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Justification Norms Under Uncertainty: A Preliminary Inquiry

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JUSTIFICATION NORMS UNDER UNCERTAINTY: A PRELIMINARY INQUIRY

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People making decisions under uncertainty may need to justify those decisions to their reputational community. This Essay considers when and how the potential need to justify might lead a decision-maker to employ a methodology better suited to yielding a justifiable choice that may not be the best choice. When a decision involves uncertainty, the possible outcomes and probabilities are not known. A broad consensus about a methodology that produces a good decision often may not exist. But norms will often arise as to acceptable methodologies—that is, methodologies that will be accepted as justifiable if justification is needed. The norms instantiate considerable stickiness – after all, the best way to demonstrate that something is (typically) "done" is to show that relevant others "do it." This Essay identifies a particular pathology associated with the practice of favoring a justifiable decision over a "good" one, and argues that this pathology can have significant negative consequences. The main example discussed is the volume of subprime securities purchased. Other examples include the process by which CEOs are selected, and decisions regarding contract terms in complex business contracts.

"The acceptability heuristic is, perhaps, the least inspiring strategy for coping with accountability. This strategy does, however, have obvious adaptive value for the individual decision-maker."[1]

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[1] Philip E. Tetlock, *The Impact of Accountability on Judgment and Choice: Toward a Social Contingency Model*, *in* 25 ADVANCES IN EXPERIMENTAL SOCIAL PSYCHOLOGY 331, 348 (Mark P. Zanna ed., 1992).

I. IDENTIFICATION OF THE PROBLEM

Investors bought enormous quantities of subprime mortgage securities when they were the hot new thing; the financial crisis began when the securities plummeted in value. Investors' reasons for buying the securities were not based on a careful appraisal of the securities.[2] Rather, the investors relied on what others said and did, even when their reliance was not warranted.[3] If more investors had done their own appraisals, the crisis might not be as severe. Indeed, if enough investors had done their own appraisals, the crisis might not have occurred. This Essay argues that the strategy investors followed – reliance on others – was adopted more to help them justify to others whatever results their investments yielded than to genuinely arrive at the best substantive decision. This Essay also argues that when enough individuals follow such a strategy, society may suffer.

One might think that the potential need to justify ex post should naturally lead to better ex ante decisions. After all, the better a decision is ex ante, the less likely an ex post justification will be needed. But in a class of cases involving decision-making under uncertainty, the potential need to justify may not lead to better decisions. Instead, it may lead to decisions that yield negative externalities and other social costs. It may also prevent the accretion of useful information, as well-worn strategies that provide justification are used in lieu of strategies aimed directly at making the best decision. The enormous volume of subprime securities purchased, and the consequent crisis, provides an important example.

The phenomenon of focusing as much or more on potentially justifying a decision as on making the best decision is exceedingly common. This Essay considers when and how the potential need to justify might lead a decision-maker to employ a methodology better suited to yielding a justifiable choice that may not be the best choice. The intuition is simple to articulate. When a decision involves uncertainty, the possible outcomes and probabilities are not known. A broad consensus about a methodology that produces a good decision often may not exist. But norms will often arise as to *acceptable* methodologies—that is, methodologies that will be accepted as justifiable if justification is needed.[4]

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[2] *See generally*, MICHAEL LEWIS, THE BIG SHORT (2010).

[3] *See id.*

[4] The contrast between decisions supported by "good" justifications and those supported by "acceptable" justifications that are not also "good" justifications unrealistically assumes that there are clear ways to determine what counts as a

The norms instantiate considerable stickiness – after all, the best way to demonstrate that something is (typically) “done” is to show that relevant others “do it.”

Justifications may need to be directed to any or all of the following: courts, regulators, self-regulatory bodies, colleagues, clients, or the “court of public opinion.” What makes a justification acceptable differs for different groups. This Essay addresses justifications to one’s colleagues or clients, or, more broadly, to one’s reputational community, and leaves other focuses of justification to later work. In that regard, the examples used in this Essay relate to business decisions. The phenomenon is not confined to business, but business is a convenient port of entry. Business actors are continually judged by their reputational community, including people in a position to offer rewards such as promotions or bonuses, or punishments such as firing or demotion. The reputational community of such actors has a rich set of norms for acceptable justifications—norms that business actors abide by.

That business actors may “herd” or abide by social norms or established practices is a commonplace observation. This Essay identifies a particular pathology associated with that practice, in disparate but common contexts, decision-makers’ potential need to justify decisions made under uncertainty, and argues that this pathology can have significant negative consequences. The goal of this Essay is to provoke inquiry as to the breadth of the problem identified, as well as possible solutions.

This Essay proceeds as follows: Section 2 articulates the problem. It distinguishes uncertainty from risk, comparing the need for and availability of justifications in both cases. Section 3 discusses the motivating example, the purchase of highly-rated subprime securities by institutional investors. Section 4 discusses several additional examples; one is the process by which CEOs are selected. The other examples involve decisions regarding contract terms, choice of state of incorporation, and the purchase of insurance. Section 5 considers ways in which law contributes to the problem. Section 6 makes preliminary suggestions for solutions. Section 7 concludes.

“good” decision and methodology. While the assumption is ultimately unrealistic, it is sufficient for purposes of this Essay.

II. ARTICULATION OF THE PROBLEM

A. UNCERTAINTY DISTINGUISHED FROM RISK

In *Risk, Uncertainty and Profit*, Frank Knight famously distinguished uncertainty from risk:

> …Uncertainty must be taken in a sense radically distinct from the familiar notion of Risk, from which it has never been properly separated. The term "risk," as loosely used in everyday speech and in economic discussion, really covers two things which, functionally at least, in their causal relations to the phenomena of economic organization, are categorically different. . . . The essential fact is that "risk" means in some cases a quantity susceptible of measurement, while at other times it is something distinctly not of this character; and there are far-reaching and crucial differences in the bearings of the phenomenon depending on which of the two is really present and operating. . . . It will appear that a measurable uncertainty, or "risk" proper, as we shall use the term, is so far different from an unmeasurable one that it is not in effect an uncertainty at all. We shall accordingly restrict the term "uncertainty" to cases of the non-quantitative type.[5]

Knight notes that in conditions of uncertainty, "no valid basis of any kind for classifying instances" exists.[6] This statement is, in some meaningful sense, an exaggeration: there is always *some* valid basis for classification.[7] Indeed, a valid basis for classifying instances of

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[5] FRANK KNIGHT, RISK, UNCERTAINTY AND PROFIT 19–20 (1921).

[6] *Id* at 225.

