Economia Aziendale Online

Business and Management Sciences
International Quarterly Review

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Pavia, June 30, 2023
Volume 14 - N. 2/2023

DOI: 10.13132/2038-5498/14.2.291-301

www.ea2000.it
www.economiaaziendale.it

PaviaUniversityPress

Electronic ISSN 2038-5498
Reg. Trib. Pavia n. 685/2007 R.S.P.

Economia Aziendale Online – Business and Management Sciences International Quarterly Review
Vol. 14-2/2023 - DOI: 10.13132/2038-5498/14.2.291-301

The Day after the Scandal [Part two]. An Empirical Evidence on Liability Action and Reputational Risk

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Cite as:

Rangone, A. (2023). The Day after the Scandal [Part two]. An Empirical Evidence on Liability Action and Reputational Risk. *Economia Aziendale Online, 14*(2), 291-301.

Section: *Refereed Paper*

Received: January 2023
Published: 30/06/2023

ABSTRACT

This paper consists of an empirical analysis, successive to Part 1 (Rangone, 2023), concerning the correlation between the execution of a liability action and the increase of potential negative effects from a reputational point of view that undermine the company's stability. The cases of application of the liability action and those which have adopted the arbitration clause as a term of comparison have been defined on a population of 428 Italian unlisted joint-stock companies. The technique of *Chi-Square* was used to avoid empirical evidence being determined by chance. The findings demonstrate the substantial correlation between the adoption of the arbitration clause – replacing the liability action against directors – and the reduction of cases of reputational problems regardless of their causes.

Questo lavoro sviluppa un'analisi empirica, successiva alla Parte 1 (Rangone, 2023), riguardante la correlazione tra l'esecuzione di un'azione di responsabilità e l'aumento di potenziali effetti negativi dal punto di vista reputazionale che minano la stabilità dell'azienda. I casi di applicazione dell'azione di responsabilità e quelli che hanno adottato la clausola compromissoria come termine di confronto sono stati definiti su una popolazione di 428 società per azioni italiane non quotate. È stata utilizzata la tecnica del *Chi-Square* per evitare che l'evidenza empirica fosse determinata dal caso. I risultati dimostrano la sostanziale correlazione tra l'adozione della clausola compromissoria – sostitutiva dell'azione di responsabilità nei confronti degli amministratori – e la riduzione dei casi di problemi reputazionali indipendentemente dalle loro cause.

Keywords: Sustainability, Corporate Governance, Reputational Risk, Conflict Management, ESG

1 – Introduction

Thanks to the analysis of the literature realized in the previous theoretical paper (Rangone, 2023), it has been possible to underline how sometimes unpredictable the judicial solution can be in cases of a liability action against the managerial class, especially in situations where the guilt of managers is not clear or not supported by clear empirical

evidence. This is because the legal procedures make extensive reference to the Business Judgement Rule principle (Rangone, 2017; Matsimela, 2011; Du Plessis, 2011; Bainbridge, 2004; Branson, 2001). The liability action can therefore represent a double-edged sword, since not only can the outcome of the judgment be favorable to the party involved (in this case the manager) but also because the dispute would become public knowledge and would expose the company to a very delicate media judgment involving the most important corporate stakeholders (Arru & Ruggeri, 2021; Detthamrong *et al.*, 2017; Gazzola & Mella, 2016; Stansfield, 2006; Gaultier-Gaillard and Louisot, 2006; Srivastava *et al.*, 1997).

As analysed theoretically, there is a fundamental and delicate relationship between critical business conditions and the reduction of the company's credibility due to the perception of its reputation. Having said that, this work aims to demonstrate empirically that pursuing the path of liability action is not always the optimal solution unless there is more than concrete evidence that managers are responsible. Liability action is not necessarily the optimal solution. It would be preferable to adopt the arbitration clause (Agarval, 2016; Veasey, 2015; Queen Mary University & PwC, 2006; Demaine & Hensler, 2004; Sayre, 1928; Balch, 1915) as a precautionary measure to follow the out-of-court settlement if necessary and to keep the episode of the dispute as discreet as possible (Mylovanov & Zapechelnyuk, 2013; Drahozal & Hylton, 2003).

