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An Economic Analysis of Trust, Social Capital, and the Legislation of Trust

"Do not trust all men, but trust men of worth; the former course is silly, the latter a mark of prudence." *Democritus*

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Forward

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1. Introduction

The advances in the fields of Law, Economics and Psychology, have reached an increasing level of congruence. One of the emerging areas off overlap is the analysis of Trust, generation of trust and Norms.

Trust is the very foundation of every interaction. Every organism on earth, which possesses even the most limited ability to communicate, utilizes trust. The assessment, generation and long term maintenance of trust, are the concern of every individual involved in any interaction. Much has been written about trust; its' importance in negotiations, in inter-personal relationships and so on. Undoubtedly, trust has a major, crucial part in the existence of any cooperation.

Trust is being studied in a large number of fields; Psychology, Sociology, Anthropology, Game Theory, Philosophy, Business Management, Political Science, and of course Law, Law & Economics and Behavioral Law & Economics. In this paper, I would like to give an interdisciplinary view point on this issue, with a focus on the contributions that various social sciences can give to Law & Economics.

Closely related to trust is the concept of Social-capital and Norms. I use the word "Norm" here, as a general appellation to various levels of rules. As I will elaborate hereafter, trust, social-capital and norms, are all closely related topics, intertwined in a circular chicken and egg relationship. At first sight, one could say that norms are part of the

social-capital and that social-capital is founded on norms. Trust in turn, seems to derive or grow out of social-capital. Another point of view could be that trust is created when social-capital and norms are present to facilitate its' generation. The main premise of this paper, is to discuss the type and quality of norms that can establish the kind of social-capital that will promote trust.

The main interest of jurisprudence in general and of contract law scholarship in particular, in regard to trust, is how to promote cooperation and trust worthy behavior among parties to commercial negotiations. Good-faith is the way a growing number of legal systems presume to facilitate the creation of trust¹. Good-faith is how legislators try to compel trustworthy behavior on parties to negotiations. From a different point of view one could say that good-faith articles are the incarnation of trust in legislation.

The role of good-faith has increased considerably over the course of the 20th century. More and more legal systems adopt various versions of good-faith legislation. There have been suggestions of various reasons that may have caused this. One could be merely historical- many legal systems are undergoing an ongoing process of a slow shift from Common Law and Tort Law related mechanisms, to a more Continental Law and Obligations/Contract Law related mechanisms, in the Civil Law premise in general and specifically in commercial law. It is generally said that this is aimed at making the private law more flexible and better suited for the fast going economical world of the present. Another reason for the growing popularity of good-faith articles is the fast expanding internet trade. Internet trade considerably reduces transaction costs, but on the other hand it also requires a lot of trust, due to its' impersonal and geographically detached nature.

¹Legal-systems (mainly Common-Law systems) which do not have per-se good-faith articles, use a variety of contract-law instruments, such as the doctrine of "Attached-Contract", to reach similar outcomes to those of good-faith doctrines.

It seems that trust is sort of magical substance, needed for doing business. So, how do we stimulate it? The heart of the question presumably lies in the nature of the environment in which this notion exists. I.e., the question is what kind of an environment is conducive to the creation of social-capital and trust? This question can be broken down to a few essential debates, regarding legislation policy: Is legislation (i.e. artificial creation of binding norms by an organization) in general conducive to the growth of social-capital? Is the legislation of trust, anchored in good-faith articles, encouraging or discouraging the generation of trust?

I would like to reflect on the generation of trust and social-capital and their relation to the type of legal and social environment in which they exist. I mean to challenge the efficiency and quality of the use of good-faith legislation, as an instrument to facilitate trust.

Scholars from different fields have substantially different intakes on these issues. This inconsistency could derive from the different research methods of the different doctrines. The difference could also result from discrepancies in the fundamental models the various doctrines use to interpret human behavior. I will give a general sense about the ideas generated in various fields of research, focusing on behavioral sciences. I mean to tie between recent behavioral science scholarship and the legal scholarship, to discuss and asses the legal and economic analysis of trust and trust promoting norms.

Even though as mentioned above, the issues at hand are studied in the fields of Sociology, Anthropology and Political Science, I will not expressly discuss these aspects. The reason (apart from the technical lack of time and space) is that these disciplines examine the subject of norms in a descriptive way and thus do not reach the heart of the matter which I intend to discuss here.

Chapter two presents the notions of trust and social-capital, and discusses the relationship between trust, social-capital and norms. Chapter three gives an overview of philosophical and legal analysis of trust promoting norms and their origin. In chapter four I present the common analysis of trust and good-faith articles in neo-classical Law & Economics. Chapter five gives game theoretical basis to the analysis of trust, through analysis of the prisoners' dilemma. Chapter six deals with drawbacks and disadvantages of the neo-classical approach. In chapter seven I survey contemporary approaches to the development of trust in the field of psychology. Chapter eight focuses the cognitive-psychological point of view, to the 'Removing the Sanction' paradigm. Chapter nine offers a pilot study aimed at connecting the psychological research to the legal world. Chapter ten discusses the implications of the psychological findings, on trust, social-capital and good-faith rules. In chapter eleven I discuss the alternatives to trust promoting norms.

2. Social Capital and Norms

According to Putnam, Coleman and others, Trust is part of a social system called social-capital. In spite of a long and lively academic debate on the subject of social-capital since it was developed by Coleman, it seems that an agreement on a definition of the notion is yet to be reached. A partial definition could be along the lines of defining characteristics of social organizing, such as social networks, norms and trust, which enable cooperation to achieve mutual benefits. In other words, one could define this as certain attributes of organizations in their very basic and primary stages, which contribute to cooperation between the members².

Another point of view, is tracing the origin of norms. We may mark Hobses' *Leviathan*, as one of the central important stepping stones in the development of philosophical thinking on norms and their origin. Out of this foundation, one could say social-capital is actually a concept describing the norm system in a society, and the benefits that come out of such a system.³

In my opinion, it can be said that trust is a mental state, existing in an environment of social-capital. Trust relies on social-capital and derives from it. Trust is the outcome of norms in the wider sense and of values. For trust to exist in a certain social setting, rules and/or values have to exist, on which reliance that the trust will not be breached, can be established. For trust to persist over time and space, stable social-capital has to exist. I.e. a normative structure has to be present.

These norms and values can appear in a large variety of forms. A normative system can be a highly elaborated, sophisticated and binding legal system. But a normative system can also be a collection of undefined rules set by a parent to a child, or even a daily routine,

²Putnam (2000),19.

³Fukuyama (1995);Fukuyama (1991)

fixed but undefined, that colleagues are used to practice during their work day. Sometimes norms are just a list of characteristics that determine affiliation with a certain group. An example for such a norm can be a preference to a certain cuisine, following a certain football club, a certain denomination etcetera. This kind of norms, aid in founding social cooperation, trust and social-capital, but does not directly create them. Other more elaborate norms from various levels, could directly promote social-capital and trust, through regulating values like fairness and standing by ones' duties and obligations.

It may be said, that trust appears only after some basic norms have been established between individuals. A collection of individuals which sets rules governing the relationships between its' members, enables the development of trust more easily. Put differently, a group which establishes norms, will tend to be more conducive to the development of trust, than a group that will not establish norms.

A lot has been written about the creation of norms. I do not intend to survey all the scholarship in the field, nor do I mean to get entangled in the endless web of the Positivism vs. Natural Law discussion. Instead, I intend to present some basic terms which I will use later in this paper, and in addition shortly introduce a few interesting inter-disciplinary approaches.

Norms are set either by authority or spontaneously by interaction between individuals. In other words, norms can be created in a Hierarchy, or between parties to a Convivial Order⁴. The later kind, can then spread and create a hierarchy which complies with it, or infiltrate an existing hierarchy. A norm dictated by authority, takes its' power from that authority. A certain instance, which is above the group in a structure, an organization, has authority, i.e. power, to dictate a rule. An example of such norms can be Kashrut rules in Judaism, which determine which kinds of food the devout Jew is allowed to eat. The dictate

⁴For elaboration see: Kelsen (1960),627;Van-Dun(*Concepts of order*)

which kinds of food are good to eat from a religious perspective, is completely arbitrary. Even though modern researchers have suggested that originally these rules had a specific rational behind them (nutritious value for example), the religious person does not prescribe to this point of view and would say, that these rules are to be obeyed because they are the word of the Lord and nothing else. These are religious canons, set by a supreme religious authority, who (at least allegedly) derives its' authority from the divinity. The nature of this kind of rules, meaning of a Lex⁵, is that it is not disputed by the lower levels of the hierarchy and that it is arbitrary for those levels. This means that the use of a Lex to administrate values, is the use of an arbitrary command to generate an inter-personal characteristic.

The other way which theoretically exists to create norms, is a spontaneous one. These would be norms which are created through interaction between individuals or small groups, within an organized community. This is not a limited set of rules created by two 'Natural Persons'⁶ to regulate their private limited convivial order. In its' beginning this may be a norm set between two individuals, but it becomes a rule, an order. It must be emphasized, that we are dealing with a Lex, a creature of social order and not with a convivial order. These are norms after all, rules, but ones that grow independent of a distinct centralized authority- norms that develop in an undefined and uninitiated evolutionary process, which is the outcome of routine interactions between persons ('Artificial Persons' for that matter) in a certain society. These are norms nevertheless.

The "spontaneous" norms, are perhaps less official, less documented, and usually harder to enforce, but their importance to the group, socially, psychologically, etc., is as eminent. These norms also certainly have an important role in most modern legal systems, when custom, convention, habit, common practice and their likes, are used as evidence

⁵*Ibid.*

⁶*Ibid.*

aids, and sometimes even constitute binding obligations which the system is willing to enforce.

The difference in the source of the norm, can be viewed as stemming from the distinction between Positive Law and Natural Law. Natural law can of course be understood as grounds to creation of a structured legal system, and not only of a convivial order. It seems that all rules in a convivial order are based on some kind of natural law, but not all natural law exists only in convivial order environments. What is suggested here, is that certain rules, derive from natural law but are part of a hierarchy. These rules may start their way as *Ius* between a small number of parties, but grow to be a *Lex* agreed upon by the group. In other words, we can describe this as a hierarchy, or part of a hierarchy, that utilizes natural law as part of its' system, or if you will, part of its' *Lex*. It may be helpful in this matter, to observe the difference between a Centralist approach to law and a Peripheral one. Both schools refer to the existence of a social order. Legal Peripheralists see society itself and the social consent, as the source of norms. Legal centralists emphasize hierarchy, structure, organization etc., as the source of norms⁷.

Obviously in reality, none of the "formation formulas" of norms described above, exist in their pure form. Norms which derive from authority, are usually re-processed and re-fashioned under the weight of the hydraulic press of social reality, and norms which spring out spontaneously are often institutionalized and turned into state enforced rules.

