The Credence Characteristics of Corporate Reform

Omari S Simmons

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OMARI SCOTT SIMMONS*

Corporate Reform as a Credence Service

Regulators get to the point of their incompetence and create the crisis because they fail to regulate, and then use the crisis as the argument for more power, and so now you have the Council of Regulators made up by the very same people who created the crisis in the first place.

1. INTRODUCTION

With the recent meltdown of the U.S. economy, there is no shortage of blameworthy corporate directors and managers. But one cannot ignore another significant dimension of the current crisis: the crucial role of lawmakers and the need to reform the reformers. In a sense, corporate governance reform is like a service: corporate constituents (e.g., managers, shareholders, employees, and populist groups) function like consumers, and corporate lawmakers (e.g., federal government and the State of Delaware) function as monopoly suppliers of reform services. These reform services, however, exhibit credence characteristics, which are service attributes whose quality cannot be fully determined even after significant use.

Examples of services with substantial credence characteristics include au-

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* Associate Professor of Law, Wake Forest University School of Law. LL.M., 2001, University of Cambridge, Pembroke College; J.D., 1999, University of Pennsylvania; B.A., 1996, Wake Forest University. I would like to thank all of the participants in the 2009 University of Maryland School of Law Roundtable on Corporate Governance and Securities Responses to the Financial Crisis for their valuable insights.


2. See, e.g., Roben Farzad, Who’s Looking Out for Wall Street? This Election Year, Shamed and Battered Financial Firms Face a Leadership Crisis, Bus. Wk., Mar. 3, 2008, at 82 (“Shares of Merrill Lynch, Citigroup, and Bear Stearns have been cut in half, their CEOs ousted in rapid succession.”); James R. Hagerty & Joann S. Lublin, Countrywide CEO Ripped by Advisory Group, WALL SR. J., Oct. 20, 2007, at A2 (discussing the letter CtW Investment Group sent to Countrywide Financial Corporation, urging Countrywide to remove its chairman because of his failures during the financial crisis); Paul Ingrassia, How GM Lost Its Way, WALL SR. J., June 2, 2009, at A21 (noting that decades of bad decisions were the cause of General Motors’ bankruptcy); Liam Pleven, AIG Debacle Not My Fault, Says Greenberg; Testifies Today, WALL SR. J., Apr. 2, 2009, at C1 (stating that an investigation into AIG’s accounting practices forced CEO Maurice R. Greenberg to step down).

3. In the monopolist scenario, the consumer does not search. See Ting Liu, Credence Goods Markets with Conscientious and Selfish Experts 6 (Boston Univ. Dept of Econ., Working Paper No. 58, 2006), available at http://www.bu.edu/econ/workingpapers/workingpapers_2006.html (“In my model, there is a monopolist expert and the consumer does not search.”).

4. See, e.g., Michael R. Darby & Edi Karni, Free Competition and the Optimal Amount of Fraud, 16 J.L. & Econ. 67, 68–69 (1973) (“Credence qualities are those which, although worthwhile, cannot be evaluated in
Corporate Reform as a Credence Service

tomobile repair services, certain medical treatments, and even spiritual guidance.\(^5\)
Credence characteristics, at least in the short-term, make it difficult for corporate
constituents to discern the impact of corporate reform due to information asym-
metries.\(^6\) In light of these informational constraints, corporate constituents nor-
mally rely on an array of decision-making heuristics as a risk reduction strategy.
These decision-making heuristics often include: (i) third parties and reputational
intermediaries (e.g., gatekeepers, institutional investors, advisory services, academic-
s, and corporate watchdogs);\(^7\) (ii) lawmaker credible commitment and brand
 equity;\(^8\) and (iii) legitimizing democratic procedures (e.g., participation, indepen-
dence, and disclosure).\(^9\) As the current crisis reveals, corporate constituent overre-
liance on these heuristics may not adequately prevent corporate opportunism.
Making matters worse, the unobservable impact of corporate reform (i.e., credence
characteristics) creates perverse incentives for lawmakers (on the supply side) to
engage in opportunist behavior at the expense of corporate constituents (on the
demand side), who are lulled into a false sense of security.\(^10\) This important chapter
in the story of the current economic crisis and corporate scandals cannot be ig-
nored because it highlights the real potential for supply-side (i.e., lawmaker) ineffi-