2 – Research Methodology

2.1 – *The identification of the sample*

A logical continuity with what was reported in the previous work should have led to choosing listed companies as the target population, as they can be identified more easily and as it would have been more immediate also the feedback on the stock trend. Nevertheless, due to their "public relevance", the sensitivity of the requested information, and the number of companies that agreed to the interview or replied to the questionnaire were insufficient to obtain a suitable population to carry out the analysis. It was therefore deemed appropriate to proceed with the sampling of a population of 428 Italian "unlisted" joint-stock companies, which are in any case considered suitable since they are subject to the consideration and important judgement of their stakeholders and, therefore, to the reputational risk better defined above.

2.2 – *Methodology of data collection*

The data are related to a population of companies that responded to an interview and stated that they had at least one experience of litigation with regard to the directors' liability for faults towards the company, creditors, individual shareholders, or third parties. The interview, therefore, focused on the correlation between potential reputational risks in companies which, despite having had an internal dispute, have benefited from the arbitration clause and those which have made a liability action against the directors found guilty.

For the purpose of the analysis, companies in the manufacturing, trade, and construction sectors were identified and evaluated. The choice has been defined as follows because together these three sectors make up a population of more than 53% of the total number of joint-stock companies in Italy of 29,585 (Figure 1). According to the surveys carried out with reference to the census of companies divided by legal nature, sectors, employees, gender, category and age of employees of Area Studi Legacoop (data available at 2017) based on Istat data.

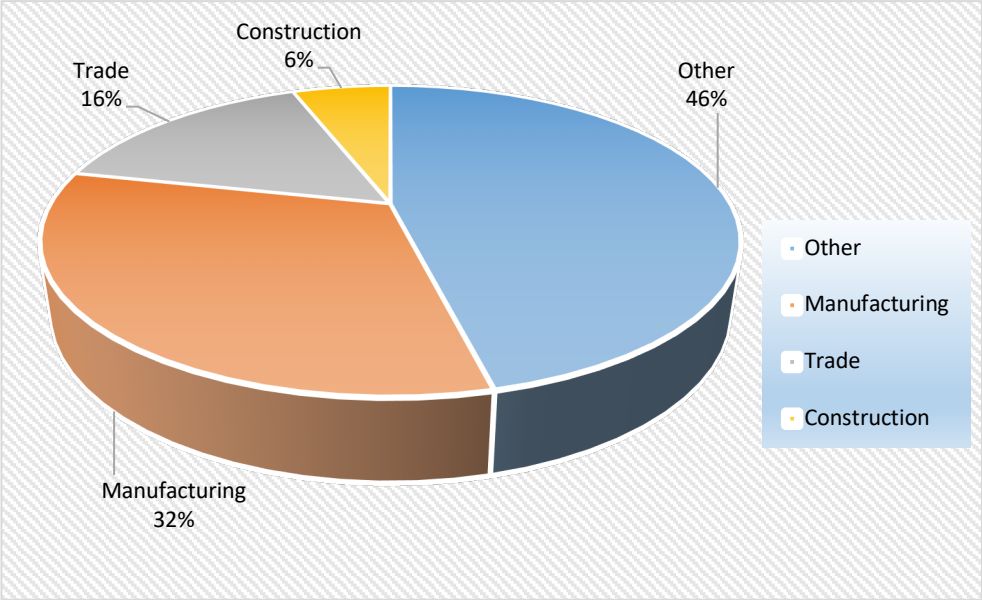

Fig. 1 – Percentage weight of companies out of the grand total. Breakdown by sector
(Source: author's elaboration)

In addition, companies in these sectors are more likely to have a board of directors who can exercise control or significant influence over decisions taken in areas such as logistics, real estate or professional activities. Finally, two dichotomous variables identified with X and Y were set for the study. The first variable relates to an arbitration clause which, in the event of its presence, allows the dispute to be referred to arbitration or civil mediation, while in its absence it leads to an action of liability against the directors. On the other hand, the second one divides the whole sample between companies that have experienced reputational problems and those that have been exempt.

