PROTECTING CONTRACT'S HIDDEN PARTIES

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There is a growing consensus among regulators, civil society, and even CEOs that corporations must consider the impact of their activities on a broad range of actors – not just shareholders. The need to do so is apparent from the externalities that corporations routinely impose on non-shareholders. These externalities are particularly apparent in global supply chains as illustrated by several recent, and unsuccessful, lawsuits against corporations involving forced labor, human trafficking, child labor, and environmental harms. Lack of legal accountability subsequently translates into low legal risk for corporate misconduct, which reduces the likelihood of prevention and results in three separate injuries to third parties: first, the initial corporate misconduct; second, denial of justice in the courts; and, third, the prospect of recurrence because of inadequate prevention.

This Article argues that corporate misconduct towards non-shareholders arises from a fundamental inconsistency within contract law regarding the status of third parties: On the one hand, we know that it takes a community to contract. Contracting parties often rely on multiple third parties – not signatories to the contract – to play important roles in facilitating exchange: kinship networks, trade associations, and community organizations help to reduce market transaction costs through screening potential trade partners, creating social preferences for pro-contractual behavior, improving information flows, and decreasing the risk of opportunism. On the other hand, we deny this community protection from the externalities that contracting parties impose on them under a traditional view of contract as an exchange between two parties.

This Article examines a corporation's duties to others in its role as a contracting party. Contracts are the primary means through which corporations interact in the world; revising our views about the duties that contracting parties owe third parties has significant implications for our views of how corporations should treat non-shareholders. Normatively, this Article proposes an alternative view of contracts as an ecosystem with three attendant objectives that result from this view: (a) third party protections from negative externalities, (b) contract design obligations of contracting parties, and (c) recourse to legal remedies for third parties. On a policy level, this Article proposes the following duty to contract in order to translate theory into practice: Contracting parties are required to take into account negative externalities to third parties when the contracting parties could reasonably foresee that performance of the contract would create a risk of physical harm to these third parties. This duty helps to address corporate externalities by providing victims with remedies for past harms and providing a legal incentive for corporations to prevent future harms through contract design. By re-imagining contracts, we also re-imagine corporations and their duties to others.

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INTRODUCTION

At the core of contract law lies a fundamental inconsistency: On the one hand, we have long known that it takes a community to contract. A contract is an ecosystem, involving the signatories to the formal contract but also sustained and nourished by a rich array of institutions maintained by third parties – parties who are not signatories to the contract.[1] Kinship networks, trade associations, and community organizations reduce market transaction costs associated with exchanges by creating social preferences for pro-contractual behavior,[2] improving information flows,[3] decreasing the risk of opportunism,[4] screening potential exchange partners through codes of ethics,[5] and reducing opportunism by increasing and re-distributing the losses that a party may suffer from cheating.[6] These are many of the ways that third parties help contract signatories by enabling exchanges – even those that might not otherwise occur but for the contract ecosystems that third parties provide.

As such, third parties are not outsiders in exchanges but very much integral to the exercise. When we exclusively focus on the most obvious part of the exchange – whether it is the paper contract, a handshake, or someone's word – we risk missing all the other actors and their roles in the exchange. The piece of paper, the handshake, and the promise are just the tip of the iceberg in the ecosystem of exchange.[7]

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1 *See, e.g.*, Ian R. Macneil, *Values in Contract: Internal and External*, 78 NW. U. L. REV. 340, 344 (1983)("[I]t is important to stress the highly relational character of all contracts in real life. Exchange of any importance is impossible outside a society."); Robert W. Gordon, *Macaulay, Macneil, and the Discovery of Solidarity and Power in Contract Law*, 1985 WIS. L. REV. 565, 569 (1985); Richard E. Speidel, *The Characteristics and Challenges of Relational Contracts*, 94 NW. U. L. REV. 823, 826 (2000); Ronald J. Gilson, Charles F. Sabel, & Robert E. Scott, *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine*, 110 COLUM. L. REV. 1377, 1386, 1402-04 (2010); Cathy Hwang, *Faux Contracts*, 105 VA. L. REV. 101, 141 (2019). For a discussion of systems approaches to corporate law, see Tamara Belinfanti & Lynn Stout, *Contested Visions: The Value of Systems Theory for Corporate Law*, 166 U. PA. LA. REV. 579, 583 (2018)(arguing that "public companies in particular can be viewed as complex systems in which multiple elements (e.g., financial capital, physical capital, and human capital) interact with each other to perform a variety of useful and desirable functions (e.g., providing goods and services, employment opportunities, investor returns, and tax revenues").

2 Robert E. Scott, *A Theory of Self-Enforcing Indefinite Agreements*, 103 COLUM. L. REV. 1641, 1667 (2003); Linda D. Molm, Gretchen Peterson & Nobuyuki Takahashi, *In the Eye of the Beholder: Procedural Justice in Social Exchange*, 68 AM. SOC. REV. 128, 150 (2003).

3 Lisa Bernstein, *Contract Governance in Small-World Networks: The Case of the Maghribi Traders*, 113 NW. U. L. REV. 1009, 1022-1023 (2019); Avner Greif, *Contract Enforceability and Economic Institutions in Early Trade: The Maghribi Traders' Coalition*, 83 AM. ECON. REV. 525, 526 (1991).

4 Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions*, 99 MICH. L. REV. 1724 (2001); Barak D. Richman, *How Community Institutions Create Economic Advantage: Jewish Diamond Merchants in New York*, 31 LAW & SOC. INQUIRY 383 (2006).

5 *See generally* Robert C. Ellickson, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES (1991)(describing several social norms that provide order in property disputes); Janet Landa, *A Theory of the Ethnically Homogeneous Middleman Group: An Institutional Alternative to Contract Law*, 10 J. LEGAL STUDIES 349, 352 (1981).

6 *See* Bernstein, *Contract Governance in Small-World Networks, supra* note __ at 1022-1023; Greif, *The Maghribi Traders' Coalition*, *supra* note ___ at 526.

7 *See* Belinfanti & Stout, *supra* note __ at 600 (describing how the elements of a public company, such as human, financial, and physical capital, "are interconnected, influencing each other in ways that allow them to operate as a unified whole, separate and apart from their individual selves.").

Unfortunately, third parties remain hidden parties in exchanges. They are not hidden because they disguise themselves, but because we choose not to see them. And this oversight has real consequences in our legal system. Contracts do not endanger signatories only; they also pose risk of harm to third parties through a variety of externalities.[8] These externalities are particularly evident in global supply chain contracts that govern the "full range of activities that firms, farmers and workers carry out to bring a product or service from its conception to its end use, recycling or reuse. These activities include design, production, processing, assembly, distribution, maintenance and repair, disposal/recycling, marketing, finance and consumer services."[9]

This Article explains that third parties – such as consumers, employees of suppliers, and local communities, for example – are at risk from two different types of externalities. Type I externalities are harms that result from *contract performance* when contracting parties perform as expected; contract terms concerning price, volume, and delivery times can exacerbate risk of third party harms, such as forced labor and human trafficking, because these risks are inherent in the contract as designed. In order to address these risks, multinational companies usually enter into a second set of contracts – codes of conduct – with their overseas suppliers. But suppliers often violate these codes, resulting in Type II externalities that result from *contractual breach*. Unfortunately, despite these risks, third parties are unable to address either externality because they do not participate in contract design (Type I externality) and cannot assert rights under supply contracts (Type II externalities).

Recent litigation provides ample illustrations of the severity of third party externalities that these supply contracts produce and the inability of third parties to address them. For example, in December 2019, an international advocacy group filed a lawsuit in federal district court on behalf of a group of children against a number of tech giants – Apple, Microsoft, Alphabet, Dell, and Tesla – for "knowingly benefiting from and aiding and abetting the cruel and brutal use of young children in Democratic Republic of Congo ("DRC") to mine cobalt, a key component of every rechargeable lithium-ion battery used in the electronic devices these companies manufacture."[10] Plaintiffs allege that "young children mining Defendants' cobalt are not merely being forced to work full-time, extremely dangerous mining jobs at the expense their educations and futures; they are being regularly maimed and killed by tunnel collapses and other known hazards common to cobalt mining in the DRC."[11]

This lawsuit is one of several concerning externalities produced by supply chain contracts. Litigation involving different human rights abuses (child labor,

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[8] *See, e.g.*, Aditi Bagchi, *Other People's Contracts*, 32 YALE J. REG. 211 (2015); Dave Hoffman & Eric Lampmann, *Hushing Contracts*, 97 WASH. U. L. REV. 165 (2019); Andrew Johnston, *Governing Externalities: The Potential of Reflexive Corporate Social Responsibility* 1 (September 1, 2012), Centre for Business Research, University of Cambridge, Working Paper No. 43, http://dx.doi.org/10.2139/ssrn.2165616; Cathy Hwang & David Hoffman, The Social Cost of Contract (working draft)(on file with author); Andrew Johnston, *Facing Up to Social Cost: The Real Meaning of Corporate Social Responsibility,* 20 GRIFF. L. REV. 221, 222 (2011).

[9] Stefano Ponte, Gary Gereffi and Gale Raj-Reichert, "Introduction," *in* HANDBOOK ON GLOBAL VALUE CHAINS 1 (Stefano Ponte et al. (eds.) 2019).

[10] Class Action Complaint, Doe v. Apple et. al., Case No. 1:19-cv-03737 (D.D.C. Dec. 15, 2019), at 1.

[11] *Id.* at 1-2.

forced labor, human trafficking, extra judicial killing, among others) by different corporations (Mars, Costco, Wal-Mart, Royal Dutch Petroleum, among others) in different countries (Thailand, Nigeria, the Ivory Coast, Bangladesh, among others) brought by a variety of corporate stakeholders (laborers, consumers, and local communities) before both federal and state courts alleging causes of action based in international law, consumer protection laws, contract law, and tort law.[12] However, almost all of these cases share a common fate: *dismissal*. The outcomes in these cases result from a lack of judicial recognition of duties that contracting parties owe to various third parties: *no duty to monitor* supply chains, *no duty of care* to laborers in supply chains, and *no duty to disclose* information to consumers about child labor or forced labor in supply chains.

The juxtaposition of third party contributions with third party harms sheds light on how we still imagine contracts in the 21st century. Namely, despite the *multilateral* nature of contracting – in which multiple third parties nourish contract exchanges – many courts still adhere to a *bilateral* model of contracting in which a contract is imagined as an agreement between two or more parties that is both isolated and insulated from the broader society.[13] This view perpetuates the notion that those *most at risk of harm* in contracts are counterparties; it also influences our diagnoses of the *types of harms* that may result from a contract, such as opportunism, which, once again, are harms that most threaten counterparties.[14]

We can come up with a variety of reasons for why we should revise this view and account for third party interests in contracts. Some are moral: it's the right thing to do. Others are economic: doing so provides long term value for the company. Some situations foster compliance considerations: the law commands it. Or strategic: it's good for brand value and marketing. But the reason that this Article highlights originates from the concept of contract itself and the fundamental tension within it. While we may continue to view contracts as bilateral arrangements when it comes to assessing *harms*, we have known for a long time that contracts are multilateral when it comes to the *benefits* third parties confer on contracting ones. Contracts do not occur in a vacuum. We rely upon institutions and organizations developed by a variety of third parties to support those contracting relationships even while contract signatories continue to impose a variety of externalities on those same parties. We need to close the loop.[15]

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12 *See, e.g.*, *Doe v. Wal-Mart Stores*, 572 F.3d 677 (9th Cir. 2009). *Rahaman v. JC Penney Corp*, 2016 WL 2616375, at *1 (Del. Super. Ct. May 4, 2016); *Doe v. Nestle, S.A.*, 906 F.3d 1120, 1122 (9th Cir. 2018); *Nat. Consumers League v. Wal-Mart Stores*, Inc., 2016 WL 4080541 (D.C. Super.); *Dana v. Hershey Co.*, 2016 U.S. Dist. LEXIS 41594 (N.D. Cal. Mar. 29, 2016); *McCoy v. Nestle, United States, Inc.*, 2016 U.S. Dist. LEXIS 41601 (N.D. Cal. Mar. 29, 2016); *Wirth v. Mars Inc.*, 2016 U.S. Dist. LEXIS 14552 (C.D. Cal. Feb. 5, 2016); *Kiobel v. Royal Dutch Petroleum*, Slip. Op. at 2 (Apr. 17, 2013).

13 *See* Bagchi, *supra* note ___ at 219 ("For different reasons, scholars from both philosophical and economic perspectives are drawn to an insular picture of contract interpretation focused exclusively on the parties to contract. The result is that, although everyone would acknowledge the legitimate interests of third parties, courts do not assign any formal and systematic role to those interests in the exercise of interpretation.").

14 *But see* Daniel Markovits, *Contract and Collaboration*, 113 YALE L.J. 1417, 1433 (2004).

15 *See* Hoffman & Lampmann, *supra* note ___ at 199-201 (discussing the ways that contract parties externalize costs to third parties while enjoying the benefits).

In order to protect contract's hidden parties, we need to recognize contract obligations that flow to those beyond contract signatories. This Article suggests a number of legislative and judicial reforms that can help to protect third parties in contracts. In the supply chain context, academics and legislators have proposed due diligence requirements that would force corporate actors to consider the human rights impacts of their conduct on a variety of third parties and to take steps to address and mitigate them. For example, in October 2019, Total, the multinational energy giant, became the first company sued under the French Duty of Vigilance Law.[16] This law "requires companies to create and implement publicly-available vigilance plans for which they can be held accountable"[17] and is "designed to improve the corporate social responsibility programs of the companies in scope, as well as aid the victims of these crimes in achieving justice."[18] Using this law, six environmental groups sued Total for its planned oil operations in a national park in Uganda which they allege creates substantial human rights and environmental risks – risks inadequately addressed by Total in its vigilance plans under the law.[19] However, many legislators around the world remain reluctant to go that route. By highlighting contract's fundamental inconsistency, this Article offers another justification to support mandatory due diligence requirements.

But this Article goes even further by proposing a new duty that borrows elements from both contract and tort law. Under this duty, *contracting parties must take into account negative externalities to third parties when the contracting parties could reasonably foresee that performance of the contract would create a risk of physical harm to these third parties*. *The standard of care is satisfied by reasonable contract design*. Many of the lawsuits alleging third party externalities either sound in contract law or negligence law independently.[20] However, each falls short because of the status of third parties in these supply chains. Under contract law, third parties in supply chains are not beneficiaries of promises exchanged in supply chain codes of conduct. Under negligence law, corporations do not owe a general duty of care to employees of their suppliers. The proposed duty addresses the gap between these two areas of law by providing incentives for contracting parties to account for third party externalities while providing the parties with significant latitude in addressing those externalities. As such, it preserves the traditional features of contract law, such as flexibility and autonomy, but curtails the freedom of contract by situating it against the background of negligence law.[21] While some scholars have advocated for the protection of third party interests through

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16 Environmental News Service, *Total Sued Under France's New Duty of Vigilance Law* (Oct. 23, 2019), https://bit.ly/2rY1Rgn.

17 Assent Compliance, *Regulatory Resource Center: What is the French Corporate Duty of Vigilance Law?*, https://bit.ly/2O9QUko.

18 *Id.*

19 Business Roundtable, *Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy That Serves All Americans'* (Aug. 19, 2019), https://bit.ly/35loTfz.

20 *See, e.g.*, *Rahaman v. JC Penney*, 2016 WL 2616375, at *7-*8 (relying upon negligence principles); *Doe v. Wal-Mart*, 572 F.3d at 681-683.

21 For another perspective on the relevance of negligence law to contract law, see Eric A. Posner, *Fault in Contract Law*, 107 MICH. L. REV. 1431, 1444 (2009)(considering contractual liability through the lens of fault).

contract interpretation[22] or public policy,[23] this Article argues that some externalities are grave enough to warrant obligations at the *ex ante* contract design stage.

This Article proceeds as follows: Section I introduces historic and current contributions to the debate on corporate purpose and whether corporations owe obligations to parties other than shareholders. Section II provides an overview of recent litigation concerning harms to third parties in supply chains. Section III traces the roots of corporate misconduct in the supply chain to contract design and the distinction between Type I and Type II externalities, including examining the reasons why these externalities arise and remain inadequately addressed. Section IV discusses the regulatory responses to third party harms, including an evaluation of the limitations of laws imposing mandatory reporting requirements and those mandating due diligence requirements. Section V provides an overview of the role that third parties undertake in contracts by briefly reviewing the institutional research on private ordering that highlights the various institutions that third parties build and maintain. This section also explains the functional advantages that these institutions offer to contracting parties, such as reducing the transaction costs associated with search and information gathering, negotiating and drafting complete contracts, or providing for legal enforcement. Section VI discusses the normative implications of this institutional research by articulating a view of contracts as ecosystems with particular normative objectives that result from this view: (a) third party protections from negative externalities, (b) contract design obligations of contracting parties, and (c) recourse to legal remedies for third parties. Section VII proposes legislative and judicial reforms that could encourage contracting parties to pursue these objectives, concluding with a duty to contract that requires contracting parties to account for third party externalities that are reasonably foreseeable as a consequence of contractual performance.

I. INCLUDING STAKEHOLDERS

In 2019, the Business Roundtable announced that corporate purpose should promote an economy that "serves all Americans," thereby departing from its earlier statements that privileged shareholder interests.[24] And the Business Roundtable is not alone, but instead echoes the views shared by many titans of Wall Street. Larry Fink, CEO of BlackRock, warned his fellow CEOs that pursuit of profits is not a substitute for corporate purpose and that "society is increasingly looking to companies, both public and private, to address pressing social and economic issues."[25] David Solomon, CEO of Goldman Sachs,

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22 Bagchi, *supra* note ____ at 242 ("When an ambiguous agreement would adversely affect the legal interests of third parties if interpreted one way but not if interpreted another way, courts should prefer the interpretation that generates fewer negative externalities.").

23 Hoffman & Lampmann, *supra* note ___ at 213.

24 Business Roundtable, *Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy That Serves All Americans'* (Aug. 19, 2019), https://bit.ly/2YZBKCe.

