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# Regulatory governance by contract: the rise of regulatory standards in commercial contracts<sup>\*</sup>

Paul Verbruggen

## 1 Introduction

Scholars of ‘regulatory governance’ promote the view that regulation is not confined to government-based rules and procedures, but constitutes a whole range of activities exercised by both state and non-state actors, either separately or in combination. This paper investigates the role of commercial contracts as instruments of regulatory governance. Various scholars have noted that commercial contracts are increasingly important vehicles for the implementation and enforcement of safety, social and sustainability standards in transnational supply chains. While commercial contracts have traditionally acted as a principal legal vehicle to facilitate the exchange of commodities *between* individual entities, they are now increasingly being employed as regulatory instruments of *entire* transnational supply chains.<sup>1</sup>

Right from the outset, however, it appears that contract law imposes constraints on the use of commercial contracts as a regulatory device. More specifically, the doctrine of ‘privity of contract’ (*relativité du contrat*) holds that a contract can give rise to rights and duties only for those who are party (‘privity’) to the contract. This implies that, as a rule, firms can bind their contracting parties only and *not* the other parties that constitute the supply chain (e.g. second or third tier suppliers) and parties positioned outside that chain but with an interest in its proper functioning (e.g. consumers, NGOs, workers and other stakeholders). The logic that underpins regulation by contract therefore differs fundamentally from that which underpins (traditional) forms of regulation: regulation operates on the logic that it is binding on the entire group of regulated entities, while contracts in principle only bind those that have agreed to the contract (i.e. the contracting parties).

Based on a literature review, this paper further explores the tension between regulation and contract law by mapping the emergence of commercial contracts as a means to implement and enforce safety, social, and sustainability standards in transnational supply chains. It highlights the scope of this development, identifies its drivers, and discusses the main challenges to governance that arise from it, also in the light of classical contract law doctrine. Accordingly, the paper summarizes the state-of-the-art in the literature on the use of contracts as instru-

\* I thank the other contributors to this Special Issue and the editors for helpful comments and discussions on an earlier draft of this paper. I am also grateful for the suggestions offered by Katerina Peterková and Louise Vytopil, who carry out innovative (empirical) research on the private law implications of codes of conduct and private standards. The usual disclaimer applies.

1 See e.g. McBarnet & Kurkchyan 2007, Vandenberg 2007, Lin 2009, Cafaggi 2013, Vandenberg 2013, Peterková (2014a, 2014b), with further references in each of these sources.

ments of regulatory governance, for which purpose it draws on (empirical) studies in the field of political economy, private law, regulation and sociology.

To be clear, the paper explores the theme of regulatory governance *by* contract, which is to be distinguished from regulatory governance *of* contracts.<sup>2</sup> Whereas the latter concerns the ways in which contracts are regulated to achieve particular ends (e.g. by imposing information duties on firms to ensure consumer protection), this paper is concerned with the strategic deployment of contracts by private actors to implement and enforce regulatory standards along the supply chain. The contribution thus focuses on the particular trend initiated by private actors (mainly retailers) to regulate the behaviour of equally private business partners along the supply chain (mainly producers and suppliers) through the use of private law contracts (typically bilateral commercial contracts) that impose regulatory standards on these business partners. The standards, finally, may be private in nature (e.g. industry codes of conduct and principles, guidelines or protocols adopted by private entities), but are not limited to that type: they can also concern public regulation and stem from legislation, administrative measures, or human rights treaties.<sup>3</sup>

Why is it necessary to study the strategic deployment of contracts by private actors to implement and enforce regulatory standards along transnational supply chains? As we shall see below, this development was triggered in part by the failure of governments and intergovernmental organisations to adequately address concerns raised by global supply chains, including poor working conditions, child labour, environmental degradation, and unsafe consumer products. In the absence of a legally binding and enforceable public framework applying to these supply chains, firms (Western multinational companies in particular) have developed several strategies to address these concerns and manage the reputational risks involved to their own business operations, their employees, and customers. The use of commercial contracts as a means to regulate safety, social and sustainability aspects in transnational supply chains is just one such strategy.<sup>4</sup> Mapping the prospects and limits of that strategy is key to understanding its potential to contribute to public policy goals, as well as its relative strengths and weaknesses compared to public regulation.<sup>5</sup> This paper highlights the formal and informal role contract law plays in the implementation and enforcement of regulatory standards in the supply chain, which is often absent in academic discussions of the rise of private regulatory governance.

The paper proceeds as follows. Section 2 discusses the use of commercial contracts as instruments of regulatory governance. Section 3 explores the drivers,

2 See also: Zumbansen 2007.

3 It should be noted here that a substantial portion of the private regulatory standards echo norms rooted in public law and policy, thus making the public/private distinction in regulation increasingly diffuse. See also McBarnet & Kurkchian 2007, p. 66; Henson & Humphrey 2009, p. 5.

4 Other (often related) strategies include the introduction of private procurement procedures through which firms subject (foreign) suppliers to strict assessments before entering into contracts with them; the use of audit protocols to audit and inspect supplier premises during the term of the supply contract; and elaborate corporate social responsibility (CSR) policies.

5 See in general: Mayer & Gereffi 2010; Lytton 2014; Verbruggen 2014.

scale, and legal forms of the use of commercial contracts as regulatory instruments by analysing the (empirical) studies that have described this development in different areas. Subsequently, Section 4 discusses the governance challenges related to the use of commercial contracts as regulatory devices to implement and enforce safety, social and sustainability standards in the supply chain. Section 5 concludes.

