* behavior-constraining factors (**II**). Stating that the process of a broadened understanding has to be seen in its historical context, we turned in a first step to the criticism of command and control-style regulation by socio-legal scholars in the 1970s and 1980s. This criticism aimed both at the state as the exclusive regulator

and law as its dominant instrument and has led to the perception that alternative regulatory approaches were necessary. The result was a turn to regulatory strategies engaging new actors and instruments. As examples of such concepts we introduced responsive and smart regulation. In a second step, we discussed the implications of the processes of globalization on national regulation and the state's capacity to regulate, particularly the emergence of new powerful actors on the regulatory stage and regulatory regimes without state participation: both resulting in an increasing reliance on alternative regulatory instruments based on dispersed mechanisms.

To sum up, we can conclude that the presented developments have led to an understanding of regulation which is characterized by the following hallmarks: the public-private boundary is increasingly disappearing, instead the focus is set on the interactions of a variety of actors, as it is increasingly recognized that no single actor has all the competencies needed, such as expertise or operational capacity, to fulfill the three functions of regulation by itself. Therefore, the focus is set on the question of how to take advantage of the regulatory capacities of state and non-state actors and dispersed monitoring and enforcement mechanisms. Considering the fragmentation of regulatory, thus behavior constraining and modifying power, there is an increasing interest in *de facto* constraining and regulating forces, such as markets and the decisions of dispersed buyers, both on a descriptive and on a practical level.

C Summary and Conclusion of Chapter One

Part A of this chapter aimed at finding out what is meant by the term regulation. Starting with the etymological roots of the term, we subsequently introduced different standard definitions and classifications of regulation, differing in the involved actors, instruments, objectives and given justifications of the activity of regulation. We introduced these concepts in order to provide an overview of the regulatory landscape and to be able to understand the broadening of regulation, implied by the premises. Furthermore, we introduced the New Chicago School approach to regulation. This approach is based on the understanding that many forces outside law regulate, thus have constraining effects on the behavior of individuals and collectives and that regulatory regimes should use the different modalities in order to regulate directly and indirectly. The adapted framework focuses on the four modalities of regulation *de facto* constraining behavior (hierarchical control, community-based control, competition-based control and design-based control) and combines these modalities with the three functions that have been found to be inherent to any form of regulation.

Four Modalities of Regulation / Three Functions of Regulation	**Hierarchical Control**	**Community-Based Control**	**Competition-Based Control**	**Design Based-Control**
Standard Setting **… in order to allow a distinction between more and less preferred states of the system.**	Law or other formalised rules	Social norms	Price/ quality ratio (and equivalents in non-market decisions)	Inbuilt design features
Information Gathering **… in order to know the current states of the system.**	Monitoring powers (by agencies or third parties)	Social observation/ interaction	Monitoring by dispersed buyers/ outcomes of competition	Interaction of design features with environment/ lack of response
Behavior Modification **… in order to correct states deviating from the standards set.**	Formalized (legal) sanctions/ enforcement	Social sanctions (e.g. disapproval or ostracism)	Aggregate of decisions by buyers, clients etc/ striving to perform better	Interaction of design features with environment/ physical inhibition

Figure 8: Modalities and Functions of Regulation [Fn 84]

In view of the objective of this thesis the framework will be helpful to understand to what extent reputation mechanisms depend on these modalities and mechanisms.

Furthermore, we have defined for the purpose of this thesis the meaning of the terms

- *Regulation*: All actions having a constraining effect on the behaviors of individuals and collectives, characterized by the four modalities of regulation: hierarchical control, community-based control, competition-based control and design-based control".
- *Regulatory regime*: A system of control that may comprise many actors, but within which it is possible to identify standards of some kind (function of standard-setting), ways of detecting deviation from the standards (function of information gathering and mechanisms from correcting such deviations (function of behavior modification) and
- *Regulatory instruments and tools*: Instruments and tools applied to perform the three functions of regulation.

In **Part B** we elaborated on the premises of the thesis, implying a broadening of the understanding of regulation in practice and theory within the last few decades. We started with two examples (IFRSs and the Dodd-Frank Wall Street Act), illustrating the extent to which non-state actors have become important players in the regulatory game and how alternative monitoring and enforcement instruments, relying on dispersed actors, can be incorporated into state law.

Following from that, we outlined two strands of arguments explaining the implied broadening of regulation and the emergence of alternative forms of regulation, characterized by a variety of actors and a variety of instruments:

- The *first* strand of arguments deals with criticisms of traditional command and control-style regulation, which is argued to have failed in many regards. It is questioned whether public regulators do act in the public interest and whether states should interfere with markets at all. Furthermore, command and control-style regulation has been criticized for a number of other reasons, such as instrument failure, information and knowledge failure and motivation failure. With command and control-style regulation falling out of favor, the interest in alternative regulatory regimes that do not solely rely on hierarchy and command increased. The focus of interest shifted from traditional, state-centered, and hierarchy-based regulation to the nature of government-society and intra-society interactions and the question of how the potential of *de facto* regulatory constraints can be used or built in to regulatory strategies.

- The *second* strand of arguments circles around the consequences of the processes of globalization: an increasingly complex, fragmented, interdependent environment has challenged nation states' capacities to regulate. As a result, non-state actors have stepped on to the regulatory stage, particularly NGOs and TNCs have become important and powerful actors in addition to the state, or independent from state actors (the Governance Triangle). The cooperation and interactions of these three groups have become the innovative feature of emerging alternative regulatory regimes. Furthermore, as these regulatory regimes are often rooted in private authority, they rely on new mechanisms and instruments, particularly dispersed instruments, to achieve effective monitoring and enforcement of rules. In summary, there is a still increasing interest in these "alternative" forms of regulation.

The findings of Part B can be summarized by referring to our premises:

Premise I: Traditional forms of regulation, state-centered and hierarchical in nature, are challenged as not being capable of dealing with an increasingly complex, interdependent, and fragmented economic and political environment and its actors.

> The state, which is seen from a traditional perspective on regulation as a centralized regulator relying on commands backed by sanctions, is seen as no longer capable of coping with an increasingly diverse, complex and interdependent environment.

Premise II: Alternative forms of regulation have emerged within the last few decades on large scale on all levels (domestic, international, global). These regulatory regimes are characterized by a variety of actors (who), state and non-state, executing the functions of standard-setting, information gathering and behavior modification by using a variety of instruments and tools (how).

> The focus has shifted from state-centered and hierarchy-based forms of regulation to co-produced, cooperative and more flexible forms, in which state as well as non-state actors can play a role and which increasingly rely on a combination of regulatory instruments, whether based on hierarchy, community, competition or design. Non-state actors and their regulatory capacity – whether as primary actors and participants in the development and execution of regulatory regimes or in their capacity as dispersed actors monitoring and enforcing rules – has been recognized. Regulation is not perceived as a matter simply for states, but it has been pluralized.

Premise III: The full potential of using the variety of regulatory sources provided by the four modalities of regulation (hierarchical control, community-based control, competition-based control and design-based control) has not yet been tapped. There is a demand, particularly regarding the regulation of firms, for new ideas which take advantage of the variety of monitoring and enforcement instruments provided by the four modalities and which are able to cope with the needs of a changed environment.

> Understanding regulation as the interaction of varieties of actors and instruments – mostly not rooted in public authority – leads to the question of how to ensure that rules, whatever their nature, are followed. A regulatory landscape, and in particular regulatory regimes characterized by the co-existence of actors and strategies, is in need for instruments which are not based on state hierarchy, to ensure compliance with rules.

This is the point where our idea of using firms' reputations as a tool to achieve behavior modification by means other than formalized legal sanctions comes into play. Our idea is that threatening a firm's reputation might have the potential to modify the firm's behavior and that this mechanism can be used as a regulatory instrument to make firms behave according to defined rules or standards. At the same time, we think that this behavior modifying effect will only occur under certain conditions.

Therefore, we have to understand how reputation and its underlying mechanisms work. Once we have gained this understanding we will be able to define the conditions that have to exist for threatening firms' reputations to be an effective regulatory tool. This is the task for the next chapters of this thesis.

Chapter Two: Reputation as a Regulatory Tool

In the first chapter we have seen that contemporary forms of regulation are characterized by a variety of actors, state and non-state, executing the functions of standard-setting, information-gathering and behavior modification by a variety of instruments. Furthermore, we have seen that the shift from state-centered and hierarchy-based forms of regulation to co-produced and cooperative forms has led to an increasing reliance on a combination of regulatory instruments, whether based on hierarchy, community, competition or design. A regulatory landscape and in particular regulatory regimes characterized by the co-existence of state and non-state actors and strategies have need of instruments which ensure compliance with rules (whatever their nature) but are not only based on state hierarchy.

This is where our idea of using a firm's reputation as a mechanism to achieve behavior modification by means other than formalized legal sanctions comes into play. Differently put, our interest is focused on the potentially behavior modifying effect of threatening a firm's reputation, whether within or outside of a formalized regulatory regime. We assume that the behavior modifying effect of threatening a firm's reputation relies heavily on dispersed mechanisms, whether competition- or community-based.

The objective of this chapter is to understand under which conditions threatening a firm's reputation is an effective regulatory tool. We aim to identify the ideal conditions for applying this regulatory instrument. Let us briefly sketch our line of argument. This chapter is organized as follows:

In **Part A** we demonstrate the behavior modifying capacity of a firm's reputation (Hypothesis I), illustrating that not only loss of reputation that has effectively occurred can have the capacity to modify a firm's behavior but also threatening a firm's reputation (Hypothesis II). This fact allows for using the deterrent effect of reputational sanctions as an instrument to achieve compliance with rules, whatever their nature (Hypothesis III). Furthermore, we argue that the behavior modifying effect of threatening a firm's reputation is only possible if non-compliance with rules leads to loss of a firm's reputation and if this loss results in the occurrence of reputational costs.

Based on the finding of Part A, we turn to the nature of reputational loss in **Part B**. In Part B we ask under which circumstances a firm is faced with loss of its reputation, based on the assumption that reputational loss occurs, firstly, if the effective behavior of a firm

deviates from its stakeholders' expectations regarding the firm's behavior towards the particular stakeholder itself and towards other stakeholder groups; secondly, if this divergence between the stakeholder's expectations and the effective behavior is observable, reported and diffused (Hypothesis IV).

Having gained an understanding of why loss of reputation occurs, **Part C** aims to analyze the circumstances under which reputational loss leads to the occurrence of reputational costs, that is when a loss of reputation has a negative financial impact on a firm's business. Part C is based on the assumption that reputational costs only occur if a firm's stakeholders are willing *and* able to react to reputational loss suffered by a firm (Hypothesis V).

In **Part D** we demonstrate that the emergence of digital technologies, particularly the internet, has increased the potential to use a firm's reputation as a regulatory instrument due to an altered information process and its impact on the factors determining the occurrence of reputational loss and reputational costs (Hypothesis VI).

In **Part E** we summarize the findings of chapter two and answer the research question of this thesis.

A Reputation and its Capacity to Modify Behavior

As discussed in the first chapter, regulation is characterized by having a constraining effect on the behavior of individuals and collectives. It consists of the three functions of *standard setting*, in order to allow a distinction between more and less preferred states, *information gathering*, in order to know the current state of the system, and *behavior modification*, in order to correct a state deviating from the standards set. The idea of using a firm's reputation as a mechanism to ensure that a system is in accordance with rules, thus enhancing compliance with certain rules, implies that targeting and threatening a firm's reputation has the general capacity to modify a firm's behavior. If its reputation was not capable of modifying or influencing a firm's behavior, using the firm's reputation would not be a promising regulatory instrument.

It is the objective of this chapter to demonstrate this behavior modifying capacity of a firm's reputation. We will see that losing its reputation can modify a firm's behavior: we present three case studies in order to illustrate this behavior modifying effect (**I**). In a second step we will see that not only loss of reputation that has effectively occurred can have the capacity to modify a firm's behavior but also threatening damage to a firm's reputation. This is due to the fact that reputational loss can have a strongly negative monetary effect on a firm's business and value, which can deter firms from acting in a manner that might cause reputational loss (**II**). The findings of this part will be finally summarized and conclusions will be drawn (**III**).

I Reputation Driven Behavior: Loss of Reputation Can Modify a Firm's Behavior

Our first assumption is that loss of reputation can modify a firm's behavior. This assumed mechanism gives a firm's reputation the capacity to have a constraining effect, thus a regulatory effect, on the firm's actions. We will introduce three case studies illustrating this mechanism: the decommissioning of Shell's Brent Spar (**1**), the "spying affair" of Deutsche Telekom (**2**) and accusations against UNICEF Germany concerning misuse of donations (**3**). In a fourth step, we summarize the findings (**4**).

1 Shell, Brent Spar and a New Attitude towards its Operations

In February 1995 Royal Dutch/Shell announced its plans to sink Brent Spar, a large floating oil storage and loading buoy, on the North Atlantic seabed. Brent Spar was installed in June 1976 in the Shell/Esso Brent oilfield in the northern North Sea and ceased operating in September 1991.[247] From 1991 to 1993 Shell, together with several independent external organizations, carried out different decommissioning studies. The two options, which were compared in detail, were horizontal onshore dismantling and deep sea disposal. On the basis of these studies Shell decided to choose deep sea disposal as the study predicted six times lower safety risks, four times less cost and a minimal environmental impact. Furthermore, the deepwater disposal of Brent Spar at a site in the deep Northern Atlantic was assessed as the Best Practicable Environmental Option (BPEO). After the public approval of the UK government to the disposal and after no objections had been raised, Shell announced that Brent Spar would be sunk.

Four months later, on June 20, 1995, Shell announced that it had decided to halt the disposal plan and that Brent Spar would be towed to Norway and moored in a fjord. In summer 1999, the topsides of Brent Spar were removed and the cut and cleaned ring sections of Brent Spar's hull were placed on the seabed at Mekjarvik (Norway) in order to form the foundations of a new quay for roll-on/roll-off ferries in order to improve transport links in western Norway.

Shell had changed its decision as to the disposal of Brent Spar and therewith its behavior. The reason why it did so is given by Shell itself:[248]

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[247] For the timeline, history and solution of Brent Spar, see Shell, 2008, 5-11.

[248] Shell, 2008, 4.

> Brent Spar was damaging our reputation. […] We recognized that we needed to change our approach – not just to offshore decommissioning […], but how we conduct operations everywhere.

The threat or indeed the damage to the reputation of Shell was the major if not the only reason for this about-face. Loss of reputation and the threat of increasing damage to its reputation modified Shell's behavior.

Why was Shell afraid of damage to its reputation and even willing finally to spend about £ 25 million for towing Brent Spar to Norway and using it as the base of a new quay instead of spending about £ 20 million on an already approved, legal disposal in the North Sea which was seen as the Best Practicable Environmental Option? The main finding when analyzing this change of attitude is that the damage to Shell's corporate reputation was combined with major financial losses because of loss of support from almost all of its stakeholders.

Let us look briefly at the actions which took place within the four months between the initial statement of Shell of its intention to sink Brent Spar, and the later announced halt to the disposal plan. After the first announcement by Shell in February 1995, Greenpeace started to put Shell and the "toxic timebomb" into the public eye: on April 30, 1995, a number of Greenpeace activists occupied Brent Spar, accusing Shell of dumping hundreds of tonnes of "toxic rubbish" into the North Sea. In a successful campaign, Greenpeace managed to portray Shell as a greedy and irresponsible company whose reasons for sinking the oil rig were of a purely economic nature. Shell's planned disposal of Brent Spar drew worldwide media coverage.[249]

Shell stuck to its point of view that sinking Brent Spar would be the most environmentally friendly option and obtained the permission of the UK government to remove the Greenpeace activists who were still occupying Brent Spar (May 23, 1995). On the same day Greenpeace called for a boycott of Shell in continental Europe and just a week later (June 2, 1995) Greenpeace supporters started leafleting service stations and motorists at over 300 locations throughout Germany. The conflict between Shell, backed by the UK government, and Greenpeace, overwhelmed by the support it got, came to its climax when Shell started to tow Brent Spar to the deep sea dump site (June 11, 1995).

Shell was increasingly put under pressure by several European governments calling for a general ban on offshore disposal of oil installations. Shell was increasingly losing

[249] Mahon, 2002, 432.

political support in important markets, not least because German Chancellor Helmut Kohl raised the Brent Spar issue with UK Prime Minister John Major at the G7 summit (June 16, 1995). Even more important, Shell faced a serious loss of market share in some of its most important markets due to consumer boycotts: in Germany massive consumer boycotts of Shell service stations took place within the following days. Shell Germany reported that several stations had experienced up to 50% loss in income due to the boycotts and that Shell was losing significant market share in the German market.[250] At the annual shareholders' meeting in February 1996 the president of Royal Dutch/Shell, John Jennings, explained that Shell had lost a significant portion of its market share in Germany due to the boycott and that it had not managed to regain this market share.[251] Furthermore, protesters threatened to damage 200 Shell service stations – 50 Shell service stations were subsequently damaged, two were fire-bombed and one was raked with bullets.

On June 20, 1995, Shell decided to halt the disposal plan "in view of [the] untenable position caused by European political shifts, increased safety risks from violence and need for more reasoned discussion"[252]. A few weeks later all members of the oceans regulatory body OSPAR commission, with reservations from the UK and Norway, agreed on a moratorium leading to a ban on the dumping of installations at sea.

After having announced it would halt the disposal plan, Shell launched the initiative "Way Forward" and invited expressions of interest and proposals from major contractors to find a solution for onshore disposal or re-use of Brent Spar. The independent organization Det Norske Veritas (DNV) was mandated to carry out an independent evaluation of the eleven different ideas that were shortlisted as potential ways to re-use or scrap Brent Spar. In parallel, several conferences ("Brent Spar Dialogue Seminar") took place for interested parties to discuss the case of Brent Spar, providing a platform to address issues and express their perspectives on the way Shell conducts its operations. In January 1998 Shell announced its choice of solution for Brent Spar: the re-use as a ferry quay.

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[250] See *Die Welt*, Feburary 16, 1996, available at <http://www.welt.de/print-welt/article652899/Rekordjahr_ fuer_Shell_Konzern.html>, accessed on January 17, 2011.

[251] See *Die Welt*, Feburary 16, 1996, available at <http://www.welt.de/print-welt/article652899/Rekordjahr_ fuer_Shell_Konzern.html>, accessed on January 17, 2011.

[252] Shell, 2008, 5.

2 Deutsche Telekom, the Spying Affair and a New Approach towards Data Privacy

The "spying affair" of Deutsche Telekom is another case highlighting the behavior modifying effect of a threatened firm's reputation. Deutsche Telekom, one of the world's leading telecommunications companies, was alleged to have violated the freedom of the press and personal rights, particularly data privacy.

The reasons for these allegations were the following: in 2005 Deutsche Telekom was facing new competitors and was losing market share. Furthermore, sensitive information about Deutsche Telekom was showing up "in a steady stream of embarrassing newspaper headlines"[253]. In order to find out how this sensitive information found its way into the press and in order to stop the leaks, Deutsche Telekom's Group Security commissioned a private security firm to scrutinize the phone records of the members of its supervisory board and business journalists. By comparing and cross-checking these large volumes of call data with published news stories about Deutsche Telekom, the intention was to find out which member of the supervisory board was leaking the information.[254]

This procedure was heavily criticized by politicians, data privacy specialists, consumer organizations and others. Amongst other things, Deutsche Telekom's "spying methods" were compared to those used by the secret service of the former German Democratic Republic (Stasi)[255]. As well as being indicted by the German public prosecutor's office and facing public criticism, Deutsche Telekom was losing its reputation – and was about to lose customers. After the "spying affair" became public, one third of the clients of Deutsche Telekom said in a survey that they want to change their communications provider and end their contracts with Deutsche Telekom "definitely" or "likely". A further 23% of Deutsche Telekom's clients said they had not decided but they could imagine changing their service provider "possibly".[256]

Being faced with allegations of data misuse and flaws in the security system, but even more important with reputational loss, Deutsche Telekom reacted – and modified its

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[253] Boston (2008) provides an interesting background to the Deutsche Telekom spying affair.

[254] Press Release of Deutsche Telekom AG, February 10, 2010, available at <http://www.telekom.com/dtag/cms/content/dt/en/812992>, accessed on January 16, 2011.

[255] Quote of the former president of the Federation of German Industries (BDI) in *Süddeutsche Zeitung*, May 27, 2008, available at <http://www.sueddeutsche.de/wirtschaft/telekom-skandal-ekelhafte-stasi-methoden-1.219632>, accessed on January 17, 2011.

[256] A representative survey by Psychonomics on behalf of Wirtschaftswoche, available at <http://www.wiwo.de/unternehmen-maerkte/umfrage-telekom-droht-massive-abwanderung-von-kunden-295625/>, accessed on January 16, 2011.

behavior. Deutsche Telekom started cooperating with the German public prosecutor's office, started its own investigation analyzing 100,000 pages of material from the documentation of the former Group Security for any kinds of compliance violation, and finally published the results of this investigation in the internet, the so-called "Open Book"[257]. Deutsche Telekom stated that the investigation "did not uncover any cases with anything like the levels of criminal activity and intended malice as the systematic spying attack on German employee representatives on supervisory boards, works councils and trade unions and on journalists" but there were 84 cases of "legally or ethically questionable conduct"[258].

As a countermeasure, Deutsche Telekom created a new Board of Management department for Data Privacy, Legal Affairs and Compliance in order to harmonize, implement and monitor compliance of "the necessary measures related to data privacy and security"[259] and announced a comprehensive action package for improving data privacy. Part of this package was the setting up of an independent Data Privacy Advisory Council and the restriction of employees' access to data.

The reasons for these countermeasures can be read in Deutsche Telekom's annual report 2009 in the section "Risk and Opportunity Management":[260]

> In the reporting year, Deutsche Telekom faced allegations of data misuse and flaws in the security system. […] These countermeasures will minimize the occurrence of other data security and privacy incidents. Negative consequences for Deutsche Telekom's business caused by a loss of reputation cannot be ruled out or accurately assessed at the present time.

3 UNICEF, Commission Payments to Fundraisers and a New Approach to Donations

In November 2007 the German newspaper *Frankfurter Rundschau* published a series of articles about misuse, irregularities and a "extremely generous" handling of donations received by the German branch of UNICEF[261]. UNICEF Germany is one of the three most

[257] The "Open Book" is available at www.telekom.com/dtag/cms/contentblob/dt/de/812996/blobBinary/dt_open_book_abschlussbericht.pdf>, accessed on January 16, 2011.

[258] Press Release of Deutsche Telekom AG from February 10, 2010, available at <http://www.telekom.com/dtag/cms/content/dt/en/812992>, accessed on January 16, 2011.

[259] Telekom, 2010, 110.

[260] Telekom, 2009, 110-11.

[261] Schindler (2007).

important contributors to UNICEF International, having raised more than US$ 80 million in donations in 2008.[262] The source of information for the newspaper articles was an anonymous letter which was sent to the chairwoman of UNICEF Germany in May 2007. The letter listed a number of instances which were witnessed by the anonymous author, who was apparently familiar with the procedures at UNICEF, such as expenditures of an "extraordinary size". Furthermore the anonymous author accused the Managing Director of UNICEF Germany of being the main person responsible for these irregularities.[263] The principal accusations were that UNICEF Germany had paid inordinately high commissions to fundraisers, all former regular employees of UNICEF Germany, that the Managing Director had mandated the renovation of UNICEF's headquarters in Cologne for more than 900 000 Euros without the authorization of the board of directors, and that the general handling of donations was not transparent.

For the next few months there was public dispute about the role of UNICEF's Germany Managing Director, and the board of directors and their approach to transparency. A mandated independent audit came to the conclusion that there was no evidence of personal enrichment but it mentioned negligence and irregularities in running UNICEF Germany. On February 2, 2007, the Chairwoman of UNICEF Germany resigned, accusing the Managing Director of failing to face up to allegations of mismanagement. The accused Managing Director, who was already in the focus of the public attention, acknowledged "sloppiness" but insisted that "no laws have been broken"[264]. The conflict was increasingly gaining interest, resulting in a statement by German Chancellor Angela Merkel, imploring all parties "to shed light on these accusations in order to protect UNICEF Germany's reputation"[265]. Additionally, UNICEF Germany's management was put under pressure by UNICEF's European head office – its spokesperson announced that it is always problematic, when UNICEF's reputation is damaged[266]. The uncomfortable position for the Managing Director got even worse when a number of celebrities, who were supporting UNICEF, wrote a letter that was published in the press asking for a crisis meeting[267].

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262 UNICEF, 2008, 34.

263 SCHINDLER (2007).

264 Unicef Germany's Managing Director Dietrich Garlich cited in DEUTSCHE WELLE (2008).

265 Chancellor Merkel's spokesman Thomas Steg cited in DEUTSCHE WELLE (2008).

266 See MATTHIAS THIEME, Sturm der Kritik trifft Unicef hart, in *Frankfurter Rundschau*, February 6, 2008, available at <http://www.fr-online.de/politik/spezials/unicef/sturm-der-kritik-trifft-unicef-hart/-/1477342/ 2792834/-/index.html>, accessed on January 16, 2011.

267 DEUTSCHE WELLE (2008).

In February 2007, the Managing Director resigned, after having been the head of UNICEF Germany for 18 years. Furthermore, UNICEF Germany lost the coveted endorsement from Germany's leading watchdogs for charities DZI (German Institute for Social Questions). It revoked its donation seal after investigating the accusations of financial irregularities. The unusually high commissions paid to fundraisers were seen as violation of DZI's standards on economy and thriftiness.[268]

Within the next months, a new management and a new board of directors were installed at UNICEF Germany, running a transparency offensive, consisting of a new organizational structure separating the functions of the management board and the board of directors (the former head of UNICEF Germany was a member of both boards, which made "independent oversight difficult"[269]), new reporting standards, new statutes and a ban on commission payments to fundraisers.

What were the reasons for these drastic changes? There were no legal sanctions to be expected as the inquiries of the German Prosecutions Office were suspended. Instead, the reputation of UNICEF Germany was damaged – with significant results for the volume of donations UNICEF Germany received in 2007 and 2008. Already during the publicly fought battle between the management and the board of directors from the end of November 2007 until the beginning of February 2008, UNICEF Germany acknowledged that about 5000 of its 200,000 regular donors had already withdrawn their support as a result of reports of funding abuses and mismanagement[270]. UNICEF Germany states in its annual report for 2007 that due to the leadership crisis and the resulting negative media coverage the donations received in December 2007 were reduced by 3 million Euros[271]. The reputational crisis was not limited to these three months but continued for more than a year: by June 2008, 38,000 of 200,000 had terminated their sustaining membership at UNICEF Germany.[272] In 2008, UNICEF Germany received about 19 million Euros less than in 2007, which is a decrease in donations of around 28%.[273] Very similar to the annual report 2007, UNICEF Germany states in its annual report for 2008 that the

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[268] Press Release of DZI (German Institute for Social Questions), February 20, 2008, available at <http://www.dzi.de/DZI-PM-UNICEF200208.pdf>, accessed on January 16, 2011.

[269] Deutsche Welle (2008).

[270] Deutsche Welle (2008) .

[271] Unicef Germany, 2008, 46.

[272] Beucker (2008).

[273] Unicef Germany, 2008, 46.

decreased volume of donations was caused by the leadership crisis and the resulted critical media coverage.[274] The volume of donations stayed on a lower level in 2009.[275]

UNICEF gives the answer to the question of why it has taken all these measures by stating that the new board of directors and the new management after a serious leadership crisis are willing to work hard and have realized that UNICEF Germany has to modify its behavior in order to regain UNICEF Germany's trust and reputation.[276]

4 Summary and Conclusion

The case studies of Shell, Deutsche Telekom and UNICEF Germany demonstrate that a firm's or an organization's reputation has the general capacity to modify or influence its behavior, and thus has a regulatory effect. The cases presented above illustrate situations in which a threatened or already damaged firm's reputation has led to behavior modification. The firms' behavior was modified in order to avoid further loss of or damage to their reputation in the short term or to regain and rebuild reputation in the long term. Shell changed its attitude towards the decommissioning of Brent Spar first of all, if not exclusively, because of reputational concerns. Due to its original decision to sink Brent Spar in the North Sea, Shell not only lost political support from a number of European governments, but was also faced with significant boycotts of its products in Germany. Shell decided to modify its behavior in order to limit the damage to its reputation. A legal decision backed by the UK government was dropped in favor of an option which promised to limit the reputational loss[277]. Deutsche Telekom categorizes damage to its reputation as a risk. Its risk analysis includes potentially occurring reputational loss – and its negative effect on its core business – in order to prevent its occurrence in future. Therewith, reputational concerns are a factor determining Deutsche Telekom's future behavior. UNICEF's countermeasures, such as the establishment of new reporting standards, have the main objective to regain UNICEF Germany's reputation. We can conclude: losing its reputation can modify a firm's behavior.

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[274] Unicef Germany, 2008, 46.

[275] Unicef Germany, 2010, 7.

[276] Unicef Germany, 2008, 5.

[277] Even the question of whether the deep sea disposal would have had a high negative environmental impact is not undisputed, as the report of the "Scientific Group on Decommissioning Offshore Structures", which was published by the Natural Environment Research Council in May 1996, confirmed Shell's original statement that the "environmental effects of deep sea disposal of Spar would have been very small and localized" (Shell, 2008, 6).

II Potential Loss of Reputation Can Affect Firms' Decision Making and Behavior due to its Deterrent Effect

The case studies presented above already indicate that not only loss of reputation that has effectively occurred has the capacity to modify a firm's behavior but also solely threatening a firm's reputation can have a behavior modifying effect. A firm might choose certain forms of behavior in order to avoid damage to its reputation and therewith concerns over reputation can become a component of the firm's decision making process. This finding is underlined by the perception of the firm's reputation by top management. Reputational loss is perceived as one of the major risks to a firm's success. The most important reason for this perception lies in the negative financial impact of loss of reputation on a firm's core business. The examples of Shell, Deutsche Telekom and UNICEF stress this perception: Shell lost significant market share in Germany due to the boycott of its service stations, UNICEF suffered from a decrease in donations of more than 20%, and Deutsche Telekom was faced with a substantial share of its customers willing to change their provider. An increased sensitivity towards the possible negative impact of reputational loss on a firm's success increases the potential to use the firm's reputation as a regulatory instrument due to its deterrent effect.

The objective of this second section of Part A is to explain the behavior modifying effect of threatening firms' reputations. In a first step, we show that damage to a firm's reputation can have a negative impact on the firm's business (**1**). In a second step we argue that the negative monetary effect of reputational loss can have a behavior modifying effect on a firm (**2**). In a third step, we conclude that therefore reputational loss and the possible occurrence of reputational costs can have a deterrent (and therewith behavior modifying) effect on a firm (**3**). In a fourth step, we summarize the results (**4**).

1 Damage to a Firm's Reputation Can Have a Negative Impact on Firms' Businesses

The positive consequences of a favorable corporate reputation in the long run are undoubted. It has been shown that a favorable corporate reputation enables firms to charge premium prices[278], to attract better applicants[279], to have enhanced access to

[278] See KLEIN/ LEFFLER (1981); MILGROM/ ROBERTS (1986); MILGROM/ ROBERTS, Information (1986).
[279] See STIGLER (1962).

capital markets[280] and generally to attract investors[281]. Nor is it doubted that a favorable corporate reputation can have positive bottom-line effects.[282] A firm's reputation is seen as an intangible asset of the firm which can represent a significant portion of its value.[283] However, the value of a firm's reputation – as well as the impact of its favorable consequences on the firm's business – is hard, if not impossible, to measure.[284]

While the effects of a positive reputation are difficult to measure, the negative impact of damage to a firm's reputation on its business is often easier to observe. This perception is stressed by a number of surveys and risk analyses.

HALL has surveyed the relative importance of the contribution made by each intangible resource to the overall success of businesses as perceived by chief executives.[285] A firm's reputation was rated as the most important contributor to the overall success of a business[286]. One of the reasons for this perception is given in HALL's survey: a firm's reputation was not only perceived as the most important intangible resource to the overall success of the business but reputation was also perceived as having the longest replacement period. The period required to rebuild a firm's damaged or lost reputation was estimated to be 10.8 years[287]. HALL draws the conclusion that a firm's reputation "is a fragile resource; it takes time to create, it cannot be bought, and it can be damaged easily"[288].

280 BEATTY/ RITTER (1986).

281 MILGROM/ ROBERTS (1986).

282 FOMBRUN, 1996, 81; for a German perspective see DUNBAR/ SCHAWLBACH (2000).

283 RINDOVA/ WILLIAMSON/ PETKOVA, 2010, 611; GAINES-ROSS, 1997, 55: "The equity in a corporate reputation is its most enduring and lasting asset […]"; SRIVASTAVA/ MCINISH/ WOOD/ CAPRARO, 1997, 62; SHAPIRO, 1983, 659: "It has long been recognized that a firm which has a good reputation owns a valuable asset"; HALL, 1992, 136: "The intangible resource of reputation may also be classified as an asset due to its characteristics of 'belongingness', and whilst it may be defendable to attack with respect to defamation and libel, it cannot be said to have the property rights of, say a trademark, which can be bought and sold".

284 ANG/ WIGHT, 2009, 21; NGUYEN/ LEBLANC, 2001, 231: "We propose to use direct measures in the absence of the consensus on the valid scales for these constructs". Accepting that "a well developed theory of reputation as an asset is lacking" (RINDOVA/ WILLIAMSON/ PETKOVA, 2010, 611), leads however to the question whether corporate reputation is measurable and quantifiable. There are no doubts that a firm's reputation is of value to that firm. However, the question how to measure this value is discussed controversially. Different evaluation methods have been proposed: more simple ones like, for example, the idea of FOMBRUN, saying that "the economic value of a corporate reputation can […] be gauged by the excess of market value of its securities" (FOMBRUN, 1996, 81), and more sophisticated ones such as the Leverage Corporate Equity approach or the Reputation Quotient. The former is a reputational measure that was designed in order to complement Fortune magazine's survey of corporate reputation, as this survey was criticized for its limited perspective (only the perspective of top executives was taken into account). The latter, the Reputation Quotient, is an approach that borrows from the basic methodology of political polling. It aims to measure a company's reputation by examining how a representative group of stakeholders perceives companies on 20 underlying attributes. For an overview, see WARTICK (2002).

285 HALL, 1992, 139-140.

286 HALL, 1992, 141.

287 HALL, 1992, 142.

288 HALL, 1992, 143.

This perception of a firm's reputation – as one of the most important contributors to overall success which is at the same time highly vulnerable – is shared by another survey, conducted by the Economist Intelligence Unit (EIU), in which 269 senior executives responsible for managing risks were surveyed. The result of the EIU's survey is that "reputational risk emerged as the most significant threat to business"[289]. According to the findings of the EIU survey, reputational risk is perceived as substantially more significant than any other risk and "stands at the forefront of business concerns"[290].

This perception of damage to a firm's reputation as a risk to the overall value of the firm is increasingly reflected in the risk assessments of firms in the financial sector. A look at the current annual reports underlines this perception. Financial institutions have been publicly pilloried and held responsible for the worldwide financial crisis in 2007 and 2008. In addition to the call for a strict and extensive legislative regulation of their industry, many of these institutions had and have to deal with damages to their reputation. The current annual reports suggest that the impact of these reputational losses on a firm's business is increasingly recognized as a threat to the financial success of these firms. Let us look at some examples.

Goldman Sachs in its 2009 annual report categorizes "reputational harm" as a potential risk to its business and the results of its operations:[291]

> Substantial legal liability or a significant regulatory action against us, or adverse publicity, governmental scrutiny or legal and enforcement proceedings, regardless of the ultimate outcome, could have material adverse financial effects, cause significant reputational harm to us or adversely impact the morale and performance of our employees, which in turn could seriously harm our businesses and results of operations.

Deutsche Bank, in the risk report section of its 2009 annual report, states that:[292]

> The most important risks we assume are specific banking risks and reputational risks, as well as risks arising from the general business environment.

[289] Economist Intelligence Unit, 2005, 2.

[290] Economist Intelligence Unit, 2005, 5.

[291] Goldman Sachs, 2010, 38.

[292] Deutsche Bank defining reputational risk as the risk "that publicity concerning a transaction, counterparty or business practice involving a client will negatively impact the public's trust in the Group" (Deutsche Bank, 2010, 45).

UBS has suffered particularly from loss of reputation during the financial crisis and conflicts between Switzerland and the EU and US governments regarding cooperation in questions of tax evasion. UBS was faced with a cash drain. The invested assets of UBS decreased by more than 30% from December 2007 to December 2008.[293] In its 2009 annual report, UBS stresses the importance it attaches to avoidance of reputational risks and elaborates the handling of reputational concerns in detail: first of all, UBS defines its reputation as its "most valuable asset" and declares the restoration and safeguarding of its reputation as one of the strategic priorities of UBS[294]. Furthermore, UBS stresses that the role of its reputation is fundamental to its success by stating that its reputation is the "key to the success of [UBS's] business"[295]. UBS amplifies that a loss of reputation is one of the risks that "can impact our ability to carry out our business strategies and directly affect our business activities, financial condition, results of operations and prospect"[296].

The risk of loss or damage to a reputation poses to the overall success is highlighted:[297]

> Any failure to restore or further damage to our reputation could have a material adverse effect on our operational results and financial condition. […] Our reputation has been severely damaged […] and has negatively affected our financial performance.

By stressing that a loss of reputation has a negative financial impact on its business the bank emphasizes the perception that a loss of reputation is a threat to the overall success of the business. Having experienced this mechanism, UBS has made the protection of its reputation one of its five key principles of risk management:[298]

> Reputation protection […] depends, among other things, on the effective management and control of risks. Our risk culture demands that all employees make the protection of our reputation an overriding concern.

The consideration of possible negative effects which any decision of an UBS employee may have on UBS's reputation makes reputational concerns an important part of decision

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[293] Invested asset of UBS on group level: end of 2007: CHF 3189 billions, end of 2008: CHF 2174 billions; see (UBS, 2008, 9) and (UBS, 2010, 43)

[294] UBS, 2010, 9.

[295] UBS, 2010, 25.

[296] UBS, 2010, 25.

[297] UBS, 2010, 25.

[298] UBS, 2010, 113.

making at UBS. UBS requires its employees to consider these risks in order achieve "an appropriate balance between risk and return"[299].[300]

2 Negative Monetary Effect Can Have a Deterrent Effect

The perception of a firm's reputation by the above-mentioned financial institutions and the results of the surveys presented have in common that loss of a firm's reputation is perceived as having a negative monetary effect on business and, therefore, in the long run, on market value. Understanding a loss of reputation as a risk has an impact on firms' decision making processes: the possible effects of firms' decisions and actions on their reputations are to be considered and assessed in order to mitigate the risk of potential damage to reputation. Due to the negative impact of loss of or damage to reputation on the overall value of a company, reputational concerns will have direct effect on a firm's actions and behavior. This perception highlights that threatening a firm's reputation can have a modifying effect on the firm, as firms will be motivated to act in a manner that does not lead to reputational loss.

This deterrent effect of a potential reputational loss is caused by the perception that damage to a firm's reputation can have a negative financial impact on its core business – reputational loss can be costly. The EIU survey underlines this perception by stating that "companies found reputational problems to be most costly in financial terms"[301]. The case studies presented above support this perception. A firm can suffer *directly* from the negative impact on its business caused by a loss of reputation (e.g. due to a boycott of its products) and *indirectly* by not being able to take advantage of the favorable consequences of a positive corporate reputation.

The perception of damage to a firm's reputation as the "risk of risks" might be explained furthermore by the experienced characteristics of reputational loss: "a single failure,

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[299] UBS, 2010, 103.

[300] Furthermore see the results of GUNNINGHAM, THORNTON and KAGAN who have studied regulated firm's perceptions in the electroplating and chemical industries of how various instrumental, normative, and social forces motivated their firms' environmental actions. Their survey comes to the result that firms "feared the stigma associated with non-compliance, and the damage that adverse publicity might have for their corporate reputation, far more than potential legal punishment following inspections" (GUNNINGHAM/ THORNTON/ KAGAN, 2005, 305). The survey furthermore suggests that "chemical companies worried that negative publicity could erode a company's relationship with its customers, suppliers, and regulators, and thus it bottom-line" (GUNNINGHAM/ THORNTON/ KAGAN, 2005, 306).

[301] Amongst those who had faced reputational problems, 28% described the financial toll as major (ECONOMIST INTELLIGENCE UNIT, 2005, 9).

whether it be willful or due to misplaced zeal or short term expediency"[302], can have serious effects on a whole organization[303]. This perception is stressed by UBS, which acknowledges that its reputation "is ultimately defined by the actions and decisions we make every day"[304]. The single action of an individual employee or a small group of employees can cause reputational damage with a significant monetary effect on the whole business.[305] The case study of Shell underlines this argument: the additional costs caused by the re-use of Brent Spar as a foundation of a quay in Norway are rather negligible compared with the costs caused by the reputational loss and the countermeasures taken by Shell to regain its reputation. Furthermore, the awareness that not only a company's own behavior can cause reputational loss but also the behavior of counterparties underlines that events causing reputational loss can be difficult to predict – as well the experience that reputational damage can be a result of *perceived* failures even if "those perceptions are not grounded in fact"[306]. Besides the *lack of proportionality* between the event causing reputational loss and the possible resulting monetary effect on a firm, and its *unpredictability*, a further aspect stressing the riskiness of reputational loss is the fact that a firm's damaged reputation is *difficult to restore*. Hall's survey has already stressed this argument by referring to a firm's reputation as the intangible resource having the longest replacement period. UBS states accordingly that "reputational damage is difficult to reverse. The process is slow and success can be difficult to measure"[307].

In summary, these three characteristics of reputational loss increases the probability that firms will consider the impact of their decisions on their reputations in order to mitigate the probability that they face reputational loss – and therewith a negative monetary effect on their businesses.

3 The Deterrent Effect of Reputional Loss as a Regulatory Instrument

The negative monetary effect caused by damage to a firm's reputation underlines the behavior modifying potential of reputational loss. We have seen that the negative

[302] De Segundo, 1997, 17.

[303] De Segundo, 1997, 16-17.

[304] UBS, 2010, 11.

[305] Economist Intelligence Unit, 2005, 9

[306] Economist Intelligence Unit, 2005, 18; A similar perception is confirmed by the Global Risk Management Survey, stating that an organization can be affected by "an event that even remotely ties to its wrongdoing" or might face reputational loss even if an organization is innocent (AON, 2009, 16).

[307] UBS, 2010, 25.

monetary effect is recognized by the majority of business executives. This perception of reputational loss is the prerequisite in order to use the mechanisms of threatening a firm's reputation as a sanction mechanism in order to increase compliance with rules, whatever their nature[308]. Firms, perceiving reputational loss in the manner described above, will try to avoid reputational loss and behave accordingly. The potential negative monetary impact of a damaged firm's reputation will cause a deterrent effect.

The underlying standard assumption of *deterrence theory* is that potential offenders are rational decision makers, comparing the expected costs and benefits of any activity of non-compliance with rules.[309] In case the expected costs of non-compliance outweigh the benefits, the deterrent effect will take place and prevent certain forms of behavior[310]. In order to be able to make this cost-benefit analysis, potential offenders have to know and understand the implications arising from not complying with certain rules[311]. By recognizing the potential negative monetary effect that can be caused by reputational loss, the probability that reputational concerns will be part of the cost-benefit analysis and therewith part of a firm's decision making process increases – and enhances the behavior modifying effect of threatening a firm's reputation: a firm does not have to *experience* reputational loss in order to modify its behavior but threatening a firm's reputation can modify its behavior in advance and cause forms of behavior which will not lead to reputational loss.

This mechanism is increasingly incorporated into formalized regulatory regimes. In particular, disclosure instruments rely on the deterrent effect of reputational loss and its possible negative monetary consequences. Examples of such mechanisms are the disclosure of inspection results, offender indexes, or other general "naming and shaming" systems.[312] The rationale is that the disclosure of negative inspection or similar results can lead to reputational loss, and that the negative impact of reputational loss on a firm's business will deter firms from certain forms of behavior perceived as undesirable. The potential of a firm's reputation as a motivation for regulatory compliance is stressed in

[308] See Guzman (2002) and Guzman (2008) on the role of states' reputations for compliance with international law. Guzman argues that international law works through reputational (and direct) sanctions: because of fear that their reputations will be harmed in case of non-compliance, reputation is one of the major factors for a high level of compliance. For an overview of the discussion about the role of reputational sanctions for compliance with international law, see Downs/ Jones (2002), stating that "the dominant view in the literature is that reputation plays an extremely important role in promoting compliance" (Downs/ Jones, 2002, 99).

[309] See Becker, 1968, 170-180 for a general introduction to deterrence theory.

[310] McAdams/ Ulen, 2008, 2.

[311] Robinson/ Darley, 2004, 175.

[312] van Erp, 2008, 146-147; Fombrun/ Shanley, 1990, 234: "Reputational rankings constitute a potentially significant and understudied form of normative control". See Van Aaken (2009) for an interesting discussion on how private market actors can help to enforce international public law.

the expert review conducted by Richard Macrory on behalf of the UK government. In this study, *Making Sanctions Effective*, he states:[313]

> When thinking about how to motivate firms to change their behavior, reputational sanctions can have more of an impact than even the largest financial penalties. […] The consequences of damaging a firm's reputation can potentially exceed the effect of a maximum fine that a court could impose.