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5. Omari Scott Simmons, Taking the Blue Pill: The Imponderable Impact of Executive Compensation Re-

6. Corporate lawmakers not only provide reform services, but also act as experts and diagnose corporate
governance problems. There are two types of asymmetry implicated by credence characteristics. See Brian Roe
& Ian Sheldon, Credence Good Labeling: The Efficiency and Distributional Implications of Several Policy Ap-
proaches, 89 Am. J. Agric. Econ. 1020, 1020 n.1 (2007). The first type involves the customer’s inability to know
their needs or diagnose their problem. Id. The second type of asymmetry involves the customer’s inability to
determine the level of service necessary. Id. The interplay between these concepts exacerbates the customer’s
dilemma because “consumer ignorance and [the] additional cost of separate diagnosis and repair provide mo-
vation for a service firm to defraud its customers.” Darby & Karni, supra note 4, at 77.


8. See generally Omari Scott Simmons, Branding the Small Wonder: Delaware’s Dominance and the Market
rations’ decisions of where to incorporate); Simmons, supra note 5 (discussing the credence characteristics of
executive compensation reform).

that too much emphasis is placed on “independence” in corporate governance); Rodrigues, The Seductive
Comparison of Shareholder and Civic Democracy, 63 Wash. & Lee L. Rev. 1389 (2006) (comparing and con-
trasting the operations of the Electoral College with the operations of corporate boards of directors).

10. Simmons, supra note 5, at 308 (detailing the implications credence characteristics have on corporate reform); see also Winand Emons, Credence Goods and Fraudulent Experts, 28 RAND J. Econ. 107, 111 (1997) (asserting that even ex post, consumers have difficulty determining the level of service needed ex ante).
Omari Scott Simmons

ciencies and the need to discipline lawmaker behavior as well as enhance lawmaker competence.

II. THE LEGAL BACKDROP

The legacies of Enron, Citigroup, AIG, and other examples of corporate dysfunction reveal that traditional corporate law does not, alone, adequately address the problem of corporate opportunism.11 Traditional corporate law and theory, characterized by shareholder-director dualism, say very little about the internal corporate organization, multiple layers of management, and how companies in specific industries should legally pursue the efficient production of products12 that customers value.13 Corporate operations are the sum of various processes such as manufacturing, sales and marketing, finance and accounting, information technology, logistics, and research and development. These internal operational processes in conjunction with corporate culture ultimately determine the profitability and sustainability of a business enterprise. In a sense, corporate law functions like bookends and does not address a broad range of corporate activity leaving it to managers, in most cases, to fill the gaps. Most routine operational decisions fall into the category of enterprise decisions.14 Enterprise decisions are standard decisions made by management, such as the decision to build a foreign production plant or what products to produce.15 These decisions are often protected under state law via the business judgment rule that rightfully vests skilled managers with the authority and protection to make countless corporate decisions without the prospect of judicial intervention and second-guessing.16 Meanwhile, the federal

11. See generally Michael Lewitt, Wall Street’s Next Big Problem, N.Y. Times, Sept. 16, 2008, at A29 (discussing the looming failure of AIG and its use of credit default swaps); Jeffrey L. Seglin, The Right Thing: Will More Rules Yield Better Corporate Behavior?, N.Y. Times, Nov. 17, 2002, §3, at 4 (describing Enron as an example of bad corporate behavior); Ben White & Vikas Bajaj, Mounting Woes at Citigroup Began with Bank’s Failed Bid for Wachovia, N.Y. Times, Nov. 22, 2008, at B1 (noting that more than half of Citigroup’s market value vanished in five days after a failed bid for Wachovia and that the disparate parts of the corporation had never been a “functional family”).

12. For purposes of this article, a product may include both goods and services.


14. See generally E. Norman Veasey, The Defining Tension in Corporate Governance in America, 52 Bus. Law. 393, 394 (1997) (discussing the types of decisions Delaware courts address, which include enterprise, ownership, and oversight decisions). Ownership decisions involve ownership changes, such as mergers, acquisitions, and corporate takeovers. Id. Oversight decisions concern managers’ monitoring role, such as ensuring employees execute their responsibilities in compliance with the law. Id.