Here rises the question that lies in the heart of this paper- What kind of norms do we want governing the contractual realm in general and specifically, what kind of norms do we want directing and encouraging trust? Do artificially legislated rules promote trust? Is the premise of contract law, where freedom to interact is a major and important right, suitable for the use of coercive norms, to govern voluntary interpersonal behaviors?

⁷Ellickson(1991)

3. Trust Promoting Norms- Philosophical and Legal Analysis of Good-Faith Articles

Nowadays, legal norms, i.e. legally binding norms, Lex rather than Ius⁸, enforce values which were considered ambiguous and abstract before. These abstract values were conceived as norms that had no place in the legal system, which enforces norms by using the states' enforcement power. In this way, the principal of "Good Faith" has become a central principal in many western legal systems⁹. Some would even say, that in many legal systems, good-faith has become the "umbrella principal" or the "super principal" of the legal system¹⁰. Theoretically it has residual applicability, meaning that it can be invoked only when other instruments are not suitable, however in reality, because it is anointed as a "Meta Principal" of the civil law, the interpretation of all other rules is done in its' light. In generalization it can be said, that in most legal systems the good-faith principle includes two kinds of "Trustworthiness" required: Trustworthiness between the parties, and trustworthiness to the spirit or object of the deal. The first, trustworthiness between the parties, is a direct power of the rule- it instructs individuals how to behave. The later, has indirect power, through influencing the system as a whole. In other words, from a last resort rule, something that has to be used only when all other contract-law instruments are exhausted, it is transformed into a rule that governs all activities in the market.

Articles dealing with good-faith, are the product of relatively modern legislation, which aims at promoting moral values in the field of civil law. The origin of the good-faith

⁸Van-Dun,*supra*-footnote 4.

⁹German-BGB, French-Code-Civil, US-model Uniform-Commercial-Code, Israeli Contract Act etc.

¹⁰**Case-law:**Beit-Yules;Kal-binyan;Sitin. **Legislation:** UCC §1-203:"Every contract or duty...imposes an obligation of good-faith in its performance or enforcement";Article 1366 Italian Civil-Code:"Il contratto deve essere interpretato secondo buona-fide"(The contract shall be interpreted according to good-faith);Article 157 German BGB:"Vertrge sind so auszulegen wie Treu und Glauben mit Rucksicht auf die Verkessitte es erfordern"(Contracts shall be interpreted according to the requirements of good-faith, giving consideration to common-usage);Article 12 Israeli Contract-Act(general part) 1973:"(a)In negotiations towards contracting, one must act in good-faith and common-practice.(b)A party that acted differently must compensate...damages incurred as result of the negotiations or due to contracting...". **Scholarship:** Beatson & Friedman (1995);Burton &Anderson (1995);Brownsword, Hird & Howells (1999); Barak (2005);Shalev (2006),41-70.

doctrines, seems to be from German jurisprudence. The philosophical basis for the doctrine, is that a party has to compensate its' counterpart for damages caused by culpable behavior. In simple words, what the principal of good-faith imposes, is fair conduct by parties to any commercial, private relationship. The generally accepted basic legal analysis of good-faith in pre-contractual negotiations, is that it is a "valve" concept aimed at defining integrity, morality, honesty etc., in commercial relationships.

In many legal systems, the legislation of good-faith rules is relatively ambiguous. Because these are rules enforcing a generally vague moral notion, they tend to be equivocal. Most legislation pieces set a general equivocal concept of "good behavior", and allow the court to fill in the frame of the rule with substance¹¹. This leaves ample, and one might dare say exaggerated room for the courts to set a moral bar for economic players. But what is the extent of the rule? How "nice" do parties have to be to each other? Is equality part of the rule? In most legal systems, the legal debate as to what exactly the good-faith Principal includes, still goes on. This ambiguous nature, has of course serious implications on legal certainty and as a result, has considerable Uncertainty Costs.

Parties are expected to be decent, fair, honest, reasonable, etcetera. It is required that players cooperate with each other, and take under consideration their counterparts' interests as well as their own ones. In some systems this is more clearly stated in the body of the good-faith legislation, and in others the language stays hazier. In my opinion, however, this "shopping list" of traits does not help much in defining the limits of the duty, it only gives synonyms to the same vague concept.

In Common Law systems where the use of case law is possible, some guidelines stating what may be considered "Bad Faith" have been set. Among this one could mention: negotiating with two parties in parallel, unreasonable offers, refusing to accept reasonable

¹¹Medina (2000),513-543

offers, retracting from issues already agreed upon, abuse of bargaining power, hiding essential details of the deal, opting out of negotiations at final stages, negotiating with no intention to contract, false presentations, inequality, pressuring the other party unfairly, exploitation of the other party and more. Legal systems differentiate in the rules adopted and in the interpretation given to rules. The main basis for variation is of course the existence of specific contract-law instruments that may apply to certain circumstances. But then again, in any case, this does not help the haziness of the rule, because some of these notions are not much clearer than other synonyms to "behave nicely", and in addition, this is obviously an open list, which means that most of the problems with the ambiguity and uncertainty of the article are not solved.

A major debate in the analysis of the good-faith doctrine, is waged on the question whether certain good-faith rules are subjective or objective. In many cases, it is unclear whether a certain article encompasses a duty to an objective universal code of behavior. A subjective interpretation on the other hand, means that there are no set standards. Some legislation¹² clearly states that an objective standard is to be applied, while other rules have no such specification and leave the decision on the extent of the rule to the courts' discretion.

It seems that at least at face value, the principal of good-faith limits individualism and egoism usually expected from negotiating parties according to the traditional neoclassical "Homo-Economicus" model, but does not require the parties to be altruistic. In the Beit Yulis vs. Raviv case, Justice Barak (as was his title at that time) wrote that "The parties do not have to act as angels towards each other, but they need not be wolves towards each other. They must act as human beings."¹³. However, in many cases the extent of the good-faith principle has been stretched quite far. The Beit Yulis affair can also serve as an

¹²For-example: the UCC

¹³Beit-Yules affair, *supra*, footnote 10.

example which shows how this principal can be pushed a little too: the Israeli Supreme Court ruled that a negotiator has to observe good-faith, in the meaning that he has to practice candor, i.e. to mean what he says. By doing so, the Supreme Court has created a new rule, which was definitely not clearly stated in the original article. Justice Barak goes even further to state that in some cases, like in the case of Beit Yulis vs. Raviv, where a private tender was being discussed, it is expected that rights such as equality, are respected in the private sector as they are in the public sector. Justice Barak also states that that these rights, should be protected by contract-law instruments, i.e., the good-faith doctrine. It must be said, that equality is not mentioned anywhere in the Israeli contract law.

In most systems the rules of good-faith are mandatory rules and cannot be contracted around by the parties. The reason that most of the civil systems are mostly default rules, i.e. permitting contracting to circumvent them, is that the democratic perception of individual freedom, leads to the freedom of forming business relations as the individual wills, without state regulatory intervention, or as contract jurisprudence would put it, freedom of contracts. It seems that the contractual environment, is the one place where freedom is most expected. This may lead to the understanding, that the legislator saw good-faith rules as central and important rules, so important, that he decided to take it out of the general rule, and demand conduct according to it, without an option to set different rules by individuals.

The introduction of the principle of good-faith into a legal system, marks a trend of moving from an individualistic school of thought, to a more social one. It marks a shift from a system that emphasizes free individual will and autonomy to a system that imposes duties and obligations on the individual. It is my opinion, that the principle of good-faith enforces a significant moral value, but very vague nevertheless. Seemingly, this is a rule that deals with something that is not necessarily part of the binding legal system of the state and it is not obvious that society should legally enforce it. It is an enforcement of a moral

rule, which enhances fairness. This is the imposition of rule, a Lex if you would like, on the relationship between two individuals. The question rises again- should this field be governed by the law? Should the state impose rules on the relationship between two individuals, in what is usually the most individual interaction in the economy?

It can be argued that the principal of good-faith derives from the fact that parties to commercial relationship, willingly enter a legally binding status. Thus, in essence, the principal of good-faith, arises from the element of consent in a legally binding relationship. However, there are other rules in the civil system, which promote "fair" conduct. Many of these rules, enforce values which do not derive from any voluntary relationship, and do not even belong in the realm of civil law. A good example for such rules, are the "Good Samaritan" rules. These rules force an individual to aid a person in distress. Usually the enforcement instruments these laws utilize, are penal. This is a harsh tool, even merely for the fact that the law uses a criminal sanction. Is this efficient? Is it socially desirable? It remains to be seen and discussed hereafter.

The origin of the good-faith principle is not completely contractual- it has tort law ancestry as well. This is expressed in the fact that it is applicable in pre-contractual stages of commercial relationships. Another hint to the mixed origin of the principle, is the fact that some legal systems have only reimbursement and negative damages, i.e. reliance compensation, a characteristic that shows similarity to tort law. The introduction of a non-contractual element into the contract law body, creates anomalies in the private law. The main inconsistency is that contractual liability rules have been extended to the negotiations stage. In fact what happens, is that there is an earlier entry to contractual obligations. In other words, the good-faith principle, hastens the entry into a binding contractual obligation. It is easier to be bounded by contract.

4. The Traditional Neo-Classical Law and Economics Analysis

4.1 Information

I think a good point to start a Neo-Classical analysis of Trust, is Akerlofs' 'The market for Lemons'¹⁴. A player needs a way to distinguish between qualities of goods, or ways to secure quality. There is an information problem¹⁵: Information is lacking in the point where it is needed. One does not and cannot have the information needed for a well informed decision to be made. This is an informational asymmetry- one party has the necessary information, but has no incentive, or rather a negative incentive, to convey it. Therefore, a decision is made based on the risk of buying a low quality good. If one cannot distinguish quality, one assumes low quality; i.e., expectations are adjusted to the lowest level. This process is commonly described as a Moral Hazard phenomenon that causes a Pooling Equilibrium that leads to Adverse Selection.

The existence of an informational asymmetry, gives way to opportunities to exploit the gap between potential contracting parties. I.e., the better informed party, has an opportunity to use its' advantage while plausibly hindering its' counterparts' interests. In simple words, this is opportunism. From this one can deduce, that good-faith is not being opportunistic when one has a chance to be. Bad faith, thus, is the equivalent of opportunistic behavior. But what exactly is Opportunism? When does someones' normal individual-utility-maximizing behavior, become opportunism? The term "strategic behavior" has been used by many scholars interchangeably with "opportunism". Other scholars say that strategic behavior is the ex-ante form, while opportunism is the ex-post form¹⁶. To my opinion, probably a mix of the two is the correct way to view the matter. It can be said that the meaning of this type of behavior, is that one of the players, changes the payoffs of the

¹⁴Akerlof (1970),488-500

¹⁵Hayek (1945),519-530

¹⁶Mackaay & Leblanc (unpublished paper);Hodgson (1983);Goldberg (2006)

interaction, at a certain crucial point in the interaction. In other words, a party to negotiations makes a one sided move that influences the other party in a negative way. The result is a shift in the placement of the burden of costs. The burden of the risk of mishap is shifted¹⁷. The severity of the shift, the magnitude of the additional cost the victim of the behavior has to bear, determines the border between opportunism and just plain tactical behavior in negotiations. I.e., in order to call the behavior "opportunistic", it has to cause major shifts of payoffs. It has to be something that is significant enough, as it would have altered a parties' decision. In other words, the exploitation has to be serious enough, for someone to care about it. The law steps in, if the opportunism is strong enough for people to change their preferences. The ability to cause such a shift in the cost-benefit balance, usually has to do with temporary or permanent differences of bargaining power, or in other words, information asymmetry. Such asymmetry can be caused simply by informational asymmetry, or by temporal asymmetry- gaps in time¹⁸. Thus, in general it can be said that a solution has to be found to the information asymmetry.