An interesting example illustrating how a firm's reputation and the reliance on dispersed mechanisms can be used as a motivation for regulatory compliance is the approach of the cities of Los Angeles[314] and Berlin as to restaurant hygiene. Los Angeles was faced with a general problem regarding restaurant hygiene that was triggered by a hidden-camera TV report of CBS, looking "Behind the Kitchen Doors" and showing unsanitary restaurant kitchens[315]. The Los Angeles County Department of Health Services (DHS) – which was responsible for the restaurant hygiene inspections – had at that time almost no power to tackle the hygiene problems as it was not able to impose any administrative fines[316]. DHS's inspectors only possibility was to close restaurants in extreme cases, but only as long as the problems continued[317]. In 1998 DHS introduced a policy of mandatory hygiene grade cards in order to achieve hygiene improvements: at the end of every restaurant inspection a grade card is issued by the inspectors that had to be prominently placed in the restaurant's window near the entrance[318]. An A grade is given for scores above 90 (out of 100), a B grade for scores above 80, a C grade is given for scores above 70, for scores below 70 the numerical score is shown on the card.

The behavior modifying effect of this policy is impressive: the average hygiene score increased from 75 (1997) to 90 points (1998)[319] and the number of food-related hospitalizations decreased by 20%[320]. Furthermore, the study highlights the reliance on dispersed mechanisms as it shows that the revenues of badly rated restaurants decreased.[321]

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313 Macrory, 2006, 83.
314 Jin/ Leslie (2009); Jin/ Leslie (2003).
315 Jin/ Leslie, 2003, 417.
316 Jin/ Leslie, 2009, 241.
317 Jin/ Leslie, 2009, 241.
318 Jin/ Leslie, 2003, 410.
319 Jin/ Leslie, 2003, 416.
320 Jin/ Leslie, 2003, 449.
321 Jin/ Leslie, 2003, 430-431.

A similar approach is chosen by the district government of Berlin-Pankow. The district government introduced a voluntary grade system (smiley system) in order to tackle restaurant hygiene problems. Besides its voluntary character, the Berlin authorities established an internet platform on which [where?] not only the names of the restaurants with serious violations of hygiene standards were published, but also pictures documenting the violations.[322]

Being highly disputed after its introduction, the results of this internet list are interesting and underline the potential of such sanctions: the number of restaurant that had been closed by the district authorities (similar to the case of LA closing restaurants is the *ultima ratio* given by the administrative law) decreased by 36%.[323] The responsible veterinary authority stresses that the Internet list has led to a change in behavior, such as "the installations of new ventilating systems, we had unsuccessfully been trying to achieve for months by imposing administrative fines, were achieved within days by publishing the list"[324]. The reliance on decisions of dispersed actors is confirmed by this case: negatively rated restaurants were faced with a decrease of revenues of up to 50%.[325]

Having realized the potential of such reputational sanctions the German Green party asked to introduce such rating systems on the federal level.[326]

4 Summary and Conclusion

We have seen that not only reputational loss that has effectively occurred but also threatening a firm's reputation has the capacity to modify a firm's behavior. There is an increased awareness that damage to a firm's reputation can have a negative monetary impact on a firm's business. Reputational loss is perceived as a threat to a company's

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322 For an overview of the project, see <http://www.berlin.de/ba-pankow/verwaltung/ordnung/smiley.html>, accessed on January 16, 2011.

323 According to the internal evaluation of the program by the responsible district administration of Berlin-Pankow.

324 E-Mail correspondence with Jens-Holger KIRCHNER, responsible project manager at the district government of Berlin-Pankow.

325 See BIRGIT BÜRKNER, Der Ekelgipfel von Pankow, *BZ*, available at <http://www.bz-berlin.de/bezirk/pankow/ der-ekelgipfel-von-pankow-article389858.html>, accessed on January 17, 2011.

326 See the motion of the German Green Party, October 6, 2010, DS 17/3220, available at <http://dip21.bundestag.de/dip21/btd/17/032/1703220.pdf>, accessed on January 17, 2011; furthermore, see the decision of the conference of the German ministers of consumer protection to launch a similar list for providers of non-safe food (September 17, 2010), available at <http://www.berlin.de/imperia/md/content/bapankow/vetleb/2010_09_24_bzstr_vetleb_protokoll_anl_1.pdf?start&ts=1295001398&file=2010_09_24_bzstr_vetleb_protokoll_anl_1.pdf>, accessed on January 16, 2011.

overall value. The two surveys and the annual reports presented, as well as the cases of Shell, Deutsche Telekom and UNICEF stress this perception and highlight the potential to use a firm's reputation as a regulatory resource (**1**). The finding that reputational loss can have a negative impact on a firm's performance enables the deterrent effect: concerns about reputation gain an increasing relevance regarding a firm's future behavior. Furthermore, the fragility of firms' reputations strengthens the deterrent effect: a single failure can cause a significant loss of reputation which is difficult to restore (**2**). Understanding the possible negative monetary consequences of a firm's damaged reputation further enhances its deterrent effect. This deterrent effect is the prerequisite in order to use a firm's reputation as a regulatory instrument in regulatory regimes as a motivation or incentive to increase compliance with rules, whatever their nature. The examples of restaurant hygiene enforcement in the cities of Los Angeles and Berlin demonstrate how reputational sanctions can be incorporated into formalized regulatory regimes (**3**).

III Summary and Conclusion of Part A

In **Part A** we have seen that loss of reputation can modify a firm's behavior: the case studies of Shell, Deutsche Telekom and UNICEF have illustrated how reputational loss can have a behavior modifying effect (**I**). Furthermore, we have seen that not only reputational loss that has effectively occurred has the capacity to modify a firm's behavior but also threats to a firm's reputation. This is due to the fact that reputational loss can cause significant negative monetary effects on a firm's business and that this negative impact can have a deterrent effect on a firm: it might behave in a manner that minimizes reputational loss (**II**). This deterrent effect is the prerequisite for using a firm's reputation as motivation or incentive to increase compliance with rules, whatever nature.

The general capacity of a firm's reputation to modify a firm's behavior has been shown. However, the assumptions of deterrence theory are that the deterrent effect of a sanction is only effective, thus has a behavior modifying effect and will lead to the absence of particular forms of behavior, if the expected costs of a sanction outweigh the expected benefits[327]. Potential offenders are expected to compare the expected benefits, including the anticipated monetary and non-monetary returns of non-compliance, weighted with their probabilities of realization, and the expected costs of non-compliance, including formal and informal sanctions, weighted with the probability of detection[328].

Without addressing the issue of the degree to which firms are rational decision makers at this point, we can conclude that the causal link between reputational loss and negative monetary effects on a firm's business as a consequence of such loss is *the* requirement in order to achieve a behavior modifying effect. Therefore, we can summarize that the idea of using the behavior modifying effect of threatening a firm's reputation, and thereby the deterrent effect of reputational sanctions as an instrument to achieve compliance with rules requires:

- that a firm's non-compliant behavior would lead to reputational loss
- that this reputational loss would have a negative financial impact on a firm's business. From now on, we will call the costs a firm faces in case of damage to its reputation "reputational costs", and
- that the expected reputational costs (which would be caused by reputational loss) outweigh the perceived benefits of a non-compliant behavior.

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[327] McAdams/ Ulen, 2008, 2.

[328] Robinson/ Darley, 2004, 173-174.

Only under these conditions will reputational sanctions, thus threatening a firm's reputation, have a deterrent effect (leading to the avoidance of non-compliant behavior). Otherwise the expected benefits of non-compliance might outweigh the reputational costs and it would be rational from the perspective of the regulatee not to be deterred by a merely potential reputational loss (reputational sanctions).

These three requirements provide the structure of our further proceeding in this chapter. We have to answer the questions: why reputational loss occurs and under which conditions reputational loss results in the occurrence of reputational costs, and which factors determine the size of reputational costs – and therewith the likelihood that reputational costs will outweigh the benefits of non-compliance.

B The Nature of Reputational Loss

The assumption we made in Part A of this chapter is that the behavior modifying effect of threatening a firm's reputation is only possible if non-compliance with rules leads to damage to or loss of a firm's reputation, and if this damage to the firm's reputation results in the occurrence of (monetary) reputational costs. This assumption provides the structure for the further proceeding: in a first step we have to answer the question of when (under which conditions) reputational loss or damage does occur. It is the objective of this part to explain this mechanism.

Our assumption is that reputational loss occurs under two conditions: firstly, if the effective behavior of a firm deviates from its stakeholders' expectations regarding the firm's behavior towards the particular stakeholder itself and towards other stakeholder groups; secondly, if this divergence between the stakeholder's expectations and the effective behavior of the firm is observable, thus reported and diffused.

We proceed as follows: in a first step, we will explain the view of a firm's environment implied by our assumptions, best reflected by the stakeholder approach that describes the interaction between a firm and its stakeholders (**I**). In a second step, we will focus on how the stakeholders of a company develop expectations regarding its behavior. We will see that a firm's reputation can play an important role in this process, particularly in environments that are characterized by incomplete information (**II**). In a third step, we will explain the link between observable effective behavior, deviating from a stakeholder's expectations and the occurrence of reputational loss (**III**). In a fourth step, the findings will be summarized, explaining the requirements that are needed in order for reputational loss to occur (**IV**).

I A Firm's Environment – A Short Introduction to Stakeholder Theory

In this section we aim to introduce a view on a firm's environment as implied by the assumption that reputational loss occurs if a firm's effective (and observable) behavior deviates from a stakeholder's expectations regarding the firm's behavior towards the particular stakeholder itself and towards other stakeholder groups. In a first step we introduce the basic idea of stakeholder theory (**1**), in a second step we discuss the typical topics of concern of the different firm-stakeholder interactions (**2**), and in a third step we summarize the results (**3**).

1 The Basic Idea of Stakeholder Theory

The assumption outlined above implies that a firm has stakeholders and that these stakeholders have expectations towards the firm's behavior. This view of a firm's environment is based on stakeholder theory which understands business "as a set of relationships among groups which have stake in the activities that makes up business"[329] – a perspective on a firm's environment that is increasingly dominant.

The idea of the stakeholder approach was to find a tool that would help managers to understand and manage a firm's environment[330]. This idea of using the stakeholder as the basic unit of analysis of a firm's environment was first developed by R. Edward Freeman whose book, *Strategic Management: A Stakeholder Approach*, became the starting point for a long lasting discussion about the role of stakeholders for the success and strategy of a business as well as its legitimacy[331].

The underlying assumption of the stakeholder approach is – as already mentioned – that business should be understood as a set of relationships among different groups which all have stake in the activities that composes a business. Freeman accordingly defines a stakeholder of a corporation "as any group or individual that can affect or is affected by the achievement of a corporation's purpose [business]"[332]. Freeman argues that if these

[329] Freeman/ Harrison/ Wicks, 2010, 24.

[330] Freeman/ Harrison/ Wicks, 2007, 229.

[331] Freeman/ Harrison/ Wicks, 2010, 29: "Stakeholder theory has evolved to address the problems of (i) understanding and managing a business in the world of the twenty-first century (the problem of value creation and trade); (ii) putting together thinking about questions of ethics, responsibility, and sustainability with the usual economic view of capitalism (the problem of the ethics of capitalism); and (iii) understanding what to teach managers and students about what it takes to be successful in the current business world (the problem of managerial mindset).

[332] Freeman/ Harrison/ Wicks, 2007, 229.

groups or individuals could affect or be affected by a firm's business then managers should worry about these groups and need to develop "an explicit strategy" for dealing with each of these groups or individuals[333].

The idea of taking the stakeholder as the basic unit of analysis is to understand and manage a firm's environment in a more effective way by identifying, analyzing and negotiating with those groups or individuals which are affected by or could affect a firm's business. In the first instance, stakeholder theory is a management approach based on the idea about "how people create value for each other"[334]. However, stakeholder theory also provides a generally framework that is helpful in order to analyze a firm's environment, its stakeholders, the stakeholders' expectations towards the firm and the impact of the different firm-stakeholder interactions on a firm's business.

2 Stakeholders of a Firm

The stakeholder approach stresses the interactions and the dialogue between a firm and its stakeholders. The basic definition, or rather the decisive criterion, is whether a group or individual could affect or be affected by a firm's business operation. Based on this definition, one can define stakeholders in a number of ways. FREEMAN distinguishes between a narrow and a broader definition of stakeholders. The former one includes those groups "without whose support, the business would cease to be viable"[335]: customers, employees, suppliers, financiers and communities. These so-called *primary stakeholders* are characterized by being part of a business's process of creating value. The second broader definition, so-called *secondary stakeholders*, includes all groups who might not be directly part of the process of creating value but can *affect* a business: competitors, consumer advocate groups, special interest groups, media and government.[336]

Both definitions stress the importance of the interactions between a firm and its stakeholders as well as among the stakeholders themselves. But what are these interactions about? Is there such a thing as a typical mindset of these stakeholders? FREEMAN describes the "typical" interests of the different primary stakeholder groups as

[333] FREEMAN/ HARRISON/ WICKS, 2007, 229.
[334] AGLE/ DONALDSON/ FREEMAN/ JENSEN/ MITCHELL/ WOOD, 2008, 166.
[335] FREEMAN/ HARRISON/ WICKS, 2010, 26.
[336] FREEMAN/ HARRISON/ WICKS, 2010, 26.

follows: *Financiers* of a firm have some form of financial stake in the firm and expect first of all some form of *financial return*.[337] Even if these expectations may differ by the type of the financier and its individual preferences, the topic of the interactions between a firm and its financiers is apparent.[338] *Customers* of a firm, first of all, are assumed to expect the *benefits of a product or service* which have been promised by it, for example, by advertising. Similar to customers, *suppliers* are linked to a firm by the exchange of resources of goods and services and typically expect that the firm will fulfill its contractual agreements. A firm's *employees* typically have their jobs and furthermore their livelihood at stake[339] and usually expect some form of return for their labor, such as *wages, benefits, security or meaningful work*[340]. Local *communities* often provide some form of infrastructure to a firm and benefit from the firm's economic (e.g. taxes) and possibly social contributions – they typically expect firms to be 'good citizens', not exposing the community to unreasonable hazards[341].

The five primary stakeholders are essential to almost any firm, while the members of the group of secondary stakeholders may vary depending on the firm's business model or the structure of the market in which it performs. It seems to be a good advice to analyze these stakeholders on a case by case basis, taking into account that it is more helpful to identify concrete groups as stakeholders instead of "large amorphous groups" like the public or society[342]. The larger and less defined a group, the less such a group has in common, the less it is likely that a firm's management will be able to build relationships with these groups[343].

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[337] The "managing for stakeholders" approach is often described as the contrary of the shareholder value approach which focuses on the financial return of a company's owners (the Freeman-Friedman debate). The resulting question is whether the interests of shareholders and stakeholders conflict. FREEMAN denies this conflict by stating that "shareholders are an important stakeholder, so we can't understand MFS as anti-shareholder or against the interest of shareholders. Without the support of the folks and institutions that put [up] money, a business can't exist. However, we do believe that if managers try to maximize the interests of any stakeholders, they will run into trouble. Maximizing the interests of one group, in essence, trades off the interests of others against the group being maximized." (FREEMAN/ HARRISON/ WICKS, 2007, 157).

[338] FREEMAN/ HARRISON/ WICKS, 2010, 24.

[339] FREEMAN/ HARRISON/ WICKS, 2010, 25.

[340] FREEMAN/ HARRISON/ WICKS, 2010, 25.

[341] FREEMAN/ HARRISON/ WICKS, 2010, 25.

[342] FREEMAN/ HARRISON/ WICKS, 2007, 161.

[343] FREEMAN/ HARRISON/ WICKS, 2007, 161.

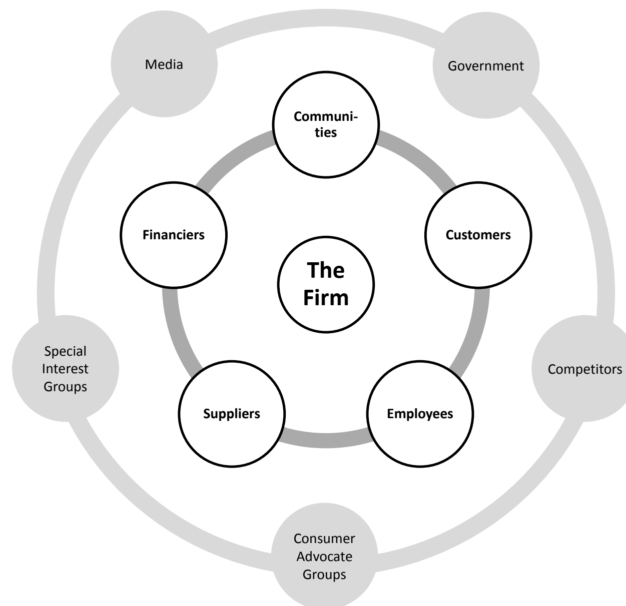

Figure 9: A Firm's Environment (Freeman, 2008)

The question of stakeholder identification has caused theoretical uncertainty and has even been called one of the "glaring shortcomings" of stakeholder theory[344]. It is evident that the definitions presented above are neither universally applicable to any firm nor exclusive. Furthermore, there might be intersections between different stakeholder groups. A party can be a member of two or more stakeholder groups: examples for these so-called *hybrid stakeholders* are "investomers" (customers-financiers), "custoyees" (customers-employees) or "investoyees" (employees-financiers).[345]

However, the general idea of understanding a firm's business as "a set of relationships between customers, suppliers, communities, employees, and financiers (and possibly others)"[346] is a realistic approach for presenting, understanding and analyzing a firm's environment and the interactions of the firm with that environment.

3 Summary

The stakeholder approach reflects a view of a company's environment as implied by our assumptions. Furthermore, this approach highlights that each of the different stakeholder groups has *primary topics of interactions* with a firm: financiers are interested in the financial performance, customers in the benefits or characteristics of a product or service, employees in the attractiveness of a firm as an employer. However, it is evident that the

[344] See Phillips/ Reichart (2000).

[345] Helm, 2007, 383.

[346] Freeman/ Harrison/ Wicks, 2010, 29.

interactions and interests of the different stakeholder groups do not have to be limited to these areas of interest. We take this understanding of a firm's environment as the basic framework in order to understand how firms' stakeholders develop expectations regarding firms' behavior towards different stakeholder groups.

II Stakeholders' Expectations

In the previous section of Part B we saw that a firm's environment can be described as relations between the firm and its stakeholders. Furthermore, we have seen that it is possible to identify five primary stakeholder groups and that these relations and interactions are characterized by *typical (primary) topics of interaction*.

The occurrence of reputational loss *and* costs assumed as the precondition for using the behavior modifying, and thus the regulatory, effect of threatening firms' reputations, and based on the assumption that reputational loss will occur if the effective behavior of a firm deviates from its stakeholders' expectations, the objective of this part is to understand how stakeholders' expectations regarding a firm's behavior develop and the role a company's reputation plays in this process.

We switch from the perspective of the firm to the perspective of the individual stakeholders of a firm by explaining how (potential) stakeholders develop expectations regarding a firm's future behavior and the role reputations plays in this decision making process. We proceed as follows:

In a first step we explain the link between individual decision making regarding the question of with whom to interact and the development of expectations. We propose that individuals (as well as collectives) have to make complex decisions while being faced with informational uncertainties regarding the future behavior of their (potential) counterparts. Decision making under uncertainty causes the individuals to form expectations about the likely future behavior of their (potential) counterparts (**1**).

Based on this finding, in a second step, we seek to answer the question of what kind of information is used by individuals – being faced with bounded rationality, asymmetric information and opportunism – in order to develop expectations with regard to the likely future behavior of potential counterparts. We will show that one's own and other people's experiences with a particular actor in the past are important sources of information for ascertaining the likely future behavior of others. Therefore, they are crucial for the development of expectations and the decision making on with whom to interact (**2**).

In a third step, we explain how a firm's reputations – arising from others' experiences with that firm in the past – affect and determine stakeholders' expectations regarding the firm's likely future behavior. We discuss the role of firms' reputations as an information system, we explain the assumed underlying mechanisms regarding the development of a firm's reputation, and discuss why people expect firms to behave

consistently with their reputations (**3**).

In a fourth step we summarize the results and draw conclusions for the further proceeding (**4**).

1 Decisions on with whom to Interact: The Role of Information in Transactions

The starting point in order to assess the role of information in transactions and decision making is the fact that people in any market have to make decisions about with whom to interact, i.e. whom to choose as their transaction partner. The essential question to be answered by every market participant is which counterpart (including the characteristic of the products and/or services offered) is behaving or will behave in a way that is consistent with its preferences and objectives. Making these decisions is a key task in everyday life and involves the need to make a choice out of many alternatives[347], whether it is a decision about where to purchase a product, in which company to invest or which firm to choose as an employer.

The ways in which people actually make these decisions (descriptive) or ought to make these decisions (normative) is the object of decision theory.[348] The process according to which descriptive decision theory generally assumes individuals to make their decisions is the following[349]: in a first step, people define (or become aware of) the general objective that they want to achieve according to their preferences. In a second step, they search for alternative strategies allowing them to achieve their objectives, answering the question of what actions are actually possible. In a third step, the consequences of these alternatives are considered, thinking about what future consequences might follow from each alternative and how likely these consequences are in case a particular alternative is chosen. In a fourth step, these consequences associated with each alternative are evaluated by asking the question of how valuable these consequences are, based on an individual's personal preferences. This evaluation, according to the individual's decision rule, is to compare the different alternatives "in terms of the extent to which their expected consequences are thought to serve the preferences of the decision maker"[350].

This decision making and evaluation process results in *expectations* about the future behavior of the decision maker's (potential) counterpart and the characteristics of the

[347] Laux, 2007, 1.
[348] Laux, 2007, 1-18.
[349] Laux, 2007, 10-13; March, 1994, 2-5.
[350] March, 1994, 2.

goods and services provided by this counterpart and serve as the basis for the decision whether or not to interact with the counterpart.[351]

The interesting questions are in the present context how an individual makes such a decision or choice, which information sources are involved in these different steps, and which techniques and mechanisms are applied in order to process information, evaluate the consequences and assess the likelihood and the value of different alternatives to an individual's preferences.

In order to understand the processes of decision making in more detail, we will, in a first step, introduce the idea of decision making in an environment characterized by complete and perfect information (**1.1**); in a second step, we introduce the assumptions of new institutional economics regarding the role of information in transactions (bounded rationality, opportunism and the resulting information asymmetries) and the consequences of these informational problems for decision making (**1.2**); in a third step, we turn to the uncertainties individuals face in ascertaining the characteristics of a good and the future behavior of their transaction partners in incomplete information settings (**1.3**). In a fourth step, we summarize the results (**1.4**).

1.1 The Neoclassical Market Model: Rational Decision Making in an Environment of Complete and Perfect Information

An individual would not face any problems in making decisions with regard to the future behavior of its counterpart (and the goods and/or services provided by its counterpart) if it was at any point in possession of all information which is of any importance to its decisions and, as a second criterion, was able to process this information without cognitive constraints. Perfect knowledge and information for any particular decision, thus all alternatives being known with certainty, all consequences of all alternatives being known with certainty, and all preferences relevant to a decision being known (and furthermore are precise, stable and consistent), is the core assumption of pure theories of rational choice and central to the neoclassical market model.[352] Decision makers are assumed to know exactly which outcome to expect from any choice and are assumed to choose the best alternative with the largest expected return according to their stable system of preferences.[353]

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[351] MARCH, 1994, 2.

[352] MARCH, 1994, 4; SIMON, 1955, 99.

[353] MARCH, 1994, 18.

Metaphorically speaking, the neoclassical market model assumes that every "consumer has a large laboratory, ready to deliver current information quickly and gratuitously"[354]. The neoclassical model is built on the assumption that every contracting party knows everything about the present characteristics and behavior of its relative counterparts, both while getting involved into (ex ante) and while executing a transaction (ex post). Every participant of a transaction has the complete relevant knowledge. Information is assumed to be complete, thus symmetric and available. SIMON summarizes the picture assumed of any individual as follows:[355]

> [The homo oeconomicus] is assumed to have knowledge of the relevant aspects of his environment which, if not absolutely, is at least impressively clear and voluminous. He is assumed also to have a well-organized and stable system of preferences, and a skill in computation that enables him to calculate, for the alternative courses of action that are available to him, which of these will permit him to reach the highest point on his preference scale.

The assumption further goes that the *economic man* is able to obtain complete and correct information without any time delay[356]. Hence, there is no uncertainty regarding which choice to make and, instead, choice is rather an automatic process depending on the system of preferences of an individual. As all possible alternatives, their consequences, the relevant preferences and their values are known, there is no need for expectations about the future behavior of a counterpart[357]; instead, everything is known for fact[358]. That means that individuals' decisions on with whom to interact are based on "true" facts.

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[354] STIGLER, 1961, 224.
[355] SIMON, 1955, 99.
[356] RIPPERGER, 2003, 21.
[357] SHAPIRO, 1983, 659.
[358] HELM, 2007, 93-96.

1.2 New Institutional Economics: Information Constraints, Bounded Rationality and Opportunism

The view of the role of information in markets has changed radically and the assumption of complete information – and therewith the idea of the large personal laboratory, ready to deliver current information quickly and gratuitously – has been found to be unrealistic for virtually every market[359]. Therewith, the processes of decision making have been found to be unrealistic, too, and the assumptions in rational choice theories have been relaxed to different degrees, for example, by assuming that the consequences of each alternative are not known with certainty but their probability or that the degree of uncertainty or risk is incorporated into theories, in order to make concession to different levels of risk preferences.[360]

While complete information has been one of the core assumptions of the neoclassical market model, the notion of incomplete information is the core assumption of the whole complex of New Institutional Economics (NIE) – an economic perspective that attempts to extend economics by borrowing from various social science disciplines in order to "understand the institutions of social, political and commercial life"[361]. For more than three decades, research on the role of (incomplete) information in transactions and its consequences for decision making and the functioning of markets have been in the focus of economic theory[362]. In the following we introduce the two basic behavioral assumptions of transactions costs economics, as a part of new institutional economics, regarding the processing of information in decision making (**a**) and discuss the role of asymmetric information in transactions (**b**).

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[359] Stiglitz, 2010, 18.

[360] March, 1994, 40-45; Based on the differentiation established by Frank Night (1921), stating that "uncertainty must be taken in a sense radically distinct from the familiar notion of risk, from which it has never been properly separated", endogenous and exogenous forms of uncertainty can be distinguished: *Endogenous* uncertainties, labeled by Knight as risks, result from the decisions of the *actors involved* in a transaction. These risks can be seen as the result of a lack of information or the incapability of the actors to process the available information. As already seen in decision theory, the major challenge for actors is that that there is a huge number of possible events which could happen in the future, but only some will. The attempt to anticipate the different contingencies and their probabilities of occurrence are the two factors from which complexity in decision making results. It is obvious that as this complexity increases, the higher is the number of contingencies. *As long as these probabilities of occurrence are theoretically measurable, Knight refers to them as risk. Exogenous* uncertainties do not result from the decision of the actors involved in a transaction. This form of uncertainty is objective, not measurable and lies *outside of the sphere of influence* of the actors involved .

[361] See the definition of NIE (New Institutional Economics) by the International Society for New Institutional Economics, available at <http://www.isnie.org/about.html>, accessed on January 16, 2011.

[362] Royal Swedish Academy, 2001, 1.

a Bounded Rationality and Opportunism: The Two Core Assumptions of Transaction Costs Economics

Let us turn to the assumptions of new institutional economics, particularly transaction costs economics, regarding the role of information and its processing in decision making. Transaction cost economics, as an important part of new institutional economics, deals with the "costs of running the economic system"[363] or, more specifically, with the costs of exchange[364]. In contrast to the neoclassical analysis which focuses on production costs, transaction cost economics poses "the problem of economic organization as a problem of contracting"[365]. Transaction cost economics is principally based on two *behavioral* assumptions: bounded rationality and opportunism[366]. Both assumptions, distinguishing the approach of transaction cost economics from neoclassical economics[367], will be explained briefly in the following paragraphs.

Bounded rationality is one of the major *cognitive assumptions* on which transaction cost economics rely[368] and means that people "experience limits in formulating and solving complex problems and in processing (receiving, storing, retrieving, transmitting) information"[369] and therefore are expected to act in a way that is "intendedly rational, but only limitedly so"[370]. Decision makers try to decide and behave rationally, but they face cognitive constraints as the core assumption is that the *cognitive capacity* of all actors is limited[371] and that mind is the scarce resource[372]. One of the results is that cognitively

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[363] ARROW, 1969, 48; WILLIAMSON distinguishes *ex ante* and *ex post* types of transaction costs: the former are costs of "drafting, negotiating, and safeguarding an agreement", the latter e.g. maladaption costs or set-up and running costs associated with the governance structures to which disputes are referred (WILLIAMSON, 1985, 20).

[364] COOTER and ULEN focus on the *three steps of an exchange* and their corresponding *three forms of transaction costs*: (1) Search costs: "First, an exchange partner has to be located"; (2) Bargaining costs: "Second, a bargain must be struck between the exchange partners. A bargain is reached by successful negotiation, which may include the drafting of an agreement"; (3) Enforcement costs: "Third, after a bargain has been reached, it must be enforced. Enforcement involves monitoring performance of the parties and punishing violations of the agreement" (COOTER/ ULEN, 1996, 84).

[365] WILLIAMSON, 1985, 20.

[366] WILLIAMSON calls these two behavioral assumptions "intended as concessions to 'human nature as we know it'" (WILLIAMSON, 1985, 30).

[367] WILLIAMSON, 1981, 553; regarding the role of the assumption of bounded rationality for the whole complex of new institutional economics see COASE (1984).

[368] WILLIAMSON, 1985, 45.

[369] WILLIAMSON, 1981, 553 citing SIMON (1957).

[370] WILLIAMSON, 1981, 553 citing SIMON, 1961, xxiv: in this sense bounded rationality is a semi-strong form of rationality, which is to be distinguished from nonrationality or irrationality as well as from maximizing and organic rationality.

[371] WILLIAMSON, 1985, 45.

[372] WILLIAMSON, 1985, 46 citing SIMON, 1978, 12.

limited actors are seen rather as satisfiers than utility maximizers: instead of calculating for the "best option" (which alternative has the highest value on an individual's preferences scale and maximizes expected return) they seem to search for an action that is "good enough"[373]. As WILLIAMSON stresses, bounded rationality is an assumption that is important for economic research in two forms: The first concerns the question of how individuals handle their cognitive limits of processing information while making decisions, thus decision making processes; The second is the question of how governance structures and institutions are to be designed in order to make allowance for these limits[374].

The second fundamental behavioral assumption of transaction cost economics is *opportunism*[375]. WILLIAMSON has defined opportunism as "self-interest seeking with guile"[376]:

> This includes but is scarcely limited to more blatant forms such as lying, stealing, and cheating. Opportunism more often involves subtle forms of deceit.

Opportunistic behavior can occur while parties are negotiating (*ex ante*) as well as during the execution of a transaction (*ex post*). Information plays an important role in opportunism as the "incomplete or distorted disclosure of information [in order] to mislead, distort, disguise, obfuscate or otherwise confuse"[377] is a core element of opportunistic behavior.[378]

The behavioral assumptions that actors are rationally bounded and that they might act opportunistically evidently have a strong impact on the costs of transactions in general and the role of information in transactions – and those costs linked to acquiring and processing them – in particular. Let us have a closer look at the implications of these behavioral assumptions on the role of information in transactions.

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373 RIPPERGER, 2003, 22; MARCH, 1994, 18-23.

374 WILLIAMSON, 1985, 46.

375 WILLIAMSON, 1985, 47: Opportunism is the strongest form of self-interest orientation, the semi-strong form is simple self-interest seeking, the weak form is obedience.

376 WILLIAMSON, 1985, 47.

377 WILLIAMSON, 1985, 47.

378 RIPPERGER claims rightly that the assumption of bounded rationality is the prerequisite for opportunism (RIPPERGER, 2003, 43).

b Information Constraints and Asymmetric Information

Complete information is an evidently unrealistic assumption in the face of cognitive limits. Instead, situations of asymmetric information are rather the default. The notion of asymmetric information describes transactions in which one side of the market has *more* or *better* information than the other – a situation which is likely to create imbalances of power in such transactions[379]. These imbalances of power are problems and risks that are associated with the formation and the execution of transactions in general[380]. There are two specific forms of asymmetric information actors face due to bounded rationality and opportunistic behavior of human nature than can be distinguished: hidden information[381] and hidden actions. The former may result in *adverse selection*, the latter in *moral hazard*.

The phenomenon of hidden information (or hidden characteristics) describes those cases in which at the time of the transaction (the time a partnership is formed) one or more features of a good or service are not as well known to one of the acting parties as to the other. This means that one of the contracting parties does not know whether the other "has disclosed all the information bearing upon the execution of the contract"[382] and is therefore not able to judge the quality of a service or good *ex ante*. The typical textbook example is that sellers know more about the quality of goods than buyers do[383]: a person who offers a second-hand car for sale knows far more about the quality of that car than a potential buyer does.

Hidden information can give rise to *adverse selection* in these markets. GEORGE AKERLOF showed in his famous example of "The Market for Lemons" that imperfect information can lead to the malfunctioning of such markets. In AKERLOF's example[384] buyers cannot, due to the informational asymmetries, observe the product quality of a good. This means that they cannot distinguish between low-quality and high-quality products. At a given price for an average quality, the seller of low-quality products will have a greater incentive to be in the market than those of better quality. The result can be that the seller of high-quality products will exit the market.

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[379] WILSON, 1985, 29; ROYAL SWEDISH ACADEMY, 2001, 1; KREPS/ WILSON, 1982, 253; VON HAYEK (1945); VAN AAKEN (2003).

[380] SCHÄFER/ OTT, 2004, 276.

[381] Some authors label this form of information asymmetry *private information or hidden characteristics*.

[382] SCHÄFER/ OTT, 2004, 276.

[383] COOTER/ ULEN, 1996, 41.

[384] AKERLOF (1970).

Hidden actions means that the value of a transaction or interaction depends on the behavior by one party that *cannot be sufficiently observed* by the other party[385]. Or, more specifically, that one of the contracting parties does not know "whether the other has engaged in actions that put them at a disadvantage"[386]. It is, contrary to hidden information, a problem which occurs during the execution of a contract (*ex post*), thus once a relationship is established and operating. The resulting *moral hazard* has been especially researched for the context of insurances and principal-agent relationships. The textbook example of hidden actions and moral hazard is the case of any insurance[387]: The insurer cannot monitor the behavior of the insured and for example does not know whether a homeowner who has just signed an insurance policy against burglary might choose not to lock the doors of his house anymore, thereby raising the probability of burglary.

It is evident that more information would help to mitigate these asymmetries but one of the core findings of transaction cost economics is that the acquisition of information and its processing are not free, but *costly*[388]. The so-called informational costs or search costs[389] are essential to any transactions, both *ex ante* and *ex post*, and are major parts of the "costs of running the economic system"[390]. Examples of *ex ante* information (transaction) costs are the search for information about the behavior of a particular actor in the past or the quality of the goods offered. An example of *ex post* information costs is the control of the quality of the goods or services purchased[391].

Hidden information and hidden actions are two forms of informational asymmetries which can be observed in markets, illustrating the possible consequences from interactions in which one side of the market has more or better information than the other. These examples highlight the pivotal role of information in transactions due to the bounded rationality of the actors involved. The resulting informational constraints have important consequences for people's decision making: *they have to make decisions under uncertainty, thus they do not know with certainty who of the potential counterparts will act according to their preferences.*

385 SCHÄFER/ OTT, 2004, 276; STIGLITZ/ ROTHSCHILD (1976).

386 SCHÄFER/ OTT, 2004, 276.

387 STIGLITZ/ ROTHSCHILD (1976).

388 COOTER/ ULEN, 1996, 84.

389 See STIGLER (1961) and his famous article "The Economics of Information" for a fundamental assessment of the role of information in transactions.

390 ARROW, 1969, 48.

391 COOTER/ ULEN, 1996, 84.

1.3 Decision Making under Uncertainties: The Result of Informational Constraints

As seen above, hidden information and hidden actions are two forms of risks or problems contracting parties have to deal with while negotiating a transaction and during its execution. While hidden information and hidden actions are examples of how people can take advantage of information asymmetries caused by bounded rationality, the limits of people in formulating and solving complex problems and in receiving, storing, retrieving or transmitting information challenge individuals' (as well as collectives') decision making processes on a more general level: individuals (and collectives) have to make complex decisions, while being faced with uncertainties regarding the future behavior of their transaction partners and the characteristics of the goods and/or services provided by them[392]. Faced with cognitive limits and informational constraints, people have to make decisions under uncertainty: decision makers may not know all the alternatives, do not consider all consequences and/or not all preferences are evoked at the same time[393].

1.4 Summary and Conclusion

The starting point of Part B is to understand how stakeholders develop expectations regarding the firms' behavior both towards the particular stakeholder itself and towards other stakeholder groups. Based on the assumption that reputational loss occurs if the observable effective behavior of a firm deviates from the behavior expected by stakeholders, the objective is to understand the factors determining stakeholders' expectations in more detail. In this section (1) we have seen that the question of with whom to interact in order to meet someone's preferences and objectives is the essential question in markets of any kind. People have to make decisions and choices out of a variety of different alternatives. The result of such a decision making process is that an individual forms expectations about the future behavior of a (potential) counterpart. In case these expectations are consistent with an individual's preferences and objectives, an interaction or transaction is assumed to occur: the expectations serve as a basis for the decision of with whom to interact.

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392 SCHRADER/ RIGGS/ SMITH, 1993, 75: "Uncertainty relates to a lack of information".
393 MARCH, 1994, 23.

The interesting question is: What role does information and its processing play in this process of deciding on whom to interact with and the accordant development of expectations towards the future behavior of (potential) counterparts? We have seen that individuals would not face any problems in making decisions with regard to the future behavior of their (potential) counterpart if they knew all the relevant aspects of its environment and had the ability to process that information (1.1). This assumption of the neoclassical economic model has found to be unrealistic. Instead, incomplete information is one of the core assumptions of new institutional economics. We have introduced the behavioral assumptions of bounded rationality and opportunism and have seen that informational problems can lead to the malfunctioning of markets (1.2). Due to the cognitive limits individuals face in processing information and due to the resulting information asymmetries, people have to make decisions under uncertainty. They are faced with a number of informational uncertainties regarding the future behavior of their (potential) transactions partners and the characteristics of the goods and services provided by them. The endogenous uncertainties, thus those in the sphere of influence of the partners involved, are of interest regarding the development of stakeholders' expectations (1.3).

In the next two sections, we have to answer the questions of how individuals – being faced with bounded rationality, asymmetric information and opportunism – develop expectations towards the future behavior of (potential) counterparts and how they make decisions based on these expectations. The focus will be set on understanding the forms of information and the techniques involved in this process, particularly the role of a firm's reputation as a basis for the decisions on whether or not to interact with that firm as a potential counterpart.

2 Information on which Individuals Make their Decisions

Based on the finding that due to informational lacks individuals have to make complex decisions under uncertainty, we will now ask about the information on which people base their decisions on with whom to interact. We will inquire which mechanisms they apply in order to reduce uncertainties, information costs and complexity, thus overcoming information asymmetries and ascertaining that a potential counterpart will act according to their preferences and objectives. As already outlined, these processes of decision making result in the development of expectations regarding the likely future

behavior of (potential) counterparts and the products and services provided by them. Therefore, understanding these processes is necessary in order to comprehend which factors determine stakeholders' expectations, or more generally how do people develop expectations regarding the future behavior of a (potential) transaction partner.

In this section we will show that individuals being faced with incomplete information settings can generally rely either on their own, direct experiences (**2.1**) or on other people's, thus indirect experiences[394] (**2.2**) in order to search for alternative counterparts or to find out whether a potential counterpart is likely to deliver the promised performance and to behave according to one's preferences and objectives. In both cases, in order to be able to use direct or indirect experiences as the informative base for predicting likely future behavior the basic mechanism applied is the extrapolation principle, a cognitive mechanism to be introduced in this section. The results will be summarized (**2.3**).

2.1 Direct Experience as the Informative Base for Making Decisions

The most obvious source of information in order to ascertain the likely future behavior of a (potential) transaction partner is one's personal experience with a person or organization in the past. Based on that experience one can judge whether the expected or promised performance of a person or organization has been met or delivered in the past.

The underlying mechanism of taking personal past experiences with a person or organization in the past as the base for predicting future behavior is *intrapersonal extrapolation*. The extrapolation principle describes "the phenomenon that people extrapolate the behavior of others from past observations"[395]. Behavior patterns or characteristics which have been observed or experienced in the past are assumed to occur again in the future[396]. The development of expectations regarding the future behavior of a counterpart with whom an individual has already interacted repeatedly in the past is generally referred to as trust (or distrust).

Trust provides information about the most likely future behavior of a counterpart and thus stabilizes (uncertain) expectations and reduces complexity in decision making[397].

[394] VON WEIZSÄCKER, 1980, 412.
[395] VON WEIZSÄCKER, 1980, 412.
[396] VON WEIZSÄCKER, 1980, 412.
[397] LUHMANN, 1989, 23-32; RIPPERGER, 2003, 45.

The assumption – already implied by the extrapolation principle – is that the counterpart will show consistent behavior that is in accordance with the former trust-building actions[398]. Therefore, trust is based on the verification of former promised or expected forms of behavior by people's own experience. As promised or advertised behavior has been performed in the *past*, this experience is the base for the development of stakeholders' expectations regarding *future* behavior: stakeholders expect a firm to show the same behavior patterns – i.e. delivering the promised performance – as observed and experienced in the past[399]. This holds also for the development of distrust, based on the direct experience that a performance promised or behavior pattern has not been performed in the past.

The development of trust based on a person's own experiences is a mechanism taking place on an *individual* level. Only a person's own experiences result in the development of trust, which then serves as the basis for the development of a stakeholder's expectations towards the future behavior of a firm. In this sense, trust is a cognitive mechanism to overcome uncertainties regarding the future behavior of a counterpart.

The role of trust in transactions has been much in the focus of recent economic research as it is seen as the *grease of an economy* due to its function of reducing complexity and uncertainty in decision making: trust significantly lowers transactions costs.

While the typical mechanism of trust and intrapersonal extrapolation relates to someone's own direct experience with a particular counterpart in order to predict this particular party's future behavior, the mechanism is not limited to this direct, *bilateral* relationship. Besides what we consider as specific trust there is another form of intrapersonal extrapolation which can be distinguished: generalized trust[400]. This term describes a form of trust and intrapersonal extrapolation that is based on someone's direct experience with a particular actor, but this experience is used as a way to predict the likely future behavior of a *different* actor that has similar characteristics, for instance, as it is part of the same entity. Due to some form of similar characteristics, the trust that has been developed due to experiences with one actor's actions in the past serves as the base for building expectations about another actor's future behavior.

[398] Ripperger, 2003, 48-51.

[399] Such forms of trust are a daily phenomenon enormously reducing the complexity of decision making and the information costs. Most of our repeated actions are based on trust. If somebody has bought bread at particular bakery for the last few years and his expectations and preferences have been fulfilled, he extrapolates his direct experiences with this bakery and expects it to deliver the same quality of bread in the future as it has done in the past.

[400] Ripperger, 2003, 99, 103ff..

The requirement for such intrapersonal extrapolation – the reliance on direct, personal experiences – is that former interactions with a specific actor have taken place. Furthermore, this interaction has to have some form of repeated character in order to perceive the experienced behavior as stable and consistent.

We can conclude that one's own experiences is one way to predict the likely future of a potential counterpart, thus it can serve as a basis for the decision whether or not to interact with a counterpart.

2.2 Other People's Experiences as the Informative Base for Making Decisions

A second source of information in order to develop expectations regarding the future behavior of a (potential) counterpart is other people's experiences.[401] Faced with the question of with whom to interact, other people's experiences with a particular actor are an important source of information. Such kind of information can be called indirect. The ways such "second-hand knowledge" can be acquired are various: someone can ask friends, rely on information provided by newspapers and other publications or search the internet for information about other people's experiences with a (potential) counterpart in the past. This source of information is particularly important in settings in which no direct, personal experience is available.[402]

Using other people's experiences in order to predict the likely future behavior of a (potential) counterpart is again based on the extrapolation principle, in this case *interpersonal extrapolation*. The behavior of others is extrapolated and behavior patterns or characteristics similar to those observed by others in the past are expected to occur again in the future.