## 2 Contracts as instruments of regulatory governance

Regulatory governance is a contested notion.<sup>6</sup> Understood broadly, it involves sustained efforts to steer and influence corporate behaviour to address a collective problem or attain a collective goal by means of (a combination of) standard-setting, monitoring and enforcement activities.<sup>7</sup> While these activities are often associated with state actors or formal legal norms, there is a widespread consensus in the literature on regulatory governance that the capacity to steer and influence corporate behaviour is dispersed; it is not the sole prerogative of public actors.<sup>8</sup> At the national and transnational level private actors (firms, trade associations, NGOs, experts, etc) co-opt, compete with or complement regulatory activities of public actors (governments, legislatures, independent agencies, international governmental organisations, etc.) and vice versa, thus creating a regulatory space occupied by states, businesses, and civil society.<sup>9</sup>

Public and private actors have at their disposal a whole range of instruments with which to pursue their regulatory objectives.<sup>10</sup> Which instruments are available depends in part on the type of actor involved. The use of legal authority and the command of law, the adoption of taxation policies, and the imposition of criminal and administrative liability are in principle only available to public actors. Other instruments and strategies of regulation may, however, be deployed by both public and private actors. For example, public and private actors strategically disclose information to empower market actors (competitors, consumers, and NGOs) to influence corporate behaviour. Public actors use information duties, labelling, public ratings, and campaigns to modify corporate conduct for that purpose.<sup>11</sup> Private actors, in particular NGOs, have also been shown to be able to disclose and use information strategically to steer corporate behaviour.<sup>12</sup> Private certification, rating and labelling schemes also operate on the logic of information disclosure to regulate businesses.<sup>13</sup>

Private law contracts form another example of regulatory instruments that are used by both public and private actors to attain regulatory objectives. Govern-

6 See in detail the Introduction to this Special Issue.

7 Black 2002 and Levi-Faur 2011.

8 Black 2001 and Scott 2005.

9 Scott 2001 and Abbott & Snidal 2009.

10 See for a review of the 'strategies' and instruments that state actors use to regulate business: Baldwin, Cave & Lodge 2012, p. 106.

11 Ibid, p. 119-121.

12 See perhaps the overly optimistic Conroy 2007.

13 Bartley 2011 and Verbruggen 2013.

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ment and regulatory agencies may deploy the state's economic powers to secure policy goals by incorporating these goals in the contracts they conclude with businesses.<sup>14</sup> Alternatively, when procuring goods or services, governments may require compliance with certain goals or standards as part of the conditions for tender, and incorporate these in the public (works) contract that is awarded.<sup>15</sup> Competition between firms on contractual terms is then leveraged to further particular policy objectives. Regulatory standards may thus be imposed on the firms that contract with government. There is evidence that a state's green procurement policies assist in the wider market take-up of social and sustainability standards,<sup>16</sup> which may in turn lead to the attainment of wider policy goals (e.g. worker safety, fair trade and environmental protection).

Private actors may also make use of contracts to regulate the behaviour of others, either contractual counterparts or third parties. These commercial contracts, which can take numerous forms (e.g. sales, supply or distribution contracts), have always included clauses and provisions setting down the expected safety and quality of the exchanged commodity, thus requiring the seller to behave in certain ways to adequately perform its contractual obligations vis-à-vis the buyer.<sup>17</sup> This regulatory aspect of private law contracting is well known and has been critically assessed before. While the strengths of commercial contracts as regulatory instruments relate to the perceived flexibility and expertise in rule-making, monitoring and enforcement, the weaknesses involve their relative inability to take account of the interests of third parties and other externalities, and to protect public goods and interests.<sup>18</sup> Further criticism concentrates on the often haphazard and incidental character of contractual controls, which usually do not extend beyond the group of contracted entities.<sup>19</sup>

This approach to regulation by contract differs from the development that this paper seeks to discuss, namely the incorporation of standards to regulate safety, social, and sustainability aspects of production throughout the entire supply chain. As noted in the literature, firms – especially multinational companies (MNCs) (e.g. large brands, producers and retailers) based in Western capitalist countries – increasingly include in their commercial contracts regulatory standards to control issues associated with production processes in the supply chain, including health and safety conditions for workers, environmental sustainability, consumer protection and animal welfare.<sup>20</sup> Clearly, such standards go beyond regulating simple safety and quality attributes of the exchanged commodity only;

14 Daintith 1979 and Baldwin, Cave & Lodge 2012, p. 116-117.

15 In the Europe Union (EU), the new Public Procurement Directive (Directive 2014/24/EU, OJ L 94, p. 65) sets out conditions under which EU Member State governments may require tenderers to comply with quality and environmental standards as a qualitative criterion for selection (Article 62).

16 See Gulbrandsen 2014.

17 Issues traditionally covered by commercial contracts include product specification, price, delivery dates, quality, warranties, remedies and penalties, and mechanisms for dispute resolution.

18 For extensive analyses see e.g. Trebilcock 1993 and Collins 1999, Ch. 3.

19 Cf. Baldwin, Cave & Lodge 2012, p. 117.

20 See in detail Section 3 below.

they also concern matters that have traditionally been associated with public policy.<sup>21</sup> The standards that are incorporated vary across firms and sectors, and may in effect be company codes of conduct, private certification schemes, technical standards, and even (international) public standards. Examples of the latter include national health and safety laws, conventions of the International Labour Organisation, guidelines adopted by the Organization for Economic Co-operation and Development, or soft law instruments set down by the United Nations (e.g. UN Compact).

By including such regulatory standards in their commercial contracts – and potentially also the monitoring and enforcement mechanisms belonging to those standards – firms seek to impose responsibilities on their business partners for the well-being and protection of third parties, such as local communities, consumers, and workers. From a regulatory perspective, however, if these standards are to be effectively implemented along the entire chain, all firms constituting that chain should be subject to the obligation to comply with the same regulatory standards. This means that not only the seller with whom the firm has a contractual relationship must be under an obligation to comply with the standards, but also the seller's supplier (second tier) and, in turn, that supplier's supplier (third tier), and so on.

Here, contract law restricts the ability of the firms at the end of the chain who demand compliance with the regulatory standards throughout the entire supply chain to regulate *beyond* their own contracting parties and address the corporate behaviour of other firms constituting the chain. More specifically, the doctrine of privity of contract (also known as *relativé du contrat*), which holds that as a rule a contract can only impose rights and duties on those who are party to the contract,<sup>22</sup> bars firms from imposing regulatory standards on the entities that constitute the second and third tiers of the chain, and other third parties. These third parties can only be legally bound if they agree to the regulatory standards, thereby making them a contracting party.<sup>23</sup> Contracts thus have relative legal binding effects, i.e. only *between* the contracting parties. This fundamental characteristic of contract law is rooted in an equally fundamental principle underpinning contract law, namely the *freedom of contract* (also known as private autonomy), which implies that parties may determine whether to contract or not, with whom to contract, and the terms of the contract itself. Thus, while commercial contracts are increasingly being deployed as means to implement regulatory standards across supply chains, the privity of contract principle implies that this approach has limitations, which are in fact very similar to the weaknesses of traditional private law contracting when regulating safety and quality attributes of exchanged commodities.<sup>24</sup>

21 McBarnet & Kurkchyan 2007, p. 60 and Vandenberg 2007, p. 914.

22 See in general for English law: McKendrick 2014, Ch. 25.

23 Again a contract may serve this purpose, though it must be held that contract law also offers specific techniques to create legally enforceable rights and obligations for third parties through contracts. These legal techniques are discussed in Section 3.