3 – Data Analysis

As already specified above, the objective of the analysis is to show the effectiveness in entering an arbitration clause that solves internally the various problems of business management, avoiding legal action, and the benefits arising at the reputational level. In order to bring empirical evidence to this thesis, it was first chosen to analyze the correlation between the two variables and then focus attention on two indicators such as "relative risk" and "odds ratio" to determine whether there is a greater probability of having reputational problems in the presence or absence of the clause.

3.1 – *Correlation study*

The most immediate method to study the correlation between two variables is surely the *Chi-Square* test, whose calculation can be summarized in the *Chi-Square* formula:

$$\chi^2 = \sum_{i=1}^{k} \frac{(observed\ frequency_i - expected\ frequency_i)^2}{expected\ frequency}$$

This indicator can vary from 0 to + ∞ and is given by the ratio between the sum of the square of the differences between the observed and the theoretical expected frequencies in a condition

of total independence between the two variables in analysis and the theoretical frequencies themselves.

In presence of this condition, the values of the theoretical frequencies coincide with those of the observed frequencies giving rise to a *Chi-square* equal to 0. The totality of the companies observed in the study are therefore divided into the following subgroups, named with a clockwise letter for the calculations that we will see later (Table 1).

Table 1 – Double-entry table of observed frequencies. Absolute number, percentage weight and nomenclature of each cell out of the grand total

X \ Y	**No reputational criticality**	**Particular reputational criticalities**	**Total**
Arbitration clause	188 (43.9 %) ***[A]***	20 (4.7 %) ***[B]***	208 (48.6 %) ***[A+B]***
Liability Action	142 (33.2 %) ***[C]***	78 (18.2 %) ***[D]***	220 (51.4 %) ***[C+D]***
Total	330 (77.1 %) ***[A+C]***	98 (22.9 %) ***[B +D]***	428 (100 %) ***[A+B+C+D]***

Analyzing the marginal frequencies of the two variables, on the one hand it is possible to note that the companies without reputational problems represent more than ¾ of the entire sample, on the other hand there is a substantial balance between the companies that have stipulated the clause and those who have opted for liability action. Instead, with regard to the frequencies in each cell in the case of total independence, we will have the following expected values and the respective contingencies, given by the difference between the observed and expected frequencies.

Table 2 – Double-entry table of expected frequencies. Absolute number and calculation of contingencies

X \ Y	**No reputational criticality**	**Particular reputational criticalities**	**Total**
Arbitration clause	160.37 (+ 27.63)	47.63 (- 27.63)	208
Liability Action	169.63 (- 27.63)	50.37 (+ 27.63)	220
Total	330	98	428

Analyzing the contingencies, we can see that there is a situation of attraction for the two couples "Arbitration clause – No reputational criticality", "Liability Action – Particular

reputational criticalities" which seems to suggest how the choice for the clause leads to a lower risk of having reputational criticalities while the legal procedure can lead to particular reputational problems for the company. At this point, by comparing the two tables, it is possible to calculate the value of χ^2:

$$\chi^2 = \frac{(188-160.37)^2}{160.37} + \frac{(142-169.63)^2}{169.63} + \frac{(20-47.63)^2}{47.63} + \frac{(78-50.37)^2}{50.37} = 4.76 + 4.50 + 16.02 + 15.15 = 40.43$$

The *Chi-square* value of "40.43", however, risks remaining a number that does not give particular indications if it is not chosen or if it is not normalized or alternatively compared with its theoretical equivalent. The normalization serves to understand when the dependence between the two variables is strong since it acts on the numerosity of the sample and of the categories of each variable bringing the value of the indicator to vary in an interval between 0 and 1, where in correspondence of the minimum value there is stochastic independence while with a unit value of the indicator a situation of functional dependence between the two variables is described. The passage from χ^2 to χ^2_{norm} can be summarized in the formula:

$$\frac{\chi^2}{N * min\{rows - 1, columns - 1\}}$$

and with the data at our disposal, putting N equal to 428 (sample number) and the minimum between rows and columns equal to 2, the value will go from 40.43 to 0.09 outlining a low connection between the variables, even if not negligible.

