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The Regulation of Reputational Information

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# CHAPTER 4

## HAS THE INTERNET FUNDAMENTALLY CHANGED ECONOMICS?

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The Regulation of Reputational Information

By Eric Goldman*

Introduction

This essay considers the role of reputational information in our marketplace. It explains how well-functioning marketplaces depend on the vibrant flow of accurate reputational information, and how misdirected regulation of reputational information could harm marketplace mechanisms. It then explores some challenges created by the existing regulation of reputational information and identifies some regulatory options for the future.

Reputational Information Defined

Typical definitions of “reputation” focus on third-party cognitive perceptions of a person.¹ For example, Black’s Law Dictionary defines reputation as the “esteem in which a person is held by others.”² Bryan Garner’s A Dictionary of Modern Legal Usage defines reputation as “what one is thought by others to be.”³ The Federal Rules of Evidence also reflect this perception-centric view of “reputation.”⁴

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¹ As one commentator explained:

Through one’s actions, one relates to others and makes impressions on them. These impressions, taken as a whole, constitute an individual’s reputation—that is, what other people think of you, to the extent that their thoughts arise from what they know about you, or think they know about you.


² BLACK’S LAW DICTIONARY (8th ed. 2004).


⁴ See, e.g., FED. R. EVID. 803(19), 803(21).
Although this definition is useful so far as it goes, I am more interested in how information affects prospective decision-making. Accordingly, I define “reputational information” as follows:

information about an actor’s past performance that helps predict the actor’s future ability to perform or to satisfy the decision-maker’s preferences.

This definition contemplates that actors create a pool of data (both subjective and objective) through their conduct. This pool of data—the reputational information—can provide insights into the actor’s likely future behavior.

### Reputation Systems

“Reputation systems” aggregate and disseminate reputational information to consumers of that information. Reputation systems can be mediated or unmediated.

In unmediated reputation systems, the producers and consumers of reputational information communicate directly. Examples of unmediated reputation systems include word of mouth, letters of recommendation and job references.

In mediated reputation systems, a third-party publisher gathers, organizes and publishes reputational information. Examples of mediated reputation systems include the Better Business Bureau’s ratings, credit reports/scores, investment ratings (such as Morningstar mutual fund ratings and Moody bond ratings), and consumer review sites.

The Internet has led to a proliferation of mediated reputation systems, and in particular consumer review sites. Consumers can review just about anything online; examples include:

- eBay’s feedback forum, which allows eBay’s buyers and sellers to rate each other.
- Amazon’s product reviews, which allows consumers to rate and review millions of marketplace products.
- Yelp.com, which allows consumers to review local businesses.

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5 Luis M.B. Cabral, The Economics of Trust and Reputation: A Primer (June 2005 draft), http://pages.stern.nyu.edu/~lcabral/reputation/Reputation_June05.pdf (treating information about reputation as inputs into Bayesian calculations).

6 Indeed, this has spurred the formation of an industry association, the Rating and Review Professional Association. http://www.rarpa.org.

Why Reputational Information Matters

In theory, the marketplace works through an “invisible hand”: consumers and producers make individual and autonomous decisions that, without any centralized coordination, collectively determine the price and quantity of goods and services. When it works properly, the invisible hand maximizes social welfare by allocating goods and services to those consumers who value them the most.

A properly functioning invisible hand also should reward good producers and punish poor ones. Consumers allocating their scarce dollars in a competitive market will transact with producers who provide the best cost or quality options. Over time, uncompetitive producers should be drummed out of the industry by the aggregate but uncoordinated choices of rational and informed consumers.

However, given the transaction costs inherent in the real world, the invisible hand can be subject to distortions. In particular, to the extent information
about producers is costly to obtain or use, consumers may lack crucial information to make accurate decisions. To that extent, consumers may not be able to easily compare producers or their price/quality offerings, in which case good producers may not be rewarded and bad producers may not be punished.

When information is costly, reputational information can improve the operation of the invisible hand by helping consumers make better decisions about vendors. In this sense, reputational information acts like an invisible hand guiding the invisible hand (an effect I call the "secondary invisible hand"), because reputational information can guide consumers to make marketplace choices that, in aggregate, effectuate the invisible hand. Thus, in an information economy with transaction costs, reputational information can play an essential role in rewarding good producers and punishing poor ones.