15. See id.

16. See Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (“The business judgment rule is an acknowledgment of the managerial prerogatives . . . .”). Professor Robert Clark describes the business judgment rule as follows:

VOL. 5 NO. 1 2010
Corporate Reform as a Credence Service

government (i.e., the Securities and Exchange Commission (SEC)), to a large extent, regulates the external trading of securities and disclosure without addressing the internal affairs of the corporation.17

On balance, American corporate law is conservative in form and function. Here, the use of the conservative label is value neutral. Historically, lawmakers have been reluctant to upset the internal power relationships between management and shareholders as well as address operational details. Instead, lawmakers have: (i) outsourced such reform to third-party gatekeepers, reputational intermediaries, and the market;18 (ii) emphasized democratically symbolic procedures reflecting values such as independence, participation, and transparency;19 and (iii) regulated business activity indirectly or outside of the traditional corporate law context (e.g., tax, antitrust, environmental, banking, and labor laws).20 Thus, the content of traditional corporate law contains significant gaps, lacks contextual specificity, and provides substantial managerial discretion that further makes the laws’ impact on corporate opportunism difficult to discern.

III. IMPLICATIONS FOR THE CURRENT CRISIS

A. Public Outrage

In the wake of the economic crisis, the Obama administration, Congress, and particularly the SEC have experienced (whether inherited or not) significant public backlash concerning the handling of an array of issues from corporate fraud to executive compensation.21 Recently, the SEC received a scathing report from David

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The rule is simply that the business judgment of the directors will not be challenged or overturned by courts or shareholders, and the directors will not be held liable for the consequences of their exercise of business judgment—even for judgments that appear to have been clear mistakes—unless certain exceptions apply.

Robert Charles Clark, Corporate Law 123 (1986); see also Franklin A. Gevurtz, Corporation Law 278–79 (2000) (“The idea underlying the rule is that courts should exercise restraint in holding directors liable for (or otherwise second guessing) business decisions which produce poor results or with which reasonable minds might disagree. This seems to be a sensible notion. After all, business decisions typically involve taking calculated risks.”).

17. See Simmons, supra note 5, at 327–29 (“There is a federal reluctance to directly regulate the internal affairs of the corporation . . . .”). Sarbanes-Oxley, however, is a notable exception.

18. See Coffee, supra note 7, at 8 (noting that the historic practice of separating ownership and control requires that "both shareholders and the board must depend on gatekeepers for an unbiased flow of information.")


20. There are numerous laws and regulations impacting business enterprise that should not be overlooked. See Clark, supra note 16, at 30–32 (discussing labor laws, federal bankruptcy laws, reorganization statutes, consumer protection laws, antitrust laws, trade laws, environmental laws, and tax laws).

21. Edmund L. Andrews & Peter Baker, At A.I.G., Huge Bonuses After $170 Billion Bailout, N.Y. Times, Mar. 15, 2009, at A1 ("The payment of so much money [to AIG] . . . will fuel a popular backlash against the government’s efforts to prop up Wall Street. Past bonuses already have prompted President Obama and Con-
Omari Scott Simmons

Kotz, the SEC inspector general, who indicated that the SEC suffered “systematic breakdowns” in its investigation of Bernie Madoff’s 17-year-long Ponzi scheme.22 Ironically, the State of Delaware, the other partner in the U.S. corporate reform joint venture, has, to an extent, escaped the heightened scrutiny and public outrage.23 This, however, is not a coincidence. Much of Delaware’s corporate law (e.g., fiduciary duties) has been developed through its common law courts which are, to a substantial degree, politically independent and lauded for their expertise and efficient dispute resolution.24 The development of corporate law in Delaware is largely incremental (i.e., on a case-by-case basis), inevitably plaintiff driven, and has an ex post orientation. By nature and design, courts, especially those with appointed judges, cannot respond to political pressures like legislatures and, to a lesser degree, agencies.25 These factors, in part, explain the lack of a public backlash against the state of Delaware, particularly its courts.26 Accordingly, the ensuing political-capital-maximization discussion more accurately depicts the actions of lawmakers who are either elected or appointed for shorter terms; it is less likely to apply to appointed judicial officers, such as those serving on Delaware’s business courts.27

B. Credence Characteristics

Even in the midst of public pressure to reform, credence characteristics create the risk that lawmakers may camouflage unnecessary or superficial reforms in order to...
CORPORATE REFORM AS A CREDENCE SERVICE

maximize political capital or conceal their lack of expertise or competence. In essence, there are two dimensions to this problem: (i) the fraudulent expert problem; and (ii) the incompetent expert problem. Both dimensions of the credence characteristic problem threaten the prospect of optimal reform and are costly. Yet their resolutions differ. These issues highlight potential weakness in the federal-state joint venture to regulate publicly traded corporations.