25 BlackRock, *Larry Fink's Annual Letter to CEOs: A Sense of Purpose* (Jan. 2019), https://bit.ly/2p26QI3 ("Purpose unifies management, employees, and communities. It drives ethical

similarly warned that sustainability is no longer a peripheral issue and that Goldman Sachs is committing $750 billion in financing, investing and advisory activity to nine areas that focus on climate transition and inclusive growth, including clean energy and transport, sustainable food and agriculture, and financial inclusion.[26]

These views are not new. The emphasis on shareholder interests has always attracted critics and dissenters.[27] One explanation for why shareholder interests are elevated over the interests of others is the *visibility of contributions* from these different groups. Many contributions to the success of the corporation are invisible contributions because we tend to focus only on one type of contribution (financial capital) provided by one type of actor (shareholder). The consequence is that "[f]ixating on the contributions of only one of these groups—shareholders—blinds us to the essential investments of the others and encourages management to prioritize shareholder interest alone."[28] The "team production" school of corporate law challenged this view by arguing that "[t]he success of corporations depends on the contributions of many different stakeholders, and the governance of corporations should recognize those contributions."[29] The contributions of various stakeholders also lead to recommendations to modify corporate boards to include stakeholder representation or other forms of governance participation.[30] Many corporate law scholars have advocated for the expansion of fiduciary duties to encompass a broader range of actors, such as employees, local communities, and other

behavior and creates an essential check on actions that go against the best interests of stakeholders. Purpose guides culture, provides a framework for consistent decision-making, and, ultimately, helps sustain long-term financial returns for the shareholders of your company.").

26 David Solomon, *Goldman Sachs' commercially driven plan for sustainability*, FIN. TIMES (Dec. 15, 2019), https://on.ft.com/2RsQqGD.

27 *See, e.g.*, E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1148 (1932); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 24 J. CORP. L. 751, 806 (1999); Belinfanti, *supra* note ___ at 678; Stone, *supra* note __ at 45-47; Anita Ramasastry, *Corporate Social Responsibility Versus Business and Human Rights: Bridging the Gap Between Responsibility and Accountability*, 14 J. HUM. RTS. 237-59 (2015); Lyman Johnson, *Reclaiming an Ethic of Corporate Responsibility*, 70 GEO. WASH. L. REV. 957, 964-66 (2002); Robert C. Hockett & Saule T. Omarova, *'Special,' Vestigial, or Visionary? What Bank Regulation Tells Us about the Corporation - and Vice Versa*, 39 SEATTLE U. L. REV. 453, 487-95 (2016); Millon, *supra* note ___ 240-51; Elizabeth Pollman, *Corporate Social Responsibility, ESG, and Compliance*, CAMBRIDGE HANDBOOK OF COMPLIANCE (D. Daniel Sokol & Benjamin van Rooij eds., forthcoming), https://ssrn.com/abstract=3479723.

28 Greenfield, *supra* note ___ at 761.

29 Greenfield, *supra* note ___ at 761; *see also* Bodie, *supra* note __ at 822. *see also* Jill E. Fisch, *Making Sustainability Disclosure Sustainable*, 107 GEO. L J. 923, 929 (2019)(proposing a "Sustainability Discussion and Analysis" that would "require an issuer to disclose, at a minimum, the three sustainability issues that are most significant for the firm's operations, to explain the basis for that selection, and to explain the impact of those issues on firm performance"); Virginia Harper Ho, *Risk-Related Activism: The Business Case for Monitoring Nonfinancial Risk*, 41 J. CORP. L. 647 (2016)(explaining the economic rationales for risk related activism); Ann Lipton, *Not Everything is About Investors: The Case for Mandatory Stakeholder Disclosure*, YALE J. REG. (forthcoming)(recommending a disclosure system that produces information for non-shareholder audiences), https://bit.ly/2NzJd6o; Stavros Gadinis & Amelia Miazad, *Sustainability in Corporate Law*, (Aug. 20, 2019)(proposing a view of ESG that "as a regimented process for understanding and managing companies' impact on third parties, which remains common across firms regardless of the underlying values served").

30 Bodie, *supra* note ___ 868-70; Greenfield, *supra* note ___ at 763-64; *see also* O'Connor, *supra* note ___ at 1220 ("One possible means of protecting employees against displacement is for unions to encourage the growth of employee ownership of the corporation.").

stakeholders.[31] For example, the duty of care would require that managers and directors consider the effects of strategic decisions on all the stakeholders of the corporation.[32] Other scholars have turned to negligence theories and advocated for the judicial recognition of a common law duty of care of businesses to respect human rights and other ESG concerns.[33]

While the rhetoric is strong, action is weak. Despite calls for change among CEOs, academics, politicians, judges, and civil society organizations, we routinely witness the consequences of corporations putting shareholders first. This is particularly true in supply chains where lean manufacturing, cost-cutting, and price pressure, among other tactics, secure generous returns for shareholders while imposing significant environmental and human rights consequences for the suppliers, workers, and local communities affected by economic activity in the supply chain. And, as discussed in Section II, *infra*, nothing better highlights the tension between rhetoric and action on corporate purpose than the numerous cases that are brought by victims in the supply chain and that are inevitably dismissed.

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31 *See* Matthew T. Bodie, *Employment as Fiduciary Relationship*, 105 GEO. L.J. 819 (2017)(arguing that employers owe fiduciary and quasi-fiduciary duties to employees); Marleen A. O'Connor, *Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers*, 69 N.C. L. REV. 1189, 1194 (1991)(proposing a "stakeholder model of corporate social responsibility" which "expands directorial fiduciary duties to encompass actions that shield workers from disruptions brought about by plant closings and other corporate changes. Such fiduciary duties toward workers would require directors to provide adequate severance payments, job retraining, and other appropriate relief to displaced workers."); Kent Greenfield, *The Third Way: Beyond Shareholder or Board Primacy*, 37 SEATTLE U. L. REV. 749, 751 (2014)(arguing that it would be a violation of fiduciary duties "to prioritize one stakeholder over others consistently and persistently or to fail to consider the interests of all stakeholders in significant corporate decisions"); Johnston, *Facing Up to Social Cost, supra* note ___ at 236 (arguing that the directors' duty of good faith "should be reformed to require the directors to take action that is capable of producing returns for the shareholders while internalising the externalities of which they become aware in the course of management."); Gadinis & Miazad, *supra* note ___ at 4 (arguing that "boards that fail to establish any mechanism for being reasonably informed about their impact on third parties should be found in violation of their fiduciary duties to shareholders"); *see also* Veronica Root Martinez, *More Meaningful Ethics*, ___ U. CHICAGO L. REV. ONLINE ___ (2019)(advocating for the development of company policies that "will (i) protect the dignity of, (ii) promote the flourishing of, and (iii) advance the interests of various stakeholders of firms").

32 Greenfield, *supra* note ___ at 763-64.

33 Doug Cassel, *Outlining the Case for a Common Law Duty of Care of Business to Exercise Human Rights Due Diligence*, 1 BUS. & HUM. RTS. J. 179, 181 (2016)(advocating for a business common law duty of care that includes human rights due diligence); Jaakko Salminen, *From product liability to production liability: Modelling a response to the liability deficit of global value chain son historical transformations of production*, 23 COMP. & CHANGE 420, 422 (2019)(proposing "production liability" that involves a lead firm's liability for the inadequate governance of its value chain towards labour, environmental and other interests"); Dalia Palombo, *The Duty of Care of the Parent Company: A Comparison between French Law, UK Precedents and the Swiss Proposals,* 4 BUS. & HUM. RTS. J. 265, 266 (2019)(discussing French, Swiss, and UK proposed and enacted liability regimes in which "extraterritorial liability is based on a duty of care and a due diligence obligation that parent companies owe in respect to the torts committed by their affiliates"); *see also* Steven R. Ratner, *Corporations and Human Rights: A Theory of Legal Responsibility*, 111 YALE L.J. 443, 449 (2001)(proposing a corporate responsibility for human rights protection under which "business enterprises will have duties both insofar as they cooperate with those actors whom international law already sees as the prime sources of abuses—states—and insofar as their activities infringe upon the human dignity of those with whom they have special ties"); Jennifer M. Green, *Corporate Torts: International Human Rights and Superior Officers*,17 CHI. J. INT'L L. 447, 452 (2016)(evaluating possibilities for holding individual corporate officers liable for human rights violations under a theory of superior responsibility); Gwynne Skinner, *Rethinking Limited Liability of Parent Corporations for Foreign Subsidiaries' Violations of International Human Rights Law*, 72 WASHINGTON & LEE L. REV. 1769, 1796–99 (considering various theories of liability for parent companies).

II. FROM RHETORIC TO REALITY: CORPORATE MISCONDUCT TOWARDS STAKEHOLDERS IN SUPPLY CHAINS

The following section highlights the difference between rhetoric and action in two ways. Parts A-C illustrate the variety of harms that corporations can cause to a variety of groups, even while they profess to consider the interests of these groups. These cases also highlight how the legal system is complicit in these harms by failing to recognize these legal claims and denying the victims remedies. Part D explains how, by denying *ex post* legal remedies, courts also chill the possibility that corporations will engage in prevention of these harms *ex ante*.

A. *(Forced) Laborers*

Some of the most painful externalities of supply chain contracts fall upon the laborers at the overseas production sites for goods that are produced for American companies. While supply contracts govern obligations between the retailer, for example, and the supplier, the terms of those contracts – such as tight price competition, high volume, and quick turn-around times – can create significant externalities for the men and women who work for those suppliers.[34]

In *Doe v. Wal-Mart*, employees of Wal-Mart's foreign suppliers in countries including China, Bangladesh, Indonesia, Swaziland, and Nicaragua brought a lawsuit against Wal-Mart regarding the working conditions at those suppliers' sites.[35] Critically, they pointed out that Wal-Mart included a supplier code of conduct ("Standards for Suppliers") in each of its contracts with its suppliers.[36] The code "require[s] foreign suppliers to adhere to local laws and local industry standards regarding working conditions like pay, hours, forced labor, child labor, and discrimination."[37] The code also provided Wal-Mart with important inspection rights regarding the enforcement of the code.[38] The plaintiffs blamed Wal-Mart for not exercising the inspection rights that it possessed by virtue of its contracts with its foreign suppliers.[39] Specifically, they alleged that "Wal-Mart does not adequately monitor its suppliers"[40] and that "in 2004, only eight percent of audits were unannounced, and that workers are [] often coached on how to

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34 *See, e.g.*, Verité, STRENGTHENING PROTECTIONS AGAINST TRAFFICKING IN PERSONS IN FEDERAL AND CORPORATE SUPPLY CHAINS 9-10 (2015)("Industries that are characterized by sharp seasonal or product life-cycle fluctuations in labor demand are also at risk. . . . The need for a large number of workers for short periods of time leads many employers to turn to labor brokers for assistance with recruitment . . . In addition, employers in industries with sharp spikes in labor demand sometimes seek to intensify production by temporarily increasing pressure on their existing workforce through the use of compulsory overtime or other forced labor practices.").

35 *Doe v. Wal-Mart Stores*, 572 F.3d 677 (9th Cir. 2009).

36 *Id.* at 680.

37 *Id.*

38 *Id.*

39 *Id.*

40 *Id.*

respond to auditors."[41] Plaintiffs also alleged that "the short deadlines and low prices in Wal-Mart's supply contracts forced suppliers to violate the Standards in order to satisfy the terms of the contracts."[42]

The code was in a contract between Wal-Mart and its suppliers. The plaintiffs' challenge was establishing that the code provided *them* with substantive obligations that *they* could enforce against Wal-Mart; after all, they are third parties to these contracts. To surmount this hurdle, plaintiffs claimed that they were third party beneficiaries of the promises exchanged between Wal-Mart and its suppliers regarding the code and that Wal-Mart promised the suppliers that "it would monitor the suppliers' compliance with the Standards, and that Plaintiffs are third-party beneficiaries of that promise to monitor."[43]

The United States Court of Appeals for the Ninth Circuit did not agree. According to the Ninth Circuit, the code provided Wal-Mart with rights but not duties to exercise those rights: "Because, as we view the supply contracts, Wal-Mart made no promise to monitor the suppliers, no such promise flows to Plaintiffs as third-party beneficiaries."[44] Plaintiffs also alleged a variety of other theories of liability that also proved unsuccessful, including a claim for negligence, which the Ninth Circuit dismissed because "Wal-Mart did not owe Plaintiffs a common law duty to monitor Wal-Mart's suppliers or to protect the alleged intentional mistreatment of Plaintiffs by the suppliers. Without such a duty, Plaintiff's negligence theory does not state a claim."[45]

If absence of a promise by Wal-Mart's proved fatal to plaintiff's claim, then that problem is addressed by drafting clauses so that buyers assume duties as well as rights. Unfortunately, many of the model clauses proposed to address human rights in supply chains avoid that approach. For example, the model clauses proposed by the Working Group of the Business Law Section (WGBLS) of the American Bar Association specifically eschews liability on the part of buyers.[46] These restrictions mean that third parties cannot sue buyers who fail to exercise the rights that these contract clauses give them. So even though a referenced appendix of supplier obligations give buyers the right to inspect facilities, interview employees, review documents, and perform other audit functions, buyers are under no contractual obligation to exercise those rights.

Under *Doe v. Wal-Mart*, therefore, employees of those suppliers who are harmed by a buyer's failure to exercise those rights cannot sue the buyer.[47] If the buyers do not face the prospect of legal liability for not exercising those rights, then they may choose not to do so. And if buyers do not exercise those rights, then suppliers face very little incentive to change their practices. They may get the impression that these clauses, policies, and codes of conduct are empty words that buyers do not intend to enforce and therefore will maintain the status quo. It is understandable why the Working Group decided to include

41 *Id.*

42 *Id.* (internal citations omitted).

43 *Id.* at 681.

44 *Id.* at 681-682 ("The language and structure of the agreement show that Wal-Mart reserved [] the right to inspect the suppliers, but did not adopt a duty to inspect them.")(internal citations omitted).

45 527 F.3d 677, 683 (2009).

46 Snyder & Maslow, *supra* note __ at 7.

47 *Doe v. Wal-Mart Stores*, 572 F.3d at 681-682.

these disclaimers regarding buyers' duties. Otherwise, buyers, fearful of legal liability, may hesitate to include such clauses in their contracts – clauses that are non-mandatory and are only included if buyers and suppliers voluntarily decide to include them.[48] The prospect of legal liability may make it less likely that buyers would choose to do so.

Almost a decade after *Doe v. Wal-Mart*, the Ninth Circuit again examined conditions in the supply chain for third parties; however, the causes of rested upon international law violation as opposed to third party beneficiary claims. In *Doe v. Nestle*, the third parties were "former child slaves who were kidnapped and forced to work on cocoa farms in the Ivory Coast for up to fourteen hours a day without pay."[49] Defendants were large manufacturers, purchasers, processors, and retail sellers of cocoa beans, such as Nestle, Cargill, and Archer Daniels.[50] In their complaint, plaintiffs raised claims for aiding and abetting slave labor under the Alien Tort Statute (ATS). The district court had dismissed the case because it involved an impermissible extraterritorial application of the ATS.[51] However, the Ninth Circuit disagreed because the facts alleged claimed that the defendants provided personal spending money to farms and cooperatives which is "outside the ordinary business contract and given with the purpose to maintain ongoing relations with the farms so that defendants could continue receiving cocoa at a price that would not be obtainable without employing child slave labor."[52] Additionally, "[d]efendants also had employees from their United States headquarters regularly inspect operations in the Ivory Coast and report back to the United States offices, where these financing decisions, or 'financing arrangements,' originated."[53] The Ninth Circuit concluded that "the allegations paint a picture of overseas slave labor that defendants perpetuated from headquarters in the United States."[54] However, following the Supreme Court's clarification of corporate liability under ATS in *Jesner v. Arab Bank*, the Ninth Circuit clarified that the ATS does not support claims against foreign corporations and that, on remand, plaintiffs would need to "specify whether aiding and abetting conduct that took place in the United States is attributable to the domestic corporations in the case."[55]

The Ninth Circuit is not alone in addressing the issue of harms to laborers in supply chains. In 2016, the Superior Court of Delaware ruled on the issue of whether a retailer can be liable in negligence for harms suffered by employees of its suppliers. In *Rahaman v. J.C. Penney*, plaintiffs brought claims for wrongful death and negligence against J.C. Penney, The Children's Place, and Wal-Mart for harms they or their loved ones suffered in the collapse of Rana Plaza in 2013, which killed 1,100 individuals and injured approximately 2,500 more.[56] The

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[48] Snyder & Maslow, *supra* note __ at 3 ("The drafters have crafted the text this way because some buyers may have the leverage to use the proposed text, and in any case, these clauses are aimed primarily at companies in the role of buyer.").

[49] *Doe v. Nestle, S.A.*, 906 F.3d 1120, 1122 (9th Cir. 2018).

[50] *Id.*

[51] *Id.*

[52] *Id.* at 1126.

[53] *Id.*

[54] *Id.*

[55] *Id.* at 1127.

[56] *Rahaman v. JC Penney*, 2016 WL 2616375 (Sup. Ct. Del. May 4, 2016).

Superior Court rejected the negligence claim, explaining that in "negligence cases alleging nonfeasance, or omission to act, there is no general duty to others in the absence of a 'special relationship' between the parties.[57] Plaintiffs also attempted to establish a duty of care based on the ethical sourcing statements made by defendants. However, the court was not convinced: "These statements by Defendants do not, by themselves, create a duty to employees of independent contractors where a duty does not otherwise exist."[58]

B. *Consumers*

Consumers have brought lawsuits against large manufacturers and retailers, claiming that conditions in the supply chain have harmed their interests.[59] For example, in *National Consumers League vs. J.C. Penney et al.*, the National Consumer League brought claims against J.C. Penney, The Children's Place, and Wal-Mart for violating the District of Columbia Consumer Protection Procedures Act.[60] The lawsuit was based on statements that each of the defendant retailers had posted on their websites concerning their policies and practices regarding conduct in their supply chains.[61] Plaintiffs highlighted two features in particular: (a) supplier codes of conduct, and (b) auditing practices. They claimed that these retailers promised NCL and the "general public that their suppliers will ensure safe and healthy working conditions for their workers and will not utilize child labor," and that the resulting harms suffered at Rana Plaza are evidence of a breach of those promises.[62]

The court, however, was unconvinced. It found that "the majority of statements referenced by NCL are aspirational statements. The statements were

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57 2016 WL 2616375, at *8.