24 See text at note 17 to 19 above.

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These limitations raise the question of how in practice companies go about implementing regulatory standards in supply chains so that they also legally bind the other firms in the chain. This question is addressed in Section 3, while Section 4 will analyse the governance challenges related to this practice in terms of legitimacy and effectiveness. The analysis, which is preliminary and based on the state of the art in the literature, will focus on concerns of legality, accountability and transparency as the principal legitimacy challenges and enforcement as a core challenge for effectiveness.

### 3 Studies in the regulation of supply chains by contract

To better understand the role that commercial contracts actually play as instruments of regulatory governance in the implementation and enforcement of safety, social and sustainability standards in transnational supply chains, this section analyses (empirical) studies that have described the strategic use of such contracts in different areas.<sup>25</sup> In essence, the section seeks to answer a set of three interrelated questions:

- 1 What are the drivers of the use of commercial contracts as instruments of regulatory governance in supply chains?
- 2 How widespread is this use, actually?
- 3 What are the technical legal forms in which the use emerges?

#### *Drivers*

An analysis of the vastly expanding literature on regulatory governance and private regulation reveals that, broadly speaking, five different though interrelated factors have driven the emergence of commercial contracts as instruments to regulate supply chains. The factors, it must be held, are closely related to (and to a great extent overlap with) factors that have driven the emergence of private standards proper.<sup>26</sup> The first factor concerns the phenomenon of *globalisation* and the creation of global supply chains. For a long time, now, firms, especially Western MNCs, have sourced their products from countries around the world. In the last two decades, however, the volume of global trade has increased rapidly.<sup>27</sup> Products are thus increasingly often being shipped across numerous territorial borders, which makes monitoring and verifying the credence qualities of products – such as product safety, environmental sustainability, worker health and safety and animal welfare – much more costly. In the case of food, it even creates systematic risks of safety incidents.<sup>28</sup> By including regulatory standards in commer-

25 The use of commercial contracts as a means to implement and enforced regulatory standards is also pervasive in areas other than those concerned with safety, social, and sustainability standards. In financial markets, for example, a large share of the international market for over-the-counter derivatives is regulated through so-called boilerplate contracts developed by the International Swaps and Derivatives Association (ISDA) to ensure standardised cash settlement and interpretation processes in case of potential credit events. See in detail: Biggins & Scott 2013.

26 See also Cafaggi 2013.

27 United Nations Statistics Division 2013, p. 3.

28 Fuchs & Kalfagianni 2010, p. 12.



cial contracts, firms at the end of the supply chain seek to manage and control such risks (and the corresponding liabilities under administrative, civil or criminal law), while at the same time shifting the costs of monitoring credence attributes to firms higher up the chain.<sup>29</sup> It may be said accordingly that firms at the bottom of the chain seek to promote harmonised conduct in that chain around specific themes and standards.<sup>30</sup>

A second driver of the increased use of commercial contracts as instruments of regulatory governance in supply chains is described as the (*inter*)governmental failure to devise rules that effectively address the concerns raised by global supply chains. As Vandenberghe notes, supply chain contracting in the environmental field emerged to fill the gap in public regulation concerning exporting firms' environmental behaviour.<sup>31</sup> Others note, however, that the inability or unwillingness of nation states and international governmental organisations to effectively regulate externalities related to transnational business activities – which do not concern environmental degradation alone, but extend to issues of poor working conditions, child labour and consumer protection – not only concerns the weakness of states as international lawmakers, but also relates to their poor record at monitoring and enforcing existing regulation.<sup>32</sup>

The third and fourth elements to be addressed are *liability* and *reputation*. Firms may be held liable for selling or placing on the market products that have been produced in breach of safety standards, in which case product liability laws may impose civil liability, while product safety laws might lead to administrative or even criminal sanctions. In the food sector, the potential for liability of Western food manufacturers and supermarket chains has been considered key in explaining the rise of private food safety standards. The introduction of strict liability under criminal law for food retailers and producers in the United Kingdom sparked the advent of such private standards worldwide.<sup>33</sup> The introduction implied that in the event of a food safety incident, food producers and retailers could be held criminally liable for the breach of food safety requirements without the need to prove fault, unless they could show they had exercised all due diligence to avoid committing the offence. To develop such a 'due diligence defence', retailers in Britain created elaborate assurance systems of their own, involving a set of food safety norms, and procedures for monitoring and enforcing compliance with those norms.<sup>34</sup> These norms and procedures were made binding upon suppliers as they were incorporated in the supply contracts used by the retailers. Liability may trigger huge reputational concerns for companies. Even if courts do not formally establish liability, firms may see their *reputation* crippled if companies that are part of their supply chain turn out to flagrantly breach accepted standards of production, in particular human rights. Well-publicized scandals,

29 Hatanaka, Bain & Busch 2005, p. 360.

30 Menting and Vranken (2014, p. 26) have called this *vertical harmonisation*, stressing the harmonising function of codes in relation to actors vertically positioned along the supply chain.

31 Vandenberghe 2007, p. 921. See also Mayer & Gereffi 2010, p. 4-5.

32 Kingsbury, Krisch & Steward 2005.

33 Fulponi 2006, p. 9-10.

34 Henson & Northen 1998.

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often backed by fierce NGO campaigns, have spurred firms to set up elaborate corporate social responsibility (CSR) policies that are implemented in supply chain contracts. The most telling example is perhaps the case of US athletics retailer Nike, which had experienced several 'public relations nightmares' in the 1980s concerning underpaid workers, child labour, and poor working conditions, which severely stained Nike's brand image and led to the creation of a company code of conduct for suppliers.<sup>35</sup> Reputational concerns have also driven the emergence of private safety standards and certification schemes in the food industry. In the last two decades, a number of high-profile outbreaks of food-borne diseases have had a considerable impact on the reputation of the food industry, and food retailers viewed the adoption of private standards as a key strategy to build and improve their reputation.<sup>36</sup> The use of private standards, and their implementation via commercial contracts is thus not only a mechanism to protect a company's reputation, but also to further develop it and contribute to the branding of products.