1. Fraudulent Expert Problem

With respect to the fraudulent expert problem, the key concern is whether corporate constituents can discipline lawmakers who seek to maximize political capital via concealing a pre-textual purpose. Addressing the fraudulent expert problem does not necessarily require more government expenditures or resources, “but only a [lawmaker’s] decision to stop” and perhaps some degree of constituent pressure. Depending on their reliability (which is far from guaranteed), the third party and intangible decision-making heuristics available to corporate constituents may expose lawmaker opportunism and also limit lawmaker discretion. The mere threat of losing political capital may constrain lawmaker opportunism and prompt lawmakers to cease and desist. A lawmaker decision to cease and desist might entail earnestly crafting more meaningful reforms or enforcing laws already on the books. But, even with the threat of losing political capital, lawmakers may still act opportunistically as the following discussion illustrates.

Generally, lawmaker incentives to reform may disappear where no transfer of political goodwill is involved. Meanwhile, corporate constituents, particularly those with greater informational constraints, find it difficult to determine clear winners and losers because credence characteristics make it easier for lawmakers to camouflage their true intentions. By the time corporate constituents, particularly

28. See, e.g., Jonathan R. Macey, Federal Deference to Local Regulators and the Economic Theory of Regulation: Toward a Public-Choice Explanation of Federalism, 76 Va. L. Rev. 265, 275–78 (1990) (discussing how Congress can shift blame by deferring to federal agencies and, even more so, to state lawmakers); Simmons, supra note 5, at 307–08 (discussing how credence characteristics can enable “opportunistic lawmaker behavior”).

29. See Darby & Karni, supra note 4, at 83 (explaining that reducing fraud requires no additional resources whereas reducing incompetence requires additional resources).

30. See id.

31. Id.


33. See, e.g., Sam Peltzman, Toward a More General Theory of Regulation, 19 J.L. & Econ. 211, 212 (1976) (explaining that where there is no transfer of wealth or goodwill to political representatives, there will be no incentive for lawmakers to effect reform); Simmons, supra note 5, at 357 (discussing how lawmakers will continue to respond and will be expected to continue to respond to corporate constituencies that contribute political capital).

Omari Scott Simmons

those with information asymmetries, discern the impact of a particular regulation, public outrage has waned, only to reappear in the future with the next scandal or economic downturn. Here, political incentives and short-termism may hinder earnest exploration of issues, resulting in modest, incremental, or superficial change. Additionally, rationally ignorant constituents concerned about macro-economic performance may respond by favoring certain reform policies, even if such policies have a trivial impact on the national economy or their own personal circumstances. Historically, executive pay reform is a prime example of this phenomenon. The market for political capital is often too imperfect to serve as an adequate restraint on lawmaker opportunism.

Corporate scandals and economic turmoil, however, may (and sometimes do) alter “the distribution of political power and create opportunities for public policy entrepreneurs to rearrange things to their advantage.” Diffuse constituencies, despite lacking organization, may nonetheless participate in the political process when they are provided with an easy-to-digest, politically salient issue that “commands attention and motivates action in the absence of political organization.” In past periods of scandal and economic crisis, lawmakers have indeed responded to public outrage. But, the credence characteristics of corporate governance reform have given lawmakers added discretion or a smokescreen that is often used for incremental, moderate, or superficial corporate reforms. Within this context, both lawmaker action and inaction can be problematic. Some legal observers have expressed concern over corporate lawmakers’ “crisis-mode” regulation or “knee-jerk” reform responses during periods of economic turmoil that are too onerous. This concern, although relevant, is often overstated in the corporate reform context.


36. See Gretchen Morgenson, Wall Street Follies: The Next Act, N.Y. TIMES, Oct. 25, 2009, § WK, at 1 (discussing how reformers focus on issues that enrage the public, such as executive compensation, instead of focusing on less polarizing issues that have a greater effect on the national economy); see also Simmons, supra note 5, at 363–64 (“The overemphasis on executive compensation functions as a . . . diversion from other pertinent socio-economic issues, like the minimum wage, health insurance, retirement accounts, education, and social security . . . .”).