58 *Id.*

59 Legal scholars have also explored different types of harms consumers may suffer that the law has yet to articulate as a legal injury or to address with legal remedies. *See, e.g.*, Omri Ben-Shahar & Ariel Porat, *The Restoration Remedy in Private Law*, 118 COLUM. L. REV. 1901, 1903 (2018)(" Unlike pecuniary or physical harms, emotional distress is difficult to verify and measure, and the remedial tools of private law—money damages or injunctions—are often ill-suited to redress it. Private law needs a new remedy to redress emotional harms that other areas of law regard as protection-worthy."); Sarah Dadush, *Identity Harm*, 89 COLO. L. REV. 863, 868 (2018)("[I]dentity harm can be used to expand the range of corporate practices considered to be unfair or deceptive, and create openings for remedies that look beyond financial compensation to include reparations. Identity harm offers a conceptual container for a special type of noneconomic injury that is currently too easy for courts to miss."). However, as consumers, these claims concern the emotional harms experienced by *contracting parties*. In contrast, this Article discusses both the economic and, often, physical injuries suffered by *third parties* in contract, who are in an even more vulnerable position under contract law. Despite this distinction, the analysis provided in this Article attempts to bridge this gap for both foreign and domestic third party victims of contractual externalities and may also prove useful to contracting parties whose injuries the law has yet to recognize.

60 *Nat. Consumers League v. Wal-Mart Stores*, Inc., 2016 WL 4080541 (D.C. Super.).

61 2016 WL 4080541, at *1.

62 *Id.* at *3 ("NCL relies on the collapse to support the inference that Retailers did not properly audit their suppliers because if they had performed the auditing procedures, defendants would have known about the unsafe working conditions and the presence of child labor.").

not false on their face and were general in nature outlining the expectations of each retailer and efforts by each retailer to place pressure on its suppliers to be more socially responsible."[63] The court engage in a textual analysis of the corporate statements to show how these statements were aspirational and did not provide assurances: "The usage of the qualifying terms 'expect', 'goal', and 'ask' is demonstrative of the aspirational nature of the statements and further demonstrates that the statements are not promises to consumers, as NCL alleges in its Amended Complaint. In these Corporate Statements, the defendants did not use qualifying terms binding Retailers such as 'ensure', 'promise' or 'forbid.'"[64] Based on this textual analysis, the court concluded that "the language of the defendants does not convey a promise" and that "NCL goes too far by recasting the retailers' aspirational statements" as such.[65]

However, the court found that that the retailers' statements regarding their auditing practices may be actionable because these "auditing statements are more specific and contain verifiable facts that may be material to a consumer's purchasing decisions."[66] Given that these statements are capable of being verified, the court found that the plaintiffs had sufficiently plead a claim and denied the defendants' motion to dismiss in part as concerning the auditing statements.[67]

Other consumer lawsuits did not fare as well. In *Hodson v. Mars*, plaintiffs brought a lawsuit on behalf of himself and other similarly situated consumers against Mars, Inc. and Mars Chocolate North America, LLC (collectively, "Mars") for violations of California's consumer protection laws and sought restitution and injunctive relief.[68] Plaintiff's claims concern the types of wrongdoing at issue in *Doe v. Nestle* – namely, forced labor and child labor in cocoa supply chains. However, the plaintiffs seeking relief were not the former child slaves but consumers of products sourced from these supply chains who claimed that they would not have purchased these chocolate products had they known about the conditions in the supply chain or, at the least, would not have paid as much for these products.[69]

Plaintiff drew particular attention to the inconsistency between what Mars professed in its corporate statements and policies and the conditions that plaintiff claimed characterized Mars's supply chains. Specifically, its human rights policy referenced the United Nations Guiding Principles on Business and Human Rights and expressed Mars's intent to perform human rights due diligence in their cocoa supply chains.[70] The complaint also referenced Mars's supplier code of conduct that prohibits child labor, forced labor, and human trafficking and reserves the right to audit suppliers' facilities.[71] Plaintiff argued that "although Mars recognizes that the use of child and/or slave labor in its supply chain is wrong and its corporate business principles and supplier code

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63 *Id.* at *5.
64 *Id.* at *6.
65 *Id.* at *6.
66 *Id.* at *7.
67 *Id.* at *8.
68 Class Action Complaint, *Hodson v. Mars*, No. 15-cv-04450 (N.D. Cal. Sept. 28, 2015).
69 *Id.* at ¶ 10.
70 *Id.* at ¶ 49.
71 *Id.*

explicitly forbid child and slave labor by its suppliers, it materially omits to disclose to consumers at the point of purchase the likelihood that its Chocolate Products are made from cocoa beans produced by Ivorian children engaged in the Worst Forms of Child Labor."[72]

Plaintiff alleged violations of California's unfair competition laws, consumers legal remedies act, and false advertising laws, but the United States District Court for the Northern District of California dismissed all these claims.[73] First, the court found that there was no violation of false advertising laws because the claims are based on omissions regarding Mars's failure to issue statements regarding child labor and forced labor in its supply chains.[74] Similarly, the court dismissed the claims based on unfair competition and legal remedies act because it found that Mars did not have a duty to disclose information regarding child labor and forced labor in its supply chain.[75] The same fate was shared by other lawsuits brought by consumers asserting claims against Nestle,[76] Hershey,[77] and Mars[78] for child labor and forced labor in their cocoa supply chains.

C. *Communities*

Finally, individuals residing in the countries in which these multinational companies operate have also brought claims alleging significant violations of their human rights. Perhaps the most famous is *Chevron v. Ecuador* that concerns Texaco's oil operations in previous decades and which plaintiffs allege polluted the rainforests and rivers in Ecuador and Peru.[79] Plaintiffs allege that these oil operations contaminated the environment and led to increased rates of cancer and other serious health issues for the individuals living in the region.[80] The facts of the case led to litigation or requests for review before multiple courts and tribunals, including: United States federal courts, Ecuadorian courts, Permanent Court of Arbitration, Canadian courts, and the International Criminal Court.

In 2013, the United States Supreme Court considered a case involving human rights abuses by multinational corporations in *Kiobel v. Royal Dutch Petroleum*.[81] Petitioners were "residents of Ogoniland, an area of 250 square miles located in the Niger delta area of Nigeria" and brought claims under the Alien Tort Statute that provides that "[t]he district courts shall have original

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72 *Id.* at ¶ 53; *id.* at ¶ 10.

73 Order Granting Mars Inc.'s Motion to Dismiss, *Hodson v. Mars*, No. 15-cv-04450 (N.D. Cal. Feb. 17, 2016).

74 *Id.* at 7 ("[W]hen the defendant has not made any statements at all, a plaintiff cannot assert a claim under the FAL.").

75 *Id.* at 8-11.

76 *McCoy v. Nestle, United States, Inc.*, 2016 U.S. Dist. LEXIS 41601 (N.D. Cal. Mar. 29, 2016).

77 *Dana v. Hershey Co.*, 2016 U.S. Dist. LEXIS 41594 (N.D. Cal. Mar. 29, 2016).

78 *Wirth v. Mars Inc.*, 2016 U.S. Dist. LEXIS 14552 (C.D. Cal. Feb. 5, 2016).

79 Business and Human Rights Resource Centre, Texaco/Chevron lawsuits (re Ecuador), https://bit.ly/2tJukCo.

80 *Id.*

81 *Kiobel v. Royal Dutch Petroleum*, Slip. Op. at 2 (Apr. 17, 2013).

jurisdiction of any civil action by an alien for a tort only, committed in violation of the law of nations or a treaty of the United States."[82] Petitioners brought claims under the ATS for violations of the law of nations concerning aiding and abetting (1) extrajudicial killings; (2) crimes against humanity; (3) torture and cruel treatment; (4) arbitrary arrest and detention; (5) violations of the rights to life, liberty, security, and association; (6) forced exile; and (7) property destruction.[83] The Supreme Court took up the issue of whether a claim brought under the ATS may reach conduct occurring in the territory of a foreign sovereign.[84] It affirmed the Second Circuit's dismissal of the case because it concluded that "that the presumption against extraterritoriality applies to claims under the ATS, and that nothing in the statute rebuts that presumption."[85]

D. *Multiplying the Injury: Lack of Accountability Ex Post Chills Prevention Ex Ante*

Given the severity of harms in the supply chain, we may want corporations to adopt supply chain compliance programs that prevent harms to stakeholders.[86] One mechanism that can encourage better compliance practices is director liability under *In re Caremark International Inc. Derivative Litigation*[87] and *Stone v. Ritter*.[88] But before there can be compliance, there must first be risk – often framed in legal terms. The absence of a duty to third parties means that there is minimal legal risk to corporations for their misconduct in the supply chain; lack of duty leads to a lack of legal risk.[89] Due to this lack of legal risk, *Caremark* may not impose much of an incentive to develop compliance programs that can serve a preventative function in the supply chain.[90]

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[82] *Id.*

[83] *Id.* at 2-3.

[84] *Id.* at 4.

[85] *Id.* at 14.

[86] *See, e.g.*, Ramasastry, *supra* note ___ at 238 (explaining that business and human rights "grows out of a quest for corporate accountability to mitigate or prevent the adverse impacts of business activity on individuals and communities and out of expectations grounded in a specific core set of human rights obligations"); David Millon, *Human Rights and Delaware Corporate Law*, 25 PAC. MCGEORGE GLOBAL BUS. & DEV. L.J. 173, 182-86 (2012)(discussing potential legal and reputational risk associated with human rights violations abroad and the risk management responsibility of the board of directors).

[87] *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

[88] *Stone v. Ritter*, 911 A.2d 362 (Del. 2006); *see also Marchand v. Barnhill*, 212 A.3d 805 (Del. 2019); *In re Clovis Oncology, Inc. Derivative Litigation*, Consol. C.A. No. 2017-0222-JRS (Del. Ch. Oct. 1, 2019); *see also* Donald C. Langevoort, *Caremark and Compliance: A Twenty-Year Lookback*, 90 TEMP. L. REV. 727, 731 (2018); Hillary A. Sale, *Monitoring Caremark's Good Faith*, 32 DEL. J. CORP. L. 719, 735 (2007); *see also* Martin Lipton *et al.*, RISK MANAGEMENT AND THE BOARD OF DIRECTORS (Nov. 2019). Another driver for compliance programs is relief in sentencing under the United States Sentencing Guidelines. *See, e.g.*, Root Martinez, *supra* note __ at 5.

[89] *See* Nolan & Boersma, *supra* note __ at 135; *see* notes Section II, *infra*; *see also* Ramona L. Lampley, *Mitigating Risk, Eradicating Slavery*, 68 AM. U. L. REV. 1707 (2019).

[90] *See, e.g.*, Eric J. Pan, *A Board's Duty to Monitor*, 54 N.Y. L. SCH. L. REV. 717, 719-720 (2009)(explaining that under *Stone v. Ritter*, the "board is responsible only for preventing wrongful or illegal acts. The board has no responsibility to prevent acts that are legal, but that lead to harmful business results."); Charles M. Elson & Christopher J. Gyves, *In Re Caremark: Good Intentions, Unintended Consequences*, 39 WAKE FOREST L. REV. 691, 701 (2004)("For directors, increasingly concerned about personal financial liability, the goal became liability avoidance rather than the prevention of corporate misconduct. . . . As the motivation for these actions was primarily liability-driven, their actual impact on

The unfortunate consequence is that third parties are wounded three times over: *First*, through the initial misconduct; *second*, through a denial of justice in the courts; and, *third*, by facing the prospect of recurrence of the earlier misconduct due to inadequate compliance or other preventative corporate policies. The proposed duty addresses the *Caremark* problem by creating an incentive for those present at the bargaining table to consider these third party externalities when contracting. Much of the current legislation addressing supply chains – in the United States and abroad – focus on transparency measures and mandatory information disclosures.[91] These approaches do not impose fines or penalties on corporations for their performance. As such, there is no legal lever to get the compliance process going from a legal risk perspective.[92]

The challenges with curtailing supply chain externalities are familiar ones associated with encouraging better compliance by corporate actors; namely, how to encourage corporate actors to adopt a socially optimal compliance program that "'a rational, profit-maximizing firm would establish if it faced an expected sanction equal to the social cost of the violation.'"[93] Scholars have noted the limitations of legal risk (usually presented through enforcement action) to incentivize corporations to adopt a socially optimal compliance program,

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corporate activities was questionable. It was the mere existence of these procedures that mattered-whether or not they would have any actual impact on corporate compliance with law was of secondary concern."); *see also* James A. Fanto, *The Governing Authority's Responsibilities in Compliance and Risk Management, as Seen in the American Law Institute's Draft Principles of Compliance, Risk Management, and Enforcement*, 90 TEMP. L. REV. 699, 705-06, 709 (2018)(discussing the prospect of legal liability to the company as a driver of corporate compliance programs); Kimberly D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U. L.Q. 487, 491 (2003)(discussing the ineffectiveness of "paper compliance programs"); Todd Haugh, *Caremark's Behavioral Legacy*, 90 TEMP. L. REV. 611 (2018)(discussing behavioral incentives and compliance initiatives).

However, some have argued that *Caremark*'s penumbra may also extend to reputational risks to the company and, therefore, not only limited to acts that may trigger legal liability. *See* Claire A. Hill, *Caremark as Soft Law*, 90 TEMP. L. REV. 681, 684 (2018)("[W]hat directors and officers apparently think they should do to abide by their *Caremark* duties is much more than what they have to do to avoid liability. . . . But what boards do to abide by their *Caremark* duties extends to activities or omissions that are not illegal."); *id.* at 689 ("[A]t least part of the story is an obligation for the company to be mindful of the harm it can do to third parties beyond anything that might be legally actionable."); Millon, *Human Rights and Delaware Corporate Law*, *supra* note ___ at 185-86 ("[R]isk management extends beyond avoidance of litigation to the broader challenge of avoiding behavior that is likely to be condemned in the court of public opinion."); Stephen M. Bainbridge, *Caremark and Enterprise Risk Management*, 34 J. CORP. L. 967, 978 (2009)(discussing the application of *Caremark* to failures in risk management). However, as discussed later, the reputational damage to a corporation from misconduct in the supply chain may depend on some predicate legal action that publicizes and disseminates the information. Here, legal sanctions and reputational costs work together with the former influencing the magnitude and effectiveness of the latter. *See* Kishanthi Parella, *Reputational Regulation*, 67 DUKE L.J. 907 (2018); Roy Shapira, *Reputation Through Litigation: How the Legal System Shapes Behavior By Producing Information*, 91 WASH. L. REV. 1194, 1196 (2016).

[91] *See* Michael R. Littenberg & Nellie V. Binder, *Corporate Social Responsibility Disclosure and Compliance: An Overview of Selected Legislation, Guidance and Voluntary Initiatives*, PLI Institute on Securities Regulation (October 2019), https://bit.ly/2tnUUWD.

[92] *See* Nolan & Boersma, *supra* note __ at 149.

[93] Donald C. Langevoort, *Cultures of Compliance*, 54 AM. CRIM. L. REV. 933, 937-38 (2017)(quoting Geoffrey P. Miller, *An Economic Analysis of Effective Compliance Programs*, in JENNIFER ARLEN, ED., RESEARCH HANDBOOK ON CORPORATE CRIME AND FINANCIAL MISDEALING (2017)).

including "limited regulatory resources, detection difficulties, legal uncertainties and procedural obstacles, conflicts of interest, [and] political pressure."[94]

These problems are further compounded when it comes to human rights compliance in supply chains because enforcement action – as limited as it may be – is absent. Most of the laws addressing supply chains rely on information disclosure without recourse to legal fines or penalties. As a result, at present, human rights abuses do not create many legal risks for companies. While these abuses are unlawful and often violate the most fundamental legal rules, corporations are rarely held liable for these acts. Many of the legal rules prohibiting these acts are based in international human rights law that are addressed to state actors and not corporations; there is therefore an open question of whether corporations can be held directly liable under international human rights law for violating one of its rules.[95]

The low probability of corporate accountability for these acts translates into low legal risk from a *Caremark* calculus. This is the dreaded chicken and egg conundrum: To avert a human rights crisis, a corporation must, at minimum, have adequate human rights compliance policies and practices in place. The incentive to do so, however, may rest upon the legal consequences to a corporation from such a crisis. When there are minimal legal consequences, then *Caremark* may provide little incentive to adopt such a compliance program. One response, therefore, is to alter the *Caremark* calculus by recognizing duties that may re-calibrate the compliance calculation by offering the prospect of legal accountability that is otherwise absent. Not only does this response offer access to justice for those harmed by the corporate misconduct but also gets the issues on the radar of corporate officers and directors so that the misconduct may be averted in the future through adequate compliance efforts. After all, compliance is not a profit center within a corporation; there is competition for those dollars from those parts of those organizations that are more profitable or from compliance areas that present more of a legal risk.[96] Increased legal accountability may shift the internal importance of these issues and transform them from departments devoted to procurement or quality control into a matter for the legal department.

III. THE CONTRACTUAL ROOTS OF CORPORATE MISCONDUCT

The previous two sections illustrated the tension between rhetoric and reality when it comes to corporate treatment of stakeholders. This section traces the roots of this tension to contracts. Contracts are the primary means through which corporations and other business enterprises interact in society. While contracts primarily benefit the contract's signatories, they can create a risk of

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94 Langevoort, *supra* note __ at 938.

95 For example, in *Jesner v. Arab Bank*, the United States Supreme Court held that foreign corporations could not be sued under the Alien Tort Statute. 138 S. Ct. 1386 (2018).

96 *See* Langevoort, *supra* note ___ at 730; Eugene Soltes, *Evaluating the Effectiveness of Corporate Compliance Programs: Establishing a Model for Prosecutors, Courts, and Firms*, 965, 1005 (2018); Assent Compliance, BUDGETING FOR COMPLIANCE IN 2020 35 (2019)("Between 2016 and 2019, companies reported increases of 16 to 25 percent in time spent on labor; compliance professionals project that an increase of 11 to 15 percent more time will be needed for compliance by 2022.").

harms to a variety of actors who are not formally part of the contract. These risks result in the human rights violations alleged in the lawsuits discussed in Section II, *supra*, that illustrate two different types of externalities created by a corporation's contracting activities.

Part A explains that Type I externalities are harms that result from *contract performance* when contracting parties perform as expected; in contrast, Type II externalities result from *contractual breach*. Both types of externalities contribute to the human rights violations discussed in Section II, *supra*, although Type II externalities tend to receive greater attention. Part B explains that while various parties suffer these risks, they are powerless to do much about it. As non-signatories to the contracts, they have no role at the bargaining table when the contract is designed and negotiated and no remedy from the courts when the contract results in injury to them.

A. Externalities in the Supply Chain: Type I (Contractual Performance) vs Type II (Contractual Breach)

International economic production is organized through a vast array of supply chains that connect individuals and companies in various countries to each other.[97] Each of these supply chains is created and maintained by a variety of supply contracts.[98] Supply contracts can vary in length, objective, terms, parties, duration, etc. For the purpose of the following discussion, this section focuses on two features of the supply contract: the master agreement and supply contract ("master agreement") and supplier code of conduct ("code"). Each of these contracts creates the risk of negative externalities for non-contracting parties, or third parties.