[7] "Classification" as used here is synonymous with "categorization;"the latter term is more commonly used in the literatures dealing most directly with the area, notably psychology. *See generally* Arthur B. Markman & Brian H. Ross, *Category Use and Category Learning*, 129 PSYCHOL. BULL. 592, 592–93 (2003) (providing a definition of "categories")"); Kristin E. Hickman & Claire A. Hill, *Concepts, Categories and Compliance in the Regulatory State*, 94 MINN. L. REV. 1151, 1185–98 (2010) (discussing linguistic and legal categories in the context of regulatory regimes); Claire A. Hill, *Beyond Mistakes: The Next Wave of*

uncertainty exists. Thus, the difference between risk and uncertainty is, in an important respect, quantitative rather than qualitative. There is a continuum of more-or-less valid bases for "classifying instances."

At the uncertainty end of the continuum, there are, in Donald Rumsfeld's famous words, "unknown unknowns."[8] At the risk end of the continuum, there are (wholly) valid bases for classifying instances: the classification yields an identifiable and determinate set of instances as to which we know the possible outcomes and associated probabilities. Thus, a risk, in the true sense of the word, can easily be assessed using a straightforward arithmetic computation typically known as "expected value." Few things are at the extreme end of the continuum- an exception is the stylized gambles used in experiments. But many things are close enough. A pool of prime mortgages is (or at least before the financial crisis, was) a notable example. The performance of prime mortgages has been tracked extensively for at least the last 40 years.[9] Of course, notwithstanding its colloquial use to the contrary, "risk" is not synonymous with "high risk." Treasury securities are technically "risky" although they are commonly referred to (and thought of) as being risk-free or nearly so.

Natural disasters are at the uncertainty end of the continuum. Which is the better classification to enable us to make predictions, the broader set of natural disasters or a subset of specific such disasters? (And: what counts as a natural disaster?) Moreover, even for a classification that is straightforward, considerable uncertainty can exist: how well can we predict the damage hurricanes will cause in 2012? Uncertainty makes it difficult to assess how much to spend insuring against the possibility of all or particular natural disasters, or how much to pay for investments that constitute bets on the occurrence of such disasters.[10]

In an idealized (and of course highly unrealistic) paradigm of decision-making, these difficulties do not arise. A decision maker can

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Behavioral Law and Economics, 29 QUEEN'S L.J. 563, 573–76 (2004) (discussing the relevance of categorization for law and economics and behavioral law and economics).

[8] Michael R. Gordon, *Rumsfeld, A Force for Change, Did Not Change With the Times Amid Iraq Tumult*, N.Y. TIMES, Nov. 9, 2006,

[9] *See* Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WASH. U. L.Q. 1061, 1119 (1996).

[10] Investments that constitute bets on the occurrence of natural disasters are called "catastrophe bonds" or colloquially, "cat bonds." *See Glossary of Economic and Finance Terms*, FREDDIE MAC, http://www.freddiemac.com/smm/a_f.htm#C. (last visited Sept. 28, 2010).

perform an accurate expected value computation – she chooses among some determinate set of identified options, and knows the possible outcomes and associated probabilities for each option. The strategy is a good one from a substantive perspective. For the same reason, it is readily justifiable.[11] Consider a choice between option A, offering a 10% chance of a $200,000 payoff and a 90% chance of a $4,000 payoff, and option B, offering a 99.5% chance of a $12,000 payoff and a .5% chance of a $1000 payoff. A choice of option A would be easy to justify: (.10x $200,000+.90x $4000) > (.995x $12,000 +.005x $1000).[12] Even a choice of B is justifiable, especially for a one-time gamble – the decision-maker could claim risk-aversion.[13]

Using this strategy requires that the outcomes and probabilities of each option are known (and even more heroically, that the options

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[11] *See generally* MATTHEW D. ADLER & ERIC A. POSNER, NEW FOUNDATIONS OF COST-BENEFIT ANALYSIS 62 (2006). This Essay uses "cost benefit analysis" and "expected value" as though they were synonymous; while they clearly are not, for purposes of the argument here, they can be treated as such.

[12] Of course such a simple computation won't often be possible. Even if a computation of this sort is possible, the numbers will almost certainly be open to argument.

[13] Of course, proceeding in this manner is not infrequently controversial. One common objection is that this approach is cold or unfeeling, or constitutes trying to value something that inherently cannot be valued. *See* FRANK ACKERMAN & LISA HEINZERLING, PRICELESS: ON KNOWING THE PRICE OF EVERYTHING AND THE VALUE OF NOTHING 35–40 (2004). For a discussion of the issue in the context of environmental law, see Richard L. Revesz, *The green community should mend, not work in vain to end, cost-benefit analysis*, GRIST, (May 8, 2008, 09:12 AM), http://www.grist.org/article/cost-benefit-environmentalism/ (promoting the use of cost-benefit analyses in the context of environmental regulation); Lisa Heinzerling, *Lisa Heinzerling responds to Richard Revesz on cost-benefit analysis*, GRIST, (May 14, 2008, 4:49 PM), http://www.grist.org/article/cost-benefit-environmentalism-an-oxymoron/ (arguing against the use of cost-benefit analysis in the area of environmentalism); Richard L. Revesz, *Richard Revesz responds to Lisa Heinzerling, defending cost-benefit anaylsis*, GRIST, http://www.grist.org/article/a-tool-in-the-toolbox (June 5, 2008, 06:21 AM) (responding to Lisa Heinzerling's posting on Grist). A related objection is that quantification makes a decision seem more well-supported than it is – to overstate, the inputs into the quantification may be "garbage," such that "garbage in, garbage out." *See* Claire A. Hill, *Law and Economics in the Personal Sphere*, 29 LAW & SOCIAL INQUIRY 219, 224 (2004). But, in principle it is a respectable method, and may come closest to commanding the most general conceptual acceptance. Certainly, there is no obvious competitor.

themselves are known), or at least known well enough. What if they are not? How do we know what our choice set consists of? Even if we know what the set consists of, how do we assess possible outcomes and the associated probabilities for each member of the set? In fact, we almost never "know" the appropriate elements of the canonical expected value computation. [14] But not infrequently enough of a consensus exists as to those elements, so that the computation can be done and defensibly used.

Any decision may need justification. Many factors bear on the possibility that justification is required, including the likelihood and nature of the possible bad outcomes (or foregone good outcomes). But closer to the risk end of the spectrum, there is, in principle, a good and acceptable justification in the form of expected value. Of course, many decisions raise issues about what can and should be quantified, and what kinds of trade-offs are acceptable.[15] Consider decisions about whether to proceed with a mass immunization program when the best evidence indicates that some small number of people will suffer serious side effects from the immunization.[16] A particular decision may make a controversial assumption about how to quantify the "cost" of the side effects. But the assumption will be used to make the decision and to justify it: the good justification and the acceptable justification are one and the same.