The χ^2 test instead allows us to understand, through a comparison between the observed $\chi 2$ and a theoretical one, if the discrepancies between observed and expected frequencies are minimal and due only to a random component or if there is an effective correlation between the two variables such as to reject the null hypothesis (called H_o) at a predetermined significant α level where the independence between the two variables is assumed. To make the comparison it is not sufficient to set a specific "α" but it is also necessary to determine the degrees of freedom given by the minimum between the rows and columns of the Table 2 subtracted 1. In our case, therefore, we can show how there is only one degree of freedom since both variables are dichotomous (only two modes) and we can choose the three values of α most used in the statistical literature (Table 3).

Table 3 – χ^2 theoretical with 1 degree of freedom for α = 0.10; α = 0.05 e α = 0.01

	α = 0.10	**α = 0.05**	**α = 0.01**
1 degree of freedom	$\chi^2_{theoretical}$= 2.70	$\chi^2_{theoretical}$ = 3.84	$\chi^2_{theoretical}$ = 6.62

The value of χ^2 observed is much higher than the theoretical consideration for each value of α and leads to a net rejection of the null hypothesis, demonstrating once again how the choice of the arbitration clause can reduce the company's reputational criticalities.

3.2 – *Study of Relative Risk and Confidence Interval*

The calculation of "relative risk" (RR) and its confidence interval is one of the most widely used indicators to indicate the number of times a given event occurs in one group compared to

another. It is often used to determine the relationship between the incidence of a specific disease in those exposed and those not exposed to the same risk factor. In the context of biostatistics, for example, this indicator is particularly functional if we would study whether, in a group of smokers, the development of lung cancer is proportionally more present than in a second group of non-smoking units. Although the analysis of this study concerns legal and economic fields, it is possible to use with due care the same indicator where the exposed are represented by the companies that have entered the arbitration clause, the non-exposed are those who act through action of responsibility and the event in question is the absence of reputational criticalities, "disease" that a company would be happy to contract.

The relative risk value varies from "0" to "+∞" with the unit term of the indicator specifying the two different situations: if it is less than 1, there is an inverse association, i.e. the probability of developing the event is lower for those exposed to the risk factor, while if it is greater than 1, there is a greater probability for those exposed to the event. The general formula for the calculation of relative risk is given by:

$$\text{RR} = \frac{A/(A+B)}{C/(C+D)}$$

That, with the data presented in Tab. 3, results:

$$\text{RR} = \frac{188/(188+20)}{142/(142+78)} = \frac{188/208}{142/220} = \frac{0.904}{0.645} = 1.402$$

The higher value of the unit suggests a rather strong direct association and confirms what has been demonstrated in the previous chapters: a company that enters into the arbitration clause has a probability of not having reputational problems about 1.4 times higher than its counterpart acting through liability action. However, since this indicator is only an estimate of the "true" relative risk, a 95% or 99% confidence interval must be calculated, depending on the margin of error we are willing to tolerate, in order to establish the protective effect of the clause with greater consistency. Only if the lower limit is higher than the unit can we assert that the choice to adopt the clause is really effective. For the construction of the confidence interval, it is necessary to calculate by the following formula the "standard error" (SE) of our sample based on the natural logarithm of relative risk.

$$SE\ (\ln RR) = \sqrt{\frac{1}{A} - \frac{1}{(A+B)} + \frac{1}{C} - \frac{1}{(C+D)}}$$ that with the data at our disposal will result:

$$SE\ (\ln RR) = \sqrt{\frac{1}{188} - \frac{1}{208} + \frac{1}{142} - \frac{1}{220}} = \sqrt{0.0053 - 0.0048 + 0.007 - 0.0045} = \sqrt{0.003} = 0.055$$

At this point, using the following formula, it is possible to calculate the lower and upper limits of the confidence interval at 95% (α=0.05) and 99% (α=0.01).

$$\text{IC}\ (1-\alpha)\% : \text{Exp}(\ln(RR) \pm Z_{1-\alpha} * \sqrt{\text{Standard Error}\ (\ln RR)}$$

With the data available, it is possible to obtain the following limits for the first interval:

LOWER LIMIT (IC 95%): $\text{Exp}(\ln(1.40) - 1.96 * 0.055) = \text{Exp}(0.337 - 0.108) = \text{Exp}(0.229) = 1.257$