What is an externality? Quite simply, it is a cost that one or more parties imposes on others.[99] Another feature of negative externalities is that those creating them are usually not inclined to account for them in their decision-making because the costs are borne by others and not themselves; "corporations that produce externalities gain all the benefits of their economic activity, but do not bear all the costs."[100] The result is that "[s]ince corporations take no account of these costs, their private costs of engaging in the productive activity are lower

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97 *See, e.g.*, Gary Gereffi & Karina Fernandez-Stark, GLOBAL VALUE CHAIN ANALYSIS; A PRIMER 7 (2016)("The value chain describes the full range of activities that firms and workers perform to bring a product from its conception to end use and beyond. This includes activities such as research and development (R&D), design, production, marketing, distribution and support to the final consumer. The activities that comprise a value chain can be contained within a single firm or divided among different firms.").

98 *See* notes ___ -___, *infra*, and accompanying text.

99 Lisa Grow Sun & Brigham Daniels, *Mirrored Externalities*, 90 NOTRE DAME L. REV. 135, 137 (2014). For the purpose of this Article, I use the term "externalities" to refer exclusively to negative externalities or costs imposed on third parties, as distinct from positive externalities that are benefits conferred on third parties. *Id*; *see also* Johnston, *supra* note ___ at 1 ("A negative externality occurs where a decision is taken that results in an event which has adverse, uncompensated effects on another party who does not consent to it.")

100 Johnston, *Facing Up to Social Cost, supra* note ___ at 221; *see also* Grow Sun & Daniels, *supra* note ___ at 137.

than the social costs, and so there will be more production than is optimal from the perspective of society as a whole."[101]

Both master agreements and codes of conduct create third party externalities but for different reasons: *Performance* of the master agreement/supply contract results in a Type I externality, while *breach* of the code of conduct results in a Type II externality.

Type	Agreement	Issue
I	Master Agreement	Performance
II	Code of Conduct	Breach

Table 1: Third Party Externalities in Supply Chains

Type I externalities do not occur when things go wrong but when parties perform exactly as expected under the supply agreements.[102] Specifically, the very terms of the supply contract create the risk of externalities for third parties; performance of these contractual terms are the root cause of the externalities that third parties encounter.[103] Terms such as purchase price, delivery schedule, and volume of orders may place a heavy burden on Supplier to perform.[104] In certain industries, Supplier may be reluctant to push back against Buyer regarding these terms because of fear of losing the Buyer's business.[105] For example, if Supplier does not have an exclusive supply relationship with Buyer, it is under pressure to agree to Buyer's demands regarding pricing and delivery because there may be multiple other suppliers who Buyer may turn to if Supplier cannot comply.[106] Additionally, if these supply contracts are short-term, then Supplier is constantly under pressure to acquiesce to Buyer so that it may continue to obtain Buyer's business in the future.[107]

These conditions increase the risk of practices in the supply chain that result in harmful externalities to third parties. For example, a short delivery window and high volume may increase the likelihood of subcontracting from the

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[101] Johnston, *Facing Up to Social Cost, supra* note ___ at 221-22.

[102] In this discussion, I keep separate the terms of the Master Agreement and Codes of Conduct. However, some buyers have combined both agreements into one contract that incorporates the second by reference. Despite this, I keep the agreements separate to identify the unique risks of externalities that each creates.

[103] *See, e.g.*, Justine Nolan & Martijn Boersma, ADDRESSING MODERN SLAVERY 41-42 (2019)(discussing the labor implications for production that relies on just-in-time production and lean manufacturing).

[104] Nolan & Boersma, *supra* note __ at 41-42, 54; Stephanie Barrientos, *Contract Labour: The 'Achilles Heel' of Corporate Codes in Commercial Value Chains*, 39 DEV. & CHANGE 977, 98-82 (2008); Pun Ngai & Jenny Chan, *Global Capital, the State, and Chinese Workers: The Foxconn Experience*, 38 MODERN CHINA 383, 385–86 (2012).

[105] *See* Nolan & Boersma, *supra* note __ at 158 (referencing a study by the International Labor Organization that "reported that 39 per cent of suppliers surveyed accepted orders 'whose price did not allow them to cover production costs.'").

[106] Suk-Jun Lim & Joe Phillips, *Embedding CSR Values: The Global Footwear Industry's Evolving Governance Structure*, 81 J. BUS. ETHICS 143, 144 (2008); Richard M. Locke *et al.*, *Complements or Substitutes? Private Codes, State Regulation and the Enforcement of Labour Standards in Global Supply Chains*, 51 BRIT. J. INDUS. REL. 519, 526 (2012); Bin Jiang, *Implementing Supplier Codes of Conduct in Global Supply Chains: Process Explanations from Theoretic and Empirical Perspectives*, 85 J. BUS. ETHICS 77, 80 (2008).

[107] Gary Gereffi & Joonkoo Lee, *Why the World Suddenly Cares About Global Supply Chains*, 48 J. SUPPLY CHAIN MGMT. 24, 25 (2012) (describing modular, relational, and captive governance strategies in global supply chains).

Supplier to another party.[108] Subcontracting relationships are fraught with risks because: (a) subcontractors may not be bound to the buyer's standards and policies, (b) buyer may be unaware of the identity of the subcontractor and its production sites so cannot send its representatives to monitor or audit those facilities, (c) subcontractors may not be approved by buyers and selected by suppliers only because the subcontractor can meet production demands and not for social compliance quality reasons.[109] It is therefore unsurprising that many incidents of publicized wrongdoing in supply chains occur at subcontracting sites.[110]

Given that the terms of supply contracts may create Type I externalities for third parties, many supply contracts include a supplier code of conduct. For example, a sample Master Agreement may provide:

> 10.1 Social Compliance. Supplier agrees to comply with and be bound by, and to cause all of its sub-suppliers and other subcontractors to comply with and be bound by, the ACME Workplace Code of Conduct and all other requirements and obligations set forth in Schedule A attached hereto, as it may be amended from time to time by ACME (collectively, the "Social Compliance Requirements").

Schedule A also obligates suppliers to comply and that they will cause all of their "officers, directors, managers, supervisors, other employees and workers, sub-suppliers and other subcontractors to comply, with all requirements and provisions set forth in the Code." The suppliers also agree to provide ACME, its dealers and licensors, third party auditors, and representatives with audit and assessment rights of supplier facilities to ensure compliance with the code of conduct.

On its face, these code of conduct appear to address Type I externalities to third parties through a variety of contract terms. First, the risks associated with subcontracting are addressed by putting ACME's suppliers "on the hook" for the actions of their subcontractors; the code states that the latter are also bound to its terms and policies and that non-compliance by the latter may have negative consequences for ACME's suppliers. In this way, the code incentivizes suppliers to choose their subcontractors with compliance considerations in mind and to take action to support subcontractors' compliance with the code's terms. The code also provides ACME (and its representatives) with audit rights, including the right to interview workers and inspect documents to assess compliance with the code.

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108 Kishanthi Parella, *Outsourcing Corporate Accountability*, 89 WASH. L. REV. 747, 790 (2014)("[L]ocal factory owners in Bangladesh report that they resort to unauthorized subcontracting by smaller, uninspected factories in order to meet the rapid turnaround of large volume orders by large retailers, such as Walmart.").

109 Locke, *supra* note ___ at 526; Michael E. Blowfield & Catherine S. Dolan, *Stewards of Virtue? The Ethical Dilemma of CSR in African Agriculture*, 39 DEV. & CHANGE 1, 6-7 (2008); Sarah Dadush, *Contracting for Human Rights: Looking to Version 2.0 of the ABA Model Clauses*, 68 A.U. L. REV. 1519, 1525, 1540-41 (2019).

110 *See* notes __ - ___, *infra*, and accompanying text.

Why would multinational buyers include such provisions in their supply agreements? One driver is reputational risk: misconduct by suppliers or sub-suppliers may expose the buyer to unwelcome media attention, consumer boycotts, shareholder activism, and even lawsuits. Therefore, buyers may want to reduce the risk of labor abuses, such as child labor and forced labor, by including contractual terms that obligate their suppliers to abide by standards and policies covering social compliance. A second driver may be the availability of model clauses addressing social compliance risks, such as those recently drafted by the Working Group to Draft Human Rights Protections in International Supply Contracts (Working Group) of the Business Law Section of the American Bar Association.[111] Finally, companies may want to include these clauses as a means to manage a variety of compliance concerns, such as compliance with national laws addressing disclosures and human rights in supply chains.[112]

The problem, of course, is that suppliers may not always comply with these terms, thereby creating Type II externalities and leading to many of the lawsuits discussed in Section II, *supra*.

B. *Managing Externalities: Contract Limitations of Third Parties*

Despite the externalities that they encounter, third parties are unable to manage these risks the way we expect contracting parties to do so. Contracting parties are provided two opportunities to address risks to themselves posed by their counterparties: *ex ante* contract design and *ex post* legal liability. Third parties are not afforded either opportunity.

When contracting parties encounter potential risks from the agreement, they minimize these risks to themselves through contract design.[113] However, contractual arrangements also create risks of Type I externalities to third parties but they are not in a position to participate in contract design. Third parties, such as laborers, consumers, and local communities do not have a seat at the bargaining table when the buyers and suppliers negotiate and execute supply agreements. Therefore, they cannot directly influence the drafting of contract terms that may minimize risks to themselves. And the contracting parties at the negotiating table may have little incentive to consider third party interests when negotiating the contract unless they are obligated to do so because of mandatory law, private governance arrangements, or fear of reputational or legal risks.[114] As a result, third parties often find themselves in the unfortunate situation that they may suffer Type I externalities but may have limited or no means to address these risks through contract design.

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111 David V. Snyder (chair) & Susan A. Maslow (vice chair), *Human Rights Protections in International Supply Chains—Protecting Workers and Managing Company Risk*, 73 BUS. LAW. 1093 (2018); Jonathan Lipson, *Contract (As) Social Responsibility*, WISCONSIN L. REV. (2019) at 5 ("Unlike the conventional bilateral contract, KSR terms deliberately contemplate the welfare of persons not parties to the contract, or conditions such as environmental sustainability, that are directed at society in general.").

112 Snyder & Maslow, *supra* note __ at 4; Lipson, *supra* note __ at 17-23.

113 *See, e.g.*, Alan Schwartz, *Keynote Address: Modern Supply Chains and Outmoded Contract Law*, 68 AM. U. L. REV. 1503, 1511 (2019).

114 Lipson, *supra* note __ at 17-23.

Third parties are similarly limited in their ability to control Type II externalities, which result from a breach of a code of conduct. Third parties are not signatories to these codes of conduct so are not in a position to sue multinational buyers for a breach of contract.[115] In fact, in *Doe v. Wal-Mart*, the Ninth Circuit found that Wal-Mart did not even take on any promises under the code of conduct; instead, it possessed inspection and audit rights that it could exercise if it wished to do so but was not under no duty to do so.[116] The inability to impose *ex post* legal sanctions in the future means that buyers may have little incentive to consider the welfare of third parties in the present.

Type	Agreement	Issue	Contract Tool	Third Party Limitation
I	Master Agreement	Performance	Contract Design	No role ex ante
II	Code of Conduct	Breach	Judicial Remedy	No rights ex post

Table 2: Challenges with Addressing Third Party Externalities in Supply Chains

IV. REGULATORY SOLUTIONS: MANDATORY REPORTING V. MANDATORY DUE DILIGENCE REQUIREMENTS

Third parties are also rendered vulnerable because current legislation does not go far enough to address contract externalities, especially those created by supply chain contracts.[117] As explained in Part A, most jurisdictions that have adopted supply chain legislation have opted for *mandatory disclosure* requirements instead of *mandatory due diligence*. This difference matters for what steps corporations are legally required to take. In a mandatory disclosure jurisdiction, a company is required to report on its policies concerning its identification and mitigation of human rights impacts within its supply chain, along with other related topics. A covered company may comply with these reporting requirements by simply reporting to the public that it does not have any such policies or practices.[118] It has complied with the disclosure laws because it has

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115 Even the model clauses developed by the Working Group of the Business Law Section of the American Bar Association limit or eliminate liability for buyers. Snyder & Maslow, *supra* note __ at 7 (Clause 5.7); *see also* Lipson, *supra* note __ at 10-12 (describing issues with buyers enforcing social responsibility clauses in contracts, such as problems of assessing damages).

116 *Doe v. Wal-Mart Stores*, 572 F.3d at 681-682.

117 *See* Johnston, *Facing Up to Social Cost, supra* note ___ at 222-23 ("[F]or a variety of reasons, many externalities are not dealt with by law, regulation or taxation. . . . Where the law fails to require corporations to take their externalities into account, corporations rarely take account of their social costs voluntarily.").

118 *See, e.g.*, Kamala Harris, THE CALIFORNIA TRANSPARENCY IN SUPPLY CHAINS ACT: A RESOURCE GUIDE (2015)("The California Transparency in Supply Chains Act does not mandate that businesses implement new measures to ensure that their product supply chains are free from human trafficking and slavery. Instead, the law only requires that covered businesses make the required disclosures – even if they do little or nothing at all to safeguard their supply chains."); *see* Nolan & Boersma, *supra* note __ at 124-26. However, the proposed Corporate Human Rights Risk Assessment,

reported truthfully on the current state of its policies and the disclosure laws do not actually require that the companies have those policies in place. In contrast, Part B explains that a mandatory due diligence jurisdiction requires that a company adopt and implement policies and practices that address a particular objective, such as the identification and mitigation of human rights impact assessments. If it does not do so, the company would be in violation of the law in the *mandatory due diligence* jurisdiction even if it is in compliance with the law in a *mandatory disclosure* jurisdiction. Part C concludes by considering the policy reasons in favor of a mandatory due diligence approach, including Part C concludes by considering the policy reasons in favor of a mandatory due diligence approach, including the inconsistent treatment of third parties within contract ecosystems.

A. Mandatory Reporting Requirements

Most jurisdictions that have adopted supply chain due diligence law have adopted an information disclosure approach as opposed to a mandated due diligence approach. The laws require that companies tell the public about their human rights mitigation approach, for example, but not that they adopt one or that it accords with a particular standard.

The EU's non-financial reporting directive requires that large companies publish regular reports on the social and environmental impacts of their business activities.[119] This law applies to large public-interest companies with more than 500 employees, including listed companies, banks, insurance companies, and other companies designated by national authorities as public-interest entities.[120] Covered companies must report their policies relating to "environmental protection, social responsibility and treatment of employees, respect for human rights, anti-corruption and bribery, [and] diversity on company boards (in terms of age, gender, educational and professional background)." However, these companies are granted significant flexibility in how they report this information and are permitted to choose from a wide variety of reporting guidelines.[121]

In the United States, the California Transparency in Supply Chains Act requires covered corporations to disclose their efforts to ensure that their supply chains are free from slavery and human trafficking, including information about their practices concerning verification, audits, certifications, internal accountability standards and procedures, and training.[122] The law requires that covered companies publish this information on their website if they have one.[123]

Similarly, the UK Modern Slavery Act requires that covered companies provide an annual statement of the measures that they take to eradicate slavery

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Prevention, and Mitigation Act of 2019 may change this status quo by obligating issuers to conduct human rights risk and impact analysis. Corporate Human Rights Risk Assessment, Prevention, and Mitigation Act of 2019, H.R. ___, 116 CONG. (2019).

119 European Commission, *Non-Financial Reporting*, https://bit.ly/2BCgmve.

120 *Id.*

121 *Id.*

122 CAL. CIV. CODE § 1714.43 (West 2012).

123 *Id.*

from their supply chains.[124] Specifically, Section 54 of the Act requires that the statement must be signed and approved by the company's leadership, such as a director or partner.[125] The company must also publish the statement on its website in a prominent place if the company maintains a website.[126]

Section 54 also recommended a number of topics that a statement should include, such as: "its due diligence processes in relation to slavery and human trafficking in its business and supply chains"; "the parts of its business and supply chains where there is a risk of slavery and human trafficking taking place, and the steps it has taken to assess and manage that risk"; and "its effectiveness in ensuring that slavery and human trafficking is not taking place in its business or supply chains, measured against such performance indicators as it considers appropriate."[127] The problem is that most companies provided insufficient information in many of these reporting categories because Section 54 did not *require* that a company statement include this information.[128]

Due to this and other shortcomings, Australia's Commonwealth Modern Slavery Act of 2018 mandates what the UK law only recommended: covered companies (those operating in Australia with an annual consolidated revenue of more than $100 million) *must* report annually on the topics that had been only suggested for disclosure under Section 54 of the UK Modern Slavery Act.[129]

Mandatory disclosure laws seek to change corporate behavior through reputational mechanisms.[130] The idea is that the regulators mandate disclosure of information that corporations would not otherwise share. Stakeholders, such as consumers, who now possess this information discriminate in the market between corporations based on the information that is reported, thereby providing financial penalties (or rewards) for superior or inferior corporate behavior.[131]

The problem is that the UK and California mandatory reporting laws neglected to include a number of features that would enable reputational markets to work effectively. One criticism of the California supply chain law is that it did not provide a public list of the companies that were covered by the law. This gap made it difficult for those who wish to "name and shame" non-compliant companies – such as NGOs – because there was no public list that

124 Virginia Mantouvalou, *The UK Modern Slavery Act 2015 Three Years On*, 81 THE MODERN LAW REVIEW 1017, 1038 (2018).

125 *Id.*

126 *Id.*

127 *Id.*

128 Business & Human Rights Resource Centre, FTSE 100: AT THE STARTING LINE 4-5 (2016)(noting inadequate disclosures among company statements provided by FTSE 100 companies); Business & Human Rights Resource Centre, FTSE 100 & THE UK MODERN SLAVERY ACT: FROM DISCLOSURE TO ACTION 14 (2018)(same).

129 *See, e.g.*, Modern Slavery Business Engagement Unit, Australian Government, COMMONWEALTH MODERN SLAVERY ACT 2018: GUIDANCE FOR REPORTING ENTITIES 39 – 61, (Sept. 26, 2019).

130 *See* Nolan & Boersma, *supra* note __ at 133-34.