Closer to the uncertainty end of the continuum, we may not have a decision methodology that is as accepted or good as expected value. By definition, in cases of uncertainty, we cannot compute probabilities and outcomes. The methodology thus is not available to help make the decision or to provide a justification. How might a decision-maker react? There is voluminous literature demonstrating the existence of "uncertainty aversion," or, as it is sometimes called, "ambiguity aversion."[17] People do

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[14] A computation of risk can be quite complex: we may only know second-order probabilities, and even those only within certain ranges. But we may know enough to make a computation in which we have significant confidence. If the decision is one of a series of like decisions, we may have considerable confidence in the aggregate results.

[15] ACKERMAN & HEINZERLING, *supra* note 13.

[16] *See, e.g.*, CTRS. *See, e.g.*, UPDATE: VACCINE SIDE EFFECTS, ADVERSE REACTIONS, CONTRAINDICATIONS, AND PRECAUTIONS RECOMMENDATIONS OF THE ADVISORY COMMITTEE ON IMMUNIZATION PRACTICES (ACIP), CTRS. FOR DISEASE CONTROL & PREVENTION (1996), *available at* http://www.cdc.gov/mmwr/preview/mmwrhtml/00046738.htm.

[17] *See, e.g.*, Uzi Segal & Alex Stein, *Ambiguity Aversion and the Criminal Process*, 81 NOTRE DAME L. REV. 1495, 1495 (2006); Craig R. Fox & Amos

not like uncertainty; they will pay money to avoid choosing in conditions of uncertainty.[18] Business actors do not have this option. They must make a choice.

A decision-maker who faces uncertainty knows she may have to justify her decision. Without a sound decision-making methodology to get the best decision, without a way to assess how likely it is that the justification will be needed, and especially when the downside of a bad decision is potentially high, she will focus significantly on seeking a justification that would be accepted by the relevant reference group.

In the stylized case of risk, there is by hypothesis a known and accepted way to make the best substantive decision – expected value.[19] The decision-maker may have to be ready to justify her decision, especially if it potentially carries a significant downside risk. The need to justify does not, however, change the decision she makes. Her decision-making methodology should yield the best decision as well as the most justifiable decision. By contrast, in the stylized case of uncertainty, there is no known and accepted way to make the best substantive decision. The decision-maker cannot accurately assess the probability that she will have to justify the decision, but she cannot rule out that it might be high. She therefore makes a decision that she is able to justify. What kinds of

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Tversky, *Ambiguity Aversion and Comparative Ignorance*, 110 Q.J. ECON. 585, 585 (1995). A search on ssrn.com for "ambiguity aversion" in the title, abstract or keywords yields 110 papers.

[18] *See* Daniel Ellsberg, *Risk, Ambiguity and the Savage Axioms*, 75 Q. J. ECON. 643 (1961), (the seminal article addressing choices under conditions of uncertainty.). *See also* Marciano Siniscalchi, *Ambiguity and Ambiguity Aversion*, *in* THE NEW PALGRAVE DICTIONARY OF ECONOMICS 138 (Steven N. Durlauf & Lawrence E. Blume eds., 2d ed. 2008).

[19] Of course, there are few cases of pure risk or uncertainty. Moreover, the situations in which an expected value computation is feasible, meaningful and sufficiently uncontroversial are few and far between. Still, expected value is, as a matter of rhetoric, a paradigmatic decision-making process in the realm of business and has significant force in other realms, as well. That being said, in the political realm—the realm which provides Tetlock's framework of accountability in Tetlock, *supra* note 1, - expected value might almost never be accepted in the broader community to which a politician is accountable because the community is intractably heterogeneous, the methodology might be too technical, there exists insufficient consensus on the components of the computation, and, probably most significantly, there may be many people who are either disingenuous in their non-acceptance or simply regard the outcome as the only thing of importance, such that a bad outcome cannot be justified.

decisions would a decision-maker be best able to justify? Decisions that invoke history or authority seem well-suited to become the norm[20] for the relevant community.[21] Indeed, taking a step back, it should not be surprising that such norms develop and persist: Decision-makers in a reputational community are similarly situated vís-a-vís one another: they all benefit from the existence of norms by which they can minimize their expected costs. The result can be path dependence,[22] stickiness,[23] herd behavior,[24] and even groupthink.

B. JUSTIFICATION, ACCOUNTABILITY AND THE ACCEPTABILITY HEURISTIC

The foregoing discusses how people may justify less-than-good outcomes of their decisions. This Section elaborates on the functions and form of a justification.

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[20] On social norms generally, see H. Peyton Young, *Social Norms, in* THE NEW PALGRAVE DICTIONARY OF ECONOMICS, *supra* note 18, at 647.

[21] What determines community boundaries, and how norms are adopted and maintained in communities, are clearly relevant to the issues this Essay addresses, but are beyond its scope. *See generally* Claire A. Hill, *A Comment on Language and Norms in Complex Business Contracts* 77, CHI. KENT. L. REV. 29 (2002) (discussing the boundaries of the complex business transacting community).

[22] *See e.g.*, Steven N. Durlauf, *Path Dependence, in* THE NEW PALGRAVE DICTIONARY OF ECONOMICS, *supra* note 18, at 318.

[23] The paradigmatic use of the term "stickyness" is in the context of wages and prices. *See* THE ECONOMIST, http://www.economist.com/research/Economics/alphabetic.cfm?TERM=STICKY%20PRICES#stickyprices (last visited Sept. 28, 2010). The term has, however, become broadly used in economics to refer to behavior that changes more slowly than the standard forces in economics, such as supply and demand, might predict.

[24] *See* Sushil Bikhchandani, David Hirshleifer & Ivo Welch, *A Theory of Fads, Fashion, Custom, and Cultural Change as Informational Cascades,* 100 J. POL. ECON. 992 (1992) (the seminal paper on herding and the related subject of information cascades in finance). There is a rich literature on the subject. *See, e.g,*

Sushil Bikhchandani, David Hirshleifer & Sushil Bikhchandani, *Information Cascades, in* THE NEW PALGRAVE DICTIONARY OF ECONOMICS, *supra* note 18; Andrea Devenow & Ivo Welch, *Rational Herding in Financial Economics*, 40 EUR. ECON. REV. 603 (1996); Torben Lütje, *To Be Good Or To Be Better: Asset Managers' Attitudes Towards Herding,* 19 APPLIED FIN. ECON. 825 (2009); David Hirshleifer & Siew Hong Teoh, *Herd Behaviour and Cascading in Capital Markets: A Review and Synthesis*, 9 EUR. FIN. MGMT 25 (2003); Ivo Welch, *Herding Among Security Analysts,* 58 J. FIN. ECON. 369 (2000).