Information can be exchanged in many ways. Some examples are: Signaling, Branding, Trade marks, Reputation, Advertising, Warranties, Buy and try, and so on. The various forms of information exchange in the contractual negotiations setting, can be organized in three categories: The buyer can invest in gaining information, the seller can invest in conveying information, and a third party, for example the state, can introduce mechanisms to supply information, or in other words to "force" one of the parties to either acquire or supply it.

Conveying information by a seller is done by Signaling¹⁹. The seller of a high quality good has an interest to signal this, but has to be able to use a method that can't be easily

¹⁷Goldberg, *ibid*; Goldberg (1989).

¹⁸Example: first you deliver and only then you get paid.

¹⁹Spence (1973)

imitated by someone who has a 'lemon'. If the signal is not "powerful" enough, not expensive enough so it is only pays off for the higher quality player, inflation in signaling could be caused: more and more sellers will acquire the signal. The solution to that could be a mechanism used by the buyer: Screening. This could be a cheaper way of generating the information. For screening to be worthwhile, the available screening mechanism has to be cheaper for the buyer than the signaling mechanism. A third solution to the questions raised by Akerlof, is trust.

Trust is a state lead to by an assessment of the situation by a player. The player considers the probability or the risk, that another party will abuse his trust. In other words, trust is a parties' assessment of the chances of opportunistic behavior by a counterpart. Thus, the trust incorporates information from many sources, because the assessment of another players' possible or plausible behavior, is done with all available information. Hence, for trust to be generated, information has to be exchanged. For a person to trust another, he must have ample information to assess his opposite numbers' trustworthiness.

One way a third party can encourage trust, is by means of licensing and permits: control of entry to the market. Another way is certification- there is no control of entry into the market, but goods are graded. Standardization is also a way in which a third party indicates the quality of a good. The process of obtaining the certificate/permit/license/standard-certificate, is the guaranty the buyer has that his trust is not misplaced. In a way, it is a transfer of the certificate-givers reputation to the seller.

In addition to the above mentioned, there is another kind of trust encouraging legislation- coercion of trust. This notion is based on a very simple, perhaps primitive, structure of ordering people to be trust worthy. After all, if what you want is that people will behave in a certain way, why not simply instruct them to do so? This form of regulation is very common. We see it in work places, both in the private sector and in

public service, where internal disciplinary codes order employees to be "Diligent", or to be "Loyal" or many other demands of trust related behavior. Failure to follow these instructions to be trust worthy, is retorted with a sanction. These norms are suitable for a situation where there is a social structure, an organization, a hierarchy. But what happens when the social structure is not as structured, when the setting is a more convivial one? This is where general trust commanding norms enter: the legal system instructs parties to act "In good faith". The super structure of organized society, the general social order, the state, picks up its' authority to demand a certain nature of behavior, even though the relevant parties are private entities.

If the instrument of good-faith is so wonderful, possibly we could say that people may interact freely and contact as they please, and if there is a problem in the relationship at any point in the process, it will be solved according to good-faith tests. However, it is easy to see that the main costs caused by good-faith legislation are uncertainty costs. Foreseeability and legal certainty are completely demolished by such rules. Any practicing lawyer will no doubt agree, that the main result open and vague tests cause, is inability to foresee the outcomes of a legal procedure based on these rules. It becomes impossible to know what is acceptable and what is not, what is legal and what is not.

4.2 Who picks up the bill? - The Holdup Problem

Amongst all this criticism of good-faith articles, one must remember that it also has an important role in increasing the overall size of the contractual pie. During pre-contractual negotiations, parties often make various investments and bear various costs. If these costs are a specific investment, they may become sunk costs if negotiations fail. Thus after an investment has been made, the incurring side is likely to contract conditions inferior to what he would have agreed to before the investment was made. This can lead to a holdup problem, under production and shrinking of the contractual pie²⁰. If the seller cannot give a credible promise at early stages that he will not exploit his superior bargaining power, after the buyer has invested in obtaining information, a mechanism has to be found to solve the holdup problem. The solution to this problem is to be found in a mechanism that will enable the parties to trust each other. In other words, a contract law mechanism that allows the parties to credibly bind themselves not to act opportunistically, after an investment has been made. Limiting the freedom to act during the negotiations is done through a "threat" to hold a party that has acted opportunistically, liable to his counterparts' costs.

One direction that this problem can be solved through is that the parties will voluntarily negotiate a binding relationship prior to the negotiations. This is a contract to have an option to contract. A preliminary contract, in the form of an option contract or a pending contract, in which all details of the final deal are settled, but the party expected to invest in information gathering, will have an option to annul the agreement if the information attained later, shows that his utility is low. The decision whether to invest in information is now influenced and in a way limited by the covenants of the preliminary option contract. Put differently, this means that the parties have already bound themselves to what will be considered a profitable deal. The problem with this approach is that the transaction costs of

²⁰Williamson (1975);Hart (1995)

the preliminary contract, may negate the chances of reaching such an agreement. This problem has been thoroughly developed in neo-classical models²¹ that show that the incentives to reach a preliminary agreement are slight. In a nut shell, the main argument against this approach is of course the main argument against neoclassical models in general- it uses an unrealistic assumption, that parties have perfect information. If we relax this assumption, we may find that prior to investing in acquiring information, parties are exposed to risk. Bearing the costs related to contracting the option contract, before information has been attained, could come out as futile if there is a risk that the information will reveal that there is no agreement area²². In addition the parties may have to incur lost opportunity costs for the period of obtaining the information.

Thus, it seems that there is a market failure, and external aid is needed in order to solve it. If the needed information is available, i.e. if the one can estimate what would have been the fair price from which a party has strayed while using its' superior bargaining power, parties can be held liable for opportunistic behavior²³. An argument against this approach, is that if we assume information is available, than under Coaseian bargaining assumptions, there should be no barrier to reaching a deal between the parties on their own, including an agreement on investment prior to contracting, meaning the voluntary arrangement suggested above.

One way to deal with this market failure, is perhaps to recognize an obligation during the negotiations. This solution suggests enforcing a contract on the parties, through manipulation of basic contract law rules, that is, mainly through variations of offer-acceptance doctrines (one familiar instrument in the Common Law is Estoppels). In other words, the system recognizes the existence of a contract even though officially one has not

²¹Medina (2000)

²²Gelfand & Brett (2004)

²³Wils (1992); Bebchuk & Ben-Shahar (2001),423–457

been completed. By this, the system saves the parties the transaction costs of the preliminary option contract. This doctrine has several disadvantages. First of all, it is extremely offensive to the Freedom of Contracts, or to be correct, Freedom *from* Contracts that drives from the Freedom of Contracts. One may consider the gravest circumstances of parties who never met and never negotiated, and are bound in a contractual relationship due to this doctrine. Another disadvantage is that this way may not be efficient, due to hindrance to the ability to exchange un-binding messages ("cheap talk"). One more drawback is possible forgone opportunities of the seller, because this rule leads to early obligations. In addition, there are legal difficulties in recognizing the crystallization of the obligation. There is also, of course, an evident added burden of legal process.

The other way a third party (i.e., the system) can assist negotiating parties, is by limiting the sellers ability to exploit his superior bargaining position, after an information gathering investment has been made. This can be done by limiting the price the seller can demand at a certain stage of the negotiations. The maximum price set, has to consider the reliance costs the buyer has already incurred. In this way the seller bears part of the information gathering costs, rather than only benefiting from their results. The system "threats" the seller, that he will be held liable for his counterparts' pre-contractual costs, if he demands more than a "fair" price. The fair price has to be determined in a way that the buyers' incentive to obtain information is not decreased.

The information gathering investment is efficient, when information gathering costs (i) are higher than forgone opportunities costs (l) multiplied by the probability a deal is struck (p): $i \geq pl$. In simple words, the investment has to correspond to the chances it leads to a contract actually being completed. So it is efficient to invest in obtaining information, only when the chances of reaching a profitable deal (if the information shows that high utility

(u_h) is to be expected), are higher than the forgone opportunities costs, in case the information leads to no deal (if the information shows that low utility is to be expected).²⁴

If there has been no preliminary contract, but the buyer did invest in information, the buyer will negotiate only if the information shows that he can expect high utility. Thus the seller may assume that the buyer has made a pre-contractual investment, and is now able to exploit this, and he will be the one setting the price. The seller will ask for what the buyer expects to benefit, minus the buyers part in transaction-costs (t). If the buyer really expects high utility, he will agree to this and to anything beyond the utility plus his part of the transaction-costs: $u_h - 1/2t$. This is of course an inefficient deal for the buyer, because he had already incurred sunk costs of obtaining the information.

If the maximum price the seller is allowed to demand is set on $u_h - 1/2t - i$, the seller has no incentive to stray from this. The buyer is anticipated to agree even to a higher price, but than he will be allegeable for reimbursement by seller for his reliance/information costs²⁵. Thus, the buyer has incentive to attain information, but a limited one, as I will now explain. I assume that the bargaining process is done by an ultimatum offer, i.e. a "take it or leave it" offer by one of the parties. Hence, the first mover, the one with the ability to give an ultimatum, is the one with the higher bargaining power (α = Probability that Buyer is First Mover, therefore $1-\alpha$ = Probability that Seller is First Mover). The size of the contractual pie, is the utility the buyer will receive, minus the production costs of the seller (c), minus transaction costs (t): $u_h - c - t$. Thus, the buyers' profit expectancy if he invests in information, is: $p\alpha(u_h - c - t) - i(1-p(1-\alpha))$, the probability the buyer gets high utility, times the probability he in the first mover, times the contractual pie, minus his information gathering costs times the probability the seller is the first mover²⁶. Hence, the buyer will invest in attaining

²⁴Medina (2000), 518-530

²⁵Shalev (2006),10

²⁶Medina (2000)

information only when $i \leq pal/(1-p(1-\alpha))$, which is a sub-optimal expression. The buyer does not have the full incentive to invest in gathering information, because of the possibility that the information obtained will show that the transaction is not worthwhile. In this case the buyer is not reimbursed for the information costs, but still he shares the benefit of the information with the seller. Therefore, the buyers' investment will not be optimal.