The requirements for such interpersonal extrapolation are threefold: *First* of all, it is obviously only possible to extrapolate, thus to infer or estimate by extending or projecting known information (here other people's experiences), if past actions have taken place: that is, some form of interaction with a particular company has to have taken place in the past.[403] *Secondly*, this knowledge or information about former interactions with a particular company has to be shared, thus exchanged[404]. Information exchange means

[401] WEIGELT/ CAMERER, 1988, 44.
[402] ANDERSEN/ SORENSEN (1999).
[403] VON WEIZSÄCKER, 1980, 413.
[404] VON DER CRONE/ LINDER, 2009, 2.

both that those who have been involved in former interactions have to make this information accessible and the person seeking information has to access this information[405]. The communication and diffusion of knowledge about a firm's past actions is inherent to interpersonal extrapolation and therewith the reliance on other people's experiences[406]. The different ways information can be communicated, thus made available and accessed, such as word of mouth, mass media, blogs or institutionalized procedures on different levels, and the role these different information intermediaries can play in this process, are to be discussed later in detail – however, for now we can define the efficient (successful) communication and diffusion of other people's experiences with a particular actor in the past as the second requirement. The *third* requirement is that the information exchanged about other people's experiences with a particular actor in the past has to be perceived as relevant for those searching for information in order to affect the development of stakeholders' expectations towards a firm's future behavior.[407] The main criterion is that the source of information has to be seen as trustworthy and credible in order to be perceived as meaningful for the expectation-building of the information searching actors[408]. In this context the question of how and by which criteria the experiences of unknown others, as the majority of information that can be found in the internet falls into this category, is selected and weighted is particularly interesting and to be discussed later.

Relying on other persons' experiences in order to predict the likely future behavior of a firm is – like trust – a mechanism to overcome uncertainties regarding the future behavior of a counterpart. As to stakeholders' expectations towards firms' future behavior, this source of information plays a crucial role as it serves as a basis for decision making whether or not to interact with a potential counterpart as it reduces information costs and the level of complexity.

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405 HELM, 2007, 28; BÜSCHKEN, 1999, 6.

406 SHAPIRO, 1983, 663.

407 BÜSCHKEN's (1999) model of reputation – that is limited to the expectations of customers – defines that the relevance of information depends, amongst other things, on three factors: the relevance of information (other people's experiences) is perceived higher, the more similar the situation of those providing and searching information; the less the information-searching party has experiences of his own with the particular counterpart; and the more trustworthy the source of information is.

408 BÜSCHKEN (1999).

2.3 Summary

In summary, faced with uncertainties, people can rely either on direct or indirect experiences in order to ascertain the likely future behavior of (potential) counterparts. In both cases, the extrapolation principle is the basic mechanism applied. The three necessary requirements for the reliance on other people's experiences are: the existence of former interactions, the exchange and diffusion of these experiences, and the perception of this information as relevant.

A firm's reputation is a form of information based on others' experiences with the firm in the past. A firm's reputation is said to embody the history of other people's experiences[409] and serves as an information system that is used in order to predict the likely future behavior of firms, again based on the extrapolation principle. The next section highlights the way firms' reputations provide information about their behavior, both in the past and in the future, and discusses why firms' reputations can therefore play a crucial role for stakeholders' decisions on with whom to interact, thus which potential counterpart will behave according to its stakeholders' preferences and objectives.

3 A Firm's Reputation and its Role Regarding Stakeholders' Expectations towards the Firm's Behavior

We have seen that other people's experiences can play an important role in predicting the likely future behavior of (potential) counterparts and thus in making decisions about with whom to interact. A firm's reputation can provide information about other people's experiences with the firm's past actions, therefore, based on the extrapolation principle it can help to predict the likely future behavior of the firm, and will affect stakeholders' expectations regarding the firm's behavior.

The objective of this section is to explain how and to what extent firms' reputations affect and determine a stakeholder's expectations regarding a company's behavior towards the stakeholder itself and towards other stakeholder groups. As already outlined, this understanding is necessary as our assumption is that reputational loss occurs if the effective behavior of a firm deviates from stakeholders' expectations regarding the firm's behavior.

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[409] FOMBRUN, 1996, 3.

In order to be able to understand the influence of a firm's reputation on stakeholders' expectations, we have to understand how reputational mechanisms work in more detail. Therefore, we start with a short introduction to the field of reputation research (**3.1**), followed by explaining some of the underlying mechanisms regarding the emergence of firms' reputations (**3.2**). In a third step, we show that a firm's reputation affects its stakeholders' expectations towards the firm's behavior in case the decision to interact with a firm was also based on reputational information (**3.3**). The results will be summarized in a fourth step (**3.4**).

3.1 Introduction: Reputation as an Area of Research and Common Findings

Reputation is, once again, not a term of easy definition.[410] A multitude of different definitions of reputation exist, mostly combined with implicitly or explicitly expressed underlying assumptions about its mechanisms and consequences. The variety of definitions reflects, on the one hand, the diversity of academic disciplines contributing to knowledge about reputation[411], on the other hand, it highlights that reputation is not a well-developed theory, but rather a "wooly concept, a mixture of constructs"[412]. Despite having been subject to research for some time and having been rediscovered by scholars from a variety of disciplines many times[413], there is no unambiguous, generally accepted or well developed theory of reputation in general, nor of firms' reputations in particular.[414] However, even being faced with a mix of constructs and concepts and a lack of a well-established theory of reputation, there are some mechanisms and components that can be extracted as somehow inherent to reputation:

- Reputation provides information in incomplete information settings: it is agreed that reputation carries information about the characteristics ascribed or attributed to a reputational entity. It can be described as an information system or informative base for decision making, effective outside of bilateral relations.

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[410] MAHON, 2002, 415.

[411] FOMBRUN/ VAN RIEL, 1997, 5.

[412] DAVIES, 2003, 57; MAHON, 2002, 438.

[413] MAHON, 2002, 438.

[414] GOTSI/ WILSON (2001); POSNER, 1990, 58; FOMBRUN/ VAN RIEL, 1997, 5: "Yet all too few can identify and provide well-reasoned and definable answers to questions about corporate reputation and reputation dynamics"; One reason, amongst others, for this lack of a consistent theory is that many academic disciplines – all with different perspectives and interests – study the same subject with little or no reference to parallel research conducted in other, less familiar, disciplines, see FOMBRUN, 1996, 5-8; MAHON, 2002, 415.

- A firm's reputation is based on or reflects the history of a firm's past actions: other people's experiences with a reputational entity define its reputation[415]. Hence, the experiences of a firm's stakeholders define the firm's reputation. Therefore, it can be said that a firm's reputation "embodies the history of other people's experiences"[416]. This finding highlights the requirements of information exchange and diffusion amongst a firm's stakeholders.
- The basic mechanism defining the character of reputation as an information source about likely future behavior is interpersonal extrapolation: people extrapolate the behavior of others from past observations.
- Due to people assuming that observed past behavior is likely to occur again in the future, a firm's reputation affects its stakeholders' expectations towards the firm's future behavior, both towards the stakeholder itself and towards other stakeholder groups. A firm is expected to behave consistently with its reputation.

In the next sections, we will elaborate on these four findings in more detail and explain some of the underlying mechanisms of firms' reputation and the manner in which they develop, how they serve as information in decision making and how a firm's reputation affects stakeholders' expectations regarding the firm's future behavior.

3.2 A Concept of Reputation: Underlying Mechanisms

In this section, we introduce a basic concept of reputation and its underlying mechanisms regarding the question of how and why a firm's reputation emerges, and under what circumstances it serves as a source of information for decision making. The elements of this concept refer to the component which we introduced in the last section as inherent to reputation: the role of reputation in incomplete information setting and the reliance of reputation on information exchange and consistent behavior:

Incomplete information settings: We have already mentioned that a firm's reputation provides information about likely future behavior based on other people's experiences[417]. It is evident that such information – thus the reliance on other people's experiences – plays a role only in incomplete information settings or, as Shapiro puts it: "The idea of

[415] Mahon, 2002, 420.

[416] Fombrun, 1996, 3.

[417] Yoon/ Guffey/ Kijewski, 1993, 215; Sjovall/ Talk, 2004, 271; Weigelt/ Camerer, 1988, 444: "[Reputation] is a set of attributes ascribed to a firm, inferred from the firm's past actions".

reputation makes sense only in an imperfect information world"[418]. It does not play any role if people do not face cognitive limits and informational constraints.

Information exchange: But how does reputation emerge and develop? We have already seen that the requirement of being able to rely on other people's experiences is that the knowledge and information about former interactions with a particular company has to be shared, thus exchanged[419]. This holds also for reputation: Those who have been involved in former interactions have to communicate their experiences and those seeking information have to be able to access that information in order to include that information in their decision making processes.

The communication and diffusion of other people's experiences can range from unstructured word-of-mouth communications to more structured processes, such as feedback mechanisms provided by online platforms like "eBay" or "Tripadvisor".[420] For now, the focus is set on the requirement of some form of information exchange between those who have interacted with a firm and those making the decision whether to interact with that particular firm[421]. The questions of how the information exchange takes place and which factors influence this process will be discussed later, as well as the different arenas in which these processes may take place[422].

Other people's experiences have to refer to stable behavioral signals: A firm's reputation is the result of processes of interactions and communication about people's experiences with the firm's past actions amongst the firm's (potential) stakeholders[423]. However, the emergence of a firm's reputation requires consistency in the firm's actions over a prolonged period of time[424]. Thus, a firm's reputation emerges if the information exchanged amongst a group about the firm's past actions refers to the stable and consistent behavior of the firm[425]. If the exchanged and shared information about

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[418] Shapiro, 1983, 659; Weigelt/ Camerer, 1988, 443-444.

[419] Nguyen/ Leblanc, 2001, 228; Büschken, 1999, 6; Spremann (1988).

[420] von der Crone/ Linder, 2009, 3; Caruana, 1997, 109-110: "Reputations can be formed even when the experience by a public is not direct as long as this is passed on either […] through word-of-mouth, or […] via the media or other publics".

[421] Büschken, 1999, 6; Shapiro, 1983, 664; see Granovetter (1985) as to the role of embeddedness in structures of social relations and their impact on the communications of reputational information.

[422] Mahon describes the exchange of reputational information as a "largely unexplored and poorly understood set of relationships and actions" (Mahon, 2002, 419).

[423] Nguyen/ Leblanc, 2001, 228; Büschken, 1999, 6; Spremann (1988); Fombrun/ Rindova, 1996, 10.

[424] Herbig/ Milewicz, 1995, 26: "Reputation is a historical notion based on the sum of the past behavior of the entity"; Herbig/ Milewicz, Reputation, 1995, 5:

[425] Helm, 2007, 60.

experiences with a firm's past actions differ significantly, no reputation will be formed[426].

Therefore, a firm's reputation develops only if a critical number of interactions within a group of (potential) stakeholders have taken place, if these experiences with the firm's past actions have been shared, i.e. have been communicated and diffused, and if the exchanged information about the firm's past actions shows a high degree of consistency.

These four mechanisms have two important implications: a firm's reputation does not only reflect "valued" forms of behavior, but consistent behavior, whether perceived as favorable or not (**a**), and there is not just one reputation of a firm, to the contrary, a firm can have many reputations, depending on the primary interests of the information exchanging stakeholders (**b**).

a A Firm's Reputation is Perceptual, whether Positive or Negative

Some of the standard definitions of corporate reputation refer to a firm's reputation as only reflecting forms of behavior which are positively valued by a group of its stakeholders[427]. However, it seems more reasonable to understand reputation as information referring to the general estimation – whether favorable or unfavorable – in which a firm is held by others[428]. The reason why a firm's reputation can refer to favorable as well as unfavorable estimations is to be found in the mechanism explained above: a reputation develops if experiences with a firm's actions sum up to a *stable behavior* of a firm.

The question of whether these experiences are perceived as favorable or unfavorable is answered by those exchanging the information, that is, actual and potential stakeholders[429]. Their answer depends above all on the preferences, objectives and primary interests of these (potential) stakeholders and, furthermore, on the performance

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[426] HERBIG/ MILEWICZ, 1995, 24; as SJOVALL and TALK point out: "The strength and homogeneity of the individual impressions in a group comprise reputation; if the members all have weak or differing opinions, then no clear reputation is formed" (SJOVALL/ TALK, 2004, 270).

[427] FOMBRUN/ RINDOVA (1996): "A corporate reputation is a collective representation of a firm's past actions and results that describes the firm's ability to deliver valued outcomes to multiple stakeholders"; POSNER defines reputation as "widely regarded in good light" (POSNER, 1990, 58); even the two etymological dictionaries BARNHART (1995) HOAD (1986) stress the positive connotations of the characteristics expressed by the term reputation by referring to "good reputation" and "high esteem". This accentuation seems surprising as the verb *reputare* – to which both etymological dictionaries refer – has a neutral meaning: to account, to deem, to consider

[428] See WEBSTER's definition of reputation as „a reckoning, estimation, from the Latin reputatus – to reckon, to count over. The estimation in which a person, thing, or action is held by others […] whether favorable or unfavorable (MERRIAM-WEBSTER, 1983, 417).

[429] FOMBRUN/ VAN RIEL, 1997, 10.

that was promised to them by a firm[430]. It is a question of how a firm's actions are perceived within an information-exchanging group. As HERBIG and MILEWICZ point out: "A firm can have a horrible reputation but be totally credible (as long as it is consistently bad)"[431]. In case a firm's actions are constantly perceived as "bad" but it shows consistent behavior and as long as the experiences are exchanged, a reputation will be formed and negative characteristics will be attributed to that firm[432].

Setting the focus on the consistency of a firm's behavior highlights that not only *valued outcomes*, i.e. positively attributed experiences, are a useful source of information in order to predict the likely future behavior of a firm, but also a "bad" reputation – the result of a firm's past actions constantly perceived as bad by a group of stakeholders – can be a valuable and helpful basis for potential stakeholders to make decisions whether or not to interact with that firm in the future[433].

b A Company Can Have Many Reputations

Understanding a firm's reputation as the result of exchange of information about the firm's past actions within stakeholder groups leads to another important question: whether a firm has only one reputation or *multiple* reputations. This question is controversially discussed in research on corporate reputation[434]. While some, such as FOMBRUN[435], assume that there is one aggregated reputation – corporate reputation is the "net perceptions of a company's ability to meet the expectations of *all* its stakeholders" –, others assume that corporations "have a reputation for something with someone, and therefore can and do have multiple reputations"[436].

Agreeing with the statement that there is "little apparent intellectual validity in attempting to combine […] different reputations in one single measure"[437], the idea that

430 GRAY/ BALMER, 1998, 697: "Corporate reputation […] indicates a value judgement about the company's attributes"; WARTICK, 2002, 374.

431 HERBIG/ MILEWICZ, REPUTATION, 1995, 6.

432 BROMLEY, 2002, 38.

433 YOON/ GUFFEY/ KIJEWSKI, 1993, 216; HELM, 2007, 60.

434 See WARTICK, 2002, 376-379.

435 FOMBRUN/ VAN RIEL, 1997, 10.

436 Title of the research agenda of the Oxford University Centre for Corporate Reputation, available at <http://www.sbs.ox.ac.uk/centres/reputation/research/Pages/2ReputationFORsomethingWIthsomeone.aspx>, accessed on January 16, 2011.

437 Outline of the research projects of the Oxford University Centre for Corporate Reputation, available at <http://www.sbs.ox.ac.uk/centres/reputation/research/Pages/2ReputationFORsomethingWIthsomeone.aspx>, accessed on January 16, 2011.

a firm's environment is characterized by different stakeholder groups and that each of these five primary stakeholder-firm interactions is characterized by particular interests (e.g. customers who are interested in a good product quality or financiers who are interested in a financial return to their investment) rather suggests the conclusion that a firm can have multiple reputations developed within each stakeholder group – or as BROMLEY states: "Commercial and industrial companies […] have as many reputations as there are distinct social groups (collectives) that take an interest in them"[438].

We therefore assume for the further ongoing argumentation that a firm has a reputation in each stakeholder group according to the primary interests, preferences and objectives of this stakeholder group[439]. In the groups of customers, for example, a firm has a reputation regarding the benefits of a product or service promised to them, in the group of financiers a firm has a reputation as to the promised financial return and, as another example, in the group of (potential) employees a firm might have a reputation with regard to its attractiveness as an employer. Indeed, a firm might even have even more reputations within one single stakeholder groups: for example, a firm might have a reputation with regards to the quality of its products offered and another with regards to the quality of its customer service. NGUYEN and LEBLANC refer to this fact by stating that a "firm can have multiple reputations defined to each combination of attribute and stakeholder"[440]. However, we assume – as a simplification in our model – that one reputation will develop within each group of actual and potential stakeholders, thus a firm's reputation refers not to one single attribute but to a set of attributes[441]. Every stakeholder group sets its main focus on a particular set of attributes against which a firm's past actions are gauged[442].

Furthermore, we assume — as already outlined — that a stakeholder's individual interest does not have to be limited to these *typical topics of concern*. Instead, stakeholders can have also preferences regarding the way a firm behaves towards other stakeholder groups to which the particular stakeholder does not belong. For example, a customer may not only be interested in its typical topics of interaction (thus, the promised benefits

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[438] BROMLEY, 2002, 36; Similar FOMBRUN and SHANLEY: "A theoretical articulation of reputation as a construct should therefore anticipate the multiple economic and noneconomic criteria different constituents are likely to apply in assessing firms" (FOMBRUN/ SHANLEY, 1990, 234).

[439] CARUANA, 1997, 109-110: "Just as firms have a multitude of publics they also have an array of reputations each public often considers a different set of attributes".

[440] NGUYEN/ LEBLANC, 2001, 228.

[441] HELM, 2007, 58.

[442] HELM, 2007, 58.

of a product or service) but might also have preferences and objectives regarding the way the firm behaves towards its employees, for instance, not wanting any child labor to be involved in the production of the good the customer wishes to purchase. Labor conditions being a *typical* topic of interactions between a firm and its employees (or involved unions or NGOs), the reputation of a firm within the other stakeholder groups can provide information as to whether the firm will behave in future according to the customer's preferences (no child labor) and therefore become important for his decision making process on whether to interact with that firm (thus buy the product) or not.

In summary, we assume that there is a *primary reputation* for each stakeholder group according to the major, primary subject of the firm-stakeholder interaction as defined by the stakeholder approach. Furthermore, we assume at the same time that stakeholders can have preferences regarding the behavior of a firm towards another stakeholder group – thus, the primary reputation of a firm in another stakeholder group, to which a stakeholder does not belong, is of importance for the latter's decision making process.

As to the question whether there is one single aggregated corporate reputation, we therefore assume that there might exist such a single reputation only where a firm's reputation in each of the stakeholder groups is consistent, thus if all of its actions are constantly perceived as positive or negative. However, there is evidence that there are spillover effects from a firm's reputation in one stakeholder group to another, especially if the reputation in the other stakeholder groups is a weak signal due to a low level of exchanged information about experiences with the firm's actions and thus a reputational vacuum exists.[443]

Furthermore, it seems reasonable and indeed is a logical consequence of the above-said, to assume that a firm‘s reputation within one stakeholder group can dominate the perception within all stakeholder groups – and thus have a particularly strong weighting – if the topics of interactions in this group are of high importance for several other stakeholder groups[444], particularly if the information of different stakeholder groups is exchanged by information intermediaries with a broad audience.

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[443] COLE and KEHOE develop a model of reputation in which an actor's misbehavior in one arena tarnishes its reputation in a different arena, thus, as they state: "At an intuitive level, the basic idea here is that if someone is thought to be sleazy or untrustworthy in one relationship, the person will be thought of as likely to be sleazy or untrustworthy in other relationships" (COLE/ KEHOE, 1996, 17); SJOVALL/ TALK, 2004, 270.

3.3 Role of Reputations Regarding Stakeholders' Expectations towards Firms' Behavior

Firms' reputations provide – based on other people's experiences – information about their likely future behavior and thus about the characteristics of the products and services provided by them[445]. The basic mechanism for this informative character of firms' reputations is, as already discussed, the extrapolation principle.[446] Therefore, the requirements of the extrapolation principle – exchange of information between those who have experience and those seeking reputational information – as well as the requirement for a firm's reputation to emerge, in the form of reported consistent behavior, have to be fulfilled.

A firm's reputation leads to the development of stakeholders' expectations about the future behavior of the firm.[447] As just discussed, this information can be related to particular areas or subjects of actions according to the different primary topics of interactions between a firm and its different stakeholder groups. Due to the extrapolation principle, a firm is expected to behave consistently with its reputation – the same patterns of behavior that have been observed and communicated in the past by others are expected to occur again[448].

Where the information transmitted by a firm's reputation is in accordance with a (potential) stakeholder's preferences and objectives, a firm's reputation can serve as the base for the decision to interact with that firm, whether that means to purchase a product, to invest in it or to start working for it.

The more a stakeholder's decision whether or not to interact with a firm relies on reputational information – e.g. in the absence of personal experiences or other sources of information, particularly in cases of strong information asymmetries – the more a stakeholder is assumed to expect reputation-consistent behavior.[449] In these cases a firm's reputation serves as *the information* about the likely future behavior of that firm and therewith as *the* informational base for a stakeholder's decision to interact with that firm.[450]

[444] Wartick, 2002, 378; Caruana, 1997, 109-110.

[445] Tennie/ Frith/ Frith, 2010, 1.

[446] Shapiro, 1983, 659-661; Sandberg defines firms' reputations as "the consensus of perceptions about how a firm will behave in any given situation" (Sandberg, 2002, 3).

[447] von Ungern-Sternberg/ von Weizsäcker, 1985, 532; Mahon, 2002, 423: "Stakeholders [...] develop expectations as to how the firm will act in a given situation"; Nguyen/ Leblanc, 2001, 233.

[448] Wilson, 1985, 28; von Weizsäcker, 1980, 412.

[449] Spremann, 1988, 613; Vendelo (1998).

[450] Büschken, 1999, 1; Yoon/ Guffey/ Kijewski, 1993, 218.

Therefore, a firm's reputation within the different stakeholder groups is an important determinant of stakeholders' expectations regarding the firm's likely future behavior, both towards the stakeholder itself and other stakeholder groups[451]. Particularly in an information setting characterized by a high level of informational constraints, the role of firms' reputations as to stakeholders' expectations can be argued to increase significantly as it provides information for those without their own experiences, thereby helping to overcome informational constraints[452].

3.4 Summary and Conclusion

The objective of this section was to explain how a firm's reputation affects stakeholders' expectations regarding the future behavior of the firm.

We have seen that – even in the absence of a generally accepted theory of reputation – there are some mechanisms that are seen as inherent to reputation, such as that reputation is made up by information about a firm's past actions (3.1).

Furthermore, we introduced some of the underlying mechanisms of reputation: firms' reputations play a central role in imperfect information settings; the formation of reputations relies on the exchange and diffusion of other people's experiences with a firm in the past; furthermore, the exchanged information has to refer to the stable and consistent behavior of the firm in order for a reputation to emerge. Additionally, we argued that reputation does not only refer to (positively) "valued" but to both favorable and unfavorable characteristics attributed to a firm, and that a firm can have multiple reputations with different stakeholder groups, depending on the primary interests and topics of interactions attributed to the stakeholder groups (3.2).

Finally, we have shown that firms' reputations can affect stakeholders' expectations regarding the future behavior of firms. Due to the extrapolation principle, stakeholders expect forms of behavior that have been observed in the past to occur again in the future: the higher their reliance on reputational information for their decision whether or not to interact with a potentially counterpart, the more likely stakeholders are to expect reputation-consistent behavior in the future (3.3).

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[451] Yoon/ Guffey/ Kijewski, 1993, 215.
[452] Helm, 2007, 51.

4 Summary and Conclusion

The objective of part II of this chapter was to understand how (potential) stakeholders develop expectations regarding a firm's behavior and what role a company's reputation plays in this process, based on the assumption that reputational loss occurs if the observable effective behavior deviates from the behavior expected by stakeholders.

We have seen that the question about with whom to interact is essential in any market: people have to make decisions and choices out of a variety of different alternatives. The result of such a decision making process is that an individual forms expectations about the future behavior of a (potential) counterpart. These expectations serve as a basis for the decision whether or not to interact with a potential counterpart. We have seen furthermore that individuals would not face any problems in making decisions with regard to the future behavior of their (potential) counterparts if they would know all the relevant aspects of its environment and have the ability to process that information. However, due to the cognitive limits individuals face in processing information and due to the resulting information asymmetries, people have to make decisions under uncertainty: they are faced with a number of informational uncertainties regarding the future behavior of their (potential) transaction partners and the characteristics of the goods and services provided by them. The endogenous uncertainties, thus those in the sphere of influence of the partners involved, are of interest regarding the development of stakeholders' expectations (1).

Moreover, we have seen that people, being faced with uncertainty, can generally rely on direct or indirect experiences in order to ascertain whether the likely future behavior of their (potential) counterparts is in accordance with their preferences and objectives. This holds both for finding out whether an actor *is* a suitable counterpart and whether a potential counterpart is likely to accomplish the performance promised (2).

In the next section we have discussed how firms' reputations constitute a form of information that is based on other people's experiences and serve as basis for decision making whether or not to interact with a potential counterpart. We have seen that reputation is a mechanism based on the extrapolation principle which is even effective outside of bilateral relations, determining stakeholders' expectations and likely to reduce information asymmetries in incomplete information settings. Firms' reputations emerge if the information exchanged about their behavior refers to consistent and stable behavior

and if the information is communicated and diffused and beyond that perceived as relevant and trustworthy by the information seeking audience. Moreover, we have seen that a firm can have multiple reputations depending on the primary interest and topics of interaction between the firm and its different stakeholder groups. However, we have argued that there is evidence of spillover effects, particularly if the topics of interaction within one stakeholder group are of importance to other stakeholder groups (3).

Based on the finding that a firm's reputation serves as information on which stakeholders base their decisions on whether or not the firm will act according to their preferences and objectives in the future and is therefore an important determinant of stakeholders' expectations regarding firms' behavior, we will now turn to the second requirement assumed to be necessary for reputational loss to occur: the effective behavior of a firm has to deviate from stakeholders' expectations and has to be observable.

III The Occurrence of Reputational Loss: The Observability of Deviating Behavior

In the last section (II) we have looked at the way stakeholders' expectations towards a firm's behavior emerge and develop: a firm's reputation – as well as direct experiences with the firm in the past – plays an important role for stakeholders' expectations regarding that firm's likely future behavior. If reputational information about a firm – i.e., exchanged information about experiences with a firm's past action – is available in a market and (potential) stakeholders base their decisions to interact with the firm on that information, stakeholders expect behavior consistent with this reputation in the future. These expectations can refer to a firm's behavior regarding the primary topics of the stakeholder-firm interactions which concern the stakeholder or a firm's behavior regarding other stakeholder groups if such interactions are of importance for the stakeholder's decision.

Thus, section II dealt with understanding stakeholders' expectations, based on the assumption that reputational loss only occurs if the effective behavior of a firm deviates from its stakeholders' expectations. In this section we turn to the second requirement assumed to be necessary in order for reputational loss to occur: the deviating behavior, being the divergence between expected and effective behavior of a firm, has to be observable by the firm's stakeholders.

Explaining how reputational loss occurs if such a divergence is observable is the last step of our journey through the nature of reputational loss, which had its starting point in the insight that the behavior modifying effect of threatening a firms' reputation is only possible if non-compliance with rules leads to damage to the firm's reputation.

In a first step we highlight the requirement that information about effective behavior of a firm, which deviates from the behavior predicted by its reputations, has to be communicated and be perceived as relevant in order to affect the firm's reputation, and thus for reputational loss to occur (**1**). In a second step, two forms of reputational loss are distinguished: gradual or continuous and abrupt loss of reputation (**2**). In a third step we summarize the findings (**3**).

1 The Delta – When a Firm's Effective Behavior Deviates from its Stakeholders' Expectations

As discussed in the previous section, stakeholders' expectations regarding the future behavior of a (potential) counterpart are mainly based on their own (if existing) and other people's experiences with that counterpart as well as their preferences and the promised performance. Due to the fact that the extrapolation principle plays an important role in decision making, firms are expected to behave according to and consistently with their reputations: the same behavior observed and reported in the past is expected to occur again in the future[453].

If a firm continues to behave in the way "predicted" by its reputation and as long as these experiences are exchanged, the firm's reputation will become stronger due to the increase of similar signals: the newly added signals correspond with the already communicated and reputation forming signals.

However, a firm's behavior can deviate from its stakeholders' expectations. This is the case if a divergence between stakeholders' expectations regarding a firm's behavior and its effective behavior exists. It is evident that the divergence has to be known and communicated in order to have any impact on the firm's reputations. Otherwise, if no information about the deviating behavior is available and accessible, stakeholders will continue to assume that a firm behaves according to its reputation.

Only when information about others' experiences with deviating behavior of the firm is communicated, diffused and perceived as relevant[454], can the divergence have an effect on a firm's reputations. We focus for the purpose of this analysis on cases where the effective behavior of a firm does not fulfill stakeholders' expectations; forms of behavior exceeding expectations are excluded from our analysis.

Let us look at the examples introduced at the beginning of this chapter. First, we can say that as long as no information was exchanged about Shell's behavior as to the disposal of Brent Spar, Shell's reputation was not damaged. From the moment Greenpeace started to report and diffuse information about Shell's actual behavior and its approach to offshore decommissioning, Shell's reputation was being damaged. Deutsche Telekom was facing damage to its reputation once the mass media started to report about other people's experiences with Deutsche Telekom, being that a private security firm was

[453] VON WEIZSÄCKER, 1980, 412.

[454] See Chapter two/ B/ II/ 2/ 2.2.

commissioned to scrutinize the telephone records of members of Deutsche Telekom's supervisory board and several business journalists. UNICEF Germany was assumed to be an exemplary NGO, as all information exchanged about UNICEF's activities continuously increased the number of signals stabilizing its reputation. The information of a former employee – that was exchanged through the mass media – made the effective behavior observable and thus caused damage to UNICEF's reputation.

2 Occurrence and Forms of Reputational Loss

Why and how does reputational loss occur? We have seen in the previous sections that a firm's reputation emerges, develops and strengthens if consistent information, signals, is exchanged about people's experiences with the firm's past actions. Indeed, we have seen that if there are no consistent signals no reputation will be formed. But what happens if, after a period of stable and consistent signals, other deviating signals are exchanged? We introduce and distinguish two forms of reputational loss: gradual, continuous (**2.1**) and abrupt loss of reputation (**2.2**). It is important to stress that – according to the finding that a firm can have multiple reputations – the two different forms of reputational loss can occur in each of the different arenas of interactions between a firm and its stakeholders and can have spillover effects.

2.1 Gradual, Continuous Loss of Reputation

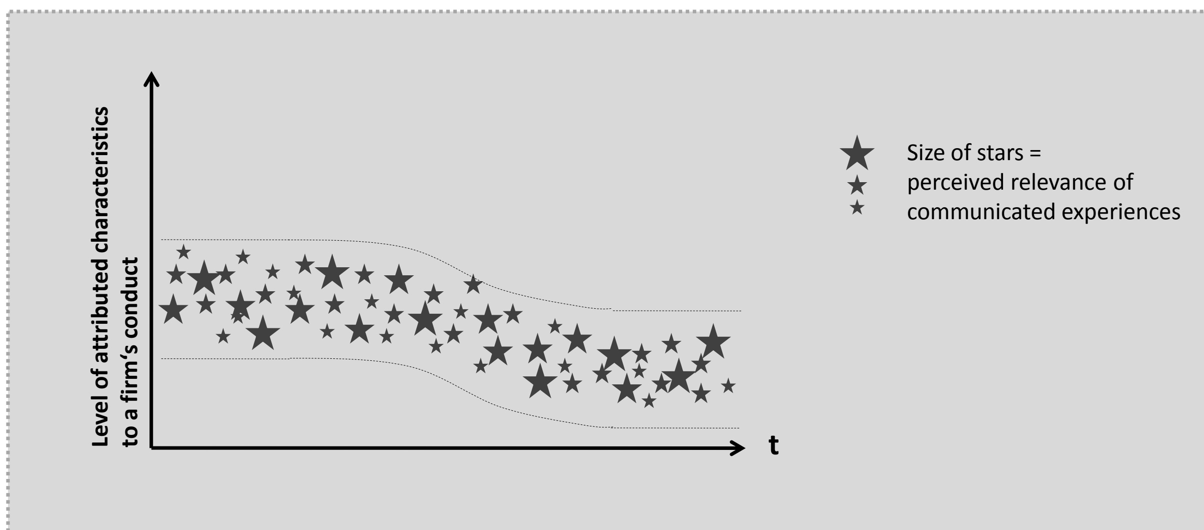

Figure 10: Gradual Loss of Reputation

If the reported experiences with a firm's actions deviate only gradually, but constantly, from the former reputation-forming experiences, we assume a firm's reputation will

decline gradually. If the communicated signals indicate a continuously declining ability of the firm to act according to its stakeholders' expectations, the firm's reputation will either fade away[455] in the long term or stabilize at a lower level.

Typical examples of such gradual loss are cases in which a firm's product quality is perceived as declining constantly as the provided product(s) and the related services, such as after sales service, do not meet the expectations of the firm's customers as in previous periods. If the newer reported experiences with a firm's actions (thus, the product) deviate only to a minor degree, the available signals in a market will show a sufficient degree of homogeneity in order to be interpreted as consistent, but at a lower level.

2.2 Abrupt Loss of Reputation

The second form of reputational loss is not gradually, but abrupt. There is a significant discrepancy between stakeholders' expected behavior (based on a firm's reputations) and the effective, newly reported actions of a firm. The consequences of experiences with a firm's actions, communicated either directly or indirectly, that deviate significantly from the former reputation-building information can likewise be significantly more drastic. Indeed, a firm's reputation can be lost at a stroke[456].

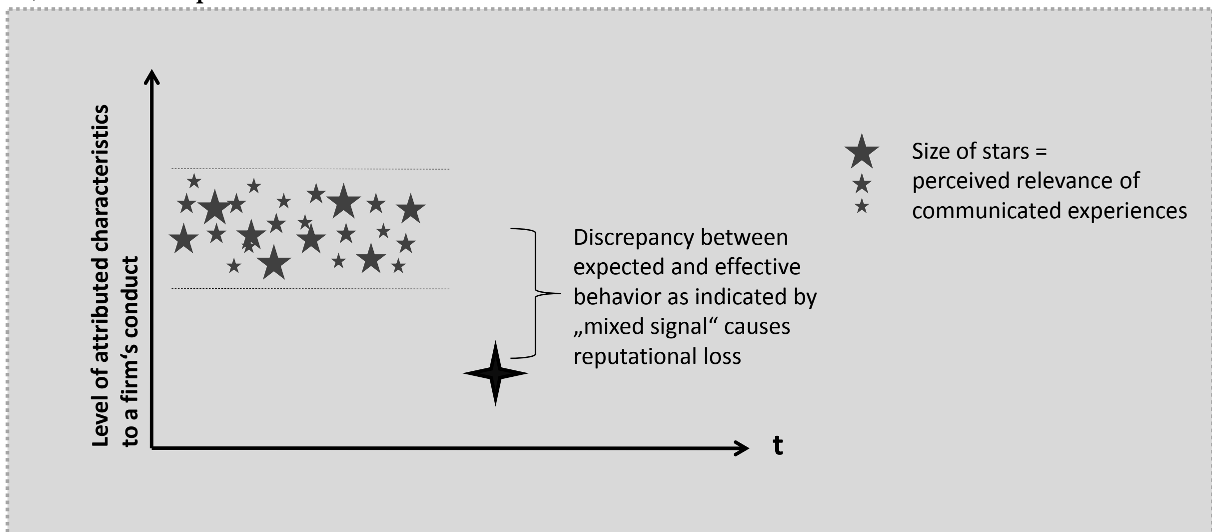

Figure 11: Abrupt Loss of Reputation

This effect causing reputational loss or damage is due to the vulnerability of firms' reputations to mixed signals:[457]

455 Davies/ Chun/ da Silva/ Roper, 2003, 122.
456 Dolphin, 2004, 4.
457 Nguyen/ Leblanc, 2001, 229.

> The building of a good reputation needs many good transactions over time, while its destruction can be easily caused by mixed signals to markets or a bad action directed at a particular group.

Mixed signals, indicating a considerable and significant discrepancy between the hitherto reported and the currently communicated signals, can damage a firm's reputation within short time. Empirical and anecdotal evidence confirm the damaging effect a single or a few sequentially reported experiences can have on a firm's reputation[458]. Furthermore, there is empirical evidence – in the case of negative user feedback on eBay – for the so-called *stoning effect*: one negatively deviating signal increases the probability that others will be inclined to "cast another stone"[459] at a firm already facing damage to its reputation.

The facts that one single event (causing mixed signals) can cause significant reputational loss and that rebuilding reputation is a long-term mission, as firms' reputations only emerge if the information exchanged refers to consistent experiences with them, is inherent to reputations and also explains the already discussed perception of reputational loss by corporate management: a firm's reputation is constantly in danger as one single event can cause it major damage[460].

3 Conclusion

In summary, reputational loss occurs if there is an observable divergence between the behavior of a firm as predicted by its reputation and its effective behavior. While consistent "signals" strengthen firms' reputations, exchanged signals deviating from the reputation-forming signals lead to reputational loss that can be either gradual or abrupt depending on the discrepancy between the firm's behavior as "predicted", thus expected, and its actual behavior. This finding stresses the requirement of *effective information exchange*: only if other people's experiences with a firm's deviating behavior can be communicated and diffused or spread, and are furthermore perceived as relevant (trustworthy), can reputational loss occur.

These requirements being fulfilled, mixed signaling – indicating a significant discrepancy between expected and actual behavior – can damage a firm's reputation within a short time. This fact enhances the deterrent effect of threatening firms' reputations as a regulatory instrument.

[458] Khopkar/ Li/ Resnick (2005).
[459] Khopkar/ Li/ Resnick (2005).
[460] See chapter two/ A/ II/ 2.

IV Summary and Conclusion of Part B

Based on the idea of using firms' reputations as a tool to achieve behavior modification by means other than formalized direct sanctions, the objective of this chapter is to identify those necessary requirements or conditions that have to exist in order for firms' reputations to be used as a regulatory tool.

The starting point of Part B was the assumption made (in Part A) that the behavior modifying effect of threatening a firm's reputation is only possible if non-compliance with rules, whatever their nature, leads to damage to or loss of a firm's reputation, and if this damage to a firm's reputation results in the occurrence of reputational costs.

The objective of this part was to explain under which conditions *reputational loss* or damage does generally occur. The following analysis was based on the assumptions that reputational loss occurs under two conditions: firstly, if the effective behavior of a company deviates from its stakeholders' expectations regarding the firm's behavior towards the particular stakeholder itself and towards other stakeholder groups; secondly, if this divergence between stakeholders' expectations and actual behavior is observable, reported and diffused. These assumptions provided the structure of our proceeding:

In a first step (I) we introduced the stakeholder approach, taking the stakeholder as the basic unit in order to understand a firm's environment. This approach highlights that each of the different stakeholder groups has *primary topics of interactions* with a firm: financiers are interested in the financial performance, customers in the benefits or characteristics of a product or service, employees in the attractiveness of the firm as an employer. At the same time the stakeholder approach stresses that the interactions and interest of the different stakeholder groups do not have to be limited to these areas of interest.

In a second step (II), based on the finding that a firm's environment can be described as relations between the firm and its stakeholders, we switched to the perspective of stakeholders, asking how (potential) stakeholders develop expectations regarding a firm's likely future behavior and what role the firm's reputation plays in this process. We have seen that the question of with whom to interact in order to meet someone's preferences and objectives is essential in any market: people have to make decisions and choices out of a variety of different alternatives. *Expectations about the future behavior of a (potential) counterpart serve as a basis for the decision whether or not to interact with*

a potential counterpart. We have seen, furthermore, that due to bounded rationality (the cognitive limits individuals face in processing information), opportunism and the resulting information asymmetries, individuals have to make decisions under uncertainty. Individuals face a number of informational uncertainties regarding the future behavior of their (potential) transaction partners and the characteristics of the goods and services provided by them. Being faced with uncertainty, people can generally rely on direct or indirect experiences in order to ascertain, i.e. building expectations based on the extrapolation principle, whether the counterpart is likely to behave in accordance with their preferences and objectives. We have seen furthermore that reputation, embodying other people's experiences, is a form of indirect experiences that can serve as a basis for deciding whether or not to interact with a potential counterpart. *Reputation is, again based on the extrapolation system, a way to predict the likely future behavior of a firm by inferring from its past actions*. Firms' reputations are particularly relevant for stakeholders' decisions whether or not interact with the firms in settings that are characterized by significant information asymmetries, and for individuals who do not have their own experience with a potential counterpart. Furthermore, we have seen firms' reputations only emerge if the information exchanged about their behavior refers to consistent and stable behavior, if the information is communicated and diffused, and beyond that perceived as relevant and trustworthy by the information seeker.

In a third step (III), based on the finding that a firm's reputation – besides their own experiences and the performance promised by the potential counterpart – plays an important role for stakeholders' expectations regarding the firm's future behavior, we turned to the question of how reputational loss occurs. We came to the conclusion that reputational loss occurs if there is an observable divergence between the behavior of a firm as predicted by its reputation and its effective behavior. Depending on how significant is the discrepancy between the reputation-forming and the newly reported deviating signals, reputational loss can be gradual or abrupt. Furthermore, the role of the communication of mixed signals in causing reputational loss highlights the role of an effective information exchange as mixed signals can damage a firm's reputation within short time.

In order to answer the question raised at the beginning of this part and thereby sum up the insights gained in this part, reputational loss will generally occur if information about a firm's effective behavior (other people's experiences) is communicated and diffused

successfully, is furthermore perceived as relevant, and affects areas of interaction that are important to a firm's stakeholders' preferences and objectives, indicating that a firm's actual behavior significantly deviates from the behavior predicted by and extrapolated from its reputation.

C The Nature of Reputational Costs

We are discussing the capacity of threatening firms' reputations as a regulatory tool. In Part A of this chapter, we argued that targeting and threatening firms' reputations has the general capacity to modify firms' behavior. We concluded – according to deterrence theory – that threatening a firm's reputation as a tool to achieve compliance with rules, whatever their nature, is only effective if the expected costs to the firm of suffering loss or damage to its reputation will probably outweigh the expected benefits from the reputational-loss-causing behavior.

We have therefore argued that the probable occurrence of a large negative financial impact on firms' businesses – referred to as the occurrence of reputational costs – as a result of potential damage to a firm's reputation is a requirement to achieve the behavior modifying, and thus constraining, effect of threatening firms' reputations.

Based on these findings we outlined that an understanding of why reputational loss occurs and under which circumstances *reputational loss* leads to the occurrence of *reputational costs* is essential in order to analyze the conditions that have to exist in order to use threatening of firms' reputations as a regulatory tool.

In Part B of this chapter, we gained insights with regard to the question of under which conditions reputational loss occurs. Firms will generally experience damage to or a loss of their reputations if information about their behavior (thus, other people's experiences) is communicated and diffused successfully by trustworthy actors, indicating that a firm is not behaving as predicted by or extrapolated from its reputation. This is the case where there is a significant discrepancy between the former reputation-building signals that have been communicated before and the newer reported experiences. In cases in which the effective behavior of a firm deviates from its stakeholders' expectations (regarding the firm's behavior either towards the particular stakeholder itself or towards other stakeholder groups) and this divergence between predicted behavior and effective behavior is observable (thus reported and diffused), reputational loss will occur.

It is the objective of this Part C to explain the conditions under which reputational loss causes or leads to reputational costs, thus which effect a damaged reputation has on a firm's business. This part will underline that the regulatory potential of firms' reputations relies on dispersed mechanisms, as only the *response* of a firm's potential and actual stakeholders to reputational loss determines whether reputational costs will occur – or whether they will not.

In a first step, we will see that reputational costs occur if a firm's reputations play a significant role in its potential and actual stakeholders' decisions to interact with that firm (**I**). In a second step, we will show that reputational loss only has a negative monetary effect on a firm's business if potential and actual stakeholders of the firm are *inclined* to react to information about the firm's effective behavior, thus if the deviating behavior concerns some of a stakeholder's preferences and objectives. Furthermore, as a second requirement, we will show that potential and actual stakeholders do not only have to be willing to sanction the deviating behavior of a firm, but that they have to be *capable* to do so in order for reputational costs to occur (**II**). In a third step, we will summarize the results (**III**).

I Reputational Costs only Occur if Firms' Reputations Serve as Base for Decision Making

In Part B, we discussed the role of firms' reputations as the basis for developing expectations regarding the firms' future behavior and we saw that firms' reputations, incorporating other people's communicated and diffused experiences, can serve as an important basis for stakeholders' decisions whether or not to interact with firms. We have furthermore argued that firms' reputations will play an increasingly important role the less potential stakeholders have direct, thus their own, experiences with a firm's actions. The more distinctive the information asymmetries, the more significant the role firms' reputations play for predicting or indicating whether a firms' future behavior is likely to be in accordance with the preferences and objectives of the (potential) stakeholder, and therefore for the decision whether to interact with a firm or not[461].

This function of firms' reputations to serve as a basis for decision making is what composes the value of firms' reputations: it is the signaling power of reputations indicating certain characteristics of firms' likely future behavior which – in the absence of full and perfect information – substitute for fact[462]. If potential stakeholders base their decisions to interact with a firm, whether that means for example to purchase a product or to invest into a company, on that firm's reputation, the firm's reputation will consequently become of high importance and value to the firm.