Justifications are needed when people are, in Philip's Tetlock term, "accountable."[25]

> Expectations of accountability are an implicit or explicit constraint on virtually everything people do . . . . Failure to act in ways for which one can construct acceptable accounts leads to varying degrees of censure, depending on the gravity of the offense and the norms of the society. Although one can make a powerful case for the universality of accountability, the specific norms and values to which people are held accountable vary dramatically from one culture or time to another.[26]

Tetlock sets forth a taxonomy of strategies for coping with accountability, including use of the "acceptability heuristic."[27] According to Tetlock, people "adopt positions likely to gain the favor of those to whom they feel accountable (a coping strategy labeled here as the acceptability heuristic)."[28] The acceptability heuristic is clearly a norm in the relevant community. The heuristic has some benefits for both the individual and groups to which the individual belongs.[29] Moreover, individuals are less likely to make certain mistakes if doing so would not pass muster with the person to whom they are accountable.[30] But it also can have some "highly dysfunctional effects, from both an individual and an organizational perspective. The acceptability heuristic implies that decision-makers can be no better as well as no worse than the constituencies to whom they are accountable."[31]

This Essay articulates a particular pathology within the broader phenomenon Tetlock describes. Uncertainty yields a need for justification, but precludes "good" justifications. The community facing decisions made under uncertainty develops norms of acceptable justifications (which are

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[25] Tetlock, *supra* note 1.

[26] *Id.* at 337 (citations omitted).

[27] *See id.* at 348–51.

[28] *Id.* at 340 (explaining why people might adopt the acceptability heuristic, Tetlock characterizes it as a "least effort solution" and notes that "[a]ll other things being equal, people prefer [such] solutions.")

[29] *Id.* at 349.

[30] *Id.*

[31] Tetlock, *supra* note 1, at 349.

"acceptability heuristics").[32] These justifications rely too much on history, authority, and present practices, which yield bad decisions that perpetuate themselves.[33] The decisions at issue may be all made in the same time period, as was the case with the purchase of subprime securities. Or they may be made at different times, as in the CEO selection example and the other examples of "sticky" corporate practices. There may be many individuals involved, or comparatively few. The individuals may be acting in ways that favor their own interests at the expense of that of their principal, typically their employer. Or they may be acting in ways congruent with their employer's interest. In all of these cases, the decisions yield real social costs – sometimes very large ones.

III. THE MOTIVATING EXAMPLE

The example motivating this Essay arises from the financial crisis. Money managers bought huge volumes of subprime securities, apparently without doing sufficient investigation.

The decision as to whether an investment is worthwhile necessarily involves making assumptions about the future. There will always be an enormous amount we do not know, but we can sometimes have enough information to provide a good basis for a decision. An investor purchasing US Treasury securities can be well assured that she will be timely and fully repaid. (Given the state of the economy, maybe she shouldn't be!). If an investor lends money to Bernie Madoff today, while he is in jail and there are presumably many superior claims on his assets,[34] the investor is unlikely to be repaid. Even though nobody can fully predict the future, it can sometimes be predicted well enough to enable a person making an investment decision to do so with great confidence.

An investor making an investment decision assesses how she expects the investment to perform. Canonically, she considers the possible outcomes and associated probabilities.[35] How much will the investment pay off in good and bad states of the world? How likely are these respective states? It is immediately obvious that the more of a basis one has for these determinations, the better one's valuation will be. It is also

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[32] *See id.* at 340.

[33] *See id.* at 349–50.

[34] *See* Diana B. Henriques, *Claims Total Over 15,400 in Fraud by Madoff*, N.Y. TIMES, July 9, 2009, at B3.

[35] *See id.*

obvious that, all else being equal, the newer and more complex the instrument, the less of a basis one is likely to have.

Subprime mortgage securities and credit default swaps became very popular investments in a short period of time, notwithstanding that they were new and highly complex instruments.[36] This is puzzling. It is one thing for consumers to stand in line all night to buy iPhone4,[37] but sophisticated institutional investors are not supposed to respond to trends simply by chasing them. They also are not supposed to chase trends they do not understand. These investors are now saying, with some plausibility, that they never understood the investments.[38] A companion paper discusses this puzzle and provides an explanation:

> Investors bought complex securities they could not properly value. Why did they pay such high prices? One might think that they would instead discount for uncertainty and demand a premium to compensate them in case they were buying a lemon. Perhaps investors thought the lemon securities had been sweetened because of the sellers' stake in their reputation—sellers, not wanting to risk the loss of reputation and future business, would do their best not to sell lemon securities. But an explanation relying on the reputational stake of the sellers – the investment banks – is insufficient. The time horizons of many individuals selling on behalf of investment banks are far shorter than those of their employers. Investment banks have failed to sufficiently constrain the behavior of these individuals. Moreover, it is generally known that the investment banks themselves sometimes put their own interests ahead of customers'.
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> Perhaps the investors were simply unfaithful agents making investments for others. They could have made

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[36] *See* Gary B. Gorton, *The Panic of 2007*, 3-4, 9, 20-30 (Nat'l Bureau of Econ. Research, Working Paper No. 14358, 2008), *available at* http://www.nber.org/papers/w14358.

[37] Dawn Kawamoto, *iPhone 4 Draws Long Lines, Entrepreneurs and Expectations of 'Wow!'*, DAILYFINANCE, June 23, 2010, http://www.dailyfinance.com/story/iphone-4-draws-early-lines-entrepreneurs-and-expectations-of-w/19527671/.

[38] *See generally* LEWIS, *supra* note 2.

> self-interested decisions to get a quick payoff in the form of fees or short-term results, calculating that the payoff would exceed any long-term financial or reputational cost. This explanation does not work either: it leaves unanswered the question of why the ultimate investors would not have chosen better agents or monitored them more carefully…
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> Perhaps the investors simply relied on the rating agencies' AAA ratings for the securities? This also seems unlikely, given that Enron was scarcely in the distant past, and that the securities offered higher yields than other AAA-rated securities, indicating that they were of lower quality. Moreover, during the latter part of the period in which subprime securities were popular investments, the securities' low quality became sufficiently evident that reliance on rating-agency ratings became progressively less tenable. …
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> The most satisfactory explanation for why investors did not demand a much larger lemons premium lies in the incentives for "herding" among agents who made investment decisions for others. Investors (and markets) compare investment managers to other investment managers. A manager's best strategy, therefore, may be to do what her peers do regardless of whether the manager believes her peers are a reliable source of information about the quality of the investment decision.[39]

These investors could have invested in ultra-conservative instruments, but such a choice would lack an "accepted" justification – that is not what their peer money managers "do." For that matter, it would also lack a "good" justification: a justification based on the merits of the decision and the methodology used. Investors were hired for their supposed expertise in investment selection – an expertise which was to

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[39] Claire A. Hill, *Why Didn't Subprime Investors Demand A (Much Larger) Lemons Premium*?, 74 LAW & CONTEMP. PROBS. 101, 102-4 (2011) ations omitted).

yield expected returns above those of an insured bank deposit or Treasury instrument.