37. It is important to note that consumers must contend with the fraudulent expert problem as well as the incompetent expert problem. See Darby & Karni, supra note 4, at 83 (explaining the distinction between the social costs of reducing fraud and reducing incompetence); see also infra Part III.B.2 (explaining the incompetent expert problem).


40. Simmons, supra note 5, at 362–65 (“Credence characteristics . . . provide lawmakers with greater latitude to maintain political capital without making significant change.”).


42. See, e.g., Lawrence A. Cunningham, The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (and It Might Just Work), 35 CONN. L. REV. 915, 923–41 (2003) (asserting that major scandals at Enron, WorldCom,
Corporate Reform as a Credence Service

Viewed through the prism of credence characteristics, Sarbanes-Oxley and other so-called far-reaching reforms seem more moderate than revolutionary.43

2. Incompetent Expert Problem

With regard to the incompetent expert problem, the key concern is boosting the capabilities, experience, and competencies of lawmakers. Addressing the incompetent expert problem and bolstering lawmaker expertise requires a different tact than addressing the fraudulent expert issue. Combating lawmaker deficits in expertise requires more than third parties and decision-making heuristics exposing deficits in lawmaker competence; it requires significant government (i.e., supply side) expenditures to boost an array of competencies and capabilities, such as prevention and enforcement resources, industry-specific knowledge, flexible and rapid action, private-public collaboration, and inter-agency coordination.44 The current capabilities of corporate lawmakers simply do not match those of the regulated. Existing reforms often lag far behind industry trends and transformations. Consequently, lawmakers are often regulating historic problems rather than current or future issues on the horizon. Matching the capabilities of regulated entities and keeping up with all industry trends and transformations is perhaps too ambitious, but closing an unacceptable gap is not.

To help address this gap, corporate lawmakers can harness internal industry expertise. Ironically, the Obama administration has endured significant criticism for its hiring of Wall Street bank insiders and its apparent closeness to Wall Street.45 In some instances, the Administration has attempted to leverage the expertise of financial industry insiders outside of the politicized appointments mechanism in an attempt to mitigate public outrage.46 Although some degree of criticism and public

43. Simmons, supra note 5, at 362 (asserting that even during periods of economic turmoil, the credence characteristics of corporate reform afford lawmakers considerable discretion to respond to perceived crises in a moderate fashion).

44. See, e.g., Bill McConnell, SEC’s Schapiro Seeks More Powers, DAILY DEAL, July 14, 2009, (outlining the sweeping regulatory proposals that the SEC needs to implement to address the shortcomings in the oversight of the financial services industry).

45. See, e.g., Tom Braithwaite, SEC Hires Goldman Alumnus to Head Enforcement Division, FIN. TIMES (U.S.A.), Oct. 17, 2009, at 3 (noting the “revolving door” between the banking industry and government agencies); Sean Lengell, Wall Street Official to Lead SEC Fraud Branch Key to Obama’s Plan to Reform the Agency, WASH. TIMES, Oct. 17, 2009, at A1 (quoting Senator John McCain’s posting on Twitter, criticizing the appointment of Adam Storch to the SEC: “SEC names Goldman Sachs exec to enforcement post—you can’t make it up”).

Outrage is indeed healthy, boosting the internal capabilities and industry-specific expertise of lawmakers is not synonymous with regulatory capture or self-regulation; it is a necessary step to enhance lawmaker effectiveness. Just as internal corporate actors may be too close to problems to think critically about them, lawmakers and other outside observers may rely on crude, readily available, heuristics, such as share price, that do not provide adequate insight into the health of a corporate organization. Outside observers often, out of necessity, are looking at aggregated readily available information, but may fail to adequately identify problems at an operational or micro level. Moreover, an outside regulator mindset, alone, may be at odds with internal corporate values like trust and loyalty that are important to the internal organization. Lawmakers, via harnessing internal expertise in the design of corporate reforms, may: function as a symmetrical debiasing mechanism offsetting or countering predictable outsider biases; prevent unintended consequences; promote more pragmatic, flexible, current, and forward-looking solutions; enhance the legitimacy of resulting reforms; and provide balance that may deter hasty decisions that are inconsistent with internal corporate norms and would dampen productivity, risk taking, and entrepreneurship. Moreover, intimate knowledge of industry-specific operational processes could assist regulators in prospectively identifying risky business practices and perhaps fraud.