Finally, broader social and economic trends have also changed the *expectations and preferences of consumers* with respect to the products they buy. Consumers in Western capitalist countries are increasingly sensitive to reliable information about the credence attributes of goods, such as fair trade, environmental sustainability, and social and labour conditions.<sup>37</sup> In the food area these issues, together with the quality and safety of products, animal welfare, as well as gustatory attributes (e.g. taste, smell, and texture of food) are nowadays considered very important.<sup>38</sup> Regulatory standards and accompanying strategies of labelling or certification, which are typically implemented via commercial contracts along the supply chain, enable the industry to respond to these consumer preferences.

### Scale

A study that is particularly revealing of the actual magnitude of the use of commercial contracts as regulatory instruments to implement and enforce safety, social and sustainability standards in transnational supply chains is the empirical study by Vandenberg.<sup>39</sup> While assessing the environmental policies and statements of the top ten firms in eight different sectors (either by US or by global sales), he finds that more than half of the firms in his sample (n= 74) impose environmental requirements on their domestic and foreign suppliers via supply contracts. These firms represent 78 per cent of the total sales of the top firms in the sectors studied.<sup>40</sup> The existence of this strategy is somewhat confirmed by Vandenberg's subsequent analysis of the supply contracts that publicly held firms based in the US submitted to the Securities and Exchange Commission during a specific period in time (fourth quarter of 2001). This document analysis reveals that 21 per cent (11 of 52 supply agreements) include environmental pro-

35 Locke, Qin & Brause 2007, p. 8.

36 Fulponi 2006, p. 6.

37 Elliot 2012, p. 11-13.

38 Fulponi 2006, p. 7-8.

39 Vandenberg 2007.

40 Ibid, p. 917.

visions.<sup>41</sup> Vandenberg argues that this development constitutes a distinctive form of global governance which, despite its shortcomings in terms of accountability and transparency, fulfils an important role in filling regulatory gaps on issues that states and international organisations are unwilling or unable to address.<sup>42</sup>

In the CSR area several studies have been conducted to assess the extent to which MNCs use contracts to regulate the actors positioned further up their supply chain. For example, McBarnet and Kurkchian have assessed corporate codes of conduct, websites and CSR reports of 35 MNCs listed on the London Stock Exchange FTSE 100, and five foreign MNCs, as well as government and NGO reports on these corporate sources. The document analysis was supplemented with telephone interviews with officials at some of these companies and three NGOs.<sup>43</sup> McBarnet and Kurkchian's analysis uncovers an emerging trend towards contractual control of CSR performance by suppliers. As they note 'Best practice is increasingly being treated as setting up a contractual obligation on suppliers to meet specific CSR standards. (...) Companies already adopting this approach are addressing it in stages, usually adding the CSR terms on the next occasion when a contract comes up for renewal, with some committing to a timed schedule for having all suppliers on CSR-inclusive contracts, and 'global templates' for contracts which include CSR being developed.'<sup>44</sup> Environmental performance is addressed in contracts, but the primary concern of most companies relates to working conditions and child labour. As such, they impose CSR standards that stem from accepted international conventions, such as those of the International Labour Organisation.<sup>45</sup>

Vytopil has conducted a study of the use of CSR-related standards by Dutch MNCs.<sup>46</sup> Using a sample of fourteen Dutch MNCs (seven listed on the Amsterdam stock exchange and six listed on the Dow Jones Sustainability World Index 2010), she assesses the CSR policies of these MNCs, as well as their contracts and related terms and general conditions in order to map and rate the content of these documents and assess their legal consequences under Dutch private law. Vytopil finds that all firms in the sample deploy codes of conduct as instruments of their CSR policies. The firms make these codes binding upon the supplier by requiring them to sign the code or by incorporating the code in a contractual arrangement with the supplier, either by reference or as standardised terms. Interestingly, the majority of the codes oblige the supplier to require its own supplier to agree to the content of the code and pass this obligation on to other suppliers positioned further up the supply chain.<sup>47</sup> Vytopil also notes that the firms in her sample proved rather hesitant to sanction non-compliance with the codes, especially when they had established long-standing contractual relations with the

41 Ibid, p. 936.

42 Ibid, p. 970.

43 McBarnet & Kurkchian 2007, p 61-62.

44 Ibid, p. 65.

45 Ibid, p. 65-68.

46 Vytopil 2012a, 2012b.

47 Vytopil 2012a, p. 168.

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supplier involved.<sup>48</sup> It should be noted, however, that other studies have reported examples of extreme cases in which MNCs did sanction non-compliance with CSR codes by cancelling the contract with suppliers.<sup>49</sup>

In the area of food, too, commercial contracts are used to implement and enforce regulatory standards. Private food standards or the certification schemes that implement and monitor compliance with these standards are typically incorporated in the supply agreements that food retailers or manufacturers conclude with their suppliers.<sup>50</sup> As Vytopil noted in relation to the use of CSR codes by Dutch MNCs, these supply contracts may also oblige suppliers to require their own suppliers to meet private standards or attain certification for them, thus effectively regulating third parties in the chain.<sup>51</sup> Compliance with food laws may also be required by contract.<sup>52</sup> Violations of public laws and private standards may result in a breach of contract, giving rise to the remedies and sanctions provided under the law applicable to the contract, but also to those agreed to in the contract, and possibly also those dictated by the private standards. The use of private standards and supplementary certification schemes is widespread in the food industry. In a survey held among quality and safety directors of major food retailers in OECD countries, the respondents estimated that between 75 and 99 per cent of all food products supplied are certified on the basis of private food standards.<sup>53</sup> Franchise and licensing agreements are also said to enhance the uptake of private standards and certification schemes for food products and food business operators.<sup>54</sup>

### *Legal techniques*

How, then, are regulatory standards incorporated in commercial contracts? By what technical legal ways do these standards find their way into commercial con-

48 Vytopil 2012b, p. 69.

49 McBarnet and Kurkchian (2007, p. 80) cite the example of H&M, which terminated contracts with subcontractors in case of child labour. O'Rourke (2003, p. 10) describes the case of Nike, which 'cancelled a handful of contracts because of poor performance [as regards environmental and labour standards] and an unwillingness of factories to change'.