Doing what their immediate peers (other money managers) did – buying an investment crafted by other peers (the big investment banks with involvement from their lawyers and vetted by still other peers, the rating agencies) – was "accepted." The money managers may also have believed their peers knew what they were doing, that subprime mortgage securities were sufficiently similar to the historically successful prime mortgage securities, that housing prices would go up forever, and that brilliant financial structuring could vastly minimize risk while keeping reward high. Whatever the money managers believed about how the instruments would perform, they knew the instruments' performance (and their own performance as money managers) was subject to considerable uncertainty. Thus, they cared a great deal about the potential need for justification. For money managers, justifying their decisions on the bases that their peers performed no worse would be easier than justifying doing far worse because they missed out on the hot new thing.[40] We know the outcome of these "safe" decisions (for the money managers): the financial crisis.

IV. OTHER EXAMPLES

This section presents several additional examples. In these examples, decision-makers use methodologies that the relevant community uses, where there is significant reason to suppose that they do not necessarily yield the best substantive decision. One example is selection of the CEO. The other examples are of choice of state of incorporation, providing for remote contingencies in a complex business contract, and public company purchases of insurance. I discuss each example below. In a recent article, I discussed another example related to my motivating example here: the choice of two (or, in more recent years, two of three) particular rating agencies for a debt issuance. I argued that a "CEO may be second guessed if he does not get two ratings [one from Moody's and one from Standard & Poor's] and the offering is disappointing; a downside

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[40] This ignores the contrarians who made bets against such securities and others who simply didn't get involved on either side. Such investors existed, but there were comparatively few, such that subprime securities came to be dangerously overvalued. *See generally* LEWIS, *supra* note 2.

for not abiding by the norm is far more likely than any upside from flouting it."[41]

A. CEO SELECTION

Another example where accepted justifications are sought as much or more than good decisions (with "good" justifications) is the selection of CEOs for larger companies – companies watched by the markets because market participants have a significant stake in the companies' performance. How such companies will perform is uncertain for many reasons. The economy's performance is hard to predict, as are other potentially significant factors, such as natural and man-made disasters. Industry-specific factors and the behavior of a company's competitors are often unpredictable. If the company does badly, those who selected the CEO may be criticized.[42] Thus, decision-makers may be highly influenced by the potential need to justify when making their decisions as to who will be CEO.[43] According to Rakesh Khurana, a leading scholar in the field:

> [B]oards employ extremely limiting criteria to define the pool of eligible candidates. These criteria, which are loosely (if at all) coupled to the specific strategic challenges facing the firm, are adopted largely with the intention of producing a candidate who will be seen as legitimate by external constituents, namely, financial analysts and the business media. . . . Because the directors and candidates involved in external CEO search are embedded in a community of overlapping business and social relationships, they are particularly sensitive to

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[41] Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L. Q. 43, 61 (2004). Fitch also became an acceptable source of one of the two ratings. *See* Claire A. Hill, *Why Did Rating Agencies Do Such A Bad Job Rating Subprime Securities?*, 71 PITT. L. REV. 585, 600-602 (2010).

[42] *See, e.g.*, Micheline Maynard, *At G.M.'s Helm or Going Under?*, N.Y. TIMES, Mar. 29, 2006 (describing the pressure placed on the board of General Motors when their choice for CEO underperformed in the position).

[43] *See, e.g.*, RAKESH KHURANA, SEARCHING FOR A CORPORATE SAVIOR: THE IRRATIONAL QUEST FOR CHARISMATIC CEOS 29–36 (2002) (discussing the role of justification in corporate searches for new CEOs).

> maintaining the appearance of propriety in the conduct of the search among their peers.[44]

Each time a prominent company needs a CEO, it chooses from the same small pool of candidates. This seems to be the accepted modus operandi, if the company does badly under the new CEO, it permits those involved to point to the process they followed, and be therefore absolved from responsibility for the results of their decision. Khurana seems to intimate that good quality is at least a necessary condition to be in the pool of candidates.[45] But perhaps good quality is not necessary – it may be that previously being a CEO is sufficient.[46]

One might think that some past performances are so bad that they should disqualify a possible candidate. If that is so, how can we explain Robert Nardelli's selection as the head of Chrysler after his performance at Home Depot?[47] In 2006, Joe Nocera of the New York Times wrote:

> Mr. Nardelli . . . has become this year's version of Mr. Overpaid C.E.O. He's earned this status, in part, by the sheer sum of money his board has awarded him in the five years since he was recruited from General Electric to take over Home Depot: $245 million, including $37.1 million just this last year. At the same time, Home Depot's stock has fallen 12 percent, while shares of its chief competitor, Lowe's, have risen 173 percent. You've heard of pay for performance? This is the classic definition of pay for pulse.[48]

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[44] *Id.* at 29, 36.

[45] *See id.* at 27–30.

[46] This, of course, is an overstatement – a CEO who is discovered committing a massive fraud probably is no longer in the pool of acceptable CEOs. If he is in jail, he is probably unavailable. "Chainsaw Al" Dunlap did not see a great demand for his services after his disastrous and criminal stewardship of Sunbeam. *See* JOHN A. BYRNE, CHAINSAW: THE NOTORIOUS CAREER OF AL DUNLAP IN THE ERA OF PROFIT-AT-ANY-PRICE 350 (1999).

[47] *See* Joe Nocera, *The Board Wore Chicken Suits*, N.Y. TIMES, May 27, 2006.

[48] *Id.*

Home Depot ousted Mr. Nardelli in January of 2007.[49] He became head of Chrysler in August of 2007, hired by Chrysler's owner, the private equity fund Cerberus, and resigned in April of 2009 as Chrysler entered Chapter 11 bankruptcy, returning to Cerberus .[50] Of course, Nardelli headed Chrysler while the economy was in crisis. We cannot know whether he did a good job; perhaps someone else would have done worse. What is important is that previously being the CEO at Home Depot seems to have been sufficient for Nardelli to obtain another CEO job notwithstanding that he had engendered considerable hostility for his lackluster performance and high pay package.

The strategy of choosing a new CEO from a small pool of present or former CEOs is problematic for many reasons. First, the strategy may not yield the best CEO: another person might have been better.[51] Second, the strategy probably contributes to the high level of CEO compensation overall.[52] It helps perpetuate the illusion that CEO candidates are scarce,[53] and amplifies the resonance of a new CEO's argument that he must be above the median of his comparison group and therefore should be paid

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[49] *See* Michael Barbaro, *Embattled Chief Executive Resigns at Home Depot*, N.Y. TIMES, Jan. 3, 2007.

[50] *See* Bill Vlasic, *Chrysler Chief Says He Believes He Has Saved the Automaker*, N.Y. TIMES, May 1, 2009, at B5. It is interesting, too, that Mr. Nardelli's new employer was a private equity fund whose own financial interests were at stake. Mark Clothier, *Chrysler's Nardelli To Rejoin Cerberus Without Golden Parachute*, BLOOMBERG, May 1, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aQ.PiZK2OzH0. Who did they need to justify their hiring decision to? In the community that includes private equity funds, there may be far more incentive to try to make the best judgment and far less reason to use a methodology importantly motivated by its justifiability. But the fund does have some agents too. They have their own often-large financial stakes, but they may face the same constraints as other agents in needing to justify what they do. The fund itself may also need justification to its investors if it does not perform as well as its peers.