This highlights that a firm's reputation for acting in certain ways that are not in accordance with its (potential) stakeholders' preferences (as well as reputational loss due to mixed signals) can have negative monetary effects on a firm's business. Customers might decide not to purchase a product as the behavior that is predicted by the firm's reputations is not consistent with the customers' preferences, regardless of whether the behavior refers to the primary topic of the firm-stakeholder interaction (e.g. the characteristics of a product) or to the primary topic of *another* firm-stakeholder relationship that is of importance according to the stakeholder's preferences (e.g. a reputation for exploiting employees). If the affected behavior is of importance for the customer's decision to interact with that firm, the behavior predicted by the firm's reputation will prevent the transaction.

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461 Spremann, 1988, 613; von der Crone, 2000, 261.

462 Research Proposal of the Oxford University Centre for Corporate Reputation available at <http://www.sbs.ox.ac.uk/centres/reputation/research/Pages/4ReputationandSignalling.aspx>, accessed on January 16, 2011.

It is this characteristic that makes reputation matter for firms' decision making[463]. The *current* actions of a firm can affect potential stakeholders' *later expectations* and choice of action, thus creating an incentive for firms to trade off the *immediate short-term* consequences against the *long-term effects* of their actions on their reputations and thereby on their business[464]. TADELIS summarizes this context: "The effects of current performance on future payoffs are central to the economics of reputation"[465].

The characteristic of firms' reputations to serve as an important basis for the decision whether or not to interact with a firm highlights why firms' reputations can be of value to them in the long-term. However, this does not hold for all firms. In case, for example, a company does not plan to stay in the market for a sustained period of time there is no need to trade-off possible *short-term gains* against their *long-term effects* on the firm's reputation as the latter will not affect the future performance of the firm[466].

Regarding our question under which circumstances reputational costs occur as a consequence of damage to firms' reputations, we can now understand that the *reaction* of potential and actual stakeholders to a loss of reputation is essential for the occurrence of reputational costs.

The reasons why potential and actual stakeholders might or might not react to reputational loss and the deciding factors for this possible reaction will be discussed in the following sections.

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463 WILSON, 1985, 27: "the essential requirement for a player's reputation to matter for his current choice of action is his anticipation that his later decisions will be conditioned by his later reputation".

464 WILSON, 1985, 59.

465 TADELIS, 2002, 854.

466 OFT/ ARMSTRONG, 2008, 11.

II Stakeholders Have to Be Willing and Able to React to Reputational Loss

The reaction of potential and actual stakeholders to reputational loss is the central requirement for the occurrence of reputational costs. Hence we will now turn to the factors determining why, whether and how firms' stakeholders react and thereby sanction deviating behavior.

In a first step, we further clarify what is understood as reputational costs (**1**). In a second step we will show that, as a first requirement, potential and actual stakeholders have to be willing to react to reputational loss (**2**). In a third step, we argue that being willing is not a sufficient requirement, but that potential and actual stakeholders furthermore have to be able to react (**3**).

1 Reputational Costs – A Definition

In Part A we have, as a preliminary definition, defined reputational costs as "the costs a firm faces in case of damage to its reputation"[467]. However, it seems to be reasonable to clarify and specify the different forms of costs that might occur as a result of reputational loss. Reputational costs, in our understanding, refer to costs that are caused by *the reaction of a firm's actual and potential stakeholders to reputational loss*. They particularly do neither include the financial penalties imposed by state or other authorities (such as administrative fines) nor the direct costs caused by resolving the reputational loss causing circumstances. Instead, reputational costs refer to the costs caused by dispersed mechanisms in the form of aggregate decisions of a firm's potential and actual stakeholders that have an impact on a firm's actual and future business.

Let us look at the examples of Part A in order to highlight this distinction: Shell had to invest additional millions for towing Brent Spar to Norway and using it as the base of a new quay instead of sinking Brent Spar on the North Atlantic seabed. These costs are direct costs. The costs caused by the reaction of Shell's actual and potential stakeholders (for instance the boycott of Shell's service stations and the loss of political support) are what we refer to as *reputational costs*. The administrative fines imposed by the Berlin authorities on restaurants violating hygiene standards are direct costs, while the decreasing revenues of badly rated restaurants constitute reputational costs[468].

[467] See chapter two/ A/ III.

[468] This differentiation is according to MACRORY's distinction between financial penalties and reputational sanctions and GUZMAN's distinction between direct sanctions and reputational sanction in public international law, arguing that reputational sanctions are characterized by their impact on the future relationships of a government (GUZMAN, 2002, 1849-1852).

2 Stakeholders Have to Be Willing to React

Why should stakeholders react to the damage to firms' reputations? We have already identified that firms' reputations play an important role in the decision making of stakeholders. People will only be inclined to react to reputational loss, if the deviating behavior affects an area of interaction that is of importance for stakeholders' decisions to interact with that firm. To put it differently, if actual stakeholders had known about the actual behavior of a firm, they would not have interacted with that firm as its behavior is not consistent with the stakeholders' preferences and objectives.

It is important to highlight that this holds both for potential *and* actual stakeholders. Firms' reputations can continue to play a role for an actual stakeholder as his or her own experiences from having interacted with the firm do not have to replace the need to rely on the firm's reputation. This can be the case if the information asymmetries continue to exist after the transaction has taken place due to the character of a good or service, or if the deviating behavior of a firm takes place (thus, reputational loss occurs) in an arena of interaction that is not the primary interest of the respective stakeholder.[469] In both cases a firm's reputation continues to be an important source of information in order for actual stakeholders to decide whether to repeat an interaction or not, as the information asymmetries persist *ex post*.

The examples given in Part A highlight that a firm can have many reputations and that spillover effects exist: the approach of Shell to offshore decommissioning in particular and conducting its operations in general was apparently of importance to German consumers of one of its products: gas, although the two areas of action of Shell that were not closely linked to each other. However, Shell's actions in one arena and the resulting reputational loss affected its business in another arena, leading to a loss of market share in Germany. At the same time we can observe that Shell's approach to offshore dismantling was apparently not of great importance to another group of stakeholders, its shareholders. Shell's share price was only marginally affected: during the climax of

[469] An example of the former form of hidden action is that the good or service in question is a "credence good", so that the consumer will not be able to judge the quality of a product or service even after he or she has experienced the product or service. Three different types of goods and services can be distinguished as to the role of reputation: firstly, "search goods" are goods whose features and characteristics can be generally evaluated before purchase; secondly, "experience goods and services" are those whose characteristics are difficult to observe in advance, but easily observed after consumption, for example, the work of a hairdresser, whose quality is difficult to assess before it is done, or the quality of after-sales customer care; thirdly, "credence goods and services" are those whose utility impact is difficult or impossible for the consumer to ascertain even after consumption: for example, how well a surgeon has conducted a surgical operation, see OFT, 2009, 15-19; SCHÄFER/ OTT, 2004, 466.

the conflict between Shell and Greenpeace – when Greenpeace supporters started to leaflet service stations and motorists at over 300 locations throughout Germany while Shell started to tow Brent Spar to the deep sea – the share price declined by around five per cent (see Figure 2).

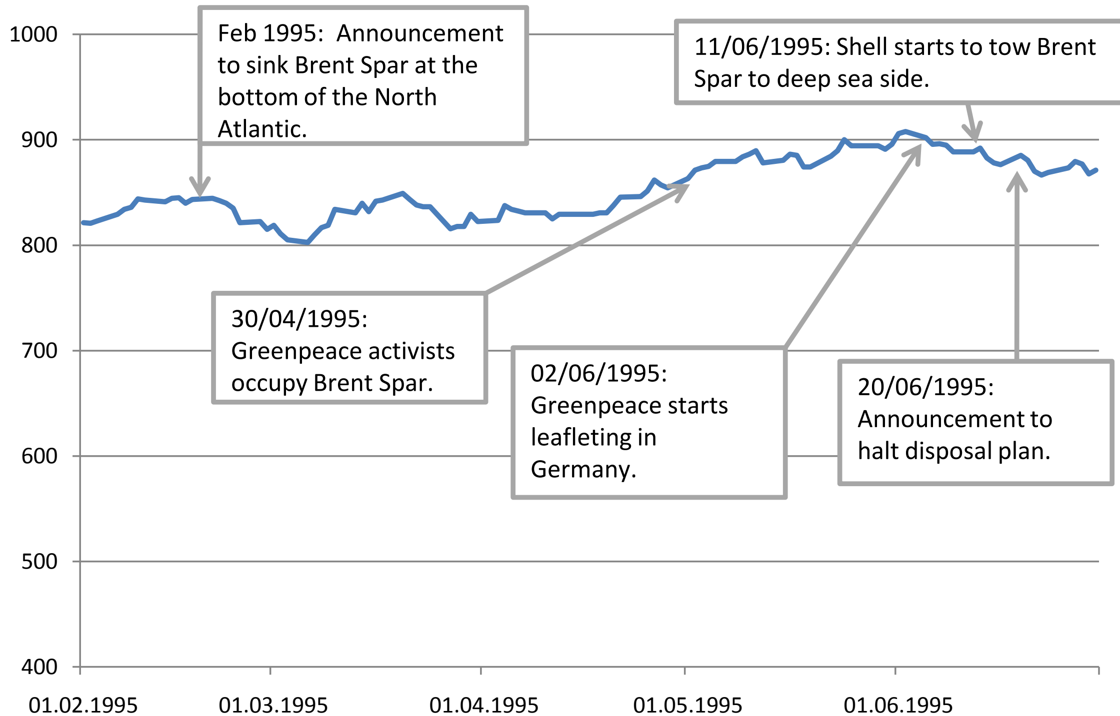

Figure 12: Shell's Share Price 01.02.1995 - 30.06.1995

The handling of donations by UNICEF is – from a donor's perspective – comparable with a credence good or service. It is a typical principal-agent conflict and an example of moral hazard: UNICEF's donors, regarding the use of their donations, primarily have to rely on information published by UNICEF. This fact explains the significant effect of the damage to UNICEF's reputation on donors' behavior: the information about deviating behavior was of great importance to them as it affected forms of behavior that were not observable for them. At the same time, we can assume that the reputational loss in the arena of "handling donations" did not have any effect on other stakeholders of UNICEF, e.g. its suppliers.

The fact that firms' reputations are a basis for deciding whether or not to interact with a firm underlines that reputational loss can not only affect repeated interactions, such as repeated purchases of a good, but also, or rather particularly, affects the decisions of prospective stakeholders to interact with a firm. Either a stakeholder might realize that a firm – according to its reputation – will not behave or is not behaving according to its preferences and objectives, or a firm's damaged or lost reputation will no longer serve

him or her as a basis for decision making due to mixed signals. The difference is that the effective behavior of a firm will be known to the prospective stakeholder before the transaction has taken place, thus *ex ante*. It seems reasonable to assume that not only regular customers stopped to fueling their cars at Shell's gas stations in Germany, but also potentially new customers decided not to visit Shell's gas stations. The same holds for UNICEF Germany as to potential donators.

3 Stakeholders Have to Be Able to React

However, being willing either to stop interacting with a firm (thus, for example stop buying its products as a customer or stop investing in a company) or not to start interacting with it as a new stakeholder as a reaction to reputational loss is only the first requirement for reputational costs to occur. However, this alone is not sufficient. Instead, we will show that prospective and actual stakeholders have to be *able* to *react* to reputational loss. Thus, they need to have the potential to react and to sanction a firm's behavior that deviates from their expectations in order for reputational costs to occur.

We have seen that dispersed mechanisms in form of aggregate decisions of a firm's potential and actual stakeholders cause reputational costs, *thus it is the reaction of firms' stakeholders to reputational loss that composes the behavior modifying potential of threatening a firm's reputation*. Reputational sanctions rely on dispersed mechanisms. This characteristic distinguishes reputational sanctions from direct sanctions, such as state-imposed penalties. Furthermore, it is *this* effect that is essential for reputational mechanisms to be an effective regulatory tool and it is therefore central to the idea of threatening firms' reputations in order to achieve (or avoid) certain forms of firms' behavior[470].

What are the factors determining whether actual and prospective stakeholders have the ability and potential to react? Basic economic insight suggests that this question depends on mainly two factors, determining whether stakeholders are able to react, and thus to sanction deviating behavior. *Firstly*, there have to be a sufficient number of alternative firms in the market that offer substitute goods or services. *Secondly*, the switching costs have to be low. The former requirement is particularly important for prospective and actual stakeholders, the latter in the first instance for actual stakeholders.

[470] See Macrory, 2006, 83.

The *first requirement* depends on the structure of the market and requires that there are other actors in the market that can be chosen as potential counterparts. These potential counterparts have to be able to satisfy the demands of the respective stakeholders, thus the provided good or service has to be perceived by the stakeholders as a substitution, and have to act in a manner that is in accordance to the preferences and objectives of the (potential) stakeholders. Whether the goods and services provided by other actors are "regarded as interchangeable or substitutable"[471] by the respective stakeholders depends primarily on the particular firm-stakeholder interaction.

The question of the market power of a firm and the definition of relevant markets is particularly discussed in competition policy. The traditional approach of competition policy suggests "to evaluate the market power of firms by analyzing the market in which they operate"[472]. In a first step the relevant product (*which services and products are seen as interchangeable and substitutable*) and geographic market has to be defined, in a second step the market power of the firm in the market is to be defined by assessing the market share.[473] Although this approach is focused on the customer-supplier relationship, its general idea can be applied analogously. For customers the question is whether other firms exist which supply a similar product or service that is able to substitute the product or service supplied by the firm that has suffered reputational loss. For investors, as another example, the question is whether there are similar firms in the market that fit into their portfolio and meet the same requirements as to the expected financial benefits. For employees the question is whether there are other similar firms that offer the same benefits with regards to wages, market position, meaningful work or location. The answers to these questions depend first and foremost on the supply-side structure of the market in which the relevant firm operates and therefore on its market power. It is self-evident, for example, that reputational loss will most probably not matter if a firm has a monopoly in a certain market.

If alternative counterparts are present in the market, the *second requirement* determining potential and actual stakeholders' ability to react to reputational loss is *switching costs*.

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471 Definition of the relevant market according to the notice of the EUROPEAN COMMISSION on the definition of relevant market for the purposes of community competition law, *Official Journal* C 372 , 09/12/1997 P. 0005 – 0013, available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31997Y1209(01):EN:HTML>, accessed on January 17, 2011.

472 MOTTA, 2004, 101.

473 See MOTTA, arguing that a firm's high market share is a strong indicator but not always sufficient to conclude that a firm is dominant in a market (MOTTA, 2004, 117).

Switching costs can be defined as "the real or perceived costs that are incurred when changing supplier but which are not incurred by remaining with the current supplier"[474]. Switching costs can take a variety of forms, "some of which are tangible and quantifiable, and others that may be less easy to observe and measure, but may nonetheless have a similar impact on the market"[475]. Let us look at some forms of switching costs:[476]

- *Compatibility costs* arise out of interactions (such as purchases) that "lock" consumers into purchasing follow-on products. A typical example is where consumers purchase both original equipment and then replacement parts, such as razors and razor blades. Another example is long life-cycle costs of a product, preventing a short-term reaction of stakeholders.
- *Learning costs* occur in situations where an investment (for example, a long-term relationship between a doctor and a patient) would be lost in case the consumer switches the supplier.
- *General transaction costs* arise in situations where changing the supplier generates transactions costs, such as drafting a new contract, or, search costs to find a new counterpart.
- *Contractual costs* are costs that might benefit firms by making customers more loyal, either by getting customers to agree to contract with a certain minimum term (e.g. mobile phone contracts) or by creating schemes that give incentives for repeat purchase by providing discounts (such as frequent flyer programs).

The occurrence of switching costs decrease the probability that stakeholder will be able "to directly punish business"[477]. Let us look once more at the examples given in Part A. Regarding the boycott of Shell's gas stations in Germany, we can conclude that it was easy for actual and prospective stakeholders, in this case customers, to change the supplier of gas. The product itself is supplied by a variety of different firms, it is perfectly homogenous and therefore perfectly substitutable and the switching costs for customers will be close to zero: they just have to fuel their car at a different gas station. The potential to react, thus to sanction, was immense. In the case of UNICEF Germany, donors were able to react, but the circumstances are different. The donors were not locked-in to long-

[474] OFT, 2003, 1.
[475] OFT, 2003, 11.
[476] Examples, see OFT, 2003, 11-14 and Klemperer, 1995, 515-518.
[477] OFT, 2009, 26.

term contracts, but the switching costs might have been significantly higher than in the Shell case: While the search costs that had to be invested in order to find a different organization that was willing to receive donations might have been small, finding a trustworthy counterpart was probably rather difficult and time intensive. The case of Deutsche Telekom has shown that a major share of the firm's customers were willing to change their telecommunications supplier, however, Telekom is an example that highlights the role of high switching costs: most of the clients were locked-in to long-term contracts of one or two years and thus did not have the capacity to react immediately to the reputational loss Telekom was facing.

However, if stakeholders are not able to change the counterpart due to its market power, there is a second possibility how actual stakeholders can react to reputational loss: stakeholders can stop to interact with the respective firm as they might be willing to relinquish a satisfaction of their relevant needs at all. If this second possibility exists, clearly depends on the preference of the stakeholder and the nature of the firm-stakeholder interaction. In the case of UNICEF there is a high probability that some people stopped donating at all – instead of donating to UNICEF.

III Summary and Conclusion of Part C

Starting point of this chapter was the assumption that the occurrence of reputational costs as a result of damage to firms' reputations is an essential requirement in order to achieve the behavior modifying effect of threatening firms' reputations. Based on that assumption, it was the objective of this part to understand the conditions that have to exist in order for reputational loss to cause reputational costs. We have seen that the nature of reputational costs underlines the dispersed and indirect character of reputational sanctions: it is the aggregated reactions of a firm's stakeholders that cause reputational costs.

In a first step, we have seen that the function of firms' reputations potentially to serve as a basis for its (prospective) stakeholders' decision whether to interact with the firm is what can make firms' reputations matter as to firms' decision making processes.

In a second step, we have seen that the area of action in which the firm suffers reputational loss has to be of importance to the firm's stakeholders. This will be the case if the actual stakeholders would not have interacted with that firm if they would have known about the effective behavior of the firm, as the effective behavior is not consistent with the stakeholders' preferences. In a third step, we have argued that, in order for reputational costs to occur, stakeholders have to be able to react. This ability of stakeholders depends significantly on the market structure and the switching costs involved with such reaction.

The reliance of threatening a firm's reputation on the aggregated *reaction* of the firm's stakeholders highlights the dispersed character of this regulatory tool.

D Digital Technologies

We have seen that the potential occurrence of reputational loss and reputational costs determines whether or not threatening a firm's reputations has a behavior modifying effect. We have furthermore shown that reputational loss occurs if information (other people's experiences) about a firm's behavior is communicated and diffused successfully by trustworthy actors, indicating that a firm is not behaving as predicted by its reputation and if the firm's actions affect areas of interaction that are of importance to its stakeholders' preferences and objectives. Furthermore, we have argued that the occurrence of reputational costs depends on the willingness and ability of the firm's stakeholders to react to reputational loss.

In this Part D the objective is to demonstrate that the emergence of digital technologies, particularly the internet, has increased significantly the potential of using the behavior modifying effect of threatening firms' reputations as a regulatory tool. This is due to the *altered information process* that has caused a structural change regarding production, distribution, access and use of information.

We argue that the altered information process increases the possibilities to exchange information about firms' effective behavior (whether deviating or not) efficiently between actual and prospective stakeholders. Moreover, we argue that the altered information process caused by the emergence of digital technologies has an enhancing impact on stakeholders' ability to react to reputational loss due to decreased transaction costs and a greater choice of potential counterparts. Both the enhanced possibilities to exchange information about firms' actions and the decreased transaction costs increase the probability that reputational costs occur.

Part D is organized as follows: In a first step, we demonstrate that the emergence of digital technologies has caused a structural change regarding the way information is produced, distributed, accessed and (re-)used, resulting in the decentralization of information production and distribution, and the establishment of new ways for information exchange besides the established mass media (**I**). In a second step, we demonstrate the impact of the altered information process on the occurrence of reputational loss, arguing that the probability that information about the effective behavior of a firm is exchanged has increased (**II**). In a third step, we turn to the impact of the altered information process on the occurrence of reputational costs (**III**). In a fourth step, we summarize the findings (**IV**).

I Digital Technologies: A Structural Change Regarding the Organization of Information Production

Digital technologies, particularly the internet, have changed the organization of information production in a radical way and have caused a structural change regarding the way people make and exchange information.[478] In order to outline the degree to which digital technologies have emerged within the last decade, we start this section by introducing data highlighting the rise of the internet and cellular mobile telephony (**1**). In a second step, we explain how the information process has been altered by the emergence of digital technologies (**2**). In a third step, we turn to the consequences of these developments for the public sphere (**3**). In a fourth step we summarize the findings (**4**).

1 The Emergence of Digital Technologies: A Short Introduction

In the last centuries there have been several technical developments that have changed radically the way people produce, distribute and access information. In the mid-fifteenth century, Gutenberg's printing machine revolutionized the production and distribution of information by drastically reducing the costs of copying and thereby increasing the scope of information.[479] This was followed by the emergence of new forms of media, such as the telegraph system, and the emergence of powerful radio and later television transmitters.[480] Each of these technological innovations has changed the way people communicate, and thus produce, distribute and receive information.

The latest development is the radical transformation of the information environment by the rise of the internet and cellular mobile telephony. In this segment the aim is to outline the extent to which digital technologies have spread within the last ten years.[481]

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[478] Benkler, 2006, 1.

[479] Palfrey/ Gasser, 2008, 3.

[480] Gillmore, 2004, IX; Benkler, 2006, 3-4.

[481] The source of the data presented in this segment is the ICT Indicators database of the International Telecommunication Union (ITU), the UN agency for information and communication technologies. *Developed countries* include Albania, Andorra, Australia, Austria, Belgium, Bosnia and Herzegovina, Bulgaria, Canada, Croatia, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Latvia, Liechtenstein, Lithuania, Luxembourg, Malta, Moldova, Monaco, Montenegro, Netherlands, New Zealand, Norway, Poland, Portugal, Romania, Russia, San Marino, Serbia, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, TFYR Macedonia, Ukraine, United Kingdom, United States, Vatican.

Let us start with the impressive development of the *number of internet users* from 2000 to 2010.[482] The number of internet users per 100 people worldwide grew from 6.4 in 2000 to an estimated 30.1 in 2010. Indeed, the total number of internet users will have surpassed the two-billion mark at the end of 2010. While the percentage of internet users in developed countries (almost) trebled from 24.6% to an estimated 71.6%, the number of internet users in developing countries increased tenfold from 2.0% to an estimated 21.1% in 2010.

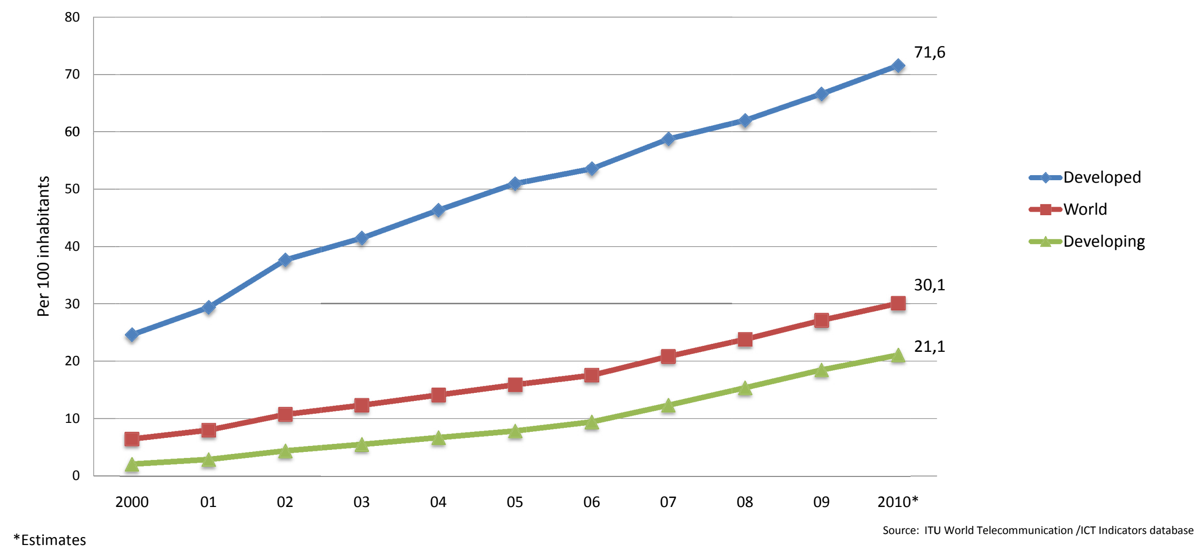

Figure 13: Internet Users per 100 Inhabitants 2000-2010
(Source: ITU World Telecommunication /ICT Indicators database)

One of the driving forces of this trend is the increasing access to broadband technology: the number of fixed broadband subscriptions per 100 people worldwide multiplied on average by more than 20, from 0.3% in 2000 to an estimated 8.0% in 2010. At the same time there is a continuing broadband divide between developing and developed countries: while in both developed and developing countries the number of fixed broadband subscriptions has multiplied within the last ten years, the differences in 2010 remain significant, as there are 24.6 broadband subscription per 100 people in developed countries versus 4.4 in developing countries.[483] One of the major factors contributing to this development is the decrease of fixed-wired broadband prices.

[482] Definitions ICT Indicators according to ITU (2010): *fixed telephone lines*: A fixed telephone line is an active line connecting the subscriber's terminal equipment to the public switched telephone network and which has a dedicated port in the telephone exchange equipment; *mobile cellular telephone subscriptions*: Refers to the subscriptions to a public mobile telephone service and provides access to Public Switched Telephone Network using cellular technology, including number of pre-paid SIM cards active during the last three months; *fixed wired internet subscriptions*: the number of total internet subscriptions with fixed (wired) internet access, which includes dial-up and total fixed broadband subscriptions; *estimated internet users*: the estimated number of internet users out of total population; *total fixed broadband internet subscriptions*: refers to high-speed access to the public internet, at downstream speeds equal to, or greater than, 356 kbit/s.

[483] See MECKEL (2001) on the *digital divide*.

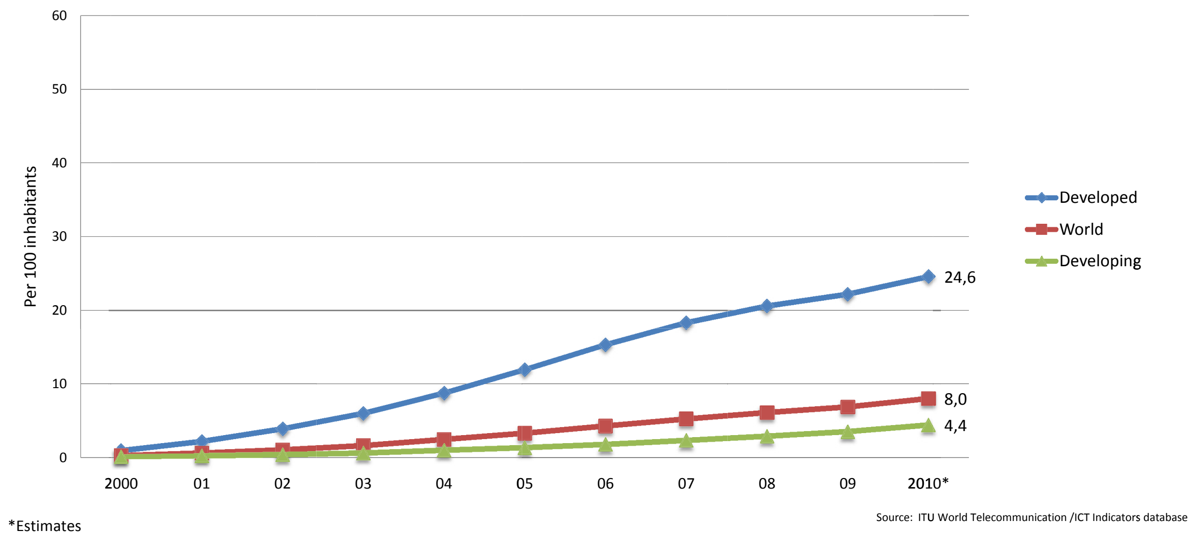

Figure 14: Fixed Broadband Subscriptions per 100 Inhabitants 2000-2010 (Source: ITU World Telecommunication /ICT Indicators database)

Not only has the number of fixed broadband subscriptions increased significantly, but also the number of mobile broadband subscriptions has multiplied to an impressive extent. While mobile broadband was almost nonexistent in 2000, the number of mobile broadband subscriptions per 100 people increased in the developed countries from 1.7 in 2004 to an estimated 51.1 in 2010, while the number of broadband subscriptions on average worldwide has increased to an estimated 13.6 per 100 inhabitants due to a lower growth of subscriptions in developing countries (from 0.2% in 2004 to an estimated 5.4% in 2010).

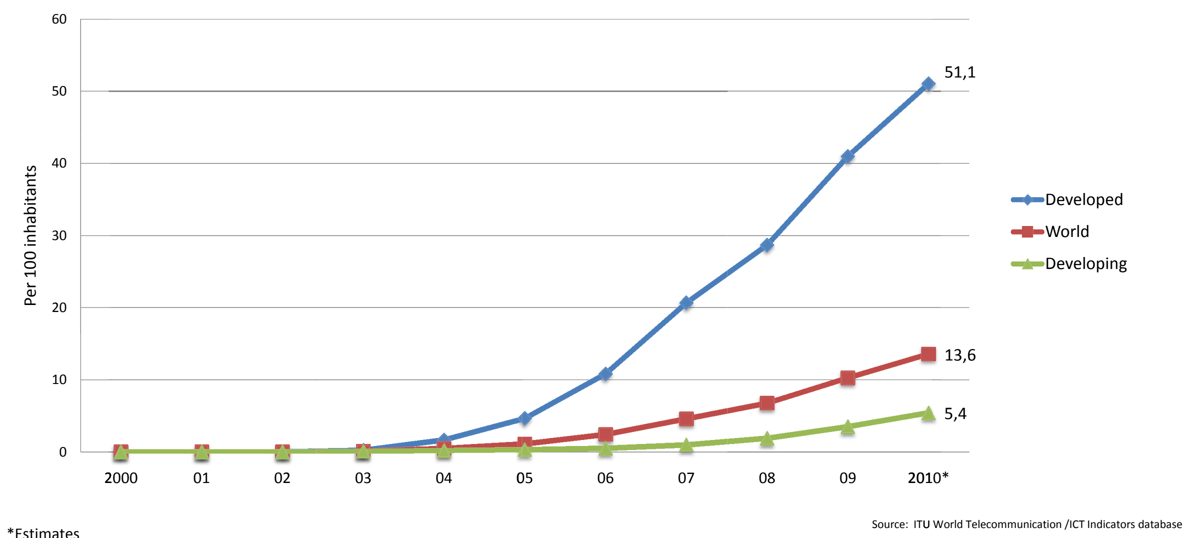

Figure 15: Mobile Broadband Subscriptions per 100 Inhabitants 2000-2010 (Source: ITU World Telecommunication /ICT Indicators database)

This increase of the number of mobile broadband subscriptions would evidently not have been possible without the triumphant success of cellular mobile telephony, another

technology that has had a tremendous effect on the way people communicate. The number of mobile cellular subscriptions per 100 inhabitants worldwide on world average grew from 12.0 in 2000 to an estimated 76.2 in 2010, resulting in a total number of 5.3 billion cellular subscriptions and the fact that 90% of the world population had access to mobile networks as at the end of 2010. This technological innovation has affected both developed and developing countries to a considerable extent: while the mobile telephony market is reaching saturation level in developed countries with, on average, 116 subscriptions per 100 inhabitants in 2010, the number of mobile subscriptions in developing countries is also at an impressive level, with 67.7 subscriptions per 100 inhabitants. At the same time the number of fixed lines is decreasing. Furthermore, the number of SMS (short messages) sent globally has trebled within the last three years (2007–2010), from 1.8 trillion to an estimated 6.1 trillion in 2010.

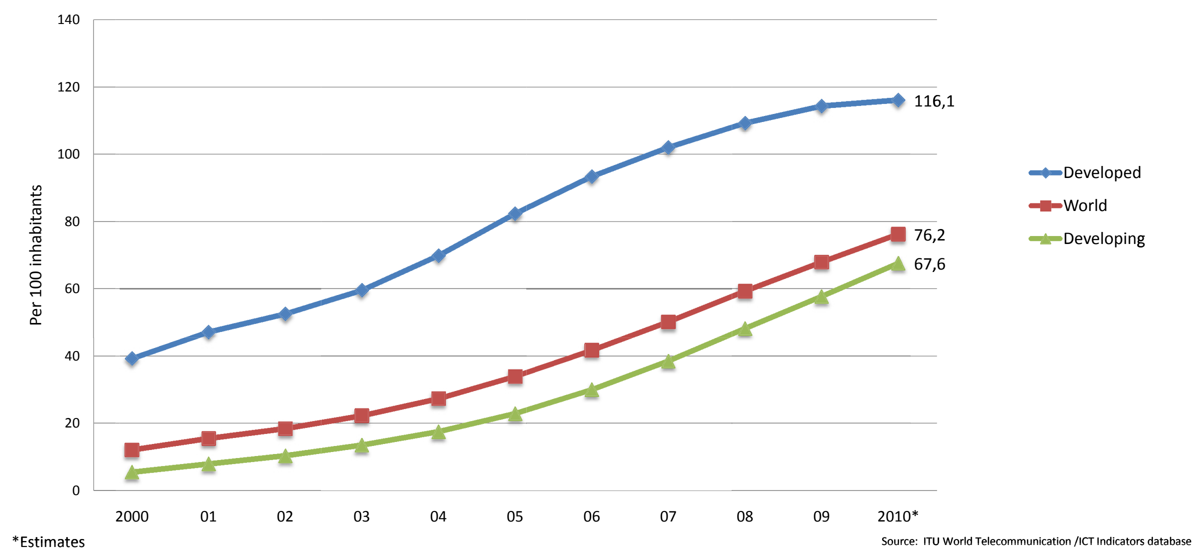

Figure 16: Mobile Cellular Subscriptions per 100 Inhabitants 2000-2010 (ITU World Telecommunication/ ICT Indicators database)

These data highlight the structural technological change that has occurred within the last one to two decades: new platforms and ways to communicate and interconnect people have emerged rapidly on a global scale even if there are significant differences regarding the availability of these platforms and mediums in the developed and developing world.

However, this impressive emergence of new technical possibilities and infrastructures to communicate and share ideas is but the first step. More important and interesting are the effects of these technological innovations on the way people actually use these technologies and the implications of this use on the process of information production, distribution and access. The next segments will illustrate these processes of transformation.

2 An Altered Information Process

Technological change is and only ever has been the precondition for changes in the ways people communicate. In this section, the objective is to show how production, distribution, access to and use of information have been radically influenced by the emergence of the internet and other digital technologies, such as cellular phones. Talking about the "internet revolution" does not seem to be an exaggeration, but rather the right dimension in order to describe the structural changes with regard to the question of how people communicate and exchange information that have been caused by the emergence and success of the internet.[484]

The most striking impact the internet has on the information process is its reliance on networks and the decentralization of the production, distribution, access and use of information, often referred to as the *networked information economy*, a term created by BENKLER. In the following paragraphs we will highlight the implications of this decentralization on the information process.

Let us start with how the *production and distribution of information* has been changed by the emergence of the internet and other digital technologies, such as web-enabled mobile phones.[485] First of all, the so-called networked information economy provides a range of tools – new ones appearing and others disappearing – that allows the production and communication of information in an unprecedented manner.[486] By far the most important tool is the worldwide web as the major platform for individuals to produce and communicate information.[487] It enables people, using different applications, to produce and distribute information to an almost unlimited number of readers. The static web page is the most important tool in order to present basic texts, sound and images that are of importance to individuals and organizations and their positions.[488] The emergence of weblogs has furthermore increased the capabilities of static web sites by enabling readers and those running the blogs to post comments to web sites.[489] This capability enables individuals to use blogs as a form of personal journal, and users to discuss the topics and perceptions in such blogs, communicating to a large number of

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[484] BENKLER, 2006, 1.

[485] See MECKEL/ STANOEVESKA-SLABEVA (2008) for a general introduction.

[486] ELKIN-KOREN/ SALZBERGER, 2004, 55: "The digital-networked-environment fundamentally changes the way information is distributed. It is much easier to copy informational works in a digital form"; OECD (2007).

[487] BENKLER, 2006, 216; OECD (2007).

[488] BENKLER, 2006, 216.

[489] BENKLER, 2006, 217.

readers.[490] Furthermore, "larger-scale, collaborative-content production systems"[491], such as Wikipedia, allow large groups of individuals to discuss and produce positions and opinions. Another important tool that has emerged within the last two decades is the mobile cellular phone, often with camera and increasingly often with access to the worldwide web. By enabling people to send short messages (SMS) and pictures, or to access the internet from any place, these devices have increased the ability of individuals to produce and distribute observations to large groups of people.

Furthermore, social networking sites have emerged on large scale as new ways for people to share personal information online, enabling people to create profiles of themselves and to link these profiles to other people.[492] Facebook.com, as the most popular social network site in 2010, has more than 500 million active users. This means that 25% of all internet users are active Facebook users. Half of the 500 million users log on to their profile on any given day and create on average 90 pieces of content each month (such as posting comments or photos).[493]

Common to all of these forms of production and distribution of information is their decentralized character and their distributed architecture.[494] Production of information has become decentralized and new forms of information production have been established, whether by individuals or in the form of peer collaborations, such as Wikipedia, or the development of software with open source codes such as the web browser Firefox. The tools described above enable individuals and organizations to participate in the production of information and allow them to share their ideas with a broad audience by running their own websites and blogs, by posting comments or sending pictures taken with their mobile phones.

While traditionally the distribution of information was physical and based on geographical segmentation combined with high costs of reproduction, individuals and organizations are now able to distribute their information and perspectives on life either by making it available (e.g. on websites, downloads or blogs) or by directly sending information to a large group of people (e.g. by e-mail). Any group or organization, as well as individuals, can reach out and communicate to people around the globe.

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490 OECD, 2007, 5; according to the European Commission 13% of Europeans were regularly contributing to blogs in 2005 (European Commission, 2006, *Interactive*, 162).

491 Benkler, 2006, 218.

492 Solove, 2007, 24.

493 See <http://www.facebook.com/press/info.php?statistics>, accessed on January 16, 2011.

494 Benkler, 2006, 212.

The significant decrease of transaction costs has not only altered the way information is produced and distributed but also the *access to information*.[495] The access to information has traditionally been controlled by gatekeepers with physical control. The Internet has changed the access to information radically. It is possible to access the vast array of information provided on the internet from every web-enabled device,[496] either by knowing directly where to find the information or by using search engines which assist users to find the particular piece of information "in the endless expanse of digital babble".[497] Whether news, digital libraries such as Google Books or encyclopedias such as Wikipedia: almost every piece of information is available by just a few clicks, independently of someone's geographic location. Again, access to information has never been as easy and cheap as it is now in cyberspace.[498]

As a fourth and last point, the *(re-)use of information* has changed as well. It is now possible to use existing data, whether texts, pictures, videos or music, in order to create new files and products. These new information products – often referred to as mash-ups or "mix & rip" – can lead to a greater diversity of creativity and participation. Many examples of such mash-ups can be found on popular platforms such as YouTube.[499]

In summary, the emergence of digital technologies has led to new tools of information exchange, decreased transaction costs for production, distribution, access and use of information, and thereby to the appearance of new forms of social production and communication.

3 Consequences for the Public Sphere

Without any doubt, the internet and mobile telephony have had a significant effect on "how we and others see the world as it is and as it might be"[500]. The costs of producing, distributing and accessing information have decreased significantly.[501] It can be stated that the technological innovations have caused structural changes regarding the way

[495] For an analysis of how cyberspace has reduced transaction costs, see SUNSTEIN (1995), arguing that the costs of searching and exchanging information have significantly decreased.

[496] ELKIN-KOREN/ SALZBERGER, 2004, 65-66.

[497] SOLOVE, 2007, 9.

[498] ELKIN-KOREN/ SALZBERGER, 2004, 68.

[499] See SOLOVE, 2007, 17ff..

[500] BENKLER, 2006, 2.

[501] ELKIN-KOREN and SALZBERGER state: "As a matter of fact, the production of content still involves the high cost of human skills, but the means of production are cheaper than they used to be, and are decreasing rapidly" (ELKIN-KOREN/ SALZBERGER, 2004, 68).

people make and exchange information. It is the decentralized character and architecture of the networked information economy that have affected the economies of information.[502]

Moreover, the internet and its tools and applications have created a new, alternative platform to exchange information, cooperate and provide observations and opinions in ways never seen before.[503] Both the range of distribution as well as the amount of information available at "one click" has never existed before: every person or organization (access to the internet assumed) has the ability to share its thoughts and perspectives with an almost unlimited audience. As BENKLER puts it[504]:

> The way we listen to what we hear changes because of [the easy possibility of communicating effectively into the public sphere], the way we observe and process daily events in our lives. We no longer need to take these as merely private observations, but as potential subjects for public communications. […] It affects the presentation of issues and observations for discourse.

However, despite the common acknowledgement of the emergence of new ways to communicate and exchange information, the expectations regarding how the emergence of this alternative platform will affect the public sphere and society in general are a matter of controversy.

On the one hand, it is argued that the economics and social practices of information production will be changed sustainably by the internet and its tools, leading to an increasing role of non-market and non-proprietary production, "both by individuals and by cooperative efforts in a wide range of loosely or tightly woven collaborations"[505]. Related to this argument is the challenge to the traditional economic view of human nature, particularly of humans as selfish rational actors, from evidence that human nature is rather of a cooperative character.[506] Furthermore, many argue that the internet has led and is still leading to the emergence of a new public sphere alongside the mass-mediated market, diagnosing a shift from a mass-mediated public sphere to a networked public

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502 For an interesting discussion on how cyberspace has affected the characteristic of information as a public good due to the reduced costs of copying and the de-materialization of information, see ELKIN-KOREN/SALZBERGER, 2004, 49-64;

503 BENKLER, 2006, 177.

504 BENKLER, 2006, 213.

505 BENKLER furthermore arguing that the internet is "the first modern communications medium that expands its reach by decentralizing the capital structure of production and distribution of information, culture, and knowledge" (BENKLER, 2006, 30).

506 See BENKLER (2010).

sphere.[507] The reasons for this shift are seen in the internet's ability to overcome the criticisms of the mass media[508], particularly as to their limited intake (too many views remain unexplored and underrepresented), the power of their owners over what is said and how it is evaluated, and the need of commercial mass media to attract large audiences, questioning whether the "commercialism undermines their will and capacity to provide a platform for public, politically orientated discourse"[509].[510] Particularly the role and impact of citizen journalism is highlighted: DAN GILLMORE states that "the ability of anyone to make the news will give new voice to people who've felt voiceless – and whose words we need to hear. They are showing all of us [...] new ways of talking, of learning"[511]. Similarly GLENN REYNOLDS, in his book *An Army of David – How Markets and Technology Empower Ordinary People to Beat Big Media, Big Government, and other Goliaths*, observes that the "power once concentrated in the hands of a professional few has been redistributed into the hands of amateur many"[512]. REYNOLDS argues that "technology has made it possible for individuals to become not merely pamphleteers, but vital sources of news and opinions that rival large metropolitan publishers in audience and influence"[513]. Even JÜRGEN HABERMAS states that the internet is reactivating the roots of an egalitarian public sphere between authors and readers.[514]

While the new possibilities for individuals "to see themselves as potential contributors to public discourse and as potential actors in political arenas, rather than mostly passive recipients of mediated information [...]"[515] are praised by some,[516] there are other less optimistic or even critical voices, pointing out the risks deriving from the emergence of digital technologies. This more critical group argues that cyberspace produces new forms

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[507] BENKLER, 2006, 359; a similar argument is that of ELKIN-KOREN and SALZBERGER, stating that the "ability to communicate directly at low costs reduces the need for intermediaries, such as publishers and broadcasters, for distributing information" (ELKIN-KOREN/ SALZBERGER, 2004, 67).

[508] For general criticisms of the mass media see BENKLER (2006); BENKLER (2010); GILLMORE (2004).

[509] BENKLER, 2006, 204; more generally see BAKER (2002).

[510] BENKLER, 2006, 197.

[511] GILLMORE 2004, XVIII.

[512] REYNOLDS, 2006, 92.

[513] REYNOLDS, 2006, 44.

[514] HABERMAS cited in the *Der Tagesspiegel*, June 23rd, 2006, available at <http://www.tagesspiegel.de/kultur/die-oeffentliche-vernunft/723748.html 06.23.2006>, accessed on January 16, 2011.

[515] BENKLER, 2006, 220.