50 Havinga 2006, Cafaggi 2012, Verbruggen 2014, p. 168-171.

51 Vytopil 2012a. Another example are the contracts that the biggest importer in the world of bananas (Chiquita) concludes with its suppliers, which include the following clause concerning the certification requirements of the seller and the producers from which the seller sources its products: 'The SELLER and the PRODUCERS commit to maintain the certification under the SA-8000 standard during the term of the agreement hereof. If any of these farms were to be decertified, the SELLER and the respective PRODUCER will have six months as of the date of notification of the decertification or suspension to remedy the farm decertification. If it does not obtain the recertification within the period stipulated hereof, the BUYER will have the right to suspend the purchase of FRUIT originating from such farms until they regain their respective certifications.' Clause 6.1.5 Chiquita International Banana Purchase Agreement [www.sec.gov/Archives/edgar/data/101063/000119312508042574/dex1016.htm](http://www.sec.gov/Archives/edgar/data/101063/000119312508042574/dex1016.htm) accessed August 2014.

52 Evidence of this practice comes from the case *Hazlewood Grocery Ltd v. Lion Foods Ltd* [2007] EWHC B5, in which the supplier of food ingredients (Lion Foods) was under a contractual obligation to supply to the food manufacturer Hazlewood products that 'comply with all UK & EU legislation concerning toxic or other objectionable substances in foodstuffs (...); and comply with all UK & EU food regulations and any other statutory requirements (...)'.<sup>53</sup>

53 Fulponi 2006, p. 6.

54 Verbruggen & Havinga 2014, Brons-Stikkelbroeck 2011.

tracts? Based on her sample of Dutch MNCs, Vytopil notes that this occurs in the Netherlands by: (i) including the provisions of codes of conduct directly in the contract; or (ii) by referencing such codes.<sup>55</sup> The inclusion or referencing occurs both in the main provisions of the contract or in standardised (non-negotiated) contract terms. Cafaggi and Peterková have also pointed out that regulatory standards are directly included in commercial contracts or by reference.<sup>56</sup> More specifically, Cafaggi notes that express warranties and obligations to deliver conforming goods are the main loci in contracts where one will find duties to comply with regulatory standards. Where retailers have significant market power, suppliers – even those positioned higher up the supply chain – will often subscribe to express warranties that require them to comply with regulatory standards or gain certification testifying to such compliance. Cafaggi contends that express warranties are therefore changing their original functions.<sup>57</sup> While express warranties have conventionally reflected market standards, they are now integrating regulatory provisions to make different remedies and sanctions available to buyers to ensure compliance.

It was held above that the doctrine of privity of contract imposes restrictions on the ability of firms to regulate beyond their contracting party (parties) and address the behaviour of other actors in the supply chain. To some extent, national contract laws provide several means to overcome these limitations and address third-party behaviour.<sup>58</sup> One such means is a *perpetual clause*, by which the buyer (A) imposes a contractual duty on the seller (B) to require its supplier (C) to comply with regulatory standards and pass on this obligation to any other supplier (D, E, F, etc.) positioned further up the supply chain. Frequently, a contractual fine is included in the contract to coerce the supplier to include the contractual duty in agreements with second or third tier suppliers. Accordingly, a chain of linked contracts is created that connects (and regulates) the different tiers of the supply chain. It has already been observed that the use of perpetual clauses is a common strategy to regulate transnational supply chains pursued by retailers in the issue areas of CSR and food, and this is likely also to be the case in other industries.<sup>59</sup>

In the final analysis, however, perpetual clauses are still based on the doctrine of privity of contract and the freedom of contract. Third parties are only bound if they have accepted (the obligation to adhere to) the regulatory standards incorporated in the contract. Acceptance is still the key criterion to be legally bound by a contract. Accordingly, it must be held that perpetual clauses primarily serve as mechanisms to pass on the obligation to comply with regulatory standards to the individual firms along the chain. The risk involved in the use of these clauses is that suppliers, in contrast to their contractual obligations, may fail to include these clauses in their contractual relations with second or third-tier suppliers. In

55 Vytopil 2012a, 2012b.

56 Cafaggi 2013, p. 1586 and Peterková 2014b, p. 13.

57 Cafaggi 2013, p. 1586-1587.

58 Vytopil and Van der Heijden discuss the options available under Dutch contract law. See: Vytopil 2012a, 2012b and Van der Heijden 2011.

59 See notes 47 and 51 above.

such a case, the doctrine of privity of contract again dictates, firms cannot seek redress from the second or third-tier supplier, and may only take remedial action against direct contracting parties. To put it differently, the chain of linked contracts implementing the safety, social and sustainability standards in that chain by using perpetual clauses is only as strong as its weakest link.

Another contract law-based technique that might be used to implement regulatory standards in supply chains are *third-party beneficiary clauses*. National and international contract law recognise the ability of contracting parties to include in their contract rights for third parties that can be enforced by the beneficiary third parties themselves.<sup>60</sup> For example, the contract between the supplier (A) and seller (B) about the supply of goods may qualify the ultimate buyer of the goods (C) as a third party beneficiary of the express warranty supplier A assumed in the contract with seller B, according to which supplier A must supply goods that comply with specific regulatory standards. That qualification may enable buyer C to enforce supplier A's obligation to provide conforming goods to seller B and thus ensure compliance with the regulatory standards in other tiers of the supply chain.<sup>61</sup>

In practice, however, third party beneficiary clauses are not likely to be used to implement regulatory standards in supply chains. The empirical studies reviewed for this paper did not indicate that third party beneficiary clauses are typically used for this purpose. A potential explanation is that the firm that is identified as a third party beneficiary does not have the proper incentives to enforce rights under a contract to which it is not a party. In the example discussed above, rather than taking action against supplier A, buyer C may simply enforce the rights it has under the sales contract entered into with seller B to obtain redress for the damages incurred as a result of the fact that seller B was unable to provide goods that complied with the regulatory standards specified.<sup>62</sup> It appears that third parties outside the supply chain (e.g. consumers, NGOs and workers), which may also be the actual beneficiaries of the regulatory standards that are included in commercial contracts, have greater interests in enforcing the terms of commercial contracts to which they are not a party. An example of that practice is the *Doe v. Wal-Mart Stores, Inc.* case, in which employees of a number of foreign suppliers of the US retailer Wal-Mart brought claims against the retailer relying primarily on a code of conduct included in Wal-Mart's supply contracts that specified basic labour standards that its suppliers should meet.<sup>63</sup> As this case shows, however,

60 Article 5.2.1 Unidroit Principles of International Commercial Contracts; Article 6:110 Principles of European Contract Law; and Article II.-9:301 Draft Common Framework Reference. English contract law was particularly late to recognise the ability of contracting parties to create rights under a contract that are enforceable by third parties themselves and did so only through the Contracts (Rights of Third Parties) Act 1999. See in detail: McKendrick 2014, Ch. 25.