[51] *See* KHURANA, *supra* note 43, at 25. How the market perceives the new CEO and what it says about the company to choose and gain her services, may influence how well the company does and hence, how successful the CEO "is" or seems to be. This might seem to complicate the story that the company is losing out when it hires the CEO chosen using the accepted strategy rather than the CEO who would have been chosen because of his skill set. Khurana suggests, however, that the market perception and its effects will fade over time.

[52] *Id.* at 30.

[53] *See id.* at 30 n.18.

accordingly.[54] Third, the strategy perpetuates the reigning narrative that a particular person – a "charismatic" CEO, in Khurana's words – can save the company.[55] CEOs may have a far smaller effect on the performance of their companies than the narrative suggests – the reigning narrative is probably a myth.[56] Finally, this strategy "restricts access to the CEO position to those who fit certain socially defined criteria."[57]

In sum, if this depiction is correct, firms expend considerable energy and money chasing a myth. Firms do this in significant part to play to an outside audience.[58] Chasing the myth may also serve to perpetuate it. Going down this mistaken path also prevents accretion of useful knowledge regarding CEO search methodologies and desirable CEO characteristics, as the same approach continues to yield what are arguably less than satisfactory results.[59]

B. PROVIDING FOR REMOTE CONTINGENCIES IN COMPLEX BUSINESS CONTRACTS

Complex business contracts are notoriously long and filled with legalese. One significant contributor to their length is provisions relating to remote contingencies. An illustration is found in a memorable "melodrama in three acts" in *Anatomy of a Merger*,[60] a book by James Freund, a leading mergers and acquisitions lawyer. In one scene in the melodrama, the senior lawyer chastises the junior lawyer's first draft of an acquisition agreement:

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[54] *See id*. at 30.

[55] *See id.* at 20.

[56] *Id.* at 21 ("The widespread, firmly held belief in the overriding importance of the CEO is all the more noteworthy considering that there is no conclusive evidence linking leadership to organizational performance."). *See also* Noam Wasserman et al., *When Does Leadership Matter? The Contingent Opportunities View of CEO Leadership* 6–7 (Harvard Univ. Strategy Unit, Working Paper No. 02-04, 2001), *available at* http://ssrn.com/abstract_id=278652 (arguing that the potential influence of a CEO fluctuates over time and is situation-specific).

[57] KHURANA, *supra* note 43, at 49..

[58] *See id.* at 20–21.

[59] *See id.* at 21 ("[B]oards find themselves trapped in an infinite loop of dashed expectations and CEO churn.").

[60] JAMES C. FREUND, ANATOMY OF A MERGER: STRATEGIES AND TECHNIQUES FOR NEGOTIATING CORPORATE ACQUISITIONS 479-540 (1975).

> And then, in the one place you *did* a little thinking, Pete, it seems to me you went too far. I know it's *possible* that they'll repeal the Copyright Act some day, but it doesn't really rise to a level of probability sufficient to warrant three pages of provisions conditional upon that event.[61]

In this situation, Pete removes the provision. The senior lawyer, Freund's alter ego, is in my experience quite idealized. In my years as a lawyer, nobody questioned such provisions, and they were therefore never removed. This is one important reason why contracts have gotten appreciably larger over time. The process by which complex business contracts are written involves starting with a "form" – a document used in a previous transaction. Contract drafters change only what is inapt; they do not remove what is unlikely to be needed. In *Why Contracts Are Written in Legalese*, I explained that:

> [in the course of the transaction or its aftermath,] [t]hings may go wrong for many reasons. If they do, clients may blame their lawyers, and senior lawyers may blame their juniors, regardless of where fault lies. And lawyers may worry more than is warranted that things will go wrong and that they will be blamed. Finally, because the form is one's point of departure, its provisions necessarily have a mantle of correctness; deviations have to be, in a sense, "justified." Things already written down come pre-legitimized – not just in the political sense that there's no payoff in challenging them, but also in the psychological sense that they "look like they belong." As a result, deviations from the form, especially more structural or innovative deviations, are disfavored. Necessary changes to use the form in the new transaction are more apt to be as limited as possible to "do the job." Deletions generally must meet a high threshold of justification: omitting a provision because it doesn't do much, but does clutter up

[61] *Id*. at 500-01, *also quoted in* Claire A. Hill, *Why Contracts Are Written in Legalese*, 77 CHI-KENT L. REV. 59, 63 (2001).

> the form, rarely suffices. But inclusion of new boilerplate that doesn't seem to help but couldn't hurt requires much less justification. Contracts get progressively longer and more cumbersome, and usually not to any positive end.[62]

The social costs of overly long and technical complex business contracts are of course much smaller than the social cost of the excess purchases of subprime securities. And they mostly fall on parties who have in a sense agreed to bear them. But the costs are not insignificant. The extra resources spent in drafting, reading, negotiating, printing, and reviewing contracts over and above what would be needed if the contracts were leaner are fairly large, especially given the billing rates of the lawyers at issue and the value of the time of top-level company officials who may review them; companies pass these costs onto their customers. And of course the longer and more complicated the contract, the more opportunities and costs arise for litigation. Moreover, litigation costs also are borne by taxpayers, who pay for courts.

C. OTHER EXAMPLES: "STICKY" BUSINESS PRACTICES

Consider the choice to incorporate in Delaware and the choice of a public company to buy insurance. A good argument can be made that the decision-makers are influenced more by justification than by trying to make the best possible decision from a substantive perspective.

1. Delaware Incorporation

Why do so many companies incorporate in Delaware? Very few companies conduct business in Delaware, yet more than half of all public companies are incorporated there.[63] A great deal of literature exists on this subject.[64] Other states would like to attract incorporation business; there

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[62] Hill, *supra* note 61, at 76.

[63] *See* Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition Over Corporate Charters*, 112 YALE L.J. 553, 554 (2002); *About Agency*, STATE OF DELAWARE, http://corp.delaware.gov/aboutagency.shtml (last updated May 27, 2010).