131 *See, e.g.*, United Kingdom Home Office, A PRACTICAL GUIDE, *supra* note __ at 6 ("[A] failure to comply with the provision, or a statement that an organisation has taken no steps, may damage the reputation of the business. It will be for consumers, investors and Non-Governmental Organisations to engage and/or apply pressure where they believe a business has not taken sufficient steps.").

identified which companies are required to report.[132] Another criticism is the lack of central repository for company statements provided under the reporting laws.[133] A central repository is important to facilitate comparisons between companies so that stakeholders can identify "leaders and laggards" and provide the appropriate market response.[134] Finally, critics also noted the lack of sanctions for non-compliance that undermines the effectiveness of the reporting regime.[135] The Australian government had the benefit of learning from the experiences in these other jurisdictions and addressed many of these shortcomings when designing their own supply chain law.[136]

These reforms certainly improve the design of reporting requirements. But reporting requirements may only get us so far. These changes do not eliminate fundamental limitations of reputational mechanisms that impede their ability to improve corporate behavior in the supply chain. Perhaps the biggest challenge is whether the audience for the information that is reported under these laws – most prominently, consumers – care enough to impose market sanctions or rewards. Some research into reputational markets suggest not. While there is no doubt that reputational sanctions can levy significant financial costs for corporate misconduct,[137] companies engaging in environmental violations do not suffer similar reputational losses.[138] One explanation for this difference is that corporations suffer reputational losses when its exchange partners, such as consumers or investors, alter the terms of the exchange, often because of a fear of opportunism. Under this explanation, the reputational sanction is only wielded by these exchange partners. Environmental harms, however, "impose costs on parties other than those with whom the polluting firm does business."[139] Exchange partners are not directly affected by the firm's misconduct and are therefore less likely to sanction the firm.[140] This insight not only raises concerns about the efficacy of "naming and shaming" relating to environmental misconduct but also other types of social impact, such as human rights abuses in the supply chain. In these situations, those wielding the

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132 Know The Chain, FIVE YEARS OF THE CALIFORNIA TRANSPARENCY IN SUPPLY CHAINS ACT 5 (Sept. 30, 2015).

133 *See, e.g.*, Joint Standing Committee on Foreign Affairs, Defence, and Trade, Parliament of the Commonwealth of Australia, MODERN SLAVERY AND GLOBAL SUPPLY CHAINS: INTERIM REPORT OF THE JOINT STANDING COMMITTEE ON FOREIGN AFFAIRS, DEFENCE, AND TRADE'S INQUIRY INTO ESTABLISHING A MODERN SLAVERY ACT IN AUSTRALIA (Aug. 2017), ¶ 2.28.

134 *See id.*; Amy Sinclair & Justine Nolan, *The Australian Modern Slavery Act 2018 – will it live up to expectations?*, Bus. & Human Rights Resource Centre (Jan. 12, 2018).

135 United Kingdom Secretary of State for the Home Dep't, INDEPENDENT REVIEW OF THE MODERN SLAVERY ACT 2015: FINAL REPORT ¶ 2.5 (May 2019).

136 Joint Standing Committee on Foreign Affairs, Defence, and Trade, Parliament of the Commonwealth of Australia, HIDDEN IN PLAIN SIGHT: AN INQUIRY INTO ESTABLISHING A MODERN SLAVERY ACT IN AUSTRALIA (Dec. 2017), ¶ 1.10 ("[A] key question for this inquiry was to examine the effectiveness of the UK's Modern Slavery Act 2015 (UK Act) and assess whether similar or improved measures could be introduced in Australia.").

137 *See* Soltes, *supra* note ___ at 1005.

138 *Id.*

139 Jonathan Karpoff, *Does Reputation Work to Discipline Corporate Misconduct?* i*n* THE OXFORD HANDBOOK OF CORPORATE REPUTATION 362 (Barnett & Pollock (eds) 2012).

140 *Id.*

reputational sanctions – often consumers – do not internalize the costs of wrongdoing; the identities of the injured and the sanctioner diverge, unlike in situations of financial misconduct where reputational sanctions are high since the party who internalizes the cost of wrongdoing is also the party who wields reputational leverage.

B. Mandatory Due Diligence Requirements

Mandatory due diligence laws differ from mandatory disclosure laws because they require that companies take specific due diligence steps; reporting on what they do (and do not do) is not enough. Much of the basis for legislative action on human rights due diligence traces back to the United Nations Guiding Principles on Business & Human Rights, which states that businesses have a "responsibility to respect human rights,"[141] and, as part of that responsibility, businesses should have in place a "human rights due diligence process to identify, prevent, mitigate and account for how they address their impacts on human rights."[142] A company's responsibility for due diligence includes evaluating: (a) the "country contexts in which their business activities take place, to highlight any specific human rights challenges they may pose," (b) "human rights impacts their own activities may have within that context—for example, in their capacity as producers, service providers, employers, and neighbours," and (c) "whether they might contribute to abuse through the relationships connected to their activities, such as with business partners, suppliers, State agencies, and other non-State actors."[143] Appropriate due diligence requires formulating a firm-specific human rights policy, impact assessments, integration of the human rights policy throughout the firm, and tracking performance through monitoring and auditing.[144] These UN guidelines have, in turn, influenced best practices and manuals produced by the OECD,[145] the International Bar Association,[146] and the American Bar Association,[147] among other organizations.

Despite these endorsements, there is only one jurisdiction to date that mandates a *general* due diligence requirement concerning human rights: France. The French Vigilance Law establishes "a legally binding obligation for parent companies to identify and prevent adverse human rights and environmental impacts resulting from their own activities, from activities of companies they

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141 *See* U.N. HUMAN RIGHTS OFFICE OF THE HIGH COMM'R, GUIDING PRINCIPLES ON BUSINESS AND HUMAN RIGHTS (2011).

142 *Id.* at 15-16.

143 *See Protect, Respect and Remedy*, *supra* note ___, at ¶ 57.

144 *Id.* ¶¶ 59–63; *see also* Working Group on the issue of human rights and transnational corporations and other business enterprises, *The report of the Working Group on the issue of human rights and transnational corporations and other business enterprises*, U.N. Doc. A/73/163 (July 16, 2018), at 4-6.

145 OECD, OECD GUIDELINES FOR MULTINATIONAL ENTERPRISES 3 (2011), https://bit.ly/1kPDOqW (introducing a new chapter on human rights).

146 INT'L BAR ASS'N, IBA PRACTICAL GUIDE ON BUSINESS AND HUMAN RIGHTS FOR BUSINESS LAWYERS 7 (2016), https://bit.ly/2CPnLUK.

147 Debra Cassens Weiss, *ABA House Considers Human Rights Responsibilities of Corporations*, ABA JOURNAL (Feb. 6, 2012).

control, and from activities of their subcontractors and suppliers, with whom they have an established commercial relationship."[148] What is most notable about this law is the prospect for legal fines; under this law, "the judge can impose a fine up to 10 million euros."[149] Soon, France may not be alone. Similar mandatory due diligence laws have been proposed or considered in at least 13 other countries, and the European Commission is also considering an EU-wide equivalent.[150]

While other jurisdictions may lack a *general* duty diligence requirement, a number of laws around the world require that companies engage in due diligence in particular industries or risk areas. In the United States, the Federal Acquisition Regulations includes specific requirements regarding compliance programs addressing human trafficking. The 2015 amendments "add a requirement for many contractors to implement trafficking compliance plans and to certify the absence of any trafficking activities every year."[151] Specifically, "compliance plan is required for any portion of a contract with an estimated value in excess of $500,000 for supplies acquired outside the United States or for services performed outside the United States."[152] These compliance plans must also meet certain requirements such as an awareness plan; process for employees to report violations; recruitment, wage and housing plans, and procedures for preventing, monitoring, detecting, and sanctioning incidents of human trafficking.[153] Federal contractors, their subcontractors, and employees are also prohibited from engaging in labor practices that contribute to human rights violations, such as denying employees access to their identity or immigration documents, recruiting practices that rely on misleading or fraudulent practices, and charging recruitment fees, among other practices.[154]

Additionally, the 2015 Dodd Frank Conflict Minerals Rule requires that "[i]f tin, tantalum, tungsten or gold is necessary to the functionality or production of a product manufactured or contracted to be manufactured by a U.S. public company registrant, it must conduct a 'reasonable country of origin inquiry' to determine whether the necessary 3TG minerals in the product originated in the Democratic Republic of the Congo or an adjoining country."[155] In situations where "the minerals originated outside of the DRC region or are from recycled or scrap sources, the registrant is required to disclose on Form SD its determination and describe its reasonable country of origin inquiry and the related results."[156] "If the registrant knows or has reason to believe that necessary 3TG minerals are from the DRC region, it must conduct enhanced

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148 Conrad *et. al*, *supra* note __ at 89-90.
149 *Id.*
150 BIICL *et al.*, STUDY ON DUE DILIGENCE REQUIREMENTS THROUGH THE SUPPLY CHAIN, *supra* note ___ at 17, 41.
151 Lyndsey Conrad *et. al.*, *Mandated Corporate Responsibility for Human Trafficking: New Federal Acquisition Regulation Steps Up Supply Chain Accountability*, 60 ST. LOUIS UNIV. L. J. 73, 87 (2015)(internal citations omitted).
152 Conrad *et. al*, *supra* note __ at 89.
153 Conrad *et. al*, *supra* note __ at 89-90.
154 Assent Compliance, HUMAN TRAFFICKING, SLAVERY, AND YOUR SUPPLY CHAIN, at 8.
155 Michael Littenberg & Nellie Binder, CORPORATE SOCIAL RESPONSIBILITY DISCLOSURE AND COMPLIANCE: AN OVERVIEW OF SELECTED LEGISLATION, GUIDANCE AND VOLUNTARY INITIATIVES, 1 (Aug. 2019).
156 *Id.*

due diligence and file a separate Conflict Minerals Report exhibit to its Form SD, detailing the measures taken to exercise due diligence on the source and chain of custody of the minerals and information concerning the processing facilities, the country of origin and the efforts to determine the mine or location of origin."[157]

In 2019, the Netherlands Child Labor Due Diligence Act introduced a duty of care for companies to prevent the supply of goods and services rendered through child labor.[158] Companies are required to produce both a disclosure statement and "to investigate whether a reasonable suspicion exists that a good has been produced using child labor." If the company finds that "a reasonable suspicion does exist, then the company has a duty to create and implement a plan of action to address it."[159] The Dutch Child Labor Act also creates criminal liability for companies who fail to meet their obligations.[160] For example, if a company repeatedly commits the same violations within five years, it not faces the prospect of increased fines but its directors may be held personally liable and imprisoned up to two years.[161]

C. *The Case for Mandatory Due Diligence*

These approaches present two different ways to protect third parties from contract externalities. Mandatory disclosure laws rely heavily on reputational mechanisms to change corporate behavior, whereas mandatory due diligence laws rest upon legal mechanisms (including legal sanctions) to change corporate behavior. While the former approach has been popular, adopted in the United States, United Kingdom, and Australia, there is increasing support among actors, around the world, for mandatory due diligence laws for a number of reasons.

First, mandatory reporting requirements don't seem to work well to improve corporate behavior.[162] A significant number of companies are still not complying with the disclosure requirements in place – an outcome that is not surprising given the weak sanctions available for non-compliance.[163]

And even if companies are improving their *reporting*, they are *not* improving their underlying *practices*, which is the goal of the reporting regime. According to the Corporate Human Rights Benchmark (CHRB), nearly one half of the 200 global companies assessed in 2019 scored zero across all indicators related to

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157 *Id.*

158 Kornel Osthoorn, *The Netherlands Adopts Business and Human Rights Legislation to Combat Child Labor*, LEXICOLOGY (Feb. 4, 2020), https://bit.ly/2XTNXrV.

159 Jones Day, WHITE PAPER: LABOR TRAFFICKING IN CORPORATE SUPPLY CHAINS— WHERE WE ARE NOW (Dec. 2019), at 2.

160 *Id.* at 2.

161 *Id.* at 2.

162 Clean Clothes Campaign et al., *A call for EU human rights and environmental due diligence Legislation*, (Oct. 3, 2019), at 2.

163 *See, e.g.*, Business & Human Rights Resource Centre, MODERN SLAVERY IN COMPANY OPERATION AND SUPPLY CHAINS 13 (Sept. 2017)(compiling summaries of analyses of company statements under mandatory disclosure laws).

human rights due diligence.[164] These indicators are important because they focus on the specific systems a company has in place to perform human rights risk assessment, prevention, mitigation, tracking, and communication with stakeholders.[165] The CHRB report also found that many companies are not improving their practices over time, thus "indicating that there have been insufficient incentives for them to change."[166] The United Nations Working Group similarly found that current shortfalls in company practices include: (a) inadequate consultation with stakeholders, including vulnerable groups; (b) "tick the box" approaches to reporting; (c) failure to consider human rights impacts beyond tier one suppliers; and (d) focus on reaction to crises than investment in adequate prevention.[167] Instead, according to a survey of businesses, the most common due diligence tools are training on human rights or environmental impacts, use of contractual codes of conduct, and audits.[168] Each of these tools is fraught with problems relating to accuracy, effectiveness, and relevance; companies that rely primarily, or exclusively, on these tools are severely limiting the operation of their human rights due diligence processes.[169] Even the business sector has reported dissatisfaction with the current regulatory landscape on supply chain human rights due diligence, finding it is "not effective, efficient, and coherent."[170]

Second, numerous stakeholders believe that mandatory due diligence laws will address many of the weaknesses of the status quo. A study commissioned by the European Commission surveyed hundreds of businesses and civil society organizations to identify incentives for improved corporate human rights due diligence practices. Civil society organizations put their faith in regulation, especially those that provide for fines or sanctions, judicial oversight, and legal claims by those affected.[171] While the business sector did not agree, placing very little weight on incentives for change offered through regulation or litigation,[172] business respondents did identify reputational risk as the top incentive for due diligence and acknowledged that a mandatory due diligence law could help them to reduce reputational risk.[173] Some businesses may also prefer mandatory due diligence in order to level the playing field and to avoid the "first mover challenge" that occurs when businesses that "transparent about risks and challenges are criticized for not doing enough whereas less responsible competitors go below the radar of NGOs and journalists."[174] Naming and

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164 Corporate Human Rights Benchmark, 2019 KEY FINDINGS 8 (Nov. 2019).

165 *Id.*

166 The CHRB report also did find that a number of companies did improve practices, especially when they have been repeatedly assessed. *Id.* at 8.

167 Working Group on the issue of human rights and transnational corporations and other business enterprises, *The report of the Working Group on the issue of human rights and transnational corporations and other business enterprises*, U.N. Doc. A/73/163 (July 16, 2018), at 8-9; BIICL Study, *supra* not ___ at 63-67.

168 BIICL Study, *supra* not ___ at 63-67.

169 *See, e.g.*, BIICL Study, *supra* not ___ at 72-74 (discussing problems with audits).

170 *Id.* at 94.

171 *Id.* at 89.

172 *Id.* at 89.

173 BIICL Study, *supra* not ___ at 22, 89.

174 Working Group on the issue of human rights and transnational corporations and other business enterprises, *The report of the Working Group on the issue of human rights and transnational corporations and other business enterprises*, U.N. Doc. A/73/163 (July 16, 2018), at 10.

shaming tactics also have limited effectiveness across companies and are usually deployed against those companies that sell directly to consumers.[175] The consequence is that some companies, whether due to conviction or pressure, will undertake human rights due diligence while others will not, thereby incurring higher costs compared to their peers. A mandatory human rights due diligence requirement "levels the field" among companies so that companies do not suffer the same competitive effects from "doing more" than their peers.[176]

There is yet another reason for mandatory due diligence laws: reconciling the inconsistency at the heart of contract law regarding the status of third parties. As discussed further in Section IV, *infra*, not all parties to a contract are equally visible. Indeed, many contracts depend upon the invisible labor of a variety of actors who are not signatories to those contracts. Their labor reduces the cost of contracting and even enables contracts that might not have been. They form the ecosystem in which contracting occurs. Despite these benefits, society largely ignores their role in contracting, rarely affording them participation rights in contract design *ex ante* or legal rights for remedies *ex post*. Mandatory due diligence laws offer a means of addressing these contract inequalities because contracting parties would be obligated to consider the impact of their actions on these parties and to take steps to prevent and mitigate those harms. As such, viewing contracts as ecosystems offers another basis for the switch to mandatory due diligence.

V. CONTRACT AS ECOSYSTEM: RECOGNIZING THIRD PARTIES IN EXCHANGES

The previous sections explained the many ways in which third parties are treated as contract "outsiders." In contrast, this section explains the many ways in which third parties are contract insiders because of the multitude of benefits they provide to contracting parties – enabling contracts that may not even occur otherwise.

Part A delves deeper into the inconsistent status of third parties in contracts as both "insiders" and "outsiders." It explains how when it comes to harms, third parties are treated very much as outsiders even while third party institutions are integral to the exercise of contracting. Part B illustrates how the "outsider" status of third parties is inappropriate given the multiple benefits they bring to exchanges, such as by reducing transaction costs by creating social preferences for pro-contractual behavior, improving information flows, and decreasing the risk of opportunism. These institutions also help parties reduce search and information costs by screening potential exchange partners and establishing codes of ethics that govern party behavior, thereby permitting one party to predict the risk of opportunism posed by another. Third party institutions reduce opportunism by increasing and re-distributing the losses that a party may

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175 BIICL Study, *supra* not ___ at 90.

176 *Id.* at 22. A concern with levelling the playing field also motivated businesses to support reporting requirements under Section 54 of the United Kingdom Modern Slavery Act. *See* Joint Standing Committee on Foreign Affairs, Defence, and Trade, INTERIM REPORT, *supra* note ___ at ¶¶ 2.41, 3.20.

suffer from cheating. Finally, third party institutions re-distribute losses from opportunism from the opportunistic party to his or her family or social circle. By reducing search and information costs, improving information flows, and magnifying and re-distributing losses, these third party institutions enable parties to exchange even at lower cost than they might have done otherwise.

A. Insiders v. Outsiders in Contracts

What does the plight of third parties in supply contracts tell us about the status of third parties in contracts generally? After all, the risks of externalities – and the limits of managing them – are encountered by a variety of third parties under a variety of contracts. A multitude of contracts have the prospect of harming us even if we have no say in the underlying bargain. Supply chain contracts are illustrative of the vulnerabilities third parties experience but do not exhaust the scenarios in which these externalities may arise. Instead, they illustrate broader challenges experienced by third parties in contract. First, they illustrate the unfortunate reality that rights do not track harms. While third parties – such as consumers, laborers, and communities – may suffer harms from conduct under supply contracts, the fact of those harms does not furnish them with legal rights at the bargaining table or in the courtroom.

Second, the exclusion of third parties from legal rights reveals differential treatment among those affected by contracts. Contracting parties are enabled to assert rights whereas third parties do not yet have a legal vocabulary that expresses their interests or provides them with remedies. This differentiation in legal rights suggests a demarcation or boundary in contracts between insiders (contracting parties) who are allowed to assert legal rights and outsiders (third parties) who are left without remedy.