[516] OECD, 2007, 36: "Citizen journalism, for instance, allows users to influence or create news, potentially on similar terms as newspapers, companies or other major entities [...]", stressing that the effects of citizen journalism "may include a greater call for accuracy within the mainstream media, as users point out inaccuracies and flaws online".

of market imperfections and challenges.[517] Particularly there is discussion about how actors can establish trustworthiness of information "in absence of intermediaries"[518] and how people deal with the proliferation of information, find the relevant information,[519] and in general deal with anonymity and disguise.[520] SOLOVE argues that "although we're getting a lot more good information via the Internet, we're also getting a lot more bad information. […] We're often exposed to information that we can't entirely trust."[521] Similarly, the terminus "Babel objection" summarizes the fear that if everyone can speak, no one can be heard. Besides the "data smog",[522] SOLOVE highlights how the information flow in cyberspace constrains people due to the fact that the information available on the internet (or "dubious data", as SOLOVE calls it) threatens people's reputations by false rumors and allegations.[523] The argument of MAYER-SCHOENBERGER, in his book *Delete: The Virtue of Forgetting in the Digital Age*, goes in a similar direction, arguing that the important role that forgetting has played throughout human history in order to make sound decisions unencumbered by the past or the possibility of second chances is being lost and overridden by the emergence of digital technologies.[524] MAYER-SCHOENBERGER points out the danger that derives from a life-long digital memory, such as compromising photographs or outdated information that might be able to be found by just a mouse click.

Notwithstanding the quality of information, the overflow of information created by cyberspace makes it hard and competitive for producers to make "content noticeable and detectable by user"[525]. Linked to this alleged information overflow is the concern that new intermediaries, such as search engines, are becoming powerful, the "new virtual

517 ELKIN-KOREN/ SALZBERGER, 2004, 67.

518 ELKIN-KOREN/ SALZBERGER, 2004, 67.

519 ELKIN-KOREN/ SALZBERGER, 2004, 68.

520 OECD, 2007, 6: "Other challenges relate to information accuracy and quality (including inappropriate or illegal content) where everybody can contribute without detailed checks and balances".

521 SOLOVE refers to an example illustrating how false information can spread rapidly on the internet: "With the Internet, false information can spread much more rapidly. In 1996 a false rumor about the clothing designer Tommy Hilfiger erupted on the Internet. According to the rumor, Hilfiger said: "If I had known that African-Americans, Hispanics, and Asians would buy my clothes, I would not have made them so nice." The rumor also had Hilfiger confirming on the Oprah Winfrey show that he had made the statement, leading Winfrey to demand that he leave. The rumor sent Hilfiger's company into a tailspin. But Hilfiger hadn't even appeared on Oprah, nor had he made the offensive remarks. Winfrey announced on her show that the rumor "is not true because it never happened. Tommy Hilfiger never appeared on this show. Read my lips, Tommy Hilfiger has never appeared on this show. All of the people who claim that they saw it, they heard it—it never happened." (SOLOVE, 2007, 35).

522 See SHENK (1997).

523 SOLOVE, 2007, 38-49.

524 See MAYER-SCHÖNBERGER (2009).

525 ELKIN-KOREN/ SALZBERGER, 2004, 70.

gatekeepers of Cyberspace",[526] as their results affect the perceived significance of information.[527]

4 Summary and Conclusion

This section aimed to demonstrate that the emergence of digital technologies, particularly the internet, has caused a structural change regarding the way people make and exchange information. In a first step, we have presented some data underlining the success of the internet and cellular mobile telephony within the last ten years (1). In a second step we have argued that the emergence of digital technologies has significantly altered the way information is produced, distributed, accessed and re-used (2). This altered information process has a considerable impact on the public sphere and people's ability to provide and access information, thereby enabling the establishment of new platforms for information exchange besides the established mass media (3). The emergence and use of digital technologies have led to a multiplication of not only eyes and ears but also voices: almost everybody is now able to raise any issue of concern due to decreased transaction costs and the ability to address an audience of a size never seen before.

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[526] ELKIN-KOREN/ SALZBERGER, 2004, 71.

[527] For the antitrust investigations of the European Commission as to the alleged unfavorable treatment of unpaid and sponsored search results coupled with an alleged preferential placement of Google's own services, see http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/1624&format=HTML&aged=0&language=EN&guiLanguage=en>, accessed on January 17, 2011.

II The Impact of Digital Technologies on the Occurrence of Reputational Loss

The emergence of digital technologies has undoubtedly affected and changed the ways people communicate and exchange information and has produced alternative platforms of information exchange. In the last section we have seen that a structural change has occurred regarding production, distribution, access to and use of information.

In Part B we demonstrated that reputational loss occurs if information about a firm's behavior is communicated and diffused successfully by trustworthy actors, indicating that a firm is not behaving as predicted by its reputation. As a consequence we have indentified an effective information exchange between actual and prospective stakeholders of a firm as the main requirement to be fulfilled for reputational loss to occur.

It is the objective of this section to set forth that the altered information process increases the probability that such information exchange about firms' effective behavior will take place and thus increases the probability of the occurrence of *reputational loss*.

We proceed as follows: in a first step we demonstrate, by referring to blogs, that people's ability to communicate and distribute their direct experiences, as well as their observations of firms' actions, has increased considerably, thus increasing the probability that firm's effective behavior is reported (**1**). In a second step, we highlight how the internet enables users to establish specific platforms for structured information exchange, bringing together those providing information and those looking for other people's experiences with particular actors in the past (**2**). In a third step, we argue that online information is considered as relevant and serves as a base for stakeholders' decision making (**3**). Finally, in a fourth step, we summarize the results (**4**).

1 People's Ability to Communicate their Experiences with a Firm Has Increased

We have seen that digital technologies have lowered the costs of distributing and providing information and have empowered individuals to share their observations and opinions with a large, almost worldwide, audience. In this section we demonstrate that the probability that information about firms' effective behavior is communicated and diffused has increased significantly, due to people's improved ability to communicate their experiences with a firm.

While in the case studies presented in Part A the communication of the reputational-loss causing action of the firm occurred via traditional mass media, the example of the publication of names and pictures of restaurants with poor standards of hygiene has already indicated that the "new media" can play an important role with regard to effective information exchange. Now, we introduce cases illustrating how the distribution and provision through digital technologies of individuals' experiences and observations of a firm's actions can cause and escalate reputational loss. Three short case studies are presented: BP (**1.1**), Reuters (**1.2**) and Kryptonite (**1.3**). The findings are summarized in a fourth step (**1.4**).

1.1 BP and the Blogosphere

In 2010, BP came under intense political and public pressure due to an oil spill caused by an explosion on the Deepwater Horizon drilling rig.[528] The Deepwater Horizon drilling rig was located in the United States sector of the Gulf of Mexico and began to drill on behalf of BP in February 2010. The explosion on the rig took place in April 2010, resulting in the largest offshore spill in U.S. history.[529] BP was publicly criticized for its insufficient crisis management and was furthermore alleged to have violated several safety standards.[530] The reputation of BP and its credibility suffered significantly and BP was alleged to have misled the public and withheld information.

In the middle of this crisis, different blogs discovered and discussed the fact that BP had released pictures related to its crisis operations at Deepwater Horizon which had been manipulated. On July 19, 2010, the blogger John Aravosis published a comment on the AmericaBlog, headed "BP photoshops fake photo of crisis command center, posts on main BP site"[531]. Aravosis discovered that BP had manipulated a picture by putting "fake content-filled screens in the photo" where some of the screens in the original photograph had blank screens, commenting: "I guess if you're doing fake crisis response, you might

[528] For a timeline of the events, see <http://www.bp.com/iframe.do?categoryId=9035136&contentId=7065156>, accessed on January 16, 2011.

[529] See *New York Times*, June 15, 2010, available at <http://www.nytimes.com/2010/06/16/us/16spill.html>, accessed on January 16, 2011.

[530] U.S. President Obama criticized the BP chief executive Tony Hayward publicly in a television interview on NBC on June 8, 2010, stating that: "He wouldn't be working for me after any of those statements", reacting to a statement of Hayward that the Gulf of Mexico was "a big ocean". See *The Guardian*, available at <http://www.guardian.co.uk/business/2010/jun/08/bp-deepwater-horizon-obama.>, accessed on January 16, 2011.

[531] See <http://www.americablog.com/2010/07/bp-photoshops-fake-photo-of-command.html>, accessed on January 16, 2011.

as well fake a photo of the crisis response center"[532]. The story spilled over from the blogosphere to the traditional mass media the next day: the *Washington Post* published an article about the altered photograph, stating that "apparently BP is no more adept at doctoring photos than it is at plugging deep-sea oil leaks"[533].

Just two days later, on July 21, another blogger – BRIAN BARRETT at gizmodo.com – posted another picture that had been published on BP's Gulf of Mexico response website.[534] According to its title it showed the view on the Deepwater Horizon site from the cockpit of a helicopter. However, the picture was alleged to be clearly 'photoshopped': there was a looming tower in the picture, the digital readouts indicated that the helicopter's door and ramp were open and the parking brake engaged and that one of the pilots was apparently holding a pre-flight checklist.[535]

Figure 17 (left): Original Image from Inside Helicopter (Source: BP)
Figure 18 (right): Altered Image from Inside Helicopter (Source: BP)

For BP the allegations came at a point where BP had promised transparency in order to regain the public's trust. BP reacted to the allegation of faking photos by providing the original unaltered versions and stating that "one of BP's contract photographers used Photoshop to edit images posted on the bp.com Gulf of Mexico Response web site"[536]. Furthermore, BP announced that it had "instructed the photographer who created the

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[532] See <http://www.americablog.com/2010/07/bp-photoshops-fake-photo-of-command.html>, accessed on January 16, 2011.

[533] See <http://www.washingtonpost.com/wp-dyn/content/article/2010/07/19/AR2010071905256.html>, accessed on January 16, 2011.

[534] See <http://gizmodo.com/5592836/bp-photoshops-another-official-image-again-terribly>, accessed on January 16, 2011.

[535] See <http://gizmodo.com/5592836/bp-photoshops-another-official-image-again-terribly>, accessed on January 16, 2011.

[536] See <http://www.flickr.com/photos/bpamerica/sets/72157624429465573/>, accessed on January 16, 2011.

images to refrain from cutting-and-pasting in the future and to adhere to standard photo journalistic best practices”[537].

The discovery of the photoshopped pictures of BP are a good example of how individuals empowered by the internet can produce and distribute information about firms’ effective behavior and thereby cause reputational loss. This case demonstrated how the observations of individuals can spread rapidly within and beyond the internet: the news spilled over from the new media (AmericaBlog calls its own work “hard-hitting activist journalism”[538]) to traditional, national and international, media. BP’s reputation and credibility were damaged by the information about its effective behavior provided by the two different blogs. The blogger at Gizmodo summarizes this effect, stating that “[…] by altering the official documentation of the event, BP erodes whatever trust we have in them even further at a time when we need and deserve to know exactly what's going on”[539].

1.2 Reutersgate

A similar case also highlighting how the internet enables individuals to report on a firm’s effective actions is the one of Reuters and the blog Little Green Footballs, sometimes referred to as Reutersgate. On August 5, 2006, Charles Johnson, a blogger at Little Green Footballs, questioned whether a photograph provided by the news agency Reuters had been digitally altered using Photoshop software:[540]

> Reuters Doctoring Photos from Beirut? […] This Reuters photograph shows blatant evidence of manipulation. Notice the repeating patterns in the smoke; this is almost certainly caused by using the Photoshop “clone” tool to add more smoke to the image.

The picture, according to its caption, showed “Smoke billows from burning buildings destroyed during an overnight Israeli air raid on Beirut’s suburbs August 5, 2006. Many buildings were flattened during the attack”[541].

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537 See <http://www.flickr.com/photos/bpamerica/sets/72157624429465573/>, accessed on January 16, 2011.

538 See <http://www.americablog.com/2010/07/bp-photoshops-fake-photo-of-command.html>, accessed on January 16, 2011.

539 See <http://gizmodo.com/5593565/bp-admits-photoshopping-multiple-official-images>, accessed on January 16, 2011.

540 See <http://littlegreenfootballs.com/weblog/?entry=21956_Reuters_Doctoring_Photos_from_Beirut&only>, accessed on January 16, 2011.

541 See <http://littlegreenfootballs.com/article/21956_Reuters_Doctoring_Photos_from_Beirut >, accessed on January 16, 2011.

Figure 19 (left): Original Picture (Source: Reuters)
Figure 20 (right): Altered Picture (Source: Reuters)

Just one day later, on August 6, faced with the widely spread allegations of manipulating photographs, Reuters announced it would end its cooperation with the photographer, Adnan Hajj. Another day later, on August 7, Reuters decided to withdraw all 920 photographs by Adnan Hajj from its sales database. In January 2007, Reuters announced that it had changed its editing policy: "The agency had tightened editing procedures to ensure that only senior photo editors dealt with sensitive images, invested in more training and supervision and strengthened its code of conduct for photographers"[542].

1.3 Kryptonite

The example of Kryptonite is another case that highlights individuals' potential to share their experiences made with a firm with a wide audience. On September 12, 2004, the San Francisco-based cyclist Chris Brennan posted a message ("Your brand new U-Lock is not safe") in the forum www.bikeforums.net, explaining how he had opened a bicycle security lock from the well known brand Kryptonite with a Bic ballpoint pen within a few seconds. Within the next two to three days, several short digital films were posted in different forums and blogs, illustrating how to open the Kryptonite locks with a ballpoint pen.[543] On September 17, the *New York Times* published an article, stating "The pen is mightier than the lock", citing some of those who had posted videos within the past few days.[544]

[542] See <http://www.Reuters.com/article/idUSL18678707>, accessed on January 16, 2011.

[543] A Bic Licks a Lock, *San Francisco Magazine*, available <http://www.sanfranmag.com/story/bic-licks-lock>, accessed on January 16, 2011.

[544] The pen is mightier than the lock, *New York Times*, available at <http://www.nytimes.com/2004/09/17/nyregion/17lock.html>, accessed on November 16, 2010.

Bloggers continued and new ones started to write about the issue and to share their experiences and every day more people started to read and to search for information about the Kryptonite lock. The number of people who had read one of the posts on KRYPTONITE increased continuously. On a single day, September 19, 2004, about 1.8 million people read one of the blogs discussing the Kryptonite issue, according to estimations of Technorati.

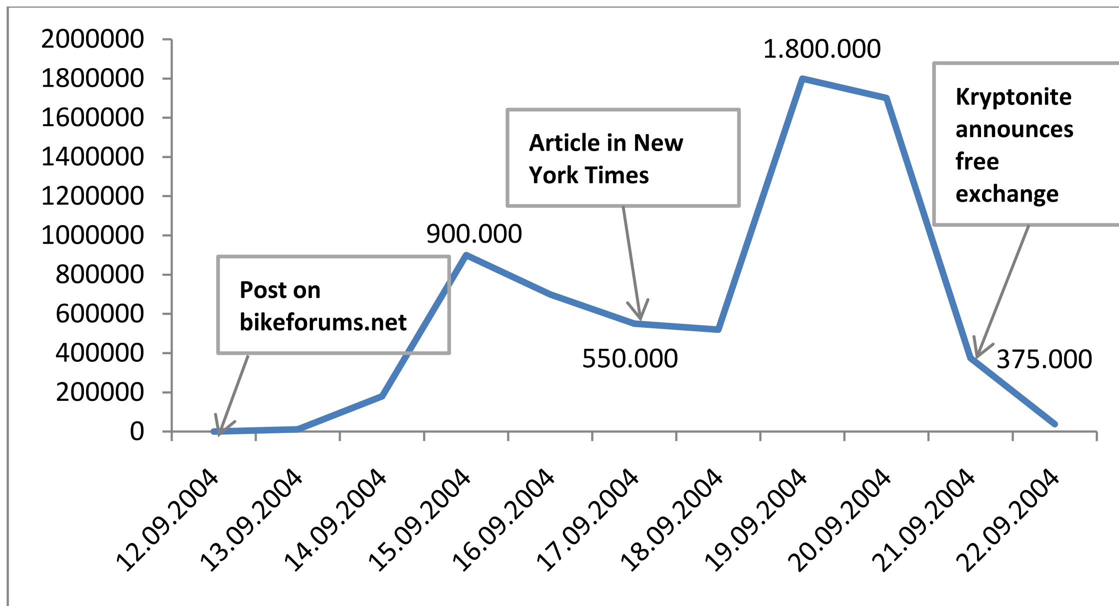

Figure 21: Internet Users Reading/ Posting in Blogs on Kryptonite
(Source: Fortune Magazine, 20.12.2004/ Technorati)

On September 22, Kryptonite announced an offer to exchange any affected lock for free. Within the next few months Kryptonite created a voluntary lock exchange program and replaced over 400,000 locks in 21 countries for free.[545] The effect on Kryptonite's business has been significant, according to its marketing director Karen Rizzo: “It's been – I don't necessarily want to use the word ‘devastating’ – but it's been serious from a business perspective”[546].

Another fact of the Kryptonite case underlines the impact of the emergence of digital technologies on the exchange of information and the occurrence of reputational loss:[547] the same information posted by CHRIS BRENNAN had already been published in an article in the

545 See Kryptonite's website, available at <http://www.Kryptonitelock.com/OurStory/History.aspx>, accessed on January 16, 2011.

546 Cited in KIRKPATRICK (2005).

547 Regarding the reputational loss, see the statement of a New York salesman of Kryptonite locks: “I feel like a Cassandra, but for years I have said to my customers, ‘This is the industry standard, and this will keep your bike safe’ - Now I tell everyone who comes in, ‘Tell your friends before the thieves tell theirs.’”, see The pen is mightier than the lock, *New York Times*, available at <http://www.nytimes.com/2004/09/17/nyregion/17lock.html>, accessed on November 16, 2010.

British magazine *New Cyclist* in 1992[548], but it did not draw much attention, neither from Kryptonite itself nor from Kryptonite's customers. Indeed, it is the internet that has enabled individuals to share such observations and experiences of a firm's product with a wide audience, having an immense effect on the probability that reputational loss will occur.

1.4 Summary and Conclusion

We stated at the beginning of this section that we expect the emergence of digital technologies to have increased the probability that information about firms' effective behavior will be communicated and diffused significantly. The case studies presented above have illustrated that the ability of individuals and collectives to produce and distribute information about their experiences with a firms' behavior has been boosted. The case studies have proved, to some extent, the statements of REYNOLDS and GILLMORE that any individual can become the source of information and news due to the internet.

In the cases of BP, Reuters and Kryptonite, individuals have communicated their experiences with a firm's conduct and products and have made this information accessible to a wide range of other users.

Furthermore, the cases highlight a characteristic of the production of information in the internet that specifically causes reputational loss: it is the interactivity of the different users who get involved and discuss the information provided by individual bloggers. In the cases of BP and Reuters several users started to analyze whether these two companies had *indeed* manipulated photographs, in the case of Kryptonite an endless number of people posted videos of their efforts to open their locks with a ball-point pen. The described phenomena were not a one-way communication, but indeed rather a discussion taking place in blogs and forums with a number of different contributions, either confirming or questioning other people's experiences.

In summary we can conclude that the emergence of digital technologies has made it considerably easier for individuals to communicate their experiences with firms' actions. The communication and exchange of information about firms' effective behavior being the requirement for reputational loss to occur[549], blogs and other tools have increased the probability that the reputational loss takes place.

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[548] See <http://www.bikebiz.com/news/read/the-pen-is-mightier-than-the-u-lock>, accessed on January 16, 2011.

[549] See chapter two/ B/ II/ 2.2.

2 The Internet Enables Specific Platforms for Structured Information Exchange

The cases presented above have illustrated how the emergence of the internet has enabled individuals to share their observations with a large audience, thus increasing the probability that the effective behavior of firms, whether deviating or not from stakeholders' expectations, will be reported and diffused. However, in those three cases the manner in which individuals' experiences and observations of a firm's actions have been communicated can be described as rather "unstructured": some individuals produced information in blogs or forums about a firm's actions, and thereby caused reactions by other users, e.g., the posting of more comments or the spillover of the reported observations to the mass media.

Another form of information exchange made possible by the emergence of digital technologies is a more "structured" form of information sharing: specific internet platforms enable users to exchange information about the performance and actions of firms in a particular context. These platforms that are dedicated to information exchange bring together those who are able to provide information about a firm's past behavior, thus having direct experiences, and those seeking information in order to assess whether or not a firm with whom they may potentially deal is likely to behave in accordance with their preferences. It is this *matching mechanism* that can reduce the information and search costs drastically and furthermore contribute to efficient reputational mechanisms.[550] The majority of these platforms deal with reviews of a particular aspect of a firm's performance, mostly the primary topic of interest to customers, e.g., the quality of the firm's products and services.

In this segment we present three examples of these platforms for information exchange: Amazon (**2.1**), Tripadvisor (**2.2**) and Wikileaks (**2.3**). The findings are summarized (**2.4**).

2.1 Reviews at Amazon

An example of structural online reviews provided by a retailer is amazon.com, where people review books and other products sold via Amazon and share their experiences online by posting comments and using a grading system of stars in order to indicate whether the seller's performance and the product have met their expectations.

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[550] Scott Morton, 2006, 75f..

A study analyzing the effects of positive and negative reviews at amazon.com and bn.com (online store of Barnes and Nobles) concludes that “the addition of new, favorable reviews at one site results in an increase in the sales of a book at that site relative to the other site”[551]. Furthermore, the study found evidence that “an incremental negative review is more powerful in decreasing book sales than an incremental positive review is in increasing sales”[552].

2.2 Tripadvisor

Tripadvisor is a similar example. It was founded in 2002 as a search engine that “hooked into travel information”[553] already available somewhere else, whether on the internet, in newspapers or magazines. After a while the traffic at Tripadvisor grew and people started to add their own reviews and experiences. Subsequently, Tripadvisor started to implement commercial links, allowing the user to make reservations directly by following the links. In 2004, Tripadvisor was sold for an estimated 430 million US dollars and became part of Expedia group, now Expedia Inc. Even after having shifted from a forum-like style to a more transactions-based site, the role of the information and observations of individuals provided at Tripadvisor as a base of information for travelers’ decisions whether or not to book a stay at a particular hotel or resort cannot be underestimated: Tripadvisor is visited by more than 25 million people a month.

Both amazon.com and Tripadvisor are interesting examples for peer-to-peer generation of information and the new forms of collaboration, proclaimed by BENKLER. Both platforms highlight how the sources and forms of information available have been altered by the emergence of digital technologies: people share and exchange their own past experiences with a firm and make this information available and accessible for others.

2.3 WikiLeaks

A different platform of information exchange that has gained much media attention in recent times is WikiLeaks. WikiLeaks describes itself as a “non-profit media organisation” whose “goal is to bring important news and information to the public” by providing an

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551 CHEVALIER/ MAYZLIN, 2006, 346.

552 CHEVALIER/ MAYZLIN, 2006, 352.

553 See Deconstructing Tripadvisor, *Wall Street Journal*, available at <http://online.wsj.com/article/SB118065569116920710.html>, accessed on January 16, 2011.

"innovative, secure and anonymous way for sources to leak information".[554] WikiLeaks is a Swedish-hosted website that is dedicated to untraceable document-leaking. It first appeared online in 2007 and is run by "an independent global group of people with a long standing dedication to the idea of a free press and the improved transparency in society that comes from this"[555].

The website provides a high security drop box "fortified by cutting-edge cryptographic information technologies"[556] in order to provide protection to sources, thus to those individuals deciding to "leak" documents that have not been produced for public access. WikiLeaks started in 2007 as a platform for information exchange that relied on the knowledge of its users in order to verify the information that was "leaked". At that time WikiLeaks stated that "users can discuss interpretations and contexts and collaboratively formulate collective publications [...] stating that the relevance of documents and their verisimilitude will be revealed by a cast of thousands"[557]. After its relaunch in 2010, the strategy of WikiLeaks regarding the verification of documents has changed: it is no longer possible for users to post comments or edit, instead the submission of documents is regulated by internal review.

However, the documents published on WikiLeaks have got the ball rolling in some interesting cases: the Swiss Bank Julius Baer was faced with allegations of having conducted illegal activities at the bank's Cayman Islands' office[558] and internal documents of Kaupthing Bank were made available indicating that serious amounts of money were loaned to various owners of the bank directly prior to Kaupting's collapse.[559]

In July 2010, WikiLeaks was in the focus of political and media attention as it released over 920,000 documents related to the war in Afghanistan, produced between 2004 and 2009, to the three journals *Der SPIEGEL* (Germany), *The Guardian* (UK) and *The New York Times* (USA), as well as to the public, in July 2010. WikiLeaks was not only heavily critized by the US government for betrayal of state secrets but also by human rights organizations for risking people's lives by identifying the names of Afghans who had acted as informers and were listed in the documents published. Just a few months later, in October 2010,

[554] See Wikileaks' website, available at <http://213.251.145.96/>, accessed on January 16, 2011.
[555] See Wikileak's website, available at <http://213.251.145.96/About.html>.
[556] See Wikileak's website, available at <http://213.251.145.96/About.html>.
[557] WikiLeaks' mirror-is archive available at <https://wikileaks.dk/wp/about-2/>, accessed on January 16, 2011.
[558] See <http://www.spiegel.de/netzwelt/web/0,1518,536293,00.html>, accessed on January 16, 2011.
[559] See <http://www.spiegel.de/wirtschaft/0,1518,640390,00.html>, accessed on January 16, 2011.

WikiLeaks published 400,000 documents from the Iraq war; a procedure that has been called by the US Pentagon the "largest leak of classified documents in history"[560]. The media attention in this case particularly focused on information indicating that the US government had ignored reports of torture by Iraqi authorities.

Whether or not WikiLeaks "could become as important a journalistic tool as the Freedom of Information Act",[561] it is "increasingly being taken seriously as a means to collect and distribute sensitive information"[562]. WikiLeaks as a platform for information exchange highlights the radical shift that has occurred regarding the way information is collected and distributed. It is a striking example of BENKLER's statement that the decentralized architecture of the internet helps individuals to fulfill the watchdog function.[563]

2.4 Summary

The internet allows specific platforms of information exchange which allow users to gather and exchange information about firms' actions in a way never seen before. By matching those who are willing to provide information about firms' effective actions and those searching for information about firms' likely future behavior, these platforms decrease information costs and increase the probability that information about firms' effective behavior is reported and diffused. The communications of firms' effective behavior being the precondition for reputational loss to occur, platforms like these increase the likelihood that reputational loss will occur.

3 Online Information Is Considered as Base for Decision Making

In the last two segments we demonstrated that people's ability to communicate and to share their experiences with firms' actions has increased due to the emergence and use of digital technologies. This development has significantly increased the probability that effective behavior, whether deviating or not, will be reported.

According to our findings in Part A, interpersonal extrapolation requires that the exchanged information has to be perceived as relevant in order to affect the expectations of a firm's stakeholders regarding the firm's likely future behavior. The cases of Amazon

[560] See <http://www.bbc.co.uk/news/world-middle-east-11611319>, accessed on January 16, 2011.

[561] TRACY SMITH, A Wiki for Whistle-Blowers, *Time-Magazine*, January 22, 2011, available at <http://www.time.com/time/nation/article/0,8599,1581189,00.html>, accessed on January 17, 2011.

[562] LYNCH, 2010, 310.

[563] BENKLER, 2006, 11.

and Tripadvisor already suggest that online reviews are perceived as relevant and have gained in importance as a basis for decision-making. In the following segment we argue that existing data underlines this assumption and indicates that online reviews and other forms of user-generated content are considered as relevant and indeed serve as a base for decision making on with whom to interact.

3.1 User Generated Content Becomes an Important Source of Information

The low search and information costs caused by the altered information process and the easy access to a vast array of information have a significant impact on the sources of information people consider when facing the decision of with whom to interact: consumer generated content is "rapidly gaining traction as part of the purchase decision making process"[564] thereby "radically altering the origin of information" on which people base their decisions.[565] This has changed the balance of power between vendors and customers.

Available data underlines this shift: a representative survey by TNS Infratest produced the result that 58% of the population in Germany (older than 14 years) names the internet as an important base for decision making on purchases of a "considerable nature". For some markets information available on the internet is even regarded as the most important source of information (e.g. purchase of automobiles).[566]

Surveying auto buyers and travelers, the results suggest that the purchasing decision of 36% was influenced by consumer review sites and advice from consumers online.[567] Results for Germany indicate that about 51% of the German population has searched the internet for travel information.[568] The results of these surveys confirm the analysis of Chevalier and Mayzlin who showed that positive reviews at Amazon have led to an increase in sales.

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564 O'Connor, 2008, 47.

565 O'Connor, 2008, 48.

566 See the survey of TNS Infratest, available at <http://www.tns-infratest.com/presse/pdf/presse/20060606_tns%20infratest_dlr2006.pdf>, accessed on January 16, 2011.

567 See the survey of TNS Infratest, available at <http://www.tns-infratest.com/presse/pdf/presse/20060606_tns%20infratest_dlr2006.pdf>, accessed on January 16, 2011.

568 Results of a survey of FUR Forschungsgemeinschaft Urlaub und Reisen e.V., available at <http://www.fur.de/fileadmin/user_upload/Newsletter/RA_NL_Sep_2010_Buchung_online.pdf>, accessed on January 16, 2011.

Apparently, these forms of user-generated content can be an important base of information for the development of stakeholders' expectations with regard to the likely future behavior of a potential counterpart. As CHEVALIER and MAYZLIN puts it: "Online user reviews have become an important source of information to consumers, substituting and complementing other forms of business-to-consumers and offline word-of-mouth communication […]"[569].

3.2 Trustworthiness of Information

The surveys presented above suggest that the anonymity of the information published on review platforms or blogs does not prevent consumers relying on such information to a significant extent. This is an interesting result, as SOLOVE and others have demonstrated that false information can spread rapidly on the internet and that "anonymity releases […] the source of information […] from any accountability", encouraging "deceitful behavior"[570].

Three different forms of mechanisms seem to be important in order to explain why people rely on online information is spite of SOLOVE's correct analysis: These mechanisms help users to overcome the problems of trustworthiness and information quality related to user generated content, leading to the result that online reviews are *perceived as relevant* by firms' stakeholders.

The first mechanism is the spillover to traditional media: the credibility and reputation of established publications can guarantee a certain level of accuracy. The second mechanism is the reliance on peers: other users help to verify information. The third approach is that the provider of specific platforms dedicated to information exchange takes measures on their own to ensure a certain level of information quality.

The cases of BP and Kryptonite have demonstrated the first two mechanisms. In both cases the news spilled over to traditional media such as the *New York Times*. At the same time the interactivity of the blogosphere helped to verify the allegations brought forward. In both cases users had the possibility to reconstruct the allegations and to determine whether or not they were legitimate. Another example of the reliance on peers and their watchdog function is the launch of the tablet PC WeTab. After the launch, several reviews were posted at the German Amazon site. Two of the reviews were written by the chief

[569] CHEVALIER/ MAYZLIN, 2006, 345.
[570] ELKIN-KOREN/ SALZBERGER, 2004, 69.

executive of WeTab and his wife, both using pseudonyms (the chief executive even using the name of a renowned computer expert) and rating the WeTab with five out of five stars.[571] The chief executive and his wife were caught due to a post by blogger RICHARD GUTJAHR[572] who revealed that the pseudonyms used referred to the accounts of the chief executive and his wife.

The third mechanism is highlighted by holidaycheck.de, a German platform for travel information and booking. Holidaychek.de employs a team of 40 people whose job is to search for questionable reviews. They are alerted if the number of reviews for a particular destination is picking up significantly, if the average rating increases considerably, or if several reviews are sent from the same IP address.[573]

3.3 Summary

We can conclude that reduction of search and information costs caused by the emergence of digital technologies has a considerable impact on the sources of information people consider in making decisions on with whom to interact. Other people's experiences with firms that are available online, for example in online reviews, do play an increasingly important role as a source of information on which people base their decisions. Doubts regarding the trustworthiness of information and the motivation of the writers do not seem to play a dominant role.

4 Summary and Conclusion

Starting with the statement that the emergence of digital technologies has undoubtedly affected the ways people communicate and exchange information by providing new platforms, the objective of this section was to demonstrate that the altered information process increases the probability that information about firms' effective behavior will be exchanged between (actual and prospective) stakeholders of a firm, thereby increasing the probability of the occurrence of reputational loss.

The case studies of BP, Reuters and Kryptonite presented in the first step have impressively demonstrated that digital technologies, and particularly the internet, have

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[571] See <http://www.spiegel.de/netzwelt/web/0,1518,721229,00.html>, accessed on January 16, 2011.

[572] See <http://gutjahr.biz/blog/2010/10/wedepp/>, accessed on January 16, 2011.

[573] See <http://www.spiegel.de/spiegel/print/d-74184603.html>, accessed on January 16, 2011.

significantly increased people's ability to communicate and share their observations and experiences of firms' actions with a large audience. Furthermore, the cases have demonstrated the interactivity of the information-generating users as one of the core characteristics of online information exchange (1).

The examples of Amazon, Tripadvisor and Wikileaks have underlined the argument that the internet has led to the establishment of efficient platforms of structured information exchange, resulting in an improved match of those able to provide and those seeking information about firms' effective behavior (2).

Both structured and unstructured information exchange increase the probability that information about firms' actual behavior will be communicated and diffused and therewith they increase the likelihood that reputational loss will occur.

In a third step we have seen that people consider other people's experiences, made public on the internet, as an important source of information. This user-generated information affects potential and actual expectations of a firm's stakeholders regarding its likely future behavior – and therewith has an impact on stakeholders' decisions whether or not to interact with a particular firm (3).

The consequences for the occurrence of reputational loss are severe as the probability that information about firms' effective behavior is exchanged successfully increases considerably. Thanks to the emergence of digital technologies any individual is in the position to share his or her observations and experiences of a firm's actions with an almost unlimited audience.

Due to the reduced transaction costs the probability that information about firms' behavior that deviates from their reputations and stakeholders' expectations is diffused increases. The multiplication of eyes, ears and voices increases the probability that reputational loss will occur, particularly bearing in mind the effect of a single or a few mixed signals on a firm's reputation.

III The Impact of Digital Technologies on the Occurrence of Reputational Costs

The underlying hypothesis of Part D is that the emergence of digital technologies has increased the potential of using the behavior modifying effect of threatening firms' reputations due to the structural change regarding production, distribution, access and re-use of information. In the last section we have discussed the impact of the emergence of digital technologies on the occurrence of reputational loss. The internet has increased the level of observability and therewith the probability that information about firms' effective (deviating) behavior will be exchanged amongst actual and potential stakeholders. Hence, the emergence of digital technologies increases the probability that reputational loss will occur.

In this section we turn to the impact of digital technologies and the altered information process on the occurrence of *reputational costs*. We have stated in Part C that reputational costs occur if a firm's stakeholders are willing and able to react to reputational loss. Therefore, the objective of this section is to demonstrate the impact of digital technologies on stakeholders' ability and willingness to react to reputational loss.

In a first step we analyze the impact of digital technologies on stakeholders' *willingness* to react to reputational loss (**1**). In a second step we demonstrate the enhancing effect of digital technologies and particularly of the internet on stakeholders' *ability* to react to reputational loss (**2**). In a third step we summarize the findings (**3**).

1 The Impact of Digital Technologies on Stakeholders' Willingness to React to Reputational Loss

We have seen that a firm's stakeholders are willing to react to reputational loss if the firm's effective (deviating) behavior affects an arena of interactions that is of importance to the stakeholder, according to the stakeholder's preferences and objectives. This holds for both actual and potential stakeholders: actual stakeholders *would not* have interacted with that firm if they had known the effective behavior of the firm, and potential stakeholders *will not start* to interact with that firm at all.

In the last section we discussed how stakeholders' ability to obtain information about firms' effective behavior has been increased by the emergence of digital technologies. While this effect is rather evident, the effect of digital technologies on stakeholders' willingness to react, thus on stakeholders' preferences and objectives, is less apparent.

However, it seems to be reasonable to assume that the emergence of digital technologies can affect stakeholders' preferences in the long term due to successful campaigning by civil society groups. We have already seen in chapter one that the internet has assisted all forms of collective groups in low-cost networking and coalition-forming in order to mobilize against a common concern.[574] Particular civil society actors have been successful on the level of agenda-setting. It seems reasonable to assume that the efforts of any of these interest groups to raise awareness for particular issues can significantly affect people's preferences and objectives in the long term.

In contrast, the short-term effects of digital technologies on stakeholders' willingness to react to reputational loss are likely to be insignificant as it seems to be reasonable to assume that stakeholders' preferences and objectives will be altered by the provision of information only in the long term.

2 The Impact of Digital Technologies on Stakeholders' Ability to React to Reputational Loss

The second requirement for reputational costs to occur, besides stakeholders' willingness to react, is stakeholders' *ability* to react to reputational loss. We have stated that stakeholders' ability to react to reputational loss depends on the market power of the relevant firm, which is determined particularly by the number of existing firms in the relevant market that offer substitutable products and services and the switching costs stakeholders face when changing their counterpart. We argue that the emergence of digital technologies can have an effect on both factors in many markets, thereby decreasing the market power of firms and increasing stakeholders' ability to react to reputational loss. Therefore, we first turn to the impact of digital technologies on the number of substitutes in a market (**2.1**) and in a second step to their impact on switching costs (**2.2**).

2.1 Impact on the Number of Substitutes in the Market

The emergence of digital technologies can have an important impact on the market power of firms by increasing the number of firms that might serve as alternative counterparts. The internet enables stakeholders to "[…] transcend the limits of physical search"[575] by

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[574] See chapter one/ B/ II/ 2.2.

[575] Bellman/ Johnson/ Lohse/ Mandel, 2006, 22.

enabling them to interact with firms across borders. As physical interaction not being required, digital technologies lead to a greater choice regarding the number of potentially substitutable counterparts. In these cases the *geographically relevant market* can be significantly broadened due to the decrease in transactions costs caused by the emergence of digital technologies. This holds for the greater choice customers have when purchasing a product online. Similarly the market for investment opportunities can be geographically broadened due to the internet. However, this effect is not relevant for every stakeholder-firm interaction. The geographically relevant market for firms' employees is unlikely to be affected by the emergence of digital technologies, at least as long as the employees have geographical preferences for where they will live and work or if their presence is required.

An increased number of substitutes in the market, whether caused by decreased transactions cost or lowered entry barriers, reduces the market power of the firm that is faced with reputational loss, thus stakeholders' ability to react to reputational loss can be increased by the emergence of digital technologies.

However, this effect depends on the nature of the market: If we look at the examples introduced in Part A, we can see that the internet would most likely not have affected Shell's position in the market for gasoline stations nor Deutsche Telekom's position in the market of telecommunications provider in Germany. In contrast, the relevant market for organizations that receive donations would certainly have been affected as stakeholders nowadays have a greater choice of organizations in the same sector that would accept their donations.

2.2 Impact on Switching Costs

The last point discussed hints at the impact of the emergence of digital technologies on switching costs. We have seen that switching costs are one of the factors determining a firm's market power. In some markets switching costs have decreased to a remarkable extent due to the internet, thereby reducing firms' market power and enhancing stakeholders' ability to react to reputational loss.

While compatibility and learning costs are not likely to decrease, the "most salient feature"[576] of the internet is the reduction of search costs. The impact of the emergence

[576] Bakos, 1997, 1691.

of digital technologies on search costs is remarkable. The internet allows the aggregation of information, combined with the possibility to compare features and prices of different providers of goods and services.[577] This availability, variety and convenience regarding the provision of information reduces switching costs by enabling potential and actual stakeholders to compare and contrast information on products and services of multiple firms.[578] This holds both for obtaining product- or service-related information in the internet in general and for any kind of comparison sites in particular: the latter, for example, allow consumers to "quickly and easily gather price quotes from a variety of sellers"[579].[580] This benefit due to reduced search costs is obviously not limited to consumers. Evidence from financial markets and the role of online brokerage suggests that the emergence of the internet has caused a change in the behavior of shareholders: shareholders managing their stocks online have been shown to have on average a significantly higher number of trades compared with shareholders managing their stocks offline.[581] This implies that stockholders' ability to react to any kind of new information has been increased due to the internet and its impact on search costs.[582]

Besides search costs, the general transaction costs have also been decreased by the internet. Online transaction platforms of any nature reduce transactions costs as purchases and other transactions can be done online without the need to interact physically with a (potential) counterpart. Contracts can be negotiated and terminated online, suppliers can be compared and changed by one click.

Scott Morton describes these efficiencies generated by the internet as quality enhancing, time and money saving,[583] and emphasizes the impact of the internet on better matching results between providers and suppliers of goods and services in markets of any kind.[584]

Therefore, we can conclude that the emergence of digital technologies has affected stakeholders' ability to react to reputational loss both by increasing the number of

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577 Scott Morton/ Zettelmeyer/ Silva-Risso, 2001, 502-504.

578 Scott Morton, 2006, 72.

579 Scott Morton, 2006, 67.

580 This can affect prices and market behavior: Brown and Goolsbee (2002) have shown that online price comparison reduced the prices of life insurance in the 1990s by 8–15%.; similar results; similar results have been shown for internet car retailing by Scott Morton/ Zettelmeyer/ Silva-Risso, 2001.

581 See Varian (1998).

582 Bakos states that the reduced search costs have a "significant impact on market equilibria, resulting in an increased allocational efficiency and increased competition" (Bakos, 1997, 1691).

583 Scott Morton, 2006, 80.

584 Scott Morton, 2006, 75-76.

available substitutes and reducing switching costs, thereby possibly reducing the market power of the relevant firm and enhancing stakeholders' ability to react to reputational loss by switching to other counterparts.

3 Summary and Conclusion

We can conclude that the emergence of digital technologies and the altered information process can have an effect on stakeholders' preferences and objectives (thus their willingness to react) in the long term (1). In contrast, the impact of the altered information process on stakeholders' ability to react to reputational loss is considerable: by increasing the number of available substitutes in some markets and decreasing the switching costs, the market power of the respective firm can be reduced (2).

IV Summary and Conclusion of Part D

The objective of this part was to demonstrate that the emergence of digital technologies, particularly the internet, has increased the potential of using the behavior modifying effect of threatening firms' reputations as a regulatory tool.

In the first section we have demonstrated that the emergence of digital technologies has caused a structural change regarding the organization of information production (I). The successes of the internet and cellular mobile telephony have led to a radical change regarding production, distribution, access and use of information. The way people make and exchange information has changed radically and was particularly affected by reduced costs of information. This altered information process and its decentralized character have a considerable impact on the public sphere and people's ability to provide and access information. New platforms of information exchange have emerged, empowering individuals to share their observations and experiences with a worldwide audience.

The impact of digital technologies on the occurrence of reputational *loss* was the topic of the second section (II). Based on the finding that reputational loss occurs if information about firm's behavior is communicated and diffused successfully by trustworthy actors indicating that a firm is not behaving as predicted by its reputation, we have demonstrated that the altered information process increases the probability that such information about firms' effective behavior is exchanged between actual and prospective stakeholders. The cases of BP, Reuters and Kryptonite have shown clearly that digital technologies have increased people's ability to communicate and share their experiences with and observations of firms' actions. Furthermore, the examples of Amazon, Tripadvisor and Wikileaks have demonstrated that the internet makes it possible to establish efficient platforms for information exchange, resulting in an improved match of those willing to provide information about their experiences with a firm's actions and those seeking such information. Additionally, we have seen that people tend to consider this form of information as relevant and reliable, so that user-generated content has an impact on stakeholders' decisions whether or not to interact with a particular firm.

In a third step we have looked at the impact of digital technologies on the occurrence of reputational *costs* (III), concluding that the altered information process can have an effect on stakeholders' willingness to react to reputational loss in the long term and that the impact of the altered information process on stakeholders' ability to react to reputational loss is considerable, particularly due to decreased switching and transaction costs. This

leads to a rise in probability that reputational loss causes reputational costs.

We can conclude that the emergence of digital technologies has a strong impact on the potential of using the threatening of firms' reputations as a regulatory tool. The increased probability that information about firms' effective behavior will be exchanged and diffused enhances the likelihood that deviating behavior will be detected and reported, thereby increasing the potential for reputational loss to occur. The occurrence of reputational loss being the requirement for the occurrence of reputational costs, the emergence of digital technologies strengthens the deterrent effect of threatening a firm's reputation as a regulatory tool.

E Summary and Conclusion of Chapter Two

Part E summarizes the findings of chapter two and thereby answers the research question of this thesis, i.e., to explain the conditions that have to prevail in order for threatening a firms' reputations to be an effective regulatory tool.

Part A: Reputation and its Capacity to Modify Behavior

As explained in chapter one, regulation is characterized by having a constraining effect on the behavior of individuals and collectives. The idea of using a firm's reputation as a mechanism to promote certain forms of behavior implies that firms' reputations have the capacity to modify their behavior.

The objective of Part A was to demonstrate the behavior modifying effect of a firm's reputation, to illustrate that not only reputational loss that has effectively occurred but also threatening a firm's reputation can have the capacity to modify firms' behavior and to show that this behavior modifying effect can be used as a regulatory tool to make firms behave according to defined rules or standards.

Hypothesis I Losing its reputation can modify a firm's behavior.

The case studies of Shell, Deutsche Telekom and UNICEF demonstrate that a firm's or organization's reputations have the general capacity to modify and influence its behavior, and thus have a regulatory effect.