[64] *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991); ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993); Lucian Arye Bebchuk, Alma Cohen & Allen Ferrell, *Does the Evidence Favor State Competition in Corporate Law?*, 90 CALIF.

have been efforts along those lines, but none that have made an appreciable dent in Delaware's market share.[65] One explanation, complementary to many of the explanations in the literature, focuses on justification. At elite law firms, incorporating new corporations in Delaware is the default norm. A lawyer attempting to deviate from the norm would have to explain and justify her decision. Incorporation is typically done by lower-level attorneys. Thus, the explanation would likely need to be made to the senior attorney. Such firms' clients tend to include many people who study the law firm's work product carefully; thus, the unusual choice would have to be explained and justified to a client as well. A typical reason given for incorporating in Delaware is that the Delaware judiciary is better suited to resolving corporate disputes: it is more sophisticated and has a quicker timeline. But very few cases go to court, and many courts follow Delaware corporate law.[66] What seems likely is overall "stickiness" based on the comfort of everyone involved with Delaware law and procedure. Decision-makers do not really investigate alternatives; other states may thus not try

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L. REV. 1775 (2002); Lucian Arye Bebchuk and Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168 (1999); Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992); William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L. J. 663 (1974); Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525 (2001); Daniel R. Fischel, *The 'Race to the Bottom' Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913 (1982); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL. STUD. 251 (1977); Ralph K. Winter, *The "Race for the Top" Revisited: A Comment on Eisenberg*, 89 COLUM. L. REV. 1526 (1989) [hereinafter Winter, *Comment*].

[65] How much other states try to get incorporation business is a matter of considerable debate. It is conventionally argued that other states do compete to get incorporation business. *See, e.g.*, Winter, *Comment*, *supra* note 63; ROMANO, *supra* note 64; Fischel, *supra* note 64. Some scholars argue that they do not try much to get incorporation business because they know they will not succeed against Delaware. *See, e.g.*, Bebchuk & Hamdani, *supra* note 63. One state recently attempting to get incorporation business is North Dakota. *See* Larry Ribstein, *The North Dakota Experiment*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Apr. 23, 2007, 11:48 PM), http://blogs.law.harvard.edu/corpgov/2007/04/23/the-north-dakota-experiment.

[66] *See, e.g.*, Hilton Hotels Corp. v. ITT Corp., 978 F. Supp. 1342, 1345-46 (D. Nev. 1997).

as hard to provide them,[67] potentially setting up a self-reinforcing dynamic. In the typical corporate context involving complex business transactions, there is virtually no chance of being second-guessed and punished for a choice to incorporate in Delaware unless there is a specific, known reason to make a different choice. By contrast, the chance of being second-guessed and punished for a choice to incorporate in another jurisdiction without some affirmative reason for doing so may very well be punished.[68]

2. Public Company Purchase of Insurance

Why would public companies buy insurance? A great deal of literature exists on the subject.[69] The starting point is that such companies should be risk-neutral, and therefore should not spend money on insurance premiums. It must cost more to buy insurance than the expected amount of any payout the insurance company would make.[70] The purchase of insurance is therefore a puzzle requiring an explanation. Many scholars have provided explanations, invoking, among other things, risk aversion of

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[67] *See* Bebchuk & Hamdani, *supra* note 63, at 553-57.

[68] My authority for this paragraph is my extensive practice experience and interviews with many other practitioners. *See also* John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame The Lawyers*, 89 CAL. L. REV. 1301, 1304-05 (2001) (arguing that adoption of particular takeover defenses is importantly determined by a particular firm's practices rather than the client's needs). Coates's article is in a different context than the one discussed in the text, and hypothesizes an "agency cost" in which the law firm's interests are being pursued at the expense of the client's, but Coates' argument and the one in this Essay are related. Law firms settle on a particular practice and do not revisit it; the mechanism by which this occurs is presumably that individual lawyers are discouraged from deviating. In the context of takeover defenses, there is a clear better alternative for the client. For incorporation, there is not. Perhaps there is a better alternative that could be found through research. Or perhaps one would arise if the norm to incorporate in Delaware became less sticky.

[69] *See* David Mayers & Clifford W. Smith, Jr., *On the Corporate Demand for Insurance,* 55 J. BUS. 281 (1982) (an early influential article posing the puzzle); Li-Ming Han, *Managerial Compensation and Corporate Demand for Insurance,* 63 J. RISK & INS. 381 (1996) (explaining corporate insurance purchases by reference to managerial risk aversion); *see also* Victor P. Goldberg, *The Devil Made Me Do It: The Corporate Purchase of Insurance,* 5 REV. OF LAW & ECON. 541 (2009), *available at* http://www.bepress.com/rle/vol5/iss1/art22 (giving alternative explanations for corporate purchases of insurance).

[70] *See* Mayers & Smith, *supra* note 69 at 282.

corporate managers,[71] expertise by insurance companies,[72] or requirements of the company's transacting partners.[73] Another explanation may be the one offered here for the purchase of subprime securities and CEO selection process: that those in charge of making the decisions are looking more to justification than to the substance of the decision. This may involve an agency cost, or it may not. The manager may think that if an event occurs that would have triggered a payout and she has not obtained insurance for the company, that she will be fired or reprimanded. But the company's shareholders might also punish the company in such a case; the manager might then be serving her company well by obtaining the insurance.

V. LAW AS PART OF THE PROBLEM

The foregoing has discussed a problem: when a decision-maker makes a decision intended more to shield her from negative consequences than to yield the best possible decision. Might law provide a solution? Law is, unfortunately, often part of the problem.

Law, especially corporate law, encourages process-based justification, even where the process at issue can be followed fairly mechanically.[74] Consider fiduciary duty law, especially the duty of care and the duty of good faith under the duty of loyalty. Directors and officers show that they met their duties by demonstrating that they hired the appropriate advisors, and had meetings which lasted a sufficient period of time and conducted enough debate and inquiry.[75] There may be a formula – a true safe harbor, or something close enough – to avoid liability. Using the court-approved process may not yield a worse decision, but it probably incurs unnecessary costs in arriving at the decision that probably would have been arrived at in any event.

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[71] *See* Han, *supra* note 69, at 281-82.

[72] *See* Goldberg, *supra* note 68, at 542-43.

[73] *Id*. at 541.

[74] *See* Claire Hill & Brett McDonnell, *Executive Compensation and the Optimal Penumbra of Delaware Corporation Law*, 4 VA. L. & BUS. REV. 333, 336 (2009) [hereinafter Hill & McDonnell, *Executive Compensation*] (characterizing the post-*Van Gorkom* process of approving mergers in Delaware as resulting in "full employment" for investment bankers and lawyers); Claire A. Hill & Brett H. McDonnell, Stone v. Ritter *and the Expanding Duty of Loyalty*, 76 FORDHAM L. REV. 1769, 1772 n.14 (2007).

[75] *See* Hill & McDonnell, *supra* note 73, at 1769-72; Hill & McDonnell, *Executive Compensation*, *supra* note 73, at 336.

The emphasis on process reflects that courts do not want to micromanage business. It also reflects a desire to give business people certainty – to specify ways of proceeding that insulate a decision and the decision-maker from further scrutiny.[76] This ethos echoes, and encourages, a mindset favoring justification by formula.[77]

The next Section argues that one important solution to the problem is to develop and promote norms against the use of justifications that are merely acceptable, but not "good." These norms should encourage business actors to use their own judgment, even if they can not consult a formula or an established past or present practice. As discussed above, law has difficulty in preventing people from using safe harbors as refuges from doing their own inquiry. But perhaps law can do something to help the problem. It can allow for more personal liability for business decision-makers in some cases. It can marshal dicta to encourage better practices, and can outlaw common practices it finds unsatisfactory. I turn to these issues in the next Section.