In order to reach the optimal outcome, there has to be an even stricter limit on the price the seller can ask for after an investment in information has been made. The price that will ensure the desired outcome is the price which would have been reached had there been a preliminary option contract. Had there been an option contract, neither of the parties would have had a bargaining advantage. The option contracts' covenants would have suited the assumption that the buyer indeed intends to gather information and therefore, the parties can assume that the chances that there will be a contract (that the option will be realized), are p , for this is the probability that the buyer will discover that he may expect a high utility. The contractual pie will thus be $p(u_h-c)-(t+i)$, split between the parties according to α . Consequently, the price will be the utility the buyer expects, minus the sellers' part in the transaction costs, minus information obtaining cost divided by the chances of the deal going through: $uh-1/2t-i/p$. If the buyer will invest in obtaining information, without contracting a preliminary option contract but under a strict limit on the sellers actions, the buyers profit expectancy will be $p\alpha(u_h-c-t)-\alpha i$ ²⁷. Hence, the buyer will invest in attaining information, when $p\alpha(u_h-c-t)-\alpha i \geq p\alpha(u_h-c-t-l)$, which can be compared to $i \geq pl$ and therefore optimal. The seller is limited to a price which equals the buyers utility minus the reliance costs: $price_{max} = u_h - i$.²⁸

In this case, the buyer is compensated for the cases in which he would have invested in obtaining information, but the information demonstrated that a deal would not have been

²⁷I skip the development of this formula. For elaboration: *ibid*, 529.

²⁸*Ibid*.

efficient and thus a deal was not completed. Such a limit on the sellers' actions, assures that whenever the parties' aggregated utility is that information is obtained, the buyer will be incentivised to do so, even if there is no preliminary option contract. The actual meaning of this, is that if the seller breaches the good-faith duty, he will be liable for more than the buyer actually incurred in reality. This is perhaps harsh and unusual, one may even say resembling punitive damages, but it ensures that the seller will ask for the efficient price.

5. Trust in a Game-Theoretical Prism

The fundamental perception of Trust in game theory, is based on a repeated Prisoners Dilemma game. The basic setting of a one-shot prisoners dilemma game²⁹, describes two accomplices (*players A and B*) who committed two crimes, one more serious than the other, and are caught. Authorities need more evidence to convict any of them of the more serious crime. The prisoners are interrogated separately. Each of them is offered a "plea bargain": the player can confess and give information leading to the conviction of the other prisoner in the serious crime, in return for full clemency. If neither of them confesses, they will both be convicted of the lesser crime. So the payoffs are set as follows (see also the game matrix on the right): If

neither confesses, they both go to jail for a short period (for example 1 year), if both confess, they both go jail for an intermediate period (for example 3 years), and if one confesses and the other doesn't, the one who confessed gets no jail time and the other goes away for a long period (for example 5 years). In the game matrix the payoffs should be considered as negative values (time done in prison).

Basic Prisoners Dilemma Game Matrix

		B	
		Don't cooperate	Cooperate
A	Don't cooperate	3,3	5,0
	Cooperate	0,5	1,1

The choice the players have to make now is either to confess or not. Each player tries to anticipate his counterparts' action, and his best strategy according to that. They are both assumed to be rational utility

Prisoners Dilemma- Player As' Choice

		B	
		Don't cooperate	Cooperate
A	Don't cooperate	3,3	5,0
	Cooperate	0,5	1,1

maximizing individuals. If B cooperates with A and doesn't confess, A has a choice between doing 3 years and doing nothing. If B does not cooperate with A and confesses, A

²⁹For short elaboration on game-theoretical terms: Pindyck & Rubinfeld (2005)

has a choice between doing 5 years and doing 3. So it is clear that in any case, A is better off not cooperating with B and confessing. B stands before the same decision, plus he anticipates this, thus he also chooses not to cooperate and to confess. The outcome in game theoretical terms is that both players have a dominant strategy of not cooperating with each other. The result is an equilibrium of don't cooperate-don't cooperate. This equilibrium is of course sub-optimal: the overall

time they will have to serve, is higher. The aggregate utility is inferior to a cooperate-cooperate decision. It is not Pareto efficient,

Prisoners Dilemma- Player Bs' Choice

		B	
		Don't cooperate	Cooperate
A	Don't cooperate	3,3 ←	5,0
	Cooperate	0,5 ←	1,1 ←

or efficient in any other economical way, for they are both worse off. This is the irony of the Prisoners' dilemma game: the rational choice leads to an inferior outcome.

Prisoners Dilemma- Equilibrium

		B	
		Don't cooperate	Cooperate
A	Don't cooperate	3,3	5,0
	Cooperate	0,5	1,1

Extensions of the prisoners' dilemma game include adding plays (Repeated or Iterated Prisoners Dilemma) and adding players (also referred to as Social Dilemma³⁰). In the repeated game the dynamics change considerably. New aspects are added: Retaliation and Reputation. The repeated sequential nature of the game creates a possibility to develop relationships between the players. The players are now accountable for their actions, because there will be another round and their counterpart can retaliate upon defection. Cooperation is much easier and in fact experiments show that it is much higher. One phenomenon shadowing cooperation is the End Game Effect³¹. If players know how any

³⁰Mansbridge (1990); Kopelman & others (2002)

³¹Dawes & Thaler (1988),187

plays there are in the game, or more accurately, how many moves are left in a given point, the incentive to create reputation and the fear of retaliation is hindered. When a player knows that the game is about to end, he has no reason to continue cooperation, thus he may defect. The other player, knowing this, will possibly want to defect before his counterpart defects. This may lead to a deterioration of the cooperation at its' few final rounds.

The strategy preferred in a repeated prisoners-dilemma game, is Tit for Tat³². This strategy was studied in a large number of experiments and it seems that it is extremely robust. It does not prevail under all circumstances, but it is by far the most successful strategy in almost all environments³³. The strategy works as follows: A player starts by cooperating, and goes on playing according to his counterparts' response- if there is cooperation on the other side the player will go on cooperating and if there is defection the player will retaliate. From the second play on, the player simply imitates the other players move. This strategy has various expansions and complications which I will not discuss here. It seems that this strategy is appealing for three reasons: First, it is "nice", i.e. it is not unprovocatively offensive and it has a measured and "forgiving" characteristic, and second, one does not become a "sucker", i.e. one may retaliate when offended, and evidently, and finally, it leads to long term benefits from cooperation³⁴. One more advantage Tit for Tat has, is that it plays on the immediate character of the repeated prisoners' dilemma game, by using short term incentives. This means that a player knows he will be retaliated against immediately when he defects.

One must remember however, that the traditional game theoretical thinking, does not see Tit for tat as altruism. It is perceived as "reciprocal altruism"- cautious behavior aimed

³²Axelrod & Hamilton (1981);Axelrod (1984)

³³Huber (1984), 1147; Hardin (1982), 150.

³⁴Axelrod *supra*, note 32; Dawes and Thaller (1988); Huber, *Ibid*

at generating selfish utility³⁵. The players each play rationally and egoistically to maximize their own utility. It is only the prospect of long term benefits that prompts cooperation.

³⁵Frank (1988),34-35

6. Criticism of the Neoclassical Approach

It seems that an economic way of thinking, leads to an understanding that trust, norms and social-capital are essential to the development of the economy³⁶. The need for foreseeability and stability, together with a need for simplicity, give incentives to the creation of norms. Norms aid foreseeability and stability by laying down a set, stable framework for the economical play. Norms aid simplicity by creating a fixed environment which does not have to be re-negotiated with every interaction. Even if we maintain the classical thought of complete individualism, one may argue that cooperation with other individuals can generate utility to the individual and thus individuals cooperate, out of intention to gain personal benefit. If people choose to cooperate, they will probably negotiate a normative base for their cooperation, i.e. decide on rules monitoring their interaction.

The basic perception of Trust in game theory, as described above, and the success of Tit-for-Tat strategies, can be explained quite simply through a social-capital prism. When an individual meets another individual who he doesn't know, has never met and will never meet again, it is probable that he will be careful, for he has no basis for trust. No social grounds, or in other words, no social-capital and no norms have been set to sponsor the creation of trust. For trust to exist, some foundation is required. That is to say, that the culturally and socially familiar phenomenon of distrust in whom one does not have a lengthy relationship with, or a relationship which is protected by rules, is translated in the game-theoretical setting into distrust in its' game-theoretical meaning.

A repeated interaction creates grounds for investment in reputation and on the other side of the same coin, investment in trust. Players who have attained a negative reputation, i.e. reputation of untrustworthiness or deceitfulness, may find themselves isolated in many

³⁶North (1990); Hodgson (1983)

ways. Players who choose a policy of reliability on the other hand, will find it easier to interact. Players who have a "positive" reputation, are naturally attracted to each other by the prospect of high probability of cooperation and long term benefits. Players with "negative" reputations will find it hard to change their tactics to trust worthy ones, because they will be suspected. The prospect of a future interaction, allows for the expectation to receive proceeds from the investment in trust. In this sense, time provides basis for trust. The continuation of the relationship, leads to dominant strategy of cooperation. This logic coincides with a spontaneous creation of norms theory, in which two players set the rules to their private game, by negotiating.

It has to be asked though, if game theory can indeed provide explanations to the creation of the variety of norms which exist in modern society. Can game theory supply explanations to the complex structure of modern society? Is the main part of rules we know, created in the independent and spontaneous way game theory suggests? Perhaps most of the norms that govern our lives and direct our behavior, are created in an hierarchical and arbitrary way? Maybe, the norms game theory describes, are ancient, simple and few?

From a utilitarian point of view, game theoretical thinking seems to provide the most reasonable answer to the question of the origin of norms. Though one cannot overlook the colorful Nietzschean criticism³⁷, behavioral studies show that a large number of norms *can* be created spontaneously. The best known study in this context in the field of Law & Economics, is Ellickson's research³⁸. The study surveyed the creation of norms spontaneously and without organizational guidance, among whalers, farmers etc. Still, no

³⁷Nietzsche (Cambridge-University Press, 1994); Nietzsche (Garden-City: Doubleday, 1956).

³⁸Ellickson (1991)

empirical data has been found to determine what kind of norms are created spontaneously, how often that happens, and what general characteristics such norms carry.

An interesting research by Elinor Ostrom³⁹ can shed some light on this issue. Ostrom observed over 5,000 cases of common use of fresh water pools. Theoretically, this is a classic case of a Common Good or Tragedy of the Commons. Her conclusion is that diverse human communities, including ones which were remote in time and space, but also ones which were relatively close, found different solutions to the dilemma. The important innovation in this research is that significantly dissimilar solutions were used in a significantly high frequency, much higher than expected. In addition, many of the solutions observed, did not involve privatization, as Law & Economics scholarship would perhaps expect or any kind of administration, monitoring or regulation. It seems that in a large number of cases, the solution came through a spontaneous creation of rules, allowing for efficient use of the resource. This suggests again that repeated interactions typically generate a few human phenomena, including norms, giving foundation to social-capital and to trust in turn.