Hypothesis II Threatening a firm's reputation can have a behavior modifying effect on a firm as the firm will act in a manner not leading to reputational loss.

The awareness that reputational loss can have a negative financial impact on a firm's business has increased, and reputational loss is nowadays perceived as a threat to the overall value of a company, in particular due to the fragility of reputation: a single failure can severely damage a firm's reputation. This perception is underlined by several surveys as well as annual reports. This finding enhances the deterrent effect of reputational loss. Concerns about reputation, potential reputational loss and its negative financial consequences caused by dispersed mechanisms will have a direct effect on firms' actions and decision making: firms will try to avoid reputational loss and behave accordingly.

Hypothesis III This behavior modifying effect can be used as a regulatory instrument in order to achieve that business follows rules within and outside of formalized regulatory regimes.

The deterrent effect of threatening firms' reputations can be incorporated into formalized regimes. The examples given of restaurant hygiene enforcement in the cities of Los Angeles and Berlin demonstrate the implementation of sanction mechanisms that rely on the deterrent effect of reputational loss and its negative financial consequences.

As a conclusion to Part A we have stated that the idea of using the deterrent and behavior modifying effects of threatening firms' reputations as an instrument to achieve compliance with rules requires

- that a firm's non-compliant behavior would lead to reputational loss,
- that this reputational loss would have a negative financial impact on the firm's business (thus lead to reputational costs being incurred), and
- that the expected reputational costs outweigh the benefits from non-compliant behavior.

These three requirements determine whether the threatening of firms' reputations is an effective regulatory tool and they provide the structure for proceeding further in this thesis. Based on these findings, Part B aims to understand under what circumstances a firm is faced with reputational loss and Part C aims to understand when the occurrence of reputational loss leads to the occurrence of reputational costs.

Part B: The Nature of Reputational Loss

According to Part A, the behavior modifying effect of threatening firms' reputations will only occur if non-compliant behavior leads to damage to or loss of a firm's reputation.

The objective of Part B was to understand the conditions in which a firm is faced with reputational loss.

Hypothesis IV Reputational loss occurs under two conditions: firstly, if the effective behavior of a firm deviates from the expectations of its stakeholders, both towards the particular stakeholder itself and towards other stakeholders, and, secondly, if the divergence between stakeholders' expectations and effective behavior is observable.

This objective of Part B was achieved by proceeding in three steps. In a first step, the stakeholder approach is introduced in order to have a basic framework for understanding firms' environments. In a second step, the questions of how stakeholders' expectations regarding firms' behavior develop and the role played by firms' reputations in this process are raised and answered. In a third step, the mechanisms of the effective occurrence of reputational loss due to the observability of firms' effective and deviating behavior are explained.

In the *first step*, we have seen that the approach of stakeholder theory to understand a firm's business as "a set of relationships between customers, suppliers, communities, employees, and financiers (and possibly others)" is a helpful concept for understanding and analyzing a firm's environment and the interactions of the firm with that environment – and reflects a view of firms' environment as implied by our assumptions. This approach highlights that each of the different stakeholder groups has primary topics of interaction with the firm. However, the preferences of the different stakeholder groups do not have to be limited to these primary topics of interest. The stakeholder approach has been introduced in order to serve as the basic framework for understanding how firms' stakeholders develop expectations regarding firms' behavior towards the different stakeholder groups.

In a *second step*, we have seen that the question about with whom to interact is essential in any market. People have to make decisions and choices out of a variety of alternatives. The result of such a decision making process is that an individual forms expectations about the likely future behavior of a (potential) counterpart. These expectations serve as a basis for the decision whether or not to interact with a potential counterpart and rely on the answer to the question of whether the counterpart is likely to behave in accordance with the decision maker's preferences and objectives. People are faced with a number of informational uncertainties regarding the likely future behavior of their (potential) counterparts. Faced with this uncertainty, they can either rely on their own (direct) or other people's (indirect) experiences in order to find out whether a potential counterpart is likely to behave in accordance with their preferences and objectives. In both cases the extrapolation principle is applied in order to infer future behavior from past actions. A firm's reputation provides information about other people's experiences with that firm's behavior in the past and hence about the firm's likely future behavior. Thus, firms' reputations can play a crucial role for stakeholders' decisions on with whom to interact.

A firm gains its reputation if and when knowledge and information about people's former interactions with the firm are exchanged, thus communicated and diffused. This means that those who have been involved in former interactions have to make their experiences accessible and those seeking information have to perceive that information as relevant. Furthermore, the information exchanged has to refer to stable and consistent behavior of the firm, otherwise no reputation will be formed. We assume firms to have multiple reputations, thus a primary reputation for each stakeholder group according to the major, primary subject of the firm-stakeholder interactions as defined by the stakeholder approach. Besides this primary interest, we assume that stakeholders can also have preferences regarding the firm's behavior towards another stakeholder group.

Particularly in information settings characterized by a high level of informational constraints, a firm's reputation serves as *the* information about the likely future behavior of the firm and therewith as *the* informational base for a (potential) stakeholder's decision whether to interact with that firm. A firm's reputation can be an important determinant of stakeholders' expectations regarding the firm's future behavior as stakeholders expect the firm to behave in a manner that is consistent with its reputation.

In a *third step*, we stated that reputational loss only occurs if a firm's effective behavior deviates from its stakeholders' expectations and if the deviating behavior, being the divergence between expected and effective behavior, is observable by the firm's stakeholders. This means that other people's experiences with deviating behavior have to be communicated, diffused and perceived as relevant by other (potential) stakeholders. While consistent information that is exchanged about people's experiences with a firm's past actions strengthens the firm's reputation, mixed signals indicating a significant discrepancy between the hitherto reported and the currently communicated information can immediately damage the firm's reputation and lead to the occurrence of reputational loss.

As a conclusion of Part B we have stated that the requirements for reputational loss to occur are

- the existence of effective information exchange among the potential and actual stakeholders of a firm so that people's experiences with that firm can be communicated and diffused successfully,

- that the information exchanged (other people's experiences with the firm) is perceived as relevant and affects areas of interaction that are of importance to the firm's stakeholders, and
- that the information exchanged indicates that the firm is not behaving as predicted by its reputation.

Part C: The Nature of Reputational Costs

According to Part A, the behavior modifying effect of threatening a firm's reputation will only occur if reputational loss leads to a negative financial impact on the firm's business, thus to the occurrence of reputational costs.

Based on this requirement, the objective of Part C is to understand under which circumstances the occurrence of reputational loss leads to the occurrence of reputational costs.

Hypothesis V Reputational costs only occur if a firm's actual and potential stakeholders are willing to react to reputational loss and if the firm's stakeholders are capable of doing so.

The definition of reputational costs as *costs that are caused by the reaction of a firm's actual and potential stakeholders to reputational loss* underlines the dispersed character of reputational sanctions. A firm's actual and potential stakeholders will only react to damage or loss to the firm's reputation if the deviating behavior affects an area of interaction that is of importance to the stakeholders' preferences and objectives and their decisions to interact with that counterpart. Stakeholders are only willed to react to reputational loss if the firm's stakeholders would not have interacted with the firm if they would have known about the firm's effective behavior. This holds for both actual and potential stakeholders. Each stakeholder group has particular preferences and objectives regarding firms' behavior according to the primary subject of the firm-stakeholder interaction as defined by the stakeholder approach. However, stakeholders can also have preferences regarding the firm's behavior towards other stakeholder groups. Thus, stakeholders' willingness to react to reputational loss can differ according to the preferences of the different stakeholder groups.

The second requirement for the occurrence of reputational costs is that firms' stakeholders have to be capable of reacting. Stakeholders' ability to react is essential as

the *reaction* of firms' stakeholders is what constitutes the occurrence of reputational costs and therefore the behavior modifying effect. This ability depends predominantly on the market power of the respective firm in the relevant market. Market power is determined mainly by the number and size of alternative counterparts in the market that offer substitutes, the switching costs of choosing an alternative counterpart and stakeholders' ability and willingness to possibly relinquish the satisfaction of their needs (no need for alternative counterpart).

As a conclusion of Part C we can state that the requirements for reputational costs to occur are

- that the firm's reported and communicated effective behavior causing reputational loss has to affect an arena of interaction that is of importance to one or more stakeholder groups as the firm's effective behavior indicates that the firm does not behave according to some stakeholders' preferences and objectives, and
- there must be alternatives to the respective firm in the relevant market to which the stakeholder group(s) who are willing to react (as their preferences and objectives regarding the firm's behavior are affected) belong.

Part D: The Impact of Digital Technologies

The findings of the Parts A, B and C suggest that the potential occurrence of reputational loss and reputational costs determine whether or not threatening firms' reputations has a behavior modifying effect. Furthermore, we have analyzed the requirements determining the occurrence of reputational loss and reputational costs.

The objective of Part D is to understand the impact of the emergence of digital technologies on the potential of using the threatening of firms' reputations as a regulatory tool.

Hypothesis VI The emergence of digital technologies, particularly the internet, has significantly increased the potential of using the behavior modifying effect of threatening firms' reputation as a regulatory tool. This is due to the emerged altered information process and its enhancing impact on the factors determining the occurrence of reputational loss and costs.

The rise of the internet and cellular mobile telephony has led to a radical transformation of the information environment in the last two decades. These developments have led to a structural change regarding production, distribution, access and use of information. The ways people make and exchange information have changed as new platforms of information exchange have emerged. The altered information process and the decentralized character of the internet have empowered individuals to share their observations and experiences with an almost worldwide audience.

The internet facilitates an effective information exchange among potential and actual stakeholders of a firm, thereby enhancing the probability that people's experiences with a firm will be communicated and diffused successfully. The cases of BP, Reuters, Kryptonite, Amazon and Tripadvisor have impressively demonstrated consumers' enhanced ability to communicate their experiences with firms' actions and other stakeholders' ability to access such information. Furthermore, surveys suggest that user-generated content is perceived as trustworthy and relevant and plays an important role in people's assessments of whether or not a potential counterpart is likely to behave consistently with their preferences and objectives.

One central insight of Part D was that the emergence of digital technologies and the altered information process has had an impact on the requirements for reputational costs to occur. In the long term the internet can assist all kinds of groups in low-cost networking and in raising awareness of particular issues, and thus affect stakeholders' preferences and therefore their willingness to react. Even more important is the impact of the altered information process on factors determining stakeholders' ability to react immediately to reputational loss: the internet can broaden the relevant geographic market by transcending the limits of physical search and leads to a considerable reduction of switching costs.

As a conclusion of Part D we can summarize that the emergence of digital technologies increases the potential of using the threatening of firms' reputations as a regulatory tool. This is due to

- the increased probability that information about firms' effective (deviating) behavior will be exchanged among actual and potential stakeholders, which in turn increases the likelihood of the occurrence of reputational loss;
- stakeholders' increased ability to react to reputational loss, caused by decreased transaction costs, and resulting in a greater choice of alternative available

counterparts (substitutes) which increases the likelihood of the occurrence of reputational costs.

Conclusion and Formula of Reputational Costs

The objective was to explain the conditions that have to exist in order for threatening a firm's reputation to be an effective regulatory tool. In Part A we have outlined the three general requirements that have to be fulfilled in order for threatening a firm's reputation to be an effective regulatory tool. In Part B and Part C we have analyzed under which conditions two of the requirements are fulfilled. The results have been summarized above.

Coming back to the finding of chapter one that regulation needs to consist of the three functions of standard setting, information gathering and behavior modification, we can conclude that the following conditions have to exist in order for threatening a firm's reputation to be an effective regulatory tool:

I. Standard Setting: The standards (rules) that should be followed by firms, according to those who seek to promote certain forms of behavior (regulators), have to be in accordance with the preferences and objectives of the firm's stakeholders if behavior modification is to take part at the firm level, or with the stakeholders of the firms in the same market if behavior modification is to take part on industry level. Furthermore, the relevant firm(s) must not have a reputation for behavior contrary to these standards.

II. Information Gathering: Additionally, there has to exist an effective information exchange between potential and actual stakeholders of the firm(s) that are sought to be regulated. This means that there has to be a high level of observability of firms' effective behavior.

III. Behavior Modification: Furthermore, those groups of stakeholders whose preferences and objectives regarding the firm(s)' behavior are in accordance with the regulatory objectives and standards have to be capable of reacting to reputational loss.

These three conditions have to exist for threatening firms' reputations to be an effective regulatory tool in any sense. Furthermore, the third requirement outlined in Part A needs to be fulfilled: the reputational costs caused by the dispersed reactions of the firm's stakeholders have to outweigh the perceived benefits of non-compliant behavior. This question evidently depends on the characteristics of the relevant market and the firms that are sought to be regulated. Firms are assumed to analyze the costs and benefits of a non-compliance decision, that is, of not behaving in accordance with stakeholders' preferences and objectives. Reputational costs are a central part of this cost-benefit analysis. A firm, being faced with diverging preferences and objectives, is assumed to trade off the preferences of the different stakeholder groups. The higher the potential reputational costs caused by behavior that does not comply with the preferences of a stakeholder group, the higher the likelihood that the reputational costs will outweigh the perceived benefits from a non-compliance decision, and the higher the probability that a firm will behave in accordance with the preferences and objectives of the relevant stakeholder group(s).

The three requirements outlined above determine the size of the potential reputational costs and can be summarized in the following formula of reputational costs:

1.1 $\Delta_{EB} \equiv [\mathbf{E}_{\text{Stakeholder}} - \mathbf{B}_{\text{Firm}}]$

1.2 $\Delta_{EB} \times \boldsymbol{\alpha} \times \boldsymbol{\beta} = \text{Reputational Costs}$

$\mathbf{E}_{\text{Stakeholder}}$	=	Stakeholder's expectations towards a firm's behavior
$\mathbf{B}_{\text{Firm}}$	=	A firm's effective behavior
$\boldsymbol{\alpha}$	=	Observability of a firm's actions and degree of information exchange
$\boldsymbol{\beta}$	=	Stakeholders' potential to react to reputational loss

The first part of the formula reflects that reputational loss will only occur if there is a divergence ($\boldsymbol{\Delta}$) between the expectations of firms' stakeholders regarding the firm's behavior and the firm's effective behavior, thus if the firm behaves *differently than predicted*.

The second part of the formula highlights that if such divergence exists, the size of the potentially occurring reputational costs is, according to our findings, determined by the level of observability ($\boldsymbol{\alpha}$) of the firm's actions. Only if the effective behavior of a firm is

communicated and diffused will reputational loss occur. Furthermore, those stakeholders whose expectations are affected by the delta (**Δ**) have to be able to react (**β**) to the occurred reputational loss. The formula highlights that reputational costs will not occur if any of these conditions is not fulfilled.

Therefore, the question of which conditions have to prevail in order for threatening a firm's reputation to be an effective regulatory has been answered.

Based on these findings, the next chapter will deal with the practical prospects and limits as well as the legal constraints of threatening a firm's reputation as a regulatory tool. We will introduce a model that provides a guideline in order to assess whether threatening a firm's reputation is likely to cause a behavior modifying effect for a particular firm or in a particular market. We have seen that the aggregation and provision of information plays a crucial role for the effectiveness of this regulatory tool. Therefore, we highlight the legal constraints for state and non-state actors regarding the function of information gathering.

Chapter Three: Limits, Prospects and Legal Constraints of Regulation by Reputation

In chapter one we defined regulation as all actions having a constraining effect on the behaviors of individuals and collectives, thus having the capacity to modify behavior. In chapter two we analyzed the conditions that have to exist for threatening a firm's reputation to be an effective regulatory tool. One of the main findings is that the regulatory tool of threatening a firm's reputation relies on dispersed mechanisms: it is the ability of the firm's stakeholders to react to reputational loss that causes the behavior modifying effect of this regulatory instrument.

The objective of this third chapter is to draw out the practical prospects and limits of this regulatory tool, and the legal constraints for those parties that seek to achieve behavior modification by threatening a firm's reputation (regulators).

In **Part A** of this chapter we examine in more detail the necessary conditions that have to prevail in order for threatening a firm's reputation to be an effective regulatory tool and introduce a model that allows interested parties to assess whether threatening a firm's reputation is a suitable tool to cause behavior modification if applied to a certain firm (*company level*) or to a particular market (*industry level*). By doing so, we highlight the practical prospects and limits of this regulatory tool. Furthermore we show that the aggregation, provision and diffusion of information about a firm's effective behavior is *the* requirement that can be adapted most easily by the parties interested in regulation.

Referring to this finding and the crucial role which the aggregation, provision and exchange of information about a firm's effective behavior plays with regard to the effectiveness of threatening a firm's reputation as a regulatory tool, **Part B** will discuss the *legal constraints* for state and non-state actors regarding their activities in performing this function of information gathering. We focus on the law applicable in Switzerland. In **Part C**, we summarize the findings as to the prospects and practical and legal constraints of applying this regulatory tool.

A A Model to Assess the Capability of Regulation by Reputation

Threatening a firm's reputation is a regulatory approach that can cause behavior modification, both on a market and an individual level. We have analyzed the conditions that have to prevail in order for this regulatory tool to be effective.

The *objective* of this part is to introduce a model that provides a guideline for interested parties in order to assess whether these conditions are likely to be fulfilled in a particular setting and thus to assess whether threatening a firm's reputation is likely to have a behavior-modifying effect.

By providing such a guideline which helps to assess whether the conditions are fulfilled we highlight the practical limits and prospects of this regulatory tool, on the one side, and clarify what those parties interested in applying this regulatory tool can do in order to make reputational sanctions work, on the other side.

We proceed as follows: In a first step, we turn to the findings of chapter two and examine the three identified conditions that have to exist in order for threatening a firm's reputation to be an effective regulatory tool in more detail (**I**). In a second step, we introduce a model that helps to assess whether threatening a firm's reputation is likely to perform the goal of behavior modification in a particular setting. The model focuses on the first condition (stakeholders' expectations) and the third (stakeholders' ability to react) (**II**). In a third step, we turn to the second condition, the need for an effective information exchange amongst the firms' stakeholders as this condition can be influenced by parties interested in regulation most easily (**III**). In a fourth step we summarize the findings (**IV**).

I The Three Conditions

The conclusion of chapter two is that *three conditions* have to exist in order for threatening a firm's reputation to be an effective regulatory tool.[585] Only if these three conditions are fulfilled in a particular market or for a particular firm is this regulatory tool likely to achieve behavior modification.

If a party that is interested in modifying the behavior of a firm or a group of firms is attempting to achieve this goal by threatening the firms' reputations, the model will provide a decision tree to assess whether this is likely to be successful.

Who might these interested parties be? In chapter one of this thesis we have seen that one of the features of "alternative" regulatory regimes is the cooperation and interaction of different state and non-state actors and its reliance on dispersed mechanisms.[586] According to this statement and the findings of the different case studies presented, we define any party as a *potential regulator* that seeks to ensure that the conduct of a single firm or a group of firms conforms to certain *standards*.

As we have seen, these parties might be state authorities (as in the Berlin case), civil society actors (as in the Shell/Greenpeace case) or individual actors (as in the UNICEF case). Besides the variety of potential regulators it is to be noted that the standards that are sought to be enforced can also vary to a great extent, and range from enacted laws and codes of conduct to generally accepted social norms. However, not only can the potential regulators and standards vary but the whole nature of the different regulatory approaches: they can be designed to achieve behavior modification and compliance with rules in the long term or just in the short term, aim at a single case or the regulation of a whole industry. They can be incorporated into law or intend to cause a one-off "scandal".

Let us now turn to the *three conditions* identified in chapter two which have to be fulfilled in order for a firm's non-compliant behavior to lead to the occurrence of reputational loss *and* costs, and thus for threatening a firm's reputation to be an effective behavior-modifying tool, and discuss them in more detail. As already discussed, the first condition is about the *preferences and objectives* of the firm's stakeholders (**1**), the second condition is about the *information exchange* between potential and actual stakeholders of the firm (**2**), and the third condition is about the *market structure* of the relevant firm-stakeholder interaction (**3**).

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[585] See chapter two/ E.

[586] See chapter one/ C.

1 Condition I: Regulators' Standards Have to Be in Accordance with Stakeholders' Preferences

Regarding the first condition and the function of standard setting, we have concluded that

- the *standards* which should be followed by a firm, according to the *potential regulator* that seeks to promote certain forms of behavior, have to be in accordance with the preferences and objectives of the firm's stakeholders. This holds both for regulation on a company level and regulation on an industry level;
- the relevant firm, furthermore, must not have a reputation for behaving contrarily to these standards.

This condition can also be found in the introduced formula of reputational costs, as a *divergence* (**Δ**) between the expected and effective behavior of a firm is the precondition for reputational loss (and therefore costs) to occur. This means that if a firm's behavior is non-compliant regarding the *standards* that the *potential regulator* seeks to enforce, *reputational loss will occur only if these standards are in accordance with the stakeholder's expectations regarding the firm's behavior*. We have seen that these expectations are made up of the stakeholder's preferences and objectives and the available information about a firm's behavior in the past. Based on this information, the stakeholder will extrapolate the firm's likely future behavior.[587]

For this reason, it is furthermore essential that a *firm does not have a reputation for behavior that is clearly contrary to the standards* that are to be implemented: reputational loss in case of non-compliant behavior would just not occur as the firm's effective (non-compliant) behavior would be *as predicted* by its reputation. Instead of reputational loss, the firm's reputation for non-compliant behavior would be strengthened due to the stability and consistency of its behavior.[588] Thus, there would not be any discrepancy between the hitherto communicated and the current (communicated) signals. Therefore, no divergence would exist between the behavior expected by the firm's stakeholders and the firm's effective (non-compliant) behavior.

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[587] See chapter two/ B/ II/ 4.

[588] See chapter two/ B/ III/ 3

2 Condition II: Existence of An Effective Exchange of Information Between Actual and Potential Stakeholders

Regarding the second condition and the function of information gathering, we have concluded that

- an effective exchange of information has to exist between the actual and potential stakeholders of the firm that is to be regulated.

This condition implies that information about people's interactions with the firm that is to be regulated has to be exchanged, thus communicated and diffused. As analyzed in chapter two, this means that those who have been involved in former interactions have to make these experiences available and those parties seeking information have to be able to access that information and furthermore perceive it as *relevant*.[589] Only if these requirements are fulfilled can the information about a firm's *non-compliant behavior* lead to reputational loss, as mixed signals that indicate a significant discrepancy between the previous reports and the currently communicated information will cause reputational loss.[590]

This condition is reflected in the formula of reputational costs by the factor $\boldsymbol{\alpha}$: if the level of observability of a firm's effective behavior is low, or if the effective behavior of the firm that is to be regulated is not reliably observable for potential and actual stakeholders at all, they would not be able to realize the potential existence of a divergence between the expected behavior of the firm (compliance with the *regulator's standards*) and its effective behavior. Thus, non-compliant behavior would not be detected and neither reputational loss nor reputational costs could occur. Therefore, a *high level of observability* of the firm's effective behavior is absolutely essential if *potential regulators* seek to achieve a behavior modifying and deterrent effect by threatening a firm's reputation.

[589] See chapter two/ B/ II/ 2.2.

[590] See chapter two/ B/ III/ 2.2.

3 Condition III: The Market Structure of the Firm–Stakeholder Interaction Has to Allow to React to Non-Compliant Behavior

As a third condition with regard to the function of behavior modification we have concluded that

- those stakeholders whose preferences and objectives regarding the firm's behavior *are* in accordance with the *regulatory standards have to be capable of reacting* to reputational loss.

The third condition has to be fulfilled in order for reputational costs to be incurred in case of non-compliant behavior. If the first two conditions are fulfilled, a firm is only likely to comply with the *potential regulator's standards* if the violation of these standards would cause not only reputational loss but also *reputational costs*.

We have analyzed that it is the aggregated reaction of a firm's stakeholders to reputational loss that ultimately causes the deterrent effect of threatening a firm's reputation.[591] Only if those stakeholders of a firm, whose preferences and objectives regarding the firm's behavior are in accordance with the *regulator's standards*, are able to react to an observable violation of the *regulator's standards* (causing reputational loss) is the behavior modifying effect likely to occur. The focus has to be set on the capability of a firm's stakeholders to react, as their willingness is already assumed to be given by the fulfillment of the first condition: if the non-compliant behavior does not affect an arena of interaction that is of importance to stakeholders' preferences and objectives, the *standards* to be enforced by *potential regulators* would not be in accordance with the preferences and objectives of the stakeholders (and the first condition would not be fulfilled).

This third condition is reflected in the formula of reputational costs by the factor $\boldsymbol{\beta}$: if a firm's stakeholders are not able to react to non-compliant behavior, no reputational costs can occur. Hence, threatening a firm's reputation would not have a behavior modifying effect as the perceived benefits from non-compliance with the *potential regulator's standards* would (from the firm's perspective) most likely outweigh the costs.

In summary, it is important to underline the need for *all three conditions* to be fulfilled in order for threatening a firm's reputation to be an effective regulatory tool. Potential regulators have to bear in mind, furthermore, that the question whether the potential

[591] See chapter two/ C/ II.

reputational costs are likely to outweigh the expected benefits from *non-compliant* behavior depends *on the number of stakeholder groups for which the three conditions are fulfilled*. The higher the number of stakeholder groups for which these three conditions are fulfilled, the higher the likelihood that the potentially occurring reputational costs caused by non-compliant behavior will outweigh the perceived benefits.

The following graph summarizes the three conditions that have to prevail in order for threatening firms' reputations to be an effective regulatory tool.

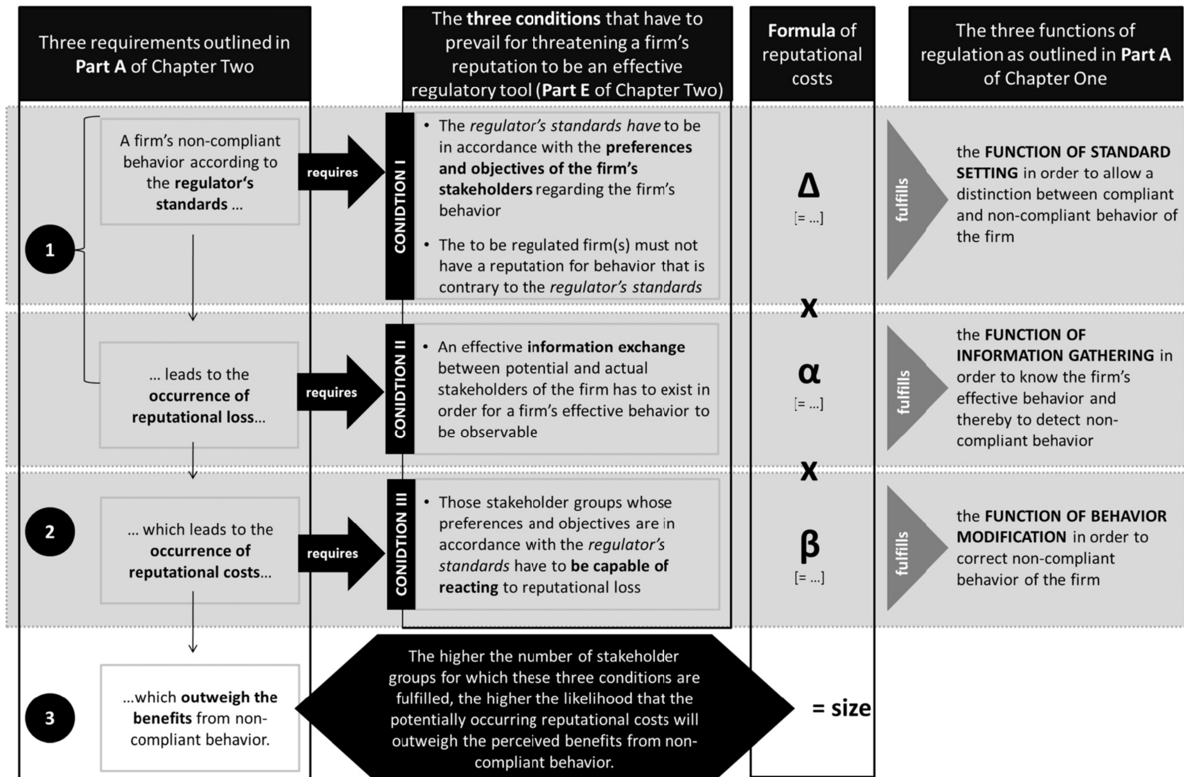

Figure 22: The Three Conditions for Threatening a Firm's Reputation to Be an Effective Regulatory Tool

II The Model

Having identified the conditions that have to prevail in order for threatening a firm's reputation to be an effective regulatory tool, the objective of this section is to introduce a model that helps to assess whether these conditions are likely to be fulfilled in a certain setting, and thus whether threatening a firm's reputation will achieve the goal of behavior modification.

The model is built on two restrictions: we focus on two of the three conditions identified and on two particular stakeholder groups.

The **first restriction** is that the model focuses on two of the three conditions:

> *Firstly*, whether the *regulator's standards* are in accordance with the stakeholders' preferences and whether the firm does not have a contrary reputation (Condition I).
>
> *Secondly*, whether the market structure of the relevant firm-stakeholder interaction allows those stakeholders whose preferences and objectives are in accordance with the *regulatory standards* to *react* to non-compliant behavior, thus to occurring reputational loss (Condition III).

The reasons why the model focuses on the assessment of these two conditions is that we assume that neither stakeholders' preferences and objectives nor the market structure (thus the market power of a firm) of a particular firm-stakeholder interaction can be influenced and changed in *the short term*. From a *regulator's* perspective these conditions have to be taken as given as they are outside the regulator's sphere of influence. That means if these conditions are not fulfilled for a certain setting, threatening a firm's reputation will not be effective as the *regulator* will not be capable of influencing the fulfillment of these two conditions in the short term, while we assume potential regulators rather to be capable of influencing the second condition. This does not imply that neither the preferences of a firm's stakeholders nor the market power of a firm cannot be influenced by *potential regulators* or other parties in the *long run*: we have already seen that campaigns of influential civil society actors can raise awareness about particular issues and change stakeholders' preferences in the long term. However, few actors have the resources to run such campaigns and furthermore these campaigns are only likely to be successful after having been run for a considerable time.

The **second restriction** is that the model focuses on the question whether these *two* conditions are fulfilled for two particular stakeholder groups: a firm's customers and its financiers.

The reason is that customers and financiers are two stakeholder groups whose reaction to non-compliant behavior can have an extremely significant negative financial impact on a firm's business, as both are central to the prosperity of any firm: without their support the business "would cease to viable"[592]. Furthermore, these two stakeholder groups are most likely to have the capability to react to non-compliant behavior: the structure in the relevant markets tends to be more competitive and thus it might be easier for customers or financiers to find substitutes than it might be for other stakeholder groups, such as employees, as these stakeholder groups either have fewer alternative counterparts to interact with or generally face high switching costs when changing their counterparts.[593]

Based on these two restrictions we introduce a model that consists of three steps. In a first step we turn to the standards that potential regulators seek to implement (**1**), in a second step we turn to the first condition and how to assess whether stakeholders' preferences are in accordance with the regulators' standards (**2**); in a third step we consider under which circumstances stakeholders are able to react to reputational loss, thus whether the third condition is likely to be fulfilled (**3**). Lastly, we summarize the findings (**4**).

1 First Step: Definition of Regulators' Standards

The first step for any potential regulator is to define those standards or rules that should be followed by a firm, thus to answer the question of which behavior should be regulated and modified. We have seen that the standards that are to be enforced by threatening a firm's reputation can differ remarkably in their nature: both the framework of the four modalities of regulation introduced in chapter one and the different case studies presented in the course of this thesis have highlighted that these standards can vary in their nature.

In the case of hygiene standards in restaurants in Berlin, the standards that were to be followed were enacted in German law regulating the minimal standards, similar to the case in Los Angeles. Contrary to these two cases, Shell's plans to sink the Brent Spar on the North Atlantic seabed conformed to the relevant UK law and were approved by the UK government. In this case, the standards that Greenpeace sought to enforced were

[592] FREEMAN/ HARRISON/ WICKS, 2010, 26; furthermore see chapter two/ B/ I/ 2.
[593] See chapter two/ C/ II/ 3.

surely not of a legal or otherwise formalized and foreseeable character. Neither were these standards part of the price/quality ratio between Shell and its customers in the gasoline market. Instead, the question of Shell's approach to offshore decommissioning and environmental issues in general rather seems to be part of social norms, thus norms which are not set through the organized and centralized actions of a state but informally by a community. It was Shell's approach to environmental issues that was not appreciated by its German customers and it was Greenpeace that used Shell's customers' preferences in order to fight for a general ban on deep-sea disposals. In the Deutsche Telekom case, the standards whose violation caused reputational loss were a mixture of German data and privacy law and competition-based standards, as its customers did not expect Deutsche Telekom either to violate binding law or to have a questionable approach to data privacy, as the latter is closely linked to the sensitive product of (personal) "telecommunication" provided by Deutsche Telekom.

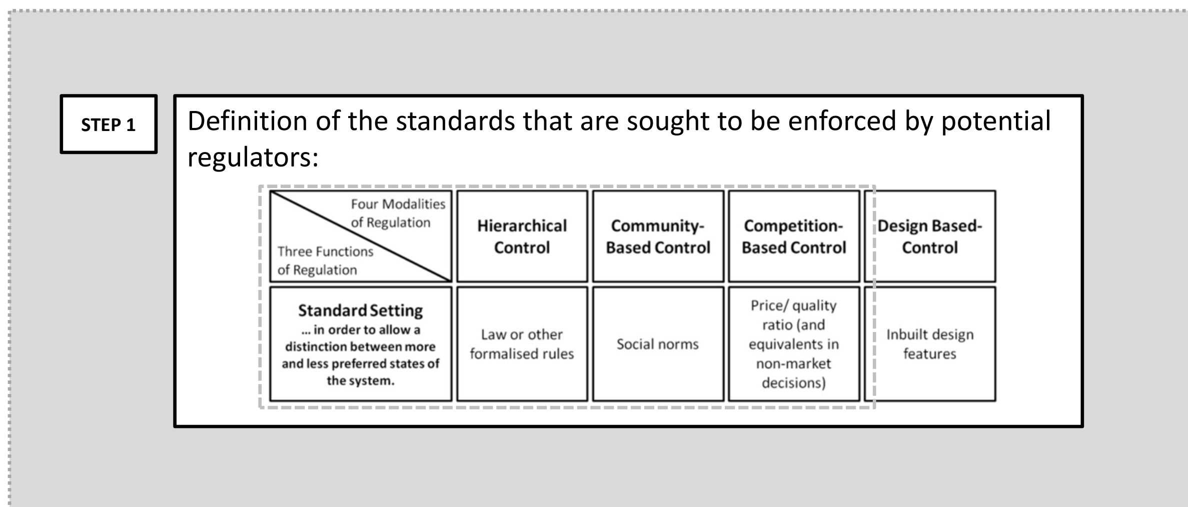

Figure 23: Step 1 – Definition of Standards

It needs to be stressed that the standards that are to be enforced can be different in their nature. The framework introduced in chapter one highlights this characteristic and underlines the different sources of the norms or rules that can be used in order to draw the distinction between *more and less preferred* forms of firms' behavior. However, there is evidence that it is easier for potential regulators to enforce these rules if there is a distinct framework of rules that serves as a *benchmark* in order to compare and analyze whether or not a firm is violating those rules. If there is a clear set of rules it will be easier for potential regulators to demonstrate firms' non-compliance with the rules as well as for firms' stakeholders to judge the firms' effective behavior.

Similar argues the focal point theory of expressive law, stating that "the law's articulation of a behavior can sometimes create self-fulfilling expectations that it will occur"[594]. In addition to the idea that people obey rules to the extent they perceives these rules and their makers as *authoritative* and/ or *legitimate*[595], the focal point theory of expressive law argues that compliance with rules can be achieved or is easier to be achieved by rule's (particularly law's) ability to make a particular behavior salient.[596] Such articulation can create a focal point around which individuals coordinate.

The cases presented in chapter two confirm this perspective: in the case of Berlin restaurant hygiene, the enacted law served as a benchmark to define compliant behavior; in the case of UNICEF the rules of a trustworthy and respected authority, the DIZ, fulfilled this function; similarly German law served as a benchmark to define compliant behavior in the Telekom case. The same function is fulfilled by the standards defined in the self-regulation frameworks (such as code of conducts) presented in chapter one where an organization, whether internally or externally, develops standards that are to be enforced against its members or even a larger community.[597]

In chapter one, we have introduced criteria that can help to distinguish the *power* of rules or standards respectively. Of particular importance is the degree of formality of the standards that are to be enforced, their legal status, i.e., whether or not the standards have binding force and – particularly if the standards do not have binding force – the involvement of external, credible third parties in formulating the rules.[598] The latter, again, refers to the focal point theory of SCHELLING, claiming that third parties could create a focal point by suggesting a possible solution in coordination games.[599]

However, the example of Shell highlights that even standards of formal status and binding force might not be perceived as relevant by a firm's stakeholders, but that the standards that are sought to be enforced by potential regulators' have to be in accordance with the firm's stakeholders. This leads us to the second step of our model.

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594 MCADAMS/ NADLER, 2008, 868; see COOTER (1998); POSNER (2000).

595 MCADAMS/ NADLER, 2008, 867.

596 See MCADAMS/ NADLER (2005).

597 See chapter one/ A/ II/ 2.2.

598 See chapter one/ A/ II/ 2.2.

599 See SCHELLING (1960) for third party influence in coordination games.

2 Second Step: Regulator's Standards and Stakeholders' Preferences and Objectives (Condition I)

If the standards that are enforced by the regulator have been defined, the next step, according to *Condition I*, is to assess whether the regulator's standards are in accordance with the preferences and objectives of the relevant customers and/ or financiers. We have seen that this is the precondition for information about non-compliant behavior of the firm to cause reputational loss.

In order to answer this question, the model suggests proceeding in four sub-steps:

Sub-step 1: Potential regulators have to ask whether the standards that are to be enforced are part of the *primary topics of interaction* of the firm's customers and/or financiers, and whether these two stakeholder groups *benefit* from an enforcement of the standards.

The stakeholder approach has defined the primary topics of interaction for a firm's *customers* to be the promised *benefits of a product or service*, and for a firm's *financiers* to be some form of *financial return*.

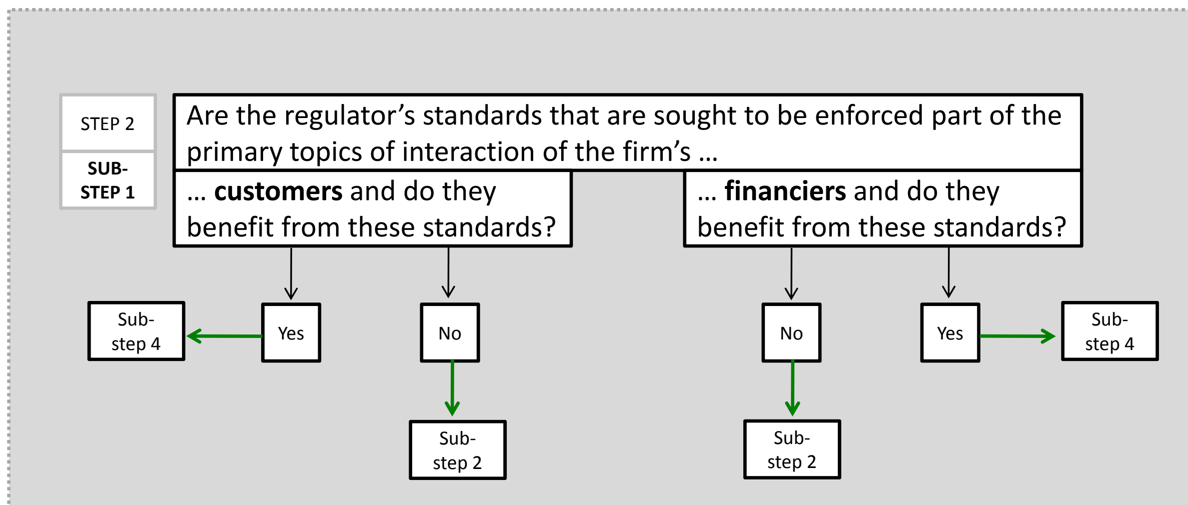

Figure 24: Step 2.1 – Primary Topics of Interaction?

If this question is answered in the affirmative, we assume that the preferences and objectives of the firm's customers and/or financiers will be in accordance with the regulator's standards as these standards concern the primary reason why the stakeholders interact with the firm. Furthermore, the stakeholders would be better off in case of an enforcement of the regulator's standards. In this case, the next two sub-steps (2 and 3) can be skipped.

The cases of UNICEF and Berlin are examples of such a constellation: in both cases the standards that were enforced by threatening firms' reputations were part of the primary topic of interaction for the firms' customers. The level of hygiene in restaurants is part of the promised benefits of the product sold by restaurants (food, pleasure) and the handling of donations affects the promised benefit of UNICEF to support unprivileged children with the donors' money.

Sub-step 2: If this question is answered in the negative, the next question that has to be raised is whether the regulator's standards are part of the *primary topic of interaction* of one of the *other* stakeholder groups of the firm and whether these stakeholder groups would benefit from the enforcement of the regulator's standards.

Why do we proceed with this question? We have seen that the preferences and objectives of a firm's stakeholders do not have to be limited to the typical, primary topics of concern, but that stakeholders can also have preferences and objectives regarding the way a firm behaves towards *other* stakeholder groups to which the stakeholder does not belong. We cited the example of customers who do not want any child labor to be involved in the production of the goods they purchase. Labor conditions being a typical topic of interaction between a firm and its employees, customers in this case would have preferences and objectives regarding a firm's behavior as to the primary interaction of *another* stakeholder group.[600]

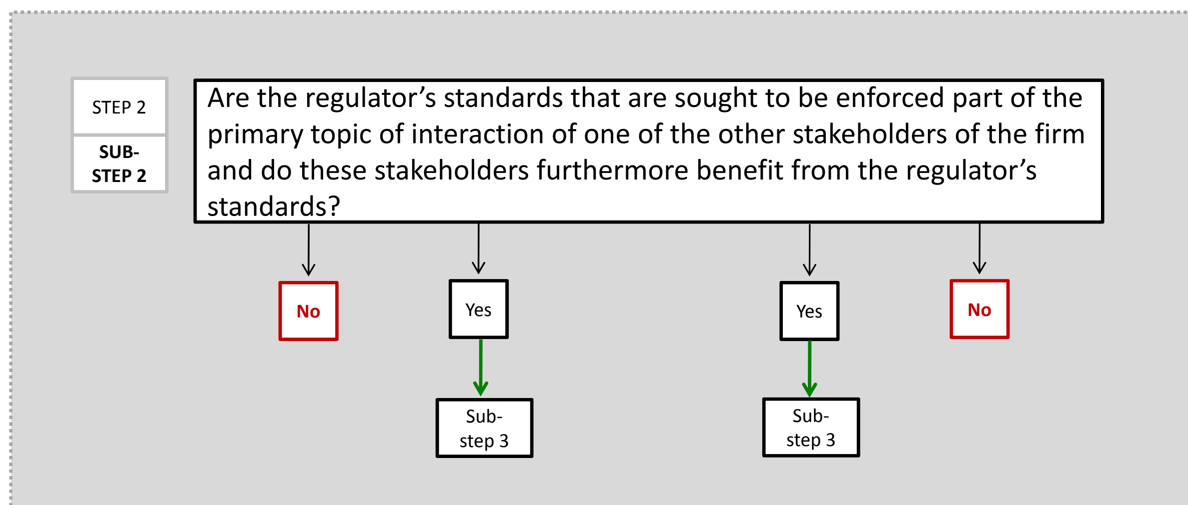

Figure 25: Step 2.2 – Topic of Interaction of other Stakeholder Groups?

The case of Shell refers to a similar situation: the deep-sea disposal of Brent Spar did not affect the primary interaction of Shell and its German gasoline customers. It was Shell's

[600] See chapter two/ B/ II/ 3.2.

attitude towards environmental issues that caused the reputational loss. There is a debate whether or not the "environment" should be considered as a firm's (secondary) stakeholder.[601] Even if one follows FREEMAN's advice to identify concrete instead of "large amorphous groups" of stakeholders[602] and does not accept that "the environment" is a firm's stakeholder, Shell's approach towards environmental issues clearly affects its primary interactions with another (secondary) stakeholder, special interest groups. We have seen that secondary stakeholders are defined as persons or groups that might not be directly part of the *process of creating value* but who can *affect a firm's business*.[603] Without doubt, Greenpeace is of the most important NGOs regarding all forms of environmental issues, particularly if MNCs are involved in any form of environmental misconduct.

Sub-step 3: If the regulator's standards affect a primary topic of interaction of one of the other stakeholder groups, the next question is therefore, whether this interaction is of importance to the customers' and/ or financiers' preferences and objectives.

Only if the standards do affect a primary topic of interactions that is of importance to the firm's customers and/or financiers is it likely that the standards are in accordance with the firm's stakeholders' preferences and objectives (Condition I).