61 The specific conditions under which a third party acquires an enforceable right under a contract to which he is not a party vary per country. See for an analysis of European jurisdictions: Beale et al. 2010, p. 1232-1250. See for an analysis of the conditions for the use of third-party beneficiary clauses under Dutch private law: Vytopil 2012a, 2012b and Van der Heijden 2011.

62 An exceptional situation in which buyer C may turn to supplier A to obtain redress is when seller (B) has become insolvent. See also: Beale et al. 2010, p. 1232.

63 *Doe v. Wal-Mart Stores, Inc.*, 572 F.3d 677, 681 (9th Cir. 2009).



the conditions under which third parties may enforce terms under a contract to which they are not a party as determined by the applicable (national) contract law may prove difficult to overcome in practice.<sup>64</sup>

#### 4 Regulatory governance by contract as good governance?

It follows that the use of commercial contracts to implement and enforce safety, social, and sustainability standards is widespread and is mainly a strategy pursued by firms – in particular Western MNCs – to respond to the risks and potential liabilities triggered by the global sourcing of products, government failures to adequately tackle externalities related to that development, reputational concerns, and consumer preferences. Given the regulatory character the strategic deployment of commercial contracts may thus assume vis-à-vis other actors in the supply chain and the benefits it may have for those actors outside it (e.g. communities, consumers and workers), we should also start to wonder about the challenges this form of regulatory governance raises. This Section analyses two key challenges, namely those regarding the legitimacy and effectiveness of regulatory governance by contract.<sup>65</sup> The analysis, which is both preliminary and based on the state-of-the-art in the literature, will focus on the issues of legality, accountability and transparency as the principal legitimacy challenges and enforcement as a core challenges for effectiveness.

##### *Legitimacy*

In regulation theory, *legitimacy* is often perceived to constitute the acceptance that a person or organization possesses the authority to govern by those it seeks to regulate and those on whose behalf it purports to regulate.<sup>66</sup> Such authority can be bestowed on regulators in a number of ways, including democratic processes, delegation of statutory powers, and legal compliance (i.e. legality). Regulators may also actively engage in a variety of strategies to manage and build their legitimacy, which as Black has stressed, are particularly relevant for private regulators.<sup>67</sup> A difficulty faced by firms engaged in regulating their supply chain is that they do not possess the same legitimation of powers as the state to motivate the response they seek to attain from others. In the absence of legitimation based

64 The employees' claim was denied when the 9th Circuit Court (Court of Appeal) held, inter alia, that third party beneficiaries could seek redress only against the party that undertook a promise under the contract for the benefit of the beneficiary. In this case, Wal-Mart did not assume an obligation to maintain these labour standards – the individual suppliers did. See also: Cafaggi 2013, p. 1591-1593.

65 It should be stressed that the factors of legitimacy and effectiveness are intimately linked. For example, the ability of regulatory standards to deliver their goals (effectiveness) is likely to enhance the acceptance of these standards (legitimacy). At times, however, tradeoffs have to be made. Demands for democratic participation and procedural fairness (legitimacy) may compromise speed and efficiency (effectiveness). See in general about the relationship between legitimacy and effectiveness: Scharpf 1999.

66 Beetham 1991. See also: Bernstein & Cashore 2008.

67 Black 2008.

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on democratic processes or a delegation of powers by states, private companies face a noticeable legitimacy deficit when pursuing regulatory functions.

The legitimation for using commercial contracts to pursue regulatory objectives is mainly found in a principle that is fundamental to contract law, namely the principle of *freedom of contract*, which has already been briefly discussed above.<sup>68</sup> Firms may adopt legally binding commercial contracts with other firms as long as the latter can freely consent to the contract and the regulatory provisions featuring in it. That freedom may however be compromised in highly concentrated and competitive markets in which chain leaders demand compliance with specific regulatory standards. The market power these firms have may prompt other firms in the chain (producers, suppliers) to adhere to the regulatory standards the chain leaders require, even though a formal contractual relationship is not (yet) in place. This development, however, does raise barriers to market access, while the failure of contracted suppliers to demonstrate continued compliance will likely result in market exit. In the agri-food sector, the use of private standards and complementary certification schemes, commonly underpinned by commercial contracts, have been reported to constitute significant barriers to trade, especially for suppliers trading from developing countries.<sup>69</sup> It goes without saying that government should be wary of such practices and should continue to monitor the implications of this development in the light of antitrust and international trade law.<sup>70</sup>

One might ask further whether firms engaging in regulatory governance by contract should be held accountable for their activities, and if so, to whom and by what means? Accountability has been considered a key determinant of the legitimacy of public and private, transnational and national regulators.<sup>71</sup> Accountability can be understood as 'an institutional relation or arrangement in which an actor can be held to account by a forum'.<sup>72</sup> Accountability is closely linked to the issue of transparency: openness empowers stakeholders to hold someone to account, while the disclosure of decision-making processes at the same time permits actors to be publicly accountable. Arguably, firms should account for their regulatory activities where they make public commitments about improving and fostering interests of third parties.<sup>73</sup> In that case, firms should be able to show and explain to the relevant (groups of) stakeholders the activities they undertake

68 See text at note 23 above.

69 Henson & Humphrey 2009, p. 33-34.

70 International governmental organizations closely watch the use of private regulatory standards in the area of food. The Food and Agricultural Organization of the United Nations (FAO) and the World Trade Organization (WTO) are suspicious of the impact of private food standards on market access (Codex Alimentarius Committee 2010, p. 21-22). In 2013, the European Commission (DG COMP) also commissioned a study to assess the impact of private labelling schemes on competition, consumer choice and innovation in the European food sector. See: European Commission, 'Competition: Commission launches study on choice and innovation in food sector', available at: [http://europa.eu/rapid/press-release\\_IP-12-1356\\_en.htm](http://europa.eu/rapid/press-release_IP-12-1356_en.htm), accessed Augustus 2014.