Given this crucial role in marketplace mechanisms, any distortions in reputational information may effectively distort the marketplace itself. In effect, it may cause the secondary invisible hand to push the invisible hand in the wrong direction, allowing bad producers to escape punishment and failing to reward good producers. To avoid this unwanted consequence, any regulation of reputational information needs to be carefully considered to ensure it is improving, not harming, marketplace mechanisms.

Note that the secondary invisible hand is, itself, subject to transaction costs. It is costly for consumers to find and assess the credibility of reputational information. Therefore, reputation systems themselves typically seek to establish their own reputation. I describe the reputation of reputation systems as a “tertiary” invisible hand—it is the invisible hand that guides reputational information (the secondary invisible hand) to guide the invisible hand of individual uncoordinated decisions by marketplace actors (the primary invisible hand). Thus, the tertiary invisible hand allows the reputation system to earn consumer trust as a credible source (such as the Wall Street Journal, the New York Times or Consumer Reports) or to be drummed out of the market for lack of credibility (such as the now-defunct anonymous gossip website JuicyCampus).\footnote{Matt Ivester, \textit{A Juicy Shutdown}, JUICYCAMPUS \textsc{blog}, Feb. 4, 2009, \url{http://juicycampus.blogspot.com/2009/02/juicy-shutdown.html}.}

\textbf{Thinking About Reputation Regulation}

This part explores some ways that the regulatory system interacts with reputation systems and some issues caused by those interactions.
Regulatory Heterogeneity

Regulators have taken divergent approaches to reputation systems. For example, consider the three different regulatory schemes governing job references, credit reporting databases and consumer review websites:

- Job references are subject to a mix of statutory (primarily state law) and common law tort regulation.
- Credit reporting databases are statutorily micromanaged through the voluminous and detailed Fair Credit Reporting Act.\(^\text{12}\)
- Consumer review websites are virtually unregulated, and many potential regulations of consumer review websites (such as defamation) are statutorily preempted.

These different regulatory structures raise some related questions. Are there meaningful distinctions between reputation systems that support heterogeneous regulation? Are there “best practices” we can observe from these heterogeneous regulatory approaches that can be used to improve other regulatory systems? These questions are important because regulatory schemes can significantly affect the efficacy of reputation systems. As an example, consider the differences between the job reference and online consumer review markets.

A former employer giving a job reference can face significant liability whether the reference is positive or negative.\(^\text{13}\) Giving unfavorable references of former employees can lead to defamation or related claims;\(^\text{14}\) and there may be liability for a former employee giving an incomplete positive reference.\(^\text{15}\)

Employers may be statutorily required to provide certain objective information about former employees.\(^\text{16}\) Otherwise, given the potentially no-win liability regime for communicating job references, most knowledgeable employers

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\(^{13}\) See Tresa Baldas, *A Rash of Problems over Job References*, Nat’l L.J., Mar. 10, 2008 (“Employers are finding that they are being sued no matter what course they take; whether they give a bad reference, a good reference or stay entirely silent.”).

\(^{14}\) 1-2 Employment Screening § 2.05 (Matthew Bender & Co. 2008) (hereinafter “Employment Screening”).


\(^{16}\) These laws are called “service letter statutes.” See Employment Screening, supra note 14. Germany has a mandatory reference law requiring employers to furnish job references, but in response German employers have developed an elaborate system for coding the references. Matthew W. Finkin & Kenneth G. Dau-Schmidt, *Solving the Employee Reference Problem*, 57 Am. J. Comp. L. 387 (2009).
refuse to provide any subjective recommendations of former employees, positive or negative.\textsuperscript{17}

To curb employers’ tendency towards silence, many states enacted statutory immunities to protect employers from lawsuits over job references.\textsuperscript{18} However, the immunities have not changed employer reticence, which has led to a virtual collapse of the job reference market.\textsuperscript{19} As a result, due to mis-calibrated regulation, the job reference market fails to provide reliable reputational information.

In contrast, the online consumer review system is one of the most robust reputation systems ever. Millions of consumers freely share their subjective opinions about marketplace goods and services, and consumer review websites keep proliferating.