The review of the case law in Section II, *supra*, suggests this demarcation in several ways. For example, despite the nature and severity of third-party externalities, courts consistently rule that there is no obligation that multinational corporations owe these third parties. Additionally, courts reject the claim that the third parties are beneficiaries of the promises exchanged under the transaction and, as such, these promises do not extend to them. Finally, by dismissing these lawsuits, our laws limit the parties who can assert contract rights and the types of harms that may be addressed. Specifically, contract litigation usually involves a breach of the underlying contract or contracts. The limitations are two-fold: As discussed above, courts do not allow third parties to assert breach of contract claims even if they were harmed by the breaches. More fundamentally, what happens if a third party wanted to assert claims based on Type I externalities, i.e. – that the third party was harmed not because of a breach but because the contract was performed exactly as designed?

This "outsider" status of third parties is as disturbing as it is puzzling. The puzzle is that the courts treat third parties as outsiders in contract even when third parties are important, even vital, to the activity of contracting. Contracts may not even get off the ground without the important roles that these third parties perform. For example, as discussed in Section IV(B), *infra*, third party institutions reduce market transaction costs associated with exchanging, such as

the costs associated with search, information gathering, negotiation, decision-making, drafting, monitoring, and enforcement. Third party institutions also reduce opportunism by increasing and re-distributing the losses that a party may suffer from cheating. Finally, third party institutions re-distribute losses from cheating from the cheater to the cheater's family or social circle.

B. How Do Third Parties Benefit Contracting Parties?

What follows is an illustrative but not exhaustive discussion of the many institutions that third parties create and the functions these institutions provide. Institutions are "the humanly devised constraints that shape human interaction" and "include any form of constraint that human beings devise to shape human interaction."[177] Institutions can include formal rules, such as laws, as well as informal ones, such as codes of conduct.[178] The purpose of an institution is to provide guidance on how to behave when we interact with other people.[179]

Institutions are often confused with a related but distinct concept: *organizations*. If institutions are the rules, then organizations are the players: political parties, religious groups, universities, intramural sports teams, community choral societies, etc.[180] Each of these organizations typify "groups of individuals bound together by some common objective[]."[181] The combination of institutions and organizations around us structure the choices we make daily, encouraging us toward some forms of behavior while deterring us from other.[182]

For the purpose of this Section, a "third party institution" refers to "rules of the game" established, maintained, and enforced by parties other than the participants in an exchange relationship; in the familiar contracts setting, third parties are non-signatories to the contracts. A "third party organization" is a grouping of individuals who are not participants in the exchange. The dividing line between exchange participants or contract signatories, on the one hand, and third parties, on the other, is not clear or fixed. After all, exchange participants are also members of our society, so help to maintain the "third party institutions" discussed below. The point is that while exchange participants may contribute to the operation of these institutions, they cannot maintain these institutions alone; instead, they need the assistance of parties not part of their exchange to maintain these institutions. These institutional services discussed below are some of the major contributions that third parties provide to contracting ones. What benefits do third party institutions provide to contracting parties? The following section discusses two main sets of

177 Douglass C. North, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 4-5 (1990).
178 *Id.* at 5.
179 *Id.* at 6.
180 *Id.* at 5.
181 Douglass C. North, UNDERSTANDING THE PROCESS OF ECONOMIC CHANGE 60-61 (2005).
182 *Id.*

advantages: *lowering transaction costs ex ante*, and (or, because of) *lowering risk of opportunism ex post*.[183]

Third Party Actors	Third Party Institutions	Institutional Functions	Contractual Advantage
Kinship groups	Kinship Institutions	• Provides credible information regarding the likelihood of opportunism by potential exchange partners	• Lowers *ex ante* information costs with selecting exchange partners
Trade associations	Merchant Law	• Provides background sets of norms and expectations with which to identify parties who cheat	• Reduces transacting costs by supporting incomplete contracts
Ethical communities	Social Preferences	• Preferences for trustworthiness, reciprocity, fairness, and prohibitions on falsehoods regarding others	• Reduces risk of opportunism • Lowers information costs by improving accuracy of information
Communities	Club goods	• Bonds social relationships to business conduct	• Increases losses from opportunism (adds social losses to economic losses) • Re-distributes losses from opportunism (from merchant to family)
Communities	Inter-generational reputational capital	• Expands time horizon for reputational capital	• Re-distributes losses from opportunism (from merchant to family)
Communities Trade associations	Coordinated punishment	• Magnifies losses of opportunism through collective sanctions	• Increases losses from opportunism by aggregating exchanges with collective
Trade associations	Private dispute resolution Information networks	• Generates accurate reputation-relevant information • Transmits information across great distances with limited number of nodes	• Supplies credible and public information that facilitates reputational mechanisms and collective punishment

Table 3: Advantages of Third Party Institutions for Contracting Parties

1. Lowering Transaction Costs *Ex Ante*

Consider the risks associated with contractual uncertainty when two parties are strangers to each other. To proceed with the exchange, a party will likely engage in at least two types of costly activities to protect itself against the risk of

183 *See, e.g.*, Ronald Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1, 15 (1960)("In order to carry out a market transaction it is necessary to discover who it is that one wishes to deal with, to inform people that one wishes to deal and on what terms, to conduct negotiations leading up to a bargain, to draw up the contract, to undertake the inspection needed to make sure that the terms of the contract are being observed, and so on. These operations are often extremely costly, sufficiently costly at any rate to prevent many transactions that would be carried out in a world in which the pricing system worked without cost.").

breach or other misconduct by the other: *information gathering* regarding the other's propensity for opportunism,[184] and *negotiating and drafting* a more complicated contract sufficiently detailed to identify noncompliance and provide remedies and other protections.[185] Third party institutions assist both these functions by lowering *ex ante* information costs by providing organizations, networks, and norms that improve the production and accuracy of information regarding potential exchange partners. Third party institutions also provide background rules against which parties contract, thereby reducing the burden to "spell everything out."

The first set of benefits that third party institutions provide is to reduce the information costs of screening potential exchange partners. After all, how does one party know whether the other party will honor their side of the bargain? Forming an opinion on that likelihood requires information and this information-gathering comes at a cost. In some situations, the cost may be too high relative to the expected value of the exchange, resulting in the trader foregoing exchanging with the unknown trader (loss of trade relationship) or, perhaps, foregoing the exchange entirely (loss of trade). In other situations, the trader may go ahead with the exchange but only after investing in costly information gathering that will cut into the trader's gains from exchange. Finally, the trader can address the risks posed by the unknown counterparty through contract design with provisions addressing opportunism; however, this will also lead to additional costs with complicated contract design *ex ante*.

Kinship networks help to reduce these costs by providing low cost credible information regarding risk of opportunism by different traders at varying levels of social distance.[186] These predictions are based on shared norms and values, such as a code of ethics, that governs those traders. In a study of ethnically homogenous middlemen, the standard of conduct was provided by the Confucian code of ethics.[187] This code allowed traders to form reliable expectations about the risks of exchanging with different types of partners at varying levels of social distance from themselves: near and distant kin, clan, village, ethnicity, and nationality.[188] These expectations are provided by the shared code of ethics that established guidance regarding how one trader will treat another based on social distance.[189] Kinship institutions thereby facilitate exchange in situations when they might not otherwise occur because of the high level of contract uncertainty, on the one hand, and an ineffective legal framework, on the other.[190] Associational membership also serves as a screening

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184 *See, e.g.*, Erik G. Furubotn & Rudolf Richter, INSTITUTIONS AND ECONOMIC THEORY: THE CONTRIBUTION OF THE NEW INSTITUTIONAL ECONOMICS 52 (2005)("[P]otential traders must search each other out, and, once such interested parties have made contact, they must try to find out more about each other. Specifically, each has to determine who the other party is and whether he is willing and able to live up to any agreement that may be reached.").

185 FURUBOTN & RICHTER, *supra* note ___ at 52 ("Negotiations are needed to find an efficient exchange relationship and to establish the detailed conditions of the exchange. Quite possibly, there may be a need to provide legal safeguards.").

186 Landa, *supra* note __ at 359-360.

187 *Id.* at 358

188 *Id.* at 352.

189 *Id.*

190 Landa, *supra* note __ at 349.

device that parties may use when searching for another party with whom they may want to exchange.[191]

Third parties develop certain types of social preferences that can help reduce information costs by decreasing the likelihood that individuals will crowd the marketplace for information with misinformation.[192] Third parties also develop social preferences for trustworthiness,[193] fairness,[194] and reciprocity that are advantageous to the activity of exchanging.[195] For example, the preference for trustworthiness reduces the risk that a party sharing that preference will engage in opportunism because they will experience some level of loss by engaging in that action. Similarly, parties often value reciprocity independent of outcomes because of the qualities that reciprocity reveals about the character of the exchange parties; these perceived qualities can then help one exchange partner predict how the other will treat them in the future.[196]

Next, third parties developed institutions that allowed contracting parties to utilize incomplete contracts and thereby economize on contract drafting costs *ex ante*. Much like the modern Uniform Commercial Code, the merchant law developed by trade associations relieved the burden on parties to "spell everything out."[197] In a historical example, the Maghribi traders of the 11th century faced high negotiation and drafting costs given the poor state of technology and vast distances of trade. The use of the merchant law reduced these costs because it provided a significant baseline of norms and expectations upon which the parties exchanged, reducing the need to rely on detailed contracts.[198] Not only did this law facilitate the use of incomplete contracts, it also provided the traders a means of identifying cheaters despite the use of incomplete contracts.[199] Without the aid of the Merchant Law, it would have proven difficult to identify cheaters and honest traders because incomplete contracts did not specify sufficient details to ascertain breach.[200] In the 20th century, the trade rules of the American cotton industry similarly reduced "negotiation costs, specification costs, information costs, [] and relational costs [] of contracting, as well as the risk of transaction breakdown."[201]

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191 *Id.*; Bernstein, *supra* note __ at 1765.

192 Richman, *supra* note ___ at 402.

193 W. Bentley MacLeod, *Can Contract Theory Explain Social Preferences?* 97 AM. ECON. REV. 187, 187 (2007).

194 *See* Robert E. Scott, *A Theory of Self-Enforcing Indefinite Agreements*, 103 COLUM. L. REV. 1641, 1667 (2003).

195 Linda D. Molm, Gretchen Peterson & Nobuyuki Takahashi, *In the Eye of the Beholder: Procedural Justice in Social Exchange*, 68 AM. SOC. REV. 128, 150 (2003); Elizabeth Hoffman, Kevin A. McCabe & Vernon L. Smith, *Behavioral Foundations of Reciprocity: Experimental Economics and Evolutionary Psychology*, 36 ECON. INQUIRY 335, 350 (1998).

196 *See* Molm, Peterson & Takahashi, *supra* note ___, at 148-49; Scott, *supra* note __ at 1667.

197 Avner Greif, *Contract Enforceability and Economic Institutions in Early Trade: The Maghribi Traders' Coalition*, 83 AM. ECON. REV. 525, 526 (1991); Bernstein, *supra* note __ at 1726.

198 Greif, *supra* note __ at 542.

199 *Id.*

200 *Id.* at 542.

201 Bernstein, *supra* note __ at 1741-42.

2. Lowering risk of opportunism *ex post*

Third party institutions discourage parties from engaging opportunistically *ex post* by improving information flows between individuals; therefore, potential cheaters know that future exchange partners will learn about their conduct. When such information is accompanied by coordinated punishment, potential defectors will likely resist the temptation to act opportunistically because of the prospect of losing future exchanges with other parties. Through such coordinated punishment, third party organizations magnify the potential losses from non-compliance. They also magnify the potential losses by binding business relationships with social position, so that misconduct in one sphere of a merchant's life has consequences for another. Finally, third party institutions re-distribute losses from the potential cheater to those in their personal circles, thereby providing additional inducements for cooperation.

First, third party institutions deter opportunism by magnifying losses from noncompliance. For example, one classic explanation for contractual compliance is that a party will refrain from opportunism when the present value of future gains from exchange (long-term benefits) outweigh the short-term gains from opportunism (short-term gains).[202] Problems arise when the short-terms gains from cheating exceed the long-terms gains of exchange with the same partner. In some situations, an exchange partner may be unable alone to surmount the gains from cheating. However, third parties acting collectively can increase the losses associated with cheating through coordinated punishment, binding social and business lives, and re-distributing losses.

Coordinated punishment occurs when third parties respond collectively to acts of cheating against one of their members. In a simple example, consider an exchange between parties X and Y in a situation where X's short term gains from cheating are greater than the present value of long term gains from exchanging with Y in the future. Even though the prospect of losing Y's future business may not be enough to deter X from cheating in the present, the cost-benefit analysis changes when the other members of the trade coalition or association also threaten to refrain from exchanging with X if X cheats Y. By threatening to ostracize X, the other trade members add the value of future exchanges with them to the cost-benefit analysis, thereby magnifying the losses associated with cheating and outweighing the short-term gains from cheating.[203]

In order for coordinated punishment to deter opportunism, those engaging in the punishment must have access to information regarding the conduct of the cheater. This depends on three separate information functions: *production, verification,* and *transmission*. Third parties provide institutions that serve each of these functions.

For example, private dispute resolution mechanisms may be very effective at generating information needed for punishment to occur. Critically, these mechanisms *may* provide sanctions but do not need to do so in order to prove effective; instead, sanctions are often provided by community or trade members

202 *See, e.g.*, Richman, *supra* note __ at 393.

203 Greif, *supra* note __ at 537; Richman, *supra* note __ at 400; Bernstein, *supra* note __ at 1764.

who respond to the information that the private dispute panel reveals.[204] For example, in the diamond industry, the New York Diamond Dealers Club's (DDC) private arbitration system "is wholly incapable of enforcing agreements on its own and is toothless in punishing diamond theft."[205] Instead, "the DDC's role is purely informational, and the power of its dispute resolution system rests on the degree to which it supports trust-based exchange and can foreclose future transactions to uncooperative merchants. The DDC fulfills this role by facilitating information exchange and publicizing individual reputations."[206]

Private dispute resolution is not only valuable for information production but also verification. Information revealed through dispute mechanisms tend to be viewed as more accurate, thereby reducing the need for independent verification processes and additional information gathering.[207] Other third party institutions also served important information production and verification functions, such as the prohibitions against lying (reducing the need to verify) and associational memberships that served screening functions.

Information production is only part of the challenge; once the information is gathered, how is it transmitted across the distances in which exchanging may occur? Here, third party institutions also operate to facilitate exchanges by creating *information networks*. Specifically, connections between communities and trade groups in different areas can aid in the transmission of reputation-relevant information.[208] Finally, the prospect for magnification and re-distribution of losses depends on information flows. Formal institutions, such as private dispute resolution mechanisms, can both generate and publicize information regarding a merchant's misconduct. These institutions do not need to supply the sanctions; instead they trigger them by invoking certain responses from the broader community or trade organizations.[209] Even informal institutions play an important role through information networks like gossip clubs or interpersonal ties that can transmit information across distances both modest and great.

These information networks deter opportunism by making the threat of sanctions credible. After all, a potential cheater engaging in opportunism that is difficult to detect, verify, or publicize may think: "Yes, but you have to learn of it first to punish me." Without information, there is no punishment; and without punishment, there is a higher risk of cheating. Information networks counteract the temptation to cheat by allowing a potential cheater to know that his acts will be detected and broadcast to all his potential future trading partners.

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[204] Paul R. Milgrom, Douglass C. North, and Barry R. Weingast, *The Role of Institutions in the Revival of Trade: The Law Merchant, Private Judges, and the Champagne Fairs*, 2 ECON. & POLITICS 1, 19 (1990).

[205] Richman, *supra* note __ at 397.

[206] *Id.* at 397-398 ("The DDC's system of arbitration and information exchange thus sets the stage for other family and community-based institutions to enforce the industry's executory contracts; if the DDC announces the verdict, then these complementary institutions are the sheriffs that enforce it.").

[207] Bernstein, *supra* note __ at 1768-89.

[208] Lisa Bernstein, *Contract Governance in Small-World Networks: The Case of the Maghribi Traders*, 113 NW. U. L. REV. 1009, 1022-1023 (2019).

[209] Even legal institutions rely upon signaling certain types of information to the public who will respond in certain ways, such as through collective enforcement. Frederica Carugati, Gillian K. Hadfield & Barry Weingast, *Building Legal Order in Ancient Athens*, 7 J. LEGAL ANALYSIS 291, 308 (2015); *see also* Gillian K. Hadfield & Barry Weingast, *What is Law? A Coordination Model of the Characteristics of a Legal Order*, 4 J. LEGAL ANALYSIS 471, 474 (2012).

Thereby, by cheating, he does not only risk his relationship with the merchant he is cheating but all the other merchants as well.

By deterring opportunism through third party institutions such as coordinated punishment and information networks, communities and trade associations reduce the risks that a non-cheating party may encounter in an exchange and reduces the costs that the party may need to incur in order to protect against risk of opportunism.

Community club goods also magnify the losses associated with noncompliance.[210] Communities may confer status upon individuals that the latter would not jeopardize through noncompliance. For example, in New York's diamond industry, brokers and cutters would normally pose a significant threat to exchange because of the significant short-term gains of opportunism (high value of diamonds), high-level of informalities in exchange, and limited future returns from future exchanges given their low wages.[211] However, one reason that some diamond brokers and cutters do not flee with the diamonds is because of the value of excludable community goods that would be denied to them following opportunism.[212] Membership may also provide a sense of belonging and identity to an association's participants such that they would not risk breaching the association's relevant institutions – religious norms, Confucian ethics, merchant law – if such behavior would result in ostracism or expulsion. Through these various means, community institutions increase the losses resulting from noncompliance and thereby deter opportunism; the interdependence between social and business institutions increased the risk that conduct within one arena may reverberate in the other.

The bonding of social and business relationships also leads to the creation of inter-generational reputational capital, which deters opportunism by re-distributing losses from noncompliance. If reputational capital only belonged to the individual merchant (with no transferability prospects), then that reputational capital would only incentivize the merchant's good behavior for the duration of the merchant's career. This creates the risk that the merchant may engage in opportunism near the end of the career when the merchant does not anticipate future exchanges; after all, what does the merchant need a good business reputation for at that point?[213] However, the time horizon for the value of reputational capital is extended through transferability of that capital to a child or other family member, thereby re-distributing the potential gains and losses from opportunism to the merchant's family members.[214]

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210 Richman, *supra* note ___ at 405 ("Club goods are available only in the club, only club members can consume club goods, and each member of the club experiences externalities from every other member's behavior. Consequently, club members strive to obtain club goods just as they would standard goods, and relatedly, the club (or community) will manipulate the consumption of club goods in order to induce behavior that is desirable to the club.").