UPPER LIMIT (IC 95%): $\text{Exp}(\ln(1.40) + 1.96 * 0.055) = \text{Exp}(0.337 + 0.108) = \text{Exp}(0.455) = 1.576$

The lower limit and of course the upper limit are higher than the unit, confirming that with a margin of error of 5% it is possible to validate the effectiveness of the arbitration clause. Deciding to tolerate a smaller margin of error and consequently a more consolidated confirmation, it is easy to calculate the two thresholds for the second range.

$$\text{LOWER LIMIT (IC 99\%)}: \text{Exp}(\ln(1.40) - 2.58 * 0.055) = \text{Exp}(0.337 - 0.142) = \text{Exp}(0.195) = 1.215$$

$$\text{UPPER LIMIT (IC 99\%)}: \text{Exp}(\ln(1.40) + 2.58 * 0.055) = \text{Exp}(0.337 + 0.142) = \text{Exp}(0.479) = 1.614$$

Again, the effectiveness of the clause is confirmed because although the lower limit has come close to the unit value, due to the reduction in the required margin of error, it is still well above 1. At this point, before moving on to the calculation of the "odds ratio", a graphic representation of what we have seen in the chapter can be particularly useful, in order to summarize the most significant evidence, given by the different sizes of the two confidence intervals and the deviation of both from the unit value (Figure 2).

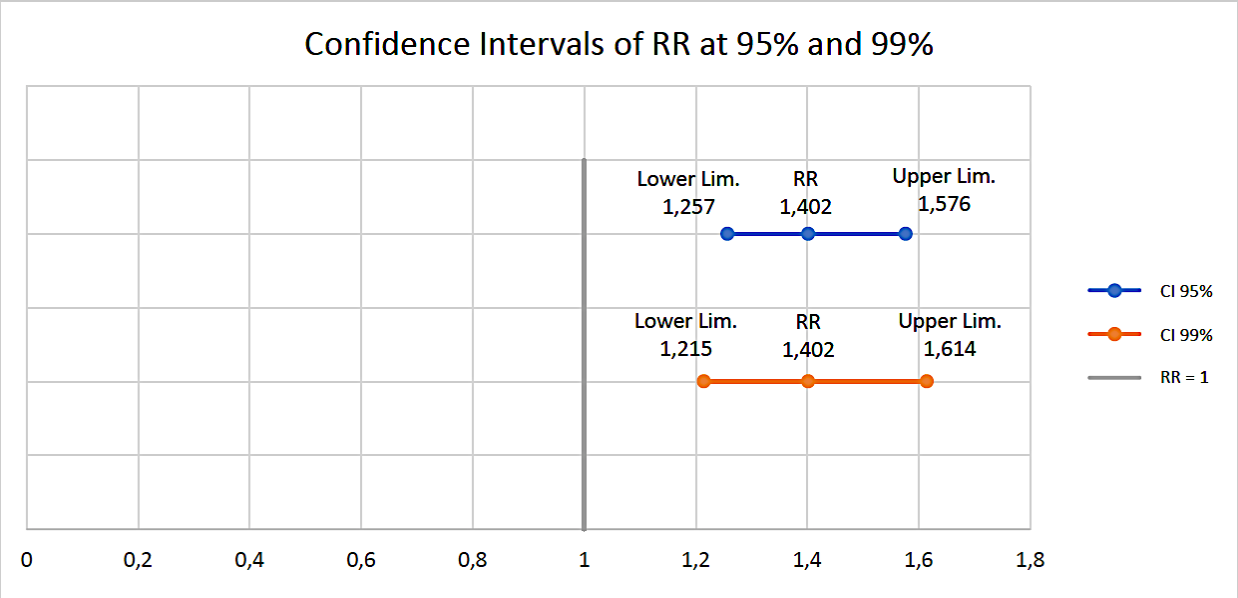

Figure 2 – 95% and 99% confidence interval for relative risk (RR). RR threshold line set at 1

3.3 – *Study of the Odds Ratio and Confidence Interval*

In order to obtain satisfying results, the type of analysis cannot be only the prospective one as considered in the previous paragraph with an initial subdivision of the reference sample between exposed and unexposed and then an observation over a period of time of the number of exposed adopting the event of our interest. In fact, always adopting an approach typically used in biostatistics the alternative to this choice is given by a retrospective study in which first the cases (those who have contracted the disease) and controls (those who have not been affected) are selected and then how many of the cases and controls have been exposed to the presumed cause. Since this study goes beyond the biomedical field, it is particularly interesting to see whether the use of a retrospective study leads to the same conclusions as a prospective study and confirms the effectiveness of the arbitration clause as an alternative to liability action.