Ostroms' study shows that only a part of known norms can be explained by spontaneous creation. According to Ostrom, rules of use of the water resource appear only under certain conditions: The community has to be relatively small, stable, consistent, and the membership in it has to be obligating. This coincides with repeated prisoners' dilemma analysis- only a repeated interaction, in a continuous system, with a definite number of participants, will generate an opportunity to create trust and cooperation. It appears that the size of the community is especially important, because the larger the group, the harder it is to find the Free-Rider and punish him. In addition, if the group is not stable, i.e. its' members frequently change, it is harder to punish "deserters" and reward cooperators.

³⁹Ostrom (1992)

This may indicate that the bigger the group, the bigger the need for organization. The larger the group grows, there is more need to determine rules by authority, and thus there is more need for a hierarchy. From this derives a conclusion, that the larger a group, the more its' norms will be based on social order, hierarchy, and the character of the norms will be influenced by this. Only in specific conditions, in a limited number of cases, will there be creation of norms spontaneously, and the norms created in this way will be of a restricted kind. In essence, the rules in large groups, such as religions, states, cities or even smaller communities, are not created spontaneously. Hence doctrines which suggest spontaneous and decentralized creation of norms in society, may give only a limited and partial explanation to the origin of norms, social-capital and trust.

This leads me back to the question of good-faith articles. The chain of argumentation above, brings us to the conclusion that in a state economy, there is little room for "private" norms. Therefore it is hard and costly for parties to create their own private social-capital. It is inefficient and ineffective to ask parties to create their own foundation to trust. Hence, organized society in the form of the legal system is expected to step in and provide the "nest" for trust to grow in. The question now is, whether good-faith articles are an essential part of the social-capital? Are good-faith articles a suitable instrument? It may be that organized society needs to provide a platform for trust to grow on, but this does not necessarily mean that good-faith articles are an essential part of the platform. It could very well be that this instrument is an "over kill", a surplus in the civil legal system. I will continue to discuss these matters hereafter.

7. The Modern Psychology Intake: Cognitive and Psychobiological Approach to Social Capital Norms & Trust

Various psychobiological researches have used prisoners dilemma to explain the evolutionary phenomena of trust⁴⁰. The idea in this kind of studies was to explain cooperation and altruism on the biological and evolutionary level, using repeated prisoners dilemma game. This line of thinking draws from the Utilitarian-Benthamian thought on Moral, by using notions of utility⁴¹. The argument is that evolution promotes altruism because it is efficient. It is efficient for the organism to be cooperative, social and for that aim altruistic and have a tendency towards being lawful. These qualities, improve the organisms' chances of survival. In other words, an individual who has traits that help him cooperate with other individuals, a friendly individual if you would like, has better chances of survival and thus his genes of "social abilities" are transferred on. This way the cooperation inducing traits are perpetuated in the Homo-sapiens. The human being has evolved to be a cooperative creature because it is efficient, it improves survival.

This point of view can be argued to strengthen the game-theoretical view on generation of trust, norms and social-capital. However, one may view this from a different angle as well: If this is indeed the reality, than the ability to solve various social dilemmas, such as prisoners' dilemma, has been imbedded in the human biology by evolution. Relying on this assumption, one could claim that typical human behavior, is not necessarily the outcome of egoistical interests, but a complicated compound of interests, some of which egoistic, and some altruistic. In other words, if the ability to rationalize in a game-theoretical way, has become part of human thought on a biological level, than it may be said that the choices made by a human individual, are at the very least, based on altruistic

⁴⁰Axelrod (1981),(1984),(1986); (1997)

⁴¹Bentham (London:Collins-1962);Bentham (Philadelphia: Lea and Blanchard).

considerations imbedded in the brain, as well other factors. This argument undermines, of course, the ability of game theory to explain the creation of social-capital norms and trust.

On the cognitive level, there is a lot of research indirectly indicating that the human psyche is built to be able to solve quandaries like prisoners dilemma. Research shows that people are better able to solve problems when they are presented in a social context rather than in any other context. I.e., solution of a problem with the same level of complexity is done faster and more efficiently by a subject, when the question is "dressed" in a social setting, than when the problem is presented in a non-social context⁴². Thus it seems that cognitive psychology too, provides evidence that the human brain is "Hard Wired" (as the psychobiological jargon goes) to be social.

Neuropsychology also suggests the same conclusion. Research shows that emotions overcome rational choice and not only as a source of preference setting⁴³. Humans are aware of the influence their behavior has on their fellow man. This consciousness of the impact of ones' behavior on the environment, leads to adjusting ones' behavior all the time. The subjective feeling we have when this process occurs, is embarrassment or awkwardness, or on the other hand encouragement. New neural pathways or "neural short-cuts" are created, allowing the brain to process faster things which are likely to affect fellow man. The brain adapts due to feedback from the surroundings, to be more social.

From a pure neoclassical point of view, utilizing the rationality assumption, one could say that the individual Homo-sapien, is indeed just that, a utility maximizing individual⁴⁴. He is not a social creature, has no altruistic characteristics and no social obligations. However, research shows that the Homo-sapien is a social creature. In this context we are more like wolfs than like sharks. I use those animals for the analogy, because both have

⁴²Cosmides & Tooby (1995)

⁴³Damasio (1994)

⁴⁴Von-Neumann & Morgenstern (1953)

bad reputations among people, but the wolf is a pack animal and the pack has strong social relationships, while sharks, even though living in schools, are completely individualistic. Social characteristics are imbedded in our psych and social behavior generates subjective benefit for the individual. It physically makes us feel good to be social, because our brains are "hard-wired" to be social animals.

Various zoological researches demonstrate that different animals show altruistic traits. Perhaps the most interesting research field in this context, is that of animals from relatively low levels of cognitions. A good example of such a study, is extensive research done by Prof. Amotz Zehavi, on the *Turdoides Squamiceps* in the Arava area in the south of Israel. The *Turdoides Squamiceps* is a small bird⁴⁵ (of the passerine order), just a little bigger than a sparrow and no doubt it is far from being a cognitively developed creature. This research gave birth to the Handicap Principle⁴⁶, which I will not discuss extensively here. Nevertheless, the study shows that there are unmistakable altruistic traits, even in undeveloped creatures. The *Turdoides Squamiceps* have various group habits conducted by the whole school. The two important examples of this kind of behavior are guarding the school and taking part in the nurturing of the schools' nestlings. The *Turdoides Squamiceps* help in equal parts in the nurturing of the nestlings, even when they are not genetically connected (and thus have no rational stake in the nestling), to the extent that it is hard to tell which of the birds is the nestlings' parent.

Support to these findings can also be found in contemporary Neuro-Science studies. Using brain imaging mechanisms, scientists were able to demonstrate that altruistic

⁴⁵*Turdoides Squamiceps*: A bird of the passerine-order, common to Great-Rift Valley. More commonly known in the Hebrew name "Zanvan".

⁴⁶The Handicap-principle argues that for a signal to be credible, it has to be costly, so it will be hard to imitate. Thus traits that handicap the individual are strong signals. **For elaboration:** Zahavi (1997). **For discussion & criticism:** Davis & O'Donald (1976),57; Eshel (1978),70

behavior activates specific areas in the brain. In a recent study⁴⁷, using fMRI⁴⁸, scientists showed that simple prizes as well as charitable donations (of money essentially), activate the same Mesolimbic Reward Pathway, a primitive circuit in the brain that is related to sexual and culinary stimulus. This perhaps shows that altruistic behavior generated simple pleasure reactions⁴⁹. However, when participants of the study placed the interest of others before their own, the Medial Orbifrontal Subgenual and Lateral Orbifrontal areas were also activated. These areas are related to social attachment and aversion. The scientists showed that more anterior sections of the Prefrontal Cortex are activated when selfish interests are put aside and altruistic decisions are made. This, in simple words, means that altruism is "hard-wired" into the Homo-sapien brain and is pleasurable.

This notion could be further developed, to say that the mind makes connections to norms, which originally were the product of rational choice. Thus, even if there was rational choice that lead to the creation of a certain norm, now the mind acts without relation to that choice, and makes decisions based on something subconscious⁵⁰, stemming from an ancient choice process. From the point in time when the neural connection was formed, one does not obey certain norms out of rational choice, but merely out of obedience to the neural circuit representing the norm. Compliance with a norm, becomes a goal in itself, and not just a simple goal, but one in which emotions are invested.

Theoretically, when a player analyzes a prisoners' dilemma, "desertion", "cheating" or "betrayal" is a strategy seriously considered. But in the real world, such behaviors are extremely emotionally charged. A choice of such behavior is never emotionally and

⁴⁷Moll & others (2006)

⁴⁸Functional-Magnetic-Resonance-Imaging.

⁴⁹This can also be extensively discussed: It can be argued that if altruistic behaviour triggers pleasure, altruistic behaviour is essentially egoistic-behaviour aimed at obtaining pleasure. The counter argument is that even if it were true, it only shows that biological mechanisms support altruistic-behaviour. It does not mean that there is no altruism, but that altruism is biological.

⁵⁰Subconscious in the cognitive-psychology meaning, and not in the Freudian-psychoanalytical meaning.

morally neutral. The emotions involved in compliance with norms, are identical to those that research ties with competition for status: anger, guilt, pride, shame. In daily life and in common culture we know disobedience out of anger for injustice to others⁵¹.

The emotionally charged nature of norms, can be well demonstrated, through compliance with Meta Norms⁵². Theoretically, one is concerned with regular norms, because they guide and set boundaries to ones' life. It is rational to be interested in what directly influences the individual. On the other hand, allegedly, the rational individual has no incentive to be interested in Meta Norms. The rational individual has no interest in enforcing Meta Norms, because they are a public good. The result is a distinct concern with enforcing regular norms, and no concern about enforcing Meta Norms. However, people do go out of their way to enforce meta-norms. Private people, seemingly rational, act to "do justice" and demand "justice" all the time, even when they have no stake in the specific case.

One must also keep in mind that all persons and thus all (real) economic players, widely differentiate in their personalities. Those differences are expressed in different attitudes towards various values, morals, etc. Each player perceives the game differently, perceives the other players differently and so forth. Each player has a substantially different personality structure, in which egoistic and altruistic preferences are blended in different ratios.