211 Richman, *supra* note ___ at 405.

212 Richman, *supra* note ___ at 408.

213 Richman, *supra* note __ at 403.

214 Greif, *supra* note __ at 533; Richman, *supra* note __ at 403; Bernstein, *supra* note __ at 1770.

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VI. NORMATIVE IMPLICATIONS: THREE OBJECTIVES TO HONOR

The analysis of exchanges in Section IV, *supra*, reveals that third parties are not outsiders in contracts but very much insiders who provide integral institutional functions to contracting parties. This "insider" status carries with it normative significance concerning how third parties should be treated. This section explains three normative implications that result from a vision of a contract as an ecosystem:

(a) *Objective 1*: If third parties are insiders within a contract ecosystem, they should be *protected from the types of harms* that other contract insiders – contracting parties – choose to address;

(b) *Objective 2*: If third parties are insiders within contract ecosystems who should be protected from harm, then we must incentivize those who are agents of those harms – contracting parties – to avoid those actions through *contract design* by asking: what would the contracting parties have bargained for in the contract if *they* were the ones who confronted the risks of harm, and

(c) *Objective 3*: If third parties are part of the contract ecosystem who are entitled to contract protections outlined in (b), then we must provide *legal sanctions* for those contracting parties who fail to do so.

Parts A-C expand on each of these three objectives to explain how each results from a vision of contracts as ecosystems.

A. Objective 1: Protection from Harm

The first implication is that third parties should be protected from negative externalities generated by the contract that the contracting parties themselves would have addressed had they been the ones at risk. This implication results from the moral equality of all contract insiders that defies placing the interests of some over others. The ecosystem view reveals that both contracting parties and third parties co-exist within contracts but we generally pay attention to the rights and interests of the former. We preserve this view even while it becomes increasingly difficult to ignore the harms that this latter category of actors confront from contracting relationships.

If both group of actors are present within contract ecosystems, it is difficult to justify a situation where one group (contracting parties) is empowered to protect itself from the harms of contract activities while the other (third parties) is not. What normative lens justifies this differentiation that results in us prioritizing the vulnerabilities of some within the ecosystem but not others? Certainly, the latter have the ability to address these risks while they former do not (as yet); however, this is an observation of current realities and does not

reflect a normative evaluation of their status within contract ecosystems. The fact that third parties *cannot* protect themselves from harm does not mean that they *should* not be able to do so. This gap only illustrates the limitations of the law.[215] For this observation to serve as a guide on the moral equality of the parties or the priorities of their harms is to doubly-wound those marginalized in contracts: First, the law ignores their plight and, second, our imagination constricts to reflect those same limitations. Encouraging this view creates the danger that those legal limitations may not be seen as limitations but as the parameters for possibilities. For those reasons, our views on the rights of third parties should acknowledge the roles they perform in contracts and not the realities that the law currently reflects.

If we cannot justify the prioritization of one set of vulnerabilities over the other, then we must ask: from what should third parties be protected? One way of reformulating the question is to ask what negative externalities would third parties address had they the opportunity to do so? Here, we may be guided by the choices that contracting parties make because their choices reflect both the vulnerabilities to externalities that contracts create as well as the contracting choices that address those externalities. At a minimum, contracting parties protect themselves against the risk of harm from other contracting parties in the exchange – namely, counterparties. Often, this risk of harm is opportunism that can affect their economic interests and the benefits that they expect to receive in the exchange. We may also expect contracting parties to protect themselves against physical risks should they be vulnerable to physical harms. We can therefore use this analysis to predict the categories of externalities that contract ecosystems create and that are priorities for attention.

1. Objection: Donor Third Parties v. Beneficiary Third Parties

One potential objection to equating the normative status between contracting parties and third parties in contract ecosystems is the observation that the third parties who maintain the institutions necessary for exchange (*donor third parties*) are not necessarily the same as those who suffer harms within contract ecosystems and whose interests this Article advances (*beneficiary third parties*). Donor third parties are the types of individuals and organizations discussed in Section IV, *supra*. These are the trade associations and their members who relay information from one end of a trading route to another. They are the community organizations that ostracize or expel members who have violated business norms. They are the kinship groups who develop and maintain ethical norms that instill social preferences for fairness, reciprocity, truth, and trust in their members. And they are the individuals who create social organizations and practices that have value in our society – social goods that are contingent upon good standing within one's community and therefore serve to bond a trader's professional and personal lives.

[215] *See, e.g.*, Bagchi, *supra* note ___ at 226-228 (arguing that contracts should protect the legally protected interests of third parties).

But these are not necessarily the third parties who are at risk from the externalities discussed in Section II, *supra*. These third parties are the laborers at supply factories who are harmed when buyers do not enforce their supplier codes of conduct. They are consumers who allege harms when they unintentionally contribute to the perpetuation of human rights abuses through their purchases. And they are the communities who are at risk of environmental, economic, and physical risk because of the nature of corporate activities in their region.

One way to reconcile this incongruence is by identifying the areas of potential overlap between these two groups. It is true that some of the beneficiary third parties are also donor third parties who maintain institutions integral to the successful operation of supply contracts. For example, consumers are important actors in maintaining the demand for certain goods and services (*market institutions*). They and other actors in society also determine the reputation of companies, thereby influencing its brand value. In these ways, beneficiary third parties contribute to the maintenance of institutions that are important to the operation of supply contracts.

Conversely, donor third parties may suffer externalities from exchanges. For examples, communities may create club goods that are only available to their members and, consequently, serve as an incentive for contractual cooperation.[216] Club goods not only induce a trader to keep her word but also creates a community interest in the trader doing so: "The credibility of its members certainly brings wealth to the community, ensuring sustained income for its current workers and its younger members, but it also reflects an adherence to values that have religious significance to the community and, according to the club good model, add to each members' utility."[217] As such, certain externalities may destroy the institutions that donor third parties build, thereby causing harms to the latter.

The extent of overlap is an empirical question; more importantly, to focus on the overlap is to miss the point. This Article does not argue that *this* individual should receive contractual protection under *this* contract because he supplied *these* beneficial institutional functions. It is not a market exchange model of rights in which a person is only entitled to contractual protection because the person provided something of value to the exchanging parties. Instead, the ecosystem view is only meant to challenge the perception that exchanges occur between two parties. Its frame illustrates that *some* subset of third parties play an important role, even if the beneficiary third parties are not among them.

Finally, at a high enough level of abstraction, all beneficiary third parties are donor third parties. The third party institutions discussed in Section III, *supra*, are generally private and do not involve state action. But a wide variety of public institutions also create the conditions for exchanges to flourish, such as laws and courts, which are also products of the third party institution of the state.

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216 Richman, *supra* note __ at 406.
217 Richman, *supra* note __ at 406-407.

B. *Objective 2: Protection from Externalities – Ex Ante Contract Design*

It is one thing to identify externalities for attention. It is another challenge to identify methods by which to address these externalities. The unique but unfortunate position of third parties is that they experience the harms from contracting relationships but are often powerless to address those externalities. If third parties are part of contract ecosystems who should be protected from harms, then the next task is to incentivize those who are the agents of that harm to avoid those actions.

One approach is through contract design. Here, we might ask: what would the contracting parties have bargained for in the contract if *they* had been the ones vulnerable to these externalities? We can imagine two sets of responses. First, contracting parties may modify contractual obligations to minimize the risk of externalities posed by the contract. For example, corporations may modify production schedules and volume expectations to minimize the risk of labor violations in the supply chain. Second, contracting parties may introduce new contract obligations to address the potential externalities that could result from contract performance. Supplier codes of conduct are one such contract mechanism but, given the externalities that remain unaddressed, contracting parties may upgrade these contract provisions with enhanced obligations. Third, contracting parties may realize that some contract requirements create the risk of externalities that may be too difficult to address through contract provisions and, as a consequence, eliminate those obligations wholly from the contract. By placing the contracting party in the position of the third party, we may expect the elimination of problematic provisions that would not been within contract ecosystems if third parties had a voice at the bargaining table. Fourth, it is also possible that the entire contract may be immune to redemption. Here, the thought exercise does not eliminate specific contract provisions but forecloses the possibility of the contract as a whole because the contract is one that creates externalities to third parties grave enough that contracting parties should ask: is this a contract that should be performed? This is an important question because not every imagined contract is a socially desirable one. Some contracts may create the risk of harms that are so grave that if third parties had a voice they would prohibit the contract. Or, if contracting parties suffered the risk of harm, they would never sanction its performance.

1. Objection: The Limits of Imagination

All these thought exercises unite the *risks* faced by third parties with the *power* enjoyed by contracting parties by asking how the latter would act if they confronted the same risks as the former. However, imagination can only get us so far. Contracting parties can only imagine what third parties may prefer. This may lead to inaccurate beliefs and suboptimal contracting choices.

Therefore, the last response from this thought exercise is *consultation*: contracting parties may be better off if they stopped imagining what third parties would want and instead ask them directly through consultations or a role in the

bargaining process. These are all natural consequences from the thought exercise described above. They may not be plausible consequences; however, this section is intended to explore how externalities in the supply chain may be addressed. Section VII, *infra*, addresses how to incentivize contracting parties to take these actions regarding contract design.

C. Objective 3: Protection from Externalities - Ex Post Legal Remedies

The other means of addressing contract externalities is through legal remedies. If third parties are part of contract ecosystems who should be protected from externalities, then they are owed the obligations outlined in Section IV(B), *supra*, and the law should provide sanctions for those contracting parties who fail to perform those contract design obligations. Specifically, the contract ecosystem view reveals that third parties should be entitled to consideration at the contract design stage in order to minimize the externalities they may face; contracting parties should take the interests of third parties into account by asking what the contracting parties would have bargained for had they been the ones facing those same risks. But contracting parties may fail to do so and the law should provide sanctions for this failure.

Legal sanctions provide two important benefits: *access to remedies* and *incentivizes compliance*. The first benefit is access to remedies. If contracting parties and third parties both sustain contract ecosystems, then it does not make sense to offer only one set of these actors remedies for harms that flow from these ecosystems. Imagine that we did not offer contracting parties legal remedies for the harms they may encounter that result from a contract? That outcome would be both impractical and unfair. It is impractical because many parties would not enter into contracts if they could not access legal remedies for harms they suffered as a result of the contract relationship, such as harms from contract breach. It is also impractical because the prospect of legal sanction for breach may influence the parties' conduct under the contract and reduce the likelihood of those harms, such as breach, arising. It is unfair because we expect the law to provide a remedy when a party has suffered a harm to its legally protected interests.

The impracticality and unfairness is magnified when it comes to third parties. While third parties do not "enter" contracts the way contracting parties do, the prospect of legal remedies *ex post* also influence the behavior of contracting parties and effects the likelihood of harms that third parties may encounter under the contract. It is also unfair because the harms that third parties confront, such as the ones outlined in Section II, *supra*, are ones that the law recognizes as injuries that deserve a remedy, such as assault, captivity, and torture. If we protect contracting parties against risks from contracts that threaten their non-physical well-being, it is even more apparent that we should protect third parties from contract threats that endanger their physical security.

This leads to the second justification for *ex post* legal remedies: incentives for compliance. Ideally, the law would incentivize prevention of harms to third parties, but contracting parties may not invest in preventative compliance

measures without the prospect of a legal sanction for a failure to do so. Therefore, by providing legal remedies *ex post*, the law also achieves the added advantage of potentially decreasing the risks of similar harms in the future.

1. Objection: Consent as a Differentiator

One potential objection is that we provide legal remedies to contracting parties and not to third parties because the former *consented* to the contract exchange, whereas the latter did not. The former exercised a choice upon the expectation of legal options should the contract not unfold as expected; or, more bluntly, contracting parties choose to place themselves in a vulnerable position vis-à-vis their counterparties because of their expectation that the background of legal rights can help mitigate their vulnerability.

In contrast, third parties made no choice to enter the contract; they took no action based upon the expectation that the law would mitigate the harms that they may face under the contract. They did not undertake any particular action (or forbearance) upon the expectation of exercising legal rights that are generally available to contracting parties. The institutional functions they perform are ones that they would otherwise perform anyway, independent of any protection that the law offers to mitigate their vulnerability to contractual harm. Unlike contracting parties, they did not choose to place themselves in a vulnerable position under the contract.

The lack of consent to contract does not reduce the claim to protection of third parties; instead, it augments it. It is true that most third parties who suffer harms from contract exchanges do not consent to these contracts. That's what makes their situation particularly perilous and sympathetic. They take on the risk of harm even when they (a) do not benefit from the fruits of the exchange, which flow to the contracting parties, and (b) did not consent to those risks. If both contracting parties and third parties have normative equality within contract ecosystems, then it is unfair that the former have the privilege of consenting to risks within this ecosystem whereas the latter does not. It is even more unfair when we punish third parties for failing to have a choice in the risks they face; to do so is to expose them to unconsented risk and then blame them for their absent consent.

VII. PRACTICAL IMPLICATIONS: INCENTIVIZING PROTECTION FOR THIRD PARTIES

The previous section explored the various implications for third parties that result from a view of contracts as ecosystems and argued in favor of three desirable objectives: (a) protection from negative externalities, (b) contract design obligations, and (c) legal sanction for failure to protect third parties through contract design. But just because an objective is desirable does not mean that contracting parties will pursue it; the normative desirability of these objectives does not translate into the likelihood that contracting parties will pursue them. The translation from theory to practice depends on incentives.

This section analyzes and compares different legislative (Part A), and judicial (Part B) approaches that can help incentivize contracting parties to pursue the objectives identified in Section VI, *supra*.

A. Legislative Solutions: Encouraging Human Rights Due Diligence Through Improved Reporting Requirements

The best way to ensure that corporations consider the impact of their actions on third parties is to command them to do so through legislative or judicial action. While Congress has imposed some due diligence requirements in specified areas or for specified actors, it is unlikely that we will witness the imposition of *general* due diligence requirements across a broad base of companies. For that reason, this part on legislative reform focuses on ways to improve the laws that Congress and state legislatures are more willing to adopt: mandatory reporting requirements. While not ideal, the current or proposed laws in California and Washington State, as well as a proposed federal bill, could prove valuable in incentivizing corporations to protect third parties – if done right.

Market mechanisms can encourage corporations to consider their impact on contractual non-signatories and to take action to prevent and mitigate harm. But this only occurs if reporting requirements are designed to facilitate market mechanisms. The Business and Human Rights Resource Centre (BHRCC) has provided guidance on the design of both mandatory reporting requirements and mandatory due diligence laws. For mandatory reporting laws, BHRCC recommends that the law apply to large and medium sized companies and that the law have extraterritorial reach; that the company statements must demonstrate progress over time and that the statements are approved by the board of directors and signed off by senior management; laws include monitoring and enforcement for detection and punishment of non-compliance, and that companies are provided with governmental guidance on best practices.[218]

In addition to those guidelines, this Part considers other reforms or suggestions that legislatures should consider concerning the existing or proposed reporting requirements in California, Washington State, and at the federal level.

1. The California Transparency in Supply Chains Act

The California Act does not require that covered companies engage in human rights due diligence.[219] Instead, it is designed to ask questions of

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218 Business & Human Rights Resource Centre, MODERN SLAVERY IN COMPANY OPERATION AND SUPPLY CHAINS, *supra* note ___ at 25; *see also* Working Group on the issue of human rights and transnational corporations and other business enterprises, *The report of the Working Group on the issue of human rights and transnational corporations and other business enterprises*, U.N. Doc. A/73/163 (July 16, 2018), at 18-19.

219 Harris, *supra* note ___.

companies so that they will. It relies on market mechanisms to encourage what the law could command. The Act depends on reputational mechanisms and market pressure to incentivize companies to practice human rights due diligence. Unfortunately, the Act's effectiveness is compromised by the absence of institutional features that are necessary for these reputational mechanisms to operate well. First, it is difficult to identify the companies that are covered by the law. One NGO, Know the Chain, has already explained that this absence makes it difficult to "name and shame" companies for their practices because they cannot easily identify which companies are obligated to report.[220] Second, it is easier to identify non-compliance when there is a central repository of company statements that facilitates comparability between companies. This allows NGOs and other actors to evaluate how companies perform relative to their peers; this evaluation leads to market differentiation among companies that, in turn, attracts reputational sanctions for some and rewards for others. Last, the Act does not offer robust penalties for non-compliance with its requirements, which compromises the comprehensiveness of the information collected and disseminated to the public.

These shortcomings are very similar to those identified with the reporting requirements of the UK Modern Slavery Act when the UK Government engaged in a review of that law.[221] That evaluation informed the design of the subsequent Australia Modern Slavery Act and proposals for change for the UK Modern Slavery Act.[222] The California legislature should similarly heed these lessons and include introduce similar reforms in order for the reporting requirements to have their full impact on corporate conduct.

2. Washington State SB 5693 – Proposed Transparency in Agricultural Supply Chain Act

In Washington State, Bill SB 5693 was introduced in the Senate in 2019 and reintroduced in January 2020.[223] This bill imposes reporting requirements on "every retail seller of agricultural products doing business in Washington State and having annual worldwide gross receipts of two hundred million or more."[224] These retailers must publish an annual disclosure statement and must "[r]equire its suppliers to report annually to the retail seller any violations of employment-related laws and incidents of slavery, peonage and human trafficking;"[225] retailers

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220 Know the Chain, *supra* note ___ at 5.

221 United Kingdom Secretary of State for the Home Dep't, INDEPENDENT REVIEW OF THE MODERN SLAVERY ACT 2015: FINAL REPORT ¶¶ 2.1.1-2.1.3, 2.4.2-2.4.3, 2.5.2-2.5.3 (May 2019).

222 *See* Joint Standing Committee on Foreign Affairs, Defence, and Trade, INTERIM REPORT, *supra* note ___ at ¶ 2.28; United Kingdom Secretary of State for the Home Dep't, INDEPENDENT REVIEW OF THE MODERN SLAVERY ACT 2015: FINAL REPORT ¶¶ 2.1.1-2.1.3, 2.4.2-2.4.3, 2.5.2-2.5.3 (May 2019).

223 Washington State Legislaure, *SB 5693 – 2019-2020: Creating transparency in agricultural supply chains*, https://bit.ly/2YQudpT.

224 *An act relating to transparency in agricultural supply chains*, SB 5693, §2 (2019)(substitute version).