The method to be used for the measurement of association in a retrospective study is the calculation of the so-called "odds ratio" (OR). To understand this measure, it is necessary to introduce the concept of "odds".

This term represents the ratio between the number of times the event occurs and the number of times the event does not occur. The interpretation of the odds ratio value and the range of values within which it can vary are absolutely identical to those of relative risk. In fact, if the odd ratio is between 0 and 1 there is a negative association, while a ratio greater than 1 indicates the existence of a positive association (the factor can cause the event), with an increasingly strong association to deviate from the unit value. Consequently, the difference between relative risk and odds ratio is that the latter is not a true measure of risk because it refers to the probability of having already experienced the event, while the term "risk" implies the idea of an event that will occur in the future. For consistency and greater simplicity in understanding, we can therefore follow the same path as before in the section on Relative Risk, with an estimate of the odds ratio and the relative conference intervals at 95% and 99%.

The general formula for the calculation of the odds ratio is given by: OR= $\frac{A/C}{B/D}$ that with data of the Table 3 results: OR = $\frac{188/142}{20/78} = \frac{1.324}{0.256} = 5.171$

The value testifies a strong positive association and provides a further confirmation to what has been previously demonstrated: the probability of not having had reputational problems is more than 5 times higher among the companies that have stipulated the clause. Although the estimate of the OR is very far from the unit value, it is possible to proceed for this indicator with the calculation of the 95% or 99% confidence interval, depending on the margin of error that we are willing to tolerate. Only if the lower limit assumes a value higher than 1, the protective effect of the clause can be confirmed. For the construction of the confidence interval, it is necessary to calculate the "standard error" (SE) of the sample using a slightly different formula from that seen for relative risk (RR), however, based on the natural logarithm of the OR.

SE (ln OR)= $\sqrt{\frac{1}{A}+\frac{1}{B}+\frac{1}{C}+\frac{1}{D}}$ that in our case will be:

SE (ln OR)= $\sqrt{\frac{1}{188}+\frac{1}{20}+\frac{1}{142}+\frac{1}{78}} = \sqrt{0.0053+0.05+0.007+0.0128} = \sqrt{0.0751} = 0.274$

Now it is possible to calculate the lower and upper limits of the confidence range at 95% (α=0.05) and 99% (α=0.01).

$$\text{IC } (1-\alpha)\% : \text{Exp}(\ln(OR) \pm Z_{1-\alpha} * \sqrt{\text{Standard Error } (\ln OR)}$$

With the data available, the limits for the first interval will be:

LOWER LIMIT (IC 95%): $\text{Exp } (\ln(5.171) - 1.96 * 0.274) = \text{Exp } (1.643 - 0.538) = \text{Exp } (1.107) = 3.026$

UPPER LIMIT (IC 95%): $\text{Exp } (\ln(5.171) + 1.96 * 0.274) = \text{Exp } (1.643 + 0.538) = \text{Exp } (2.181) = 8.855$

Both limits are well above the unit, confirming that we can validate the arbitration clause's effectiveness with a 5% margin of error. Deciding to tolerate a smaller margin of error and consequently a more consolidated confirmation, the thresholds for the second range can be calculated.

LOWER LIMIT (IC 99%): $\text{Exp}(\ln(5.171) - 2.58 * 0.274) = \text{Exp}(1.643 - 0.707) = \text{Exp}(0.938) = 2.554$
UPPER LIMIT (IC 99%) : $\text{Exp}(\ln(5.171) + 2.58 * 0.274) = \text{Exp}(1.643 + 0.707) = \text{Exp}(2.350) = 10.486$

Again, the effectiveness of the clause is confirmed because although the lower limit has come close to the unit value, it is still significantly higher than 1.