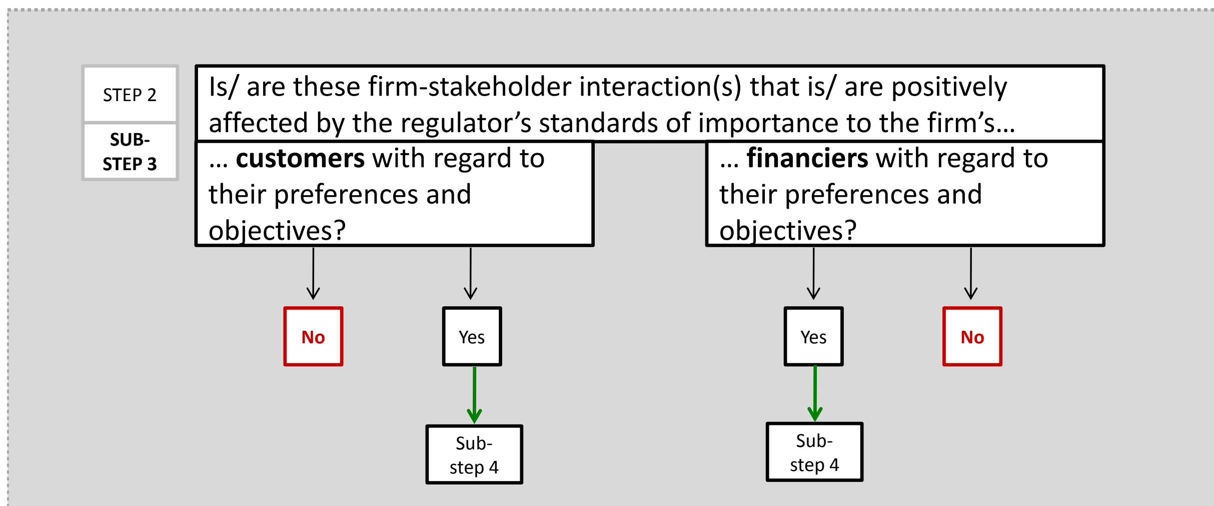

Figure 26: Step 2.3 – Are Topics of Importance?

This question cannot be answered easily by potential regulators. The ultimate way to assess whether this is the case is to conduct representative surveys by asking potential

[601] See PHILLIPS/ REICHART (2000).

[602] FREEMAN/ HARRISON/ WICKS, 2007, 161.

[603] See chapter two/ B/ I.

and actual customers and financiers of a firm whether or not the primary topics of interaction with other stakeholder groups are of importance to them. However, some factors might help to answer this question, or at least help to highlight the different factors that might contribute to the answer:

- *Structure of clients*: a high fraction of end consumers can increase the likelihood that these have more sophisticated expectations regarding a firm's behavior towards other stakeholder groups, such as employees. This can be particularly the case where a socially (or ecologically) sound production or conduct is visible for and can be easily assessed by consumers.[604]
- *Involvement of public entities*: public entities are subject to severe requirements as to the legitimacy of their action and are expected to act as role models (e.g. with regards to the implementation of human rights). Due to the need to often publicly justify their conduct and decisions, including their purchase behavior and investment strategies, it can be assumed that in those cases where public entities constitute a large proportion of a firm's customers and/ or financiers that the firm's conduct towards other stakeholder groups *is* of importance to these stakeholders.
- *Product segment*: it seems to be reasonable that the higher and more luxurious a product or service is (e.g. according to Maslow's pyramid of needs), the more likely consumers have preferences and objectives *beyond* their primary topics of interaction.
- *Nature of industry*: if a firm operates in an ecologically, socially or otherwise sensitive industry and thus provides goods and services with ecological, social or other risks, (end) consumers are more likely to be sensitive towards the firm's behavior towards other stakeholder groups.[605]
- *Geographic preferences*: geographic preferences can play an important role with regards to the social or ecological sensitivity of a firm's customers and financiers.[606]

[604] HAUFLER, 1999, 213.
[605] CONZELMANN/ WOLF, 2005, 16; KING/ LENOX, 2000, 702; REES (1997).
[606] CONZELMANN/ WOLF, 2005, 15.

Sub-step 4: The last requirement that has to be assessed is whether the firm has a reputation among the stakeholder groups of customers and/or financiers for constantly violating the regulator's standards, thus behaving in a non-compliant manner.

We have already outlined why this precondition is important: if a firm does have such a reputation, reputational loss in case of non-compliant behavior simply would not occur, as the firm's effective (non-compliant) behavior would be *as predicted* by its reputation and thus no divergence between the expected and the effective behavior would exist.

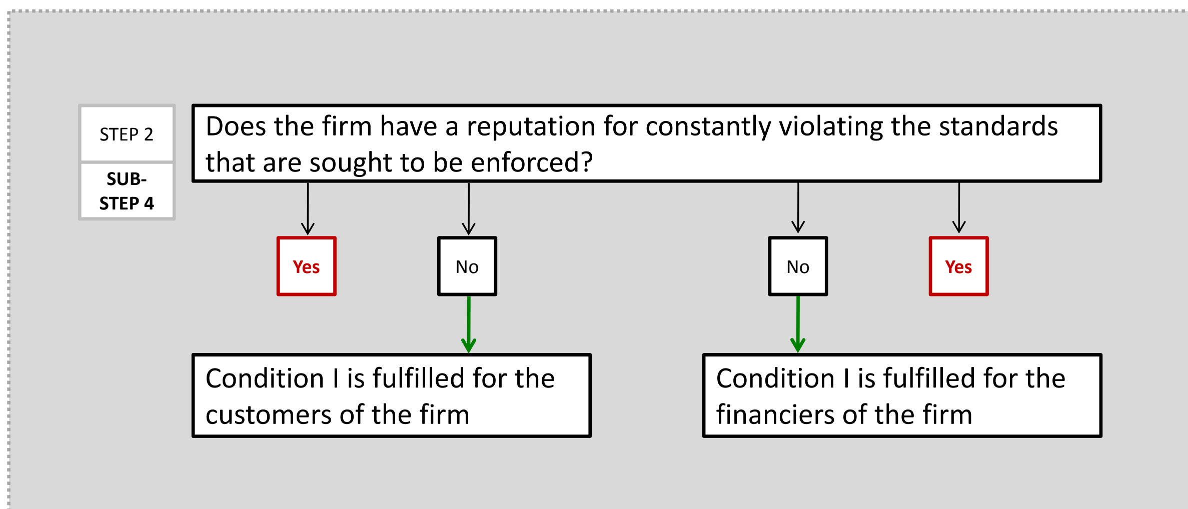

Figure 27: Step 2.4 – Contrary Reputation?

It can be assumed that potential regulators who try to achieve behavior modification by threatening a firm's reputation have a considerable knowledge of the industry and the reputations of firms in it. However, media analyses or surveys might help to substantiate these perceptions.

In summary: a potential regulator who has answered these different questions knows whether *Condition I* is fulfilled for the two stakeholder groups of customers and financiers. Thus, the regulator knows whether its standards are likely to be in accordance with the preferences and objectives of the firm's customers and/or financiers. We have seen that Condition I is important as otherwise no reputational loss would occur in case of non-compliant behavior as no divergence (Δ) between the expected and effective (non-compliant) behavior would exist.

3 Third Step: Stakeholders' Ability to React (Condition III)

If the standards that the potential regulator seeks to enforce are in accordance with the preferences and objectives of the relevant customers and/or financiers, the following question that has to be answered is whether those stakeholders whose preferences *are* in accordance with the regulator's standards *have the capability to react to non-compliant behavior* (= reputational loss). The aggregated reaction of a firm's stakeholders to *reputational loss* being the crucial element of threatening a firm's reputation, an affirmative answer to this question is essential. Only if the stakeholders are able to react to a communicated violation of regulator's standards, will reputational costs and therefore the behavior modifying effect occur.

In order to answer this question the model suggests proceeding in two sub-steps:

Sub-step 1: The first question is whether there is a sufficient number of actors in the market that could be chosen as alternative counterparts, as these actors are able to satisfy the demands of the typical stakeholder-firm interactions. The goods and services offered by these alternative counterparts have to be perceived as "interchangeable or substituting" by the stakeholders and the alternative counterparts must not have a reputation for also violating the regulator's standards.

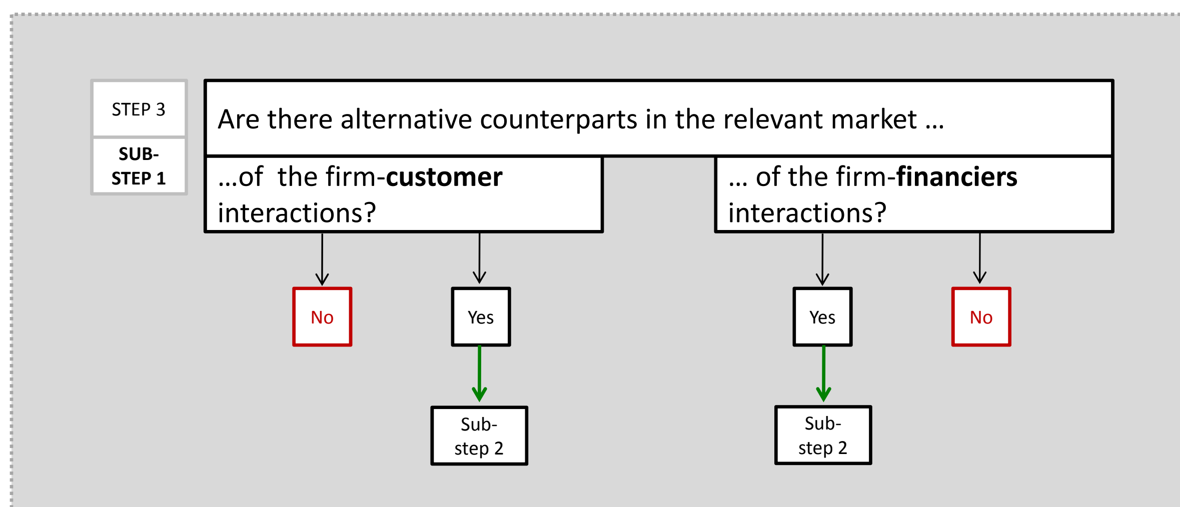

Figure 28: Step 3.1 – Alternative Counterparts?

For both customers and financiers this a question of the market power of the relevant firm. Therefore, the market power of the firm(s) to be regulated has to be assessed. The procedure for both customers and financiers (and indeed every other stakeholder group) is – as already discussed – generally analogous[607]:

[607] See chapter two/ C/ II/ 3.

Firstly, the relevant product and geographic market must be defined, this means questions have to be answered about what kind of products, services and/or benefits are perceived as interchangeable by the respective stakeholders, and in which areas "the undertakings concerned are involved in the supply and demand"[608] of the relevant products and services. The model focuses on the perceived substitutability on the demand side, as this is the relevant factor to decide whether the firm's stakeholders have alternative counterparts with which to interact *in the short term*. To the contrary, supply substitutability, thus the question whether "producers that are currently supplying a different product possess those skills and assets that make it possible to switch production"[609] within a period of six months or one year, has only a long-term effect on the availability of alternative counterparts. Furthermore, it is a criterion that is limited to the stakeholder group of customers.

Secondly, the assessment of the market power of the relevant firm(s) by measuring the market shares held by the firm(s) is a helpful screening device in order to judge whether stakeholders (customers and financiers) do have the possibility to switch to different counterparts.[610] Two thresholds are established in order to decide whether a firm is likely to be dominant in a particular market. The UK Office of Fair Trading suggests that firms with a market share below 40% are unlikely to be dominant while above 50% dominance can be presumed.[611]

Particularly for the definition of the relevant market for a firm's customers it is important to stress that "physical characteristics of products and their use might give some indication as to the possible degree of substitutability between products"[612], but that the focus should rather be on a set of products that "exercise some competitive constraints on each other".[613]

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608 Definition of the relevant market according to the notice of the EUROPEAN COMMISSION on the definition of relevant market for the purposes of community competition law, *Official Journal C 372 , 09/12/1997 P. 0005 – 0013*, available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31997Y1209(01):EN:HTML>, accessed on January 17, 2011.

609 MOTTA, 2004, 103.

610 MOTTA highlights that "a firm's market share is not sufficient to conclude that it is dominant" (MOTTA, 2004, 117). For example, in cases in which other actors could easily enter the industry, or where stronger actors on the demand side exist, a firm's market power might be lower than indicated by its high market share (see MOTTA, 2004, 117ff.). However, it is a reasonable starting point, particularly for the purpose of this model.

611 UK Office of Trading and Fair Competition cited in MOTTA, 2004, 117.

612 MOTTA, 2004, 110.

613 MOTTA, 2004, 102; an example that highlights this point: while trains and buses are different products they can still be in the same market as long as they provide a similar benefit, that is, public transportation from A to B.

Consumer surveys and market research studies can contribute to understand which products and services are seen as interchangeable and substitutable by consumers.

For *financiers* the case is more difficult as the question whether different investment opportunities are perceived as interchangeable cannot be answered easily on a general level, as the answer to the question depends much more on each financier's individual perspective. However, at least for listed companies, it should be possible to assess whether there are interchangeable investment opportunities as to the expected financial return, the latter being the primary topic of interactions between firms and their financiers. Of particular interest will be the portfolio structure of the relevant financier and the question whether alternative investment opportunities exists with regards to criteria such as industry, performance, return and risk.[614]

Sub-step 2: If sub-step 1 can be answered in the affirmative, the next question that has to be answered is whether changing to one of the alternative counterparts would cause high switching costs.

The impact of high switching costs on stakeholders' ability to react to non-compliant behavior (thus, reputational loss) is significant. We have already seen that switching costs can take a variety of forms, some quantifiable and some less easy to measure.

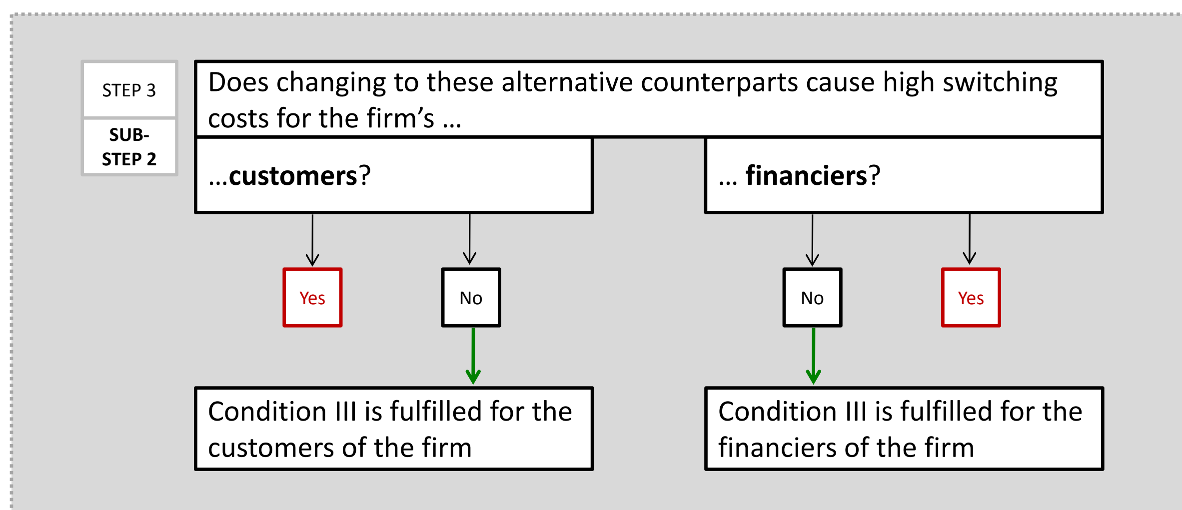

Figure 29: Step 3.2 – Switching Costs?

[614] See SPREMANN (2000).

Potential regulators have to assess whether customers and/or financiers might face considerable switching costs if they switch to one of the alternative counterparts in the relevant market. Particular attention should be paid to

- *Firm-created contractual costs*: costs that are supposed to make stakeholders more loyal, i.e., by getting customers to agree to a contract with a certain minimum term or by getting shareholders to agree to restrictions on the transferability of their shares. If stakeholders are locked in, they will not be able to react to non-compliant behavior.
- *General transaction costs*: costs that arise in situations where changing a counterpart leads to certain efforts.
- *Learning costs*: costs where an investment would be lost if the stakeholder changes its counterpart; e.g., if one has learned how to use certain software and would have to invest a significant amount of time to learn how a different program operates.
- *Compatibility costs*: costs that lock consumers into purchasing follow-on products, or long life-cycles of a product that prevents a short-term reaction of consumers.

The assessment of the possibly occurring switching costs is of particular importance as they reduce the number of alternative counterparts as soon as stakeholders *have interacted* with a firm, as these costs make it worth remaining with a particular counterpart even if this actor is behaving in a manner that is non-compliant with the regulator's standards.[615]

In summary: If alternative counterparts exist and if switching to these counterparts does not entail high switching costs, Condition III is fulfilled, and thus the firm's customers and financiers are able to react to the violation of the regulator's standards.

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[615] MOTTA, 2004, 79.

4 Summary

The model introduced provides a guideline that helps potential regulators to assess whether a particular firm or group of firms is likely to respond to the regulatory tool of threatening a firm's reputation. The model focuses on two of the three conditions that have been identified as essential in order for threatening a firm's reputation to be an effective regulatory tool. The reason why the model concentrates on the first condition – thus on the question whether a firm's stakeholders' preferences and objectives are in accordance with the regulator's standards – and on the third condition – thus on the market structure of the relevant firm–stakeholder interaction – is that these two conditions are outside the sphere of influence of most potential regulators, at least from a short-term perspective. If these conditions are not fulfilled, threatening a firm's reputation will not cause behavior modification.

Furthermore, the model highlights that, due to the reliance of this regulatory tool on dispersed mechanisms, it is important to gain a deep understanding of the situation of the majority of a firm's stakeholders. Only if a firm's stakeholders are willing and able to react, is threatening a firm's reputation likely to cause behavior modification and compliance with the regulator's standards.

In the next section we will turn to the second condition, the existence of effective information exchange, and demonstrate that potential regulators' capability of influencing the fulfillment of this condition is remarkable.

III Condition II: The Existence of Effective Exchange of Information

While the questions whether the regulator's standards are in accordance with the stakeholders' preferences and objectives, and whether the market structure of the relevant firm–stakeholder interaction allows stakeholders whose preferences and objective *are* in accordance with the regulator's standards to react to non-compliant behavior is hardly influenceable by potential regulators in the short term, this does not hold for the second condition. The existence of an exchange of information between potential and actual stakeholders of a firm and the degree of observability of a firm's actions can be influenced by potential regulators in a variety of ways. There is a wide range of instruments and mechanisms that can be applied by those parties that seek to achieve behavior modification of firms.

In a first step, we recall the requirements for an effective information exchange (**1**). In a second step we highlight how potential regulators can contribute to the fulfillment of these requirements (**2**). In a third step, the findings are summarized (**3**).

1 Requirements For an Effective Information Exchange

We have seen that reputational loss occurs if there is a significant discrepancy between hitherto communicated and currently communicated signals, thus experiences with a firm's actions. However, in order for informational signals to cause reputational loss there are three requirements that have to be fulfilled:[616]

> *Firstly*, it is only possible that reputational loss occurs and that non-compliant behavior is detected if some form of interaction with a firm has taken place in the past;
>
> *Secondly*, this knowledge and experiences have to be exchanged: this means that those who have been involved in former transactions have to make the information accessible and those seeking information have to access the information;
>
> *Thirdly*, the information exchanged has to be perceived as relevant by the information seeking parties in order for reputational loss to occur. This means that the source of information has to be perceived as trustworthy.

Only if these three requirements are fulfilled will the diffusion of mixed signals cause reputational loss.[617]

[616] See chapter two/ B/ II/ 2.2.
[617] See chapter two/ B/ III/ 2.2.

2 Contribution of Potential Regulators

The three conditions highlight that potential regulators can play a crucial role for the existence of an effective exchange of information by providing reliable information about firms' effective behavior. By providing or aggregating such information about a firm's effective behavior, potential regulators are capable of triggering a reaction by the firm's stakeholders if the information provided refers to non-compliant behavior.

The range of mechanisms potential regulators can apply is diverse. The case studies have already highlighted some of the possible mechanisms:

- In the case of Shell, Greenpeace provided information about Shell's effective behavior and encouraged Shell's customers in Germany to react to this information. Greenpeace not only monitored the activities of Shell but also *judged* those activities. Performing this watchdog function is typical of the self-concept of many NGOs.
- In the cases of UNICEF and Deutsche Telekom, *individuals* gathered information which they acquired as a by-product of their daily work and provided it to newspapers having a high degree of credibility. Thus this information was perceived as credible and relevant by many of UNICEF's and Deutsche Telekom's stakeholders.
- In the Berlin case, a different approach was highlighted: publicizing the official results of state inspectorates. In this case the regulator itself gathered the information about restaurants' effective behavior as to hygiene, made this information accessible by providing it on the internet, and it was perceived as relevant by many of the restaurants' customers due to the high credibility of the state authority.

These examples already highlight a range of means of how potential (private or state) actors can manage to establish an effective exchange of information between potential and actual stakeholders. However, this list can be extended as the combination of actors and instruments is almost endless. Important mechanisms – particularly for the establishment of a *structured or institutionalized* exchange of information – are furthermore ratings and certificates:

- *Ratings*: ratings of firms have been an important way to provide information about a firm's effective behavior for over a century, ranging from Michelin Guide's

restaurant ratings to corporate debt ratings.[618] The common objective of this form of information provision is always to credibly reduce information asymmetries between those actors being rated and the stakeholders of these actors,[619] particularly to reveal "difficult-to-observe information" about firms' effective behavior. Often this provision of information is combined with the definitions of standards in order to be able to decide whose behavior is to be judged as 'good' or 'bad'.[620] However, the ratings can vary as to the rating process and the actors involved: they can be peer-reviewed or consumer-reviewed, they can be structured or be more randomly organized. A different mechanism is the provision of a platform that allows stakeholders of firms to provide, share and aggregate information about their experiences with and observations of a firm's actions: the examples introduced in chapter two, e.g. Tripadvisor, have highlighted such user-generated information is likely to be perceived as relevant. Other examples include the blacklisting procedure of the Financial Task Force on Money Laundering (FATF), an intergovernmental body whose purpose is to develop and promote national and international policies to combat money laundering and terrorist financing.[621] These recommendations are not binding on the states but compliance is monitored and enforced by a two-tier process consisting of a self-assessment exercise and a multilateral peer-review. Nonmembers of the FATF are monitored as well and since 1998 it has been possible to blacklist a nonmember as non-cooperative country or territory (NCCT) combined with a warning that business partners should give special attention to transactions involving NCCTs.[622]

- *Certificates*: another way how (potential) regulators can provide information about a firm's effective behavior are certificates. The certificates are to guarantee that a firm has complied with certain standards and rules e.g. in the production of a good or that an financier's investment strategy has followed particular standards. A prominent example is the Forest Stewardship Council (FSC). The FSC describes itself as an independent, non-governmental, not for profit organization establish in 1993 to promote the responsible management of the

[618] CHATTERJI/ TOFFEL, 2010, 198.
[619] CHATTERJI/ TOFFEL, 2010, 198.
[620] CHATTERJI/ TOFFEL, 2010, 202.
[621] See <http://www.fatf-gafi.org>, accessed on January 17, 2011.
[622] See VAN AAKEN, 2009, 45ff..

> world's forests. It provides standard setting, trademark assurance and accreditation services for companies and organizations interested in responsible forestry. This is to promote better forest management through the empowerment of consumers to express their demand for responsible forestry by offering an independent and global certificate and label for forest products. At the same time, the FSC highlights that it can be difficult for such information provided by certificates to be perceived as *relevant* as more than twenty different certifications standards as to forestry management co-exist.[623]

While the naming and shaming of *bad performers* is the strength of the blacklisting approach as it allows a firm's stakeholders to easily identify that a firm behaves non-compliant to certain rules, certificates are more likely to cause reputational loss if these certificates are *revoked*. In these cases the discrepancy between *expected* and *effective* behavior becomes obvious for a firm's stakeholders and they are able *to react* to such non-compliant behavior. This effect can be observed with regard to the UNICEF case where the revocation of the donation seal of Germany's leading watchdog for charities DZI had significant impact on UNICEF's reputation as it now became obvious that DZI's formalized standards on economy and thriftiness had been violated by the unusually high commissions paid to fundraisers.[624] Again, this effect highlights the function of any formalized (private) rules of credible actors as focal points and benchmarks that help to judge a firm's effective behavior:[625] it is easier for (potential) regulators to demonstrate non-compliant behavior.

3 Summary

We have seen that the provision of information and the closely linked establishment of an effective information exchange between actual and potential stakeholders of a firm is the condition that can be influenced most easily by potential regulators in a variety of ways. If potential regulators bear in mind that reputational loss occurs if there is a significant discrepancy between hitherto communicated and currently communicated experiences with a firm's behavior and that the information has to be perceived as relevant, thus trustworthy by the firms' stakeholders, the performance of this function of information gathering has huge potential to contribute to the effectiveness of reputational sanctions.

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[623] Conzelmann/ Wolf, 2005, 9-10; Darnall/ Carmin (2005); for the legal nature of another prominent certification scheme, the Kimberley Process Certification Scheme, see Curtis (2007).

[624] See chapter two/ A/ I/ 3.

[625] See chapter three/ A/ II/ 1.

IV Summary and Conclusion of Part A

The objective of Part A was to introduce a model that provides a guideline for interested parties in order to assess whether the conditions necessary for threatening a firm's reputation to be an effective regulatory tool are likely to be fulfilled in a particular setting. The model is to help those parties that seek to ensure that the behavior of a single firm or group of firms conforms to certain standards to assess whether threatening a firm's reputation is likely to have a behavior-modifying effect.

In a first step, we discussed the three conditions identified in part two in more detail: threatening a firm's reputation will only have a behavior-modifying effect if all three conditions are fulfilled.

Having discussed the three conditions that have to prevail in order for threatening a firm's reputation to be an effective regulatory tool, we introduced the model which is built on two restrictions: it focuses on the first (stakeholders' preferences and objectives) and the third condition (stakeholders' ability to react to reputational loss) and it set its focus on two particular stakeholder groups: a firm's customers and financiers. The model provides a guideline that helps to assess whether a particular firm (or group of firms) is likely to respond to reputational sanctions and highlights the reliance of this regulatory tool on dispersed mechanisms: stakeholders have to be willing *and* able to react to non-compliant behavior.

The second condition, an effective information exchange between potential and actual stakeholders, is the conditions that can be influenced most easily by potential regulators: a variety of means is available in order to aggregate, provide and diffuse information about a firm's effective behavior.

The model makes clear that potential regulators have to conduct a *detailed* analysis of the market in which a firms that is sought to be regulated operates and of the preferences and objectives of the relevant stakeholders of a firm in order to find out whether the behavior modifying effect of threatening a firm's reputation is likely to occur.

B Legal Constraints Regarding the Provision of Information about Firms' Effective Behavior

In Part A we have seen that potential regulators are most likely neither capable of influencing the *preferences and objectives* of a firm's stakeholders (Condition I) nor able to modify *the structure of the relevant markets* that determine the different firm-stakeholder interactions (Condition III) in the short term. These two conditions that have to prevail in order for threatening a firm's reputation to be an effective regulatory tool either *do* or do *not* exist in a certain setting in which the firm that is to be regulated operates.

In contrast, we have argued that the existence or establishment of an information exchange between potential and actual stakeholders of a firm (Condition II) is *the* condition that can be influenced most easily in the short term and is therefore the point where potential regulators, thus parties that seek to achieve behavior modification of firms, should concentrate their activities in cases where the other two conditions *are fulfilled*.

The aggregation, provision and diffusion of information about a firm's effective behavior is the core element of a functioning information exchange between a firm's potential and actual stakeholders. The objective of this part is to discuss the legal constraints for both state and non-state actors in performing this *function of information gathering* regarding the actual provision of information about firms' effective behavior. We focus on the law applicable in Switzerland. In a first step, we highlight the legal constraints that *state actors* face when providing information about a firm's effective behavior (**I**). In a second step, we turn to the legal boundaries *private actors* have to take into account regarding the provision of information about a firm's effective behavior (**II**). In a third step, we summarize the results (**III**).

I Legal Constraints for State Actors Regarding the Provision of Information about Firms' Effective Behavior

We have seen that state actors can use the regulatory tool of threatening a firm's reputation as a means to achieve behavior modification. The examples of the cities of Berlin and Los Angeles have shown impressively how *the provision and diffusion of information by state departments* about restaurants' effective behavior regarding compliance with hygiene standards can cause behavior modification of the firms as they are faced with reputational loss and costs in case of non-compliance.

However, state actors have to respect the legal constraints regarding the provision of such information set by the legal order. The approach of the Berlin district administration, as one example, was criticized[626] for interfering with several fundamental rights defined in the German Basic Law without the necessary legal basis for such interference existing.[627]

In Switzerland, the state has the right and the duty to inform the public about its activities as communication with citizens and the broad public is essential to fulfill the functions of the judiciary, legislature and executive.[628] At the same time it is unquestioned that legal constraints regarding the provision of information about firms' effective behavior exist which have to be respected.

This becomes particularly important if the information provided by state actors is intended or likely to *de facto* influence other people's behavior and may thus affect the economic and social success of the relevant firms.[629] Examples of such forms of information include educational appeals, recommendations, or direct warnings,[630] which in many cases serve to prevent and/or avert risks. In the following sections we focus on the provision of these forms of information about firms' effective behavior by state actors that might – whether intentionally or not – cause a reaction by the firms' stakeholders and which are part of an *active* provision of information by state actors.[631]

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[626] See HOLZNER (2010) and the expert opinion of ALEXANDER SCHINK (2010), available at http://www.berlin.de/imperia/md/content/bapankow/vetleb/rechtsgutachten_senguv_zum_smiley_29.09.2010.pdf>, accessed on January 17, 2011.

[627] Namely the freedom of occupational choice (Art. 12 of the German Basic Law), the guarantee of ownership (Art. 14 of the German Basic Law) and the principle of equality before the law (Art. 13 of the German Basic Law).

[628] SAXER, 2004, 19.

[629] SAXER, 2004, 22.

[630] BRANDENBERG, 2002, 71-73; see TSCHANNEN (1999).

[631] See BRUNNER, 2010, 599, for the classification of passive and active provision of information by state actors.

Given the variety of different forms of information provision and aggregation, the objective of this section is to outline the most important legal constraints state actors have to take into account when considering the communication of information about a firm's effective behavior that is likely to lead to the occurrence of reputational loss and reputational costs caused by the aggregated reaction of the firm's stakeholders.

As it is evident that the aggregation, provision and diffusion of information about firms' effective behavior can be performed in a variety of ways, this section will give just a summary overview of the relevant legal boundaries set to state authorities. In a first step we turn to the rule of law and the fundamental rights as general constraints for any form of state action (**1**). In a second step we focus on those fundamental rights that are likely to be restricted if state actors provide information about firms' effective behavior (**2**). In a third step, the findings are summarized and a short checklist is introduced (**3**).

1 The Rule of Law and Fundamental Rights

The rule of law and fundamental rights are two benchmarks against which any state action has to be measured. This holds also for the aggregation, provision and diffusion of information about firms' effective behavior.[632] Therefore, we first turn to the rule of law as a fundamental principle defined in the Swiss Constitution (**1.1**). In a second step, the role, function and sources of fundamental rights are discussed and the requirements for their restriction are introduced (**1.2**). The findings are summarized in a third step (**1.3**).

1.1 The Rule of Law

The rule of law is one of the fundamental principles defined in the Swiss Constitution. It sets clear and distinct constraints to any state action and furthermore contains a set of principles against which every state action has to be measured.

It is self-evident that these constraints and principles have to be followed by any state actor that aggregates, provides and diffuses information about firms' effective behavior.

[632] SAXER, 2004, 20-21.

The rule of law is defined in Article 5 of the Swiss Constitution and determines

- that all activities of the state shall be based on and limited by the law
- that state activities must be conducted in the public interest and be proportionate to the ends sought and
- that state institutions and private persons shall act in good faith.

Based on this article, four principles have been developed in doctrine that serve as general principles and maxims of any administrative action:

(1) the *principle of legality*, requiring that any state activity is deduced from a statute

(2) the *principle of public interest*, which is the requirement for any state action

(3) the *principle of proportionality*, the obligation that any state measure is suited, necessary and proportionate to achieve the goal pursued

(4) the obligation of the administration to act in *good faith*.

It is evident that any provision of information about firms' effective behavior by state actors has to be in accordance with this fundamental principle.

1.2 Fundamental Rights

Fundamental rights can be defined as "the rights of an individual vis-à-vis the state that have their basis either in a constitution or in an international convention"[633]. These rights are to protect individuals and groups from "undue governmental intrusion"[634]. Fundamental rights, again, set clear limits to any state action.

Three different forms of fundamental rights are usually distinguished:[635] *firstly*, civil liberties (or fundamental freedoms)[636] which are to protect essential spheres of human existence[637] by obliging the state to tolerate these institutionally protected spheres of liberty and freedom and to refrain from any undue interference.[638] *Secondly*, the equal protection clause that guarantees individuals the right to be treated equally by all state

[633] HALLER, 2009, 145, n. 342.

[634] FLEINER, 2005, 153, n. 464.

[635] HÄFELIN/ HALLER/ KELLER, 2008, 67-69.

[636] See FLEINER, 2005, 153, n. 466.

[637] HALLER, 2009, 145, n. 343.

[638] HALLER, 2009, 145, n. 343; FLEINER, 2005, 153, n. 466; besides this *status negativus* the idea that civil liberties can embody guiding principles for state activities in general that might have an impact on all areas of law has gained in importance (HALLER, 2009, 145-146, n. 343).

authorities.[639] The *third* form are social fundamental rights (or social basic rights) which "oblige the state to take positive action"[640].

With regard to the provision of information by state actors, the first two forms are relevant as we will show in the following. Firstly we introduce the main characteristics of fundamental rights (**a**) and then, in a second step, introduce the requirements that have to be fulfilled for a restriction of these rights (**b**).

a Fundamental Rights in General

Let us look at some of the main characteristics of fundamental rights, particularly as to their sources, the addressees and the subjects of fundamental rights:[641]

- *Sources*: As to Switzerland, there are mainly four sources of fundamental rights: *First of all*, the Swiss Federal Constitution contains a catalogue of different fundamental rights.[642] *Secondly*, cantonal constitutions might contain catalogues of fundamental rights. This source of fundamental rights is only relevant if the cantonal constitutions protect individuals to a greater extent than does the federal constitutional law.[643] *Thirdly*, the European Convention on Human Rights (ECHR) is an important source of fundamental rights. The ECHR is particularly important as to the determination of the content and scope of civil liberties.[644] Due to the concept of monism, the fundamental rights guaranteed by the ECHR are part of the Swiss domestic legal order and are directly applicable.[645] The *fourth* source of fundamental rights are international conventions. Of particular importance in Switzerland are the UN Covenant on Economic, Social and Cultural Rights and the UN Covenant on Civil and Political Rights.[646]
- *Addressees*: *First of all*, fundamental rights are rights of individuals vis-à-vis the state. Article 35 of the Swiss Constitution makes clear that the fundamental rights are addressed to the state in the first instance. It is important to underline that

639 HALLER, 2009, 146, n. 345.

640 HALLER, 2009, 147, n. 347.

641 See MÜLLER (2008); HÄFELIN/ HALLER/ KELLER, 2008, 66f..

642 HÄFELIN/ HALLER/ KELLER, 2008, 69, n. 221-225; However, this catalogue "is not to be regarded as a straitjacket, in spite of its elaborate nature" (HALLER, 2009, 145, n. 356): new spheres and areas of liberty and freedom can be developed and evolved by the judiciary.

643 HÄFELIN/ HALLER/ KELLER, 2008, 71, n. 233.

644 HALLER, 2009, 151-152, n. 358.

645 FLEINER, 2005, 155, n. 472; HALLER, 2009, 152, n. 359; HÄFELIN/ HALLER/ KELLER, 2008, 72, n. 235.

646 HÄFELIN/ HALLER/ KELLER, 2008, 75, n. 245.

the notion of *the state* includes *all state authorities at any level*: legislative bodies, governmental and administrative bodies as well as judicial bodies, whether on federal, cantonal or municipal level. All these bodies are obliged to respect and implement the fundamental rights. *Secondly*, Article 35 (2) of the Swiss Constitution provides that *whoever acts on behalf of the state is bound by fundamental rights and is under a duty to contribute to their implementation*. This highlights that private actors who perform public tasks delegated to them are bound by fundamental rights as well as state authorities that are parties to private law contracts.[647] *Thirdly*, more diversely discussed is the question whether fundamental rights have an effect between private parties if private parties threaten some of the freedoms protected by fundamental rights. Article 35 (3) of the Swiss Constitution provides that *the authorities shall ensure that fundamental rights, where appropriate, apply to relationships among private persons*. This means – according to the prevailing doctrine – that private parties are not directly bound by fundamental rights and that no direct third-party effect exists. However, fundamental rights "include a […] mandate to the legislatures […] to protect the values inherent in the catalogue of fundamental rights […]"[648].[649]

- *Subjects*: In general, individuals are the subjects to all fundamental rights.[650] Furthermore, legal persons constituted under private law can be subject to all fundamental rights as long as these rights do not particularly aim at the protection of rights that cannot be enforced by legal persons (such as the right to marriage).[651] Legal persons constituted under public law usually cannot evoke fundamental rights.

With regard to the provision of information about firms' effective behavior we can summarize that any state actor is bound by the fundamental rights and that firms generally enjoy the protection of the fundamental rights.

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[647] Häfelin/ Haller/ Keller, 2008, 682, n. 272-277; Haller, 2009, 155, n. 366.

[648] Haller, 2009, 156, n. 369.

[649] Furthermore, an indirect third-party effect does exist which means that courts on all levels have to take fundamental rights into account when applying general clauses or other terms that "leave room for judicial interpretation" (Haller, 2009, 156, n. 369); Häfelin/ Haller/ Keller, 2008, 84, n. 278-286.

[650] However, there are exemptions and restrictions for foreign nationals: they cannot invoke political rights, the freedom of domicile or, depending on their status, economic freedom (Haller, 2009, 154, n. 363).

[651] Häfelin/ Haller/ Keller, 2008, 88f., n. 294-297.

b Restrictions of Fundamental Rights

Fundamental rights exist to protect natural and legal persons from state interference. The main characteristic is that they are directly applicable and enforceable and that they set clear boundaries to the actions of state authorities of any kind. However, they can be restricted and their scope can be limited under certain requirements. Before introducing those fundamental rights that are likely to be restricted by the provision of information by state actors, we now highlight the requirements that have to be fulfilled cumulatively in order for the restriction of fundamental rights by actions of the state to be legal. These requirements are laid down in Article 36 of the Swiss Constitution[652]:

1. *Legal basis*: Article 36 (1) of the Swiss Constitution requires that any restriction of fundamental rights must have a *legal basis*.[653] This means that the limitation of the fundamental right at stake must be described in general and abstract terms[654] and that this rule must be sufficiently precise.[655] Significant or grave restrictions must be foreseen in a federal act: as to the provision of information this means that the higher the probability that third-party interests are affected by the information provided, the more important is a sufficient legal basis.[656]

2. *Public interest or the protection of fundamental rights of others*: Article 36 (2) of the Swiss Constitution requires that restrictions of fundamental rights must be justified *in the public interest or for the protection of the fundamental rights of others*. There is no "abstract and clear-cut formula of what public interests are"[657]. However, an important category of public interest that may justify limitations of fundamental rights is that of the so-called *police interests*: comprising the protection of public order, peace, safety, health morals and good faith in business relations.[658] Further important public interests include, for example, the protection of the environment. If fundamental rights are restricted in order to protect the fundamental rights of others, courts have to balance the diverging

[652] While the text of this article covers all types of fundamental rights, the "preparatory materials to the framing of the constitution [...] suggest that the restrictions were aimed at civil liberties rights only" (Haller, 2009, 158, n. 371); see Müller (2009).

[653] Or there must be a clear and present danger where no other course of action is possible.

[654] Fleiner, 2005, 180, n. 562;

[655] Häfelin/ Haller/ Keller, 2008, 93, n. 307-308.

[656] Saxer, 2004, 22; Häfelin/ Haller/ Keller, 2008, 93, n. 308; less important for our topic is the so-called "general police power" clause, which can temporarily replace a legal basis in case of dangers which might present threats to public security.

[657] Fleiner, 2005, 180, n. 565; Häfelin/ Haller/ Keller, 2008, 95ff..

[658] See BGE 91 I 457, 460.

rights.[659] As to the provision of information, the requirement of public interest demands that state authorities only provide information issues that are in their sphere of responsibility.[660]

3. *Proportionality*: Article 36 (3) of the Swiss Constitution requires that any restriction on fundamental rights must be proportionate to the goal pursued. The underlying idea is that restrictions of fundamental rights should not go further than required by the public interest or the protection of fundamental rights of others. This is the case if a restriction conforms with the following three requirements:

   (1) The measure must be *suited* to achieve the goal pursued by public interest:[661] this means that any information provided by state authorities has therefore to be *correct*[662], *complete*, *clear*, *coherent*, and *factual*, as false information is not suited to achieve the goal pursued by public interest.[663]

   (2) The measure must be *necessary* which means that that no milder means to achieve the goal are available:[664] regarding the provision of information this is primarily a question of how detailed the provided information has to be.

   (3) The *proportionality* of the measure in relation to the public interest must be taken into account.[665] This is of particular importance if the information provided is likely to cause reputational loss and/ or to worse the competitive position of firms.[666]

4. *Essence*: Article 36 (4) of the Swiss Constitution requires that the essence of fundamental rights cannot be violated. The essence refers to "a sphere of constitutional protection, which cannot be limited under any circumstances by the state"[667].

This means that the provision of information by state actors may restrict the fundamental rights if the requirements above are fulfilled.

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659 HALLER, 2009, 161, n. 377.
660 SAXER, 2004, 23.
661 HÄFELIN/ HALLER/ KELLER, 2008, 97, n. 321.
662 In the sense of Article 5 of the Federal Data Protection Act.
663 BRUNNER, 2010, 616.
664 HÄFELIN/ HALLER/ KELLER, 2008, 98, n. 322.
665 HÄFELIN/ HALLER/ KELLER, 2008, 98, n. 323.
666 BRUNNER, 2010, 618.
667 FLEINER, 2005, 179, n. 560.

1.3 Conclusion

The rule of law and fundamental rights set clear boundaries to all state action, thus also to the provision of information about firms' effective beh*avior*. While the rule of law is a general principle that cannot be limited, fundamental rights can be restricted if the requirements outlined above are fulfilled.

In the next section we turn to some fundamental rights that might be affected and restricted if information about firms' effective behavior is provided by state actors. The findings of the next section will help to distinguish under which conditions the provision and aggregation of information about firms' effective behavior *does* limit the scope of fundamental rights and when such restrictions *can be justified* according to the requirements of Article 36 of the Swiss Constitution.

2 Three Fundamental Rights in Focus

We have seen that fundamental rights set constraints on all forms of state actions as all parties acting on behalf of the state are bound to respect these rights. In this section we introduce three fundamental rights that are likely to be limited by the provision and aggregation of information about firms' effective behavior: economic freedom (**2.1**), equality before the law (**2.2**) and right to privacy (**2.3**). Following that, the findings are summarized (**2.4**). We explain which spheres are protected by each of these rights, highlight why these rights might be affected, and discuss whether and how such restrictions could be legitimated.

2.1 Economic Freedom

The general guarantee of economic freedom as defined in Article 27 of the Swiss Constitution is unique.[668] It is not a traditional human right.[669] This individual right is closely linked to Articles 94 to 107 of the Swiss Constitution where economic freedom is defined as a principle of the economic system of Switzerland, stating that "The Confederation and the Cantons shall abide by the principle of economic freedom" (Article 94 (1) of the Swiss Constitution).

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[668] FLEINER, 2005, 175, n. 542; HÄFELIN/ HALLER/ KELLER, 2008, 184, n. 614-620.
[669] HALLER, 2009, 191, n. 438.

The right of economic freedom, in the first instance, protects "every remunerative activity in the private sector"[670].[671] The right covers all actions which aim at gaining profit or income[672] and protects this sphere from state intervention.[673] Article 27 (2) of the Swiss Constitution highlights three areas that are particularly protected by the economic freedom: first, the freedom to choose one's profession, which applies to all occupations in the private sector;[674] second, free access to private economic activity which "prohibits the state from taking measures to hinder […] the individual's access to the market on the territory of the Swiss Confederation",[675] and thirdly, the right to pursue such activity. As Haller summarizes:[676]

> […] economic freedom embraces the free choice of when, where and how to perform private economic activity, including amongst others, capital investments, patterns of organisation, use of technical equipment, business relations and advertising.