There are several possible reasons why consumer review websites might succeed where offline reputation systems might fail. My hypothesis, discussed in a companion essay in this collection, is that the difference is partially explained by 47 U.S.C. § 230, passed in 1996—at the height of Internet exceptionalism—to protect online publishers from liability for third party content. Section 230 lets websites collect and organize individual consumer reviews without worrying about crippling legal liability for those reviews. As a result, consumer review websites can motivate consumers to share their opinions and then publish those opinions widely—as determined by marketplace mechanisms (i.e., the tertiary invisible hand), not concerns about legal liability.

The success of consumer review websites is especially noteworthy given that individual reviewers face the same legal risks that former employers face when providing job references, such as the risk of personal liability for publishing negative reputational information. Indeed, numerous individuals have been sued for posting negative online reviews.\textsuperscript{20} As a result, rational actors should find it imprudent to submit negative reviews; yet, millions of such reviews are published online. A number of theories might explain this discrepancy, but one theory is especially intriguing: Mediating websites, privileged by their own liability immunity, find innovative ways to get consumers over their fears of legal liability.

\textsuperscript{17} See Baldas, \textit{supra} note 13.

\textsuperscript{18} The immunizations protect employer statements made in good faith. \textit{EMPLOYMENT SCREENING}, \textit{supra} note 14.

\textsuperscript{19} See Finkin & Dau-Schmidt, \textit{supra} note 16.

What lessons can we draw from this comparison? One possible lesson is that reputation systems are too important to be left to the market. In other words, the tertiary invisible hand may not ensure accurate and useful information, or the costs of inaccurate information (such as denying a job to a qualified candidate) may be too excessive. If so, extensive regulatory intervention of reputation systems may improve the marketplace.

An alternative conclusion—and a more convincing one to me—is that the tertiary invisible hand, aided by a powerful statutory immunity like Section 230, works better than regulatory intervention. If so, we may get better results by deregulating reputation systems.

**System Configurations**

Given the regulatory heterogeneity, I wonder if there is an “ideal” regulatory configuration for reputation systems, especially given the tertiary invisible hand and its salutary effect on publisher behavior. Two brief examples illustrate the choices available to regulators, including the option of letting the marketplace operate unimpeded:

**Anti-Gaming.** A vendor may have financial incentives to distort the flow of reputational information about it. This reputational gaming can take many forms, including disseminating false positive reports about the vendor, disseminating false negative reports about the vendor’s competitors, or manipulating an intermediary’s sorting or weighting algorithm to get more credit for positive reports or reduce credit for negative reports. Another sort of gaming can occur when users intentionally flood a reputation system with inaccurate negative reports as a form of protest.

Do regulators need to curb this gaming behavior, or will other forces be adequate? There are several marketplace pressures that curb gaming, including competitors policing each other, just as they do in false advertising cases. In

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addition, the tertiary invisible hand may encourage reputation systems to provide adequate “policing” against gaming. However, when the tertiary invisible hand is weak, such as with fake blog posts where search engines are the only mediators, government intervention might be worth considering.

Right of Reply. A vendor may wish to publicly respond to reputational information published about it in an immediately adjacent fashion. Many consumer review websites allow vendors to comment or otherwise reply to user-supplied reviews, but not all do. For example, Yelp initially drew significant criticism from business owners who could not effectively reply to negative Yelp reviews because of Yelp’s architecture, but Yelp eventually relented and voluntarily changed its policy. As another example, Google permitted quoted sources to reply to news articles appearing in Google News as a way to “correct the record.”

Regulators could require consumer review websites and other reputation systems to permit an adjacent response from the vendor. But such intervention may not be necessary; the tertiary invisible hand can prompt reputation systems to voluntarily provide a reply option (as Yelp and Google did) when they think the additional information helps consumers.

Undersupply of Reputational Information

There are three primary categories of reasons why reputational information may be undersupplied.


Inadequate Production Incentives

Much reputational information starts out as non-public (i.e., “private”) information in the form of a customer’s subjective mental impressions about his/her interactions with the vendor. To the extent this information remains non-public, it does not help other consumers make marketplace decisions. These collective mental impressions represent a vital but potentially underutilized social resource.

The fact that non-public information remains locked in consumers’ heads could represent a marketplace failure. If the social benefit from public reputational information exceeds the private benefit from making it public, then presumptively there will be an undersupply of public reputational information. If so, the government may need to correct this failure by encouraging the disclosure of reputational information—such as by creating a tort immunity for sites that host that disclosure, as Section 230 does, or perhaps by going further. But there already may be market solutions to this problem, as evidenced by the proliferation of online review websites eliciting lots of formerly non-public reputational information.