The argumentation above leads to a new and interesting challenge to the assumption of rationality, and undermines the neoclassical analysis of social-capital and trust. To this I would like to add at his point, the main body of research done on the assumption of

⁵¹Fukuyama, *supra*-footnote 3

⁵²Meta-norms, as defined by Axelrod: norms which allow for the enforcement of other norms and administer the way in which other norms are defined.

rationality. Tversky and Khanmans'⁵³ extensive research on Heuristics and other subjects related to the assumption of rationality⁵⁴, show that there is little basis to this ethos. In a nutshell, the main argument of this line of research is that the way in which a dilemma is portrayed, influences the players' decision extensively. Thus, assuming economical rationality is incorrect. Other doctrines have undermined the assumption of rationality as well. For example⁵⁵, it has been argued that if people, even the most rational people, would make only rational decisions in each and every point in their life, their behavior would become unpredictable on the intuitive day today level and they would have become paralyzed by the constant need to calculate every possible outcome of their choices. Rules of thumb, routines, habits and all other sorts of instruments we utilize to make our decision making easier and to limit our need to decide at all, are essential for our decision making process. These are all Schemes⁵⁶, mechanisms the brain uses to render decision making faster and simpler. Without these irrational instruments, we cannot function.

⁵³Tversky & Kahneman (Science-1974),1124-1131;Kahneman & Others (AER-1986),728-741;Kahneman & Others (JPE-1990),1325-1348

⁵⁴Together with the vast body of supporting-research and repetition studies.

⁵⁵Heiner (1983)

⁵⁶For elaboration on Schemes:Atkinson (Fort-Worth,2000)

8. Removing the Sanction Paradigm

In a multi player prisoners dilemma (hereafter: social dilemma), the narrow personal interest of a player is to defect, i.e., not to cooperate with the group. This is due to the setting in which when the group cooperates each individual receives a lower payoff than what he could have, had he defected while the rest of the group cooperates. The phenomenon is also referred to as The Tragedy of the Commons.

In addition, in a social dilemma, an individuals decision is effected not only by his own interests and motivations, but also by those of the other individuals in the game, i.e., by the players' assessment of the other sides' likelihood to cooperate⁵⁷. In other words, as explained above, ones' decision is subject to the players trust in his counterpart. Lack of basis for trust, i.e., lack of social-capital, will result in a tragedy of the commons situation.

As elaborated above, one way to solve this problem is by setting a rule that will coerce cooperation. In other words, compelling cooperation by threatening the implementation of a sanction. This is done by creating a rule (legislating in the modern state context) that will punish defectors. Various studies have showed that a binding rules system, a sanctioning system in the jargon used in psychological research, increases trust⁵⁸. The generally accepted explanation for the trust increasing influence is that it shifts the payoffs, meaning that it changes the structure of the game matrix. In summary, the profitability of defection is decreased when the sanction is added to the considerations.

It has also been suggested that a sanctioning system encourages cooperation not only by making it more expensive to defect, but also by assuring the player that his counterparts are subject to the same rules⁵⁹. The assurance that all players play by the same rules, is

⁵⁷De-Cremer & others (2001),93;Parks & others (1996),134;Rapoport and Eshed-Levy (1989),325

⁵⁸Eek & others (2002),801;Yamagishi (1992),267;Yamagishi (1986),110

⁵⁹**In philosophy:** Hobbes (1946). **In social science:** De-Cremer (2001);Rapoport & Eshed (1989); Yamagishi, *supra* footnote 58.

conducive to trust. Knowing that retaliation for untrustworthy behavior is eminent, encourages trust. This has been researched and it seems that individuals support the introduction of a sanction when there is little other basis for trust⁶⁰.

In recent years, however, behavioral research has shown that a sanctioning system actually has negative results as well⁶¹. One good example is a study which demonstrated that the presence of a sanctioning system shifted the players' perception of the situation, from an ethical situation to a business situation⁶². Because of the presence of a binding rule, a legal system, players view the decision as an economical transaction that has to do more with weighing cost and benefit, than with morality. The psychological meaning of this is that motives are shifted. Other studies have shown that American players faced with a social dilemma with no option of sanctioning their peers for defection, are more cooperative than Japanese players⁶³. The explanation offered by the scientists who conducted the experiments, were that the Japanese society is more accustomed to being monitored than the American society. This may suggest that the routine presence of a sanctioning system, weakens the ability to trust others outside the system. Another study demonstrated that participants tend to put more trust in players that seem to have decided to cooperate unilaterally, rather than in a quid-pro-quo way⁶⁴. This indicates that when a player exposes himself to risk in order to achieve cooperation, he gains more trust. Because regulation in general and trust promoting norms specifically, by their nature, reduce risk, additional use of regulation will reduce trust⁶⁵.

As mentioned above, in a social dilemma the player considers not only his preferences and motives, but also those of his counterparts. Thus, it could be important, whether a

⁶⁰Yamagishi, *ibid*.

⁶¹Sitkin & Roth (1993),367;Kramer (1999),569.

⁶²Tenbrunsel & Messick (1999),684. See also, in economics: Frey (1993),635;Fehr & Falk (2001),687

⁶³Yamagishi (JESP-1988);Yamagishi (SPQ-1988),265.

⁶⁴Lindskold (1978),772

⁶⁵Cross (2005),1457

player conceives his counterparts' motives to be internal or external. The issue is whether a player thinks the other players are motivated externally, by an incentive (threat of a sanction), or internally, by their own morale. It may well be, that a legal system, increases trust by augmenting the assessment that the other players will not behave opportunistically, but only because of external motivation.

The discussion about the origins, nature and qualities of intrinsic and extrinsic motivation is well developed in psychological scholarship⁶⁶. To put it briefly, one could perhaps say that extrinsic motivation is relatively short lived, shallow you might say and forever dependent on the presence of the incentive. People show much less emotions of confidence and attribute less credibility to an individual who is perceived to be externally motivated. In very simple words, people put less trust in people who are not internally motivated.

Therefore, if the presence of a sanctioning system, signals that players are externally motivated⁶⁷, than a formal legal system can actually be bad for the cultivation of trust. It signals that without such a system there may be no ground to trust others, because people are not likely to cooperate without the threat of a sanction⁶⁸. The system actually weakens trust by causing its' attribution to external factors. This may undermine the assumption that a positive rule, a legal system, is needed to support trust. It could mean that a formal platform actually hurts trust rather than helps it.

A recent research by Mulder, van Dijk, De Cremer and Wilke⁶⁹, made an important contribution in this field. The study set out to check whether the presence of a sanctioning system indeed decreases the belief in intrinsic motivation. The authors argue that the

⁶⁶For elaboration on intrinsic and extrinsic motivation: Hilgards, *supra* footnote 56; Ryan & Deci (2000),68; Deci & others (1999),627

⁶⁷Tenbrunsel (1999),1350

⁶⁸De Dreu & others (1998),408; Strickland (1958),200

⁶⁹Mulder and others (2006)

presence of a sanctioning system may help trust in others, but this trust will mainly be based on the existence of the sanction, hence cooperation will be attributed to external motivation, and will push aside any chance of trusting others based on a belief in internal motivation. In other words, the research tackles the question whether the sanctioning system itself undermines trust.

Because it could well be that the overall level of trust is not hindered by the sanctioning system, but rather only its' nature is negatively effected, the methodology of such experiments has to be adapted to discriminate that possible confounding factor. For this the study mentioned above utilized the innovative Removing the Sanction Paradigm. This method compares the level of trust between participants who were previously exposed to a sanctioning system, and people with no such exposure. This is done as follows: Participants in the study are confronted with two social dilemma settings. The distinguishing variable is the presence of a sanctioning system. In simpler words: in each setting they have to decide how much they intend to cooperate. The control group receives two scenarios in which there is no sanctioning system (No Sanction Condition), while the condition groups' first scenario contains a sanctioning system (Sanction Condition) and the second does not. It is expected that the no-sanction-condition group will have a higher level of trust in the second scenario presented, because their trust has not been demolished by the assumption of external motivation.

This setting of the experiment can also allow for examination of cooperation level under the two different variations of trust: trust due to belief in internal motivation (of the other party) and trust due to belief in external motivation. This may in turn allow to asses the efficiency of the types of trust. That is to say, that this setting can allow for assessment of cooperation under a sanctioning system and without one.

All three experiments run in the study discussed here, have shown that the presence of a sanctioning system, i.e., of a binding norm, undermines trust. It is very clear from these findings that in the occurrence of a sanctioning system, players attribute their counterparts' cooperation to external motivation, a fact that negatively affects the quality of trust. The existence of a sanction considerably reduces the belief that other players are intrinsically motivated. Furthermore, when the sanction was removed, trust was decreased below the level of the control group. I.e., when the coercive power of the system is taken away from an environment, the players will have less trust than what they could have had, if there had been no system in the first place.

It still may be, that the sanctioning system increases trust, under the assumption that the other players are externally motivated, coerced if you will, to cooperate where there was no basis at all for trust before hand⁷⁰. However, the study also demonstrated that in general, introduction and then removal of a sanctioning system, is unfavorable to assessment that others are internally motivated, no matter whether the preliminary level of trust was high or low. Hence, even if the trust level was low, introduction and removal of a sanctioning system, can take it even lower.

Mediational analysis of the data of two of the three experiments performed, can also suggest that overall cooperation decreases in participants that were exposed to a sanctioning system. This means that the shift from trust based on belief in internal motivation, to trust based on belief in external motivation, diminishes the overall level of trust. I.e., that trust based on external motivation, prompt by a sanctioning system, is of lower quality than trust based on internal motivation. However, mediational analysis is not a sound statistical method and therefore this analysis has to be regarded with suspicion until further research is done.

⁷⁰Macy (1993),819

To summarize, it seems that the mere presence of a binding legal system could cause people to think that their peers are externally motivated and thus to diminish the level and quality of trust. This leads to the conclusion that inducing trust using legal rule, may not be efficient. At the very least, it seems clear that it will make the system and the players in it dependant on that rule, for without it the level of trust would drop considerably. I go furthermore to suggest, that good-faith articles, can in the long run, damage trust and the level of cooperation in the economy rather than encourage it.

One must remember the vulnerability of social studies experiments: in the end, this is only an experiment. This is a closed and controlled environment, with limited ability to mimic reality. There are many confounding variables that can be imagined about the experiments described in this paper, and there are many more which one could not even hope foresee. For example, it could be that the limited time in which the experiment was run, influences the outcome. It could be that over time people adapt to the sanctioning system and regain the ability to generate trust independent of it. It could also be that the saliency of the sanctioning system, which was brought up in the participants' mind close to the decision making, is what caused the results described above. No man, and for that matter no psychologist and no economist, can look into the future or look directly into the minds of people and predict human behavior with one hundred percent accuracy. Thus, we must be careful with the prediction abilities of such studies. It does not mean that the concurrent or predictive validity⁷¹ of the study is uncertain, but it could mean that the facts found in this research do not unavoidably lead to the conclusions one might want to attribute to them. However, the studies I surveyed have a sound scientific base and there is little room to doubt their credibility, reliability and validity. Moreover, as I described before, there are numerous supporting evidence from a considerable number of studies. In

⁷¹Credibility, reliability and validity in the scientific-sense.

any case, the prudent thing to do would be to go on experimenting and collecting information about the effects of rules on the generation of trust⁷².