VI. SOLUTIONS

The foregoing described contexts in which decision-makers made decisions that the decision-makers had more reason to think were

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[76] *See* Hickman & Hill, *supra* note 7, at 1188.

[77] A recent paper pointing out the extent to which justification can distort behavior is Gideon Parchomovsky & Alex Stein, *The Distortionary Effect of Evidence on Primary Behavior*, 124 HARV. L. REV. (forthcoming 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1568884. The authors discuss how actors' behavior can be distorted by their need to make the best evidentiary case to a court. Inefficiency may result since a person may, for instance, allow behavior that harms her to continue so she can demonstrate that it occurred. Parchomovsky and Stein's paper shares with this Essay the idea that the need to get some desired treatment – avoiding professional censure or getting a recovery in a lawsuit – can distort behavior and potentially be costly to society. Parchomovsky and Stein's paper has some important differences, though. First, in their scenario, the behavior that does not represent a distortion is known, at least as a matter of theory. This Essay's analogue– the best decision from a substantive point of view – is not known. This is precisely why the problem arises. Second, demonstrations made to a court are governed by different forces than demonstrations or justifications to one's peers. In both instances, law and norms are relevant. But, to overstate for expository ease, norms inform law to a court, whereas law informs norms to one's peers.

justifiable than were substantively good. The decisions have varying social costs, some quite large and some smaller.

What kind of solutions might be possible? If we characterize the greater society as having an interest in more critically-minded and less formulaic decision-making, one approach might be to align the interests of decision-makers with those of the greater society. One way this might be achieved is to make decision-makers personally responsible for their decisions. This might be achieved in several different ways.

One is to make decision-makers personally liable for their decisions. The liability could arise from the decision's outcome or from the process used to reach the outcome. Richard Painter and I have argued for the former solution in a particular context: highly compensated bankers. These bankers made risky decisions that allowed their banks to fail or suffer significant losses. We argued that such bankers should be personally liable if their banks fail; we would allow them to retain a million dollars of their own wealth, but no more. Investment banking is a business that can impose, and has recently imposed, enormous social costs. We argue that investment banking is presently structured in a manner that rewards excessive risk-taking. Investment bankers had significant equity stakes in their banks, and were willing to risk those. We argue that they might not be willing to risk losing amounts they hold outside the firm that enable them to maintain their accustomed standard of living.[78]

Obvious objections exist to our proposal, mostly notably that it may not be politically feasible.[79] But this may change given public disgust at continuing high banker compensation.[80] Even if it does become feasible, though, it is only a partial solution for highly compensated people in a field that imposes social costs. Limited liability is a bedrock principle in business, and it is simply not realistic to advocate abandoning it wholesale. Thus, many decision-makers making decisions more because the decisions

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[78] Claire A. Hill & Richard Painter, *Berle's Vision Beyond Shareholder Interests: Why Investment Bankers Should Have (Some) Personal Liability*, 33 SEATTLE U. L. REV. 1173, 1173-74 (2010).

[79] Substantive objections include the following: a regulation imposed by the U.S. or a state would tempt bankers to work where the regulation did not apply; fewer people would want to be investment bankers; bankers would find ways to hide their assets; innovation would be stifled as bankers flocked to safety. *Id*. at 1196-99.

[80] *See, e.g.*, Eric Dash, *Federal Report Faults Banks on Huge Bonuses*, N.Y. TIMES, July 22, 2010, at A1.

are justifiable than because they are substantively good could not feasibly be made guarantors for their decisions.

What about trying to increase oversight of process? If the oversight is to be done by courts, this does not seem like a promising solution. As argued in the previous Section, courts, especially those deciding matters of corporate law, are notoriously reluctant to micromanage process. Courts are sometimes willing to say directors did not think long enough; they are not generally willing to say they did not think hard enough.[81] But one related avenue might be promising: trying to encourage norms and best practices in favor of critical thinking and against mechanical and formula based decision-making methodologies. Corporate "law" nowadays very much includes extra-legal forces such as pressure imposed by major shareholders, through the proxy process as well as the media.[82] Such pressure could make it less "safe" for decision-makers to follow certain types of established practices. Law could also have a role: decisions could include dicta encouraging more critical-mindedness. Of course, critical-minded decision-making is no panacea. Formulaic decision-making methodologies may at least impose a lower bound on the quality of decision-making.[83] But it may be realistic to hope that the decisions at issue, mostly those made by individuals working in an institutional setting, would be constrained by those institutions, thus providing a lower bound.

Law can also play another role. It may not be good at dictating the specifics of good process, but it can be quite good at dictating the specifics of bad process. In that regard, it can have a more direct role in limiting "safe harbors." It can, for instance, label a particular practice "unreasonable" as a matter of law. By itself, this may not be sufficient. Consider that in 1999, the Seventh Circuit characterized reliance on Standard and Poor's rating as unreasonable.[84] Eleven years later, reliance continues unabated, notwithstanding Enron and the subprime crisis. But

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[81] *See, e.g.*, Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 241-44 (Del. 2009).

[82] *See generally* Hill & McDonnell, *Executive Compensation*, *supra* note 73, at 357-64.

[83] *See* text accompanying note 31.

[84] *See* Quinn v. McGraw-Hill, 168 F.3d 331 (7th Cir. 1999), *quoted and discussed in* Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43, 56 (2004).

court attempts to specify bad process, making "safe harbors" less safe, is an approach with some potential.

A final approach to consider is that interested parties – perhaps, industry groups – might be willing to subsidize research on better decision-making methodologies. They might be motivated by their collective interest or perhaps by an interest in avoiding regulation. In cases where there is a public interest, government, too, can subsidize such research.

VII. CONCLUSION

Decisions made under uncertainty may be made more with a view towards justification than with a view towards making the best substantive decision. Norms may arise as to justifications the decision-maker's community will accept; the decision-maker will often be guided by these norms. The result may be inferior decisions that impose social costs, sometimes significant ones. This phenomenon matters for law and policy. Massive overinvestment in subprime securities is an important example.

The problem will not be easy to address. At first blush, law would not seem a good place to look. The problem involves people taking refuge in an accepted methodology or practice rather than fully using their critical faculties. Law notoriously judges actions by reference to accepted norms in the community; it also notoriously focuses on process rather than substance.

This Essay aims to draw attention to the breadth of the problem, showing its roots and manifestations in standard human motivations. The breadth of the problem has not been appreciated. Might better solutions be possible if the problem is viewed at a higher level of abstraction? This Essay aims to raise this possibility, and otherwise inspire new ways of looking at what may have seemed like diverse phenomena.