Further, relatively small amounts of publicly disclosed reputational information might be enough to properly steer the invisible hand. For example, the first consumer review of a product in a reputation system creates a lot of value for subsequent consumers, but the 1,000th consumer review of the same product may add very little incrementally. So even if most consumer impressions remain non-public, perhaps mass-market products and vendors still have enough information produced to keep them honest. At the same time, vendors and products in the “long tail”30 may have inadequate non-public impressions put into the public discourse, creating a valuable opportunity for comprehensive reputation systems to fix the omission. However, reputation systems will tackle these obscure marketplace options only when they can keep their costs low (given that consumer interest and traffic will, by definition, be low), and reputation system deregulation helps reduce both the costs of litigation as well as responding to takedown demands.

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Vendor Suppression of Reputational Information

Vendors are not shy about trying to suppress unwanted consumer reviews ex post, but vendors might try to suppress such reviews ex ante. For example, one café owner grew so tired of negative Yelp reviews that he put a “No Yelpers” sign in his café’s windows.

That sign probably had no legal effect, but Medical Justice offers an ex ante system to help doctors use preemptive contracts to suppress reviews by their patients. Medical Justice provides doctors with a form agreement that has patients waive their rights to post online reviews of the doctor. Further, to bypass 47 U.S.C. § 230’s protective immunity for online reputation systems that might republish such patient reviews, the Medical Justice form prospectively takes copyright ownership of any patient-authored reviews. (Section 230 does not immunize against copyright infringement). This approach effectively allows doctors—or Medical Justice as their designee—to get reputation systems to remove any unwanted patient reviews simply by sending a DMCA takedown notice.

Ex ante customer gag orders may be illegal. In the early 2000s, the New York Attorney General challenged software manufacturer Network Associates’ end user license agreement, which said the “customer will not publish reviews of this product without prior consent from Network Associates, Inc.” In response, the New York Supreme Court enjoined Network Associates from restricting user reviews in its end user license agreement. Medical Justice’s scheme may be equally legally problematic.

From a policy standpoint, ex ante customer gag orders pose serious threats to the invisible hand. If they work as intended, they starve reputation systems of the public information necessary to facilitate the marketplace. Therefore,
regulatory efforts might be required to prevent ex ante customer gag orders from wreaking havoc on marketplace mechanisms.

**Distorted Decision-Making from Reputational Information**

Reputational information generally improves decision-making, but not always. Most obviously, reputational information relies on the accuracy of past information in predicting future behavior, but this predictive power is not perfect.

First, marketplace actors are constantly changing and evolving, so past behavior may not predict future performance. For example, a person with historically bad credit may obtain a well-paying job that puts him or her on good financial footing. Or, in the corporate world, a business may be sold to a new owner with different management practices. In these situations, the predictive accuracy of past information is reduced.37

Second, some past behavior may be so distracting that information consumers might overlook other information that has more accurate predictive power. For example, a past crime or bankruptcy can overwhelm the predictive information in an otherwise-unblemished track record of good performance.

Ultimately, a consumer of information must make smart choices about what information to consult and how much predictive weight to assign to that information. Perhaps regulation can improve the marketplace’s operation by shaping the information that consumers consider. For example, if some information is so highly prejudicial that it is likely to distort consumer decision-making, the marketplace might work better if we suppress that information from the decision-maker.38

At the same time, taking useful information out of the marketplace could create its own adverse distortions of the invisible hand. Therefore, we should tread cautiously in suppressing certain categories of information.

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38 *Cf.* FED. R. EVID. 403 (“Although relevant, evidence may be excluded if its probative value is substantially outweighed by the danger of unfair prejudice, confusion of the issues, or misleading the jury…”). This fear underlies a French proposal to enact a “right to forget” statute. See David Reid, *France Ponders Right-to-Forget Law*, BBC CLICK, Jan. 8, 2010, http://news.bbc.co.uk/2/hi/programmes/click_online/8447742.stm.
Conclusion

Although “reputation” has been extensively studied in a variety of social science disciplines, there has been comparatively little attention paid to how regulation affects the flow of reputational information in our economy. Understanding these dynamics would be especially valuable in light of the proliferation of Internet-mediated reputation systems and the irresistible temptation to regulate novel and innovative reputation systems based on emotion, not necessarily sound policy considerations.