The subjects of this right are individuals and legal persons constituted as such under private law.[677]

The provision of information about firms' effective behavior by state authorities can limit their economic freedom: we have seen that information indicating a discrepancy between predicted and effective behavior can cause reputational loss and reputational costs due to the aggregated reaction of a firm's stakeholders.[678] A firm might lose market share or political support, or might be faced with the withdrawal of financial resources. In the Berlin case, negatively rated restaurants were faced with revenues that decreased by as much as 50%.[679]

This means that if the information provided by state actors is likely to cause such reaction and thus have an impact on a firm's actual and future business, the sphere of protection of economic freedom is restricted.[680]

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670 Fleiner, 2005, 176, n. 543.
671 Häfelin/ Haller/ Keller, 2008, 187ff..
672 Haller, 2009, 191, n. 440
673 Häfelin/ Haller/ Keller, 2008, 191, n. 652.
674 Haller, 2009, 193, n. 442. It does not include the right to admission to an educational institution.
675 Fleiner, 2005, 176, n. 546.
676 Haller, 2009, 193, n. 442.
677 Häfelin/ Haller/ Keller, 2008, 192f..
678 See chapter two/ A/ II.
679 See chapter two/ A/ I/ 3.
680 See Tschannen, 1999, 412ff, 93ff..

Restrictions of economic freedom have to fulfill the general requirements set by Article 36 of the Swiss Constitution: they require a legal basis, have to be justified by public interest, must be proportionate to the goal pursued, and the essence of economic freedom has to remain untouched. Furthermore, measures *deviating* from the principle of economic freedom as defined in Article 94 of the Swiss Constitution are only allowed if foreseen by the Constitution or based on cantonal monopolies (Article 94 (4) of the Swiss Constitution).[681]

As to the *public interests* that might justify a restriction of economic freedom, the *police interests*, thus the protection of health, safety, morals and good faith in business dealings, are particularly important as they can justify the restriction of fundamental rights caused by the provision of information about firms' effective behavior. The need to protect public health, as one example, has justified the confiscation of spoilt food, or the protection of good faith in business dealing can justify measures that protect consumers from fraud due to misleading information.[682]

The Swiss Federal Supreme Court has developed the *principle of equal treatment of direct competitors* as a further requirement that has to be fulfilled for the restriction of economic freedom in addition to the requirements of Article 36 of the Swiss Constitution.[683] Direct competitors are – according to the Swiss Federal Supreme Court – members of the same branch of business offering the same products to the same group of consumers in order to satisfy the demand of that group of consumers.[684] According to this principle, "measures undertaken by the state [have to] be neutral in effect"[685] and "may not favor one business competitor over another who offers the same goods or services"[686] – otherwise, if competition between direct competitors is distorted, these measures are *unconstitutional*.

We are discussing here the provision of information by parties that seek to achieve behavior modification by threatening a firm's reputation. The information provided for this goal is likely and intended to cause an aggregated reaction of a firm's stakeholders as the reliance on dispersed mechanisms is one of the core characteristics of this regulatory tool. Therefore, the provision of such information is very likely to affect the

681 Fleiner, 2005, 178, 557; Haller, 2009, 193, n. 443.
682 Häfelin/ Haller/ Keller, 2008, 196ff.; Haller, 2009, 197, n. 675-677.
683 Häfelin/ Haller/ Keller, 2008, 201ff., n. 692-699.
684 BGE 125 I 431.
685 Fleiner, 2005, 178, n. 556; Häfelin/ Haller/ Keller, 2008, 202, n. 695.
686 Haller, 2009, 194, n. 444.

firm's economic freedom. This means that the aggregation, provision and diffusion of information about firms' effective behavior by state parties has to be in accordance with the requirements of Article 36 of the Swiss Constitution. Thus a legal basis and a public interest are required. Furthermore, the provision has to be proportionate, must not violate the essence of this fundamental right and, moreover, has to conform to the principle of equal treatment of direct competitors.

2.2 Equality before the Law

Article 8 of the Swiss Constitution contains the general equal protection clause. This right is supplemented by the protection against arbitrariness and the principle of good faith defined in Article 9 of the Swiss Constitution. Furthermore, the closely linked basic procedural rights can be found in Articles 29 to 32 of the Swiss Constitution. We introduce *equality before the law* and the basic procedural rights as far as these rights might be touched by the provision and aggregation of information about firms' effective behavior.

a Equal Protection

We have already mentioned that the procedure in the Berlin restaurant hygiene case has been criticized for violating the fundamental right of equal protection defined in the German Basic Law. The reason for these criticisms was that the criteria by which the restaurants that were controlled had been selected were not clearly defined.[687] We now introduce the general equal protection clause as well as the special protection clauses.

The general equal protection clause is defined in Article 8 (1) of the Swiss Constitution, providing that *everyone shall be equal before the law*. This clause binds all state authorities and branches of government.[688] The wording *before the law* is even too narrow as the clause is not only binding in the processes of law application and adjudication but *also* in the processes of rule- and law-*making*.[689]

Legal rules on all levels of the Swiss Confederation violate the general protection clause if these rules draw distinctions without a reasonable or objective cause and justification

[687] See Holzner (2010) and the expert opinion of Alexander Schink (2010), available at <http://www.berlin.de/imperia/md/content/bapankow/vetleb/rechtsgutachten_senguv_zum_smiley_29.09.2010.pdf>, accessed on January 17, 2011.

[688] Haller, 2009, 196, n. 447; Fleiner, 2005, 162, n. 488.

[689] Fleiner, 2005, 162-3, n. 489-494; Haller, 2009, 196, n. 47.

or if these rules ignore significant factual differences.[690] The legal rules must be consistent not only with the general equal protection clause but also the application and adjudication of these rules: the law must be applied equally in all cases. The clause is violated if two similar factual situations are treated differently without reasonable grounds. However, cantonal rules with the same wording can be applied differently in different cantons.[691]

The subjects of the equal protection clause are natural persons and legal persons constituted as such under private law. Besides the general equal protection clause, Article 8 (2-4) of the Swiss Constitution defines three additional *special equal protection clauses*. As to the provision of information about firms' effective behavior, the ban on discrimination (Article 8 (2) of the Swiss Constitution) is of particular interest. Any such information about firms' effective behavior must not discriminate against people, in particular on the grounds of origin, race, gender, age social position, way of life, religious, ideological, political convictions or physical, mental or psychological disabilities.[692] This enumeration is not exhaustive. Discrimination occurs "when people are treated by state authorities in a *derogatory* manner because they belong to such category"[693]. However, differentiating regulations based on these attributes are allowed if they are justified on special grounds.[694]

The fundamental right of equality before the law is particularly important regarding the procedural aspects of provision of information about firms' effective behavior by state actors: it is to ensure that firms in similar factual situations are not treated differently without reasonable grounds.

b Arbitrary and Basic Procedural Rights

Another fundamental right closely linked to the equal protection clause is Article 9 of the Swiss Constitution which defines the right for everyone to be treated by state authorities

[690] BGE 122 I 18, 25; Fleiner, 2005, 162, n. 489; Haller, 2009, 196, n. 448.

[691] Fleiner, 2005, 163, n. 495; It should be underlined that the unlawful application of rules in general does not confer on other persons the right to be treated alike, as the principle of legality has priority over the principle of equality (Haller, 2009, 187, n. 450). Only if a state authority constantly derogates from the applicable norm and indicates that it will continue with this practice, the Swiss Federal Supreme Court has confirmed the right to be treated the same (unequal) way (BGE 122 II 446).

[692] Häfelin/ Haller/ Keller, 2008, 219ff..

[693] Haller, 2009, 197-8, n. 451.

[694] Haller, 2009, 197, n. 451.

in good faith and in a non-arbitrary manner. All state authorities are bound by Article 9 of the Swiss Constitution.

An act is *arbitrary* if it is plainly untenable:[695] this is the case for law- or rulemakers if a legal rule is not based on serious objective reasons, or is senseless or useless; or if a norm is clearly interpreted wrongly by those applying the law. The principle of good faith is a central concept that embraces both private and public law and requires parties to behave loyally and trustworthily.[696]

Furthermore closely linked to the equal protection clause are the basic procedural rights defined in Articles 29–32 of the Swiss Constitution. Regarding the provision and aggregation of information about firms' effective behavior, the general procedural guarantees (Article 29), the guarantee of access to the court (Article 29a) and the presumption of innocence (Article 32 (1)) are of specific interest and set boundaries to the actions of state authorities.[697]

Additionally, the presumption of innocence is contained in Article 32 (1) of the Swiss Constitution. While this presumption particularly applies in criminal proceedings by imposing the burden of proof on the prosecution, which has to convince the court that the accused is guilty by presenting compelling evidence,[698] it also implies *beyond judicial proceedings*. This holds also for statements of politicians or even the media.[699]

Equality before the law and the closely linked procedural rights are important benchmarks for any provision of information by state authorities. Any form of provision and diffusion of information by state actors has to conform to these boundaries as they cannot be restricted.

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[695] HALLER, 2008, 201, n. 457.

[696] HALLER, 2009, 202, n. 459.

[697] The general procedural guarantees confer on everyone the right to equal and fair treatment in judicial and administrative proceedings and to have the case decided within a reasonable time. This means that parties "must be given a reasonable opportunity to present their case before an independent body, and under conditions that do not put them at a disadvantage vis-à-vis their opponents" (HALLER, 2004, 204, n. 464). Furthermore, the right to be heard is contained in Article 29 (2) of the Swiss Constitution, obliging state authorities to inform individuals and legal persons about the preparation of an administrative order that limits their rights or imposes new obligations upon them and to give parties the right to have access to the files and to give their views on all relevant aspects; Article 29a of the Swiss Constitution gives everyone the right to have their cases determined by a judicial authority in a legal dispute. At least one judicial authority has to be entitled to a full review of law and of fact (HALLER, 2009, 205, n. 467).

[698] HÄFELIN/ HALLER/ KELLER, 2008, 256, n. 869-869b; HALLER, 2009, 210, n. 477.

[699] HALLER, 2009, 210, n. 478; HÄFELIN/ HALLER/ KELLER, 2008, 256; n. 869-869a.

2.3 Right to Privacy and Protection of Data Privacy

Another fundamental right that can be affected and limited by the aggregation, provision and diffusion of information by state actors is the right to privacy (**a**). Closely linked to this fundamental right is the Federal Act on Data Protection (**b**).

a Right to Privacy

Pursuant to Article 13 of the Swiss Constitution everyone has the right to privacy in their private and family life and in their home, and in relation to their mail and telecommunications (first paragraph). Furthermore, everyone has the right to be protected against the misuse of their personal data (second paragraph).[700]

The Swiss Federal Supreme Court has furthermore adopted the right to informational self-determination (*"Informationelle Selbstbestimmung"*) which has been developed by the German Constitutional Court in order to protect individuals against the unlimited collection, storage, use and *disclosure* of personal data. The essence of the right to informational self-determination is that everybody has the right "to decide what information about one's own personal matters should be communicated to others, and the right to inspect personal data kept by authorities"[701].

Let us look at an example: regarding the disclosure of personal data the Swiss Federal Supreme Court has decided that the disclosure of the name of a person in the official gazette who had been unsuccessfully distrained in order to save possible creditors the way to the debt enforcement office is a *disproportionate* restriction of the person's right to privacy.[702]

The right to privacy can be restricted according to the general requirements of Article 36 of the Swiss Constitution.

b Federal Act on Data Protection

The Federal Act on Data Protection (DPA) contains detailed regulations on the collecting and handling of personal data by federal authorities, individuals and private enterprises. It particularly states that personal data may only be processed lawfully (Article 4 (1) of

[700] Of particular important in this context is Article 8 ECHR.

[701] HALLER, 2009, 169-70, n. 399.

[702] HÄFELIN/ HALLER/ KELLER, 2008, 119, n. 387; BGE 107 Ia 52, 56 ff..

DPA), that its processing must be carried out in good faith and must furthermore be proportionate (Article 4 (2) of DPA). Anyone who processes personal data must furthermore make certain that the data is correct (Article 5 (1) DPA). Moreover, the Federal Act on Data Protection stresses that any person may request information from the controller of a data file as to whether data concerning them is processed (Article 8 (1) of DPA). This duty to provide information may be restricted if a formal enactment so provides or where this is required to protect *overriding interests of third parties*. Federal authorities may further refuse, restrict or defer the provision of information where this is required to protect overriding *public interests* (Article 9 (1) of DPA) or where the information would jeopardize the outcome of a criminal investigation or any other investigation proceedings (Article 9 (2) of DPA).

The Articles 16 to 25bis of the Federal Act on Data Protection define the legal requirements for the processing of personal data by federal bodies. The requirements for the disclosure of personal data by federal authorities are specified in Article 19 of the DPA, stating amongst others that federal bodies may make personal data accessible *online* only if this is expressly provided for. Furthermore, Article 20 (1) of the DPA defines that the disclosure of data can be blocked if a data subject can credibly demonstrate a *legitimate interest* and as far the non-disclosure does not prejudice the fulfillment of the tasks of federal bodies.

2.4 Conclusion

In the last paragraphs we have introduced the most important fundamental rights that are likely to be affected or restricted by the provision of information about firms' effective behavior by state actors. We have outlined the fundamental rights of economic freedom, equality before the law and the right to privacy which all can but do not necessarily set severe constraints to applying the tool of threatening a firm's reputation. In the next section we summarize the essentials that can be drawn from these different provisions and introduce a short checklist.

3 Summary and Conclusion

The finding of Part A of this chapter was that potential regulators who seek to achieve behavior modification by threatening a firm's reputation are most likely neither capable of influencing the preferences and objectives of a firm's stakeholders (Condition I) nor

able to modify the structure of the relevant markets determining the firm-stakeholder interaction (Condition III). Contrary, the existence of an information exchange between actual and potential stakeholders of a firm (Condition II) can be influenced easier by potential regulators.

The aggregation, provision and diffusion of information being the core element of an effective information exchange, the objective of this section was to outline the *most important* legal constraints *state actors* face when they aggregate, provide and diffuse information about firms' effective behavior which is likely to cause reputational loss and reputational costs due to firms' stakeholders' aggregated reaction.

While the ways how state actors can provide and aggregate information about firms' effective behavior are various, we presented the most relevant fundamental principles that have to be respected in all cases: the rule of law, the fundamental rights of economic freedom, equality before the law and the right to privacy. What is the conclusion that can be drawn from the different findings? The following list summarized a set of criteria that have to be fulfilled if state actors aggregate, provide and diffuse information about firms' effective behavior:[703]

1. There has to be a *legal basis* for the aggregation, provision and diffusion of information and the information has to deal with issues that are within the *sphere of responsibility* of the relevant state actor. These two requirements can be derived from the principle of public interest, the principle of legality (Article 5 of the Swiss Constitution) and furthermore from Article 36 of the Swiss Constitution. A sufficient legal basis is particularly important if the information provided is likely to cause reputational loss and reputational costs.
2. The provision of the information has to be *in the public interest*. We have seen that the category of *police interests*, including the protection of public order, peace, safety, health morals and good faith in business relations are particularly important. Furthermore, the information provided and diffused by state actors has to be *correct*, *complete*, *clear*, *coherent* and *factual* as the provision of false information is not in the public interest as it would be misleading. This requirement can be again derived from the principle of public interest.

[703] See Brunner, 2004, 632-633 for a similar scheme.

3. The provision and/or aggregation of information about firms' effective behavior must furthermore be *proportionate* to the goal pursued. Thus it must be suited to the achievement of the goal, it must be necessary as no milder means exist, and furthermore it must be reasonable (Articles 5 and 36 (3) of the Swiss Constitution).
4. As to the restriction of the economic freedom, the *principle of equal treatment* of direct competitors has to be fulfilled.
5. Additionally, the *essence* of the fundamental rights of economic freedom, the right to privacy and any other limited fundamental right must remain untouched.
6. The equal protection clause has to be respected, which requires that two similar factual situations are not treated differently without reasonable grounds. Furthermore, the *procedure* of the provision of information by state actors has to be in accordance with the basic procedural rights.

These requirements are based on the assumption that it is the explicit objective of potential state regulators to achieve behavior modification by aggregating, providing and diffusing information about firms' effective behavior, thus that the information provided is to make reputational sanctions work. Due to the fact that such intended reaction of a firm's stakeholders will most likely affect fundamental rights held by firms, the legal requirements are more severe.

If the outlined requirements as to the provision of information are followed, threatening firms' reputations seems to be a potent way to enforce state regulators' standards.

II Legal Constraints for Private Actors Regarding the Provision of Information about Firms' Effective Behavior

Based on the findings of Part A of this chapter that the aggregation, provision and diffusion of information about firms' effective behavior in order to establish an effective exchange of information between actual and potential stakeholders is the one of the three conditions that can be influenced most easily by potential regulators, we have laid down the legal boundaries that have to be taken into account by *state actors* when performing this function of information gathering.

However, we have seen that not only state actors but also *private actors* can provide and indeed aggregate information about firms' effective behavior that is perceived as relevant by a firm's stakeholders. Information possessed by private actors about a firm's non-compliant behavior can lead to reputational loss if the information indicates a significant discrepancy between the hitherto reported and the currently communicated informational signals. The examples introduced in chapter two of this thesis have impressively shown how such information provided by private actors can cause reputational loss *and* lead to the occurrence of reputational costs. In the case of Shell it was Greenpeace, a private NGO, that provided the information about Shell's effective behavior. In the case of UNICEF it was an anonymous letter firstly sent to the chairwoman of UNICEF and then leaked to the mass media. In the case of BP it was the private blog entry of an individual revealing that BP was actually manipulating several images, similarly in the case of Reuters and Kryptonite. In all these cases the information that caused reputational loss was provided by private actors.

Having seen how essential the provision, aggregation, and diffusion of information about firms' effective behavior is for the effectiveness of reputational sanctions, and the aggregated reactions of a firm's stakeholders such information can cause, the objective of this section is to outline the general legal constraints private actors face when providing information about firms' effective behavior.

In a first step we present those fundamental rights that protect the provision of information about firms' effective behavior by private parties (**1**). In a second step, we discuss the boundaries set on the provision of information about firms' effective behavior by private actors under the protection of personality in the Swiss Civil Code (**2**). In a third step we turn to the legal constraints imposed by the Federal Act against Unfair Competition (**3**). In a final step we summarize the results (**4**).

1 Freedom of Expression

Freedom of expression is one of the cornerstones of every democracy and ensures that "opinions and information must be able to be freely exchanged by all available means of communications"[704]. The objective of this fundamental right is to safeguard the "basic human need to freely communicate with other human beings"[705]. This right of freedom of expression is codified in Articles 16 and 17 of the Swiss Constitution: Article 16 (1) and Article 16 (2) cover freedom of opinion, Article 16 (3) of the freedom of information, and Article 17 the freedom of the media.

Even in the absence of a direct third-party effect, the freedom of expression is important as private actors who provide information about firms' effective behavior are generally protected by this right. We highlight the different aspects of this right in a first step (**1.1**) and then explain under which conditions the rights of expression can be restricted (**1.2**).

1.1 Different Aspects of the Freedom of Expression

Freedom of expression includes different aspects, which are presented in the following paragraphs.

First of all, freedom of opinion is defined in Article 16 (1) and (2) of the Swiss Constitution. Freedom of opinion gives natural and legal persons the right to form an opinion, to give an opinion and to disseminate an opinion.[706] Article 16 of the Swiss Constitution covers all forms and all types of opinions[707], including – according to the practice of the European Court of Human Rights – the provision of information that is motivated by commercial purposes.[708]

It is important to highlight that all *means* of expression are protected, whether verbal or written communications, films, messages on the internet or audio media.[709]

This means that whether private actors diffuse reports of facts, communicate their political opinions, express their feelings in everyday life, or critically discuss diverging

[704] Haller, 2009, 175, n. 412.

[705] Haller, 2009, 176, n. 412.

[706] Häfelin/ Haller/ Keller, 2008, 137, n. 456.

[707] Haller, 2009, 177, n. 414; Häfelin/ Haller/ Keller, 2008, 138, n. 459.

[708] Häfelin/ Haller/ Keller, 2008, 150, n. 505.

[709] Haller, 2009, 177, 414; However, the Swiss Federal Supreme Court has decided that not all *symbolic speech* lies within the sphere of protection of this fundamental right: The Court had to decide the case of an attorney who had been disciplined for leaving the court room to protest against the judge's conduct and invoked the right to freedom of expression (see BGE 108 Ia 316).

opinions, their expressions are generally protected by the freedom of opinion. If private regulators provide information about firms' effective behavior this action will generally fall in the scope of protection of the freedom of expression.

The subjects of freedom of opinion are natural and legal persons.[710]

Secondly, freedom of expression includes *freedom of information*. Article 16 (3) of the Swiss Constitution protects the right to receive information freely, to gather it from generally accessible sources and to disseminate information. This right to transfer information enjoys the same protection as the expression of information itself.[711]

Thirdly, Article 17 of the Swiss Constitution defines the freedom of the media, stating that the "freedom of the press, radio and television and of other forms of dissemination of features and information by means of public communication is guaranteed". Furthermore, censorship is prohibited and the protection of the media's sources is guaranteed. This means that the dissemination of information about firms' effective behavior by media actors is generally protected.

1.2 Restrictions of the Freedom of Expression

Regarding the provision of information about firms' effective behavior, freedom of expression grants private actors a wide scope of protection. Various means of expression are covered by the freedom of expression that makes up the provision and diffusion of information about firms' effective behavior: the expression and diffusion of private opinions on, experiences with and perceptions of firms' conduct and performance.

However, the freedom of expression is not unlimited. It can be restricted and constrained:

Firstly, the state can restrict this fundamental right. We have already introduced the requirements of Article 36 of the Swiss Constitution which have to be fulfilled for such restriction. There has to be a legal basis, the restrictions have to be in the public interest or necessary in *order to protect fundamental rights of others*, any restriction has to be proportionate to the goal pursued, and the essence of the freedom of expression cannot be violated.

Secondly, and most importantly for our case, are the constraints particularly set by civil and criminal law.

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[710] For the restrictions of this right as to foreigners, see Häfelin/ Haller/ Keller, 2008, 145, n. 483.

[711] Haller, 2009, 177, n. 415.

Thirdly, the provision of information about firms' effective behavior by private parties is restricted by the provisions of the Federal Act against Unfair Competition.

All these provisions aim to restrict the freedom of expression of one party in order to protect the personal rights of another party.

In the next two sections we turn to the constraints imposed by the protection of personality rights and the Federal Act against Unfair Competition as these provisions are the most important as to the provision of information about firms' effective behavior by private parties.

2 Provision of Information about Firms' Effective Behavior as Injury to Personality Rights

An important legal constraint regarding the provision of information about firms' effective behavior is set by the Swiss Civil Code (CC) which protects the legal personality of natural and legal persons.[712]

Articles 27 and 28 CC protect the legal personality including the rights to life, limb, body, health, and reputation, and the right to personal freedom.[713] These provisions of the CC on the protection of legal personality are – as already mentioned – complemented by the Swiss Criminal Code and furthermore closely linked to the personal liberties in the Swiss Constitution.

The objective of Articles 27 and 28 CC is legally to safeguard the protection of personality against oneself and against others. Regarding the provision of information about firms' effective behavior, the protection *against others* laid down in Article 28 (1) CC is of particular interest. Article 28 CC states that "any person whose personality rights are unlawfully infringed may apply to the court for protection against all those causing the infringement".

Legal personality includes all attributes and rights which are accorded to a person as such, considering its existence and its mental and physical capacity.[714] While three forms of personality rights are usually distinguished (physical, emotional and social), the protected characteristics of honor, dignity, privacy and economic freedom are most likely to be affected by the provision of information about firms' effective behavior. Honor and

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[712] Tuor/ Schnyder/ Schmid, 2002, 102.
[713] Dessemontet/ Ansay, 2004, 53.
[714] Tuor/ Schnyder/ Schmid, 2002, 94.

dignity include both the injury of a person's (external) reputation and its (internal) sense of honor. Privacy refers to the three protected spheres of private, intimate and public life. However, the scope of protection of a person's privacy depends on their popularity: well known people enjoy less protection than less known people.[715]

The infringement of a person's legal personality is unlawful "unless it is justified by the consent of the person whose rights are infringed or by an overriding private or public interest" (Article 28 (2) CC). Again, the overriding public interest is of particular importance as to the provision of information about firms' effective behavior. This holds particularly for journalists and civil society actors who report on firms' conduct. It is difficult to provide general rules that help to balance an overriding interest against the interest of the person whose personal rights are injured. However, it can be stated that, firstly, the principle of proportionality applies (thus, that the more serious the injury to a legal personality, the more important the overriding public interest), secondly, that an *actual information need* of the public has to be proved, and, thirdly, that *false or derogatory* information can never be justified on the grounds of public interest.[716]

What are the consequences if a person is injured in its legal personality?

First of all, the Swiss Civil Code provides a range of specific rights for anybody who has been injured by others: Article 28a CC allows the applicant to ask the court to *prohibit* a threatened infringement, to order that an existing infringement *cease* or to make a declaration that an infringement is unlawful if it continues to have an offensive effect. Of particular importance as to the provision of information in periodically appearing media is Article 28g CC as it provides the right for any person whose personality rights are directly affected by a representation of events in such media to reply.[717] The latter is particularly the case if a legal person is immediately injured in its personal rights, e.g. if its professional or social standing is affected.

Secondly, Articles 41 and 49 of the Code of Obligations (CO) state that any person whose personality rights are unlawfully infringed is entitled to a sum of money by way of satisfaction provided this is justified by the seriousness of the infringement and no other amends have been made (Article 49 (1) CO) – an injury is unlawful if material *or*

[715] Dessemontet/ Ansay, 2004, 53; Tuor/ Schnyder/ Schmid, 2002, 102 ff..

[716] The Swiss Federal Supreme Court has decided that a media report about the unacceptable business conduct of a company falls within the sphere of an overriding public interest (Häfelin/ Haller/ Keller, 2008, 146, n. 485).

[717] Tuor/ Schnyder/ Schmid, 2002, 197-112.

immaterial damage exists.[718] Furthermore, the Article provides the base for the compensation of emotional hardship ("tort moral"). Pursuant to Article 55 CO, not only the person who has directly caused injury to personality rights, but also an employer can be held liable for damage caused by its employees. This is especially important for media companies, which can be liable for the material or immaterial damage caused by employed journalists.[719]

Thirdly and closely linked, Articles 173 to 179 of the Swiss Criminal Code (PC) penalize offences against personal honor. Article 173 (1) PC provides that any person who, in addressing a third party, makes an accusation against or casts suspicion on another of dishonorable conduct or of other conduct that is liable to damage another's reputation shall on complaint be liable to a monetary penalty.[720] If the person knows that his allegations are untrue, the degree of penalty increases (Article 174 (1) PC). Furthermore the Swiss Criminal Code puts verbal defamation on a level with "defamatory statements made in writing, in pictures, by gestures or in any other manner" (Article 176 PC).[721]

The protection of legal personality sets boundaries to freedom of expression and hence it is relevant to the provision of information about firms' effective behavior by private actors.

3 Provision of Information about Firms' Effective Behavior as Unfair Conduct

A further constraint is imposed by the Federal Act against Unfair Competition (AUC). According to Article 1 of the AUC, its purpose "is to ensure fair and undistorted competition in the interest of all parties". In Article 2 of the AUC the basic principle defines any conduct or business practice which is deceptive or violates the principle of good faith dealing in another manner, and which affects the relationship between competitors or between sellers and purchasers as *unfair and illegal*.

This basic principle already highlights that the AUC applies not only to the conduct of *competitors* but also to *other parties* that are capable of affecting the relationship between competitors or between sellers and purchasers. This means that private parties who provide information about firms' effective behavior whose purpose is to cause

[718] HAUSHEER/ AEBI-MÜLLER, 2004, 142; SCHWENZER, 2003, n. 17.10-12.
[719] SCHWENZER, 2003, 50.13; HAUSHEER/ AEBI-MÜLLER, 2004, 149.
[720] See DONATSCH (2004) and TRESCHEL (2008).
[721] See BGE 96 IV 149.

reputational loss and costs by the reaction of a firm's stakeholders are subject to the AUC.[722] This objective – the applicability of the AUC to other parties such as journalists – is explicitly laid down in the Federal Council Message to the AUC, stating that it is conceivable that consumer organizations, by publishing product testing or press reports, might affect competition unfairly and thus may be subject to the AUC.[723] However, the Swiss Federal Supreme Court is applying the UWG very cautiously to the media and similar parties in order to respect the freedom of expression and the freedom of the media.[724]

Of particular interest are the offenses within the definition of Article 3 lit. a and Article 3 lit. e of the AUC:

Article 3 lit. a of the AUC provides that any disparagement of others' products, works, performance or prices thereof, or their business dealings, by false, misleading or unnecessarily injurious statements is unfair. A statement or expression is disparaging if it is calumnious, e.g. by characterizing a product as useless or defective.[725] This means that negative statements about others' products, work, or performance, or the prices thereof, or their business dealings, are disparaging if they involve a certain level of seriousness.[726]

Within the definition of Article 3 lit. a of the AUC clearly fall *false* statements. However, even correct statements can be disparaging if they give a false impression due to the manner of their dissemination.[727]

A disparaging statement is *misleading* if it is generally correct but suitable to evoke a wrong impression due to its presentation or in the entirety of the circumstances.[728] This is the case if the correct statement on a product is likely to evoke the wrong impression that the described (positive or negative) characteristics are specific to the relevant product, even if it is known that other products have the same characteristics. The leading case is the "Contra-Schmerz" case: the Swiss TV show *Kassensturz* planned to broadcast a report about the side effects of analgesics using the example of an analgesic of the "Contra-Schmerz"-brand. The Swiss Federal Supreme Court decided that such

[722] The leading case is the *Bernina* sewing machine case (BGE 117 IV 193).

[723] Bundesrat, 1983, 1060; Born, 2010, 134.

[724] See the decision of the Swiss Federal Supreme Court BGE 123 IV 216.

[725] See the decision of the Swiss Federal Supreme Court BGE 122 IV 36.

[726] See the decision of the Swiss Federal Supreme Court BGE 122 IV 36.

[727] Born, 2010, 136; the leading case is BSE case (BGE 123 IV 211).

[728] Born, 2010, 136.

exemplifying reporting is unfair and that journalists have to ensure that they do not give the impression that problems which are characteristic to a whole industry sector are limited to a certain actor.[729] As to scientific statements, the Swiss Federal Supreme Court has decided that statements which are not evidence-based have to be considered as misleading.[730]

A disparaging statement is *unnecessarily injurious* if it overshoots the target, if it is unrelated, irrelevant, unobjective, or even untenable considering the facts and circumstances that are sought to be described and judged by the statement.[731] This means that any value judgment about a firm's conduct, performance, product or prices thereof is allowed to be negative but must not be unnecessarily injurious.

The criterion whether a statement is unfair according to Article 3 lit. a of the AUC is the objectified perception of an average reader.[732]

Article 3 lit. e of the AUC provides furthermore that anybody who compares himself, his products, works, performance or the prices thereof in a false, misleading, unnecessarily disparaging or imitating manner with others, their products, works or performance or with the prices thereof, or who benefits third parties in the market place by like conduct, is acting unfairly. Regarding the provision of information about firms' effective behavior, this can be the case if a private actor publishes results of product tests, service tests or price comparisons,[733] which either include false descriptions or are likely to evoke wrong impressions by a considerable part of the audience due to imprecise, irrelevant or incomplete (correct) information.

As to the consequences of unfair action, Article 9 of the AUC lays down that anyone whose clientele, credit, professional standing, business or other economic interests are threatened or injured by unfair competition, may petition a judge to enjoin a threatening injury, to abate an existing injury or to find that an injury is the result of illegal conduct, should the same continue to have an injurious effect. Furthermore, an injured person can request that a rectification or the judgment either be communicated to third parties or published (Article 9 (3) AUC). Independent entrepreneurs and companies themselves are directly regulated. According to Article 11 of the AUC, the principals of a business

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[729] Bengtosson-Bänziger, 2008, 133, n. 268; see the decision of the Swiss Federal Supreme Court BGE 123 III 176.

[730] The leading case in the *microwave* case (BGE 120 II 81).

[731] See the decision of the Swiss Federal Supreme Court 4C.205/2000 from September 13, 2000.

[732] Bengtosson-Bänziger, 2008, 134, n. 372.

[733] Born, 2010, 138.

may also be liable if the unfair conduct has been committed by employees or other auxiliary personnel in the performance of their duties. Furthermore, the injured person can sue for damages and compensation, and petition for disgorgement of profit according to the provisions of the Code of Obligations on conducting business without mandate (Article 9 (3) AUC).

In summary, information provided by private actors in order to cause a reaction by a firm's stakeholders can fall within the definitions of Article 3 lit. a and e of the AUC as it might affect the relationship between competitors or between sellers and purchasers.

4 Summary and Conclusion

While the freedom of expression protects a wide set of different forms of private statements about firms' effective behavior, the provisions of the Swiss Civil and Criminal Codes and the Federal Act against Unfair Competition (AUC) set clear constraints to the provision and diffusion of information on firms' conduct and performance by private actors.

If private actors decide to provide and diffuse information about firms' effective behavior with the intention to cause behavior modification due to the aggregated reactions of a firm's stakeholders to reputational loss (given that Condition I and Condition III are fulfilled), several legal constraints have to be taken into account. Of particular importance are the following aspects:

1. The information provided should not injure the legal personality of the relevant firm. If the information is likely to do so, the provision of information must be justified by an overriding public interest, which means that an actual need for the information has to exist and that the information has to be correct.
2. As to Article 3 lit. a of the AUC, the information may not be disparaging. This means that the information

   a. must not be *false*;

   b. must (if correct) not be suitable to evoke a wrong impression about the firm's products, works, performance or prices thereof (not *misleading*);

   c. must not be *unnecessarily injurious*.

3. Furthermore, with regard to Article 3 lit e. of the AUC, the information provided by private actors – if comparing the performance and conduct of different companies – may neither be false nor evoke a wrong impression due to imprecise, irrelevant or incomplete information.

III Summary and Conclusion of Part B

The starting point of this part was the finding that potential regulators are most likely neither capable of influencing the preferences and objectives of a firm's stakeholders (Condition I) nor able to modify the structure of the relevant markets that determines the different firm-stakeholders interactions (Condition III). The aggregation, provision and diffusion of information about firms' effective behavior being the core element of a functioning information exchange, the objective of Part B was to discuss the legal constraints for both state and non-state actors in performing this function of information-gathering.

In a first step, we discussed the most important legal constraints that face *state actors* when providing information about a firm's effective behavior that is likely to cause reputational loss *and* costs due to firms' stakeholders' aggregated reaction to this information (I). We concluded that any information of state actors about firms' effective behavior has to be based on a legal basis, has to be in the public interest, has to be proportionate to the goal pursued, must not neither violate the principle of equal treatment (if the economic freedom of a firm is restricted) nor touch the essence of any relevant fundamental right. Furthermore, the equal protection clause has to be respected.

Based on the finding of chapter two that *private actors* can provide information about firms' effective behavior that is perceived as relevant and can be essential in order to make reputational sanctions work, we introduced the most important legal constraints which grant and restrict such information provision (II). We argued that the freedom of expression gives natural and legal persons the right to form, give and disseminate an opinion of firms' effective behavior but that clear constraints are set by personality rights (and the closely linked provision in the Code of Obligations and the Swiss Criminal Code) and by the Federal Act against Unfair Competition, if the information provided is likely to cause reputational loss and costs.

C Summary and Conclusion of Chapter Three

The objective of this chapter was to draw out the practical and legal prospects and limits of the regulatory tool of threatening a firm's reputation.

In **Part A** we examined in more detail the three conditions identified that have to prevail in order for this regulatory tool to be effective. Furthermore, we introduced a model that provides a guideline for interested parties in order to assess whether threatening a firm's reputation is likely to have a behavior-modifying effect in a certain setting.

The finding of the first part was that potential regulators, defined as any party that seeks to ensure that the conduct of a single firm or a group of firms conforms to certain standards, are most likely neither capable of influencing the preferences and objectives of a firm's stakeholders (Condition I) nor able to modify the structure of the relevant markets that determines the different firm-stakeholders interactions (Condition III). In contrast, we found potential regulators to be able to significantly contribute to the fulfillment of the second condition, the existence of an effective exchange of information about firms' effective behavior between potential and actual stakeholders of a firm. Potential regulators can aggregate, provide and disseminate information about firms' effective behavior and thereby cause a reaction of a firm's stakeholders leading to the occurrence of reputational costs. This provision of information can take a variety of forms, ranging from a single actor's letter leaked to the press to the establishment of certification schemes.

Bases on this finding, we turned in **Part B** to the *legal constraints* potential regulators face when they perform this function of information gathering in order to help firms' stakeholders to detect conduct that is not in accordance with their preferences and objectives. We have seen that the rule of law and the fundamental rights granted to firms set important constraints to the provision of information by *state actors*. We analyzed a number of requirements that have to be fulfilled in order for such restriction of fundamental rights to be legal. Regarding the provision of information about firms' effective behavior by *private actors* the constraints to their freedom of expression are set by the personality rights (and the closely linked provisions of the Code of Obligation and the Swiss Criminal Code) and the Federal Act against Unfair Competition if the information is likely to cause reputational loss and/ or reputational costs.

The conclusion that can be drawn from these findings is that potential regulator who

have seek to achieve behavior modification by threatening a firm’s reputation have to analyze and understand the firm’s environment, particularly the market in which the firm operates and the preferences and objectives of the firm’s stakeholders. In case the preferences and objectives of a firm’ stakeholders are in accordance with the regulators standards, the firm does not have a reputation for behavior that is contrary to the regulator’s standards, and if the firm’s relevant stakeholder groups are capable of reacting to non-compliant behavior, potential regulators can make a big difference by aggregating, providing and disseminating information about firm’s effective behavior. In these cases and if potential regulators take the severe legal constraints into account, threatening a firm’s reputation is a potent regulatory tool that is capable of achieving compliance with rules.

Conclusion

The starting point of this thesis was the observation that reputational sanctions and regulatory regimes relying on such sanctions achieve behavior modification in some cases, but are toothless in others. The question of why some firms seem to fear the verdict of the court of public opinion while others do not, defined the objective of this thesis: to investigate the conditions that have to prevail in order for threatening a firm's reputation to be an effective regulatory tool.

After having given an overview of the regulatory landscape and having introduced the premises on which this thesis is built in chapter one, we answered the research question in chapter two. We concluded that the following conditions have to exist in order for threatening a firm's reputation to be an effective regulatory tool:

I. Standard Setting: The standards (rules) that should be followed by firms, according to those who seek to promote certain forms of behavior (regulators), have to be in accordance with the preferences and objectives of the firm's stakeholders if behavior modification is to take part at the firm level, or with the stakeholders of the firms in the same market if behavior modification is to take part on industry level. Furthermore, the relevant firm(s) must not have a reputation for behavior contrary to these standards.

II. Information Gathering: Additionally, there has to exist an effective information exchange between potential and actual stakeholders of the firm(s) that are sought to be regulated. This means that there has to be a high level of observability of firms' effective behavior.

III. Behavior Modification: Furthermore, those groups of stakeholders whose preferences and objectives regarding the firm(s)' behavior are in accordance with the regulatory objectives and standards have to be capable of reacting to reputational loss.

Furthermore, as an additional requirement, the reputational costs caused by the dispersed reactions of the firm's stakeholders have to outweigh the perceived benefits

of non-compliant behavior. This question evidently depends on the characteristics of the relevant market and the firms that are sought to be regulated. Firms are assumed to analyze the costs and benefits of a non-compliance decision, that is, of not behaving in accordance with stakeholders' preferences and objectives. Reputational costs are a central part of this cost-benefit analysis. A firm, being faced with diverging preferences and objectives, is assumed to trade off the preferences of the different stakeholder groups. The higher the potential reputational costs caused by behavior that does not comply with the preferences of a stakeholder group, the higher the likelihood that the reputational costs will outweigh the perceived benefits from a non-compliance decision, and the higher the probability that a firm will behave in accordance with the preferences and objectives of the relevant stakeholder group(s). This result is summarized in the following graph:

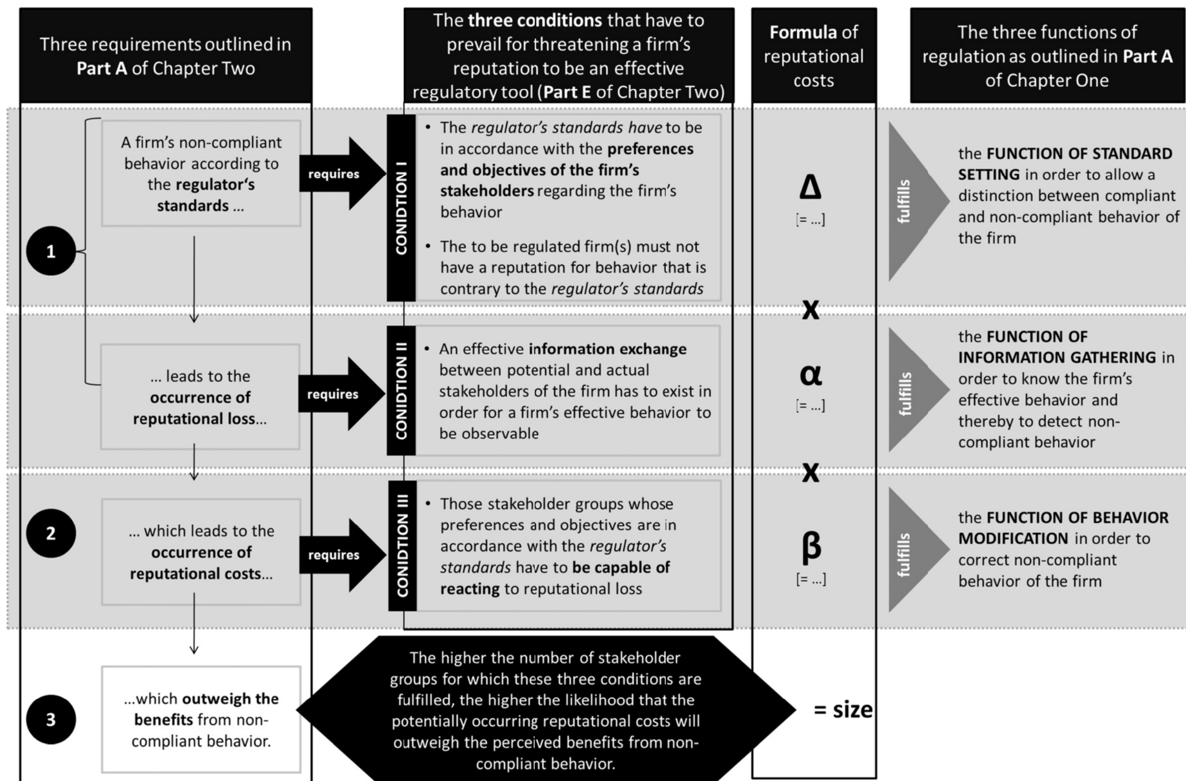

Figure 30: The Three Conditions for Threatening a Firm's Reputation to Be an Effective Regulatory Tool

If these conditions are fulfilled for a certain firm or market threatening firms' reputations is a powerful tool to modify firms' behavior, thus to have a regulatory (constraining) effect on their conduct. We have seen that this behavior modifying effect can be used by a variety of actors to achieve compliance with their "rules", whether within formalized regulatory regimes or to cause a one-off "scandal".

However, the results of chapter three suggest that the following constraints have to be taken into account:

- Potential regulators have to assess the firms which are sought to be regulated and their environment in detail. Only if potential regulators have considerable knowledge of the firm and its stakeholders, regulators will be able to predict whether behavior modification is likely to be caused by threatening a firm's reputation. The guideline introduced provides a good tool to accomplish this task.
- Two of the three conditions can most likely not be influenced by potential regulators in the short term: the preferences and objectives of a firm's stakeholders and their potential to react to non-compliant behavior (reputational loss). Potential regulators must be aware of these restrictions caused by the reliance of this regulatory tool on dispersed reactions and realize that their most powerful contribution is to establish an effective information exchange between actual and potential stakeholders of the firms that are sought to be regulated.
- Severe legal constraints exist both for state and private actors when applying the regulatory tool of threatening a firm's reputation that have to be taken into account, particularly as fundamental rights might be restricted.

If these constraints are taken into account, threatening a firm's reputation is indeed a powerful tool to achieve compliance with rules. This regulatory potential has been particularly enhanced by the emergence of digital technologies empowering individuals to share their experiences and observations with a firm's behavior with a wide audience, the appearance of new powerful actors on the regulatory stage and the increasing perception of firms' reputations as valuable but vulnerable asset with a significant impact on a firm's success.

Future regulators, whether state or private, should be encouraged by these results to include the behavior modifying potential of threatening a firm's reputation into their analysis when considering how to motivate firms to behave in compliance with rules. The statement, that "reputational sanctions can have more of an impact than even the largest financial penalties"[734] is true – if the conditions outlined are fulfilled. This thesis aimed at contributing to fill the existing knowledge gap about reputational sanctions by identifying those conditions that have to exist in order for threatening a firm's reputation

[734] MACRORY, 2006, 83.

to be an effective regulatory tool. The findings presented should help future regulators to identify whether firms in a certain setting are likely to react to reputational sanctions. By reducing the uncertainty of the impact of reputational sanctions the considerable regulatory potential of this tool will hopefully be considered by an increasing number of regulating parties.

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