71 Black 2008.

72 Curtin & Senden 2011, p. 166.

73 Compare Vandenberg 2007, p. 45-48.



and what difference these efforts have made.<sup>74</sup> These stakeholders include not only the investors and shareholders of the firm in question, but also the employees of suppliers in the chain, the consumers of the products involved, the communities that may potentially suffer from environmental degradation caused by production processes, all depending on the goals the firm pursues with its strategy. It has been noted that the communication concerning regulatory goals and achievements, and thus the act of being accountable to relevant stakeholders, is very significant as part of obtaining a 'social license' to do business.<sup>75</sup>

A strategy that is frequently deployed by firms to account for their regulatory activities is the use of private certification and labelling schemes. These schemes, which typically operate on the basis of paid-for audits, primarily serve to monitor and enforce compliance with the regulatory standards that are imposed via commercial contracts. Provided the schemes and their contracted auditors do indeed operate on the basis of integrity, independence and professionalism, they constitute important alternative mechanisms of accountability. They facilitate transparency about the goals and achievements of the regulatory strategy and offer consumers the opportunity to make informed choices about their purchases. It has been noted, however, that supply chain auditors do not perform their tasks as vigilantly as they might because applicant firms usually pay for an auditor's services.<sup>76</sup> In addition to such economic dependency, other social factors – auditor experience, gender, and professional training, ongoing relationships between auditors and audited factories, and gender diversity on audit teams – have also been documented as influencing auditor performance and rigidity.<sup>77</sup> The failure to adequately assess supplier compliance can have tragic consequences, as was observed in the fire at a Bangladeshi garments factory in 2012, in which many workers were killed even though a social audit had recently suggested that working conditions had improved.<sup>78</sup>

### *Effectiveness*

Poor auditor performance impairs the potential of certification and labelling schemes to serve as accountability mechanisms for companies using commercial contracts to implement safety, social and sustainability standards in supply chains. Clearly, it also undermines the *effectiveness* of this regulatory strategy in terms of its ability to induce the regulated firms to change their behaviour. In the absence of astute and persistent monitoring and enforcement by external actors, regulatory compliance becomes only voluntary and the risk increases that this particular regulatory strategy is used as 'window dressing'. To be effective, regula-

74 This is particularly so where firms include such public commitments in marketing strategies. If these commitments prove to be illusory, extra-contractual liability for false and misleading advertising may be the consequence. See for example: *Nike Inc. et al. v. Marc Kasky* (539 U.S. 654 (2003)).

75 Gunningham, Kagan & Thornton 2004.

76 O'Rourke 2003.

77 Short, Toffel & Hugill 2014.

78 Yardley, 2012.

tory strategies and regimes require vigilant and robust mechanisms for the detection and sanctioning of non-compliance.<sup>79</sup>

From a narrower, dogmatic contract law perspective, the effectiveness of the inclusion of regulatory standards in commercial contracts to motivate behavioural change among firms can also be said to depend on the enforceability of the rights and obligations enshrined in such contracts. In other words, the success of this regulatory strategy is grounded in its potential to ensure enforceable rights and, in case these rights are violated, to impose formal legal sanctions. Here, the underlying presumption is that the binding force of law and its enforcement mechanisms will spur parties that have assumed a contractual duty to comply with the regulatory standards concerned not to default so that the objectives embodied in those standards are attained.

Several empirical studies point to weaknesses in the current practice of contract drafting and design which hamper the enforceability of contractual rights and obligations as regards regulatory standards, and therefore, by extension, undermine the potential of commercial contracts as effective regulatory instruments. One such weakness relates to the degree of specificity of contractual rights and obligations. National and international contract law hold that contractual rights and obligations should be sufficiently specific and have determinative terms to be enforceable before a court of law.<sup>80</sup> It should thus be clear what standards are referred to and what these standards mean to ensure enforceability. If this is not the case, lawyers may also wonder whether the parties to the contract intended to create enforceable rights and duties. References, for example, to a particular code of conduct are likely to be sufficiently determinative, but if the code itself contains only broad statements and encouragements this will generally impede contractual enforceability.<sup>81</sup> McBarnet and Kurkchian cite some insightful clauses used by MNCs in commercial contracts to implement CSR codes of conduct throughout the supply chain. As they note, such codes require that suppliers ‘must meet *all the appropriate* relevant industry and country standards’ or ‘must work *towards* higher standards’.<sup>82</sup> These references appear to fail the test for specificity, meaning that enforcing such duties in court will be particularly difficult. Related to the degree of specificity of contractual rights and obligations is the nature of the contractual obligation itself. National and international contracting

79 Clearly, other factors than enforcement are important for effectiveness of regulatory strategies and regimes. Mayer and Gereffi (2010), for example, hypothesize that the effectiveness of private regulation in global supply chains depends on the potential for collective action by consumers, workers, or other activists to ensure that such regulation is actually observed. They claim, however, that also the structure of the particular global value chain in which production takes place, the brand identity of the produced products, and the degree of overlap between the commercial interests of lead firms in the supply chain and related social and environmental concern determine the effectiveness of private governance.

80 See e.g. Articles 2.1.2 and 5.1.6 Unidroit Principles of International Commercial Contracts; Article 2:103 Principles of European Contract Law; and Article II.-4:103 Draft Common Framework Reference. See for an analysis of Dutch and English law on this aspect Vytopil 2012b and Vytopil 2013 respectively.

81 See also: Peterková 2014b, p. 15-16.

82 McBarnet & Kurkchian 2007, p. 70 (emphasis in original).

laws differentiate between two main types of obligations that contracting parties may assume: a duty to achieve a specific result (*obligation de résultat*) and a duty of best efforts (*obligation de moyens*).<sup>83</sup> The two types imply a different degree of severity in the assumption of a contractual obligation: whereas the first requires the contracting party to attain the promised result (e.g. 'the supplied goods must meet safety standard X'), the latter obliges him to make all the efforts that can reasonably be required under the circumstances (e.g. 'the supplier must work towards compliance with safety standard X'). Proof of non-performance (and thus a proof of a breach of contract, giving rise to remedies) is easier to establish in the case of a duty to achieve a specific result than in case of a duty of best efforts: the failure to achieve the promised result amounts to non-performance in itself, whilst the efforts of the contracting party must be assessed in the light of what could have reasonably been required under the circumstances. The difficulties a firm may encounter in providing the necessary proof for its claim may restrain it from initiating civil proceedings.