⁷²Three more studies were conducted recently in this field by the same group that performed the RTS experiment, which are partially relevant to this paper: Mulder & others (2005),443; Stouten & others (2006),894; Mulder & others (2006),1312

9. Experiment

9.1 General

In order to focus the discussion to the efficiency of good-faith articles, I performed a limited experiment on the foundations of the body of research described above, and the removing-the-sanction paradigm. This is only a pilot study aimed at doing the connection between the existing research and the good faith doctrine. Once the logical connection is made between the conclusions of the body of research conducted so far, and the legal world, to my opinion it is clear that norms which allegedly promote trust, norms that are erected to support trust, possibly only hinder it. It seems that the social science research described here, demonstrates the negative effects of good-faith articles. In that sense, the experiment I offer here has a limited contribution, only in focusing and validating the existence of the phenomenon in regard to good-faith rules.

Thus, my hypothesis is that the introduction and then removal of a good-faith article from a cooperation dilemma, will diminish trust.

9.2 Method

Participants: The participants are 58 of my friends, colleagues and former classmates (38 men, 20 women, ages varying between 28 and 32 with an average of approximately 30.5). All participants hold a B.A. degree and all are Israelis. I controlled the selection of participants so the group will not contain any lawyers, jurists or anybody with former legal training. The reason for this condition is that I wanted to avoid a confounding variable of previous conditioning and exposure to sanctioning systems. The participants were split into two groups randomly- A condition group (*A*) and a control group (*B*).

Design:

The instrument I chose for this experiment is a questionnaire. The main reason for this choice was logistic: budget, time and space constraints. The questionnaire is about one page long. It contains descriptions of two scenarios of negotiations and eight questions, three of which are distracters. The scenarios position the participant, as an organizational consultant to a big international firm, heading together with the company lawyer negotiations to purchase electronic components from a foreign company. There are other competitors in the market trying to obtain the same components, and in addition, there is urgency in completing the deal.

In the first scenario, negotiations are going well and the interpersonal relationship is excellent, when unexpectedly the opposite negotiating team asks for a considerably long recess with no explanation but with a statement that the recess is important. The counterpart asks the participant to trust him. In the second scenario, a different deal is negotiated with the same counterparts, in a different country. During the negotiations competitors are sighted and a suspicion of parallel negotiations is raised. Again, the counterpart asks for the participants' trust.

In group *As'* questionnaire, the first scenario mentions the existence of a good-faith article. In the second scenario, the negotiations are shifted to a different country and it is mentioned that there is no good-faith article there. In group *Bs'* questionnaire there is no mention at all of good-faith rules what so ever.

This is an intra participant, one factor array, the independent variable is group affiliation, the manipulated variable is the trust level according to the questionnaires.

Procedure: The participants were asked to read the scenarios and then answer the questions. The results were accumulated, edited and analyzed by me.

9.3 Results

I performed a t test on the results accumulated from the questionnaires. The results ((A,B): *Average* (2.04,3.52), *Median* (2,4), *SD* (0.76,0.94)) show a significant effect ($\beta=1.96$, $t= 3.607$). As hypothesized, the results from this mini-study reinforce the data so far and confirm that the theory is applicable to good-faith articles. Introduction and then removal of a good-faith article, negatively influences the level of trust among participants.

I will conduct the discussion of these results in the next chapter, together with the discussion of all the empirical data presented here.

10. Implications of the Empirical Data

Empirical data overwhelmingly show, that norms which are directed at promoting trust, have a negative effect on trust. The negative effect is caused when a trust promoting norm is installed and then removed. This is plausibly applicable to a situation where the same player acts in two environments, one in which a trust promoting norm exists and one in which there is no such norm. The explanation suggested to this phenomenon, is that the introduction of trust promoting norm causes a shift in the players' understanding of his peers' motivation, attributing cooperation to external reasons of enforcement by trust promoting rule, rather than to internal morally based trust.

It still may be that the sanctioning system increases trust, under the assumption that the other players are externally motivated, coerced if you will, to cooperate where there was no basis at all for trust before hand⁷³. In other words, we must not overlook the evident fact that has long been established by research, that sanctioning system increase overall trust and cooperation. This is especially true when originally trust is low. In certain circumstances, the level of trust could be so low to begin with, that the efficient thing to do would be to introduce trust promoting norms. The argument brought here, is that this increase is limited and causes side effects that hinder the quality of trust and thus, in a "big picture view", reduce trust. One must ask whether such a situation: a setting where there is no prospect for trust at all, is something which is relevant to policy making. The answer to that may lie in the extensive research of altruism described above. It is hard to imagine a society (in the narrow sense of the term) in which there is no foundation to trust at all.

Another argument to counter the criticism of trust promoting norms discussed here, is that the dependency trust promoting norms create once they are legislated, does not matter, because in reality there is no reason to remove them. In other words, there is no actual

⁷³Macy (1993),819.

situation in which a sanction is removed, and even if there was a reason to remove the rule, knowing the effect of removing it will prevent that. Therefore there will be no harm in using good-faith articles, as long as they are not stricken down later on. In fact, research has shown that people prefer not to remove a sanctioning system after one has been introduced⁷⁴. In answer to this argument, we must consider whether there is in reality a situation in which there is never ever a removal of the sanctioning system, or removal *from* the sanctioning system. I.e., the sanction may not be removed, but the player could plausibly be removed from the sanction system environment. Is there a player who always, with no exception, plays within the boundaries of the same system? I for one, doubt it. Economic players change environments all the time. One day a certain businessman or a lawyer could be negotiating in country A, where there is a good-faith article, the next day he will be home negotiating with his kids who certainly do not recognize the existence of any rules, the day after that he will still be negotiating in country A, but on a different deal, governed by a different field of law, where good-faith rules do not apply, and the day after that he will be negotiating in country B where there is no good-faith article at all.

Another aspect of this issue that should also be considered is that the negative effects of the sanctioning system, are possibly not constrained only to the area the sanction refers to. In other words, it could be that a rule referring to one specific tragedy of the commons issue, creates a negative trust reducing effect on other issues or maybe even on the whole legal system. This proposes two contradictory arguments: One, is that trust promoting norms in one place, will cause a ripple effect across the whole system, hindering trust in places detached from the narrow issue for which the norm was legislated. This argument

⁷⁴Mulder & others (2006)

plays well of course with Austrian School economists, who would say that, a Knowledge Problem⁷⁵ makes it impossible to foresee the long term consequences of this legislation.

The other argument erected by the possibility of a cross-system effect, is that there is a legal system at place anyway. We live in an organized society, we have a huge number of rules and today there are very few areas of life which are not regulated by some body of norms. This is true in regard to the general existence of a legal system and in specific in regard to other trust promoting rules. An example of another kind of trust promoting norms that may continue to influence economical actors even if good-faith articles are removed, is unjust enrichment rules. Unjust enrichment rules will almost certainly, lead to the same legal out come as good-faith rules will, thus, they too are a sanction system influencing the players. Therefore, it could be argued, that the trust diminishing process is already in place, and thus, there is no reason not to make the best of it, and use trust promoting norms. Furthermore, if a good-faith principle is in place in one part of the whole legal system, it makes sense to make it a basic, umbrella, fundamental principle of the system, for the ripple effect described above, is demolishing trust across the system.

⁷⁵Hayek (1945)

11. Alternatives to Trust Promoting Norms

From the scholarship brought here so far, it seems that trust promoting norms in general and good-faith articles specifically, have a negative effect on the generation of trust. The extent of the effect and the question whether the drawbacks outweigh the advantages, is a matter for a discussion which I will address hereafter. But first, I would like to discuss the alternatives for such rules.

From the social science analysis I brought, it appears that for any alternative to apply, the existing sanctioning system has to be set aside. Setting aside this system means either rendering the rules as default rules or legislating them out of the system all together. The solution most systems prefer in similar circumstances is turning the rules into default rules. The reason for this originates in the incomplete contract doctrines⁷⁶. The legal system strives to give a "safety net" to incomplete contracts, so that they do not necessarily have to be rendered invalid or void. For this purpose the system supplies an arsenal of non binding rules, which are applied only when parties do not intentionally contract around them. As part of this body of law, legal systems tend to keep good-faith articles as default rules and not remove them all together. The problem with this way of disposing of the trust promoting norms is that as described above, it seems that the mere existence of a sanctioning system can influence trust, and thus this does not aid the cause it is supposed to aid.

The following question also has to be pondered upon: who in his right mind would contract around a good-faith article? Who would straightforwardly allow his counterpart to treat him in bad faith? The answer to that is actually not as clear as one would think. Parties do contract around good-faith articles when it is possible, and the reason is the uncertainty costs that these articles create.

⁷⁶Goldberg (1989), (2006); Shalev (2006);Barak (2005)

Nevertheless, shifting to a default rule is perhaps not a perfect solution, but it still may be better than a mandatory rule. The reason is that conceivably it does not solve the problem of trust diminishing effects, but it still can reduce the additional uncertainty costs that come with the vague nature of most good-faith rules.

This leads me to another plausible alternative: more precise rules. I.e., some other form of regulation, perhaps not as harmful, will replace the vague existing rules. This can be done either by good-faith articles that specify what will be considered good-faith and/or what will be considered bad faith. It can also be done by abandoning the good-faith legislation, and strengthening other contract-law instruments, such as anti-fraud, anti-exploitation, and anti-coercion rules. This kind of solution may at least solve the uncertainty costs caused by the ambiguity of most existing good-faith legislation.

The legislation could also be limited to a specific sector of the economy. For example, possibly specific trust promoting norms can be applicable only from a certain size of a transaction on. Small transactions are the ones that usually suffer from incompleteness of contracts. In this case, because we are dealing with a problem of incomplete contract, a default rule would be enough. In addition, most of the small transactions in the economy, are consumer transactions. These are the most vulnerable to opportunistic manipulation. Thus, there are grounds to defend consumers with good-faith articles. In regard to large transactions, the rationale is that these are usually more professional players, and even if this is not the case, than perhaps the size of the deal warrants the employment of professionals as consultants. If this is correct, than there is less risk of difficulties with incomplete contracts. In addition, it is more likely that the parties will be able to design their own negotiating environment (as I will explain hereafter) and protect themselves against opportunistic behavior. Thus, perhaps there are grounds to design legislation of good-faith rules, so that it is applicable only below a certain size of a deal.

The discussion of consumer contracts also indicates one more possible area where perhaps trust promoting norms are justified: standard form contracts. Standard form contracts are used in all levels of the economy. However, it is mainly in the consumer level where they create a problem in regard to opportunism. This type of contracts is used in settings where there is immense informational asymmetry and considerable differentiation of bargaining power. In addition, room for negotiation is limited. Therefore, it may be wise to have good-faith articles applied to standard form contracts, as part of consumer protection policy.