Despite these benefits, knowledge of these operational practices is often taken for granted. Some of the most prominent corporate scandals over the past decade have concerned operational issues that arguably could have been detected earlier, or perhaps even prevented had regulators possessed intimate knowledge of corporate operations across industry sectors. Consider Eliot Spitzer’s famed investigation of
Corporate Reform as a Credence Service

Citigroup that unraveled abusive practices between Citigroup’s equity research and investment banking units. Here, operational cross-selling practices and conflicts figured prominently into the New York Attorney General’s investigation. Spitzer’s unraveling of the abusive practices at Citigroup illustrates the importance of insider operational knowledge. More recently, AIG’s operational practices involving the sale of largely unregulated credit default swap derivatives to numerous counterparties not only subjected AIG to excessive risk, requiring a federal bailout, but also introduced significant instability into the broader financial system.

These above examples are instructive because they highlight the importance of internal operational knowledge and the information asymmetry that exists between corporate lawmakers and internal corporate actors. In order to detect and prevent various modes of corporate opportunism, lawmakers need to harness valuable internal knowledge. Addressing the current information asymmetry requires ongoing interaction between lawmakers and internal corporate actors. This type of interaction differs from standard lobbying and notice and comment procedures. Instead, the desired type of interaction is more discursive, continuous, cooperative, and interactive where “[i]ndustry is expected to participate as part of a search for common goals, not just rigidly asserting its narrow economic or political interests.”

This perspective bears a resemblance to new governance theories of institutional reform that eschew an overly top-down approach and favor inside-out approaches to institutional reform.

53. See Brooke A. Masters, Spoiling for a Fight: The Rise of Eliot Spitzer 117–18 (2006) (providing detailed information about Spitzer’s investigations into several corporations, including Citigroup); see also Citigroup Proposes Rules Limiting Conflicts, L.A. Times, July 16, 2002, § 3, at 4 (reporting that Mr. Spitzer investigated analysts at Salomon and Morgan Stanley who tailored their public opinions of companies to win lucrative banking work for their firms).

54. See Masters, supra note 53, at 262; Patrick McGeehan, Spitzer Sues Executives of Telecom Companies Over ‘Ill Gotten’ Gains, N.Y. Times, Oct. 1, 2002, at C1 (reporting that Mr. Spitzer prosecuted former top officials of five telecommunications companies for steering investment banking business to Citigroup in exchange for inflated ratings on their companies’ stock and new shares of other companies).

55. See Mary Williams Walsh, A.I.G. Lists Firms to Which It Paid Taxpayer Money, N.Y. Times, Mar. 16, 2009, at A1 (explaining that AIG’s investments in subprime mortgages, credit default swaps, and other shaky loans exposed the company to high risk, and when AIG’s investments turned sour, the stability of the entire financial system was jeopardized).


57. Lobel, supra note 56, at 377.

58. See id. (“The governance model thus views traditional patterns of hierarchical top-down regulatory control as obsolete. It advocates instead the adoption of cooperative governance based on continuous interaction and sharing of responsibility. It signifies a move to partnership, to horizontal relationships, and to two-way communications.” (footnote omitted)).
Omari Scott Simmons

IV. THE FUTURE?

The credence characteristics of corporate reform allow lawmakers greater latitude to “straddle the fence between political symbolism and conscientious resolution.” Accordingly, corporate reform will most likely continue to evolve incrementally without substantial shifts despite corporate scandals and economic turmoil. Massive reforms are often too risky because substantial lawmaker movements could cause broad constituent backlash, expose ineptitude, and make lawmakers blame-worthy. Perhaps the gravity of the current crisis will break this pattern, but less desirable corporate constituents (including the public) should not hold their breath. Even if the current crisis compels lawmakers to act in a non-opportunistic fashion, deficits in expertise (e.g., internal operational knowledge) could undermine even the best intentions. The fraudulent expert and incompetent expert problems must be addressed simultaneously.

59. Simmons, supra note 5, at 362.
60. Id. at 363.
61. Id.