Even if the regulatory standards are designed and phrased such that they have legally binding force, there is a broader set of social factors that may withhold firms from formally enforcing these standards in practice. It has been observed in the literature that contract law and court proceedings are unlikely to be used to enforce contractual duties in transnational business relations.<sup>84</sup> Also, in relation to safety, social and sustainability standards imposed through commercial contracts, it is held that non-compliance with these standards seldom leads firms to bring contractual claims before courts.<sup>85</sup> One reason may well be, as the work of Macaulay and others aptly points out, that contracting parties prefer to resolve disputes informally, without making reference to the contractual provisions concerned or indeed their lawyers, especially if the contracts concerned are relational in nature and thus represent continuous and longstanding business relationships.<sup>86</sup> If that is the case, firms may hesitate to directly sanction violations by terminating supply agreements.<sup>87</sup> They are more likely to seek remedies in the range of a suspension of performance or payment, a refusal to accept non-compliant products, or even more, corrective actions to restore compliance and ensure things remains that way.<sup>88</sup>

A key question remains whether the incorporation of regulatory standards in commercial contracts, the compliance of which is enforced more often informally than formally, has any effect on the conduct of regulated firms. Indeed very little is known about the relationship between the contractual incorporation of regula-

83 See e.g. Article 5.1.4 Unidroit Principles of International Commercial Contracts; Article 6:102 (Comment D) Principles of European Contract Law; and Articles IV. C.-2:105 and 106 Draft Common Framework Reference. See on this distinction in detail Fontaine & De Ly 2002, p. 207-225.

84 See e.g. Dietz 2012.

85 Cafaggi 2013, p. 1576, and Lin 2009, p. 724-725 and McBarnet & Kurkchiyan 2007, p. 79.

86 Macaulay 1963, p. 10 and Beale & Dugdale 1975.

87 See also Vytopil 2012b, p. 69.

88 See also Dietz 2012, p. 42-43 and 47-49.

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tory standards and the impact this practice actually has on the behaviour of the contracting party and other regulated firms in the supply chain.

One way to tentatively approximate that relationship is by looking at the effect that private certification schemes, which are commonly implemented in supply chains by commercial contracts, have on corporate behaviour. The domain of environmental protection offers some important first empirical insights as regards the relationship between private certification and behavioural change among firms. In 2012, a report was produced by leading representatives from the business, NGOs and academic world that sought to assess the impact of private certification schemes on firm behaviour in the domains of agriculture, forestry, fisheries and aquaculture.<sup>89</sup> Based on a review of dozens of case studies and large-sample-size quantitative and qualitative analyses of private certification schemes, the report finds that such schemes have had extensive impact on the adoption of sustainability practices by companies, thereby substantially changing individual firm behaviour.<sup>90</sup> A recent study by Potoski and Prakash on ISO 14001, which is the most widely used private certification standard in the world for environmental management and often implemented by commercial contracts,<sup>91</sup> adds to this that this private standard has enhanced environmental quality by achieving a reduction of air pollution.<sup>92</sup> While these studies reveal a positive correlation between the uptake of private certification schemes and increased environmental performance and quality,<sup>93</sup> the exact role of commercial contracting in this context is yet to be established.

## 5 Conclusion

This paper has explored the role that commercial contracts concluded between private actors play as instruments of regulatory governance in supply chains. Such contracts are becoming increasingly important vehicles for the implementation and enforcement of safety, social, and sustainability standards throughout the supply chain. The use of commercial contracts as regulatory instruments is widespread, though certainly not uncontested. Clear governance concerns exist in terms of legitimacy and effectiveness, in part due to the restrictions created by

89 Steering Committee of the State-of-Knowledge Assessment of Standards and Certification (2012). This Steering Committee is composed of leading academics, businessmen and NGO representatives. See [www.resolv.org/site-assessment/steering-committee/](http://www.resolv.org/site-assessment/steering-committee/) (accessed August 2014).

90 *Ibid.*, p. 57-72.

91 For example, US automotive manufacturer Chrysler Group LLC requires all organizations supplying production and/or service parts to it, to comply with ISO 14001. See: 'Chrysler Group LLC Customer-Specific Requirements for use with ISO/TS 16949:2009 and ISO 14001:2004' (2013), available at: [www.iatfglobaloversight.org/docs/Chrysler%20Customer-Specific%20Requirements%20JAN%202013.pdf](http://www.iatfglobaloversight.org/docs/Chrysler%20Customer-Specific%20Requirements%20JAN%202013.pdf) accessed August 2014.

92 Potoski & Prakash 2013.

93 Other studies have stressed that the evidence on the impact of private certification schemes on the environmental quality (e.g. levels of energy use, forest preservation and biodiversity) remains largely rather general or anecdotal, such that a 'paper reality' has been created around the effectiveness of these schemes. See for example Visseren-Hamakers & Pattberg 2013.

the doctrine of privity of contract and the freedom of contract, both of which constitute fundamental principles of national and international contract law. While different legal techniques are used to overcome the limits these principles pose, they have limitations of their own and do not essentially depart from these principles. Furthermore, the paper has shown that very little is known about the impact that the use of regulatory standards in commercial contracts has on the corporate behaviour of contracting parties and other regulated firms in the supply chain. Understanding how and under what circumstances commercial contracts that incorporate regulatory standards achieve behavioural change among firms – for example in the area of environmental protection, but also in other domains – will be a key challenge for socio-legal research in the coming years. For now, however, it should be noted that the use of commercial contracts to regulate corporate behaviour constitutes an important addition to the existing array of regulatory strategies, in particular those related to public (international) regulation. It was observed in this paper that the use of commercial contracts emerged against the background of the failure of state actors to adopt public (international) standards and their inability to effectively monitor and enforce these standards. It should therefore be stressed that in judging the adequacy of using commercial contracts as a regulatory strategy, the advantages and disadvantages of this strategy should be compared to public, and other forms of regulation.<sup>94</sup> Understanding the relative qualities of the various regulatory strategies will facilitate the construction and orchestration<sup>95</sup> of complementarities between commercial contracts and other sorts of regulatory instruments so to maximise their benefits and compensate for their potential shortcomings. Needless to say, this is also an important point on which to focus future (socio-)legal research.

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94 Vandenberg 2007, p. 970, Vandenberg 2013, p. 192-193. See also: Lytton 2014 and Potoski & Prakash 2013.

95 Abbott & Snidal 2009.

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