225 *Id.*

are also required to include this information from suppliers in their annual statement under the bill.[226] The bill also enables the attorney-general to commence a civil action against retailers and suppliers who do not comply, and enables courts to provide for a range of remedies, including punitive damages.[227]

There are a number of strengths to this bill. It mandates reporting along the supply chain from supplier to retailer, so that the latter must be informed about certain forms of misconduct. It also requires that retailers disclose that information to the public. The bill also provides for some legal sanction – a shortcoming of other mandatory reporting laws concerning the supply chain. However, the original bill that was introduced provider a stronger legal sanction by enabling the attorney general or "[a]ny person residing in this state," and applied to both retailers and manufacturers and had a lower financial threshold.[228]

Additionally, the bill also appears to suffer from a number of the weaknesses of the California law by not providing for a public list of covered companies or a central repository of company statements for comparison. Finally, the bill only applies to agricultural supply chains and does not impose reporting requirements on a broader base of companies.

3. H.R. Proposed Corporate Human Rights Risk Assessment, Prevention, and Mitigation Act of 2019

In 2019, a bill was introduced to amend Section 13 of the Securities and Exchange Act of 1934 by requiring issuers to perform an annual analysis to identify any human rights risks or impacts in their operations and supply chains "that are known or should be known" and to rank those risks or impacts based on severity.[229] Issuers are required to include in their annual report a section on human rights that shares the information from this analysis, including the ranked list of risks and impacts, as well as other information relating to the structure of the supply chain and the human rights due diligence processes in place.[230]

This bill has many strong features of a human rights reporting law. It facilitates the collection and comparison of human rights disclosures by requiring that these are included in the annual report. In addition to mandating information disclosure on human rights due diligence processes, such as the California and Washington State law, it also mandates disclosures on *outcomes*. Issuers are required to share information on the ranked list of risks and impacts, as well as their responses and the *effectiveness* of those responses.[231] Section 3 of the bill requires disclosure "for any action taken, the assessment of the issuer of the efficacy of the action and a description of any outcomes of such action"[232] and " if no action was taken, a reasoned explanation of why no action was

[226] *Id.*
[227] *Id.*
[228] *An act relating to transparency in agricultural supply chains*, SB 5693, §2 (2019)(original version).
[229] Corporate Human Rights Risk Assessment, Prevention, and Mitigation Act of 2019, H.R.__, 116 Cong., 1st Session §3 (2019).
[230] *Id.*
[231] *Id.*
[232] *Id.*

taken."[233] The bill requires that issuers share the processes and actions undertaken or provide an explanation for their absence; by including the "explain" component, the bill places added pressure on companies to include these processes in the first place.[234] It borrows from the reporting requirements under Section 54 of the UK Modern Slavery Act by expanding the scope of topics for disclosure to include structure of the supply chain and, critically, information on the effectiveness of company policies and practices. But while the UK Modern Slavery Act only recommends this information for disclosure, this bill mandates disclosure.

Finally, this bill is helping to lay the groundwork for subsequent legislation that may go further to incentivize human rights due diligence in supply chains. As proposed, no later than five years after enactment of the Act, the Comptroller General of the United States shall submit a report (a) assessing the effectiveness of the human rights disclosure requirements, including challenges encountered, and (b) "analyze[] the humans rights impacts reported,"[235] "identif[y] the most egregious human rights impacts, and assesses potential criminal liability or the issuers whose actions caused such human rights impacts."[236]

And while criminal liability, or the prospect of it, may go far in improving human rights due diligence practices, the reporting requirements provide one more added bonus. While legislatures may want to impose mandatory due diligence requirements on corporations and business enterprises, their ability to do so is partially compromised by information asymmetries between themselves and the regulated industry. The latter is in possession of better information concerning the nature of human rights risks, the severity and distribution of those risks, contributing factors, resulting human rights impacts, company responses (including preventive steps) and the effectiveness of the steps. Of course, corporations are unlikely to want to share that information with legislators or the public. There is also the possibility that many corporations do not collect this information because of low reputational, litigation, or regulatory incentives to do so; as a result, they do not have information to share. Mandatory reporting requirements obligate them to collect, analyze, and disclose this information. However, by mandating information on supply chain structure, nature and severity of risks and impacts, and the effectiveness of those policies, legislators and regulators will substantially increase their information baseline regarding human rights abuses in the supply chain. And, as argued elsewhere, this information may grow to reach a "tipping point" when these government actors are equipped with sufficient information to intervene directly by mandating what the reporting laws only encourage.

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233 *Id.*
234 *Id.*
235 *Id.*
236 *Id.*

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B. *Judicial Solutions: Recognize a (New) Negligence Duty to Consider Contractual Non-Signatories*

If legislatures are unwilling to mandate due diligence in supply chains, then it may be necessary to turn to the courts to incentivize regard for others that may otherwise be absent. There are three possibilities that all arise from tort law: (a) recognize that negligence law already imposes a duty to avoid human rights abuses in the supply chain, (b) recognize a new corporate duty of human rights due diligence, or (c) recognize a new and broader duty to third parties in contracts.

1. Recognize the Current Duty to Avoid Human Rights Abuses in Supply Chains

In *Rahaman*, defendants successfully presented their misconduct as nonfeasance by focusing on what they did not do: "Plaintiffs have alleged that Defendants *failed* to implement standards and oversight mechanisms; *failed* to monitor construction of Rana Plaza; *failed* to properly inspect the building to ensure compliance with local code; and *failed* to take reasonable steps to implement policies, audits, or other oversight to ensure that workers were safe and healthy."[237] The Supreme Court of Delaware accepted these allegations as involving nonfeasance in which defendants are under no duty to act unless there is a special relationship between the parties or an exception applies.[238]

As illustrated in *Rahaman*, the search for a duty depends on the distinction between misfeasance and nonfeasance. The Delaware Supreme Court focused on third party externalities as nonfeasance.[239] However, one could also argue that by creating specific terms of exchange, multinational buyers affirmatively act in the world and create risks of harm to others. This is not nonfeasance but misfeasance; as such, they are bound to exercise a reasonable standard of care that is triggered "when the actor's conduct creates a risk of physical harm."[240]

According to comment *c* to § 37 of the Restatement (Third) of Torts, "the proper question is not whether an actor's failure to exercise reasonable care entails the commission or omission of a specific act. Instead, it is whether the actor's entire conduct created a risk of harm."[241] As an illustration, the Restatement explains,

> [A] failure to employ an automobile's brakes or a failure to warn about a latent danger in one's product is not a case of nonfeasance governed by the rules in this Chapter, because in these cases the entirety of the actor's

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237 *Rahaman,* 2016 WL 2616375 at *7.

238 *Rahaman v. J.C. Penny Corp.,* No. N15C-07-174, 2016 WL 2616375, at *7–8 (Del. Super. Ct. May 4, 2016.

239 *Rahaman,* 2016 WL 2616375 at *7–8.

240 RESTATEMENT (THIRD) TORTS: LIABILITY FOR PHYSICAL AND EMOTIONAL HARM 77 (2005).

241 RESTATEMENT (THIRD) TORTS: LIABILITY FOR PHYSICAL AND EMOTIONAL HARM 3 (2012); *id.* at 4 ("It would be necessary to explore, hypothetically, whether the same risk of harm would have existed even if the actor had not engaged in the conduct.").

> conduct (driving an automobile or selling a product) created a risk of harm. This is so even though the specific conduct alleged to be a *breach* of the duty of reasonable care was itself an omission.[242]

The Restatement's explanation further clarify that multinational buyers' actions constitute misfeasance warranting a duty of reasonable care. The terms of supply contracts that relate to volume, price, and delivery times create the risk of subcontracting and oversourcing, with all the attendant labor abuses.[243] These are the predictable consequences of the supply contracts that multinational buyers routinely write. As such, the course of the entire "conduct create[s] a risk of harm."[244]

In *Rahaman*, the defendants focused on the *omissions that illustrated the breach of a duty* rather than on the *conduct that created the duty in the first place* (terms of supply contract). The Restatement recommends emphasis on the latter over the former and, under this view, multinational supply contracts create a risk of harm that triggers the general duty to exercise reasonable care.

2. New Business Duty of Care to Include Human Rights Due Diligence

Some scholars have argued for the recognition of a business common law duty of care that include human rights due diligence.[245] For example, parent companies would need to undertake due diligence for all activities undertaken by the entities in the enterprise, and victims could bring claims under negligence so long as their "injuries were of the kind reasonably forseeable by the exercise of due diligence."[246] According to one scholar, "[a] company would not be liable for breach of its duty of care if it proved that it reasonably exercised due diligence as set forth in the [UNGPs], . . . On the other hand, a company's failure to exercise due diligence—its negligence—would create a rebuttable presumption of causation and hence liability."[247] In situations when a " plaintiff proves that a business activity adversely affected her human rights, causing injury and resulting in damages, a company could then avoid liability for breach of its duty of care, or mitigate the amount of damages, only by carrying its burden to prove that the risk of the human rights violation was not reasonably foreseeable, or that the damages would have resulted even if the company had exercised due diligence."[248]

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242 *Id.*

243 *See* notes __-__, *supra*, and accompanying text.

244 RESTATEMENT (THIRD) TORTS: LIABILITY FOR PHYSICAL AND EMOTIONAL HARM 3 (2012).

245 Cassel, *supra* note ___ at 179; *see also* Salminen, *supra* note ___ at 422; Palombo, *supra* note ___ at 266.

246 Cassel, *supra* note ___ at 179-180.

247 *Id.* at 180.

248 *Id.*

3. New Duty to Consider Third Party Harms in Contracting

A final possibility is to go beyond the human rights due diligence contemplated in Section VII(B)(2), *supra*, and formulate a duty that would apply to broader group of third parties. After all, victims in the supply chain are only one group of potentially affected third parties. And the outsider status of third parties does not only create problems in the supply chain but also in numerous other contractual settings. These third parties, like those in the supply chain, also suffer from no voice in *ex ante* contract design and no remedies in *ex post* legal action.

What we need is a regard for others at the bargaining table, especially when those others are not present to advocate for their own interests. The contract contemplated may create significant externalities for third parties besides the contracting parties. These externalities will manifest themselves following the conclusion of the contract and during performance; in this way, these are *ex post* externalities. However, the parties suffering from these externalities are not present during *ex ante* contract design to address the risk of externalities through negotiating and drafting contract clauses. And the contracting parties may have little incentive to consider those externalities. This tracks the familiar problem that negligence law often addresses: incentivizing parties to have some concern for the welfare of others who may be injured by their own actions. Here, the action is contracting, which, as explained in Section II, *supra*, can have significant consequences for the welfare of others not at the bargaining table. We need to similarly incentivize contracting parties to take these externalities into account.[249]

In order to do so, this Article proposes the following basic idea for a new duty: *Contracting parties must take into account the interests of third parties when they could reasonably foresee that performance of the contract would create a risk of physical harm to third parties. Reasonable contract provisions would satisfy the standard of care.*

Why blend contracts and torts? Tort law is valuable because it incentivizes regard for others when such regard may otherwise be absent. It reminds us that our actions in the world do not affect our interests only but can create significant risk of harm to others. Without these reminders, and the attendant liabilities, we may be tempted to act in ways that maximize benefits to ourselves while thoughtless to the costs that we impose on others. It is the "other-regarding" features of tort law that are particularly important. These reminders are particularly important in the realm of contracting when parties may be tempted to view their transaction as affecting themselves only.

This duty to contract blends elements of both contract law and negligence law. It preserves the traditional arena for contracting (with all its attendant benefits of flexibility, bargaining, and autonomy) but situates the freedom to contract within the background of negligence law. Specifically, it borrows the duty element from negligence and uses it to circumscribe the freedom to contract and uses the concept of foreseeability from negligence as a limiting principle for when this duty is triggered.

There is no question that economic activity in supply chains creates a risk of physical harm to many individuals, especially laborers in those chains. The

[249] Johnston, *Facing Up to Social Cost, supra* note ___ at 223.

multiple lawsuits brought by laborers in these supply chains provide graphic details of the abuse that they suffered by corporations and their suppliers.[250] And these conditions are often a product of the terms of the supply contract (Type I externality) or a failure of the supplier code of conduct (Type II externality). Therefore, under a negligence framework, the act of contract design creates a risk of physical harm to these parties such that the contracting parties have a duty to exercise reasonable care.[251]

Second, parties satisfy the duty with adequate contract design. All this duty asks of the parties is that they consider whether contractual performance would create the risk of physical harm to parties not present at the negotiating table. If so, this duty requires that they adopt contract terms to address those harms. While this duty is inspired by negligence, it falls short of what negligence may require. Specifically, it does not hold contracting parties liable for all harms that may occur in the supply chain. Instead, this duty requires that contracting parties control what they can control: contract design.

One disadvantage that third parties confront is that they are vulnerable to risk but powerless to address those risks because they are not at the bargaining table when supply contracts are negotiated and designed. There may be very little incentive for the parties at the bargaining table – buyers and suppliers – to take their interests into consideration, unless mandatory laws requires the parties to do so or market pressure creates incentives for consideration. This duty fills the gap by providing incentives for contracting parties to consider externalities to others besides themselves.

A contracting party satisfies the standard of care through contract design that appropriately addresses the third party externalities that the contemplated contract creates. Here, the reasonable actor is not just any ordinary actor but one who is charged with "any extra knowledge the defendant" possesses. Contract design that satisfies this standard must reflect the contracting parties' knowledge of both foreseeable risks of physical harms to third parties and the types of contractual provisions that are necessary to address those risks.

Because the standard of care depends on knowledge, what constitutes "reasonable contract design" under this duty varies with time. Imagine a hypothetical where Buyer and Supplier are aware of media coverage of forced labor conditions in the supply chains for the goods they are planning to exchange. To combat this risk, they adopt a standard model clause promoted by an industry association of which they are members. This clause provides for monitoring and inspection rights of Buyer and establishes a "hotline" for grievances. However, eight months later, Buyer learns of a number of instances of forced labor in its supply chain involving Supplier. Buyer promptly terminates its contract with Supplier. An internal audit by Buyer reveals that one reason that the forced labor occurred is because Buyer announced its visits

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250 *See, e.g.*, First Amended Class Action Complaint for Injunctive Relief and Damages at ¶¶ 20–31, Doe I v. Wal-Mart Stores, Inc., No. 05-7307 (C.D. Cal. Dec. 23, 2005) (describing conditions inducing fatigue, situations of physical assault); *Doe v. Nestle, S.A.*, 906 F.3d 1120, 1122 (9th Cir. 2018) ("While being forced to work on the cocoa farms, plaintiffs witnessed the beating and torture of other child slaves who attempted to escape.").

251 RESTATEMENT (THIRD) TORTS: LIABILITY FOR PHYSICAL AND EMOTIONAL HARM 77 (2005).

to Supplier's work sites, thereby enabling the latter to hide the forced laborers and present Buyer with a fake set of records.[252] Another reason for the abuse is because the forced laborers did not have access to the means to utilize the "hotline" that Buyer provided for in its code of conduct with Supplier. In its new supply contract with Supplier's replacement, Supplier 2, Buyer cannot satisfy the standard of care by using the exact same language it used in its previous contract with Supplier. It now knows that announced visits will not work and that hotlines are ineffective. It must therefore use its increased knowledge to design more effective clauses in its new contract with Supplier 2.[253] Whereas the initial contract clause could have satisfied the standard of care with Supplier, the same clause does not satisfy the standard in Buyer's new contract with Supplier 2 because the latter knows more; therefore, it must do more by incorporating that new knowledge in its contract design going forward.

Finally, this duty to contract is limited by foreseeability: contracting parties are not required to consider the interests of every third party under the sun. Negligence law supplies the limiting principle to this duty: contracting parties are only under a duty to address externalities to third parties who they can reasonably foresee may experience physical harm through performance of the parties' contract. Given the guidance of NGOs, government actors, and the past experiences of repeat actors in supply chains, such as multinational corporations, contracting parties can have some reasonable foundation for anticipating who may be harmed by their activities. Indeed, under some national and international law guidelines, transnational corporations are already expected to engage in human rights impact assessments when undertaking their business operations.[254] This duty may also encourage buyer companies to engage meaningfully in stakeholder engagement with those who may be potentially harmed in order to draft clauses that are appropriate.

CONCLUSION

This Article explores the issue of third party externalities in the global supply chains in which many of our familiar products are created and valued services rendered. The men, women, and children who work in these supply chains – or are otherwise affected by them – have very little voice in designing the contracts that these supply chains support. However, it is often they who suffer from

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252 *See, e.g.*, Parella, *Outsourcing Corporate Accountability*, *supra* note __ at 774-779 (describing various strategies of audit evasion).

253 Johnston, *Facing Up to Social Cost, supra* note ___ at 223.

254 U.N. Human Rights Office of the High Comm'r for Human Rights, *Protect, Respect and Remedy: a Framework for Business and Human Rights Report of the Special Representative of the Secretary-General on the issue of human rights and transnational corporations and other business enterprises, John Ruggie*, U.N. Doc. A/HRC/8/5,(Apr. 7, 2008). *See* SUMMARY OF THE REPORT OF THE WORKING GROUP ON BUSINESS AND HUMAN RIGHTS TO THE GENERAL ASSEMBLY: CORPORATE HUMAN RIGHTS DUE DILIGENCE: EMERGING PRACTICES, CHALLENGES AND WAYS FORWARD, U.N.Doc. A/73/163 (October 2018); OECD, GUIDELINES FOR MULTINATIONAL ENTERPRISES (2011)(introducing a new chapter on human rights), https://bit.ly/1kPDOqW; International Bar Association, IBA PRACTICAL GUIDE ON BUSINESS AND HUMAN RIGHTS FOR BUSINESS LAWYERS (2016), https://bit.ly/2CPnLUK; IPIECA, HUMAN RIGHTS DUE DILIGENCE PROCESS (2012), https://bit.ly/2HAhXo3.

physical harm that result from the performance of these contracts or breaches of the codes that are meant to address these risks.

This problem highlights the vulnerable position of third parties in contracts. On the one hand, third parties provide a variety of important institutional functions that allow exchanges to occur. Specifically, the private ordering arrangements established by kinship groups, communities, and trade associations, among others, reduce transaction costs associated with search, bargaining, negotiating, drafting, and enforcing contracts. Despite these benefits, third parties have a limited role to address these externalities because they do not have a seat at the bargaining table so cannot participate in contract design *ex ante*, and they are without a cause of action with which to address these harms *ex post* through legal enforcement.

This Article seeks to fill this gap by proposing a duty that blends the most desirable dimensions of contract and tort law. It preserves the traditional arena for party autonomy and flexibility with a standard of care that is satisfied by appropriate contract design. However, it also borrows negligence law's incentives for exercising care towards others. In combination, this duty offers a way to incentivize contracting parties to address both Type I and Type II externalities that they may impose on third parties through contracting decisions in supply chains.