Before concluding, a useful graphic representation (Figure 3) summarizes the most significant evidence previously calculated, given both by the different sizes of the two confidence intervals and by the deviation of both from the OR threshold value. Moreover, it is interesting to see how for the odds ratio both the confidence intervals not only move away from the unit value much more clearly than their counterparts shown in the previous paragraph but are much wider.

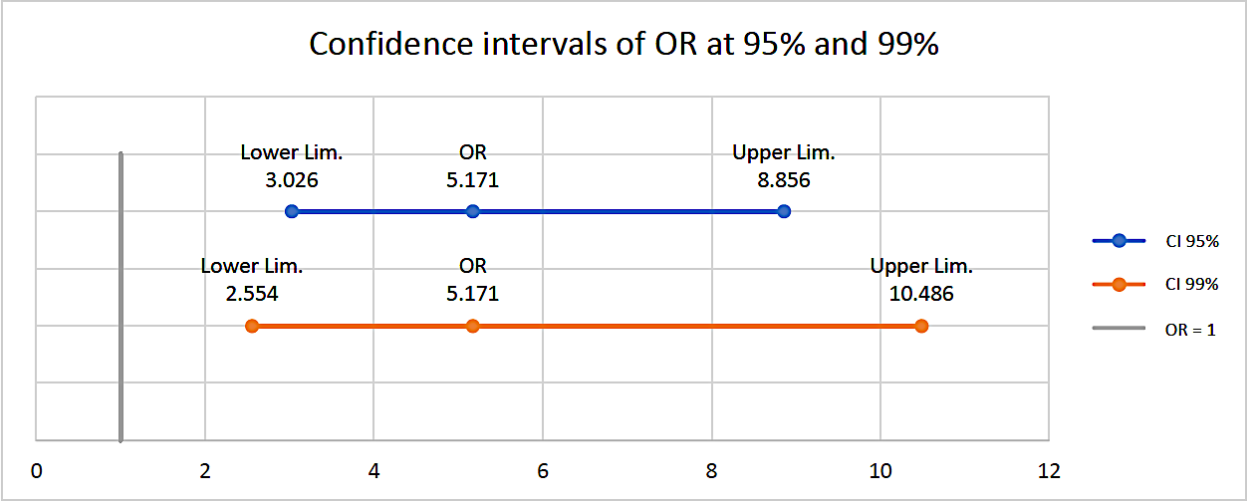

Fig. 3 – 95% and 99% confidence interval for the Odds Ratio (OR). OR threshold line set at 1

4 – Conclusions

Reputational risk is now a crucial issue that is widely interconnected with the countless dimensions in which a company operates. The advantage of maintaining the company's reputation for the continuation of the business is certainly preferable to the desire to obtain satisfaction through a liability action. Even a single business criticality that triggers a liability action at the same time can produce a "chain reaction" in the relationship with stakeholders, often leading to irreparable consequences. This work provides continuity with the previous paper, confirming the theoretical approach to the correlation between reputational risk and liability action.

The analyses carried out in the chapters arrive at a common understanding of the effectiveness of the arbitration clause. Through this empirical evidence, in fact, the work demonstrates how much the use of the arbitration clause may be preferable when drafting the statute, always if provided for by the legal system.

The *Chi-square* test shows a correlation between the two variables such that it is impossible to accept the null hypothesis of stochastic independence and to assert that the contingencies between the observed and theoretical frequencies are completely attributable to a random component. Moreover, both by carrying out a prospective study using relative risk as a reference indicator and by opting for a retrospective study analyzing the value of the odds ratio, it is clear

that both indicators deviate from the unit value even with a minimum margin of error, testifying to the strong significance of the independent variable in question, namely a marked increase in the probability of not having reputational problems in case of inclusion of the clause.

Therefore, in view of the indecision still existing around the adoption of the arbitration clause for institutional disputes, it is believed that work such as the one presented here could contribute to the development of new legal formulations aimed at enabling its adoption in a simpler way.

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