Another possible circumstances that could guide the limitation of trust promoting norms, is the level of trust in society. As explained in the chapter dealing with the removing-the-sanction paradigm, the sanctioning systems trust diminishing effect plausibly depends on the initial level of trust in the group examined. When people essentially distrust each other, perhaps there is more justification to use trust promoting norms, as explained in the chapter about the implication of the removing-the-sanction paradigm. In addition, different people with different personalities have different inclinations towards trust. Different cultures vary in their basic trust level as well⁷⁷. This is true not only in regards to nations, but also in regards to different sectors of the economy. For example, in the diamond industry trust is a major issue. Deals are closed with a hand shake with not piece of paper in sight, people are trusted to carry immense sums of money, only because "they belong to the industry". In other industries it is inconceivable to close a deal without an elaborate contract. There are various indexes that attempt to measure trust⁷⁸. Such indexes can perhaps, subsequent to additional research, generate the needed knowledge to be able to decide when and where trust promoting norms are needed. Another instrument that can give a general idea of the level of trust in a society is a credit index. When people do not

⁷⁷Sato and Yamagishi (1986),89;Yamagishi (1992)

⁷⁸Hilgards, *supra* footnote 56.

pay their bills, when credit risk is at high level across the board in a certain sector, one can assume that there is little room for trust. Thus perhaps credit rating can be an aid in deciding on the application of trust promoting norms.

If trust promoting norm is disposed of, one way or the other, something else will take their place. In interpersonal relationships and in commercial relationships as well, there never is a vacuum. So what are the alternatives to state enforced regulation?

As suggested above, one alternative is that parties will set their own rules. The situation here is a pre-contractual contract, an agreement on the rules of the negotiations, either formal and carved into an actual option contract, or informal. The discussion in the chapters on social-capital and norms and on philosophical and legal analysis of good-faith articles, in this paper, suggests that social-capital is something that develops only in an organized society, i.e. only in an organization. In other words, if social-capital is an array of rules, norms, etc., which governs the interactions between members of a group, than without the existence of a group, there is no existence for social-capital. If there is no structure, no organization, there is no need to generate rules. The rules which grow in the alternative to the social order, the convivial order, are temporary and local ones. They are *Ius* rather than *Lex*. Thus one of their main characteristics is limited reach- they apply to those who set them and to them alone. There is neither need nor scope for developing norms and thus social-capital, in a non-structural order. This is because the relationships between players in a non-social-order setting, are determined by the parties interacting, by them alone and they apply to them alone. This means, that such alternatives, have a limited ability to solve the main problems which lead to the need of trust promoting norms- the need for a transaction cost reducing instrument. As explained in the neoclassical analysis chapter, one of the reasons to legislate good-faith articles is to save negotiating parties transaction costs related to the need to set the rules of negotiations on each and every

interaction. Thus it seems that relying on "private" solutions may not solve the problem completely.

However, the idea that the Homo-sapien is "Hard Wired" to be social, moral, lawful and so on, may advocate that there is indeed a universal morale. This may work to strengthen arguments in favor of private solution, perhaps even based on some sort of Natural Law⁷⁹. Jurisprudence usually views private law, as the freest area of the legal system. Commercial relationships should be un-instrumental, un-obstructed interactions between economic players, which do not affect others. Individuals should be allowed to create their own environment, their own private social-capital and trust, when there are no barriers and asymmetries between them and when they cause no costs to other individuals. According to this argumentation, it seems that there is no dispute, that contract law is the place where individual freedom should be emphasized. Principally, contract law is about the meeting of wills of free entities. Introduction of social order, with all its' implications, into this field, will probably always cause anomalies.

However, one must keep in mind the well known criticism on natural law in this context⁸⁰: Natural law becomes one mans' subjective morale imposed on others. Use of natural law to administer justice to others, as was well known under Canon Law and as is suggested by classic natural law scholars, is the application of one certain individuals' alleged morale over a different individual. It is the use of subjective and arbitrary moral, to determine right and wrong. After all, we live in an organized society. Therefore disputes are brought to the decision of the courts. If the judiciary will have to settle disputes between parties, based on natural law related rules, this is what will happen, and the problem of uncertainty costs will not be solved at all. In other words, the ambiguous nature

⁷⁹Aquinas

⁸⁰Austin (1885)

of rules generated by private individuals, leads to the same difficulty as ambiguous good-faith rules have.

The last alternative to good-faith legislation is the generation of trust naturally in society. I do not refer here to clearly defined rules set by parties as discussed above, but to trust in its simplest meaning. Internally motivated trust, produced through interpersonal relationships. It is very probable that for such traits to develop a social order has to be in place. I.e., a body of norms that will be a platform for trust to grow from. It is hard to tell whether this kind of trust is possible in modern society. It is definitely not sufficient in many areas of modern life and in many sectors of the economy.

In my opinion, it is clear that in the large, visible, corner cases, which reach the supreme courts and the media, the Good-faith legislation has an important role to play in protecting players against extremely opportunistic behavior. In other words, in cases where there has been foul play or unusually self-seeking behavior by one of the parties, it seems that the good-faith doctrine has had an important contribution in protecting the victims' interest. By doing that, this doctrine probably encourages trust, because it assures the vulnerable party that its' counterpart has potent incentives, further than reputation or altruism, not to abuse trust. In addition, as I discussed in this chapter, there are areas where good-faith legislation is probably warranted. However, a few things should be kept in mind: In most of the grave cases, the ones in which outrageous behavior is displayed, the behavior of the culpable party falls under other contractual instruments, such as fraud, coercion and so forth. To this I must add the range of negative effects I contemplated in this paper and it should be said, that those negative effects have influences across the whole legal system.

12. Summary

In this paper I mixed legal studies, philosophy, psychology, economics and other social sciences, to answer the question: Do we need good-faith rules (or other trust promoting norms) in order to have more trust in our society in general and specifically in our economy. The different fields produce different points of view on the matter, and all show both positive and negative aspects of it.

On the one hand, it seems that trust promoting norms are an over-reaching of the system. Not only do they cause considerable uncertainty costs, but they also diminish peoples' abilities to build trust relationships on their own. On the other hand, there is no doubt that social-capital is needed in order to provide a platform for trust to grow on, and that under certain circumstances, that social-capital must include trust promoting norms. Whether or not the negative effects outweigh the positive effects of this legislation, is a question I leave for future research and for policy makers.

I believe a balance has to be found between the need to regulate behavior in the market, and the need for economic freedom. There has to be a balance between protection against opportunism, and over protection to the extent it degenerates economical actors. However, it is my opinion that regulation of ambiguous values in general, and specifically of trust and other values in contract law, moves in a pendulum motion. Seemingly in our days, in most western legal systems, the pendulum has swayed a little too much to the side of regulation. Over-use of good-faith doctrines has expropriated trust from the individual, and handed it to contract law, which suffers from ambiguity. It is probably the time, in certain societies and in certain contexts, to start shifting again towards more freedom in contract law. Most of all, I believe it is important that specific rules are set and the uncertainty caused by good faith articles diminished.

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Authorship Declaration

I hereby declare and confirm that this thesis is entirely the result of my own work except where otherwise indicated.

Appendix A- Questionnaire

Group A

Please read the following scenario and then answer the questions below.

Scenario

You are an organizational consultant for a big international firm. You and the company lawyer lead negotiations, for buying electronic components from a foreign company. You know that there are other competitors in the market, waiting to close a deal for the very components you were sent to purchase. It is important to your company to complete the negotiations quickly, if possible within the next 3 days. The negotiations are going well and the interpersonal relationship is excellent.

Suddenly, two days into the negotiations, the lead negotiator of the other company, asks for a one day recess in the negotiations. He does not explain why, but says it is imperative to his company, and asks for you to trust him. You consult with the lawyer, who explains to you that in your state (where the negotiations are conducted) there is a "good faith" article in the contract law, and that this means that if this is a tactical, opportunistic stalling of the negotiations, they could be liable for any losses your firm may suffer because of their stalling. You agree to have the recess as asked.

The deal is completed successfully. Six months later, following your success in the previous transaction and because of the good interpersonal relationship you developed with your counterparts, you are sent on your own to their country, to negotiate another deal. Before you go, the company lawyer explains to you that there are no good faith rules in that country.

On the second day of the negotiations, as you leave the building, you notice representatives of one of your competitors entering the building. You confront your negotiating partner, who shrugs it off and says, "Trust me, you're getting the deal, not them" and asks that you go on with the discussions without further ado.

Questions

Answer Yes or No:

Do you believe the first request for a recess was reasonable?	
Do you believe your opposite number when he says you have nothing to worry about?	
Do you go on with the negotiations?	
Do you think it is unethical to negotiate in parallel with two players for the same deal?	
Do you accept his request to go on with the discussions without further ado?	
Do you trust him?	

Answer on a 1 to 5 scale:

How much do you trust your opposite number in the negotiations, given the circumstances described, on a 1-5 scale, 5 being the highest level of trust?	
How concerned are you that this deal will not end as well as the previous deal, on a 1-5 scale, 1 being the lowest level of concern?	

Group B

Please read the following scenario and then answer the questions below.

Scenario

You are an organizational consultant for a big international firm. You and the company lawyer lead negotiations, for buying electronic components from a foreign company. You know that there are other competitors in the market, waiting to close a deal for the very components you were sent to purchase. It is important to your company to complete the negotiations quickly, if possible within the next 3 days. The negotiations are going well and the interpersonal relationship is excellent.

Suddenly, two days into the negotiations, the lead negotiator of the other company, asks for a one day recess in the negotiations. He does not explain why, but says it is imperative to his company, and asks for you to trust him. You consult with the lawyer, and agree to have the recess as asked.

The deal is completed successfully. Six months later, following your success in the previous transaction and because of the good interpersonal relationship you developed with your counterparts, you are sent on your own to their country, to negotiate another deal.

On the second day of the negotiations, as you leave the building, you notice representatives of one of your competitors entering the building. You confront your negotiating partner, who shrugs it off and says, "Trust me, you're getting the deal, not them" and asks that you go on with the discussions without further ado.

Questions

Answer Yes or No:

Do you believe the first request for a recess was reasonable?	
Do you believe your opposite number when he says you have nothing to worry about?	
Do you go on with the negotiations?	
Do you think it is unethical to negotiate in parallel with two players for the same deal?	
Do you accept his request to go on with the discussions without further ado?	
Do you trust him?	

Answer on a 1 to 5 scale:

How much do you trust your opposite number in the negotiations, given the circumstances described, on a 1-5 scale, 5 being the highest level of trust?	
How concerned are you that this deal will not end as well as the previous deal, on a 1-5 scale, 1 being the lowest level of concern?	